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Using accessible pension savings to provide a financial safety net

Introduction

Automatic enrolment (AE) into pension schemes was launched in 2012 to capitalise on people's inertia and so increase saving in private pension schemes. Unless they make an active choice to opt out, employees aged over 22 and earning above a trigger amount are automatically enrolled into their workplace pension scheme. So far opt out levels have been low, at an average of 9% of individuals.[1]

This note considers the impact of a debt prevention measure suggested by StepChange Debt Charity, which they propose is built into the pension system via automatic enrolment.

StepChange's research indicates that £1,000 of accessible cash savings could reduce the likelihood of someone falling into problem debt by 44%.[2] Incorporating cash saving into the automatic enrolment pension system may help encourage some lower-income workers to put money into non-pension savings.

This note examines the suggested policy and the potential policy implications on members of the target group of individuals.

Encouraging people to save

The aim of the policy is to use the automatic enrolment pension system to give people an accessible savings fund to meet unforeseen costs or a transitory loss of income; circumstances that might otherwise result in them borrowing and the risk of problem debt.

The StepChange proposal would mean diverting a portion of automatic enrolment pension contributions into an accessible pension savings pot, up to a maximum level. When the maximum level is reached, the diversion ends. The accessible pension savings could be instantly accessed in appropriate circumstances.

StepChange asked the Pensions Policy Institute to consider their policy proposal, and to model the potential impact on pension outcomes of individuals under their accessible savings policy.

Key points

The following is a summary of the main points of the research.

- Allowing people to avoid debt by diverting contributions from pension savings into accessible pension savings is likely to reduce private pensions. Once we consider the State Pension, the impact on total retirement income is far smaller.
- Accessible pension savings may be more easily achieved with a DC pension system as opposed to DB.
- The criteria for acceptable use of the accessible pension savings would have to be carefully considered.
- There would have to be careful consideration of tax issues surrounding accessible pensions savings in order to avoid offering any tax advantaged loophole to people who are not in financial difficulty.

Modelling the policy

The modelling for this note requires a detailed formulation of the policy. The following bullet points set out the modelled policy based on the StepChange proposal. This is one possible implementation for the analysis, actual implementation could be constructed differently.

Pension contributions are diverted from the pension fund into an Accessible Pension Savings (APS) pot in the following manner:

- There is an upper threshold to APS contributions set each year. The upper threshold determines the contributions made into the APS and when they stop. It is assumed to be uprated each year in line with an index.
- While the APS pot is less than 30% of the upper threshold, only employee contributions feed into it, at a proportion of 50% of net contributions. Employer contributions and tax relief are unaffected and enter the regular pension pot.
- When the APS is over 30% of the upper threshold, 50% of total contributions flow into it (that is 50% of contributions from the employee, employer and tax relief).
- When the APS is at the upper threshold no contributions are diverted and 100% of

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contributions remain with the main pension fund.

It is possible for the individual's APS to exceed the upper threshold as a result of interest on the fund. On accessing the APS, it is refilled again through the mechanism set out above.

The modelling assumes that the initial amount of the upper threshold is £1,000 in 2017, and that it is uprated each year in line with growth in average earnings.

It is also assumed that accessing the APS is of benefit only up to age 55. Thereafter, under the Freedom and Choice regulations, the whole of the pension scheme would be accessible.

Scenarios modelled for each case study as appropriate:

1. Baseline scenario – The individual is auto-enrolled at age 25 (or when they start work if later) and contributes at 8% of band earnings with their employer every year until State Pension Age (SPa).
2. Unused APS – The individual has funds diverted to an APS within the scheme, which they never access. At SPa their pension fund is the combined value of the APS and their main retirement fund.
3. APS used once, at age 40 – The individual has funds diverted to an APS within the scheme, which they access at age 40, taking i) the full amount ii) £500. The APS is then replenished from contributions at that point. At SPa their pension fund is the combined value of the APS and their main retirement fund.
4. APS used multiple times before retirement, at ages 35, 40, 45, 50 – In this scenario the individual faces a number of events that cause them to access their APS fund at 5 yearly intervals from age 35 to age 50, taking i) the full amount ii) 50% each time. The APS is then replenished from contributions from that point forward. At SPa their pension fund is the combined value of the APS and their main retirement fund.
5. Without an APS system the individual ceases pension contributions – In this scenario there is no APS fund and the individual stops making pension contributions at age 40 as a result of an unexpected event which might lead to debt. They re-join the pension scheme after either i) one AE cycle of 3 years, or ii) 3 AE cycles, totalling 9 years.

