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Closing the gap: the choices and factors that can affect private pension income in retirement

Executive summary

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Executive Summary

When saving for retirement in a Defined Contribution (DC) pension scheme there are a number of choices that an employee and their employer will make. These choices can have an impact on the final income received in retirement by the employee. Employee choices include: increasing employee contributions; whether to opt out of pension provision; when to retire; how much of the pension fund to convert into an income and which retirement income product to use to convert a pension fund into an income in retirement. Other factors include employer choices regarding the level of employer contributions and the level of charges of the pension scheme.

The individual impact of positive and negative choices and factors
The research shows the impact of certain specific choices and factors for a median earning man and woman, and their potential to either reduce or enhance private pension incomes.

The modelling shows that making sacrifices earlier on in life such as increasing contributions into a pension, or later on in life by working and saving for longer, or annuitising some or all of the 25% tax free lump sum, can significantly enhance your pension (Chart 1). For example:

- Saving a total of 12% of band earnings[1] (rather than the 8% of band earnings minimum under auto-enrolment, and above the current average for a DC occupational scheme of 6% employer contributions and 3% employee contributions[2]) into your private pension can increase private pension income by 50%;
- Retiring 2 years after state pension age and continuing to save in that time has a positive two-fold effect through saving more and deferring annuity purchase and can enhance private pension income by 20%;
- Opting out between the ages of 30 and 40 and starting to save ten years later can reduce private pension income by 32%;
- Retiring 2 years before state pension age and starting to draw down your pension can reduce private pension income by 18%.

The research also demonstrates the adverse impact of an individual being a member of a pension scheme with higher charges, or from an individual not ‘shopping around’ for the best annuity rate available on the market. These are choices and factors that, if changed, could increase individual’s private pension income. However, they rely on the employer securing access to a lower charging scheme, which may not be possible especially for smaller schemes, or on an individual shopping around at retirement to find an annuity on the market offering a better rate.

[1] Band earnings is the earnings range over which employee and employer pension contributions are made. Under auto-enrolment, band earnings will be earnings between £5,715 and £38,185 in 2010/11 earnings terms for those earning over the auto-enrolment threshold which is equal to the standard personal tax allowance (£7,475 in 2011/12).
[2] ONS (2011)

Chart 1[3]

