Submission to the Work and Pensions Select Committee on the Government's Pensions Reforms

Summary

I. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI exists to contribute facts, analysis and commentary to help all commentators and decision-makers to take informed policy decisions on pensions and retirement provision.

II. This submission provides the PPI's evidence to the Work and Pensions Select Committee on the Government's pensions reforms. It covers the Government's proposals in three main areas:

a. The Government's proposals to bring forward the planned increase in the State Pension Age for both men and women from Age 65 to Age 66 by 2020;
b. The Government's plans to index occupational pension income and S2P to the Consumer Price Index (CPI) instead of the Retail Price index (RPI);
c. The Government's proposed changes to the detail of the proposals for auto-enrolment into private pension saving.

This submission concludes that:

III. On the proposed accelerated increase in SPA for men and women:

- The current Government proposals to bring forward the SPA give men just over 7 years of notice and only 5 years to women. This may be insufficient notice to allow individuals to adapt to the SPA changes, by for example, delaying their retirement plans, or saving more during their working life.

- Economic activity rates suggest that men may need at least five years notice of any SPA changes, and ideally should be given ten years of notice of any SPA changes. In 2010, around 76% of men aged between 55-59 are still economically active, by age 60-64 that figure drops to 54%. Once individuals have left the labour market at older ages it may be difficult for them to re-enter it.

- Women may need more than ten years notice of any SPA changes, given that they tend to exit the labour market much earlier than men. In 2010, 65% of women aged 55-59 are still economically active, but by age 60-64 that figure drops to 34%.

IV. On the proposals to uprate workplace pensions by the CPI:

- Neither the CPI nor the RPI provide a true reflection of the inflation experienced by pensioners, who are likely to spend a higher proportion of their income on basic goods that may increase in price more quickly than other consumer goods.

- A change to CPI indexation, combined with the triple lock mechanism for the uprating of the BSP, may decrease a public sector median earner's retirement income by 4% per year at age 75 and by 8% per year at age 85, in 2010 earnings terms, compared to what they would have received under RPI indexation.

- For a median earner member of a private sector DB scheme, total retirement income could be reduced by 4% at age 75 and by 2% per year at age 85 compared to the income that they would have received under RPI indexation (capped at 2.5%).

- Deferred members will be affected by the proposed changes if the employer decides to switch from RPI to CPI indexation. A median earning man with 15 years of entitlement who leaves his scheme at age 40, could see his starting pension income reduced by around 20% at age 65, from what it would have been under RPI uprating (capped at 2.5%).

- Between 20% and 40% of private sector schemes have rules that could allow them to adopt CPI indexation. This change could help the survival of DB schemes as it will reduce scheme liabilities for existing and future members by around £60.9bn. However, it may also be detrimental for scheme members' retirement incomes.

V. On the Government plans for auto-enrolment and the establishment of NEST:

- The announced 'triple lock' mechanism for the uprating of BSP will tend to improve the value of saving for all individuals with BSP entitlement, however the use of the CPI instead of the RPI for the uprating of S2P could tend to reduce the value of saving for those who have high entitlements to S2P.

- The policy changes that include the staging and phasing in of auto-enrolment may reduce the value of saving, particularly for older individuals. If older individuals are auto-enrolled into NEST, then the new NEST charging structure may also reduce the value of saving for them. This is because the contribution charge and the delays to the introduction of auto-enrolment reduce the level of contributions and the length of time that older savers can benefit from the reforms.

- The current pension reform plans do not significantly affect the value of savings for individuals who are likely to rent in retirement, who will still be at a high risk of finding auto-enrolment unsuitable for them if they may otherwise have qualified for housing benefit. However, it should be noted that this interaction will depend on how the Government reforms housing benefit.

- The announced threshold for auto-enrolment of £7,475, combined with a contribution threshold of £5,715 will have little impact on the value of savings for different individuals over a full working life, as they are unlikely to remain within those earning levels during their working life.

Further information on the issues summarised in this submission to the Work & Pensions Select committee is available at the PPI's website: www.pensionspolicyinstitute.org.uk. Relevant documents available on the website include:

- The PPI's response to the DWP's Consultation on raising the State Pension Age from 65 to 66;

- The PPI's Briefing note on the impact of the switch from RPI to CPI indexation for pension income;

- The PPI's response to the Making Automatic Enrolment Work Review.