Table 1: Individuals modelled

Characteristics of the individuals modelled

Name	Characteristics
Laura	Laura is a low earning woman in a single adult household. She is 25 in 2017 and works every year from 2017 to her SPa at the 10th percentile level of the women's earning distribution for her age.
Sally	Sally is a median earning woman in a single adult household. She is 25 in 2017 and works every year from 2017 to her SPa at the median level of the women's earning distribution for her age.
Derek	Derek is a married man in a low earning household. He is 25 in 2017 and works every year from 2017 to his SPa at the 30th percentile level of the men's earning distribution for his age. He is married to Sue who does not work.
Rajesh	Rajesh is a median earning man in a single adult household. He is 45 in 2017 and works every year up to his SPa at the at the median level of the men's earning distribution for his age.
All the individuals are assumed to be automatically enrolled into their work pension scheme in 2017 and contribute at 8% of band earnings	

Case study modelling

Table 1 sets out the characteristics of the individuals modelled. These represent some of the characteristics of targeted individuals. Primarily these are lower earning individuals and couples, or people with no savings. The case studies are stylistic individuals designed to illustrate the policy rather than be accurate examples of working lives.

The individuals are assumed to be automatically enrolled into an employer provided pension scheme in 2017 and to remain with the employer until reaching their SPa.

The individuals are assumed to have no other savings or sources

of income in retirement, apart from the State Pension.

This note analyses:

- the amount of time taken to build up a full APS,
- the impact on the retirement pension of withdrawing full or partial APS, and
- the impact on the retirement pension of withdrawing APS more than once.

Lower paid employees take longer to build up the APS

The speed at which the APS is built up depends on the amount of the contributions being made into the pension. Higher amounts of pension contributions leads to a shorter time to build up the APS.

For Laura, a woman aged 25 in 2017 and earning at the 10th percentile of female earnings, it would take up to 7 years of diverted contributions to achieve an APS pot up to the upper threshold. For Sally, a median earning woman aged 25 in 2017, it would take around 3 years to achieve (Chart 1).

Chart 1: Number of years to save full APS

Number of years of saving by each of the case study individuals until their APS pot is at the level of the upper threshold

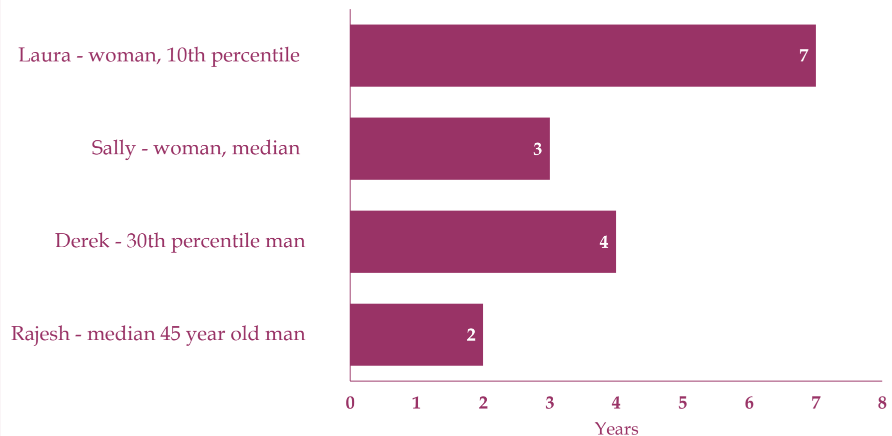
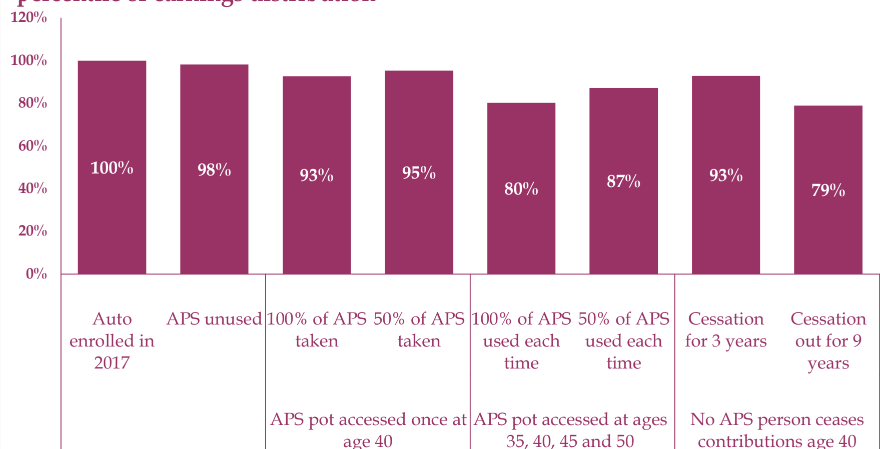


