PENSIONS POLICY INSTITUTE

PPI

Written Evidence on the Pensions Bill 2007-8

Niki Cleal, Director, on behalf of the Pensions Policy Institute

Summary

I. There is widespread support for the principle of auto-enrolment and broad agreement that the proposed levels of contribution to personal accounts (4% individual, 3% employer and 1% from tax relief) are reasonable.

II. However, there are two significant concerns about the Government's proposals for personal accounts:
- Personal accounts may not be suitable for all employees due to their interaction with means-tested benefits; and
- There remains a significant risk of levelling-down of existing pension provision.

III. PPI analysis has shown that:
- People in their twenties in 2012 who remain opted-in may be at low risk of personal accounts being unsuitable;
- Single people who rent in retirement are likely to be at high risk of personal accounts being unsuitable;
- Some low-earning individuals in their forties and fifties in 2012 with no additional savings are at medium risk of personal accounts being unsuitable. This is because they may lose entitlement to means-tested benefits as a consequence of saving in a personal account.

IV. This does not mean that people should not be auto-enrolled, but does imply that people will need very clear information and generic advice to help them make informed decisions about whether they should stay in or opt out of personal accounts.

V. An important test of the personal accounts policy will be whether it is possible to design information and generic advice in a simple and easy to understand way to help people decide whether they should opt-out of personal accounts.

VI. There are policy options that the Government could consider to improve the incentives to save for some of the "at risk" groups. Increasing the trivial commutation limit or introducing a limited pension income disregard could improve the returns from personal accounts for some individuals at a cost of increasing Government expenditure on means-tested benefits.

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Introduction

The role of the Pensions Policy Institute

1. 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 does not make policy recommendations, or support any one reform solution, but exists to contribute facts and analysis to help all commentators and policy decision-makers.

2. This response gives the PPI's analysis of the Government's proposals to introduce a requirement for auto-enrolment, for minimum employer contributions and for a new system of personal accounts as set out in Part 1 of the Pensions Bill 2007/8.

3. The PPI's published research in this area includes an assessment of:
   - A stocktake of key stakeholders' views on the Government's White Paper proposals; [1]
   - The suitability of personal accounts for all individuals.[2]
   - Policies which might improve the incentives to save in personal accounts such as changes to the trivial commutation limit[3] or introducing a limited pension income disregard.[4]
   - The PPI's aggregate assessment of the implications of the reforms for the existing pensions market and the new personal accounts under alternative scenarios about how employers might respond to the reforms.[5]

4. This response summarises the PPI's work in each of these areas. Further details can be found in the detailed research reports which can be downloaded from www.pensionspolicyinstitute.org.uk.

Stakeholders' views

5. The PPI conducted a stocktake of key stakeholders' views on the main elements of the Government's pension reforms in October 2006.[6] The stocktake revealed broad support for the principle of auto-enrolment, with 22 out of 24 organisations surveyed in favour.

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[1] PPI (2006) Briefing Note 34, ***Pension reform: is there consensus?*** The PPI mapped the White Paper responses of 24 organisations, including charities, unions, pension providers, and representative bodies for consumers, business and the pensions industry.
[2] PPI (2006) ***Are Personal Accounts suitable for all?***
[3] PPI (2007) ***Increasing the value of saving in Personal Accounts: taking small pension pots as lump sums.*** Commissioned by the Equal Opportunities Commission.
[4] PPI (2007) ***Increasing the value of saving in Personal Accounts: rewarding modest amounts of pension saving.*** Commissioned by B&CE Benefit Schemes.
[5] PPI (2007) ***Will Personal Accounts increase pension saving?*** Funded by the Nuffield Foundation.
[6] PPI (2006) Briefing Note 34, ***Pension reform: is there consensus?*** The PPI mapped the White Paper responses of 24 organisations, including charities, unions, pension providers, and representative bodies for consumers, business and the pensions industry.

