Keep on nudging

Making the most of auto-enrolment

Standard Life

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Introduction

This report details the key findings from a research project undertaken by Standard Life, with the assistance of experts in behavioural economics from the University of Edinburgh.

Standard Life regularly provides new insight and support to policy makers, industry and other key stakeholders to help stimulate long-term savings, which are vital to the present and future UK economy. In March 2011 we published *Insights into Financial Responsibility*[1] which demonstrated that, although people know that they are responsible for their own long-term financial wellbeing, the employer-employee relationship has a crucial role to play in helping them achieve their goals.

That is why Standard Life fully supports auto-enrolment into workplace pensions. Starting next October, employers will begin to automatically enrol their eligible employees into a qualifying workplace pension scheme, with set minimum contributions from both employers and employees. This offers a unique opportunity to put in place an affordable and sustainable pension system for millions of people working in the UK.

As government and industry prepare for the introduction of auto-enrolment, we wanted to understand how to make it a resounding success. Auto-enrolment was designed using behavioural economics to 'nudge' people into savings. We applied this science to look for practical solutions to the two fundamental questions:

- How can we communicate the new workplace pensions to achieve the highest possible retention of savers?
- How can we encourage people to save more than the minimum contribution?

We concentrated on the group of people that is most at risk of significant under-saving – also called the 'squeezed middle'[2]. They are the people earning low to medium incomes (£18-£45k a year) and who need to make long-term saving more of a priority.

With auto-enrolment only 12 months away, a key aim was to be practical. The recommendations put forward in this report can be put into action now.

It may seem obvious, but carefully designed communication is essential in achieving results. By presenting information about auto-enrolment that is clear and effective, our research found that 82% of people would remain members of an auto-enrolment pension scheme. This is a hugely encouraging finding.

There are no quick fixes to addressing the UK savings gap. Beyond auto-enrolment, substantial personal voluntary savings will continue to be required to give people the kind of retirement they expect. While there is much we can do today, we need to be thinking now about the future development of auto-enrolment – about the next 'nudge'. We tested two possible 'extensions' to auto-enrolment, designed to increase savings even further, and found that they too could have high levels of take-up. Either of these extensions could potentially add £13-£14bn in retirement savings annually by 2025, over and above the £12.5bn we expect from auto-enrolment alone, and as such are worthy of further investigation.

I believe that, working together, employers, the long-term savings industry and government can realise the full potential of auto-enrolment. We must present a simple, unified message – one that is proven to be effective – in order to foster the trust of the UK working population. By collaborating we can help put millions of people firmly in charge of their own financial future.

I hope that you find this report informative and useful.

David Nish
Chief Executive
Standard Life

1 *Insights into Financial Responsibility,* Standard Life, March 2011.
2 *Squeezed in Retirement: The Future of Middle Britain*, Chatham House, March 2011.

Foreword

It's been a pleasure to advise on the research described in this report. The advent of auto-enrolment in workplace pensions and current concerns about low saving rates make this report timely. As a behavioural economist, it is pleasing to see ideas drawn from my discipline being investigated.

This is possible because behavioural economics has now moved from being an esoteric subfield of academic research to being at the heart of policymaking. A 'nudge' unit, more formally the Behavioural Insight Team, has been set up within the UK Cabinet Office to advise the Government on the implementation of ideas taken from behavioural economics. Auto-enrolment itself is also very much derived from findings from this field.

The basis of behavioural economics is the idea of forming models of human behaviour from observation rather than from an ideal of rational action. In the current context of asking whether people save enough, the extreme end of the rationalist tradition might say that the answer is yes, almost tautologically. A rational person saves exactly the amount she wants, and who is a better judge of an individual's needs than the individual herself?

Against this, behavioural economists, most prominently Richard Thaler of the University of Chicago, have observed that in fact many apparently irrelevant factors seem to have a substantial influence on saving behaviour. This suggests that choices over pensions, rather than being taken optimally, are subject to at least two problems. People go with the default option far too often and procrastinate in making difficult choices. This means that if workers actively have to opt-in to participate in a pension scheme, they may delay enrolment and, if the default contribution level is low, they may not save enough.

The findings in this report are thus encouraging in two directions. First, since the research indicates that retention rates will be relatively high, retirement savings should increase when auto-enrolment is implemented. Second, it provides some support for another behavioural prediction based on the importance of procrastination: people may be more prepared to raise their savings rates if the pain of cutting current consumption will happen in the future rather than right away.

Old habits die hard so I must add the economist's traditional caution: these conclusions are taken from survey data where people were asked hypothetical questions. When individuals have to make crucial decisions about their own pensions, they may act differently.

These results should make a very useful contribution to the debate over the evolution of pensions policy in the UK over the coming years.

Professor Ed Hopkins
School of Economics
The University of Edinburgh

Making auto-enrolment work

The introduction of auto-enrolment offers a unique opportunity to put in place an affordable and sustainable pension system which meets the needs of future generations. By building on people's natural tendency towards inaction, the Department for Work and Pensions (DWP) expects to have 4-8 million new savers in workplace pensions[3] from 2012, leading to an additional £10-15bn[4] of annual retirement savings by 2050.