Chart 2: A low-earning woman's private pension could be reduced by diverting contributions toward accessible pension savings

Impact of modelled scenarios on pension pot at SPa, compared to private pension without diverted contributions. As achieved by Laura currently aged 25 earning at gender specific 10th percentile of earnings distribution



For Rajesh a median earning man, it would take 2 years of partially diverted contributions to reach the upper threshold of the APS pot. This is shorter than for Sally because of the gender related pay gap.

How does contributing to APS affect private pension outcome?

Diverting contributions to the APS is likely to lead to a lower private pension income in retirement when compared with all contributions being made directly into the pension scheme.

Lower contributions leads to a lower pension fund, which in turn leads to a lower pension at retirement.

Saving in an APS fund but not taking a withdrawal from it reduces the pension fund at retirement, even though unused APS is assumed to flow back to the pension pot. In Laura's case (our first case study individual who is assumed to be a low earner, at the 10th percentile level

for women of her age) her pension fund is 2% lower (Chart 2).

If the APS is unused, then the main source of the difference between the presence and absence of the APS is the investment return achieved on the main pension fund compared to the APS pot. The APS fund is likely to achieve a lower investment return because of investing in safer and realisable assets to be able to offer immediate access. In the event of a market downturn the safer assets of the APS could outperform the pension fund.

Withdrawing the whole of the APS pot once reduces the pension fund at retirement by 7%. If Laura withdraws the pot more than once there is a greater impact. Withdrawing and replenishing the APS pot four times could have the result of reducing her private pension fund by around 20%.

However if, under the current pension system, Laura decides that she cannot afford a reduction in take-home pay, then her retirement income could be more significantly impacted. Ceasing contributions for one automatic enrolment cycle of three years could reduce her private pension savings by around 7%, the same as withdrawing the whole APS pot. Ceasing contributions for three cycles, (nine years) could reduce her private pension fund by 21%. That is more than the impact of withdrawing a full APS pot four times.

Chart 3: Laura's total retirement income is less significantly affected by diverting contributions to accessible pension savings

Weekly post retirement income at SPA (age 68) achieved by Laura currently aged 25 earning at gender specific 10th percentile of earnings distribution (£ a week in 2017 earnings terms)

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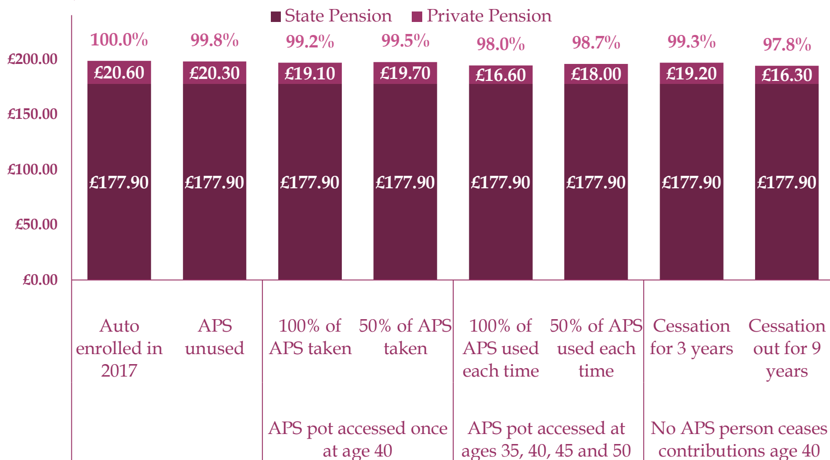

Job loss is a major financial upheaval that could lead to someone accessing the APS. If Laura were to lose her job at age 40 she could access her available APS. If she is out of work for one year then gets a new similarly paid job at age 41, then the impact on her private pension fund at retirement is projected to a reduction around 7.5% under the same circumstances but without the APS.

This compares to the drop of 7% for Laura if she took the full APS at age 40 but did not have a broken career history.

