PPI Submission to the Workplace Retirement Income Commission

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 summary of evidence to the Workplace Retirement Income Commission. It covers the following questions:

- Q2. What are the barriers to getting people to save, and to save more, for their retirement?
- Q3. How do you think employees and employers will respond to auto-enrolment?
- Q6. What are the remaining gaps in coverage both in terms of types of worker who will be at risk of undersaving for retirement and sectors of the labour market?
- Q7. What level of income should individuals be targeting in retirement?
- Q8. Is an 8% total contribution enough to achieve the desired outcomes? If not, what are the potential policy responses and how might these be delivered?
- Q11. What are the respective roles of Government, employers, individuals, employees and other groups (e.g., trade unions) in helping to improve understanding about the need to save for retirement?
- Q13. In saving for retirement, how much risk is appropriate for the employee to bear and how much is appropriate for the employer to bear? Could risks be shared differently or more equitably? Does the capacity for risk alter with firm size?
- Q17. What impact will the increase in the State Pension Age and the abolition of the default retirement age have on a) employee behaviour and b) employer behaviour?
- Q20. Does the current structure of tax relief incentivize the right people? If not, what would a more effective structure look like?

III. There are a number of policy areas which the PPI feels the Commission may wish to focus on:

a. The Commission may want to consider ways of encouraging both employers and employees to contribute to pension funds at higher than the minimum levels of 8% of band earnings that will be required in legislation.
b. The Commission may wish to consider ways to encourage employers with existing good pension schemes to auto-enrol their eligible employees into those good pension schemes, and ways to reduce the likelihood of individuals opting-out of pension saving once they have been auto-enrolled.
c. The Commission may wish to focus on who will provide advice and information to people who are likely to have to make more choices and more complex financial decisions about their retirement savings during their working life, at the point of retirement and during retirement.
d. The Commission may wish to consider how well different individuals with different characteristics are likely to be able to cope with the inherent risks in Defined Contribution pension schemes.
e. The Commission may want to consider the implications of the Government's policy agenda to extend working lives for providers of private pensions, for employers and for pension scheme members.

1. Q2. What are the barriers to getting people to save, and to save more, for their retirement? People's savings decisions are influenced by their own particular financial circumstances, attitudes and behaviour. While auto enrolment might address some of the behavioural factors such as inertia,[1] financial constraints also play a part in people's decisions not to save; more than half of people not saving in a pension in 2010 cited lack of affordability as the reason for not saving.[2] The potential interaction between low levels of savings and means tested benefits which could result in people losing out as a result of saving,[3] may also discourage some low income individuals from saving in a pension.

2. Q3. How do you think employees and employers will respond to auto-enrolment? Assuming that opt-out rates after auto-enrolment are in line with Government expectations of around 25%,[4] the Government estimates that the proportion of people with private pension savings after 2012 could rise from around 40% of the working age population in 2010 (around 14 million people)[5] to around 21 million people, or roughly 60% of the UK working-age population, once auto-enrolment is fully implemented.

3. Previous PPI research has modelled different scenarios of how employers could respond to auto-enrolment and found that there could be a wide range of outcomes for the flow of contributions into private pension funds in the UK once auto-enrolment takes place depending on how employers respond to the Government's reforms:
   - In the absence of auto-enrolment and the introduction of conditional, compulsory employer contributions, contributions into private pensions are projected to fall from around £40 billion in 2006/7 to around £30 billion by 2050 (in 2006/7 earnings terms), the 'no-reform scenario.' This is due to the assumption that employers continue to close DB pension schemes and replace them with less generous DC schemes.
   - The PPI modelled four stylised scenarios to show the possible implications of employers responding to auto-enrolment and the introduction of conditional, compulsory employer contributions in different ways.

[1] For a list of behavioural characteristics that influence savings decisions see Elliot, A. Dolan, P. Vlaev, I. Adriaenssens, C. Metcalfe, R. (2010) ***Transforming Financial Behaviour: developing interventions that build financial capability*** www.cfebuk.org.uk/pdfs/20100713_transforming_financial_behaviour.pdf
[2] ABI Quarterly Survey 2010 Q3, 55% did not save in a pension because they 'had no spare money.' www.abi.org.uk/Publications/52295.pdf
[3] PPI (2006) ***Are Personal Accounts suitable for all?***
[4] DWP (2009) DWP Factsheet: ***People benefiting from private pension reform: explanation of participation estimates*** www.dwp.gov.uk
[5] PPI analysis of Family Resources Survey 2005/06 and 2006/07

- The modelling indicated that in the most optimistic scenario, in which all employers with an existing good pension scheme auto-enrol all eligible employees into their existing schemes and employers who currently offer no pension offer at least the legal minimum required by legislation, auto-enrolment could increase total annual pension contributions (made by individuals, employers and the state combined) by up to £10 billion by 2050 (in 2006/7 earnings terms) compared to the no-reform scenario.
- In the most pessimistic and extreme scenario, in which all employers with existing pension schemes were to "level-down" their contributions to the minimum level of 8% combined contributions on a band of salary and employers with no pension schemes offer the legal minimum levels of contributions, total annual pension contributions into UK pension funds (made by individuals, employers and the state combined) could be reduced by up to £10 billion by 2050 (in 2006/7 earnings terms) compared to the no-reform scenario.[6]
- This wide range of potential outcomes from the reforms highlights how important the response of both employers and individuals to the introduction of auto-enrolment will be in determining the final impact on overall <u>levels</u> of pension saving in the UK.