From next October, all eligible employees will need to be automatically enrolled into a qualifying workplace pension scheme, with an eventual contribution rate based on 8% of employee earnings. This will be made up of 3% from the employer, 4% from the employee and 1% from the Government through pensions tax relief. If an employer chooses to adopt the **National Employment Savings Trust (NEST)** as its pension provider, these minimum contribution values will be set as the default for auto-enrolment.

NEST: the Government's new low-cost pension scheme for auto-enrolment

Median income: the income level in the middle of the sample

Replacement rate: income at retirement as a percentage of an employee's pre-retirement income

Retention rate: the proportion of employees not opting out

These minimum contributions are designed to help the current non-saver on a **median income** achieve a 45% **replacement rate** of pre-retirement income, up from the circa 30% provided by the state. This is a good first step, but the real challenge is to unlock additional personal saving so that people enjoy higher levels of retirement income – in line with the Pension Commission's target replacement rates of 60%-66%[5] by 2053 (see illustration below).

We know from our recent findings in *Insights into Financial Responsibility* that employees believe their employers play an important part in helping them to save for retirement and that employers who offer help in financial planning are more attractive. Similarly, 59% of employers believe they have a responsibility for their employees' financial security. Taken together, this confirms the importance of the workplace in reducing the nation's savings gap, and in making the introduction of auto-enrolment a success.

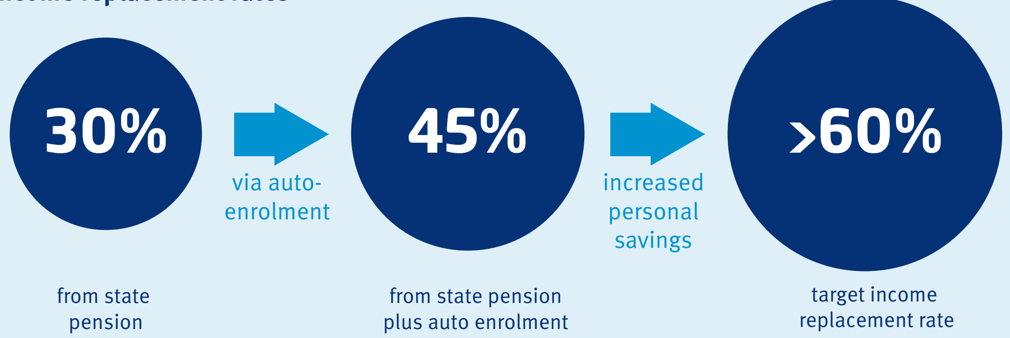
Based on consumer research and behavioural theory, we set out recommendations on how best to describe the new workplace pension to employees at the point of enrolment, and how effective communication can be used to reduce opt-outs and to increase voluntary personal savings both in the workplace and beyond.

Getting it right at the point of enrolment

The key to getting auto-enrolment right is communicating information in such a way that guides people to the desired outcomes:

- We can keep the vast majority of employees saving. Our research shows that **retention rates** could be as high as 82% when information is presented clearly and effectively. This is encouraging when compared to other published estimates of 67-85%[6].
- **We can get employees to contribute more than the 4% minimum.** From our survey, more than a third of those enrolling (36%) could be guided to increase contributions voluntarily at enrolment.

Income replacement rates



3 *Pensions Bill - Impact Assessment*, DWP, published April 2008.
4 *Impact Assessment of Pensions (Automatic enrolment) Regulation 2009*, DWP, published March 2009.
5 *A New Pension Settlement for the Twenty-First Century, second report*, the Pensions Commission, November 2005.
6 There has been a wide range of estimates on opt-out rates, which may not always be comparable. The closest comparable number is from Chatham House, which assumes 30% of workers with £18-45k annual household income range opt-out.

Making carefully designed communication a priority can ensure the success of auto-enrolment. By our calculation it will add six million new people saving for retirement, with increased annual retirement savings of £12.5bn annually by 2017 – fully in line with the DWP's ambition.

Based on our research, here are our recommendations for presenting the new auto-enrolment workplace pension to employees in a clear and effective way.

Make the most of existing incentives

- **Present the employer contribution and tax relief together as matched contributions, forming a powerful incentive.** When employees contribute 4% they are "effectively doubling their contribution for free"[7]. Our research found that these matched contributions were the biggest driver of retention at enrolment.
- **Show employees more incentives to save more.** An increase in their contribution leads to an increased contribution from government (through tax relief).
- **Highlight that investing in a pension can be a good deal.** A simple illustration of the multiplying impact of long-term saving on a contribution that is achievable for most – £50 per month[8] – was shown to be very impactful.

Play to people's aversion to losses

- Savers respond well to reassurance that their funds are not at risk if their employer runs into financial difficulties. In general they do not particularly trust pensions or decisions made by 'experts' (or government for that matter).
- Remind them what they miss out on if they choose to opt-out. Those surveyed did not like being told that they would not benefit from free employer contributions if they opted out. This is a desired reaction and suggests that such a statement could prevent opt-outs among those with greater aversion to loss.

Keep it accessible and something people can relate to

- **Show employees round numbers, not percentages.** "4% of your annual salary over £5,700" should be complemented by a simple illustration such as "£50 a month for someone on a £20,000 annual salary". We have also found a preference for even numbers (see page 14).
- **The use of clear language** needs to be a key goal in any communication and in particular when it comes to financial services, where complexity has long been an issue.

7 The tax relief is even greater for higher rate tax savings but we concentrate here on basic rate tax relief.
8 Only 32% of survey respondents said saving £50 extra a month would be difficult.