6. Auto-enrolment has potential advantages and should lead to an increase in the number of people saving for retirement. For example:
   - Automatic enrolment can combat people's tendency not to act when faced with difficult financial decisions[7].
   - Automatic enrolment is associated with increased participation rates. On average, 56% of those who are eligible to join a pension scheme in the workplace do so. This compares to 90% where auto-enrolment exists[8].
   - There is also evidence that employers and individuals are in favour of automatic enrolment[9].

7. The majority of organisations in the stocktake supported the proposed minimum levels of contributions to personal accounts (4% employee contribution, 3% employer contribution and 1% from the Government through tax relief).

8. However, two major concerns were raised about the risks involved with introducing a new system of personal accounts:
   - The risk of employees being auto-enrolled into a product which may not be suitable for them. 11 out of the 24 organisations in the PPI stocktake had specific concerns regarding the suitability of auto-enrolment into Personal Accounts for all employees. For example, concerns were expressed about people with low incomes, high levels of debt and/or people currently over a certain age, say 45, whose accounts may not have enough time to mature.
   - The risk of employers 'levelling-down' their contributions to existing pension provision in response to the increased costs that they may face as a result of auto-enrolment. Three-quarters of the organisations in the PPI stocktake raised concerns about levelling-down.

Suitability and incentives to save

9. The PPI has conducted an analysis of the suitability of personal accounts for all employees.

10. According to the Government, personal accounts could give as many as 10 million people access to a low-cost pension savings product with an employer contribution for the first time.[10] 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. (Chart 1)

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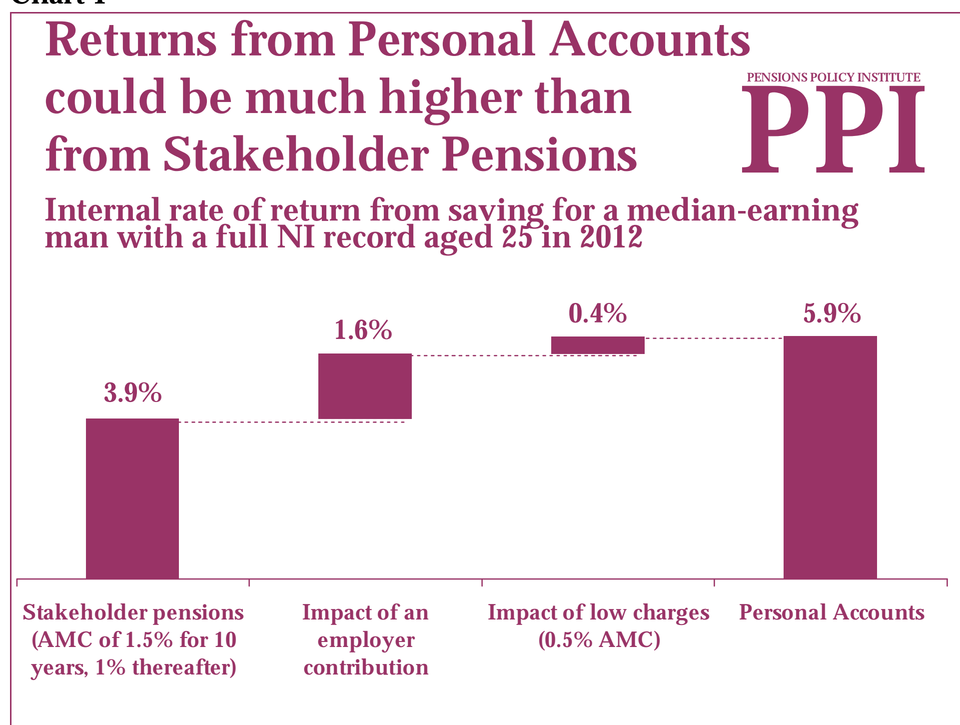
[7] DWP (2006) White Paper: ***Security in retirement***, p. 63

[8] Deloitte (2006) ***Employer pension contributions and pension reform***, ABI research paper 2, page 17. Based on a survey of private companies with at least five employees, It should be noted that other factors than the existence of auto-enrolment could be affecting participation rates, such as whether employees receive encouragement to save from their employer, see PPI (2006***) Response to the Government's White Paper, security in retirement***, paragraph 3.29.

