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The impact of opting-out of private pension saving at younger ages

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Summary of Conclusions

Prior to the introduction of auto-enrolment from 2012, Prudential has commissioned the Pensions Policy Institute (PPI) to produce a series of case studies illustrating the financial impact on individuals of opting-out of workplace pension provision in the early stages of their working lives.

The examples shown in this report are hypothetical, and the outcomes are dependent on the assumptions used to construct them. In particular, the final pension fund and retirement income generated from pension saving will be heavily dependent on investment returns, which are very uncertain. The impact of different levels of investment return, or the volatility of investment returns, are not considered in this report. The case studies have been designed to highlight particular generic issues that can occur from opting-out of pension saving rather than to be projections of the levels of retirement income that different individuals achieve in practice. None of the findings should be generalised as being applicable to the population as a whole and the results of the case studies should not be used to advise individuals of what their own particular outcomes might be from pension saving or opting-out.

When individuals are auto-enrolled into workplace pension provision, they face a choice. If they do nothing, and remain auto-enrolled, a contribution of 4% of their band earnings[1] is taken from their pay and paid into the pension scheme. On top of this, a minimum contribution of 3% of band earnings is made by the employer into the individual's pension, as well as a government contribution worth at least another 1% of band earnings (paid through tax relief). In effect the individual's own contribution is at least matched by the combined contribution from the employer and the government, giving a total contribution of 8% of band earnings.

Some individuals, however, will choose to opt-out of their workplace pension provision. This decision is likely to be influenced by a range of factors including the affordability of the employee's pension contributions and the extent of personal or household debt.

By opting-out, an individual's take home pay will by higher by 4% of band earnings as a result of not making employee pension contributions. While this will mean that the contributions are not made into the pension scheme and so will reduce the individual's final pension fund value, no assumptions are made as to what use the extra income is put to, or what its value is to the individual.

[1] Band earnings denote the minimum level of earnings that must be eligible for contributions in order to satisfy the auto-enrolment legislation. The current Coalition Government proposes in the draft Pensions Bill 2011 to set the earnings threshold above which every worker should be auto-enrolled at £7,475 in 2011/12. Contributions become payable on band earnings over £5,715 in 2011/12 and up to a limit of £38,185.

However, the employer and the government contributions are foregone by the individual who opts-out, as are the investment returns that these contributions could have accrued had they been invested into the pension scheme. This report therefore considers the impact of unpaid employee contributions separately from the impact of foregone employer and government contributions.

Under the assumptions used in this report, a median-earning man who is auto-enrolled into NEST[2] at the minimum contribution level for his entire working life could accumulate a final fund value at State Pension Age (SPA) of £93,600.[3] Upon retirement he could take a 25% tax free lump-sum of £23,400, and purchase a single-life, level annuity worth £3,850 per year after tax.[4]

Had he opted-out for the first 10 years of his working life:

- He would receive cumulatively £6,200 more income while opted-out
- His fund would reduce by £18,800 (20%) to £74,800 at SPA, of which:
  - £9,400 arises from unpaid employee contributions and associated investment returns.
  - £9,400 arises from foregone employer and government contributions and associated investment returns; which accounts for 50% of the total reduction.
- His tax-free lump-sum reduces by 20% to £18,700.
- His post-tax annuity income reduces by 20% to £3,100 per year.

If this median earning man is auto-enrolled into a more generous pension scheme than the minimum required by legislation, he could forego more in the form of employer and Government contributions.

For example, if he is auto-enrolled into an existing employer Defined Contribution scheme with the average level of contributions seen today (consisting of an employee contribution of 2.5% of gross salary, a 6% employer contribution and a government contribution delivered, through tax relief, equivalent to 0.6% of gross salary), he could accumulate a final fund value at SPA of £118,500. Upon retirement he could take a 25% tax free lump-sum of £26,600, and purchase a single-life, level annuity worth £ 4,900 per year after tax.

Had this median earning man opted-out of pension saving for the first 10 years of his working life:

- He would receive cumulatively £5,300 more income while opted-out
- His fund would reduce by £22,700 (19%) to £95,800 at SPA, of which:

[2] Employers may choose to auto-enrol their eligible employees either into an existing qualifying private pension scheme, or they can use the new low cost scheme that has been established by the government – The National Employment Savings Trust (NEST).
[3] PPI calculations using the Individual Model – see Technical Appendix for further information
[4] Post tax income estimates assume that the individual's annuity income is fully taxable at the basic rate. If this is not the case, the individual's post-tax annuity income will be different.

    - £6,200 arises from unpaid employee contributions and associated investment returns.
    - £16,500 arises from foregone employer and government contributions and associated investment returns; this accounts for 73% of the total reduction.
- His tax-free lump-sum reduces by 19% to £23,400.
- His post-tax annuity income reduces by 19% to £3,950.

The individual auto-enrolled into his workplace scheme at average contribution levels, rather than minimum contribution levels, receives a much more generous employer contribution. Overall, 73% of his pension contributions are paid by his employer and the government, compared with 50% for his counterpart receiving minimum employer contributions. By opting-out of private pension saving he is therefore foregoing a larger amount.

The impact of opting-out early in working life can have a larger proportional impact on some individuals, depending on their work history and when they take time out of the labour market.

For example, if a low earning woman (with a typical female work history, including breaks for caring) is auto-enrolled into NEST at the minimum contribution level she could accumulate a final fund value at SPA of £35,000. Upon retirement she could take a 25% tax free lump-sum of £8,700, and purchase a single-life, level annuity worth £1,300 per year after tax.

Had she opted-out for the first 10 years of her working life:

- She would receive cumulatively £2,900 more income while opted-out
- Her fund would reduce by £8,800 (25%) to £26,100 at SPA, of which:
    - £4,400 arises from unpaid employee contributions and associated investment returns.
    - £4,400 arises from foregone employer and government contributions and associated investment return; this accounts for 50% of the total reduction.
- Her tax-free lump-sum reduces by 25% to £6,500.
- Her post-tax annuity income reduces by 25% to £1,000.

The low earning woman sees a greater proportional impact on her pension fund and pension income because a greater proportion of her lifetime earnings are received in the first 10 years of her career than is the case for the median earning man. Women are, on average, more likely to take years out of the work force for caring responsibilities in their mid and late careers.[5]

[5] Phillipson, C. Smith, A. (2005)

The outcomes produced in this report are for hypothetical individuals, under very specific assumptions. In reality, outcomes from workplace pension saving will depend upon many factors:

- All of the individuals illustrated are 22 in 2018, when auto-enrolment is assumed to have been fully introduced. Today's older people are likely to receive less through auto-enrolment as there are fewer years in which they can contribute, although some older workers may have accrued pension rights from earlier in their careers.
- The individuals illustrated are assumed to have typical work histories and earnings profiles. The amount of private pension saving that an individual can accumulate in their lifetime is likely to be smaller if they do not work as many years, or experience lower earnings.
- Investment returns achieved by an individual's pension fund may vary. In addition, the impact of the volatility of investment return levels is not considered in this paper as the focus is on decisions rather than fund performance.
- The case studies used here do not consider the possible interaction between the private pension fund built-up as a result of auto-enrolment and the state pension system, and in particular means-tested benefits. Individuals who might be entitled to means-tested benefits (in particular Housing Benefit) at some point during retirement may find that the income received from the state falls as income from private pension increases. This could reduce the value to some individuals of remaining auto-enrolled. If such an individual remains auto-enrolled, the loss in income from the state can offset the higher private pension income from the employer and Government contributions.