What did we test?

We developed an example of how auto-enrolment might be communicated to employees as they join the scheme. It assumed the pension scheme is similar to NEST in its contribution levels and investment strategy ie, a balanced portfolio of funds appropriate for the employee's age.

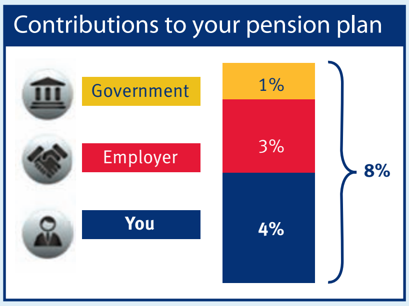
We used behavioural insight and our qualitative research to design the description ('concept') to try to maximise both retention and voluntary additional contributions. For the purposes of the research, we stated that this replaced any existing pension plan. In practice, employers may wish to maintain separate pension plans.

Starting next month, **your employer will automatically enrol you into a new workplace pension plan** to help you build up your savings for retirement. This replaces any existing pension plan.

How much will you be saving for your retirement?

A minimum of 4% of your salary above £5,000 will automatically be invested into your pension plan every month. This is £50 a month for someone on a £20,000 salary.

Your contribution will be matched by your employer and the Government, effectively doubling your investment for free.



How will this money be invested?

Your money will go into a portfolio of investment funds that experts believe is appropriate for your life stage.

Funds will be held in a trust, so that there is no risk to your pension if your employer runs into difficulties or you change jobs.

Should you save more?

The 4% minimum contribution is not likely to give you the lifestyle most people expect in retirement. You are encouraged to increase your contribution. When you contribute more so does the Government.

For someone who is 30, saving an extra £50 a month is expected to give them an extra income of £150 a month for as long as they live after age 65.

What if you don't want to join?

You can choose to opt-out of this workplace pension. This means that you will not be saving for your retirement through work and you will not benefit from your employer's free contribution.

This concept is based on the current auto-enrolment design. Further concepts were tested with a single change in wording and associated diagrams, to generate the additional insights shared throughout this report.

Increasing retention through targeted communication

A survey result is called **statistically significant**, or **significant** if it is unlikely to have occurred by chance

Ultimately, workplace saving should become the norm, with as close to 100% enrolment as possible under a voluntary scheme. Until then, targeted communication can be used to try to persuade those employees who choose to opt-out and have no alternative savings mechanisms to opt back in.

We need to be able to find those most at risk of opting out, understand their motivation and communicate with them in a way that influences their behaviour, so they become better prepared financially for their future.

Finding those most at risk

We found that **26% of employees who have never had any form of pension would choose to opt-out**, which is **significantly** higher than the 12% who opt-out among employees with some prior or current form of pension saving. This difference is to be expected as people who have already been investing in a pension are more likely to understand the benefits. Also, people have a preference for preserving the status quo, meaning that those currently enrolled in a workplace pension are most likely to remain so.

This does, however, confirm **a continued need for financial education**, as highlighted in the *Everyone Needs a Plan* report from the Life Academy[9]. And we need to apply additional focus on increasing the financial capability of those without pension experience.

Interestingly, **there is no conclusive evidence of a 'most at risk' demographic group** in terms of gender, income[10], age or type of employment. Communications should, therefore, avoid stereotypes and be written to appeal to a wide audience.

9 *Everyone Needs a Plan*, Life Academy, November 2010.
10 Within the £18-45k annual income bracket.

Understanding motivation

As anticipated, affordability was the most commonly stated reason for opting out.

Top five reasons for opting out

(Percentage of those opting out stating the reason, with multiple reasons permitted)

I cannot afford to contribute at this time - 61%

I do not trust government - 33%

I do not trust pensions - 28%

I am saving in other ways for retirement - 22%

I have other priorities to save for - 19%

However, **the concept of affordability appears to be subjective** for two reasons:

- There is no significant difference in income between those who opt-out and those who enrol.
- Those who opt-out find saving an additional £50 a month equally as difficult as those who enrol.

This suggests that the actual decision to opt-out may be the result of deeper-rooted, attitudinal barriers to saving, rather than a matter of actual affordability.

To illustrate, the auto-enrolment legislation permits a gradual build up of contributions over three years, starting with only 0.8% from the employee, eventually rising to 4%. We found that this gentle introduction and gradual increase made no difference to the level of opt-outs, even among those without prior pension savings. Affordability actually became much less of a reason for opting out, but it was clear that other reasons persisted.

Addressing attitudinal barriers

We need to look past the barrier of affordability and design communications to address attitudinal barriers. In comparing those people who would opt-out against those who would remain enrolled, we found the opt-outs had a significantly greater tendency to:

- believe that retirement is too far off to worry about;
- dislike locking up their money.

Communication could be designed to help people understand that retirement is not too far off and that the benefits of pension savings outweigh the drawback of not having instant access to their money. However, **these and other attitudes, such as the distrust of pensions and government, are likely to be deeply ingrained** and may condition those inclined to opt-out of pensions to reject even the most attractive form of saving.

In fact, we found that 70% of those who would opt-out of auto-enrolment would also reject a theoretically very attractive alternative. This alternative consisted of an imaginary savings scheme where the employee contributed 4% of their income into a workplace ISA and at the same time the employer contributed 3% into a pension. Even the incentive of matching contributions without locking up their money was not enough for truly reluctant savers.