Impact may be lower when considering total retirement income

While allowing a portion of private pension savings to be diverted into an APS pot could have significant impact on the private pension fund, the impact may be less pronounced on total retirement income. For a low earner like Laura saving at the automatic enrolment minimum contribution levels, the State Pension is likely to provide the bulk of their retirement income. Their total income may therefore be relatively less significantly impacted than when taking their private pension in isolation (Chart 3).

For Laura, no scenario of making contributions to an accessible pension savings pot affects her total retirement income by more than 2%; which is when she withdraws the full APS pot four times.

Impact of the APS on pension income may reduce as earnings increase

Sally is a median earning woman. Her pension contributions are higher than Laura's so she is able to build up a larger private pension income than Laura. But,

because the maximum level of the APS is fixed irrespective of income level, the APS fund represents a smaller proportion of Sally's private pension income than of Laura's.

Having a larger pension means that the proportional impact of withdrawing funds from the APS is likely to be lower for Sally than for Laura. Withdrawing the full APS at age 40 reduces Sally's total private income by around 0.7%, for Laura the figure was around 0.8% (Chart 4).

Sally is able to build up her full APS pot more than twice as fast as Laura; in 3 years rather than in 7 years. In the scenario where she is withdrawing the APS every five years, Sally is withdrawing the full maximum amount of APS. In contrast, Laura would be unable to save the full maximum amount in that time and so would be withdrawing the amount she had managed to save.

Means-tested benefits may reduce the impact on a low income household

In 2017 Derek is a 25 year old married man earning at the 30th percentile level for men of his age. He is married to Sue, who has neither private nor State Pension entitlement. As a couple when they reach retirement they are assumed to be eligible for the means-tested Guarantee Credit, which provides a minimum guaranteed income to all pensioners.

Chart 4: A median earner' total pension is less significantly affected by APS than a lower earner

Weekly post retirement income at SPA (age 68) achieved by Sally currently aged 25 earning at the median of the female earnings distribution (£ a week in 2017 earnings terms)

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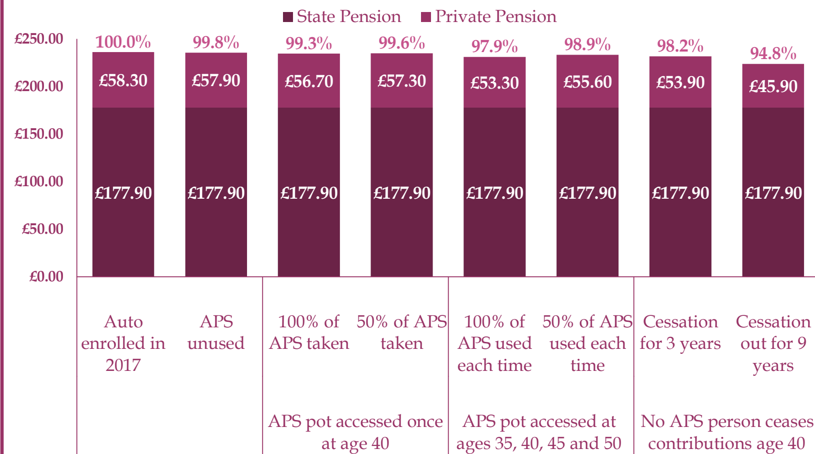

Chart 5: Total retirement income of people receiving pension credit may be largely unaffected by APS

Weekly post retirement income at SPA (age 68) achieved by Derek's household. Derek is currently aged 25 earning at 30th percentile level of earnings for men (£ a week in 2017 earnings terms)

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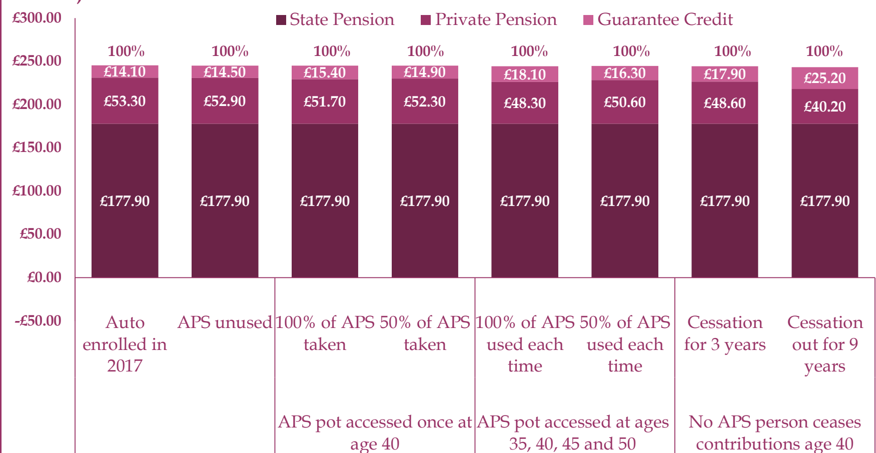


The APS policy would reduce their household income from Derek's private pension in retirement. However their retirement income would be largely unaffected as the reduction in pension income would be offset by a corresponding increase in the Guarantee Credit on a one-for-one basis (Chart 5).