[9] DWP (2006) White Paper: ***Security in retirement***, p. 63

[10] DWP (2006) ***Security in retirement: towards a new pension system***, Fig 1.xi.

Chart 1[11]



11. However, auto-enrolment inevitably raises questions about the suitability of personal accounts for the employees who are auto-enrolled. The value of an individual's personal account depends on the complex interaction of a number of factors and will vary depending on an individual's particular circumstances.

12. The employer's contribution, tax relief and investment returns all increase the value of an individual's personal account but charges, income tax and any eligibility to means-tested benefits that an individual may forego as a consequence of saving in the personal account will reduce the total value. How these combined factors interact will depend on an individual's particular circumstances. (Chart 2)

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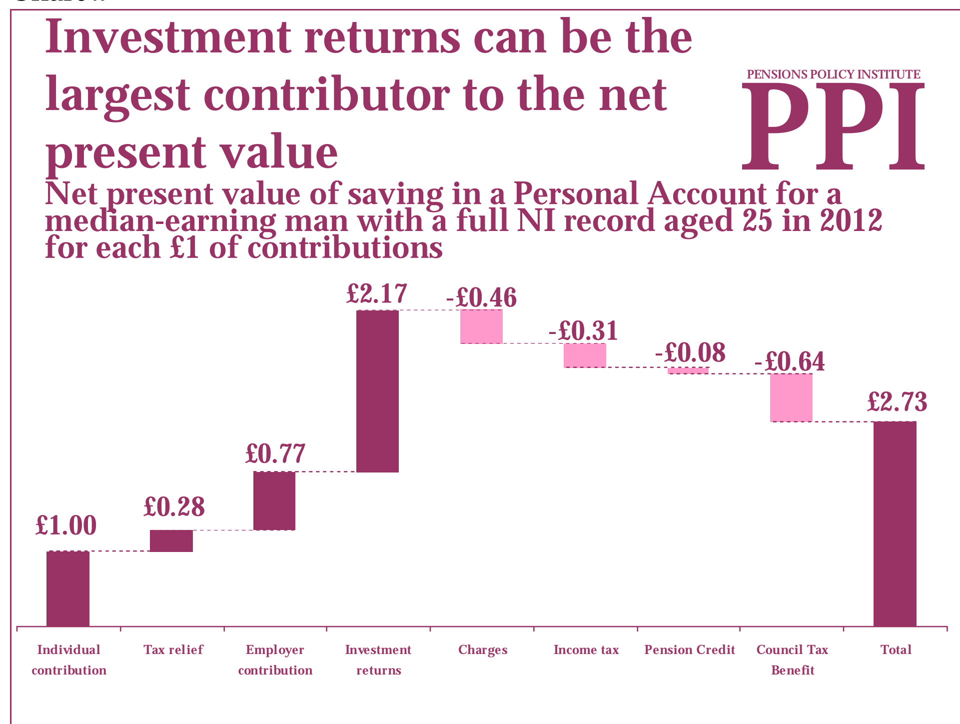
[11] PPI (2006) *Are Personal Accounts suitable for all?* p. 18. Assumes Stakeholder contributions are equivalent to the minimum employee contribution to Personal Accounts, with no employer contribution. The 'internal rate of return' is the nominal interest rate that the individual receives on his or her individual contributions to Personal Accounts, after allowing for the effects of tax relief, employer contributions, investment returns, charges, income tax and means-tested benefits. It is the same as the 'effective rate of return' used by the Pensions Commission and should not be compared with investment returns on other forms of saving.

