Submission to the House of Commons
Work and Pensions Committee's inquiry into
the Government's proposals for Personal Accounts,
January 2007

PENSIONS POLICY INSTITUTE
PPI

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Summary

I. The PPI's stocktake of the views of 24 organisations suggests that there is broad support for the Government's proposals to increase the State Pension Age.

II. There is strong support for elements of the Government's state pension reforms (e.g. re-linking the Basic State Pension to earnings) but a widespread view that the state pension system remains complex and with too much reliance on means-tested benefits.

III. 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.

IV. However, two significant concerns about the Government's proposals for Personal Accounts were expressed by a majority of organisations in the stocktake:
- There remains a significant risk of levelling-down of existing pension provision; and
- Personal Accounts may not be suitable for all employees due to their interaction with taxes and means-tested benefits.

V. 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; but
- Single people who rent in retirement and some low-earning individuals in their forties and fifties in 2012 with no additional savings are at high 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.

VI. This does not mean that people should not be auto-enrolled, but does imply 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.

VII. The PPI will be conducting further analysis into the merits of policy options that may improve the incentives to save for some individuals. These might include changes to the trivial commutation limits and/or not auto-enrolling some groups of individuals – for example today's older people or low-earners.

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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. The Government set out the broad details of its pension reform package in its May 2006 White Paper: *Security in retirement: towards a new pensions settlement*. The PPI gave written and oral evidence to the Work and Pensions Committee's earlier inquiry into Pension Reform in 2005/6[1] and published a detailed evaluation of the Government's White Paper state pension reforms in July 2006.[2]

3. The PPI has previously recognised the potential benefits of auto-enrolment, while raising concerns about the risks in both the policy and the design of Personal Accounts.[3]

4. The PPI's response to the DWP's White Paper: *Security in retirement* in September 2006 highlighted that:[4]
   - The success criteria for Personal Accounts are not fully defined;
   - Expectations of Personal Accounts may be over optimistic as they will be expected to make up for inadequacies in the state pensions as well as providing income replacement;
   - Uncertainty means that Personal Accounts may not necessarily be good value for taxpayers' money; and
   - There are significant implementation risks for Government.

5. This submission updates the Committee on the further analysis that the PPI has conducted since September 2006:
   - A stocktake of key stakeholders' views on the Government's White Paper proposals;[5] and
   - An assessment of the suitability of Personal Accounts for all.[6]

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[1] PPI (2006) *Submission to the Work and Pensions Committee's inquiry into pension reform.* All PPI publications are available on the PPI's website www.pensionspolicyinstitute.org.uk.
[2] PPI (2006)*An evaluation of the White Paper state pension reform proposals*
[3] PPI (2006) *NPSS policy and design choices.*
[4] PPI (2006) *Response to the Government's White Paper, Security in retirement*
[5] 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] PPI (2006) *Are Personal Accounts suitable for all?*

Stakeholders' views

6. The PPI conducted a stocktake of key stakeholders' views on the main elements of the Government's pension reforms in October 2006. The key findings were that:
   - The majority of the 24 organisations in the stocktake now accept that, due to increases in longevity, an increase in the State Pension Age is necessary. Those organisations that did not agree expressed concerns about the possible disproportionate impact that such a change could have on those in lower socio-economic groups.
   - There was broad support for some elements of the Government's state pension reforms. In particular, there was strong support for the proposal to re-link the Basic State Pension to earnings. However, the majority of the organisations wanted to see Government proposals go further by increasing the BSP from £84 a week to a higher level, possibly to the current level of the Guarantee Credit (£114 a week).
   - There was a widespread view that the state pension system remains complex and subject to a high level of means-testing even after the reforms. The Government estimates that in 2050 around 30% of pensioner households may be eligible for the means-tested Pension Credit benefit. However, the PPI's central estimate is that this figure could be significantly higher than the Government suggests, at 45% of pensioner households.[7]

7. The stocktake revealed broad support for the principle of auto-enrolment, with 22 out of 24 organisations surveyed in favour. 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[8].
   - 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[9].

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[7] *An evaluation of the White Paper state pension reform proposals*, PPI, July 2006, Box 5 page 25
[8] DWP (2006) White Paper: *Security in retirement*, p. 63
[9] 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.

- There is also evidence that employers and individuals are in favour of automatic enrolment[10].

8. 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).

9. However, two major concerns were raised about the risks involved with introducing a new system of Personal Accounts:
    - **The risk of employers 'levelling-down' their contributions to existing pension provision** in response to the increased costs that they may face from the increased participation rates. Three-quarters of the organisations in the PPI stocktake raised concerns about levelling-down.
    - **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, organisations expressed concerns 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.

Levelling-down

10. Levelling-down refers to the risk that, in response to the Government's 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.

11. Levelling-down is an important policy issue. The Government is to undertake further research to investigate individual and employer attitudes towards pension reform options and their likely responses. This research is essential as it is far from clear how individuals and their employers will actually respond to the Personal Account proposals. 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, even if the proposals are phased in.