Instant gratification can help, but only a little

If someone already believes that retirement is too far off to worry about, there is limited value in communicating incentives that can only be enjoyed at a later date. Behavioural economics suggest that a more immediate incentive might be effective. To test this in our survey, we offered entry in a £10,000 prize draw for those who would remain in the workplace pension scheme. This led to a marginal increase in retention, suggesting that there may be a limited opportunity to design attractive short term incentives to capture those employees who have weaker barriers to enrolment.

It is likely there will always be some non-savers for whom no saving structure or incentive will work. Consequently, efforts may be better focussed on encouraging those who currently save, to save more.

Encouraging people to save more after enrolment

Nudging people to save through auto-enrolment is only the first step. The next step must be to nudge them into saving more than the default level of 4%, which is likely to provide the median earner with a pension of just 45% of pre-retirement income.

There is ongoing debate about the need for further pension reform, but **there is already a substantial opportunity to encourage people to save more** within the current pension tax regime. In this section, we outline possible nudges in the workplace and additional communication strategies to encourage people to save more voluntarily.

Opportunities in the workplace

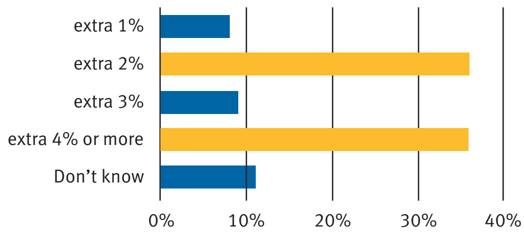
In the previous section, we noted that introducing a gradual build-up of contributions up to the 4% default minimum level had no positive effect on retention rates. It produced virtually the same levels of retention that were achieved when the 4% employee contribution rate was introduced from the beginning.

However, it did cause a noticeable (but not significant) reduction in the number of employees who would spontaneously contribute more than the minimum at the point of enrolment. This implies that a gradual increase of contributions to the default minimum could therefore be counter-productive to improving savings behaviour. Where it is affordable to employers, we should encourage them to introduce the full 4% auto-enrolment contribution straight away.

Even if employees do not make higher contributions spontaneously, our research suggests that employees could be nudged into increasing their contributions under the following conditions:

- **Employees are shown they are not saving enough at every opportunity.** 28% of employees enrolling with a 4% contribution said they would consider contributing more if their 'pension progress' was shown on their payslip.
- **Employees are given access to guidance and information.** Employers can deduct up to £150 per employee from their taxable profits for providing employees with advice or information. This appears to be an underutilised provision, but could be deployed effectively to increase contributions.
- **Employees are given three even numbers to choose from when increasing contributions.** There was an overwhelming preference for increasing contributions by an even number rather than an odd one. Add this to the human tendency to 'pick the middle one' and to prefer limited choices, we expect a choice between a rate of 2%, 4% or 6% to have the greatest effect on increasing contributions.

Likely contributions in addition to the 4% minimum



For the median earning 25-35 year old, increasing contributions by 4% of earnings would add £135,000 to their pension pot. This would make a material difference to their income in retirement.

Communication campaigns beyond the workplace

It has been widely reported that considerable numbers of people are not saving at all and most are not saving enough for the kind of retirement they want. People know they need to be saving but have different priorities and constraints. Others are burying their heads in the sand.

However much effort employers and the voluntary sector put in, it is the role of government and the financial services industry to change individuals' propensity and ability to save and boost their willingness to take responsibility for their retirement income.

The Government is currently planning a communications campaign to publicise the introduction of auto-enrolment and clearly this is an ideal time to make sure the most effective messages are used. It also presents a wider opportunity to help foster a revived savings culture.

There is a growing consensus to increase and improve financial education. Standard Life has a clear strategy on financial inclusion and education and works together with the Standard Life Charitable Trust to help ensure all sections of society are reached with effective initiatives.

The section opposite summarises our findings on what helps and encourages people to save more in the workplace and beyond. It includes messages that have been shown to be effective and some other best practices based on our findings.

Simple numerical facts are most effective

If people are to be encouraged to prioritise long-term saving, they need to be provided with the right information to make that decision. This means explaining in straightforward language what happens when they save, or don't save.

- The strongest call to action is to show employees what they can expect to receive in retirement for the amount they are being asked to save today. And that it is a good deal.

  "For every £100 a month you are saving from the age of 30, you will get £300 a month for the rest of your life after retiring at 65." A tripling of investment looks attractive.

- The second strongest message is simply showing employees what the tax incentive is.

  "The Government contributes 25p to your pension for every pound you put in." People like the notion of 'getting money back' from the Government.

  As previously highlighted, the employer and government "effectively doubling your contributions for free" is a very appealing statement. But even when the tax incentive is taken alone, it is very impactful.

- A statement that shows how postponing savings decisions delays retirement would also be effective in spurring people into action today.

  "For every year you defer saving for your retirement, you will need to work 'X' months longer."

  As the impact of delayed savings on retirement age is greatest the older one gets, this would not be appropriate for a wider communication campaign. However, it could be adapted for use in illustrations of individual circumstances.

Using numbers to communicate effectively

From the research and our own customer experience, we know that people respond well to numbers when they are kept simple and relevant to them. However, all too often this insight is ignored. Where there is limited understanding of pensions, a few poignant facts can truly make the difference between opening the door wider, or closing it altogether.