Chart 2[12]

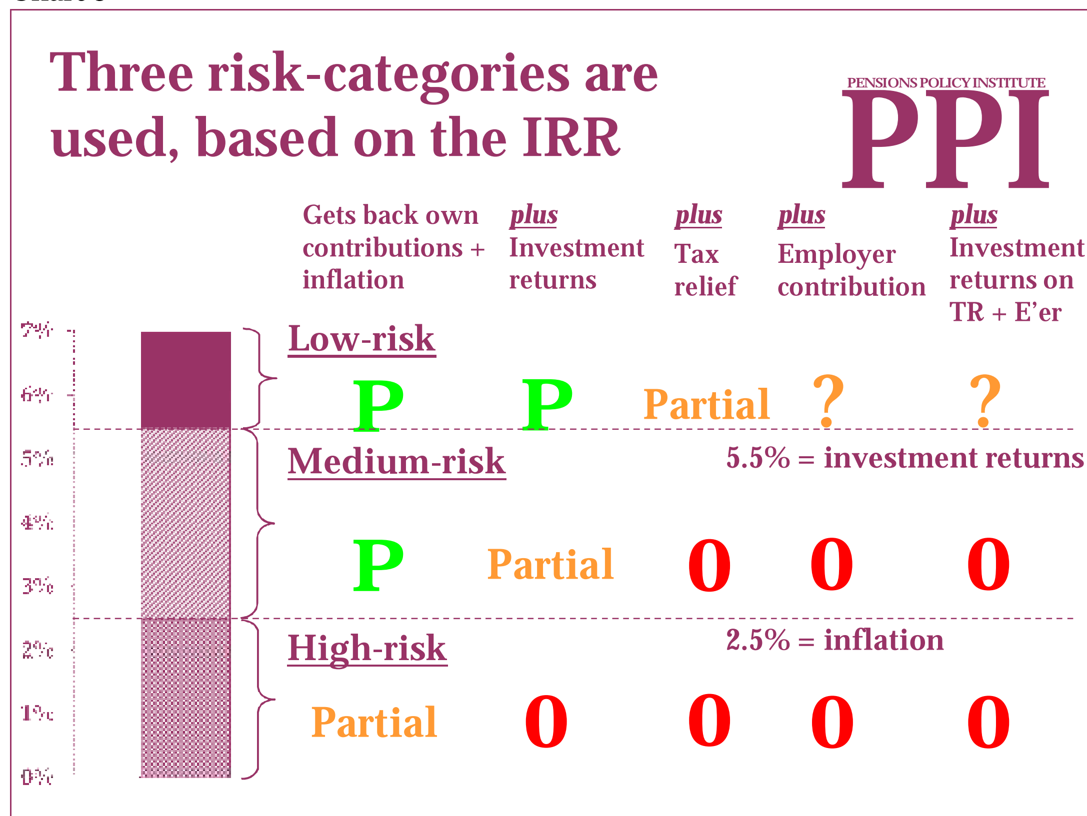


13. In the PPI's analysis, personal accounts are defined as being 'suitable' if individuals do not lose out as a result of their saving. This is a less stringent definition than ensuring that saving in personal accounts is the right thing for all consumers, which would be more consistent with the FSA's definition of 'suitability'.

14. Individuals are categorised as being at low risk, medium risk or high risk of personal accounts being unsuitable for them depending on the internal rate of return (IRR) that they are likely to receive from saving in a personal account. (Chart 3)

[12] PPI (2006) ***Are Personal Accounts suitable for all?*** p.12. In this example we assume the man remains opted in to Personal Accounts for his entire working life. The 'net present value' of an individual saving £1 in a Personal Account is the total amount received in pension income during retirement as a result of that saving in today's prices. This man loses entitlement to some Pension Credit and Council Tax Benefit as a consequence of saving in a Personal Account. He does not lose any entitlement to Housing Benefit because we assume that he owns his own home.

Chart 3



15. People at low risk 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.

16. People at medium risk 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.

17. 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. These people are likely to qualify for less means-tested housing benefit as a consequence of saving in a personal account.
    - 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.

18. 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. Returns from saving in a personal account could be higher for people who are married at some point in their retirement than for single people.

19. The Government's test is that individuals should get back at least the value of their own contributions (but not necessarily the value of their employer's contributions, real investment returns or the tax relief) protected for inflation.[13] This suggests that the Government would only be concerned about individuals in the PPI's high-risk group.

How many people could be affected?

