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Are Personal Accounts suitable for all?

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A Discussion Paper by Adam Steventon

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Introduction

The Government published its proposals for reform of the pension system in May 2006[1]. This includes a new system of Personal Accounts to be introduced from 2012. Employees would be auto-enrolled into a Personal Account or approved alternative, with the opportunity to opt out.

Auto-enrolment into private pension provision has potential advantages and should lead to an increase in the number of people saving for retirement. There is a broad degree of consensus for the principle of auto-enrolment.

One concern that has been raised is whether Personal Accounts would be suitable for all of the employees who are auto-enrolled, either due to the interaction with the tax and means-tested benefit systems, or due to an individual's particular circumstances.

If Personal Accounts are not suitable for everybody, then this would not necessarily mean that individuals should not be auto-enrolled. But it would have important implications for what information is needed to help people make informed decisions about whether they should opt out.

This paper considers the interactions between Personal Accounts, state pensions and the tax and means-tested benefit systems, in order to identify groups for whom Personal Accounts are likely to be suitable and those for whom they are less likely to be suitable.

Chapter 1 describes the Government's proposal to introduce a new system of Personal Accounts and explores the key concerns that have been raised.

Chapter 2 discusses the factors that would affect returns from Personal Accounts and what affects the minimum level of return that is needed for a Personal Account to be suitable.

Chapter 3 analyses hypothetical individuals who are in their twenties in 2012.

Chapter 4 analyses hypothetical individuals who are in their forties or fifties in 2012.

Chapter 5 considers the implications of debt and affordability on the decision about whether to stay opted in or to opt out of Personal Accounts.

Chapter 6 gives a summary and next steps.

This paper is intended as a contribution to the policy debate on Personal Accounts. It should not be relied on by individuals or their advisors as the basis for saving and investment decisions.

[1] DWP (2006 WP). A full list of references is available on pages 54 and 55.

Summary of conclusions

The Government recently proposed a new system of Personal Accounts be introduced from 2012. Auto-enrolment into private pension provision has potential advantages and should lead to an increase in the number of people saving for retirement.

Personal Accounts could give many people access to a low-cost pension savings product with an employer contribution for the first time. 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.

Inevitably, auto-enrolment raises questions about the suitability of Personal Accounts for the employees who are auto-enrolled. In this paper, 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'.

In this paper, 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.

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.

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.

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.

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.
- 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.

Other factors can affect whether or not Personal Accounts are suitable:

- Returns from saving in Personal Accounts could be higher for people who are married at some point in retirement, rather than always single as the above examples assume. The majority of pensioners are married at some point in their retirement, so this could improve suitability for many people.
- It may still be advisable for some people in the high-risk category to save. For example, they could have a strong preference to smooth consumption over their lifetime.
- Conversely, it may not be advisable for people in the low-risk category to save, for example if they have high levels of debt. Levels of both secured and unsecured debt appear historically high and a sizeable minority of people carry over credit card balances from month to month.
- Whether contributions are affordable will depend on individual preferences on current expenditure and saving.

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.

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.

Two further factors for the Government to consider are:

- The design of the information provided for Personal Accounts may need to change over time, to reflect the gradual transition to the proposed pensions system, which could affect today's younger and older workers differently.
- Trivial commutation may improve returns from saving in Personal Accounts. How the trivial commutation limit is uprated in future could make a large difference to some people.

Chapter 1: Background to Personal Accounts

This chapter describes the Government's proposal to introduce a new system of Personal Accounts, describes key stakeholders' reactions to the proposed scheme, and explores the key concerns that have been raised.

Personal Accounts

The Government proposed that a new system of Personal Accounts be introduced from 2012. Although many details are yet to be finalised, the basic framework would be:

- Auto-enrolment for all employees aged over 22 and earning more than £5,035 a year into a Personal Account (or an equivalent), with the opportunity to opt out.
- A minimum contribution of 4% from the individual on band earnings between £5,035 and £33,540 a year. This would be matched by a minimum[2] 1% contribution of band earnings from the Government and a compulsory[3] 3% contribution of band earnings from the individual's employer.
- Low charges, aiming for an annual charge of 0.3% of assets under management.

The Government consulted on its proposals between May and September 2006. It now plans to release a second White Paper in December 2006, containing more detailed proposals on the operation of Personal Accounts.

Responses to the Government's consultation revealed broad support for the principle of auto-enrolment. A recent PPI stocktake of consultation responses found almost unanimous support among key stakeholders for the principle of auto-enrolment, with 22 out of 24 organisations surveyed in favour[4]. 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[5].
- 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[6].
- There is also evidence that employers and individuals are in favour of automatic enrolment[7].

[2] As this is provided through the current system of pension tax relief, the Government contribution would be higher for individuals who pay higher rate tax

[3] For employees who do not opt out of Personal Accounts

[4] PPI Briefing Note 34. 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. 22 of the 24 organisations supported the principle of auto-enrolment.

[5] DWP (2006 WP) page 63

[6] Based on a survey of private companies with at least five employees, Deloitte (2006) page 17. 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) paragraph 3.29.

[7] DWP (2006 WP) page 63

However, two major concerns have been 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.

Levelling down is an important policy issue and further research is needed to assess how employers may respond to the new proposals. This paper does not attempt to assess the possible risk of levelling-down but instead focuses on the other major concern that has been raised – whether Personal Accounts will be suitable for all.

What is 'suitability'?

The regulatory framework for Personal Accounts has not yet been decided. One important consideration when giving advice to individuals on any savings product is the criteria that are used to assess whether the product is suitable or not.

Two possible criteria that could be used to assess the suitability of saving in Personal Accounts are:

1. That saving in a Personal Account is the best thing for individuals who stay auto-enrolled. This condition would not be met if another product would have been preferable than a Personal Account, even if an individual would not strictly lose out from saving in a Personal Account.
2. A less stringent condition is that individuals who stay auto-enrolled should not lose out as a result of their saving. This compares the difference between the amount saved and the likely amount eventually received as pension income. It aims for there to be at least a minimum return on saving.

The first of these criteria is more consistent with the definition of 'suitability' that the Financial Services Authority (FSA) requires firms to consider when giving advice on investment products to consumers. The FSA definition broadly aims to ensure that, when consumers are being advised about investments, any recommendation takes account of client's particular circumstances[8].

[8] For full details, see FSA Handbook Conduct of Business Section 5.3

The Government has specified that Personal Accounts should have a low charge. This charge means that Personal Accounts will most likely provide a system of generic advice rather than advice tailored to individuals' detailed circumstances, which would be more costly to provide.

This paper therefore adopts the second of the suitability criteria as the definition of 'suitability', rather than the FSA definition. This paper compares the difference between the amount saved and the likely amount eventually received as pension income, and treats a product as being suitable if there is at least a minimum return on saving.

The next chapter discusses the factors that would affect returns from Personal Accounts, and the minimum level of return that is needed for a Personal Account to be suitable.

The required minimum level of return will vary from person to person, depending on their preferences. This paper will therefore categorise individuals as 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.

For many people, personal indebtedness and the affordability of Personal Account contributions could be important factors that affect whether Personal Accounts are suitable for them. Debt and affordability are therefore considered in detail in Chapter 5.

Chapter 2: Returns from saving in Personal Accounts

This chapter discusses the factors that would affect returns from Personal Accounts and what affects the minimum level of return that is needed for a Personal Account to be suitable.

This chapter shows that no single definition of 'suitability' is likely to be appropriate for the circumstances of every individual:

- Expected returns from Personal Accounts will vary from person to person, depending on how they are affected by the tax and benefits systems.
- Different individuals could have different requirements for expected returns from Personal Accounts, depending on their preferences.
- This paper categorises individuals by the risk of Personal Accounts being unsuitable for them, rather than by whether Personal Accounts are definitely suitable or definitely not suitable.

Returns from saving in the new Personal Accounts are likely to be higher than returns from saving in the current Stakeholder pensions.

What determines returns from saving?

The combination of compulsory employer contributions[9], tax relief and expected investment returns could make saving in Personal Accounts relatively attractive for some individuals. But on the other hand, the tax and means-tested benefit systems in retirement could put some people at risk from a low return from Personal Accounts.

The employer contribution to Personal Accounts can be a significant incentive to save in a Personal Account. For every £1 that an employee contributes, his or her employer will be compelled to contribute at least 77p[10], unless the employee has opted out.

In this paper, it is assumed that employers do not reduce salaries in order to recover the expense of the compulsory contributions. If salaries were reduced, then this could reduce expected returns from saving in Personal Accounts, depending on how the reductions were applied. The appendix discusses this possibility in more detail, using the quantitative tools that are introduced later in this chapter.

[9] The employer would be compelled to make a contribution provided that the employee does not opt out of Personal Accounts

[10] This is 77p rather than the 75p that would result from a strict 4:3:1 system of individual, employer and Government contributions because of the impact of income tax. The matching would be £1-for-£1 rather than 77p-for-£1 for higher rate taxpayers, due to the greater value of tax relief making the net cost of employee contributions less.

The Government contribution to Personal Accounts can also be an incentive to save. For every £1 that an employee contributes, the Government would contribute at least 28p[11]. However, retirement income from Personal Accounts would be taxable, so some of this Government contribution could be reclaimed by the Government as income tax in later life.

While the employer and Government contributions can be incentives to save, means-tested benefits in retirement can be disincentives to save.

There are currently a number of means-tested benefits for which pensioners may be eligible:

- Pension Credit consists of two elements, Guarantee Credit and Savings Credit[12]. Guarantee Credit aims to ensure that the poorest people over age 60 have a minimum level of income. Savings Credit is an additional amount that aims to reward saving for some low-income pensioners.
- Council Tax Benefit is a rebate scheme which can provide an amount to cover council tax.
- Housing Benefit is an amount to help with housing costs. It can cover rent and some accommodation-related service charges. It does not cover the cost of buying a home or mortgage payments.

All three of these means-tested benefits aim to target state spending where the need is greatest. However, one disadvantage of means-tested benefits is that they can be disincentives to save. This is because, if an individual makes private saving, then the extra income received in retirement can mean lower entitlements to means-tested benefits.

The future extent of the means-tested Pension Credit is very uncertain, with a potential range of between one-third and 45% of pensioner benefit units eligible in 2050[13]. There are no estimates of how many people may be eligible for Council Tax Benefit or Housing Benefit in future.

[11] This is 28p rather than the 25p that would result from a strict 4:3:1 system of individual, employer and Government contributions because of the impact of income tax. The matching would be 67p-for-£1 rather than 28p-for-£1 for higher rate taxpayers due to the greater value of tax relief.

[12] For a more detailed description of Pension Credit, see ***The Pensions Primer***, available on the PPI website, www.pensionspolicyinstitute.org.uk

[13] The percentage of benefit units eligible for Pension Credit in 2050 could be higher if future incomes from state and private pensions are lower than these estimates assume. See PPI (2006 WP) chapter 4 for more details. A 'pensioner benefit unit' is a single or a couple who can apply for Pension Credit.

