

Viewpoints

What should we expect from phasing?

The first phased increase of auto enrolment contributions is due in April this year. Drawing upon research from around the globe, Will Sandbrook, executive director of NEST Insight, tells us more about the reaction we could see from savers.



Within the pensions policy community attention has turned to phasing, the 'next big challenge' for auto enrolment. With the first phased increase in minimum contributions set to take place in April this year, and a further rise planned for April 2019, discussions have focused on the likely behavioural reaction among savers. Will the increase in contributions lead savers to cease contributions, and cause new joiners to opt-out at a higher rate?

The view that this might be a problem is intuitively compelling. People have normalised at the current rate of contributions, creating an anchor against which an increase in contributions may feel like a 'loss' and could mean that some people have to cut spending elsewhere. This is in return for the future benefit of having a higher income in retirement. But, retirement is far away and we know from the behavioural literature that people exhibit 'hyperbolic' discount rates, especially over decisions that require 'pain' now for 'gain' in the far future.

Yet this intuitive concern is not strongly borne out in the evidence of similar programmes elsewhere. Those programmes present reasons for optimism that the implementation of phasing should be smooth.

This paper identifies some of that evidence to suggest that:

- **consumers' elasticity in response to changes in contribution rates is low** - contribution rate increases tend not to prompt a significant negative behavioural response
- **this is particularly true for the flow of new joiners to pension schemes after contributions are increased** – so we should not expect headline 'opt out' rates to rise much
- **at the same time, the evidence there is does point towards some level of behavioural reaction** – we shouldn't be surprised by a modest uptick in cessation, but
- **from the much lower than anticipated baseline of current opt-out rates, a modest increase should not be mistaken for 'failure' of the policy** – not least because the true equilibrium in behavioural reactions to auto enrolment won't be known for some years.

All in all, we share the optimism reflected by many others that auto enrolment will continue to be a major policy success once phasing is implemented. It's possible that some commentators have adapted to the very low initial opt-out rates and are at risk of casting even small changes in behaviour as a 'problem'. Whereas, in fact, such marginal changes are to be expected and fall well within any reasonable definition of success for the policy.

Insights from around the globe

The desire to 'smooth' the experience of savers, and indeed employers, building on academic and real-world evidence of similar implementations, were the major drivers behind the UK government deciding to take a 'phased' approach to increasing auto enrolment contributions. The idea that individuals can bear even relatively steep increases in contributions without stopping saving has been borne out in various places both before and since that decision. And, indeed, it's important to note that increases in the UK case will not be very steep. The recent policy paper from Royal London does an excellent job of breaking down how tax and minimum wage changes coinciding with the April 2018 increase mean that the take-home pay impact for most will be modest.¹

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Below we cite three cases that help contribute to this evidence base and give us cause for optimism in the UK:

1) The Save More Tomorrow programme

The Save More Tomorrow (SMarT) programme² was developed by leading behavioural economists Shlomo Benartzi³ and Richard Thaler⁴. In the SMarT context, participants commit in advance to increase their contributions in line with some future schedule. This could coincide, for instance, with future pay increases.

This fits with people's tendency to procrastinate, and with their present bias, because it enables them to commit to increased contributions now while only feeling the impact later. In the original SMarT studies, the vast bulk of those enrolled remained with the programme through all four scheduled contribution increases. They also ended up saving at higher rates both than they started with, and than others who simply went straight in at a higher level of contributions. The roll-out of SMarT features at scale across US pension plans has repeatedly produced these findings.

In the original implementations of the SMarT programme across three organisations:

- The first employer found that 78 per cent of those declining to increase contributions straight to a recommended level nonetheless signed up for the SMarT programme. Just 2 per cent dropped out prior to the second increase, and only 20 per cent dropped out in total. None of those withdrawing from the programme reduced their contributions back to pre-programme levels.
- Both of the other two employers found that the average contribution rates for those joining the SMarT programme far outstripped those of the workers who didn't take part, and attrition rates from the programme were again low.

¹ Royal London (2018) *Royal London policy paper 20: Will Britain take the next pension contribution increase in its stride?* London: Royal London. Available [here](#).

² Details of the Save More Tomorrow programme can be found in the original academic journal article in which Benartzi and Thaler set out their findings: Thaler, R. H., & Benartzi, S. (2004). *Save more tomorrow™: Using behavioral economics to increase employee saving*. *Journal of political Economy*, 112(51), S164-S187. Further detail is also available in the book, *Save More Tomorrow*.