20. It is difficult to produce a definitive assessment of exactly how many people could fall into the high and medium risk groups because there are so many factors that need to be taken into account that affect an individual's return and therefore their risk group.

21. In 2005, 20% of pensioner households were eligible for housing benefit which is likely to place them in the high risk group. The latest PPI projections suggest that by 2050 this figure could fall to 15% if current trends in home ownership continue.[14] Annex A sets out in detail the latest PPI projections for eligibility to means-tested benefits.

22. The proportion of pensioner households eligible for housing benefit represents a floor rather than a ceiling to the number of people who may be affected by reduced incentives to save in personal accounts. There will be other people who could fall into the medium risk group – for example, low earners in their forties or fifties in 2012 who have not yet started saving. These people may lose eligibility to pension credit, council tax benefit or housing benefit as a consequence of their saving depending on their circumstances.

[13] DWP (2006) ***Financial incentives to save for retirement***, Paragraph 1.12
[14] PPI (2007) ***Projections of future eligibility for means-tested benefits***

23. It is important to note that, just because an individual is likely to be eligible for means-tested benefits, does not necessarily imply that they face poor incentives to save. It is the people who face the very high marginal deduction rates[15] - for example through housing benefit or a combination of more than one means-tested benefit - that are potentially of most concern.

24. If personal accounts are not suitable for everybody then this does not necessarily mean that individuals should not be auto-enrolled as this is not a compulsory system. Individuals do have the right to opt-out. But it does have important implications for what information is needed to help people make informed decisions about whether they should opt out.

Generic advice

25. Some of the factors that affect the suitability of personal accounts could be more problematic than others to incorporate into a system of information and generic advice. Clearly, nobody can predict with certainty all of their future life circumstances when making a savings decision.

26. Some factors may be relatively straightforward to reflect in a system of generic advice, 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.

27. These findings 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.
- Any system of generic advice will need to be able to cope with providing advice to a wide range of individuals with different characteristics and financial circumstances.

28. Factors that have an impact on the likely return that an individual may receive from a personal account (and hence their decision to stay in or opt out) include their:
- Age
- Current and projected future earnings
- Whether they have taken, or plan to take, time off work
- Level of employer contribution (if not self-employed)
- Investment returns
- Tax treatment
- Level of other savings and wealth (eg home ownership) that they have accrued
- Eligibility for any means-tested state benefits in the future

[15] The marginal deduction rate is the proportion of a marginal change in a pensioner's income from private pensions that is offset by lower entitlement to means-tested benefits. A higher marginal deduction rate can mean that an individual has a lower return from saving, although returns are influenced by other factors besides the marginal deduction rate.

29. Other factors which don't directly affect the likely return from the personal account but may need to be considered by individuals in their decision about whether or not to opt-out include the affordability of their contributions, their level of indebtedness and their preference to spend rather than save.

30. The Government has asked Otto Thoresen, CEO of AEGON to research and design a national approach to generic financial advice, taking account of personal accounts.

Policy options to improve incentives to save

31. The PPI has conducted analysis to consider possible policy options that might improve the incentives to save for some of the individuals in the high and medium risk groups.

32. Increases to the trivial commutation and capital limits and/or the introduction of a limited pension income disregard are both policies that could improve the incentives to save in personal accounts for some individuals.

Increases to trivial commutation and capital limits

33. Individuals with small pension pots (less than £15,000 in 2006/7) are allowed to take the whole amount as a lump sum and are not required to purchase an annuity. This is referred to as trivial commutation. 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. The PPI published an assessment of increases to the trivial commutation limit and capital disregards on incentives to save in personal accounts for the Equal Opportunities Commission.[16]

34. The research showed that an increase in the trivial commutation limit from £15,000 to £30,000, with a corresponding increase in the capital limit from £6,000 to £10,000 could increase the proportion of retirees who would be able to trivially commute their pension pots from 13% to 22%.

35. 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.

36. 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

[16] PPI (2007) *Increasing the value of saving in Personal Accounts: taking small pension pots as lump sums*

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.

