Pensions Policy Institute

PPI

Executive Summary

The benefits of automatic enrolment and workplace pensions for older workers

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Executive Summary

Under automatic enrolment, employers are required to enrol their employees into a qualifying pension scheme. A key feature of the reforms is harnessing the effects of inertia, by making saving into a workplace pension scheme the default for those eligible individuals with earnings above the automatic enrolment threshold of £10,000 per annum (in 2014-15).

Individuals have the opportunity to opt out of saving into a pension scheme, but must do so within the first month of being automatically enrolled if they are to receive back the pension contributions they have made. Research carried out by the Department for Work and Pensions (DWP) found that opt out rates for larger company employees aged 50 and over were between 25% and 50% higher than those of other age groups. A typical example is an employer where the opt out rate was 8% for employees under 30, 9% for 30-49 year olds and 15% for those aged 50 and over.[1] The main reasons cited by older workers for choosing to opt out were that they had made other provision for their retirement, that they believed they had insufficient time to build up pension savings, and that they perceived the contribution rates as being too low.

This report analyses how suitable automatic enrolment is for older workers, based on ensuring that individuals who stay automatically enrolled in a Defined Contribution (DC) pension scheme (i.e. who do not opt out) do not lose out as a result of their saving. This compares the difference between the amount saved into a workplace pension and the likely amount eventually received as additional pension income in retirement. It uses the internal rate of return (IRR) to calculate the returns from savings, expressing these as an annual interest rate and calculating the rate of interest per year that an individual might receive on his or her pension contributions. It aims for there to be at least a minimum return on saving. For the purposes of identifying individuals who might be at high risk of automatic enrolment not being suitable for them, we assume a rate of return is required at least in line with inflation, such that they at least receive back the inflation protected value of their own contributions. We do not look into other factors that might otherwise make it unattractive to save into a workplace pension, for example having unaffordable debt.

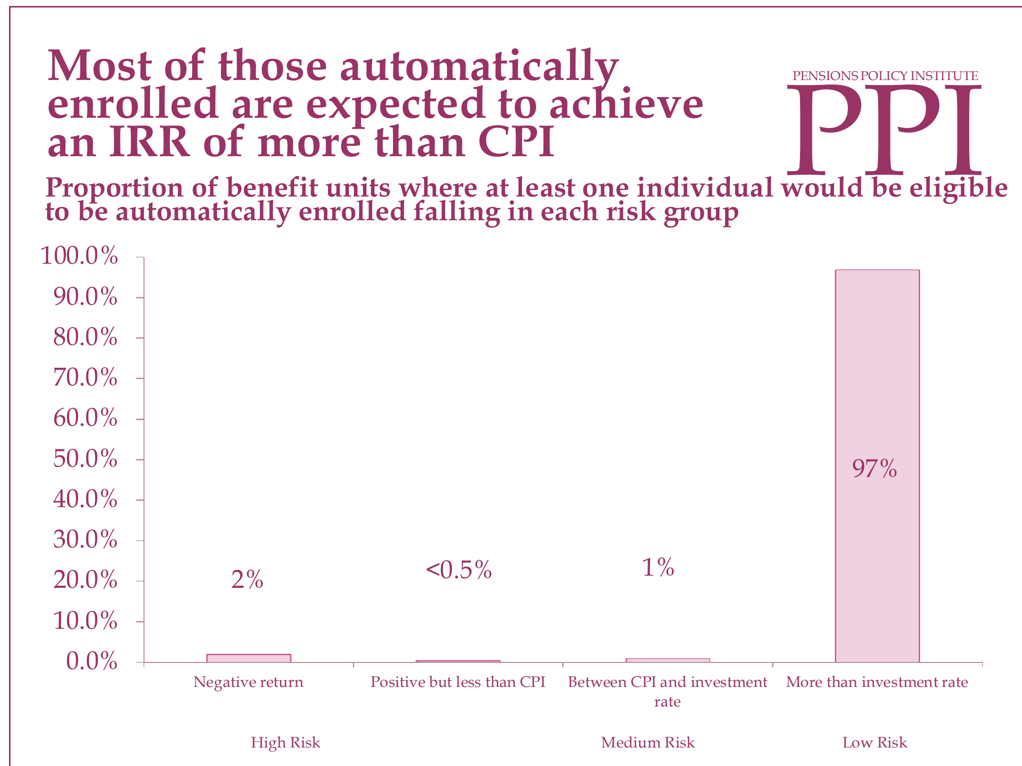
In addition to illustrating examples of the types of individual older workers who might be at high risk of automatic enrolment being unsuitable for them, this report uses dynamic modelling based on data collected in the English Longitudinal Study of Ageing (ELSA) to explore rate of return at a household level. So, for example, where one or more individuals in an older worker household are expected to be automatically enrolled, the dynamic model would consider the circumstances of the household (rather than just the individual) to calculate a rate of return. This is important as entitlement to