³ Benartzi is the Professor of Behavioural Decision Making at University of California at Los Angeles. He's also a member of NEST Insight's advisory panel. He has authored numerous papers relating to behaviour in the consumer financial decision-making space, as well as three books: the aforementioned *Save More Tomorrow*; *Thinking Smarter*; and most recently *The Smart Screen*.

⁴ Thaler has published numerous books and articles through which he has helped popularise the ideas behind behavioural economics. He co-authored the seminal behavioural economics book *Nudge*, with Cass Sunstein, and subsequently published *Misbehaving*, a summary of the major themes that have contributed to the field of behavioural economics. In 2017 he was awarded the Nobel Prize for Economics.

2) How do consumers respond when default options push the envelope?

Benartzi, along with colleagues John Beshears, Richard Mason and Katherine Milkman, recently researched the impact of higher default contribution rates on participation and savings levels in American 401(k) retirement plans.⁵ Their excellent paper, **How Do Consumers Respond When Default Options Push the Envelope?**, reveals very positive findings. Increasing default contributions led to higher overall contribution rates for no apparent decrease in participation levels until much higher contribution levels were reached.

In this study, there was only a perceptible increase in those opting not to save at all once the default savings rate reached 11 per cent, relative to a base of 6 per cent. Below that, around one in ten people chose not to save irrespective of the contribution level, which is consistent with opt-out rates in the UK.

3) An employer case study from the UK

In the UK, prior to the introduction of auto enrolment, the Employer Task Force on Pensions⁵ identified a natural field experiment from within one large UK employer, ICI. They automatically enrolled workers into their defined contribution (DC) scheme, offering a pre-defined range of contribution options and using the middle of that range as the default.

When they discovered that very few people changed their default contribution rates, they increased the default to the maximum rate, which was as high as 7 per cent for some workers. Among new joiners to the organisation, overall opt-out rates remained unchanged following this increase, at around 10 per cent, and only a further 10 per cent of people opted to reduce their rates from the default level.

Digging one step further into the evidence

These findings give rise to legitimate confidence about likely reactions to increases in contributions under auto enrolment. We're certainly among those who expect phasing to be successful. But, our expectations for what success looks like need to be reasonable, and it's worth digging one step further into these pieces of evidence presented to assess what 'reasonable' might look like.

Crucially, there are two important differences in some of these examples to the present UK case.

Some of the evidence presented here relates to new enrolments after a rise is implemented. The findings here are consistent with the broader evidence base on auto enrolment that shows, at a variety of initial contribution rates, that people tend not to opt-out when automatically enrolled. It's also consistent with NEST's evidence that opt-out rates are at their lowest among those enrolled as part of starting a new job. This is perhaps partly explained by the fact that for many people starting a new job, many things will have changed including their salary and the presence of other salary deductions. Therefore, there is no 'anchor' against which to have normalised expectations and so people simply experience, and then adapt to, their new 'normal' in terms of take-home pay.

“...the combination of mandatory re-enrolment and every-day labour-market movements mean that even now anyone opting out of a pension or ceasing contributions is never far from being re-enrolled.”

⁵ The Employer Task Force on Pensions (2004) *Good practice guide*. pp27-28. Available [here](#).

This in itself is very promising, not least as the combination of mandatory re-enrolment and everyday labour market movements mean that even now anyone opting out of a pension or ceasing contributions is never far from being re-enrolled. This is one of the reasons that the real equilibrium rate of saving in response to auto enrolment won't be known for a number of years post-implementation. But it doesn't, in itself, tell us much about the response we might see from people already saving who will experience a change in take-home pay.

As highlighted earlier, the actual take-home pay impacts for people at the point that contributions rise in April 2018 will be fairly modest which is another cause for optimism. But the evidence that's available, in terms of these three cases, highlights the second key contextual difference to the present UK case. That is, the alternative choices available to people when presented with the new, higher contribution rate.

For example, SMarT programmes set a schedule of future rises that are entirely voluntary. At the point when the perceived affordability of the next increase becomes a problem, savers can step off the escalator and remain at their current level. They can also reduce contributions at a later date.

As outlined, one of the employers in the original SMarT trial found that around 20 per cent of participants ended up stopping the increases before the schedule was completed:

- around 2 per cent before the second rise
- 14 per cent before the third rise
- 4 per cent before the final rise.

These rises were steeper, and went further, than in the UK case. And, the overall success of the programme is in many ways further confirmed by the fact that those who stopped didn't go back to the initial lower contribution rates, they just didn't complete the full schedule.

