# The case for extending automatic pension enrolment to young workers

BRIEFING PAPER

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In this briefing, Gareth Davies MP makes the case for young workers to be automatically enroled into a workplace pension scheme. He argues that, instead of waiting until the age of 22, extending automatic enrolment 18-21-year-olds will better equip them meet the challenges of their generation.

## KEY POINTS

- Automatic enrolment is a remarkable and underappreciated success story. Since 2012, It has increased pension participation 88%, boosting the savings of 10 million by a combined £17bn.
- However, in stark contrast to the high rate of enrolment among those over 22 years old, only 18% of eligible 18–21-year-olds are enrolled in a workplace pension.
- Extending automatic enrolment to those aged 18-21 would result in 910,000 young workers newly participating in a workplace pension, with approximately £800 million more savings every year.
- For young workers today, there are several problems for which early saving offers a solution: demographic pressures are set to stretch pension incomes, mental health challenges are proven to inhibit pension participation, projects to tackle climate change require support from pension funds, and financial disengagement is likely to exacerbate pension under-saving.
- Time is literally of the essence. As such, this paper recommends that the extension of automatic enrolment to young workers be prioritised.

## FOREWORD

The cause of extending automatic enrolment is one which has been championed by MPs of all parties, and finds widespread support among industry groups such as the Pension and Lifetime Savings Association (PLSA) and the CBI.

This paper is intended to build on the important work recently produced by James Blagden at Onward UK,[1] which makes a compelling case for a significant extension of automatic enrolment to all employees currently ineligible – achieved by abolishing the current lower earnings limit and the income threshold, as well as reducing the age threshold. In Blagden's comprehensive report, he highlights not only the savings which these changes might achieve, but the distribution of those savings, with some of the greatest gains coming from those regions which are most disadvantaged.

This paper is limited to the extension of automatic enrolment to young workers, as an adjustment which is appropriate to the immediate present; minimally disruptive while retaining far-reaching benefits. Indeed, bringing the enrolment age threshold in line with the national minimum wage would serve to reduce administrative burdens on business.

Automatic enrolment should be extended as a priority to young workers because, for them, the potential compound interest is greatest, the pressures of demographic change are most acute, the challenges of mental health and climate change are especially relevant, and the need for financial engagement is most pressing.

## INTRODUCTION

In his personal notes, Ronald Reagan wondered: "*Why can't life's problems hit us when we're 18 and know everything?*" What he noted in jest may be stated in earnest when it comes to pension enrolment. Not because we 'know everything' about pensions when we are 18, but rather because 18 is the age at which our savings potential, and thus our capacity to anticipate many of 'life's problems', is greatest.

Accordingly, the majority of retirees wish they started saving younger,[2] and this is only set to increase. The nature of compound interest has always dictated that it pays to save early. Added to this, for young workers today, are several particular problems for which early saving offers a solution: demographic pressures are set to stretch pension incomes, mental health challenges are proven to inhibit pension participation, projects to tackle climate change require support from pension funds, and financial disengagement is likely to exacerbate pension under-saving.

There has arguably never been a generation for which saving early into a pension scheme has mattered more.

At present, however, the advantages of youth are being squandered. For most working 18–21-year-olds, a pension is a 'future problem'; the horizon beyond the horizon.[3] Understandably, the focus of their attention is elsewhere. Those who can spare to save, do so with an eye on a holiday or a car; the next enjoyable activity or desired object. For many, their overriding aspiration is to buy a home.[4]

While home ownership is a noble ambition, the priority it takes over saving for retirement is disproportionate. According to the Office for National Statistics (ONS), pensions have now become the greatest component of household wealth, as well as making the greatest contribution to the increase in total wealth.[5]

This paper affirms the importance of pension saving for young workers, and identifies automatic enrolment as a triumph in increasing pension participation. It argues that we should therefore extend automatic enrolment to 18–21-year-olds, equipping them to meet the challenges of their generation.

Time is literally of the essence. As such, this paper recommends that the extension of automatic enrolment to young workers be brought forward.