[1] These figures should be treated as indicative as they are based on a small number of employers who were able to provide detailed age breakdowns to DWP

means-tested benefits in retirement is a key driver of low rates of return and entitlement is calculated at a household level based on combined income and assets.

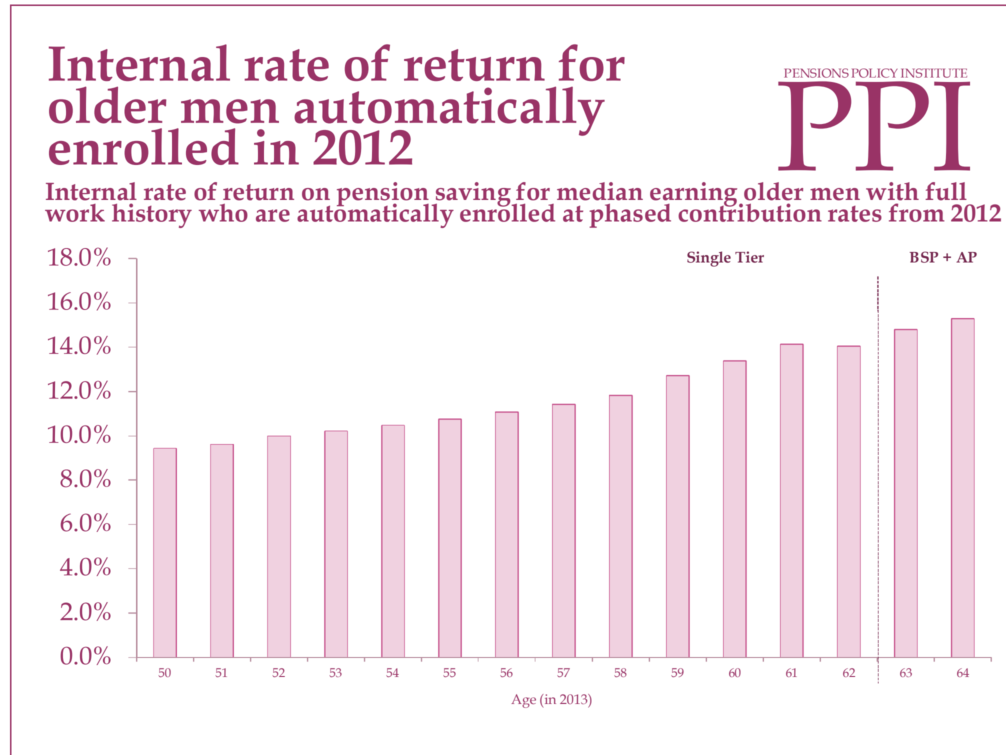
Despite the higher opt out rates seen so far amongst older workers, the vast majority (over 95%) of this group are likely to receive good value on their pension contributions from staying automatically enrolled. Many individuals are expected to see rates of return on their contributions well above the thresholds for them to be at low risk of it not being good value to stay automatically enrolled. The household analysis finds that over 95% of the individuals identified as eligible for automatic enrolment are expected to see a rate of return on their pension contributions above the benchmark investment return of 6%, even after the effect of means-tested benefits and taxation has been taken into account.