Introduce a pension income disregard

37. B&CE benefit schemes commissioned the PPI to produce an assessment of an alternative policy that could improve the incentives to save in a personal account - the introduction of a limited disregard of pension income on the incentives to save.[17]

38. Currently an individual can save up to £6,000 in a bank account or ISA without it affecting their entitlement to means-tested benefits. In contrast under the current system all pension income is taken into account when calculating eligibility to means-tested benefits.

39. The PPI analysed the introduction of a pension income disregard of £12 a week. A disregard of £12 a week is broadly equivalent to the first £6,000 of pension saving being disregarded in calculating an individual's entitlement to means-tested benefits. This would bring the treatment of pension income broadly into line with the treatment of saving in a bank account or ISA.

40. The PPI analysed the implication of introducing the disregard for six hypothetical individuals with different characteristics. The analysis showed that all of the individuals analysed would improve their returns from personal accounts as a result of the reform. The individual who rented in retirement (and was therefore eligible for housing benefit) was moved from the high risk to the medium risk category.

41. PPI estimates that the introduction of a £12 a week pension income disregard would increase Government expenditure on means-tested benefits by £600m in 2012 and would also increase the numbers of people eligible for means-tested benefits.

42. The Government could consider changes to the trivial commutation and capital limits and/or introducing a limited pension income disregard if it wants to improve the incentives to save for some of the "at risk" groups. Both policies come with a cost to the exchequer and would increase the proportion of pensioners eligible for means-tested benefits.

[17] PPI (2207) ***Increasing the value of saving in Personal accounts: rewarding modest amounts of pension saving.*** Commissioned by B&CE Benefit Schemes.

Levelling-down

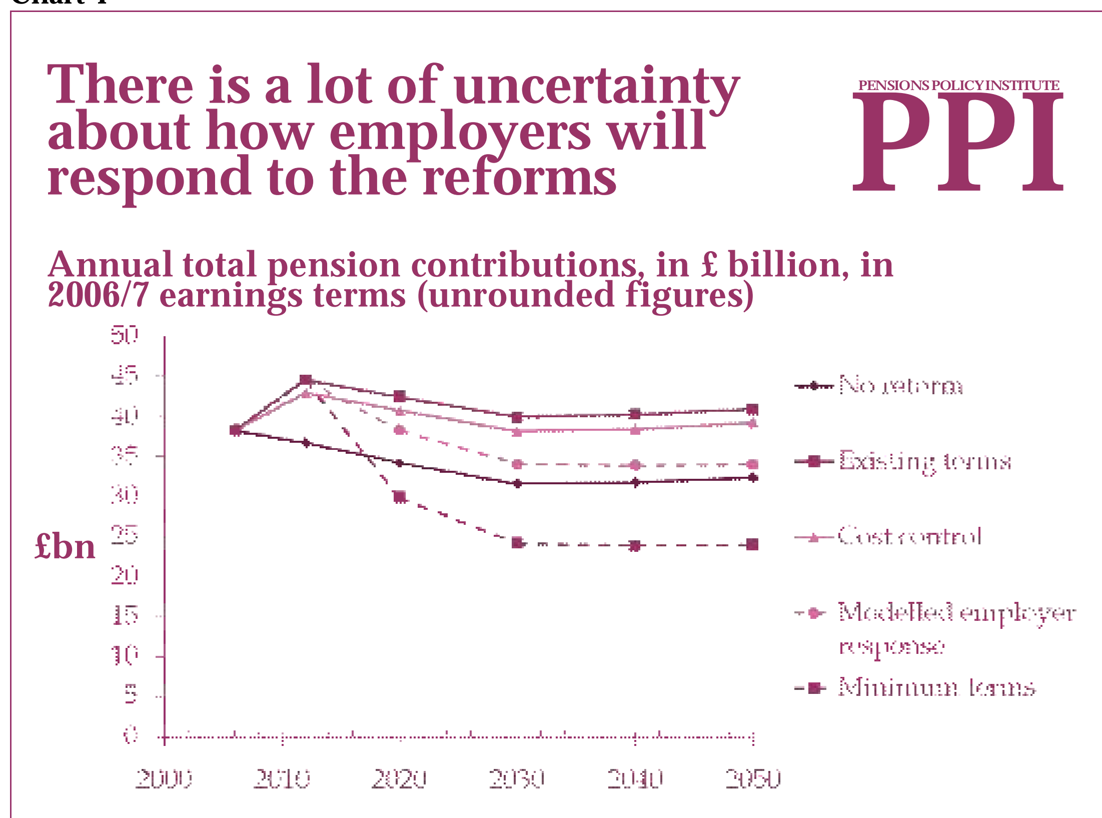
43. The second major concern that has been expressed about the Government's pension reforms is the risk of employers levelling-down existing provision. Levelling-down refers to the risk that, in response to the Governments proposals, employers may decide to close existing occupational pension schemes that offer more generous pension benefits to their employees and instead enrol employees into the new personal accounts.