To calculate the expected returns from Personal Accounts, it is important to consider the interaction between all elements: means-tested benefits and also the employer and Government contributions to Personal Accounts. Being on Pension Credit in retirement does not necessarily mean that an individual would have received a poor return from a Personal Account.

The proposed Personal Accounts aim to have low charges. All other things being equal, a low charge would give a higher pension outcome than a high charge[14], and therefore increase expected returns from saving.

This paper uses the PPI's Individual Model[15], which has been extended for this paper to incorporate the means-tested Housing Benefit and Council Tax Benefit.

Measuring returns from saving

To understand the interaction between the different factors that determine returns from saving in Personal Accounts, this paper uses two different measures: the net present value and the internal rate of return. This section describes these two concepts.

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.

The net present value calculation allows for the factors that affect the returns from saving in Personal Accounts: employer contributions, tax relief, expected investment returns, charges, tax and means-tested benefits.

For example, the net present value of a saving of £1 in a Personal Account could be £2.73 for a median-earning man with a full National Insurance (NI) record who is aged 25 in 2012 and who retires at age 68 in 2055[16]. Box 1 explains in more detail how this is calculated.

[14] See PPI Briefing Note 33 for a discussion of the importance of low charges in Personal Accounts

[15] For more details on the Individual Model see Curry (2003). The Individual Model was used in January 2006 to validate the model that the Department for Work and Pensions uses for its incentives to save calculations. The two models were found to produce broadly similar results if the same assumptions are used. More details are available upon request.

[16] PPI analysis. This individual is assumed to contribute continuously to a Personal Account from age 22 until state pension age. Net present value figures are presented as unrounded numbers in this paper, to enable a comparison between similar figures. However, it should be realised that figures are not accurate to a precision of £1 because of uncertainties around what will happen in future.

Box 1: Calculation of the net present value

The net present value of saving £1 in a Personal Account could be £2.73 for a median-earning man with a full NI record who is aged 25 in 2012. This is calculated as follows:

- This particular individual is assumed to make the minimum contribution to Personal Accounts in every year from 2012. This saving attracts the minimum level of employer contributions, tax relief, assumed investment returns and charges.
- On average, for every £1 that he contributes, he receives an annuity which provides income of 23p a year. A level annuity is assumed to be bought, so that this amount is not increased from year to year[17].
- The expected total amount received from his annuity, over the course of his retirement, is £3.76, in today's prices. This assumes that he dies at his life expectancy of 89[18]. It allows for the gradual erosion of the annuity with inflation over time that results from the level annuity.
- The net present value of the £1 of saving is less than £3.76 because of the effects of income tax and means-tested benefits. Not all of the £3.76 is an increase in income because it is taxable and because it results in a reduction in means-tested benefits.
- Allowing for income tax and means-tested benefits reduces the net present value from £3.76 to around £2.73.

The net present value is expressed in today's prices, so that it allows for the effects of inflation over time. In other words, the median-earning man with a full NI record receives a return that is high enough to protect his contributions against inflation and in addition increase the real value of a £1 contribution to around £2.73.

The net present value calculation is based on a projection of state pension entitlements. The median-earning man with a full NI record who is aged 25 in 2012 is projected to receive a total of £140 a week in state pensions at state pension age, consisting of the full Basic State Pension of £76 and State Second Pension of £64 (in today's earnings terms).

The calculation makes assumptions about the expected level of investment returns, inflation, longevity, and the future tax and benefit systems. These assumptions are set out in the appendix.

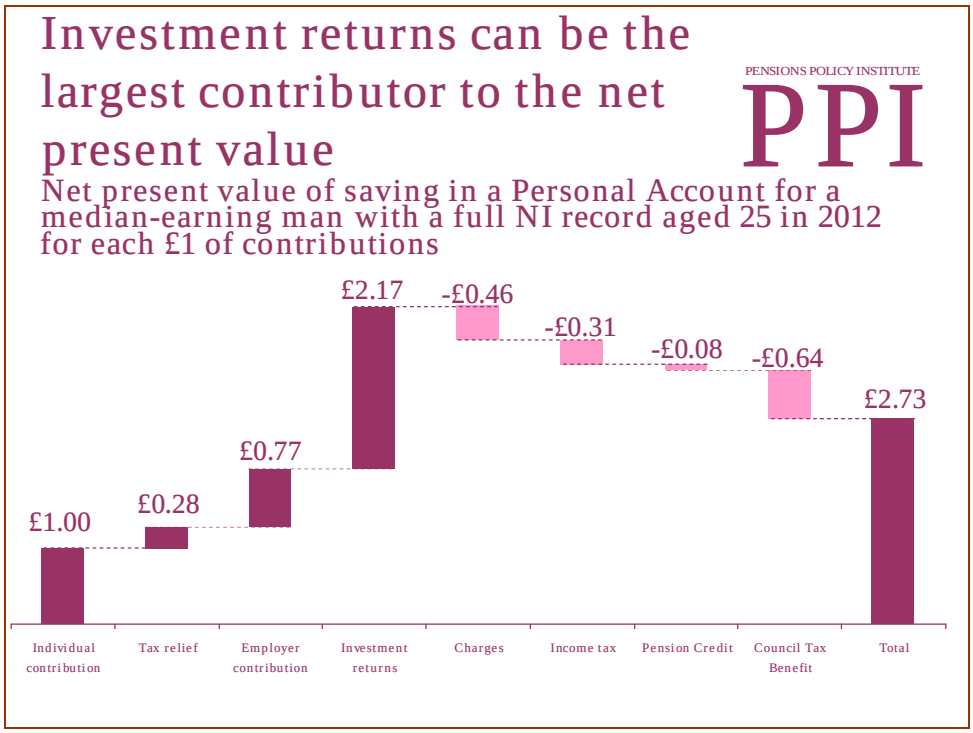
These and other figures shown in this report are illustrative only and do not provide any indication of a guaranteed return. Nothing in this paper should be used by individuals or their advisors as the basis for saving and investment decisions.

[17] See the appendix for full details of the assumptions used
[18] Cohort life expectancy from GAD 2004-based population projections

The employer contribution, tax relief and investment returns all contribute to a higher net present value. For the median-earning man with a full NI record who is aged 25 in 2012, investment returns are the largest contributor, reflecting the power of compound interest over the working life (Chart 1):

- Before the impact of income tax and means-tested benefits, expected investment returns increase the net present value of the £1 of saving by £2.17.
- This compares to 77p for the employer contribution and 28p for tax relief.

Chart 1[19]



An alternative to the net present value is the internal rate of return. This is similar to the net present value but is expressed as an annual interest rate. Effectively, it is the nominal interest rate that the individual receives on his or her individual contributions, after allowing for the effects of tax relief, employer contributions, investment returns, charges, income tax and means-tested benefits[20]. It is the same as the 'effective rate of return' used by the Pensions Commission to investigate the expected returns from saving in the National Pensions Saving Scheme (NPSS, renamed 'Personal Accounts' in the White Paper)[21].

[19] PPI analysis

[20] Formally, the internal rate of return is defined to be the discount rate that sets the net present value to £1 (i.e. to the value of the contributions paid in). Although net present values are calculated by summing income in real terms in this paper, they could be calculated by discounting payments at any given rate, rather than necessarily with inflation. The definition of the internal rate of return means that if the net present value is calculated at a discount rate equal to the internal rate of return, then the net present value would be equal to £1.

[21] Pensions Commission (2006) page 21. See also Pensions Commission (2004) Chapter 6 and Pensions Commission (2005) Chapter 7.

The median-earning man with a full NI record who is aged 25 in 2012 could have an internal rate of return of around 5.9%. This is higher than inflation which is assumed to be 2.5% a year.

All other things being equal, a higher net present value means a higher internal rate of return, and vice versa. One advantage of the internal rate of return is that it shows the gains from saving on an annual basis.

The internal rate of return is the approach that will be principally used in this paper to estimate returns from saving in Personal Accounts, although net present values will also be shown.

Important note

It is important to realise that the internal rate of return cannot be compared with investment returns on other forms of saving. For example, it is not possible to say that, if an individual has an internal rate of return of 4% from saving in a Personal Account, and another savings product such as an ISA has an investment return of 5%, then saving in the ISA is preferable to saving in a Personal Account. This is because the 4% figure for the internal rate of return of saving in a Personal Account takes account of the impact of means-tested benefits. Means-tested benefits can also affect the value of saving in an ISA, and many other products. The impact of means-tested benefits is not taken into account in the 5% figure for the investment return from the ISA, and so the 4% and 5% figures cannot be directly compared.

There are therefore two types of 'return' that are discussed in this paper – the internal rate of return and the investment return - and they cannot usually be compared. For clarity, where investment returns are meant, the full term is always used. Sometimes, for brevity and where the context means that there can be no confusion, 'internal rate of return' is abbreviated to 'return'.

What is an acceptable return?

Different individuals could also have different requirements for expected returns from Personal Accounts.

As a starting point, a return equal to inflation would imply that the individual is expected to receive back the inflation-protected value of his or her individual contributions. In one sense, this would mean they are not "worse off" from saving in a Personal Account.

However, it is possible to argue that a return equal to inflation would not be acceptable, and that a higher return than the level of inflation is necessary. For example:

- Saving in a Personal Account is also less flexible than saving in some other products. For example, contributions usually cannot be accessed until retirement. So, an individual may expect a higher return than the level of inflation to compensate for this relative inflexibility.
- There are risks involved with any long-term savings product. For example, an individual may require a higher expected return to compensate for the risk that the value of his or her investments could fall. An individual with a return equal to inflation would not receive any of the real investment returns on his or her contributions.
- Individuals may also perceive that there is a political risk in long-term saving.

On the other hand, it is possible to argue that in some cases a lower return than inflation could be acceptable:

- Individuals may perceive that there are risks in not saving for retirement. For many individuals, not saving for retirement could mean a low level of retirement income, relative to income during working life.
- An individual who has a relatively high disposable income in working life but who has made little savings for retirement may want to smooth his or her consumption over his or her lifetime. This refers to the possibility that an individual may value the extra income in retirement that results from saving more than the reduction in income in working life that results from saving. He or she may choose to save for retirement, even if it means getting back less than he or she puts in, after allowing for inflation.
- An individual could desire the inflexibility of Personal Accounts, as a way of taking away the temptation to spend money now.

However, there is a risk that, if returns from saving in Personal Accounts are low, then individuals will not perceive that they have benefited from saving in them. All other things being equal, a high return rather than a low return would both make saving more attractive to an individual, and also reduce the risk to future governments that pensioners in future perceive that they have done badly from Personal Accounts, and lobby for compensation.