A. The impact of the proposed accelerated increase in the State Pension Age (particularly among women)

1. The Government has introduced provisions in the Pensions Bill to increase the SPA for both men and women to 66 by 2020.

2. In 1981, individuals received the state pension for 25% of their adult life on average. By 2010 this had increased to 33% of adult life. If the SPA remains unchanged, and if longevity continues to improve then the proportion of adult life spent in receipt of the state pension will continue to increase.

3. Most commentators agree that due to improvements in longevity, the state pension age (SPA) will need to rise in the future. However, not all commentators agree on the rate at which the SPA rises should happen.

What will be the impact of the changes on men?

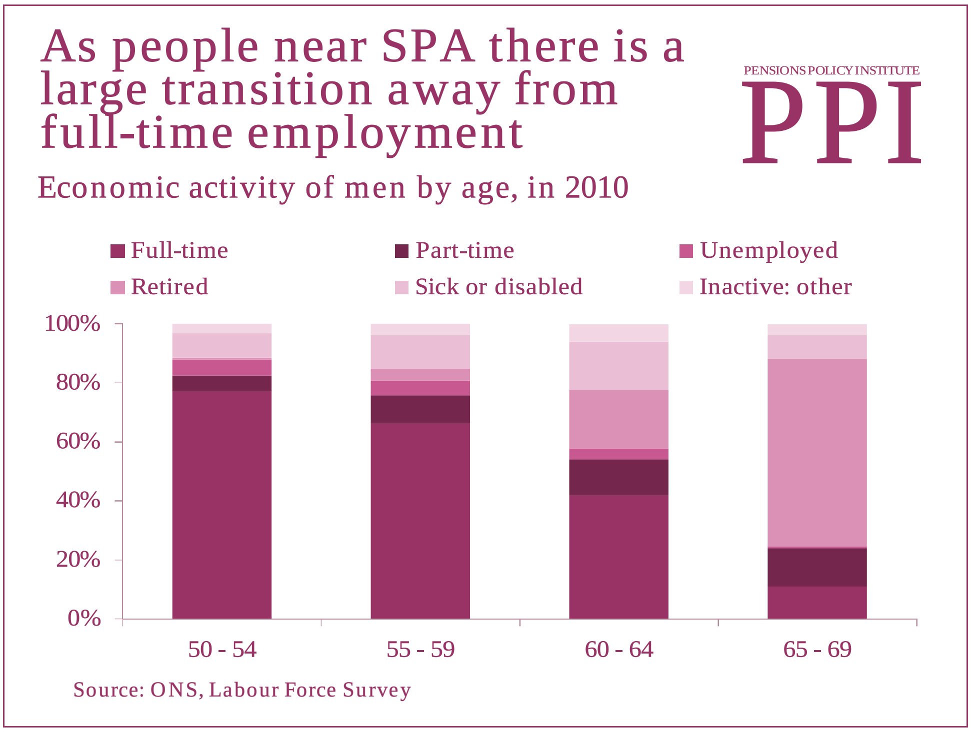
4. Bringing forward the increase in SPA will affect men born between 6 April 1953 and 6 April 1959. This group will see their SPA increased to 66 much earlier and faster than under previous legislation.

5. The previous changes legislated in the Pensions Act 2007 gave men an effective 17 years notice from the year in which the changes were legislated to the year in which the SPA increase started (2024). The current proposals are giving men just over 7 years of notice (2018).

6. Chart 1 shows a snapshot of the male workforce aged 50-69 in 2010. It shows that there is a significant transition from full-time or part-time employment into 'inactivity' past age 59. Approximately 76% of men aged 55-59 are in employment, falling to around 54% aged 60-64, and only 24% aged 65-69. In order to make an increase in SPA effective, both individuals and employers' attitudes towards working longer would need to change.

7. The evidence on participation rates at older ages would suggest that policymakers would be unwise to give anything less than 5 years notice of the male SPA changes. Within 5 years of the current SPA of 65, only 54% of the male workforce is still economically active. It would be desirable to give 10 years notice, because within 10 years of the current SPA of 65, around 76% of men are still economically active and could therefore respond to the policy change by delaying their retirement if they need to. Once individuals have left the labour market at these ages it is likely to be very difficult for them to re-enter the labour market at a later date.

Chart 1



Impact on Women

8. Women born between 6 April 1953 and 6 April 1954 will face a steeper increase in their SPA than under previous legislation.