4. The Commission may wish to consider ways to encourage employers with existing good pension schemes to auto-enrol their eligible employees into those good schemes, and ways to reduce the likelihood of individuals opting-out of pension saving once they have been auto-enrolled.

5. Q6. What are the remaining gaps in coverage both in terms of types of worker who will be at risk of undersaving for retirement and sectors of the labour market? Levels of pension savings differ between people of different genders, ethnicities and geographical location. Women, ethnic minorities, people with disabilities, the self-employed and people who take time out of work to care will often have lower levels of private pension savings than average.
   - Receiving income from occupational pensions is often associated with higher income in retirement than receiving income from some other sources such as state benefits.
   - In 2008 male pensioners received an average of 26% of their income from occupational pensions while female pensioners received an average of 20%.[7]

[6] PPI (2007) ***Will personal accounts increase pension saving?*** See also PPI Briefing Note 42
[7] PPI (2010) ***Retirement Income and Assets: Do pensioners have sufficient income to meet their needs?***

- In 2008, 60% of White pensioners, 43% of Chinese/Other, 38% of Black/Black British pensioners and 30% of Asian/Asian British pensioners received some income from occupational pensions.[8]
- Disabled people and people from ethnic minority groups are less likely to be accruing private pension savings than the average for the whole population. In 2005/06, 63% of all people aged between 45 and 54 were accruing a private pension, however 55% of people with disabilities and 54% of people from ethnic minority groups aged between 45 and 54 were accruing a private pension.[9]

6. Q7. What level of income should individuals be targeting in retirement? Income needs vary during retirement as a result of changes related to ageing, health, and economic circumstances.[10] The majority of people feel that in order to be satisfied with their level of income in retirement, their income will need to provide them with a standard of living similar to the standard they experienced in their working life. Most pensioners can achieve a similar standard of living with an income in retirement of between 50% and 80% (gross) of their working life income.[11] For example, a median-earning man with a weekly income at the point of retirement in 2010 of around £460pw[12] might need a gross weekly retirement income of around £320pw to meet a 70% replacement rate of working life income (and recreate working-life living standards).[13]

7. Modelling results suggest that in future, some pensioners with lower incomes may find it easier to meet their target replacement rates, as established by the Pensions Commission, because of the reforms to state pensions which were legislated for in the Pensions Act 2007.[14]

8. However, the private sector shift from DB to DC may mean that more moderate to high income pensioners will find it hard to meet their target replacement rate from state and private pension income alone. These pensioners may need to supplement their income with other savings and assets. Conversely, they may need to either defer their retirement or increase their contributions during working life.

[8] PPI (2010) ***Retirement Income and Assets: Do pensioners have sufficient income to meet their needs?***
[9] PPI analysis of the Family Resources Survey 2005/06, PPI (2008) ***The under-pensioned: disabled people and people from ethnic minorities***
[10] PPI (2010) ***Retirement Income and Assets: outlook for the future.*** Chapters 1 and 2.
[11] Pensions Commission (2004) ***Challenges and Choices: The First Report of the Pensions Commission*** TSO
[12] 50th percentile, age-specific earnings, Labour Force Survey (2008)
[13] Pensions Commission (2004) and PPI calculations
[14] PPI (2010) ***Retirement Income and Assets: outlook for the future.***

9. Q8. Is an 8% total contribution enough to achieve the desired outcomes? If not, what are the potential policy responses and how might these be delivered? The Pensions Commission found that a total contribution rate of 8% of band earnings could allow a hypothetical median earning (private sector) member of NEST,[15] to achieve a replacement rate of around 45% of pre-retirement earnings (from state and private pension income) compared to a target replacement rate of 67%.[16] This shows clearly that an 8% total combined contribution will not be sufficient for many individuals, particularly median and higher earners to have adequate retirement incomes, unless they are able to use other income and assets to make up the shortfall.

10. The Pensions Commissions modelling results also indicated that by doubling total contributions to 16% of band earnings, a median earning member of NEST could achieve his target replacement rate of 67% of pre-retirement earnings with income from both his state and private pensions. The Commission may want to consider ways of encouraging both employers and employees to contribute to pension funds at higher than minimum levels.