In the absence of a definitive single benchmark, a number of benchmarks are used in this paper. Based on the value of the internal rate of return, examples are classified by the risk of Personal Accounts not being suitable for them (Chart 2):

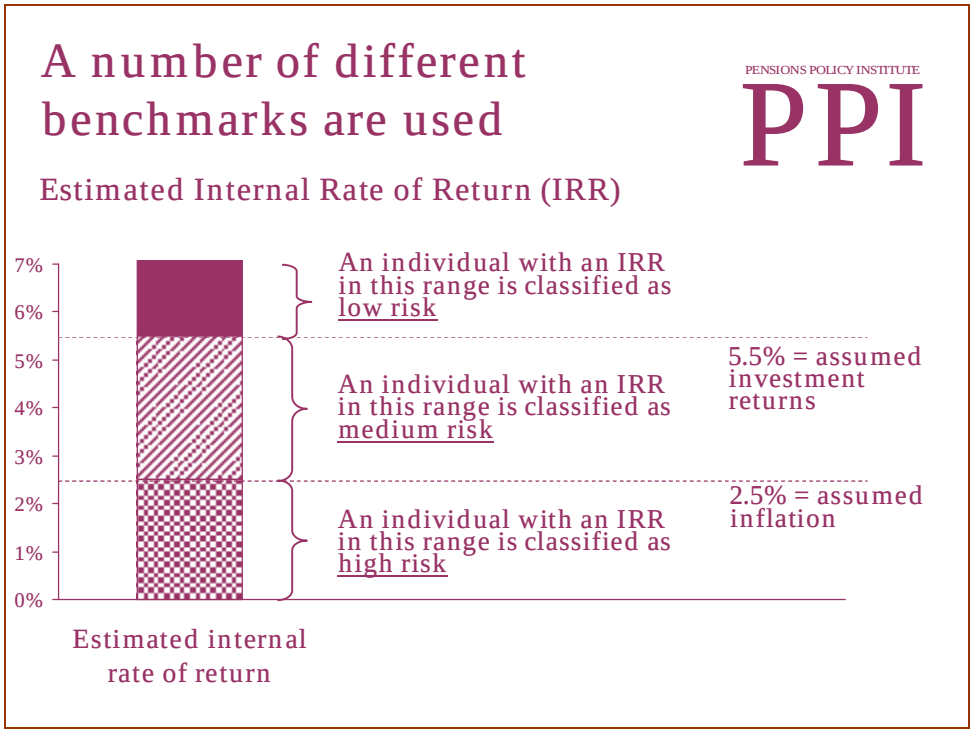
- An individual is classified as high-risk if he or she has a return of less than inflation. An individual in this situation would not receive the inflation-protected value of his or hers own individual contributions back from Personal Accounts.
- An individual is classified as medium-risk if he or she has a return of more than inflation but lower than the expected investment return. An individual in this situation would receive the inflation-protected value of his or her own individual contributions plus some credit (but not necessarily total credit) for the real investment returns earned by investing those contributions.
- An individual is classified as low-risk if he or she has a return that is higher than the expected investment return. An individual in this situation would receive the value of his or her own individual contributions plus full credit for the real investment returns earned by investing those contributions. In addition, he or she would receive back some (but perhaps not all) of the value of the employer contribution, the Government contribution and investment returns on the employer and Government contributions.

The calculation of the internal rate of return requires an assumption to be made on the expected level of future investment returns. The assumptions used in this paper is 3% in excess of prices, or a nominal rate of 5.5%. The categorisation of individuals into the low, medium and high-risk categories used in this paper is not particularly sensitive to the assumed level of expected investment returns. This is because a higher investment return would increase the upper benchmark used[22].

The median-earning man illustrated above with an internal rate of return of 5.9% a year would therefore be in the low-risk category.

[22] The appendix contains more information about the assumptions used in this paper and illustrates the effect of varying the assumptions made

Chart 2



Other benchmarks are possible than the ones adopted in this paper. For example:

- The Government have used net present values in a way consistent with the lowest of the benchmarks, equal to the level of inflation. ***The analysis shows that people's expected payback from saving will generally be improved as a result of reform, with the large majority of people able to expect a payback of at least £1 plus inflation for each £1 that they save. This is the basis on which we are introducing automatic enrolment***[23].
- Some other organisations have advocated using a higher benchmark than any of those used in this paper[24].

The aim of the risk categories used in this paper is to identify the groups of individuals who may be 'at risk' of being auto-enrolled into a Personal Account that is not suitable for them. The Government will need to ensure that these groups are provided with information to help them make a decision about whether they should opt out of Personal Accounts.

It may still be rational for an individual to save in a Personal Account, even if he or she is in the high-risk category. For example, if an individual has made little saving for their retirement, they may be willing to accept very low returns in order to provide them with some income in retirement on top of state benefits.

[23] DWP (2006 FISR) paragraph 1.12
[24] For example, Standard Life (2006), Royal London (2006)

Conversely, it may not be rational for an individual to save in a Personal Account, even he or she is classified as 'low-risk'. For example, he or she might be affected by the debt or affordability issues that are discussed in Chapter 5.

Even for individuals in the high-risk and medium-risk categories, a Personal Account may still be the best retirement savings product available to them. The next section shows that returns from saving in Personal Accounts are likely to be higher than returns from saving in the current Stakeholder pensions for many people.

Personal Accounts and Stakeholder pensions

Although there are concerns about the suitability of Personal Accounts for all, it is important to realise that the White Paper proposals are likely to mean higher expected returns from saving for a pension than they would be the case if the pensions system were not reformed.

Personal Accounts could give many people access to a low-cost pension savings product with an employer contribution for the first time. 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.

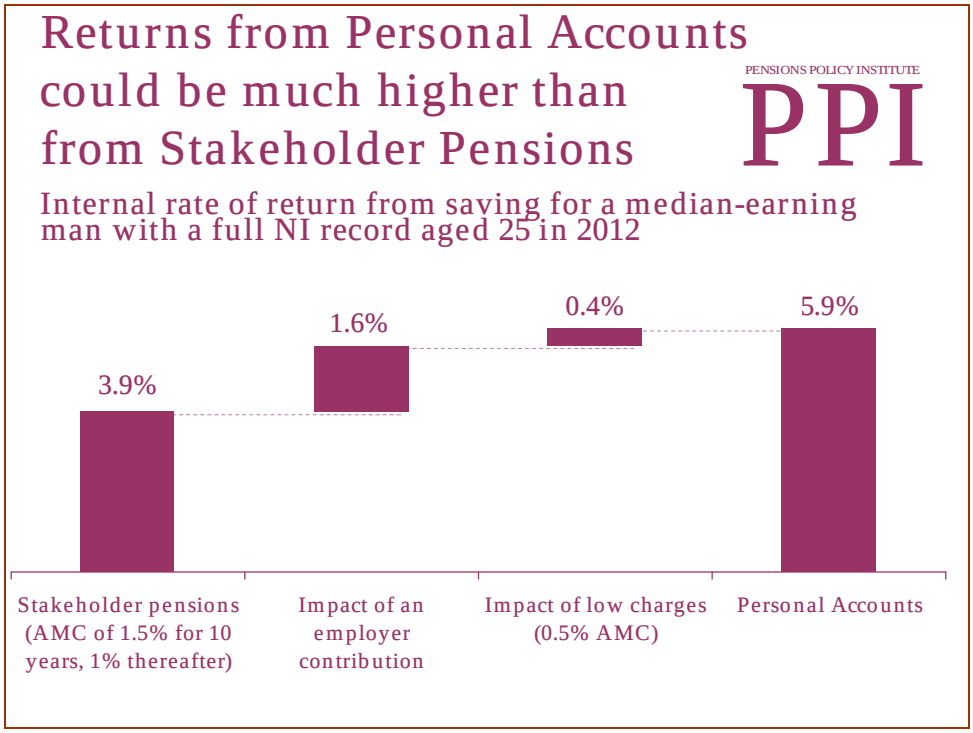
In 2004/5, around 14 million employees either did not have access to an occupational pension scheme, or else had access to one with an employer contribution of less than 3%[25]. Personal Accounts should mean that many of these employees (those aged over 22 and earning more than £5,035 a year) will have access to an employer contribution for the first time, of at least 3%.

The employer contribution and low charges in Personal Accounts could increase returns from saving significantly. For example, assuming the proposed state pension reforms are fully implemented (Chart 3):

- A median-earning man with a full NI record who is aged 25 in 2012 could have an internal rate of return of 3.9% if he saved in a Stakeholder pension.
- The impact of a 3% employer contribution could be to increase the internal rate of return by 1.6%, to 5.5%.
- The impact of a low charge, of 0.5% of assets under management each year, is to increase the internal rate of return by a further 0.4%, to 5.9%.
- Returns from saving in Personal Accounts could therefore be 2.0% a year higher than returns from saving in the current Stakeholder pensions, at 5.9% rather than 3.9% for the median-earning man.

[25] DWP (2006 WP) page 65

Chart 3[26]



Impact of state pension reform

This paper assumes that the proposed state pension reforms in the May 2006 White Paper are fully implemented[27]. In the absence of state pension reform, returns from saving in Personal Accounts would typically be lower than shown in this paper. For example, the median-earning man with a full NI record who is aged 25 in 2012:

- If the state pensions system were not reformed at all, but Personal Accounts were still introduced, then his internal rate of return from saving in a Personal Account could be significantly lower, at 4.4%.
- However, the Government has decided to reform state pensions. The impact of their state pension proposals could be to increase his return from saving in a Personal Account from 4.4% to the 5.9% shown in Chart 3.

The next chapter estimates returns from saving in Personal Accounts for several different hypothetical individuals, in order to identify groups for whom Personal Accounts are likely to be suitable and those for whom they are less likely to be suitable.

[26] PPI analysis. Assumes he saves the equivalent of the minimum employee contribution to Personal Accounts (5% of gross earnings between £5,035 and £33,540 a year, including the tax relief component).
[27] These reforms include the re-indexing of the level of the Basic State Pension (BSP) to average earnings, improvements to the coverage of BSP, the gradual flattening of State Second Pension and the gradual increasing of state pension age See the appendix for more details.

Chapter 3: What individual characteristics affect returns?

This chapter analyses hypothetical individuals who are in their twenties in 2012, to identify the individual characteristics that could lead to low returns from Personal Accounts, and may therefore be important to consider when designing the information to be provided with Personal Accounts. Today's older workers are likely to be affected by the proposed transition to the new pension system, and are given special attention in the next chapter.

This chapter shows that:

- Individuals in their twenties in 2012 with full working histories could be at low risk of Personal Accounts being unsuitable for them.
- Individuals in their twenties in 2012 with a combination of low earnings and broken working histories could be at medium risk.
- Individuals who are likely to rent in retirement could be at high risk of Personal Accounts being unsuitable for them. For these people, saving in Personal Accounts could mean a large reduction in future entitlement to Housing Benefit.
- Although the self-employed would not be auto-enrolled into Personal Accounts, periods of self-employment can reduce the value of Personal Account saving made during periods of employment.
- Returns from saving in Personal Accounts could be higher for individuals with retirement savings on top of the 4% minimum.
- Returns from saving are likely to be higher for individuals who will be married in retirement than for individuals who will be single.

Individuals tested

In its White Paper response, the PPI identified certain 'groups' of individuals who are more likely to have an uncertain value of saving in a Personal Account[28]:

- People with interrupted National Insurance and Personal Account histories.
- People who will potentially be eligible for means-tested benefits, including Pension Credit, Council Tax Benefit and Housing Benefit.
- People already close to state pension age (say, in their fifties today).