## BACKGROUND: AUTOMATIC ENROLMENT

The Government has made great progress in increasing savings with automatic pension enrolment. By default, most workers now contribute to a pension pot unless they opt-out of the arrangement. Currently, to be eligible, a worker must be at least 22 years old and earning above £10,000 per annum. For every pound earned above £6,240, this automatically enroled worker contributes 5% of their income, with their employer contributing an additional 3%. As a result, a minimum 8% of an eligible worker's income above the lower earnings limit is saved out of their first paycheck.

Automatic enrolment is a remarkable and underappreciated success story. It has emphatically reversed a downward trend in pension participation rates. Whereas the rate of workplace pension participation fell from 58% to 55% between 2009 and 2012, that rate is now 88%. Today, 19.4 million eligible employees are participating in a workplace pension and together saving a total of £105.9bn in a single year.[6] It is estimated that automatic enrolment has resulted in over 10 million people either beginning to save or saving more than they otherwise would have, which in turn has increased annual pensions savings by an incredible £17bn.[7] The largest increase in workplace pension participation rates in the private sector was among younger age groups.[8]

The policy has had a significant attitudinal, as well as financial, impact. The 2018 British Social Attitudes survey found that 82% of employees agreed with the statement 'it is normal for someone like me to save into a workplace pension'. Whereas 68% agreed in 2016 that 'saving into a workplace pension is something I am used to doing', 76% said the same in 2018.[9]

However, in stark contrast to the high rate of enrolment among those over 22 years old, only 18% of eligible 18–21-year-olds are enrolled in a workplace pension.[10]

According to the Department for Work and Pensions, extending automatic enrolment to those aged 18 and above would result in 910,000 more people enrolled in a workplace pension and approximately £800m more savings every year.[11]

## THE ARGUMENT FOR EXTENDING AUTOMATIC ENROLMENT TO YOUNG WORKERS

### 1 – Harnessing the power of compound interest

The strongest ally young workers have in maximising their savings is compound interest.

The advantage of saving is not simply the interest you gain in any particular year but the ability to earn interest upon interest, or 'compound interest', year after year. It has been claimed that Albert Einstein once called compound interest the '*most powerful force in the universe*'. Perhaps the best and simplest explanation is Benjamin Franklin's: '*money makes money. And the money that money makes, makes money.*'

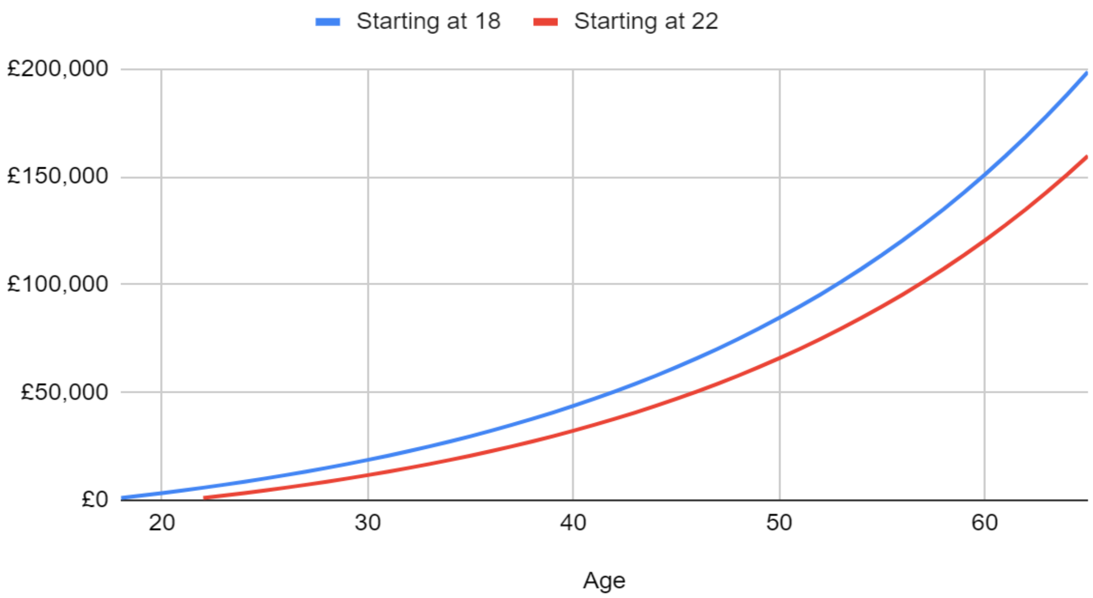
Consider, for example, saving £1,000 at 5% interest. In the first year, this would earn you £50, leaving you with £1,050. In the second year, saving the £1,050 would earn an additional £52.50, giving you £1,102.50. Whilst this extra compound interest might sound like a few pennies here or there, over time it would grow your savings exponentially. In the fifty-second year – if you saved £1,000 aged 18 for your retirement at 70 – your money would be worth over 12 times as much at £12,642. Like rolling a snowball down a hill, the further away from the bottom you start, the bigger the end result.