Caution is needed on the use of numbers due to their inherent ability to anchor themselves in the mind. Here are some insights on using numbers when offering choices to employees:

- £100 seems high for many, but £50 is a more familiar amount – the cost of a good night out.
- Actual amounts are much more tangible than percentages. Telling people they needed to save 10% didn't work in our research. Despite it being an easy to calculate number, it is not as 'real' as £50, nor can percentages easily be made appropriate for everyone.
- As previously stated, round numbers and even numbers are preferable when giving people choices.

Things to avoid

From the behavioural insight developed during the course of this research we can also highlight communication strategies that are unlikely to be effective.

Appealing to lifestyles

Scaring people into saving is not an effective approach. Messages of poverty in retirement are the least effective and seem to make people stick their head in the sand even more. However, concern about having to work beyond their planned age of retirement had a degree of positive impact.

The opposite approach, painting a picture of the kind of retirement lifestyle to which they might aspire and where they can be generous to their children, also had an impact, but it was insufficient on a stand-alone basis. Such positive illustrations could be used to complement the more effective, fact-based, statements of encouragement already highlighted in this report.

Social comparison

Social comparison has been used to positive effect, such as in trials to reduce energy consumption. However, we found that comparing people's savings or lifestyles in retirement to their peers had a limited positive effect and can make people quite defensive. Openly talking about personal financial health is perhaps still too much of a cultural taboo in the UK.

Talking about pensions

We would support replacing the term 'pension' in favour of 'retirement income' when referring to any retirement planning that is not the state pension. The state pension would be merely one element of a person's retirement income. Our two main reasons for this are:

- There was a perception in our focus groups that pensioners "spend all day gardening". The generation in our research (18-50) has more exciting visions of their retirement. If communications can't relate to them personally, people are unlikely to take any action.
- The word 'pension' is associated with government, and the group displays a distinct lack of trust in government when it comes to retirement.

Worrying too much about affordability

Earlier, we discussed affordability as one of the greatest barriers to saving more, but recognised that it is subjective. In fact, even the 'squeezed middle' considers affordability a matter of choice. When prompted, focus group participants could easily come up with a list of luxuries they could do without if they had to: wine, taxis, fashion and nights out. They knew they were making a 'naughty choice' by spending rather than saving.

In our survey, close to 70% of people would not find it difficult to save an additional £50 per month if they had to. And 48% admitted they would find it easy. To put this into perspective, an additional £50 a month would double the individual pension contributions of someone on an annual salary of £20,000 saving at minimum auto-enrolment levels.

We found that 41% would be willing to give more than £50 a month to a friend or family member in difficulty, showing again that £50 is an 'affordable' amount.

With the right approach, we can help people make saving such an amount a priority.

The importance of being 30

The age of 30 appears to be a pivotal point when it comes to long-term financial planning. From our experience, this milestone tends to trigger a more 'grown up', serious attitude to financial planning and leads to an increased understanding of the need to save, both for the medium-term (property, children, education) and the long-term. Our report *Your Commitments, Your Future*[11] highlights how emotional and financial commitments change at different life stages and is designed to help individuals plan better for them.

In our focus groups, the under-30s believed they had all the time in the world to think about retirement planning, but many in their mid-30s believed they had already "missed the boat". We did not find in our survey that attitudes to savings varied significantly between age groups, or that there is a significant difference among the messages that worked well. But we do believe that turning 30 presents a (literally) once in a lifetime opportunity to find a receptive audience for communications around financial planning.

11 http://www.knowyourcommitments.co.uk

The future for auto-enrolment

Auto-escalation: the employee's pension contribution levels increase automatically at set times or milestones

Parallel saving: saving for the medium to long-term in vehicles other than a pension plan

We believe that the work to understand how auto-enrolment can be enhanced must begin as soon as possible. This is because people will continue to retire on incomes that fall well short of what they expect. We cannot wait for the review of auto-enrolment in 2017 to start developing new proposals.

Anticipating a successful introduction of auto-enrolment, we looked at the principles behind it to see if they could be re-applied to provide new policy and produce another leap forward for savings rates.

Principles behind auto-enrolment:

- The workplace is a good place to save.
- People will go with the default option, so make the default lead to the desired outcome.
- People should be allowed to choose whether they participate.

In our survey we tested two extensions to auto-enrolment: **auto-escalation** and **parallel saving**. We found that, if introduced from 2017, each could add £13-£14bn to annual retirement savings by 2025. **Either of these could therefore double the impact of auto-enrolment alone.**

For the median earning 16-24 year old today, either one of these policy extensions could help raise replacement rates to 55%, a significant move towards target replacement rates greater than 60%. For these individuals, private pension savings would represent 43% of total income at retirement compared to 35% for auto-enrolment alone.

We have assumed that policy makers want to help people save more, knowing that this will have an impact on their short-term disposable income and on the cost of tax incentives to the Treasury. This cost could be offset positively against the long-term benefit of a population that has a lower call on public finances and is instead generating taxable pension incomes.