These groups are similar to those identified by the Financial Services Authority (FSA) as groups for whom Personal Accounts may not be suitable[29].

[28] PPI (2006) paragraph 3.14
[29] FSA (2006) paragraphs 12 to 14

This paper analyses 210 hypothetical examples, including people with the characteristics identified by the PPI and the FSA, in order to identify who might be at risk of Personal Accounts being unsuitable for them.

People have many different life histories and it is not possible to be fully representative of the entire working age population, even with several hundred examples. But by analysing different examples, insights can be gained about the factors that are likely to affect returns from saving in Personal Accounts.

The hypothetical individuals analysed have:

- 7 different career histories: People with different working, caring and saving patterns. These different career histories are described in Box 2.
- 3 different generations: This chapter analyses hypothetical individuals who are aged 25 in 2012 when Personal Accounts are introduced. The next chapter analyses similar people aged 40 and 55 in 2012.
- Men and women. Females are assumed to have longer life expectancies and lower annuity rates.
- 5 different levels of earnings. Earnings are assumed to differ for people of different ages and sex, in line with earnings patterns observed today.

The individuals and their employers are assumed to contribute only the minimum amounts to Personal Accounts, unless specified otherwise in Box 2.

Throughout the analysis, Council Tax Benefit, Pension Credit and Housing Benefit are all assumed to remain in the future in their current form. It should be noted that future Governments may alter these benefits in the future.

All individuals are assumed to pay Council Tax during retirement, of £15 a week[30]. Council Tax rates are assumed to increase in line with the growth in earnings in future.

Some hypothetical individuals who rent in retirement are included in Box 2. These individuals are potentially eligible for Housing Benefit in retirement. They are assumed to pay rent of £70 a week[31]. Rents are assumed to increase in line with the growth in average earnings in future.

A discussion of the likely impact of making different assumptions regarding future growth in rents and Council Tax rates is in the appendix.

None of the individuals are assumed to qualify for Working Tax Credits or Child Tax Credit during working life. Receipt of tax credits can lead to increased returns from saving[32].

[30] This is the average amount of Council Tax paid by today's Council Tax Benefit claimants, DWP (2006 HB) Table HB2.2
[31] This is the average amount of rent for today's Housing Benefit claimants, DWP (2006 HB) Table HB1.5
[32] Pensions Commission (2005) Chapter 6

Box 2: Individuals modelled

A) Full NI Record: An individual who is in full-time work from leaving education until retiring at state pension age. He[33] has the maximum number of qualifying years for Basic State Pension (BSP) and State Second Pension (S2P). He contributes to a Personal Account continuously from 2012 until reaching state pension age.

B) Caring breaks: An individual with two short career breaks for caring. She is out of work for six years in her late twenties and early thirties to care for her child, during which she receives credits to BSP and S2P. After the six years, she works part-time for five years and then full-time until her mid-fifties, when she is out of work for five years to care for an elderly relative. It is assumed that this second period of caring does not qualify for credits for BSP and S2P, perhaps because she does not care for the 20 hours per week required under the White Paper proposals. After these five years of caring, she returns to work until she retires at state pension age. She and her employer contribute to a Personal Account while she is working but not during her 11 years of caring.

C) Intermittent unemployment: An individual with a total of 18 years of unemployment. When he is unemployed, he receives Jobseekers Allowance or Incapacity Benefit. He contributes to Personal Accounts from 2012 when in work.

D) Full NI record, renting in retirement: The same as individual A, except that he is assumed to rent accommodation in retirement. He is therefore potentially eligible for Housing Benefit, if his income is low enough to qualify. He is assumed to pay £70 a week in rent[34], increasing in line with growth in average earnings.

E) Self-employed: An individual who is employed until age 40 and then becomes self-employed. When he is employed, he stays opted in to a Personal Account. When he is self-employed, he voluntarily opts in, contributing the standard employee amount of 5% of band earnings, including the tax relief component. He does not receive an employer contribution when he is self-employed.

F) Full NI record, large other saving: The same as individual A, except that he is assumed to have other private saving on top of his Personal Account, equal to £100,000 in 2006/7 earnings terms by the time he reaches state pension age[35]. This could be saving made before Personal Accounts are introduced in 2012 or could be saving made after 2012, on top of Personal Accounts.

G) Caring breaks, small other saving: The same as individual B, except that she is assumed to have other private saving on top of her Personal Account, equal to around £35,000 in 2006/7 earnings terms by the time she reaches state pension age[36]. This could be saving made before Personal Accounts are introduced in 2012 or could be saving made after 2012, on top of Personal Accounts.

[33] For the purposes of illustration some individuals are taken as being male and others female. Males and females have different life expectancies and therefore different internal rates of return. Results for all of hypothetical individuals are included in the appendix, for comparable people of either sex.
[34] £70 is the average amount of rent for today's Housing Benefit claimants, DWP (2006 HB) Table HB1.5
[35] PPI assumption consistent with income currently received at the 7th decile of the pensioner income distribution, an assumed future decline from Defined Benefit schemes and some switching from existing forms of saving into Personal Accounts in future. Analysis based on DWP (2006 PIS).
[36] As footnote 35 but consistent with the 3rd rather than 7th decile of the pensioner income distribution

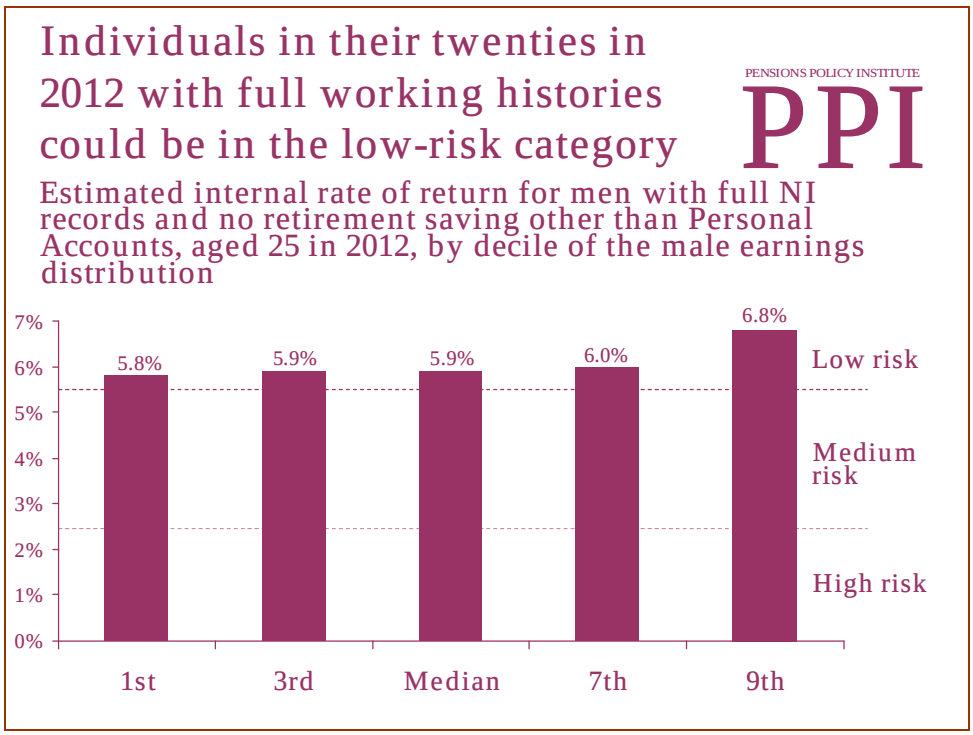
Individuals with full working histories

Individuals with full working histories who are aged 25 in 2012 could be at low risk of Personal Accounts being unsuitable for them.

A median-earning man with a full NI record could have an internal rate of return of 5.9%. Returns could differ for people with higher or lower earnings. However, all of the men analysed with full NI records who are aged 25 in 2012 would be in the low-risk category, regardless of how much they earn (Chart 4):

- If he earns at the 1st decile of male earnings[37] rather than at median earnings[38], then his return could be lower, at 5.8% rather than 5.9%. This is because he is affected more by means-testing in retirement.
- If he earns at the 9th decile of male earnings[39] rather than at median earnings, then his return could be higher, at 6.8% rather than 5.9%. This is primarily because he would receive a higher Government contribution to his Personal Account, since he pays higher-rate tax for part of his working life.

Chart 4[40]



[37] Decile points divide the earnings distribution into ten groups each of which contain the same number of workers. So, for example, 10% of males earn below the 1st decile of the male earnings distribution. The 1st decile of the male earnings distribution is around £11,500 at age 25, increasing to around £14,500 by age 40 and increasing further to around £15,000 by age 50, in 2006/7 earnings terms.

[38] Around £18,500 at age 25, increasing to around £27,000 by age 40 and declining to around £25,500 by age 50, in 2006/7 earnings terms

[39] Around £30,000 at age 25, increasing to around £53,000 by age 40 and declining to around £52,000 by age 50, in 2006/7 earnings terms

[40] PPI analysis using the Individual Model

Individuals with broken working histories

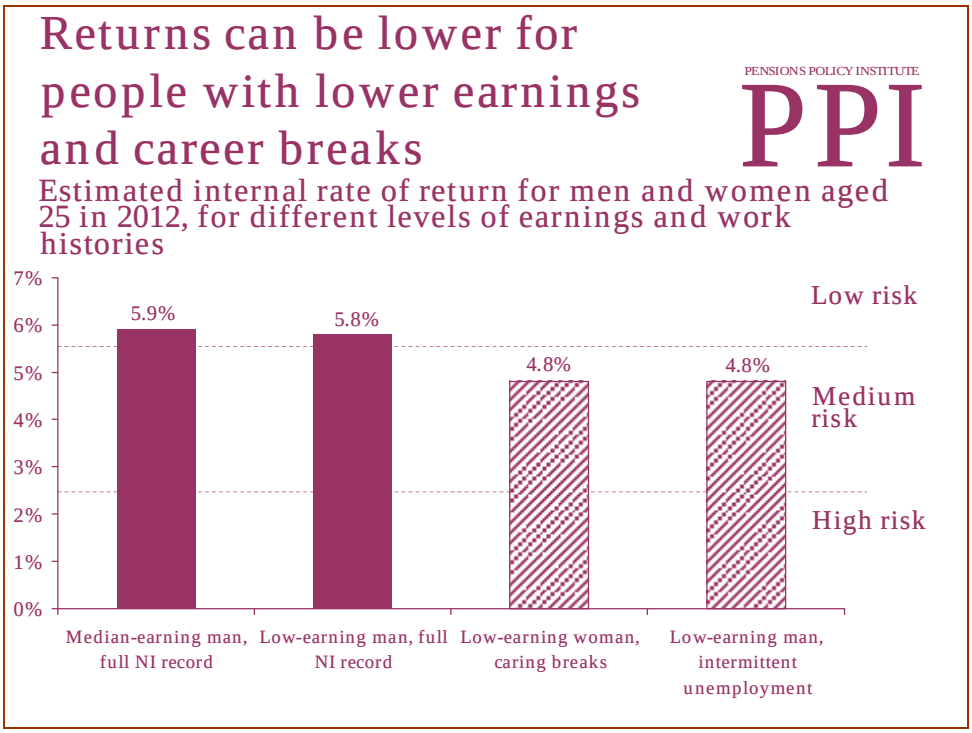
The combination of low earnings and interrupted contribution histories can reduce returns from saving in Personal Accounts significantly. The combined effect can potentially mean that such individuals are in the medium-risk category. For example (Chart 5):

- A woman who is out of work for 11 years with caring responsibilities and who earns at the 1st decile of female earnings[41] while in work could have an internal rate of return of 4.8%. This would put her in the medium-risk category.
- A man who has intermittent periods of unemployment and who earns at the 1st decile of male earnings while in work could also have a return of 4.8%. This is also in the medium-risk category.

