PENSIONS POLICY INSTITUTE

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Are Personal Accounts suitable for all?

Summary of conclusions

The Government recently proposed a new system of Personal Accounts be introduced from 2012. Auto-enrolment into private pension provision has potential advantages and should lead to an increase in the number of people saving for retirement.

Personal Accounts could give many people access to a low-cost pension savings product with an employer contribution for the first time. As a result of the low charges and employer contribution, incomes from saving in Personal Accounts are likely to be higher than incomes from saving in Stakeholder Pensions for many people.

Inevitably, auto-enrolment raises questions about the suitability of Personal Accounts for the employees who are auto-enrolled. In this paper, Personal Accounts are defined as being 'suitable' if individuals do not lose out as a result of their saving. This is a less stringent definition than ensuring that saving in Personal Accounts is the right thing for all consumers, which would be more consistent with the FSA's definition of 'suitability'.

In this paper, individuals are categorised by being at low risk, medium risk or high risk of Personal Accounts being unsuitable for them, depending on the effective level of return that they are likely to receive.

No single definition of 'suitability' is likely to be appropriate for the circumstances of every individual. For some people, it may be rational to save even if they have a low return on their saving, for example, if they have a strong preference to smooth consumption over their lifetime. On the other hand, some people may require a high return, for example if they are very risk-averse or have high levels of debt.

People at <u>low risk</u> of Personal Accounts being unsuitable for them are likely to receive back the value of their individual contributions to Personal Accounts, together with a full investment return on their contributions. Examples are:

- Single people in their twenties in 2012 with full working histories.
- Single men in their forties and fifties in 2012 who have a full working history and large additional savings.

People at <u>medium risk</u> of Personal Accounts being unsuitable for them would receive back the value of their individual contributions, protected for inflation, and some investment returns on their contributions, although they may not receive full credit for the investment returns. This group includes:

- Single people in their twenties in 2012 with low earnings and broken working histories, whether because of caring breaks or unemployment.
- Single people in their forties and fifties in 2012 with low earnings and full working histories.
- Single people in their twenties in 2012 who stay opted in to Personal Accounts while employed, and then become self-employed at a later date.

People at high risk of Personal Accounts being unsuitable for them are likely to receive back less than the value of their contributions into Personal Accounts. This group includes:

- Single people who are likely to rent in retirement and have no additional savings.
- Although they would not be auto-enrolled, single people in their forties and fifties in 2012 on low to median incomes who are self-employed.

Other factors can affect whether or not Personal Accounts are suitable:

- Returns from saving in Personal Accounts could be higher for people who are married at some point in retirement, rather than always single as the above examples assume. The majority of pensioners are married at some point in their retirement, so this could improve suitability for many people.
- It may still be advisable for some people in the high-risk category to save. For example, they could have a strong preference to smooth consumption over their lifetime.
- Conversely, it may not be advisable for people in the low-risk category to save, for example if they have high levels of debt. Levels of both secured and unsecured debt appear historically high and a sizeable minority of people carry over credit card balances from month to month.
- Whether contributions are affordable will depend on individual preferences on current expenditure and saving.

If Personal Accounts are not suitable for everybody, then this does not necessarily mean that individuals should not be auto-enrolled. But it does have important implications for what information is needed to help people make informed decisions about whether they should opt out.

Some of the factors that affect the suitability of Personal Accounts could be more problematic than others to incorporate into a system of generic information. Clearly, no-one can predict with certainty all of their future life circumstances when making a savings decision. Some factors may be relatively straightforward to reflect in a system of generic information, such as current age, earnings and level of debt. Others may be more difficult, such as the affordability of contributions and likely future housing or marital status. However, these findings do suggest that people will need very clear information to help them make informed decisions about whether they should stay in or opt out of Personal Accounts.

Two further factors for the Government to consider are:

- The design of the information provided for Personal Accounts may need to change over time, to reflect the gradual transition to the proposed pensions system, which could affect today's younger and older workers differently.
- Trivial commutation may improve returns from saving in Personal Accounts. How the trivial commutation limit is uprated in future could make a large difference to some people.