What, then, are the implications of compound interest for the extension of automatic enrolment to those aged 18-21?

For illustrative purposes, we might assume two workers of the same age with a constant annual income of £19,448 (the median income of those aged 18-21),[12] of which both save £1,056.64 each year (8% of their annual earnings above the lower earnings limit). We might also assume a constant 5% rate of interest on their savings (in line with Fidelity International's savings rate assumptions).[13] As shown in Figure 1, all other things being equal, retiring at 65, the worker who started saving at the age of 18 would accumulate £38,971 more than their counterpart who began at 22. Which is remarkable when you consider that, aged 22, this difference was only £4,782.

If the £38,971 of additional savings are multiplied by the 910,000 estimated to become newly enroled as a result of extending automatic enrolment, it equates to over £35 bn total in extra pension savings.

**Figure 1: Cumulative pension savings**




Of course, this last estimate is optimistic[i] – for one thing, not all of those newly enroled would be 18 – but it nonetheless serves to highlight the awesome power of compound interest and the significance of early investment.

It also further underlines the time-sensitivity of extending automatic enrolment to those aged 18-21. Each year of delay sees an age-group inch along the x-axis towards the red line, and these potential extra savings slip through our fingers like sand in an hourglass.

Undesirable in its own right, such a loss becomes even harder to justify in view of the challenges young workers are set to face.

## 2 – Anticipating demographic pressures

Britain is living longer. 12 million people are aged 65 or older, and in the next fifty years this is set to nearly double to exceed 20 million.[14] After decades in the workforce, it is only right that we should be able to spend our later years in comfort, without fear of financial worries.

Unfortunately, studies suggest that 33% of those now retired do not feel their income is enough to live on comfortably.[15] Demographic trends mean that this sentiment is an even greater possibility for future retirees who will, in all likelihood, need their savings to go further. Currently, over 50% of people are deemed at high risk of not meeting the target replacement rate of 67% set by the Pension Commission.[16] Clearly, ameliorating this rising risk will require an increase in savings.

In fifty years' time, those newly entering the workforce today will likely be newly retired. The easiest way they can bolster their retirement income is to start saving early. This is most clearly illustrated by the rule of thumb that the percentage of earnings you should contribute each year is roughly half the age at which you start saving. In other words, a person who saves half as early, only needs to save half the proportion of their income each year to ensure the same outcome. It is therefore unsurprising that 66% wish they saved more while they were young.[17]

Yet, the vast majority of eligible 18–21-year-olds are currently un-enroled, saving later, and facing the unenviable choice of either contributing a larger percentage of their earnings to guarantee their income in retirement, or saving insufficiently to preserve their disposable income. Given the effectiveness of automatic enrolment, this situation is one which we can and should avoid.