This is because:

- Interrupted National Insurance histories lead to lower state pensions. This results in state pensions being a less adequate floor for private saving, so that private saving interacts to a greater degree with means-tested benefits.
- Interrupted contribution histories to Personal Accounts tend to mean that incomes from Personal Accounts are lower. This means that a greater proportion of income from Personal Accounts replaces means-tested benefits rather than increasing overall retirement income.

Chart 5[42]



[41] Around £11,000 a year, in 2006/7 earnings terms

[42] PPI analysis using the Individual Model. The low earners earn at the 10th decile of the earnings distributions rather than at median earnings.

People who rent in retirement

Individuals who are likely to rent in retirement could be at high risk of Personal Accounts being unsuitable for them. For these people, saving in a Personal Account could mean a large reduction in future entitlement to Housing Benefit.

People who rent in retirement are potentially eligible for Housing Benefit for help with rent. Housing Benefit is a means-tested benefit which is withdrawn at the rate of 65p for each additional £1 of income[43]. So saving in a Personal Account could result in a significant loss in income from Housing Benefit.

It is possible to be entitled to Housing Benefit, Council Tax Benefit and Pension Credit at the same time. In this situation, the combined amount received in these means-tested benefits can be withdrawn at a rate of 91p for each additional £1 of income. An individual in this situation who saves enough to receive £1 of income from Personal Accounts could therefore see his overall income increased by only 9p.

The high withdrawal rates that result from being on Housing Benefit can mean that people who rent in retirement receive less than the inflation-protected value of their Personal Account contributions, putting them in the high-risk category.

For example, the main example of a median-earning man above (with a full NI record and aged 25 in 2012) is assumed to own his own home in retirement. He could have an internal rate of return of 5.9%. If he rented, his return could be as low as 0.2% (Chart 6). This would put him in the high-risk category. In this situation, he is unlikely to receive back the inflation-protected value of his contributions. For each £1 of saving he makes, he could only receive back 54p after adjusting for inflation[44].

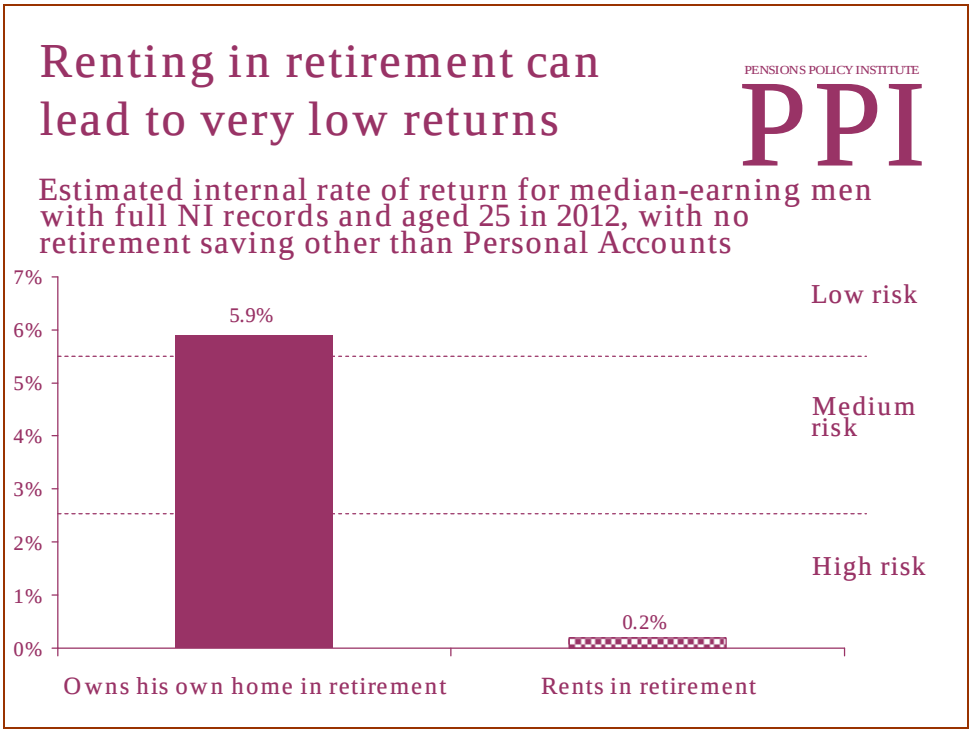
This suggests that the system of generic advice for Personal Accounts should pay careful consideration to the possibility that individuals could rent in retirement.

It is possible that Housing Benefit does not exist in future, and therefore returns are higher than the 0.2% shown in Chart 6. However, it seems likely that some form of means-tested rent assistance scheme will exist in future. Housing Benefit has so far remained in place for 24 years, since 1983, and there has been some form of housing subsidy in Great Britain since 1919.

[43] For incomes above a lower threshold

[44] This is the net present value amount described at the start of this chapter. Net present values for all of the individuals are in the appendix to this paper.

Chart 6[45]



The median-earning man illustrated in Chart 6 would see a much lower return from his saving in a Personal Account if he rented in retirement. This assumes that he has no other saving besides his Personal Account. If he did have some saving, then he may be affected by Housing Benefit to a lesser extent.

However, it should be noted that his internal rate of return from saving in a Personal Account could still be affected by Housing Benefit, even if this saving takes him above Housing Benefit in retirement. This is because he may have been eligible for some Housing Benefit if he had not saved, which he would not receive if he does save.

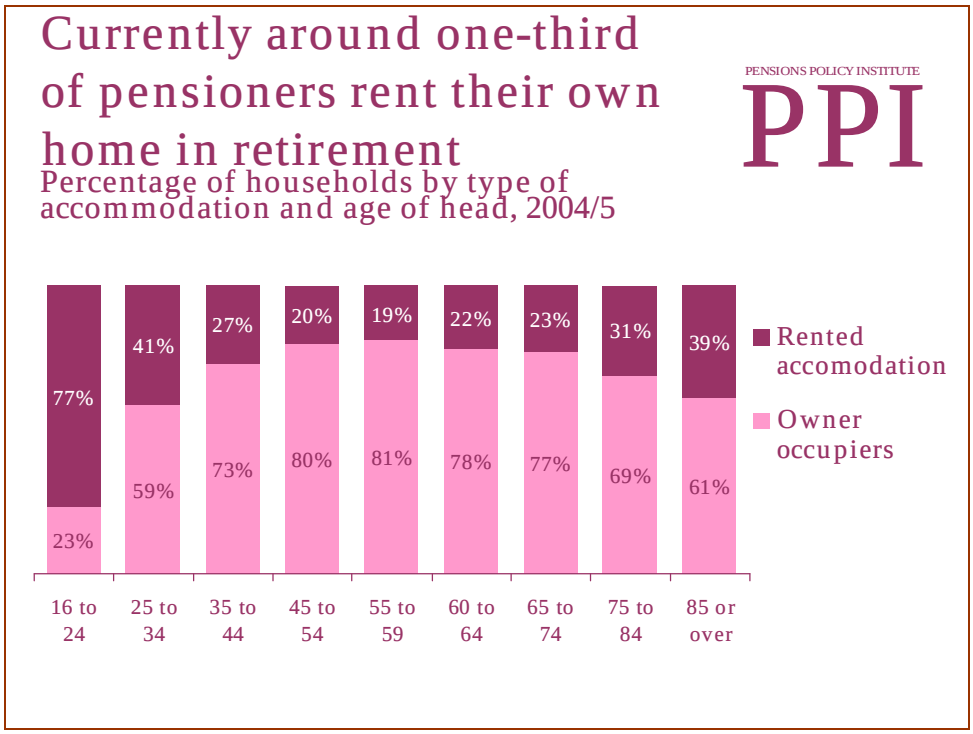
Around one-third of pensioner households currently rent accommodation. Around two-thirds of these (20% of all pensioner households[46]) are currently eligible for Housing Benefit. This suggests that around one-third of pensioner households that rent in retirement currently have sufficient income to take them above Housing Benefit.

[45] PPI analysis, assuming that his rent is £70 a week in today's earnings terms. £70 is the average amount of rent for today's Housing Benefit claimants, DWP (2006 HB) Table HB1.5. Rents could increase faster or slower than earnings in future. Sensitivity analysis is included in the appendix.
[46] DWP (2006 IRB)

It is possible that future levels of home ownership among pensioners increases in future:

- People aged between 45 and state pension age are currently more likely to own their own home than people over state pension age. For example, 81% of households in which the head is aged between 55 and 59 own their own home, compared to 77% for 65 to 74 year olds and 69% for 75 to 84 year olds (Chart 7).
- This pattern suggests that the proportion of pensioners owning their own home in future could increase. This is because the greater home ownership observed for people aged 45 and state pension age today could lead to greater home ownership for people over state pension age in future.

Chart 7[47]



[47] Family Resources Survey 2004/5 Table 4.3. Figures are based on those in private households only.

However, future home ownership is uncertain and this increase in home ownership cannot be taken for granted, particularly in the long term which is relevant for people aged 25 in 2012:

- The future increase expected in the number of single person households could mean that fewer households own their own home in future.
- The average age at which people purchase their first home is increasing[48].
- Future levels of home ownership may be affected by other Government policies than pensions, such as the financing of higher education.
- Whether younger generations inherit housing assets from their parents is uncertain. Equity release could become a more popular way of funding retirement in future. If younger generations do inherit property, this could be after they have reached state pension age.

Self-employment

Although the self-employed would not be auto-enrolled into Personal Accounts, periods of self-employment could reduce the value of Personal Account saving made during periods of employment.

Spending time self-employed could reduce an individual's total retirement income, meaning that he or she is more likely to be eligible for means-tested benefits:

- State Second Pension (S2P) is not accrued during periods of self-employment.
- Spending time self-employed could reduce private income in retirement. Currently 36% of self-employed people of working age contribute to a pension, in comparison to 57% of employees of working age[49].

A study in 2000 found that pensioners who had been self-employed at some point during their working lives were slightly more likely than pensioners who had never been self-employed to be in receipt of means-tested benefits (14% compared to 11%)[50].