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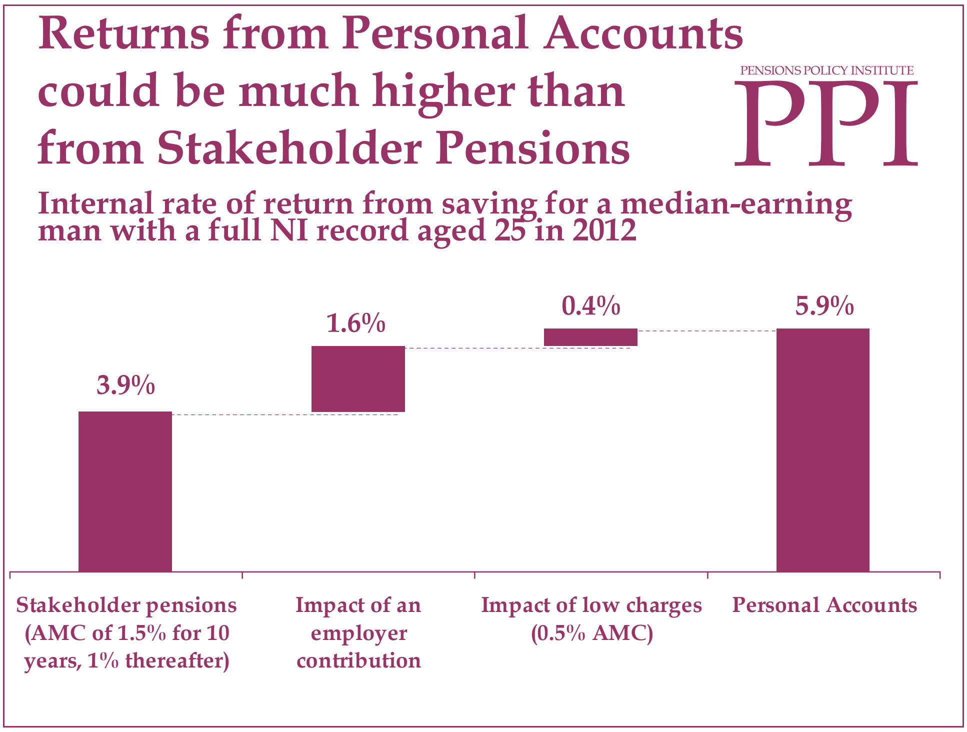
[10] DWP (2006) White Paper: *Security in retirement*, p. 63

Suitability and incentives to save

12. The PPI has conducted further analysis on the second major concern which was expressed about the suitability of Personal Accounts for all employees.

13. 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.[11] 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)

Chart 1[12]



14. 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

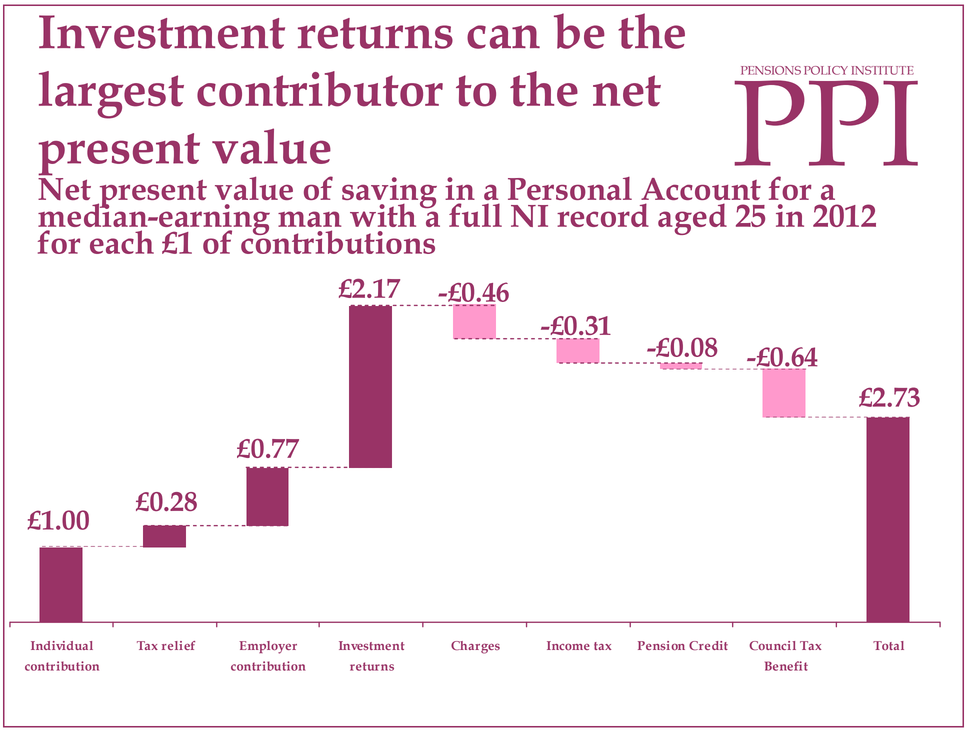
[11] DWP (2006) *White Paper: security in retirement*, Fig 1.xi.

[12] PPI (2006) *Are Personal Accounts suitable for all?* p. 18. Assumes Stakeholder contributions 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.

on the complex interaction of a number of factors and will vary depending on an individual's particular circumstances.

15. 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)

Chart 2[13]



16. 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'.

[13] 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.

17. 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.

18. 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.

19. 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.

20. People at <u>high risk</u> 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.

21. 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.

22. 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.[14] This suggests that the Government would only be concerned about individuals in the PPI's high-risk group.

23. 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.

Generic advice

24. 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.

Further analysis

25. The PPI is planning to conduct further analysis to consider the impact of possible policy options that might improve the incentives to save for some of the individuals in the high and medium risk groups identified. Policy options that may be analysed include increases to the trivial commutation limits and/or not auto-enrolling certain groups of individuals, for example, today's older people or people with low earnings. The PPI will keep the Committee informed.

[14] DWP (2006) *Financial incentives to save for retirement*, Paragraph 1.12