There is a rule regarding "deliberate deprivation", which is intended to stop people disposing of money in order to increase their eligibility for means-tested benefits. If using an APS was

deemed to be deliberate deprivation, then Derek and Sue would not receive an offsetting increase in their Guarantee Credit and there would be a similar level of impact as for Sally.

The impact could be greater on people starting pension saving in middle-age

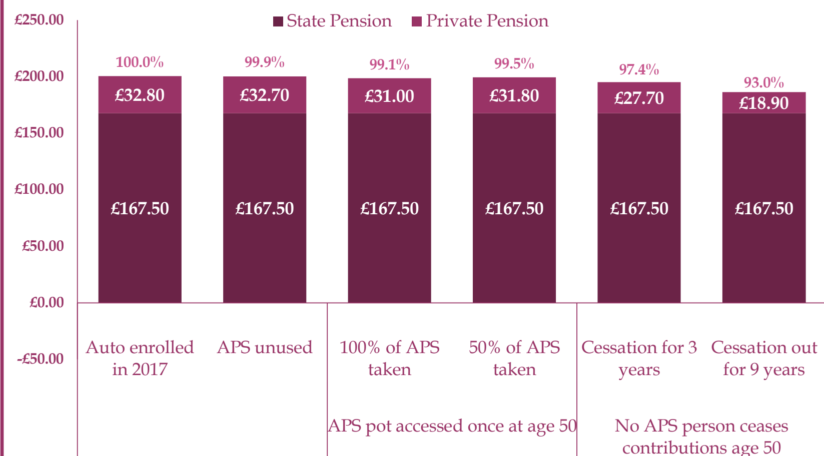
Rajesh is a 45 year old median earning man without any prior pension savings. He is assumed to be automatically enrolled in 2017. He has 20 fewer years to build up a pension than the other case studies.

Because he has fewer years to save, the loss of any contributions to his pension saving is significant to Rajesh. Using the APS results in a larger reduction in his retirement income than for Sally or Laura (Chart 6). Withdrawing the full APS once reduces Rajesh's retirement income by 0.9%, compared with a reduction of 0.7% for Sally.

Implications for the target market

The target market of low earners may see a small reduction in their private pension income at retirement because of the APS, especially if they use the pot.

However, having access to a portion of their pension fund may have the double benefit of making pension schemes more attractive to people who might otherwise feel that they could not afford to save in a pension and to also build up a cushion against financial hardship. The case studies show



that ceasing contributions could be more damaging to pension savings than the APS.

For example, ceasing contributions would be very damaging for Rajesh's pension income. If he were faced with a choice between saving in a pension scheme or paying off a problem debt, then the impact of ceasing contributions for one automatic enrolment cycle of three years could reduce his private pension saving by 16%, whereas having access to accessible pension savings and withdrawing the whole APS pot once reduces his private pension pot by 6%.

Implementation issues

The accessible pension savings pot would be a significant change to the pension system and comes with a number of issues that would need careful consideration.

In what circumstances would a withdrawal from the APS be allowed?

The APS contains contributions from the employer and tax relief from the government that are ostensibly intended to be part of pension savings, rather than just a freely accessible account. It may therefore be considered appropriate to place some limitation on the conditions of access to the APS.

So withdrawal from the APS may be available under prescribed circumstances or to pay for a defined range of expenses. For example this could include emergency home repairs such as a boiler replacement, but not for a holiday cruise.

However this may be difficult to implement in practice, as it would be difficult to know how people used the money.

Implementation may be difficult for Defined Benefit pension schemes

The APS fund works within the contribution and savings structure of a Defined Contribution pension scheme, however implementation within a Defined Benefit scheme structure would be more complicated to introduce. This has also been the case for other recent pension policies, such as the Freedom and Choice initiative. Most automatic enrolment schemes are Defined Contribution.