## 3 – Closing the mental health gap in pension participation

Young workers are more likely than any other working-age group to face challenges with mental health. Statistically, those aged 16-19 are the most likely group to be in contact with mental health services; more than twice as likely as those aged 25-29.[18]

Academic research published by Liam Delaney and Karen Arulasmy found that, in the UK, male private sector employees with poor mental health were 3.2% less likely to participate in a workplace pension scheme. For female private sector employees, the same likelihood was 2.6% less.

Remarkably, the same study also found that the implementation of automatic enrolment completely removed this mental health gap in pension participation. Among eligible employees, the negative correlation between participation and ill-health disappeared.[19]

The UK therefore currently finds itself in a bizarre situation where young workers, who are the most vulnerable to the mental health gap in pensions, are the very workers who are not covered by a mechanism proven to eliminate that gap. Amending this anomaly is a clear argument in favour of extending automatic enrolment to young workers.

## 4 – Funding the fight against climate change

The ONS have found that over 3 in 4 people aged 16-24 are either 'very worried' or 'somewhat worried' about the impact of climate change.[20] Although this level of concern is very similar to that of the UK population at large, it stands to reason that the planet's present trajectory will most adversely impact those with the longest yet to live.

The Intergovernmental Panel on Climate Change (IPCC) has warned of severe weather, rising sea levels, and shrinking biodiversity. In turn, these developments will threaten such things as food security, water supply, and ultimately economic growth. It has also warned that our adaptive capacity to these changes is especially limited once the world exceeds a 1.5 C° increase in temperature above pre-industrial levels. To avoid such an outcome, the IPCC has stressed the need for transitions in energy, land, urban, infrastructure, and industrial systems. The overarching objective is to reach net zero emissions by 2050.[21]

The UK Committee on Climate Change reported in 2017 that domestic priority risks included flooding, heatwaves, water supply shortages, and disruption to international food production and trade.[22]

In sum, without intervention, climate change entails rising costs for future generations.

The UK Government's Net Zero Strategy identifies private capital as a vital source of funding. Within this bracket, pension funds are long-term institutional investors, ideally suited to sustainable investment – whether that be in low-risk green infrastructure or high-growth green technology. Already, UK pension schemes invest globally in green assets. The top 10 defined contribution pension schemes in the UK, covering 85% of all members, have all set net zero targets.[23]

Sustainable investment is not in conflict with the fiduciary duty of fund managers to their members. In fact, Fidelity International found that the relative market performance of companies was strongly positively correlated with their Environmental, Social and Governance (ESG) rating.[24] In other words, a high ESG rating connotes resilience and reliability, only enhancing the attraction of sustainable investment to pension funds. Indeed, an increasing number of schemes - including Nest, Scottish Widows, BT, and Aviva - are treating the 1.5 degree pathway agreed at the Paris climate conference as part of their fiduciary duties.[25]

Recently, the Government has acted to integrate the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD) into UK pension regulation. The impact of these reforms will be to mandate that pension funds consider climate change at every stage of the investment process. Ongoing policy initiatives also include a green taxonomy to determine which activities may be defined as environmentally sustainable, and a consultation on increasing charge caps to allow a broader range of green investments.

When it comes to automatic enrolment specifically, the Association of British Insurers have said that all of its members offering automatic enrolment either have, or are in the process of, integrating environmental risk factors into their default funds.

With UK private pension wealth already worth £6.1 trillion,[26] the contribution of a further £800 million to this war-chest can only add depth to the capital available to fund the UK's transition to Net Zero in our fight against climate change.

If young workers stand to lose the most from inaction on climate change, they stand to gain the most from climate action.

## 5 – Encouraging financial engagement

Approximately 12 million people, or 38% of the working age population, are estimated to be under-saving for their pension.[27] With Direct Contribution (DC) pensions placing the responsibility for retirement incomes on individual savers, financial engagement with pensions is increasingly important.