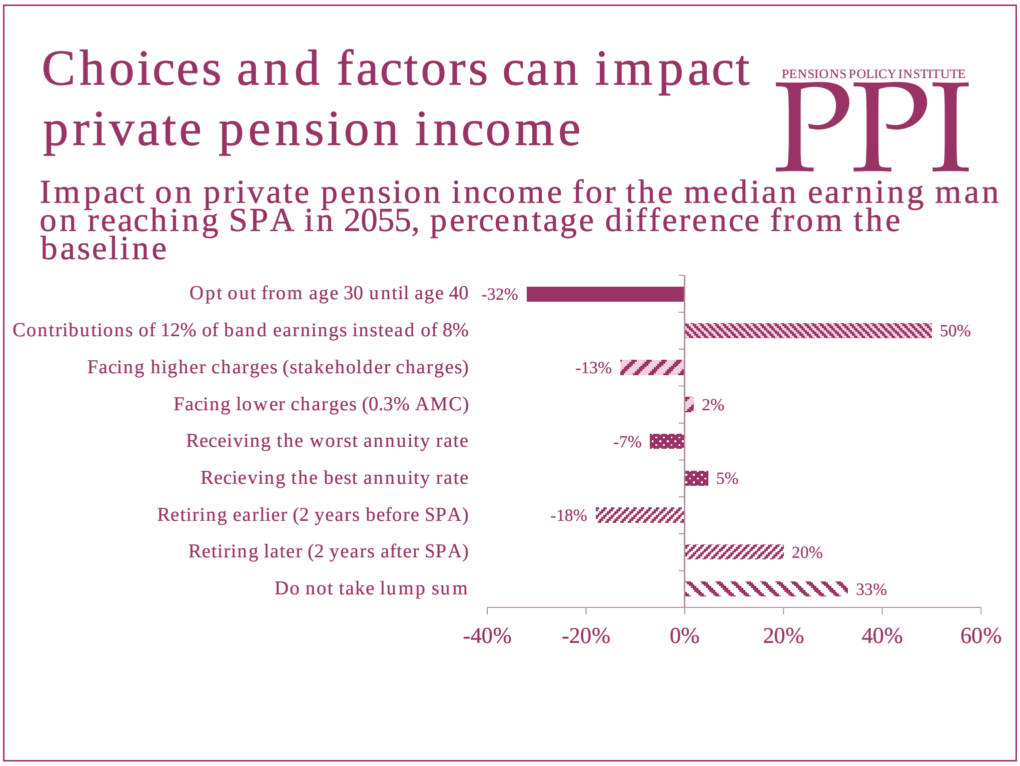
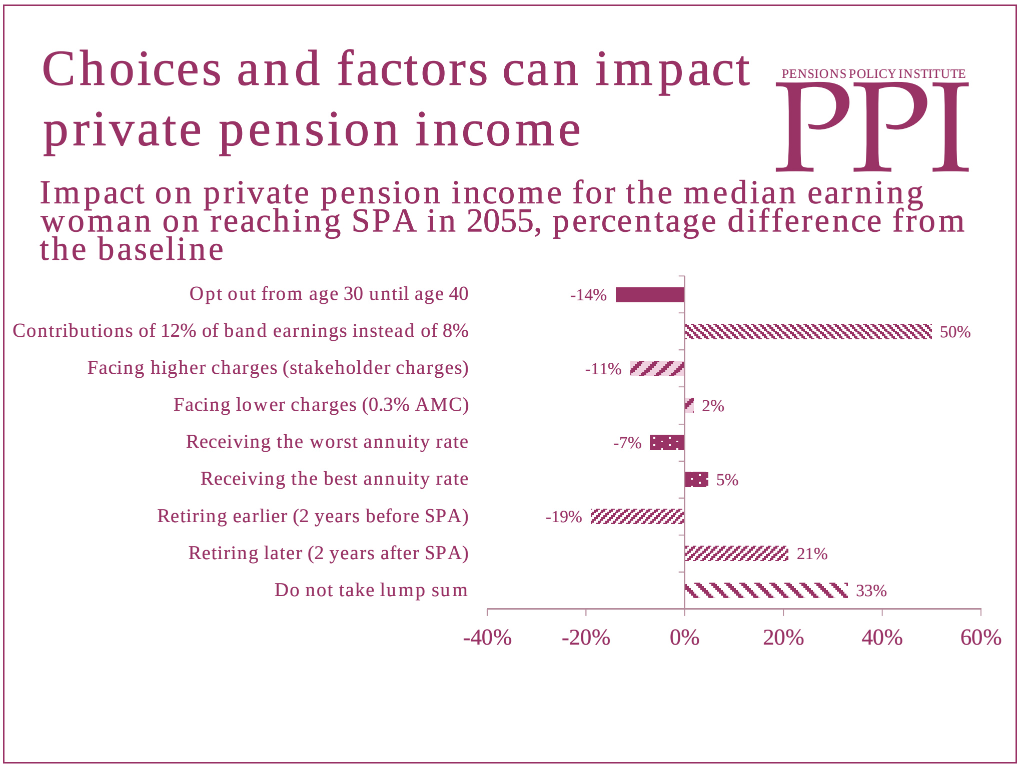


Chart 2[4]



3 PPI modelling
4 PPI modelling

On charges, even the difference between a low charge[5] and a charge set at the level of the stakeholder cap[6] is significant. Compared to the National Employment Savings Trust (NEST) combined charge[7], a lower annual management charge (AMC) at a flat rate of 0.3% increases a male median earner's private pension income by 2%, whilst charges in line with stakeholder caps reduce private pension income by 13%.

Securing the best single life, level annuity rate on the Money Advice Service tables[8] compared to a mid-range annuity rate can increase private pension income by 5%, whilst locking into the lowest annuity rate on the Money Advice Service tables can reduce private pension income by 7%. The example used in the modelling is for a median level annuity. In practice the variation observed for specific individuals, particularly those eligible for an enhanced annuity, can be much greater.