9. The Pensions Act 1995 gave women an effective 15 years notice to the year in which the SPA increase started (2010). The current proposals are giving some women just 5 years of notice, which may not provide them with enough time to adapt to the changes.

10. Economic activity rates among women suggest that currently they tend to leave the labour market at an earlier age than men (Table 1 and Chart 2).

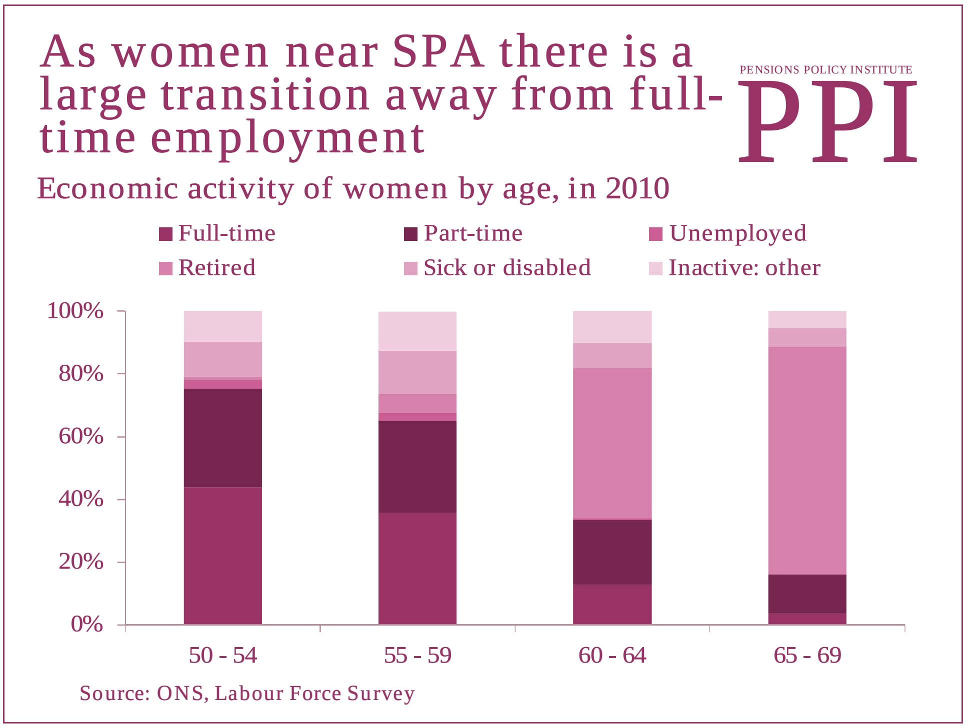
Table 1: Percentage of Men and Women Economically Active at older ages in 2010[1]

Age	Men	Women
50-54	83%	75%
55-59	76%	65%
60-64	54%	34%
65-69	24%	16%

11. Only 65% of women in the 55-59 year range are economically active (compared to around 76% of men), and by ages 60-64 only 34% of women are currently economically active (compared to 54% of men).

12. This evidence suggests that policymakers should ideally give women more than 10 years' notice of any future SPA changes to allow them sufficient time to adjust their retirement plans, or to save more while still working.

Chart 2



[1] Source: ONS, Labour Force Survey. Economically active include both full-time and part-time working. Data for 2010.

B. The impact of the change to using the CPI to uprate workplace pensions

13. This response briefly explains the differences between the CPI and RPI and it then analyses how the intended changes may affect different scheme members.

Key differences between CPI and RPI

14. The RPI measures the rise in inflation for a basket of goods and services that include housing costs. Since 2003, the UK official measure of inflation has been the CPI, which uses a similar basket of goods and services but excluding housing costs.