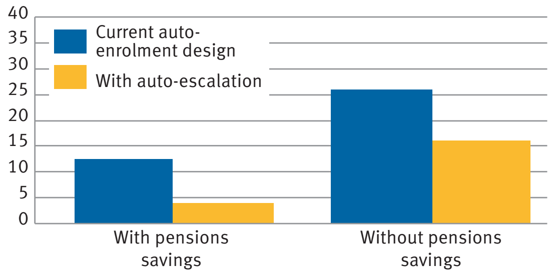
Auto-escalation - Save More Tomorrow®

The Save More Tomorrow®[12] scheme, where the level of pension contribution is increased as employee pay increases, has achieved outstanding results for some American company pension schemes[13]. There is growing debate around introducing such auto-escalation as part of future pension policy in the UK. The basic principle is that employees would be enrolled at the 4% contribution level, but every time they receive a pay rise, their contribution level increases in a gradual way (eg. 4.5%, 5.0%, etc.) so that employees still end up with higher take-home pay.

For the current median earning 16-24 year old, this could automatically increase their pension savings by £85,000 compared with the current auto-enrolment design.

The critics of auto-escalation believe that current UK savers would be averse to the loss of control associated with automatic increases to contributions. We have not found this to be the case. Our survey found that only 4% of people with some form of pension savings would opt-out of a workplace pension with built-in auto-escalation[14]. It could also have a positive effect on retention rates among the 'at risk' group with no prior pension savings.

Opt-out rates (%)



12 Registered trademark of Benartzi and Thaler.
13 *Nudge: Improving Decisions About Health, Wealth and Happiness*, Richard H. Thaler and Cass R. Sunstein.
14 Our design showed an increase in contributions of 0.5% at every pay increase, with employee contributions capped at 9%.

The results on the previous page may seem counter-intuitive. Why would someone more readily join a pension scheme where they are expected to pay more? Behaviourally, we believe it makes sense:

- **Auto-escalation prevents the need for further decisions.** When people are told that their initial 4% contribution is not sufficient, auto-escalation provides an immediate solution and reduces the need to take further action.
- **Auto-escalation looks like a more complete solution.** Being presented with a workplace pension that ensures that you are saving sufficiently, rather than one where additional voluntary saving is merely recommended, is likely to engender more trust in the scheme.
- **Employees will feel some pain today, but this is offset by no pain tomorrow.** Auto-escalation is designed so that take home pay after a pay rise is higher than before, even with the additional contributions towards their pension. Therefore people will not need to adjust their spending habits to accommodate the additional saving in future. In fact, people believe that their prospects will improve in future and this may distract from the adjustment they will need to make today.

There is a second encouraging insight. Of those people who would remain enrolled nearly one in three (31%) said they were willing to make a 'triple' contribution. First, they would remain enrolled. Second, they would agree to rising contributions as their income increases. Third, they would be willing to make additional voluntary contributions on top of all this. This is striking because the number of people willing to make this commitment is broadly the same as those willing to save more than 4% of income on a voluntary basis. In other words auto-escalation is not a disincentive to remaining enrolled.

If this data were representative of the entire group in the UK, such an auto-escalation scheme introduced in 2017 could lead to additional annual retirement savings of approximately £13bn by 2025.

Parallel saving – auto-enrolment into workplace ISAs

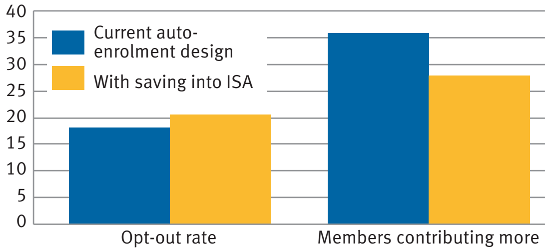
Individual Saving Accounts (ISAs) are popular for medium to long-term saving. They include an easily understood tax benefit and easy access. Standard Life's work with employers shows that the provision of a workplace ISA is a popular additional benefit with employees.

We found that there could be a considerable appetite for ISA savings in parallel with pension savings. We presented people with a workplace savings scheme in which they were automatically enrolled into a pension plan with the current auto-enrolment design and had an additional 2% of income automatically paid into a workplace ISA (without any matching contribution). It was made clear that ISA savings could be accessed at any time.

We expected a greater level of opt-outs from employees, thinking that perhaps this was a step too far. **But we found only a very minor increase of 3% in opt-outs.** Reasons for opting out included having an ISA already. This suggests, again, that the barrier of affordability can be overcome and that the reluctance to stay enrolled in workplace savings schemes is driven by barriers to any savings habit, rather than to a specific savings habit.

There is a drawback to this particular scheme. **The number of people choosing to save more than the minimum 4% into their pension at enrolment reduced to 28% from 36%** in the current auto-enrolment design. Whilst this was not a statistically significant difference, there would be a trade-off between pension and ISA savings.

Impact on saving (%)



Based on our research findings, there would be **additional annual savings of approximately £14bn by 2025** on top of auto-enrolment at a very limited cost to government[15]. This gain would need to be weighed against 750,000 fewer people saving, £1.15bn less being saved into pensions and the expectation that at least half of the money saved into ISAs would be spent prior to retirement.

Nevertheless, we believe that there is an opportunity for workplace ISAs to complement pension provision in the future and would encourage more imaginative industry and government thinking on this.

For example, our qualitative research suggests that a workplace ISA account, seeded with £100 by the employer, could already stimulate regular savings to some extent. This suggests that we may not need to go as far as auto-enrolling everyone into a workplace ISA.