Tax status for Accessible Pension Saving

Tax on the APS pot could be a complex issue. In the pension fund, contributions are eligible for tax relief, investments are granted favourable tax treatment, then when accessing the pension, there is an allowance to take up to 25% of the pot as a tax free lump sum, but the rest of the pot is taxed at the individual's marginal rate.

The APS pot would receive diverted contributions from tax exempt pension contributions. The APS pot may have to mirror the tax structure used in pension schemes. That could mean that tax is paid at the marginal rate on withdrawals made from the pot, or that the APS is counted as part of the tax free lump sum.

If it is subject to tax at the marginal rate then a basic rate taxpayer who withdraws £1,000 from the APS pot would pay tax of £200 and receive £800. This would need to be clear to people when making withdrawals in order to make sure they are fully informed and ensure that they withdraw the correct amount for their requirements.

Having instant access to pension savings may encourage people to find ways to use the APS system to avoid tax. For example, someone with fluctuating pay might choose to take a withdrawal from the APS in years where they have a lower marginal tax rate, and increase pension contributions in years where they have a higher tax rate. If that were to happen it could increase the cost of tax relief to the Government.

APS and the pension scheme

The APS could either be part of the pension scheme or could be an entirely separate entity, perhaps with a separate provider.

Being part of the pension scheme could bring some administrative advantages because the data is all in one place and it would be easier to track contributions. It might also ease combining the APS back into the pension scheme at retirement.

However having the APS and pension scheme as part of the same scheme could cause issues when moving employment. Making correct contributions to the APS requires keeping a running total of an individual's total APS entitlement which could be difficult if different APS pots are scattered round employers. This may also lead to difficulties when trying to access the multiple pots.

This concern could be eased if the APS were to be integrated into the planned "pensions dashboard" which is intended to bring all pension savings information together in one place. This would allow monitoring of the total level of APS.

Claiming the correct tax relief would require clear communication between providers

Under the policy set out, contributions made to the APS pot are separated from the tax relief on those contributions, which is paid into the pension scheme. This would require reliable communication between the pension provider, the APS provider and the employee's payroll department in order to ensure that the correct tax relief is being claimed.

Could existing saving products be used for the APS?

The Lifetime ISA (LISA) offers a tax favoured savings vehicle for people who want to save either for retirement or buying a house. LISAs do not allow early access except under certain circumstances; for a house purchase, or in the case of terminal illness.

A conventional ISA does allow access before retirement, however under automatic enrolment rules contributions must be paid into a pension scheme, not an ISA which

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has a substantially different tax structure.

As it stands the Lifetime ISA or conventional ISA may not be a good fit for providing the APS. Differences in tax structures between the ISAs and the pension scheme products may make the two incompatible. However the providers of Lifetime ISAs and other financial providers may have the structures in place to provide the APS.

Summary of results

- The amount of time that contributions are being diverted from the pension fund depends on the contributions being diverted. This could influence how attractive the APS is to individuals.
- While diverting contributions to the APS is likely to lead to a lower private pension income in retirement, if the alternative is to cease contributions for one AE cycle of three years, ceasing contributions could be more detrimental than taking the full APS pot once.
- For a low earner, the State Pension is likely to provide the majority of their retirement income, so a reduction in their private pension is not such a large reduction in their total retirement income
- If an individual or couple were eligible for Guarantee Credit then they may not see any reduction in their retirement income as the income guarantee would cover the reduction in pension income.
- However if using APS were to be considered deliberate deprivation then the Guarantee Credit may be restricted.
- The APS system would most easily be incorporated into a Defined Contribution pension system.
- The definition of allowable circumstances to access the APS would need to be considered. Could the APS be freely accessed for any purpose or should there be defined criteria for its use?
- There would have to be careful consideration of tax issues surrounding the APS to ensure that the intended target group are able to use the APS, but without offering a tax loophole to those who are not part of the target group.
- Other practical considerations include whether the APS would be provided through a centralised fund, or within the pension scheme or with external providers.

This Briefing Note was commissioned by StepChange. We are grateful to StepChange for their support in producing this note.

[1] Department for Work and Pensions (2016) *Employers' Pension provision survey 2015*

[2] StepChange (2015) *Becoming a nation of savers* https://www.stepchange.org/policy-and-research/becoming-a-nation-of-savers.aspx

StepChange Debt Charity

For more information on this topic, please contact
John Adams, Senior Policy Analyst
020 7848 3675 john@pensionspolicyinstitute.org.uk

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