It is possible that business assets are built up during time spent self-employed, which are then used to finance retirement. However, this will not be the case for everybody. A recent survey by the Association of British Insurers found that only 6% of self-employed people thought it was realistic that the sale of their business could fund their retirement[51]. PPI analysis suggests that a woman who is self-employed for her entire working life would need to have a business worth around £50,000 to take her completely above Pension Credit, if she had no other forms of private saving[52].

[48] Data supplied by the Council of Mortgage Lenders
[49] Family Resources Survey 2004/5 Table 7.12
[50] Knight and McKay (2000)
[51] ABI (2006) page 5
[52] In 2006/7 earnings terms. See PPI (2006 SW) page 12.

Not accruing S2P while self-employed can significantly reduce returns on saving made in Personal Accounts while employed:

- A median-earning man with a full NI record could receive £141 a week in state pensions[53] when he reaches state pension age in 2055, in 2006/7 earnings terms. This assumes that he is employed for his entire working life. If he becomes self-employed from age 40, then his state pension at state pension age could be £34 a week lower, at £107 a week, as a result of not accruing S2P while self-employed.
- If he were an employee for his entire working life and saved continually in a Personal Account from age 25 to age 40, then he could have an internal rate of return of 5.7%[54]. If instead he became self-employed at age 40, and still did not save after reaching age 40, then he could have a return of 4.7%. The impact of this period of self-employment is therefore to reduce the internal rate of return on the saving he made while he was employed, by 1%. This is as a result of the reduction in his S2P, which means he is more likely to be eligible for means-tested benefits in retirement. It moves him from the low-risk category into the medium-risk category.

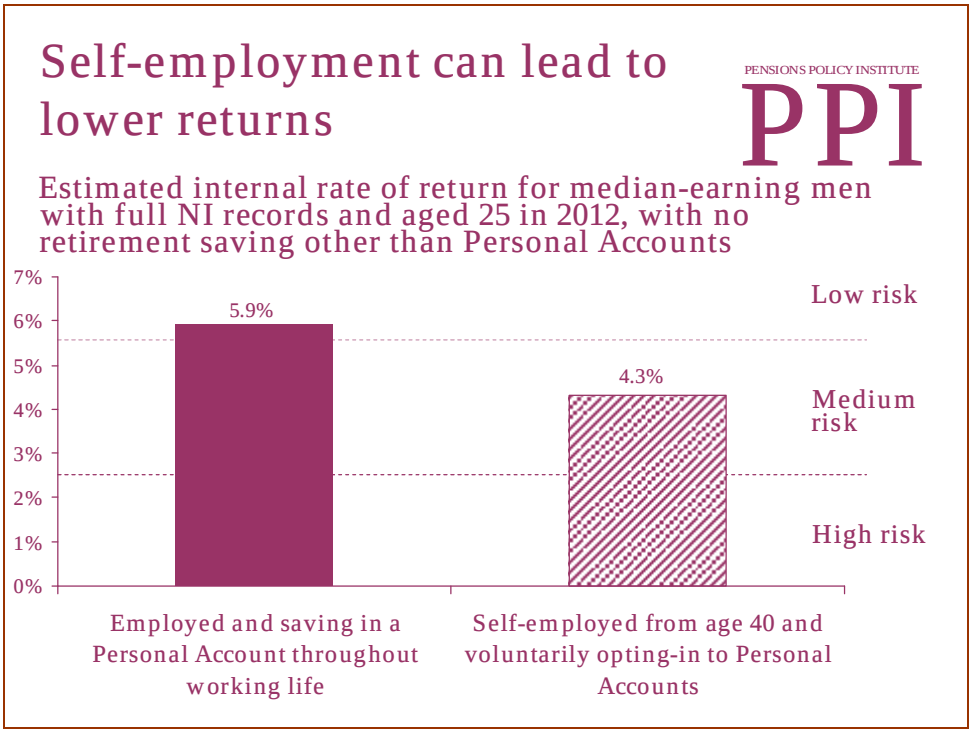
A further consideration regarding the self-employed is that they would not receive an employer contribution.

The value of saving made when self-employed is likely to be lower than the value of saving made while employed, due to the absence of an employer contribution for the self-employed. This means that if an individual voluntarily opts in to Personal Accounts when he is self-employed, then this could reduce the overall internal rates of return from Personal Accounts (averaging over all saving).

For example, if he opted in to a Personal Account when he was self-employed, then his overall internal rate of return could be 4.3% (Chart 8). This compares to the 5.9% that a median-earner could receive if he is employed and contributing to a Personal Account for his entire working life.

[53] Here, 'state pensions' means the combination of Basic State Pension (BSP) and State Second Pension (S2P)
[54] For the purposes of this paragraph, the individual is assumed to opt out of Personal Accounts from age 40. This means that his internal rate of return is slightly lower than the 5.9% that a median-earning man who saves constantly in a Personal Account could receive.

Chart 8[55]



Other private saving

Returns from saving in Personal Accounts could be higher for individuals with retirement savings on top of the 4% minimum. This is because means-tested benefits could be replaced by other saving, rather than by Personal Accounts saving. Returns from saving in Personal Accounts could therefore be higher.

For example (Chart 9):

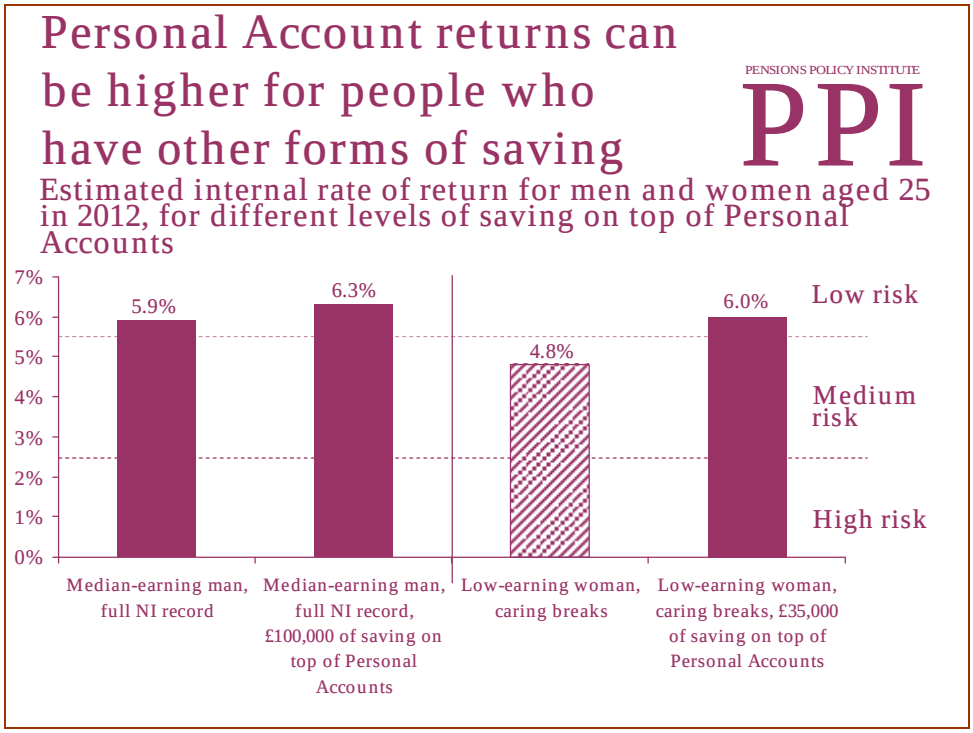
- A median-earning man with a full NI record could have an internal rate of return of 5.9%. If he has savings of £100,000[56] on top of his Personal Account, then this return increases to 6.3%.
- A woman with caring breaks who earns at the 1st decile of female earnings while in work could have a return of 4.8%. If she has savings of £35,000[57] on top of her Personal Account, then this return increases to 6.0%. This would be sufficient to take her out of the medium-risk category and into the low-risk category.

[55] PPI analysis using the Individual Model

[56] See Box 2 for how the £100,000 figure has been derived. For this median-earning man, a saving of £100,000 corresponding to his saving just less than 10% of his salary while he is in work, on the assumptions made in this paper.

[57] See Box 2 for how the £35,000 figure has been derived. For this low-earning woman, a saving of £35,000 corresponding to her saving just less than 10% of her salary while she is in work, on the assumptions made in this paper.

Chart 9[58]



Couples

Returns from saving are likely to be higher for individuals who will be married in retirement than for individuals who will be single.

Many pensioners are either married or cohabiting for at least part of their retirement. In 2003, around 55% of individuals over state pension age were married. This proportion is projected to fall slightly by 2030[59].

Pensioner couples are less likely to be in receipt of means-tested benefits than single pensioners:

- Currently, 12% of pensioner couples are eligible for Pension Credit, compared to 22% of single male pensioners and 30% of single female pensioners (Table 1).
- Similar patterns are observed for Housing Benefit and Council Tax Benefit, with single pensioners more likely to be in receipt than men.
- PPI analysis suggests that Pension Credit could be even more concentrated on single pensioners rather than couples in future, under the White Paper proposals. The Government has recently published similar findings[60].

[58] PPI analysis using the Individual Model
[59] GAD 2003-based population projections by marital status for England and Wales
[60] DWP (2006 PC) page 1

Table 1[61]: Proportion of different types of pensioner benefit units in receipt of means-tested benefits in 2004/5

	Pensioner couples	Single male pensioners	Single female pensioners
Pension Credit	12%	22%	30%
Housing Benefit	8%	21%	24%
Council Tax Benefit	17%	31%	39%

As pensioner couples are less likely to receive means-tested benefits than singles, this suggests that couples are more likely to have higher returns from saving in Personal Accounts than singles.