15 Income from saving into an ISA is not taxable.

Conclusions

Our research confirms that the launch of next year's auto-enrolment could be transformational. This is particularly important to those on low to medium incomes – the 'squeezed middle' – who are currently most at risk of a large drop in income at retirement. Our research found that among this group:

- **Up to six million extra people could be saving for the first time,** leading to an additional £12.5bn being saved annually for retirement.
- **Over 82% of employees could stay enrolled,** which represents a low level of opt-outs compared to published estimates of 67-85%. Of the 18% who would opt-out, 20% are saving in other ways (for example, through property).
- **Over a third of enrolled employees could be encouraged to save more than the 4% default contribution rate.** This is crucial because enrolling a median earning young person at the 4% default rate will only build a retirement income of around 45% of final salary. The Pensions Commission's recommended target is 60-66%.

Looking further ahead:

- **We believe it should be possible to double the impact of auto-enrolment.** This could be achieved by re-applying the principles behind auto-enrolment when adjusting policy after its review in 2017. For example, extensions to auto-enrolment could be:
  - 'Auto-escalation' structures like Save More Tomorrow®, which increase contributions at each pay increase; or
  - Automatically enrolling employees into a workplace ISA.

Either of these extensions could add £13-14bn to annual long-term savings over and above the £12.5bn expected from auto-enrolment alone.

Until then:

- **Clear and effective communications are critical** in the run up to auto-enrolment next year to achieve the desired high levels of retention and contributions above the default rate.
- **Effective messages draw on the principles of behavioural economics** but even then, some will resonate better than others. In this report we share insights and recommendations for anyone looking to communicate effectively to encourage long-term savings. These include:
  - **Understand why people opt-out.** Our research shows that personal attitudes may be a greater barrier to saving than the often-mentioned, yet subjective reason of affordability. For example, those who opt-out more strongly believe retirement is too far away and have a stronger dislike of locking up their money.
  - **Recognise that familiarity with long-term savings is key.** Those without any prior experience of workplace pension schemes are significantly more likely to opt-out of auto-enrolment and have a greater need for education.
  - **Make the most of existing incentives.** For example, state how the employer contributions and tax relief are "effectively doubling your investment for free." Where there is little awareness of tax relief for pensions, messages such as "the Government contributes 25p to your pension for every pound you put in" are very powerful.
  - **Use numbers which people can understand and relate to personally.** A majority of people in the £18-45k annual income bracket could save £50 a month if they had to.
  - **Simple messages, which clearly illustrate the benefits of saving for retirement, work best.** For example: "For every £100 a month you save from the age of 30, you will get £300 a month for the rest of your life after retiring at 65" had the highest potential to encourage saving.
  - **Appeal to people's aversion to losses.** Provide reassurance on risk and reminding them of the incentives they lose by opting out.
- **Further subtle 'nudging' techniques can encourage employees to contribute more in the workplace.** For example, 28% of those enrolling with minimum contributions would be encouraged to save more if they could see the progress towards their pension goal shown on their payslip. Also, a choice of three even numbers for contribution levels is likely to have the greatest impact on savings.

Collaboration is the key to success

With only 12 months to go before auto-enrolment goes live, the focus for policy makers, employers and the long-term savings industry must be on getting the communications strategy right.

We believe communications need to be consistent and effective at a time when employees and the public in general will be exposed, perhaps like never before, to communications about auto-enrolment and long-term savings.

- **We urge policy makers, industry and other key stakeholders to work together in designing their communications around long-term savings.** We hope that insights from this report can be of use in this exercise, in combination with the DWP's recently published *Auto-Enrolment and Pensions Language Guide 2011*[16].

Specifically, we suggest the following:

- **Develop guidelines for communications** that create a greater propensity to save and for these to be applied widely and consistently. The findings from this research will be applied by Standard Life in its communications with and through employers in the run up to auto-enrolment.
- **Agree a set of fact-based messages** to be used in communications around retirement savings and in financial education. These need to be used for at least the next three years. The success of the '5 a Day' healthy eating campaign is an excellent example of this and we feel it will help people make better choices in their retirement planning.
- **Consider sending a letter or email to everyone on their 30th birthday** that offers guidance on retirement planning, as this appears to be a pivotal moment in a person's attitudes to long-term savings. Other uses of social networking to reach those aged 30 or under should also be investigated.
- **Reserve the use of the word 'pension' for the state pension**, using 'retirement income' for all other sources of income.
- **In parallel, there needs to be appropriate focus on improving financial capability among those most at risk of undersaving.** Standard Life, through the Standard Life Charitable Trust, is supporting programmes with this aim.
- **Given the potential impact of making further extensions to auto-enrolment, we strongly encourage policy makers to begin designing the next steps in auto-enrolment now,** so that any changes can be implemented rapidly after the 2017 review.

  We have contributed to this work by proposing two extensions to auto-enrolment. They both entail automatic enrolment into enhanced savings schemes and our research suggests that they would lead to a substantial boost to medium and long-term savings.

  We have not quantitatively tested opt-in versions of these savings structures because we believe they would be less effective than auto-enrolment.
- **We would also ask for other bodies to share their research findings and insight on this subject**, as we have done, so that we can all benefit from this shared knowledge and therefore collaborate more effectively.

16 http://www.dwp.gov.uk/docs/auto-enrol-language-guide.pdf

Summary of our approach

Behavioural economics is at the heart of our approach for this research. Experience tells us that people do not necessarily behave rationally, and there is a growing recognition of the potential to apply behavioural economic insights to increase long-term savings.