Young workers have the most ground to make up on this score. 18–24-year-olds are the most likely age group to strongly agree that they avoid thinking about retirement (39%) and are also most likely to say they know little or nothing about pensions. Compared to those aged 25-34, almost twice as many of the younger age group (42%) say they have no form of financial resource for later life.[28]

Around 30% of 18–21-year-olds either agree or strongly agree with the statement that 'I have more important things to spend my money on than saving into a workplace pension'.[29] For 28% of 16–24-year-olds, their 'biggest financial concern' is to afford a house, compared to only 8% who prioritise saving for retirement.[30]

The Financial Conduct Authority (FCA) has found that 45% of 18–24-year-olds are unaware that their pension is invested, the least knowledgeable of any age group. It deemed that only 6% of 18–24-year-olds were 'highly engaged' with their pension.

It is therefore unsurprising that the median size of a Direct Contribution pension pot among those aged 16–24 is £1,100[31] – a figure which excludes all those with zero occupational pension wealth (only 20% of this age group have DC pension wealth).

Once again, automatic enrolment offers some answers to the puzzle of financial engagement. Whereas 24% of 22–29-year-olds were saving into a pension in 2012, this has risen under automatic enrolment to 84%, in 2018.[32] Among those currently eligible for automatic enrolment, agreement with the statement 'it is normal for someone like me to save into a workplace pension' is above 80% across *all* age groups. This is reflected by the persistence of savings, with only 1% of all savers not saving persistently in 2015.

Furthermore, the extension of automatic enrolment is well suited to overcoming four key obstacles to retirement saving which researchers have identified in young people: myopia, affordability, trust, and knowledge.[33] Myopia refers to the preoccupation of young people with the present, to the detriment of prudent preparation for the future. The perception of retirement saving as a constraint on immediate consumption is only exacerbated by the jarring transition a young person currently makes, from zero contributions to 8%, at the age of 22. This impression is avoided if contributions are present from day one. Likewise, if retirement savings are immediately deducted from earnings by default, young people will develop their spending habits, accordingly, sparing them a potentially painful readjustment in the future and thus pre-empting concerns of affordability.

In terms of trust and knowledge, research suggests that automatic enrolment is interpreted as an endorsement of retirement contributions as good financial sense.[34] This both allays distrust, and acts as a heuristic for the under-informed. In each of these ways, automatic enrolment helps to teach and instil habits of sound money management among young people.

Beyond the individual, automatic enrolment could also enhance interest in the public finances and the health of the national economy.

In 1923, Conservative MP Noel Skelton wrote for The Spectator about the virtue of a 'property-owning democracy'. After the franchise was extended in 1918, he observed that many had the right to vote but no economic stake in the future of the country. His concern was that the economically desperate would contribute to rising electoral support for communism, fascism, and other forms of radicalism. He therefore stressed the importance of extending a stake in the economy to as many people as possible.

Pension savings are one such stake, meaning enrolment has a clear social function, in addition to its obvious economic benefits. The rise of defined contribution pensions entails a growing dependence of livelihoods on the performance of firms.[35] If we all own a stake in our economy, we have a stake in society; when the country and the economy does well, savers do well. If our economic interest is tied to society's, then we have 'skin in the game' and are incentivised to not only care for the state of society but even to identify ourselves with it. In our democracy we all hold a stake with a vote, but for everyone to own a stake in the economy, the young need to own assets like a pension pot.

In this way, automatic enrolment will create more young capitalists, more aware of the stability and prosperity of our nation, and in turn more mindful of the potential implications of who they vote for at the ballot box.

## CONCLUSION

According to the Department for Work and Pensions, extending automatic enrolment to those aged 18 and above would result in 910,000 more people enroled in a workplace pension with approximately £800m more savings every year.[36]

Extending automatic enrolment would therefore mean an additional £800 million each year accruing compound interest, exponentially bolstering retirement incomes against demographic headwinds. It would mean an additional £800 million each year is available to invest in combating climate change, and is spread evenly to include those of all ages with poor mental health. It would also provide 800 million additional reasons for young workers to engage with their personal finances and the health of the national economy.

When the Government comes to consider extending automatic enrolment, it should consider extending it to young workers as a priority.

# ENDNOTES

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