[61] Family Resources Survey 2004/5 Table 3.15

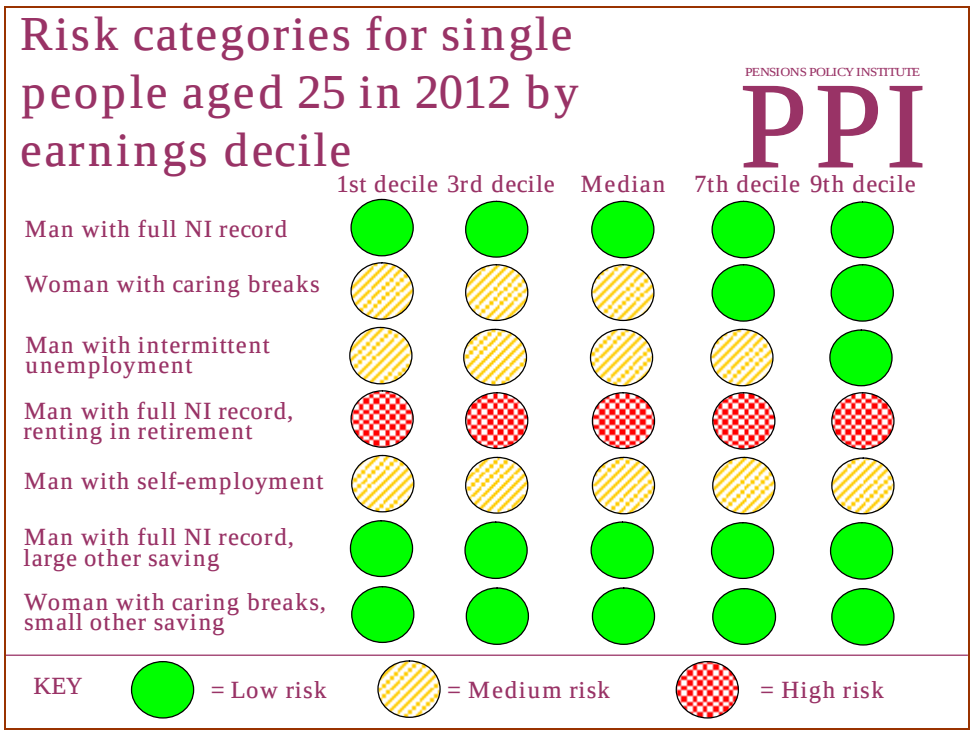
Summary

In summary, most of the hypothetical examples of single people in their twenties in 2012 would be either at low-risk or at medium-risk of Personal Accounts being unsuitable for them (Chart 10):

- People with full working histories could be at low-risk, meaning that they are likely to receive back the value of their individual contributions to Personal Accounts, together with a full investment return on their contributions.
- People with a combination of low earnings and broken working histories could be at medium-risk. It may be suitable for these people to save in Personal Accounts, although their returns are likely to be lower than returns for people in the low-risk group. They would still receive back the value of their individual contributions to Personal Accounts, protected for inflation, and some investment returns on their contributions, although they may not receive full credit for the investment returns.
- People who will rent in retirement could be at high-risk, meaning that they are likely to receive back less than the value of their contributions into Personal Accounts.

Most pensioners are married at some point in retirement and could have higher returns than people who remain single throughout their retirement. This suggests that returns from saving in Personal Accounts could be higher for many people than Chart 10 shows.

Chart 10[62]



[62] PPI analysis using the Individual Model

Chapter 4: The transition to the new system: today's older workers

This chapter analyses hypothetical individuals who are in their forties or fifties in 2012.

This chapter shows that:

- Single people in their forties and fifties in 2012 are likely to have lower returns from Personal Accounts than single people in their twenties in 2012.
- Trivial commutation may improve returns from saving in Personal Accounts, depending on how the trivial commutation limit is uprated in future.

The design of advice may therefore need to change over time, to reflect the gradual transition to the proposed new pensions system.

Returns for today's older workers

People in their forties and fifties in 2012 would be affected by the proposed transition to the new pension system, which is very slow[63].

People in their forties and fifties in 2012 are likely to have lower returns from Personal Accounts than people in their twenties in 2012. This reflects that they are likely to:

- Benefit less from the recent introduction of State Second Pension and the improvements to state pension coverage proposed in the White Paper. This means that income from Personal Accounts is more likely to be subject to means-testing.
- Be eligible for higher levels of Pension Credit. This is because, in the White Paper proposals, Savings Credit would become less generous over time, so would typically be more generous for today's older workers than for today's younger workers.
- Have fewer years of contributions to Personal Accounts, meaning they would typically receive smaller incomes from Personal Accounts. This means that a greater proportion of income from Personal Accounts could reduce means-tested benefits rather than increase overall income.
- Be in Personal Accounts for a shorter period of time and so there is less scope for compound interest to increase the value of funds.
- Have lower investment returns from Personal Accounts, if they invest in a lifestyle fund. Although lifestyling has not been assumed in this paper[64], it could mean that today's older workers are invested for a shorter amount of time in equities, meaning a lower expected investment return (and lower risk).

[63] See PPI (2006 WP)

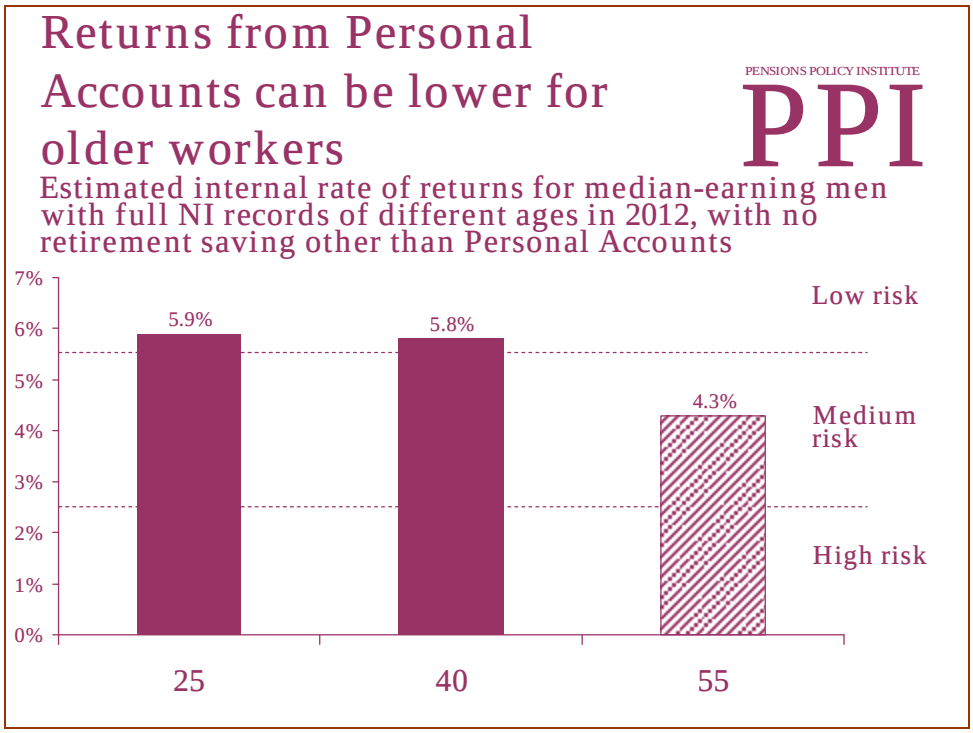
[64] See the appendix for more details on the assumptions used

These factors affect today's older workers and so should be reflected in the system of generic advice for Personal Accounts. However, this system of advice may need to change over time because some of these factors may not apply to people aged in their fifties in future.

The analysis in the previous chapter showed that a 25 year old median-earning man with full NI record and no other saving could have an internal rate of return of 5.9% on his saving. Older workers with identical working histories could have lower returns (Chart 11):

- An equivalent person who is aged 40 in 2012 could have a similar internal rate of return, of 5.8%. This would mean he is still in the low-risk category.
- The equivalent 55 year old would have a much lower internal rate of return, of 4.3%, which puts him in the medium-risk category.

Chart 11[65]



Trivial commutation

Returns can be therefore be lower for people in their fifties in 2012 than for people in their forties in 2012. Trivial commutation may improve returns from saving in Personal Accounts, depending on how the trivial commutation limit is uprated in future.

[65] PPI analysis using the Individual Model

Currently, an individual retiring with pension saving worth less than the trivial commutation limit (£15,000 in 2006/7) is able to take the value of the saving as a one-off lump sum. This is called 'trivial commutation'. This means that these individuals are not obliged to buy an annuity which would give them a very small monthly income.

It is currently up to occupational pension schemes to decide whether to offer a facility for trivial commutation. For personal pensions and Stakeholder pensions, it is up to the individual to decide whether to trivially commute.

If Personal Account funds can be trivially commuted, then this could improve incentives to save for the people who are eligible to take this option.
This is because Pension Credit entitlements could be higher than if an annuity were bought:

- If an individual bought an annuity with his or her saving, then all of the income from that annuity would normally count in the Pension Credit calculation.
- However, the first £6,000 of capital is not included in the Pension Credit calculation. So if an individual takes a lump sum, then not all of it would count in the Pension Credit calculation.
- The impact of the lump sum on Pension Credit entitlement depends on how it is spent. A given individual is less likely to be eligible for Pension Credit in the years immediately following retirement than in later years. So if the lump sum is spent in early years, then it is less likely to affect Pension Credit entitlements than if it is saved for later years.

How the trivial commutation limit is uprated in future could have a large impact on this median-earning man's returns from saving in Personal Accounts. The trivial commutation limit is scheduled to increase broadly in line with expected growth in average earnings until 2010. Thereafter, the level is subject to reviews every five years.

If the trivial commutation limit continued to be increased with average earnings after 2010, then this median-earning man aged 55 in 2012 could be able to trivially commute. However, if the trivial commutation limit was increased more slowly than average earnings after 2010, then he may not be able to trivially commute.

Other factors affecting returns

Chart 11 showed that a median-earning man with a full NI record and no other saving who is aged 55 in 2012 could have an internal rate of return of 4.3%.

The combination of being older and having career breaks can reduce the return on saving in Personal Accounts further.

For example, women aged 55 in 2012 who have taken two short caring breaks and have no other saving could be in the medium-risk category, regardless of their level of earnings (Chart 12):

- A woman who earns at the 1st decile of female earnings[66] could have an internal rate of return of 3.8%.
- A similar woman who earns at the third decile of female earnings[67] could have a higher return, of 5.2%. She receives a higher return because she does not fall under the lower threshold for Savings Credit eligibility in the way that the woman who earns at the 1st decile does.
- Women with higher earnings could have a lower return, as low as 3.0% for women earning at the 9th decile of female earnings[68]. This is towards the lower end of the medium-risk group. Note that this example shows that returns can be lower at higher earnings levels. In this case, this is partly because Council Tax Benefit is not withdrawn until incomes reach the Personal Allowance level (£130 a week for single pensioners when she reaches state pension age in 2022, in 2006/7 earnings terms) and this happens to a larger extent for women further up the earnings distribution. In addition, Personal Account income becomes taxable for people further up the income distribution.

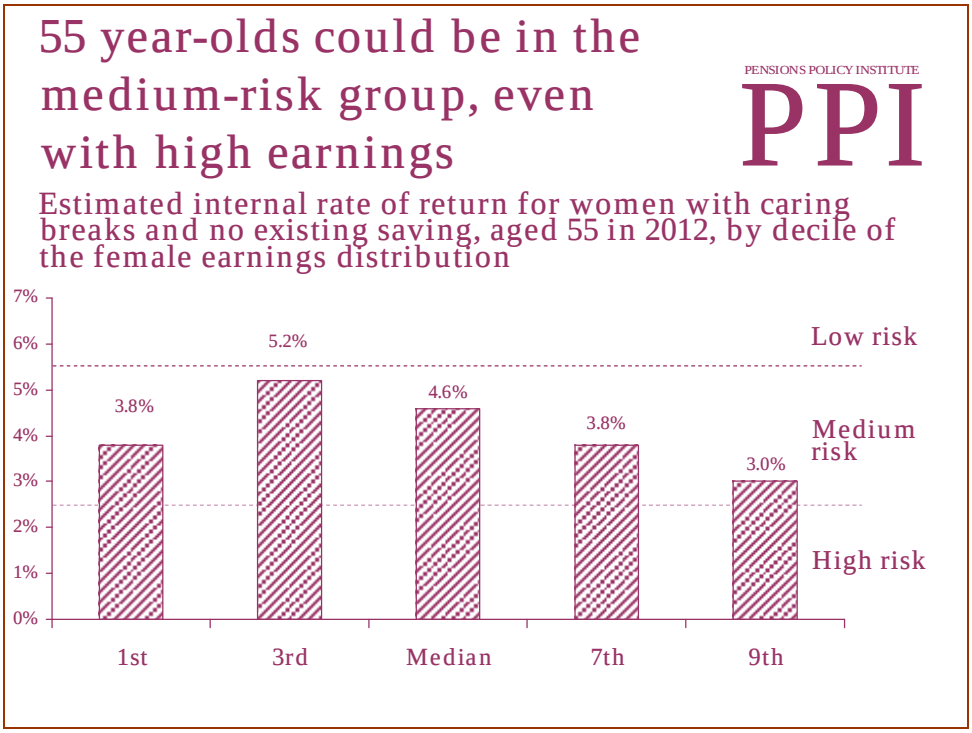
The relationship between earnings and internal rates of return is therefore not simple. It is possible that, in some cases, individuals can be more at risk of Personal Accounts being unsuitable for them if they have relatively high earnings than if they have very low earnings.