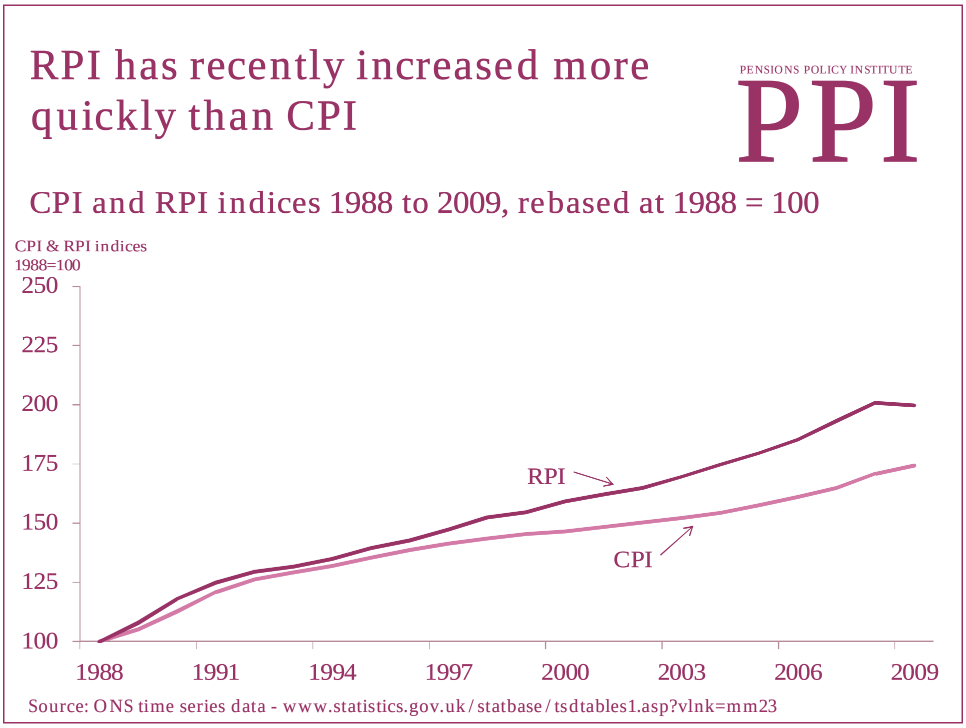
15. CPI rises more slowly than RPI because the indices use different average formulae. While the RPI uses the arithmetic mean the CPI uses the geometric mean, which allows for trends in "price switching" (switching from one brand to another of a lower price for a same good). Over the last four years, the 'formula effect' has accounted for between 0.5% and 0.9% difference each month.[2]

16. CPI's exclusion of housing costs also influences the different way each index rises (Chart 3). The use of the CPI to uprate pensioner's income may not accurately reflect all pensioners experience with inflation as 7% of pensioners have mortgage payments outstanding, while 21% of them live in rented accommodation.[3]

17. Neither index provides a perfect calculation of inflation: RPI better reflects increases in housing costs while CPI better reflects trends in price switching. Both indices provide an average measure of inflation, which may be different from the one experienced by pensioners, who are more likely to spend a higher proportion of their income on basic goods that may increase more quickly than other consumer goods.[4]

[2] ONS (2010) ***Focus on Consumer Price Indices,*** September, table 1.4.
[3] ONS, DWP (2010) Households Below Average Income, table 6.1.
[4] www.ageuk.org.uk/latest-news/archive/inflation-leaves-over-55s-600-pounds-a-year-worse-off/?paging=false

Chart 3



How will the proposed legislation impact members of occupational pension schemes?

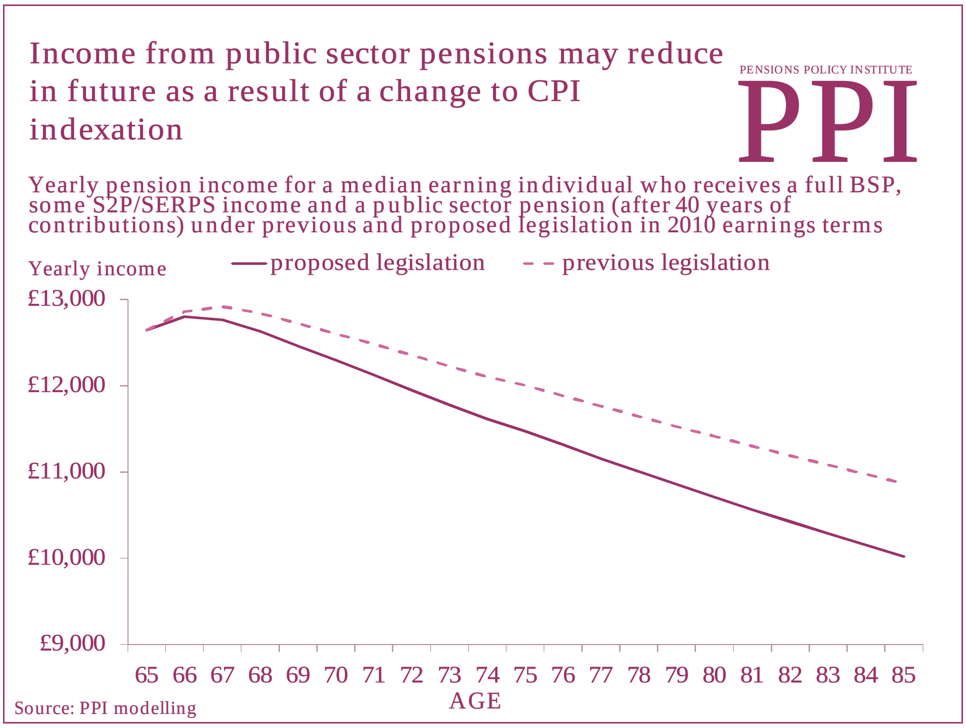
18. The Government proposes that schemes that do not have an obligation to uprate by RPI written into their rules could switch to CPI from April 2011. The Government has also announced that from April 2011 payments from state benefits, public sector pensions and S2P will be indexed to CPI. In addition, the Basic State Pension will be uprated by a 'triple lock' of earnings, CPI increase or 2.5%, whichever is higher.