Opting out of pension saving from age 30 until age 40 has a smaller impact on private pension income for the median earning woman than it does for the median earning man. This is because the median earning woman is already assumed to care for children from age 30 to 35, so opts out from fewer years of pension saving than the median earning man.

The cumulative impact of positive choices and factors

The research also demonstrates the cumulative impact that such choices and factors can have on an individual's private pension income in retirement. For example, a median earning man who remains opted-in to pension saving from age 30; contributes an extra 1% of band earnings and receives an extra 1% contribution from their employer; is in a scheme with low charges; works an extra year after their state pension age; and who annuitises their lump sum and shops around for an annuity could have a private pension income that is three times higher (£7,710 a year compared to £2,200 a year) than a median earner who makes different choices and is subject to different factors (Chart 3).

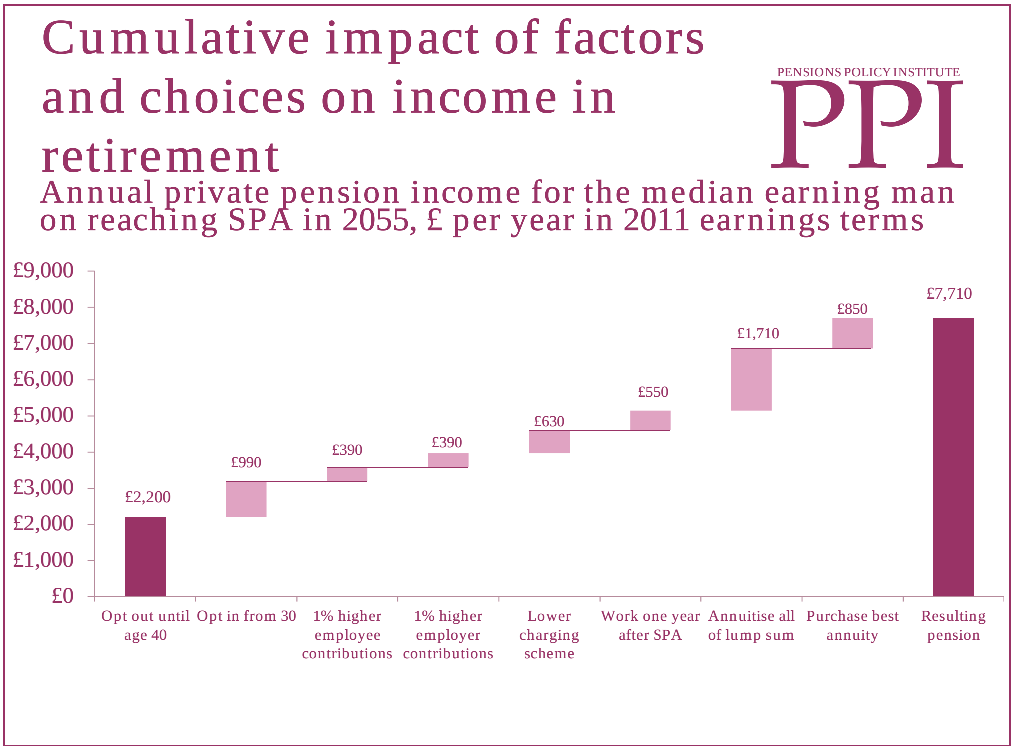
[5] In line with a long-term NEST rate of 0.3% AMC

[6] An AMC of 1.5% for the first ten years falling to 1.0%.