11. Q11. What are the respective roles of Government, employers, individuals, employees and other groups (e.g., trade unions) in helping to improve understanding about the need to save for retirement? The state and private pension systems in the UK are already complex and recent policy changes (for example, changes to taxation on pension contributions, the removal of the requirement to annuitise and the introduction of Capped and Flexible Drawdown) have increased not only their complexity but the level of choice individuals face both in the accumulation of savings and in the decisions they need to make when they come to access their pension savings.

12. Advice and information services will need to be able to support people who are likely to have to make more choices and more complex financial decisions about their retirement savings during their working life, at the point of retirement and during retirement. However it is not currently clear who will be responsible for providing the advice and information that people will need in order to navigate the pension system and make the right decisions for their individual needs. The Commission may wish to focus on who will provide advice and information and what form this advice might take.

[15] Retiring in 2053
[16] Pension Commission (2005) ***A New Pension Settlement for the Twenty-First Century***, p.283.

13. Q13. In saving for retirement, how much risk is appropriate for the employee to bear, and how much is appropriate for the employer to bear? Could risks be shared differently or more equitably? Does the capacity for risk alter with firm size? Previous PPI projections have shown that active DB membership in the private sector are very likely to reduce significantly from current levels of around 2.5 million. Active membership in DC schemes could grow from an estimated 5 million in 2008 to around 15 million by 2020 and around 17 million by 2050.[17] These estimates highlight the trend in the private sector for the risks associated with pension saving to be passed from the employer to the employee, particularly investment and longevity risks.

14. The Commission may wish to consider how well different individuals with different characteristics are likely to be able to cope with the inherent risks in Defined Contribution pension schemes.

15. Hybrid schemes that are designed to share risks between employees and employers are growing (though still small).[18] However, there is not a lot of appetite amongst private sector employers to engage further in risk-sharing schemes and so it is unlikely that without a significant push the market for risk-sharing schemes will grow much further.[19]

16. Q17. What impact will the increase in the State Pension Age and the abolition of the default retirement age have on a) employee behaviour and b) employer behaviour? Once individuals have left the labour market at older ages it may be difficult for them to re-enter it.[20] There is already a gap between the current SPA and when many people choose to retire.

17. 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 were still economically active, by age 60-64 that figure drops to 54%. 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 were still economically active, but by age 60-64 that figure drops to 34%.

18. It is not clear that raising the SPA will cause people to work for longer, though the Government intends SPA rises to encourage people to work

[17] For this section, see PPI (2009) ***Retirement Income and Assets: how can pensions and financial assets support retirement?*** p.22 to 26
[18] See PPI (2007) ***The Changing Landscape for Defined Benefit Pension Schemes.***
[19] IGNIS Asset Management (2010) ***Sharing the Pensions Challenge: What role for risk-sharing arrangements in workplace pensions?***
[20] See PPI (2011) ***Submission to the Work and Pensions Select Committee on the Government's Pensions Reforms***

longer. The Commission may want to consider the implications of the Government's policy agenda to extend working lives for providers of private pensions, for employers and for scheme members.

19. Q20. Does the current structure of tax relief incentivise the right people? If not, what would a more effective structure look like?
Tax relief on pension contributions is not equally distributed amongst pension savers. Around 60% of all tax relief on pension contributions goes to higher rate tax payers.[21] In general, there is evidence that tax relief is poorly understood.[22] Alternative approaches that could be more equitable and might be easier for people to understand could be:
- moving towards a system where matching contributions are made by the Government (or re-casting the current system using that terminology); or,
- shifting the balance of incentives to lower rate taxpayers by limiting tax relief on pension contributions to the Basic Rate of Tax.
- However, this must be balanced by the impact of changing the tax relief system on DB schemes and on those individuals who would receive lower levels of tax relief. This could have broader impacts on levels of employer pension provision.[23]

20. Summary
In summary there are a number of areas which the PPI feels the Commission may wish to focus on:
a. The Commission may want to consider ways of encouraging both employers and employees to contribute to pension funds at higher than the minimum levels of 8% of band earnings that will be required in legislation.
b. The Commission may wish to consider ways to encourage employers with existing good pension schemes to auto-enrol their eligible employees into those good pension schemes, and ways to reduce the likelihood of individuals opting-out of pension saving once they have been auto-enrolled.
c. The Commission may wish to focus on who will provide advice and information to people who are likely to have to make more choices and more complex financial decisions about their retirement savings during their working life, at the point of retirement and during retirement.

[21] PQ Ian Pearson, House of Commons Hansard 9 October 2008 Column 796W
[22] Opinion Leader (2008), ***Pensions Taxation Reforms: a baseline study of individuals.*** HMRC, London
[23] PPI (2011) ***The impact of tax policy on employer sponsored pension provision***, p.51.

d. The Commission may wish to consider how well different individuals with different characteristics are likely to be able to cope with the inherent risks in Defined Contribution pension schemes.
e. The Commission may want to consider the implications of the Government's policy agenda to extend working lives for providers of private pensions, for employers and for pension scheme members.