19. Defined Benefit (DB) pension schemes, both in the private and the public sector, have traditionally used the RPI as the basis for uprating pension payments and for yearly revaluations of deferred member entitlements (although private sector schemes have capped RPI at 2.5% from 2004). If the legislation is enacted, then from April 2011 those pension schemes that do not have explicit references to RPI in their scheme rules will be able to use CPI for indexation of pensions.

20. Assuming average yearly increases of 2% for the CPI and 2.87% for the RPI, and allowing for the BSP to be increased in line with the

'triple lock',[5] the total yearly income that a public sector median earner man receives from the state and public sector pensions could be reduced by 4% per year at age 75 (10 years after retirement) and by 8% per year at age 85, in 2010 earnings terms (Chart 4).

Chart 4

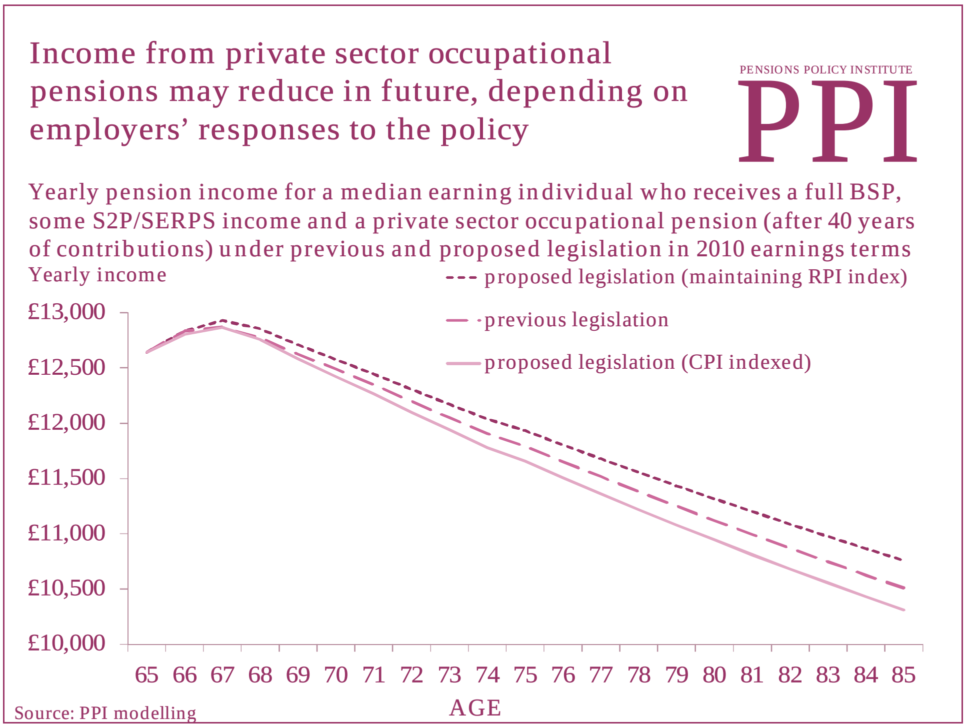


21. Similarly, a median earner man in a private sector Defined Benefit (DB) scheme that switches to CPI indexation and retires after 40 years with a full BSP and S2P could see his retirement income reduced by 2% at age 75 and by 4% at age 85 in 2010 earnings terms, from what he would have obtained if RPI indexation had remained.