44. Levelling-down is an important policy issue. Although the Government's proposals to limit transfers into personal accounts will prevent individuals transferring existing pensions into the new personal accounts, it is not at all clear how employers will react or respond to the potential increase in costs that some will face as a result of auto-enrolment, even if the proposals are phased in.

45. Employers who don't currently contribute at least 3% will need to increase their contributions to that level. Employers who already offer a generous pension scheme will have a choice about whether to maintain their existing scheme for new and existing members or to change their arrangements. They could, for example, change their existing scheme by reducing contribution levels' introduce a new, less generous scheme for new members; or they could enrol new members into personal accounts at the minimum contribution level.

46. So, whether the reforms will lead to a greater amount being saved in pensions each year will depend on how employers respond to the reforms (Chart 4).

Chart 4



47. Without the reforms there could be a decrease in annual total pension contributions from around £40 billion in 2006 to around £30 billion by 2050. This is mainly the result of employers continuing to close Defined Benefit (DB) schemes and opening less generous Defined Contribution (DC) schemes in their place. After the introduction of the reforms in 2012 a wide range of outcomes is possible. The PPI has undertaken scenario analysis to illustrate the possible outcomes if employers were respond to the reforms in particular ways. These represent the range of outcomes that could occur, however they are not intended to be forecasts of the future.

48. In a very optimistic scenario, if employers with generous schemes were to auto-enrol all of their eligible employees into existing schemes on existing terms, then the reforms could increase annual total pension contributions by around £10 billion per annum. This would result in growth of the overall pensions market. (Chart 4: existing terms) However, if employers with generous existing schemes were to reduce their average pension contributions to hold their pension costs constant, the reforms could still increase annual total pension contributions but only by around £5 billion compared to without reform. (Chart 4: cost control)

49. In a very pessimistic and extreme scenario, employers could decide to only offer the minimum 3% contribution for all new employees. If this happened, the 3% minimum contribution would become the norm over time. While annual total pension contributions could initially be higher than without reform, by 2050 annual pension contributions could be £10 billion lower. This overall shrinking of the market could be particularly detrimental for existing pension provision. (Chart 4: minimum terms)

50. In reality, employers are likely respond in a variety of different ways. If employers act in line with a survey of their likely responses carried out by Deloitte in 2006, the reforms could initially increase annual total pension contributions by around £10 billion compared to without reform. But this initial increase could wane over time as employers respond to the reforms by closing existing schemes to new members, reducing average pension contributions or auto-enrolling their employees into personal accounts. By 2050, the reforms could still increase annual total pension contributions in 2050 but by less than £2.5 billion above the level without the reforms. (Chart 4: modelled employer response)

Conclusions

51. Overall, the jury is still out as to whether the Government's pension policy will deliver both more people saving and more saving and better retirement incomes.

52. There is much that is positive in the reforms. The introduction of auto-enrolment should increase the number of people saving for their retirement. However, the interaction of the reforms with means-tested benefits and the risks of employers "levelling-down" their pension contributions both pose real challenges to the success of the reforms.