Chart A



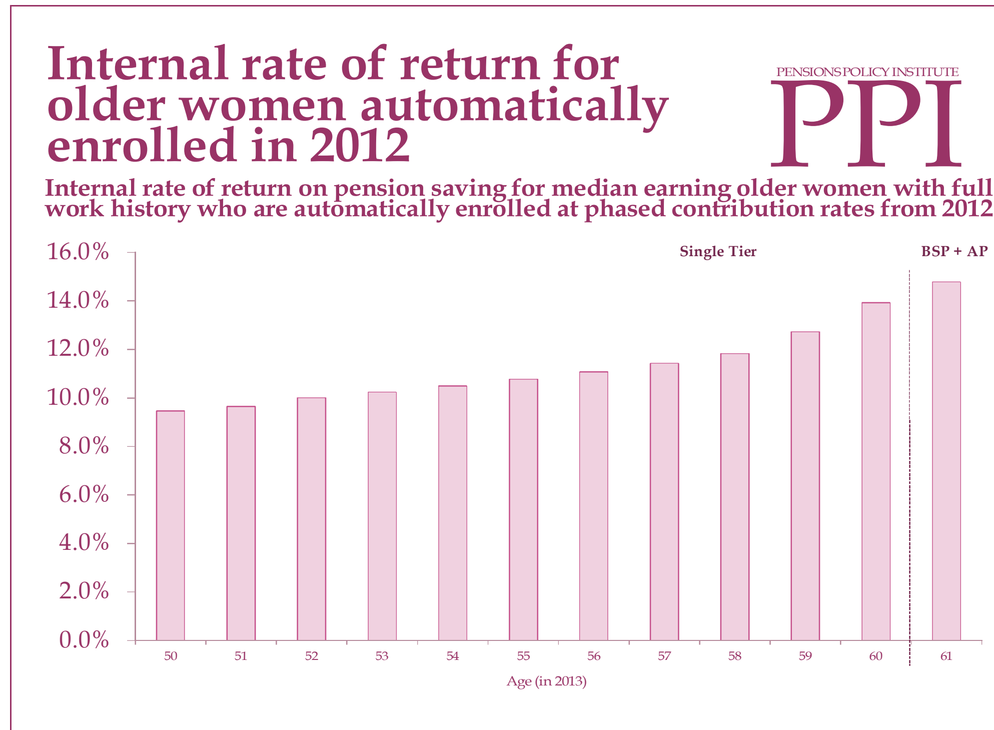
Recent changes in the pensions landscape, including the phased introduction of minimum contributions for automatic enrolment, and the introduction of the single-tier state pension in April 2016, are expected to improve rates of return for older workers. For example, the employer paying a higher share of contributions in the early years of phasing will boost the return an individual sees on their own pension contributions. The oldest men in this group, who see a higher proportion of their total pension contributions made while the phasing of contributions is taking place, see the greatest benefit to their rate of return.

Chart B



A similar pattern can be observed for older women, with those who see a higher proportion of their total pension contributions made while the phasing of contributions is still taking place receiving the highest rates of return.

Chart C



The introduction of the single-tier state pension is also expected to lift many of those who would have otherwise been eligible for the Guarantee Credit above the threshold. Assuming the single-tier pension remains uprated by the triple-lock[2] in future years, this will ensure those individuals' incomes stay above the Guarantee Credit throughout their retirement and so any increase in their private pension income from staying automatically enrolled will not be offset by reductions in means-tested benefits.