22. However, if the employer continues to index his pension payments to RPI (capped at 2.5%), his total yearly pension income could be higher than under previous legislation due to the BSP triple lock, by 1% at age 75 and by 2% at age 85 (Chart 5).

[5] It is assumed that the 'triple lock' will lead to an increase in the BSP of 0.25% above nominal earnings growth of 4.5% each year, which is equivalent to a nominal growth rate of 4.75%.

Chart 5



23. Deferred members will also be affected by the proposed changes if their employer decides to switch from RPI to CPI indexation. Assuming a median earning man with 15 years of entitlement who leaves his scheme at age 40, he could see his starting pension income reduced by around 20% at age 65, from what it would have been under RPI uprating (capped at 2.5%).[6]

A switch to CPI could help the survival of DB schemes

24. A switch to CPI indexation could reduce scheme liabilities for both existing and future members, possibly making it easier to continue offering DB schemes for some employers. Between 60% and 80% of schemes have rules that require indexation by a minimum of RPI.[7] The DWP has recently estimated a reduction of £60.9bn in the total liabilities of pension schemes that could switch from RPI to CPI indexation.[8]

[6] PPI modelling
[7] NAPF (2010) Press Release: "Pension funds seek clarity on inflation switch", December.
[8] DWP (2011) Impact Assessment. The Impact of the move to CPI for Occupational Pensions, Impact Assessment. www.dwp.gov.uk/docs/cpi-private-pensions-consultation-ia.pdf

C. The Plans for Auto-enrolment in workplace pension schemes and the establishment of the National Employment Savings Trust (NEST)

25. This response focuses on the suitability or 'value' of saving for different individuals. 'Value' is calculated by modelling the internal rate of return those individuals would get from being auto-enrolled into a scheme similar to NEST, taking into account the interaction with employer contributions, tax relief and post-retirement means-tested benefits.[9]

26. This response compares the estimates produced in previous PPI analyses[10] that followed the provisions in place at the time, to more recent ones that take into account the latest changes announced by the government:
- The introduction of the 'triple lock' mechanism for the uprating of the BSP and the use of the CPI for the uprating of the S2P.
- NEST charging structure of an AMC of 0.3% per year plus an initial contribution charge of 2%.[11]
- The staging and phasing in of auto-enrolment from 2012 to 2016.

The interaction between savings and means-tested benefits

27. The minimum employer contribution and the tax relief mean that for every £1 that an employee contributes, the individual receives 77p and 28p from the employer and the state, respectively.[12] These may constitute potential incentives to save.

28. However, means-tested benefits in retirement can be disincentives to save. This is because if an individual makes private saving, then the extra income received in retirement can result in lower entitlements to means-tested benefits. There are three main means-tested benefits to which pensioners may be eligible: Pension Credit, Council Tax Benefit and Housing Benefit.[13]

29. As of 5 May 2010, it was estimated that around 60% of pensioners were entitled to some form of means-tested benefit.[14] However, the introduction of the 'triple lock' for the Basic State Pension from 2011 is likely to further reduce entitlement to means-tested benefits in the

[9] PPI individual modelling.
[10] PPI (2006) ***Are personal accounts suitable for all?*** and subsequent briefing notes.
[11] It has been recently announced that the contribution charge will be reduced to 1.8%,however, this analysis was undertaken prior to this announcement and uses the 2% figure previously announced.
[12] This is rather than 75p and 25p that would result from a strict 4:3:1 system of individual, employer and Government contributions because of the impact of income tax.
[13] Details on each benefit can be found in PPI (2010) ***The Pensions Primer***
[14] PPI estimates. See PPI (2010) Submission to the DWP Review: Making auto-enrolment work.

future. At the same time, other changes such as the CPI indexation of S2P and of pensions (and revaluation of deferred pensions) in public sector schemes and in some private sector ones could increase eligibility.

Calculating the returns from being auto-enrolled:

30. The internal rate of return is used to measure an individual's value of saving. This measure is the nominal interest rate that an individual receives on her contributions, after allowing for the effects of tax relief, employer contributions, investment returns, charges, income tax and means-tested benefits.