[7] A 1.8% contribution charge and a 0.3% AMC

[8] Money Advice Service annuity comparison tables are available at tables.moneyadviceservice.org.uk/Comparison-tables-home/Annuities/Compare-Annuities/

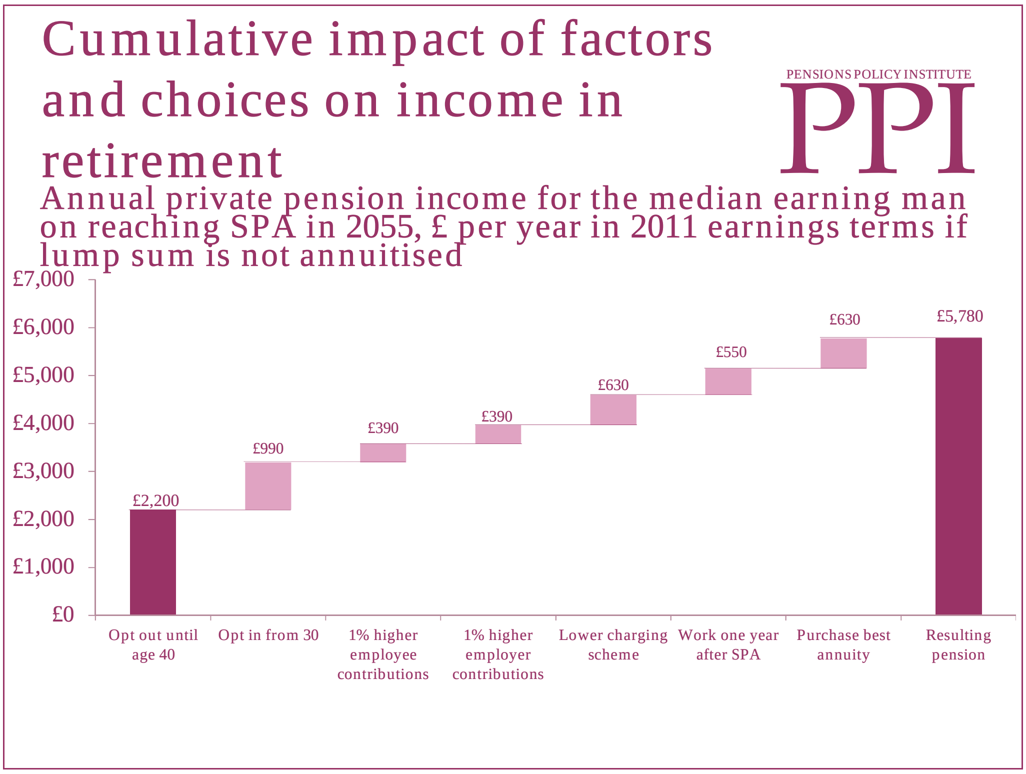
Chart 3[9]



The case for an individual to not take their tax-free lump sum at retirement and annuitise it instead is not clear cut - given the beneficial tax treatment of the lump sum and the resulting impact on overall income and capital at, and during, retirement. However, even if the impact of not taking the lump sum is stripped out of the modelling, annual private pension income is still two and a half times higher under the high income scenario at £5,780 a year instead of £2,200 a year (Chart 4).

[9] PPI modelling

Chart 4[10]



Overcoming the impact of opting out, higher charges, and lower annuity rates

Finally, the research shows the potential implication to the individual of some of the negative choices and factors by considering what increase in contributions would be needed, or how much longer the individual would need to work and save, to reinstate levels of private pension income.

The modelling finds that:

- Opting out until age 40, instead of starting to contribute into a pension from age 30, could reduce the available pension pot at retirement from £59,500 to £40,600. So starting to save at age 30 could have produced a private pension income in retirement nearly 50% higher. To make up for these lost 10 years the individual might need to contribute an extra 4% of their band earning into their pension for the rest of their working life.
- Being in a scheme with charges in line with the stakeholder charge cap, instead of a scheme with charges in line with the long-term NEST rate of an annual management charge of 0.3%, could reduce the available pension pot at retirement from £60,600 to £52,000. Being in a scheme with lower charges could have produced a private pension income in retirement around 17% higher. To compensate for this difference in charges the individual might need to save an extra 1.5% of their band earnings into their pension every year or could retire 3 years after state pension age.

[10] PPI modelling

- Converting the pension fund to an income using the lowest annuity rate on the Money Advice Service tables, instead of securing the highest annuity rate available on the Money Advice Service tables, could reduce the pension income by around 12%. To compensate for the lower annuity rate the individual might need to save an extra 1% of their band earnings into their pension every year or could retire 2 years after state pension age.