Behavioural economics is a field of research that uses social, cognitive and emotional factors in understanding the economic decisions of individuals and institutions. Human tendencies and preferences that could influence decisions in long-term savings include:

- **Inertia:** a preference not to act or make a decision – also reflected in a preference for the status quo and an aversion to planning.
- **Loss aversion:** people strongly prefer avoiding losses to acquiring gains.
- **A preference for immediate rewards:** people behave differently when confronted with a choice between an immediate and future reward than when deciding between two rewards in the future.
- **Paralysis of choice:** decisions may not be made because there is too much choice available.
- **A tendency to overestimate the probability of good events** (winning in prize draws) and underestimate the probability of bad events (poor health).
- **Social comparison, norming and herding:** people compare themselves to others and are sensitive to social norms and to crowd behaviour.
- **A susceptibility to framing:** how information is presented.

Commissioned by the Cabinet Office, the Institute for Government has designed the MINDSPACE[17] framework, using behavioural economics, to help guide policy development. We used this to develop a list of possible tactics to build on these behaviours and encourage long-term savings. This list was further refined using our own knowledge base and what had been published elsewhere to develop hypotheses for effective communication or policy strategies.

We commissioned a market research agency, Nunwood, to carry out focus groups (qualitative research) and a survey (quantitative research) to test our hypotheses:

- Four focus groups were held with low to medium income households of different ages and different family compositions. This gave us insight on attitudes and barriers to saving, helping us to identify potentially powerful messages to encourage saving.
- A survey was completed by 600 employed people earning £18-45k a year. The survey presented different descriptions of workplace savings schemes, which we call concepts, and measured how each change in concept would impact retention and levels of employee contributions. We also asked people to rank our messages on their relative effectiveness in encouraging them to save more.

The results from this quantitative research were used to model the impact that changes in workplace savings schemes would have on the nation's savings, and on an individual's income replacement rates. This model used inputs from various sources including the ONS *Wealth and Assets Survey* and *Annual Survey of Hours and Earnings 2010*, as well as internal assumptions on future economic conditions. The main assumption is that the results from our survey sample apply to the rest of the working population in that income bracket.

17 *MINDSPACE: Influencing behaviour through public policy*, Institute for Government and Cabinet Office, March 2010.

David Nish

David Nish was appointed Chief Executive in January 2010. He joined Standard Life as Group Finance Director in November 2006. David is a Deputy Chairman of the Association of British Insurers (ABI) and chairs the Life Insurance Management Committee. He was previously a non-executive director with Northern Foods plc, a major food manufacturer, Thus plc, a telecoms and internet provider, and the Royal Scottish National Orchestra.

Before joining Standard Life, David was Executive Director, Infrastructure Division at Scottish Power plc. He joined in 1997 as Deputy Finance Director, and became the Group Finance Director in 1999. Prior to this, David was a Partner with Price Waterhouse.

Standard Life

Standard Life is an international savings and investments business that looks after the long-term financial needs of around six million people worldwide. Headquartered in Edinburgh, Standard Life has more than 9,000 employees in the UK, Canada, Europe, USA, Hong Kong, India and mainland China.

The Group's main businesses are in the savings, investments, corporate pensions and employee benefits markets. It includes Standard Life Investments, a leading global investment manager. The Group has also set up joint venture insurance businesses in India and China.

Standard Life is a major provider of corporate pensions and benefits in the UK. The company has a strong reputation for innovation in the corporate pensions market. In March 2011 it launched **Life**lens, a groundbreaking flexible benefits portal that offers employers a fully scalable employee benefits solution that can be tailored to meet the needs of employees. Standard Life currently manages group pension and flexible benefits schemes in the UK for some of the world's biggest and best known brands.

Professor Ed Hopkins

Ed Hopkins is a professor in the School of Economics at The University of Edinburgh, with a particular interest in behavioural economics and applying game theory to social issues. He is director of the Behaviour, Incentives and Contracts programme of the Scottish Institute for Research in Economics. He obtained his PhD at the European University Institute in Florence, where he returned as a Jean Monnet Fellow. He has also been a visitor at the University of Pittsburgh, University of California - Santa Barbara and the California Institute of Technology.

Dr Tatiana Kornienko

Tatiana Kornienko is a senior lecturer at the School of Economics at The University of Edinburgh, with a particular interest in behavioural and experimental economics. She obtained her PhD at the University of Pittsburgh, and has held academic posts at the University of Manitoba and at the University of Stirling.

The University of Edinburgh

Founded in 1583, the University of Edinburgh has for more than 400 years been one of the most influential centres of knowledge in the world.

Located in the Scottish capital, among the great figures who have studied at Edinburgh are naturalist Charles Darwin, philosopher David Hume, telephone inventor Alexander Graham Bell, former Prime Minister Gordon Brown and Harry Potter author JK Rowling. Inventions linked to Edinburgh include the thesaurus, the TB vaccination, the microchips which power iPod music players and Dolly the Sheep, the world's first cloned animal.

Today Edinburgh is home to nearly 28,000 students, more than 9,000 of whom come from outside the UK to study here. The University of Edinburgh is ranked 20th in the world in the latest QS World University Rankings.

For more information on Standard Life go to

www.standardlife.com