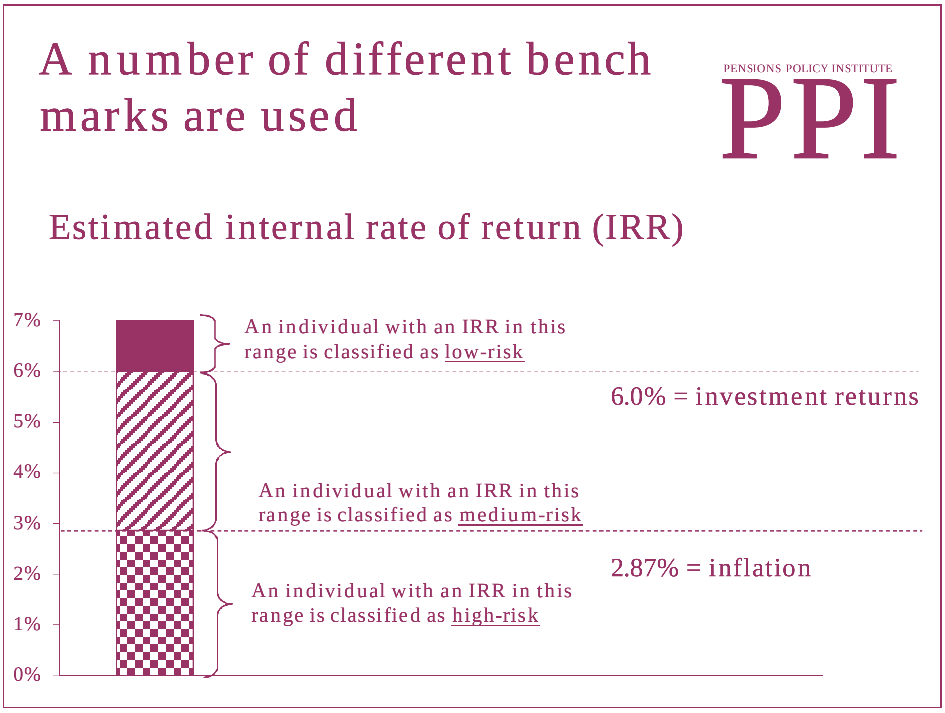
31. Individuals are classified as high-risk if they have a return of less than inflation. These individuals would be receiving a low value from auto-enrolled saving.

32. Individuals are classified as medium risk if they have a return of more than inflation but lower than the expected investment return.[15]

33. Individuals are classified as low-risk if they have a return that is higher than the expected investment return. (See Chart 6)

[15] We assumed an investments' nominal rate of return of 6% and RPI of 2.87%, which implies a real rate of return of 3%.

Chart 6



Comparing the impact on different individuals

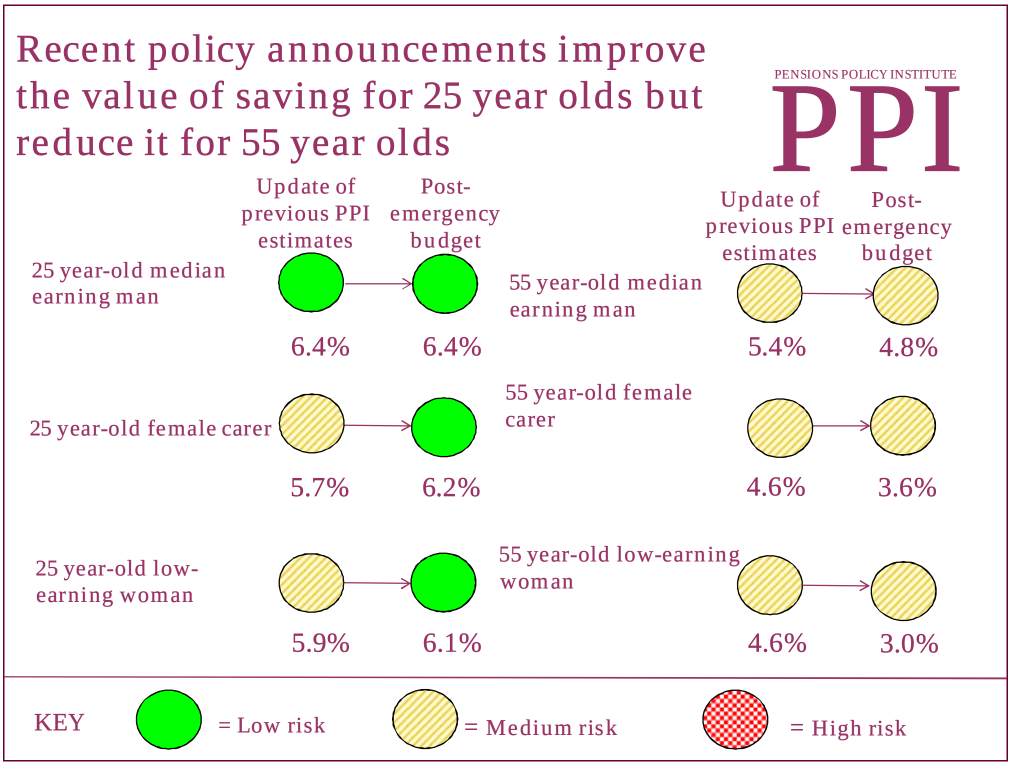
34. The initial analyses undertaken in 2006/7 highlighted that individuals with different characteristics were more or less likely to find auto-enrolment 'suitable':
- Individuals in their twenties in 2012 with full future working histories could be at low risk of auto-enrolment being unsuitable for them.
- Individuals in their twenties in 2012 with a combination of low earnings and broken working histories could be at medium risk.
- Individuals who are likely to rent in retirement could be at high risk of auto-enrolment being unsuitable for them. For these people, staying in a pension after auto-enrolment could mean a large reduction in future entitlement to Housing Benefit.
- Individuals who were auto-enrolled at an older age (55 year-old) could be at a medium risk of finding auto-enrolment unsuitable.