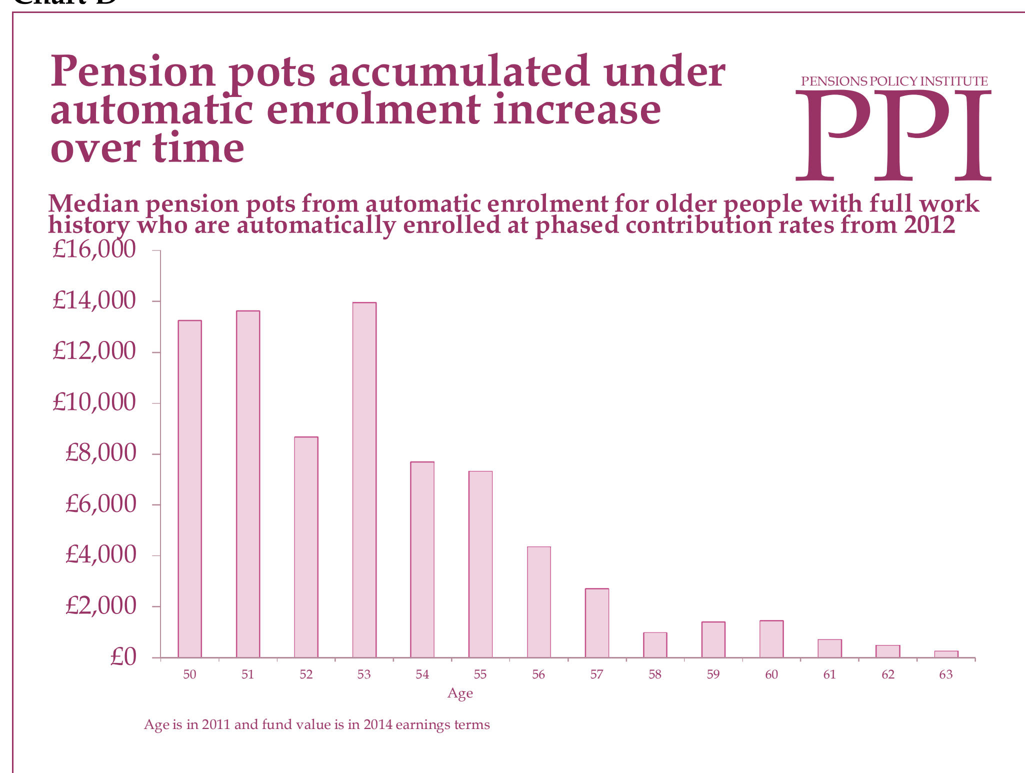
While the rates of return for older workers are generally very positive, it is important to bear in mind that the pension pots being built up by older workers, particularly those on low earnings, are still likely to be relatively small. Our analysis of the ELSA data suggests that the median 50 year old in 2011, automatically enrolled in 2012 and making the minimum level of contribution, builds up a DC pot of £13,250 by State Pension Age (SPA). However, an individual aged 50 in 2011, also enrolled in 2012, and at the 10th percentile of earnings, only builds up a DC pot of £2,870. An individual of the same age at the 90th percentile of earnings builds up a much larger DC pot of £32,880.

This analysis assumes that individuals and their employers contribute at the minimum level. It also assumes that individuals currently in work are able to continue working and saving until their SPA, and they do not access their private pension saving until SPA. On retirement individuals are assumed to purchase a single life, level annuity after taking their 25% tax-free lump sum.

For the median earning 59 year old in 2011 automatically enrolled in 2012 this is lower, at £1,410. So whilst the rates of return may be very positive the actual pension pots built up under automatic enrolment are still relatively small. However, an individual aged 59 in 2011, also enrolled in 2012 but earning at the 10th percentile (and in this case a women very close to SPA), would only build up a DC pension pot of £80 while an individual at the 90th percentile builds up a pot of £3,170.

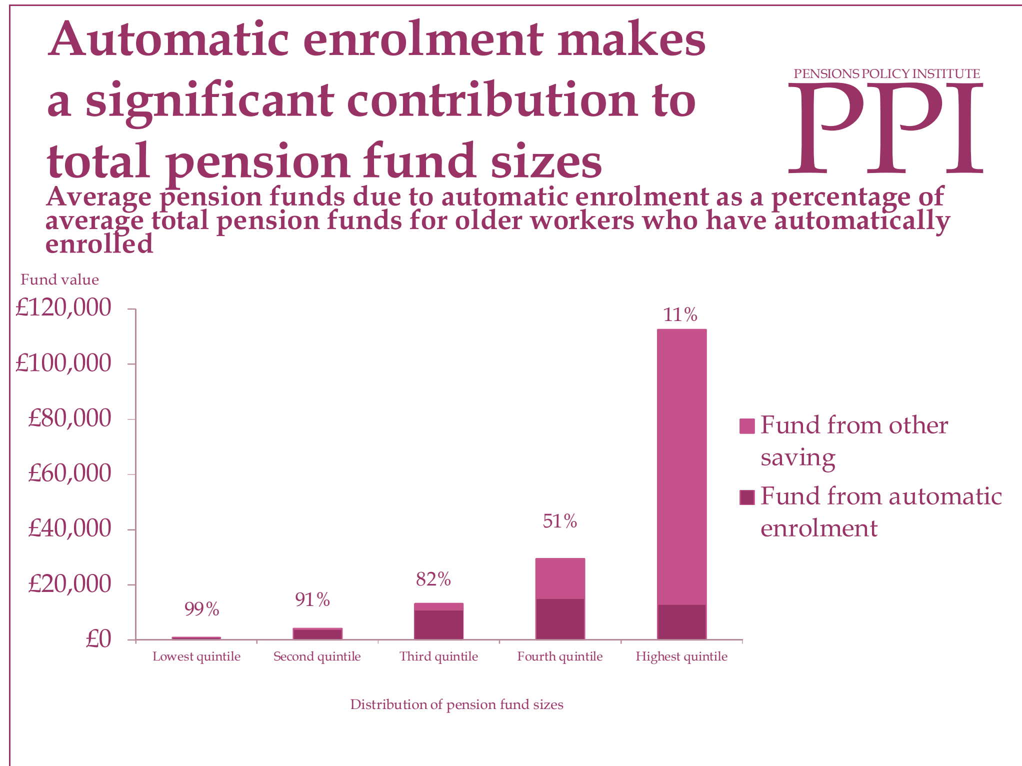
[2] Under the triple-lock the state pension is uprated by the higher of earnings inflation, the Consumer Price Index (CPI) and 2.5%.