In the context of UK phasing, unlike in the SMarT study, people's choice is more binary as the increasing default is also a minimum. If the experience of SMarT programmes is that some people fail to complete the full schedule of rises, this could point to some modest cessation among savers following phased increases.

Similarly in the example of ICI, the vast majority of workers stayed in the scheme, and at the default contribution rate. But lower contribution options were offered, and around 10 per cent of those remaining in the scheme chose to drop down to one of the lower contribution rates rather than opt-out.

In the most recent work by Benartzi and colleagues, participants opted-in to the retirement plan rather than being automatically enrolled. They also had the choice to shift contributions down from the default rate. Indeed, the research showed that people did exactly this. Default rates above 6 per cent led to a 20 to 50 basis points increase in the average level of contributions 60 days after enrolment.⁶ In the context of that study those increases represent an excellent outcome worth potentially thousands to an individual over their saving career. But it stops short of suggesting that there is no behavioural reaction to higher default contribution rates.

⁶ Increase relative to the base case of 6 per cent

So what can we expect?

This evidence suggests that auto-escalation leads to higher contributions, as does being enrolled at a higher initial default contribution rate. Nothing in the evidence presented here suggests that we should expect to see large shifts in behaviour in response to phasing.

In most similar examples of increasing default contribution rates, there were effectively three options on offer:

1. save at the default or automatically increasing rate
2. opt-out
3. continue saving but at a rate below the default.

Findings show that the first option, the 'good' outcome from a programme perspective, tends to be the most common. The third is also adopted by a minority of savers, an option that won't be present in the more binary framing of UK auto enrolment. In the different examples highlighted in this paper, having option three available meant that around 10 to 20 per cent of people took the 'middle-ground' of continuing to save but doing so at a level below the new default rate.

This has potentially important consequences in how we set our expectations for what the impact of phasing might be. A reasonable expectation from these comparators suggests that we might see a pretty minimal headline change in opt-out rates, that is, the numbers opting out within the 30 day window after first being enrolled. Sat behind that, we might expect to see a modest uptick in those ceasing to contribute for reasons other than moving jobs.

Importantly, any such modest changes in behaviour, as well as being in line with experience elsewhere, should not be a cause for undue concern in the context of UK auto enrolment policy. Firstly, responses, should we see these effects in practice, need to be measured and not blown out of proportion. It's important to remember that the success of the auto enrolment programme to date has far exceeded initial predictions in terms of coverage growth and opt-out rates. Some degree of correction would still leave outcomes of the overall programme well within the range of a 'good' or 'very good' outcome. It's also important to note that the idea behind auto enrolment, and behind Thaler's 'libertarian paternalism', as opposed to straight-forward compulsion, is to reflect the fact that for some people, some of the time, not saving may be an appropriate course of action.

Secondly, there are existing safeguards built into the automatic enrolment programme in the form of mandatory re-enrolment, which, coupled with job churn, will mean those who cease or opt-out will be enrolled again in the coming years.

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Of course, if too many people stop contributing, and don't then remain in when re-enrolled, there could be such a thing as 'too big' a reaction. Judging the level that would represent this 'too big' threshold being reached is a decision for government, as is what to do in response. AJ Bell recently proposed that giving people an 'opt down' option could be part of a package to continue increasing contributions beyond 8 per cent. That kind of option could be considered as a response to an adverse response to phasing, as could other options for savers such as slower escalation, deferral of contributions or partitioning of some contributions into an accessible account for emergencies. However, because these options introduce more complexity and choice for savers, they should arguably not be on the table unless the response to phasing proves to be more significant than the evidence perhaps suggests it will be.

For now, the phased increases to contributions are the next big milestones in the auto enrolment programme. There's every reason to believe that the programme will remain a successful one the other side of those milestones. But, the important thing is for our expectations of the shape of that success not to be too extreme or too heavily anchored on the unexpectedly low levels of opt-out we've seen thus far. Some increases in cessation and opt-out are to be expected, and from such an excellent starting point can still leave us well within the range of an overall successful outcome. With mandatory re-enrolment and the natural re-enrolment created by job churn, it will take some time before the 'true' rate of opt-out and participation arising from auto enrolment is known. Until then, we have every reason to be optimistic.

NEST Insight is a collaborative research unit set up by NEST Corporation to help understand and address the challenges facing NEST members and other defined contribution savers. NEST Insight's work is supported by Vanguard, the unit's strategic partner.



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