35. The announced 'triple lock' mechanism for the uprating of BSP will tend to improve the value of saving for all individuals with BSP entitlement, however the use of the CPI instead of the RPI for the uprating of S2P could tend to reduce the value of saving for those who have high entitlements to S2P.

36. The policy changes that include the staging and phasing in of auto-enrolment may reduce the value of saving, particularly for older individuals. If older individuals are auto-enrolled into NEST, then the new NEST charging structure may also reduce the value of saving for them. This is because the contribution charge and the delays to the introduction of auto-enrolment reduce the level of contributions and the length of time that older savers can benefit from the reforms.

37. Chart 7 compares the IRRs of individuals under the system that was in place at the time of the last analyses in 2006/7 (rolled forward to 2010) with the system now in place after incorporating the recent policy changes in NEST and state pension indexation.

Chart 7



38. The policy changes tend to increase the value of saving for younger individuals, and reduce the value of saving for older individuals:

- The IRRs for 25 year old female median earners with and without caring breaks are both increased by the policy changes.
- However, the IRRs for different individuals aged 55 in 2012 will be reduced by the policy changes.

39. The current pension reform plans do not significantly affect the value of savings for individuals who are likely to rent in retirement, who will still be at a high risk of finding auto-enrolment unsuitable if they may otherwise have qualified for housing benefit.[16] However, it should be noted that this interaction will depend on how the Government reforms housing benefit.

40. Following the review on auto-enrolment, it was recently announced that individuals with earnings above £7,475 will be auto-enrolled but that they will pay contributions on band earnings in excess of the National Insurance Primary Threshold of £5,715. Auto-enrolled workers will contribute 4% of their band earnings, employers will contribute 3% and a further 1% will be provided by the State through tax relief.

41. The announced contribution and auto-enrolment thresholds are unlikely to have an impact on the overall value of savings for different individuals over a full working life, as it is unlikely that individuals will remain within those earning levels for a significant period of their working life. PPI analysis suggests that even an auto-enrolment threshold of £10,000 would not have a significant impact on the overall value of saving for different individuals.[17]

42. However, such a threshold would reduce the number of people that could be auto-enrolled and it would especially affect lower earners and part-time workers. An estimated 600,000 individuals have earnings between £5,715 and £7,475,[18] and under the proposed policy changes these individuals would not benefit from an employer contribution that would increase their retirement income.

[16] Full modelling estimates for individuals with different characteristics are available in: ***PPI Submission to the DWP Review: Making auto-enrolment work*** (2010). Available at: www.pensionspolicyinstitute.org.uk
[17] See PPI (2010) Submission to the DWP Review: Making Auto-enrolment work, paragraphs 80 to 82.
[18] See Johnson, P., Yeandle, D. and A. Boulding (2010) ***Making Automatic Enrolment Work,*** p.100.