Chart D



Household data also shows that around 60% of individuals eligible for automatic enrolment will already have some other forms of private pension saving, either in a DB pension, a DC pension, or both. Just over half of this group have some other form of DC private pension saving only. However, automatic enrolment will play an important role in boosting the pension pots of older workers. Chart E considers the distribution of pension funds by quintile. In the lower quintiles, funds due to automatic enrolment make up the majority of pension funds. However, the proportion of total pension funds that is due automatic enrolment is lower for the higher quintiles.

Chart E



The analysis of household data shows that the factors driving lower or negative rates of return at a household level are possible to identify but complex to predict with any great certainty in advance. Less than 3% of households are expected to be at risk of having low or negative rates of return from staying automatically enrolled. For example, for those households where one or more individuals have little or no state pension entitlement, and little or no private pension savings, there is a likelihood that they may still be reliant on Guarantee Credit during their retirement. And for those who are living in rented accommodation during retirement, they may also be reliant on Housing Benefit. Interactions with Council Tax Reduction and increasing retirement income above the thresholds for higher rates of personal income tax also play a role in reducing rates of return.

Even for these individuals, rates of return may be underestimated by our analysis. For example, the changes recently announced by the Chancellor in Budget 2014 provide much greater flexibility about how individuals use their DC pension pots in retirement, which may make it less likely that pension income interacts with means-tested benefits. For those saving under automatic enrolment for the first time, the majority (over 90%) would have already had access to these flexibilities via the existing trivial commutation rules, and by the increases to the trivial commutation limits from April 2014. The high profile of the Budget 2014 announcements may however make it more likely that more individuals take the route of a lump sum withdrawal rather than buying an annuity and receive guidance that encourages them to do so.

Table A: Proportion of older workers automatically enrolled in 2012 with pension pots below the trivial commutation limits which were in place up to April 2014 (£18,000) and from April 2014 to March 2015 (£30,000)

	Individuals with a DC pot due to automatic enrolment only	Individuals with a DC pot from automatic enrolment and/or existing DC and/or DB pots
% under £18k	91%	44%
% under £30k	99%	56%

The introduction of Universal Credit is also expected to see those making pension contributions during working age with low incomes receive an additional boost to their rate of return, as their Universal Credit entitlement will be based on their income after they have made pension contributions. This advantage exists now through the rules around Working Tax Credit and Housing Benefit but the treatment of pension contributions will become more explicit once Universal Credit is introduced and the incentive will be strengthened with a 100% offset of pension contributions (currently 100% for Working Tax Credit but only 50% for Housing Benefit).

Depending on how individuals respond to the changes in the Budget 2014, there may be scope for them to significantly alter how they draw their pension income in retirement. For comparative purposes this report assumes that an annuity is taken in order to generate a benchmark rate of return based on a secure guaranteed income in retirement. However, greater flexibility to take a lump sum, or to use a form of phased income drawdown, could open up opportunities to reduce the interactions with means-tested benefits and tax. On the other hand, some individuals may be at risk of paying more income tax.

