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Increasing the value of saving in Personal Accounts:

taking small pension pots as lump sums

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Pensions Policy Institute

Women. Men. Different. Equal.
Equal Opportunities Commission

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EXECUTIVE SUMMARY

Personal Accounts

Many people are not currently saving enough for retirement to secure the level of income they are likely to consider adequate. As a response, the Government has proposed Personal Accounts, a new national pension savings scheme targeted at low to median earners not currently saving for retirement, which would be introduced in 2012.

Individuals over the age of 22 and earning more than around £5,000 would be auto-enrolled into a Personal Account or an approved equivalent scheme, with the right to opt out. Auto-enrolment has many potential advantages and should increase the number of people who save for retirement. However, there are risks involved with the policy. Stakeholders have expressed concern that some employees may be auto-enrolled into a product that is not suitable for them. This could lead to a significant number of individuals seeing little or no benefit from saving in Personal Accounts, which may had an adverse impact on the number opting out. This risks reducing the benefits of the reform package and undermining the potential for reducing long term reliance on means testing.

There are several different definitions of ‘suitable’. Many factors could be taken into account when deciding whether saving in a Personal Account is suitable for a particular person, including whether they can afford the contributions, their levels of unsecured debt and their desire to smooth consumption over their lifetime. This paper categories individuals as being at low risk, medium risk or high risk of Personal Accounts being unsuitable for them, depending on the effective rate of return they are likely to receive. The effective rate of return takes into account the complex interaction between Personal Accounts, state pensions and the tax and means-tested benefits systems.

There are certain characteristics that, when combined, could lead to lower effective returns from Personal Accounts. Many of these factors, such as low earnings, broken working histories, low levels of saving and being single in retirement are factors more likely to affect women than men whereas men are more likely than women to be self-employed. Women and men have similar rates of renting accommodation in retirement.

Lump sums in retirement

Taking a lump sum can lead to higher entitlements to means-tested benefits and a higher return from saving. This is because small amounts of capital can be treated more advantageously than equivalent amounts of pension income, when calculating entitlements to means-tested benefits.

All individuals can take 25% of their pension saving as a tax-free lump sum, which can increase their returns from saving. Trivial commutation allows people with small pension funds (limited to those below £15,000 in 2006/7) to take their entire pension saving as a lump sum, without having to buy an annuity. The Government has suggested that individuals with small amounts of saving in Personal Accounts could use trivial commutation as a way of improving their effective return.

Currently around 13% of people are on course to have pension saving that is within the current trivial commutation limit of £15,000 when they retire. Women are more likely to be able to trivially commute than men (16% of women and around 10% of men) because they typically have smaller pension funds. They also have lower incomes in retirement.

However, trivial commutation would not be appropriate for everybody who is at-risk of Personal Accounts being unsuitable for them:

- For people who have non-pension saving, the current system of trivial commutation may provide a particular incentive to spend lump sums quickly. This is because their capital disregard (the amount of saving and other capital that is ignored when calculating entitlement to means-tested benefits, currently £6,000) may have been used up by the non-pension saving, so that capital is treated less, rather than more, advantageously than equivalent amounts of pension income. For these people, it may not be possible to save lump sums for later consumption without a large negative impact on their entitlement to means-tested benefits.

- The trivial commutation limit is a global limit, applying to a person's combined private pension saving from all sources. Pension saving besides Personal Accounts, perhaps made before 2012 into an occupational or personal pension, may reduce the potential for an individual to trivially commute their saving in Personal Accounts.

- People who have previously contracted-out of the State Second Pension, without making voluntary saving in addition to the rebate, may be less likely to be able to trivially commute small amounts of Personal Accounts saving than those who have remained contracted-in. This is because any private pension that results from the contracting-out rebate counts against the trivial commutation limit.

- People who are even marginally above the trivial commutation limit will not be able to trivially commute. People in this group may be at medium or high risk of Personal Accounts being unsuitable for them, such as some people with a combination of low earnings and broken working histories, those who rent in retirement and those who spend time self-employed.

Reforms proposed by the EOC

The Equal Opportunities Commission (EOC) has specifically asked the PPI to analyse a series of reforms to the trivial commutation limit, which could improve the suitability of Personal Accounts. These include increasing the trivial commutation limit from £15,000 to £30,000. The capital disregard for means-tested benefits would at the same time be increased from £6,000 to £10,000 and the upper capital threshold, which marks the cut-off point for eligibility to Council Tax Benefit and Housing Benefit, would be increased from £16,000 to £50,000.

This policy could increase the proportion of retirees who are able to trivially commute by around 9%, from 13% to 22%.

The policy could improve returns from saving for both women and men. Some examples of people with a combination of low earnings and broken working histories could be lifted from medium risk to low risk of Personal Accounts being unsuitable. Some examples of people who rent in retirement or who spend time self-employed could be lifted from high risk to medium risk.

Increases to the trivial commutation limit and capital disregard may increase the rate of return for some people who would already be in the low-risk group under current policy, such as some individuals in couples.

The EOC also asked the PPI to analyse a new drawdown product. This would enable individuals to choose to take their trivial commutation lump sum and use it to buy a special type of temporary annuity lasting ten years, which would not count in the calculation of entitlement to means-tested benefits. If the drawdown product was incorporated alongside a trivial commutation limit of £30,000 and a capital disregard of £10,000, then it may encourage individuals to buy voluntarily an annuity with part

of their lump sum. Voluntarily buying this special type of annuity could increase the effective rate of return even more for some individuals and mean that the examples of people who spend time in self-employment could be lifted from medium risk to low risk.

Reform costs

The reforms to increase the trivial commutation limit to £30,000 and the capital disregard to £10,000, could cost the Government around £500 million a year if they were introduced in 2012. The bulk of the cost would result from higher entitlements to means-tested benefits. To put these figures in context, £500 million is around 4% of the current cost of pensioner means-tested benefits, or around 2% of the current fiscal cost of tax and National Insurance relief on private pension saving.

The cost of the reforms would grow over time, to around £1,400 million by 2050. This would represent an increase of 20% on the projected level of spending on pensioner means-tested benefits in 2050.

It is very important to realise that these cost estimates are subject to a very high degree of uncertainty and should only be considered illustrative. Estimates are based on current behaviour and the pattern of pension incomes observed today persisting into the future.

Returns could be further increased by increasing the capital disregard to £30,000. This could cost an additional £2 billion a year on top of the current system in 2012.

Conclusion

The lower the risk that people are auto-enrolled into a product which is not suitable for them, the lower the risk that they later discover that Personal Accounts did not deliver for them, which may have repercussions for future Governments. However, the reforms proposed by the EOC could improve the suitability of Personal Accounts as a savings scheme for both women and men by improving their rate of return.

Estimating the number of women and men who fall into the different risk categories can only be carried out by use of dynamic models, such as those used by the Government. Ideally, the Government should project the number of individuals in each group who are likely to be affected by Personal Accounts, and the possible range of outcomes from a policy of auto-enrolment. The clearer the Government can be about the value of saving in Personal Accounts, the more likely Personal Accounts are to meet their aim.