53. The PPI hopes to continue to play a constructive role in the debate as the Government introduces its Pensions Bill and would be happy to discuss this evidence with the Pensions Bill committee in an oral session if that would be helpful.

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Annex A: PPI Projections of Eligibility for means-tested benefits

1. The PPI published projections of future eligibility to Pension Credit in February 2007.[18] The models used to produce these projections have since been updated for new data, as well as extended to produce projections of eligibility for Housing Benefit and Council Tax Benefit. This note presents the updated projections.

2. Future levels of eligibility for means-tested benefits are very uncertain, especially when looking as far as 40-50 years into the future. The projections are therefore presented as a range. As before, a central scenario is given, which is based on a detailed underlying projection of pensioners' incomes, as well as an optimistic and pessimistic scenario.

3. Pension Credit: In the central scenario, the proportion of pensioner benefit units eligible for Pension Credit is projected to fall slightly from 45% in 2005 to 40% by 2050. This compares to the previous projection, which showed levels of eligibility remaining level at around 45% until 2050. The projection has been updated for new data, including new population projections from the Office for National Statistics, new data on current and projected entitlements to Basic State Pension and an updated set of projections for private pensions.

4. The projected range of levels of eligibility for Pension Credit in 2050 is 25% to 55%. This compares to the previous projection, which showed a range of 30% to 65%.

5. Housing Benefit: The proportion of pensioner benefit units eligible for Housing Benefit is projected to fall from 20% in 2005 to 15% by 2050 in the central scenario. The projected range of levels of eligibility for Housing Benefit in 2050 is 10% to 15%.

6. Council Tax Benefit: The proportion of pensioner benefit units eligible for Council Tax Benefit is projected to fall from 55% in 2005 to 40% by 2050 in the central scenario. The projected range of levels of eligibility for Council Tax Benefit in 2050 is 25% to 55%.

7. Overall levels of eligibility: Overall levels of eligibility for any means-tested benefit are projected to fall from 60% of pensioner benefit units in 2005 to 50% by 2050. The projected range of levels of eligibility for means-tested benefits in 2050 is 35% to 65%.

[18] Pensions Policy Institute (2007) ***Incentives to save and means-tested benefits***

Table 1:[19] **Projected proportion of pensioner benefit units eligible for means-tested benefits under the central scenario**

	Pension Credit	Housing Benefit	Council Tax Benefit	Any means-tested benefit
2005	45%	20%	55%	60%
2012	45%	20%	50%	55%
2020	45%	15%	45%	55%
2030	40%	15%	45%	55%
2040	40%	15%	45%	55%
2050	40%	15%	40%	50%

Table 2:[20] **Projected proportion of pensioner benefit units eligible for means-tested benefits in 2050 under different scenarios**

	Pension Credit	Housing Benefit	Council Tax Benefit	Any means-tested benefit
Optimistic scenario	25%	10%	25%	35%
Central scenario	40%	15%	40%	50%
Pessimistic scenario	55%	15%	55%	65%

Returns from saving

8. When interpreting these figures, it is important to note that eligibility for means-tested benefits does not necessarily lead to a low return from saving. Returns from saving depend on a wide range of factors, including the level of employer contributions, tax relief, investment returns, charges and income tax paid in retirement, as well as eligibility for means-tested benefits.

9. It is the people who face the very high marginal deduction rates – for example through housing benefit or a combination of more than one means-tested benefit - that are potentially of most concern.

10. The analysis shows that 15% of pensioner benefit units could be eligible for Housing Benefit in 2050 in the central scenario. Previous PPI research has shown that people eligible for housing benefit can be at high risk of not receiving good value for saving in a personal account.

11. There will be other people who could be at medium risk of not receiving good value from saving in a personal account – for example, low earners in their forties or fifties in 2012 who have not yet started saving. These people may lose eligibility to pension credit, council tax benefit or housing benefit as a consequence of their saving depending on their circumstances.

[19] PPI analysis using the Aggregate and Distributional Models. All figures are rounded to the nearest 5%.
[20] PPI analysis using the Aggregate and Distributional Models. All figures are rounded to the nearest 5%.