Box A provides an overview of the circumstances of an individual (Individual C in Chapter 5) who is automatically enrolled. It considers the implications of the Budget 2014 proposals in terms of her tax and mean-tested benefits.

Box A: Options for drawing down pension income

Full National Insurance (NI) record, previous Defined Benefit (DB) pension, automatically enrolled in 2012. She retires at State Pension Age (SPA) in 2022 and was automatically enrolled in 2012. She receives a state pension of £154 per week (£8,009 per year), receives income of £1,005 per year from a Defined Benefit (DB) pension, £900 from savings and investments and has accumulated a pension pot of £7,328 under automatic enrolment. She owns her home. She has a rate of return of 10%, assuming that she annuitises 75% of her pension pot at SPA and is therefore at low risk of automatic enrolment being unsuitable for her.

Individual C is not eligible for any means-tested benefits and, if she received her state pension, income from her DB pension only and income from savings and investments, she would receive £9,914 per year and would not be liable for income tax. On reaching SPA she could withdraw a tax-free lump sum of £1,832 from her pension under automatic enrolment without affecting her tax position.

Withdrawing her whole pension fund

If Individual C withdraws the whole of her pension fund in one year, her other income (£9,914) uses up most of her Personal Allowance (£10,000). This means that, while she could take 25% tax-free, she would pay 20% tax on most of her pension fund.

Purchasing an annuity

If Individual C uses the remaining £5,496, after she has taken 25% of her pension under automatic enrolment as a tax-free lump sum, to purchase an annuity, she might receive £237 per year – this would mean that her annual income would be £10,151 per year, giving rise to a tax liability of £30 per year.

The whole pot is placed in income drawdown

Individual C could place her whole pot in income drawdown and limit the amount taken out to avoid a higher marginal rate of tax, once she has taken her tax-free lump sum. Individual C could limit the income that she draws from her pension pot to £86 per year in the early years of retirement to avoid a tax liability, particularly if she is likely to spend the capital that is giving rise to her other investment and savings income in the early years of her retirement. Individual C may wish to increase the amount that she draws down if her spending needs increase over the course of her retirement.

The role of clear advice and guidance will be critical to ensure that those being automatically enrolled are maximising the return on their individual pension contributions. The introduction of the single-tier pension from April 2016 should make it easier to identify the groups of older workers most likely to be entitled to Guarantee Credit, Housing Benefit and Council Tax Reduction in retirement, and therefore at greatest risk of seeing a low rate of return from staying automatically enrolled. Maintaining the triple-locking of the single-tier

should also give households much greater confidence that they will not fall back onto means-tested benefits later in retirement.

Clear communications about the future state pension entitlements of older workers when the single-tier is introduced in April 2016 could support the workplace pension reforms and help reduce or maintain opt out rates by clarifying how state pension entitlements interact with means-tested benefits and where individuals are likely to be above the threshold for Guarantee Credit.

As details of the Budget 2014 proposals develop between now and April 2015, guidance will need to clearly signpost where individuals might be at risk of financial detriment through poor financial planning, for example by taking their pension pot in a way that moves them onto a higher marginal tax threshold, or that generates an income in a given year or capital sum that loses them entitlement to means-tested benefits.

Given the DWP's research into older workers' reasons for opting out, the analysis in this report suggests that many older workers could still see very good returns from saving into a workplace pension, and the additional flexibilities announced at Budget 2014 about how pension saving is accessed at retirement could make it more attractive still. Communications from government, employers and industry bodies targeted at older workers could illustrate the potential gains from them staying automatically enrolled, and how easily their DC pension can be accessed from age 55 should they need it. This could help to ensure that opt out rates for older workers remain low, or even reduce, as more employers reach their staging dates and as the minimum contributions rise between now and 2018.

Greater clarity over the Budget 2014 changes and the new flexibilities on how to access pension saving at retirement may also help employers who may wish to encourage their older workers to stay saving, or save more, into a workplace pension, in order to ensure they can afford a comfortable retirement and retire at an age in line with their personal expectations.

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