[66] Around £11,000 a year, in 2006/7 earnings terms

[67] Around £14,000 at age 25, increasing to around £16,000 by age 40 and declining to around £14,500 by age 50, in 2006/7 earnings terms

[68] Around £27,000 at age 25, increasing to around £37,500 by age 40 and declining to around £37,000 by age 50, in 2006/7 earnings terms

Chart 12[69]



Summary

In summary, most of the hypothetical examples of single people in their forties or fifties in 2012 would be at medium-risk of Personal Accounts being unsuitable for them (Charts 13 and 14):

- The only hypothetical individuals who are at low-risk of Personal Accounts being unsuitable for them are those with either high earnings and / or substantial savings on top of the Personal Account minimum.
- Most of the other hypothetical examples would be at medium-risk. It may be suitable for these people to save in Personal Accounts, although their returns are likely to be lower than returns for people in the low-risk group. They would still receive back the value of their individual contributions to Personal Accounts, protected for inflation.
- People who will rent in retirement or who spend time self-employed could receive lower returns from saving, possibly putting them at high-risk of Personal Accounts being unsuitable for them.

Single people in their forties and fifties in 2012 are likely to have lower returns from Personal Accounts than single people in their twenties in 2012. This means that the design of the information provided for Personal Accounts may need to change over time, to reflect the gradual transition to the proposed pensions system.

[69] PPI analysis using the Individual Model

Chart 13[70]

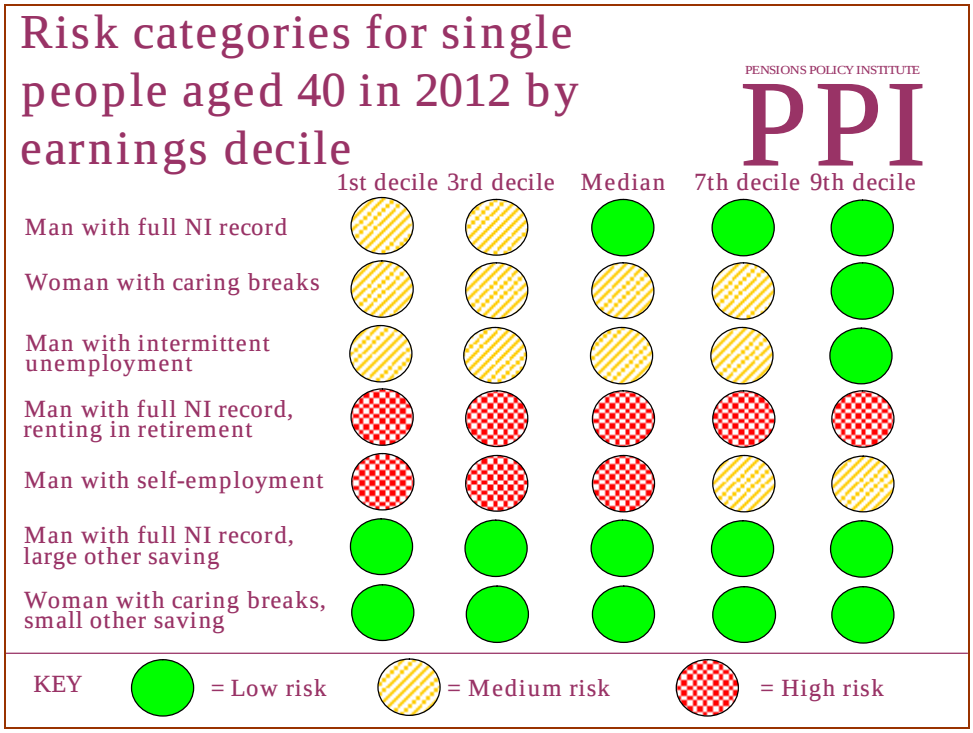
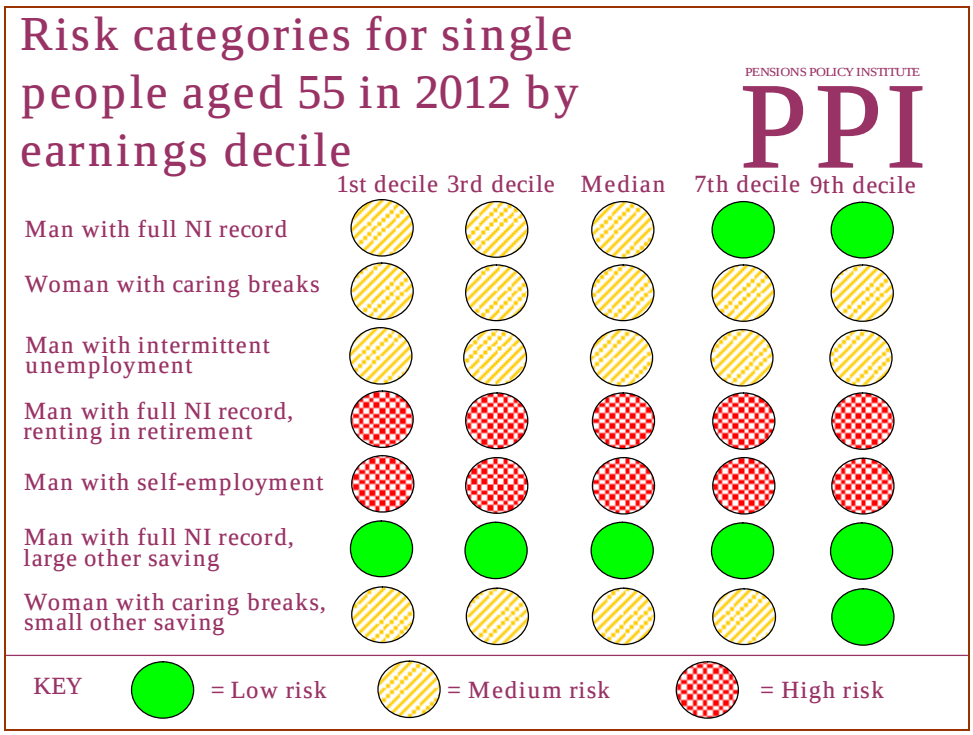


Chart 14[71]



[70] PPI analysis using the Individual Model. Note that the self-employed individuals in this chart would be self-employed from 2012 and so would not be auto-enrolled into a Personal Account at any stage in their working life. They are assumed to voluntarily opt-in.

[71] As footnote 70

Chapter 5: Debt and affordability

This chapter considers the implications of debt and affordability on the decision about whether to stay opted in or to opt out of Personal Accounts.

For many people, personal indebtedness and the affordability of Personal Account contributions could be important factors that affect whether a Personal Account is suitable for them.

- Levels of both secured and unsecured debt appear historically high and a sizeable minority of people carry over credit card balances from month to month.
- Affordability may be a more difficult consideration for a generic advice regime to consider than debt because it is more subjective, depending on individual preferences on current expenditure and saving.

Debt

Levels of both secured and unsecured debt appear historically high and a sizeable minority of people carry over credit card balances from month to month. But levels of debt clearly underlines the importance of a generic advice regime for Personal Accounts and also continued efforts to improve financial capability.

In the UK, levels of household debt have been increasing faster than income since the late 1990s (Chart 15). The increase has been faster for secured debt than for unsecured debt, but the average amount of both is historically high:

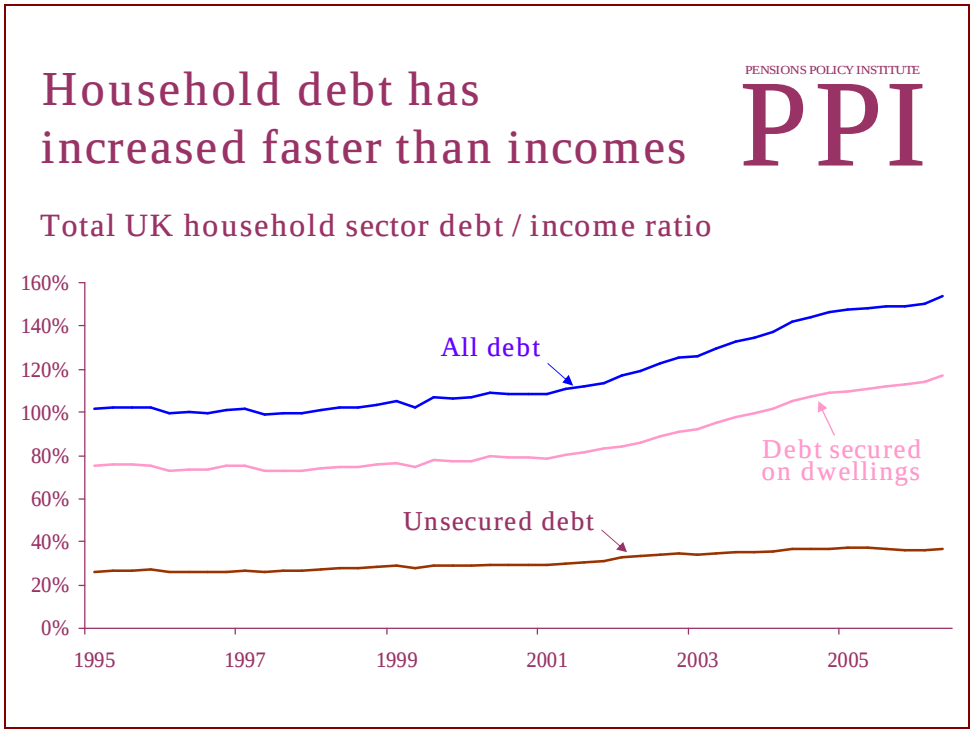
- The average secured debt is currently around 117% of annual household income, up from 75% in 1995.
- The equivalent figure for unsecured debt is around 37%, up from 26% in 1995.

Available evidence suggests that it is the norm to have some kind of unsecured debt. A recent survey by the Association of British Insurers (ABI) found that 43% of respondents had a credit card debt carried over from the previous month, while 30% had a loan not secured on property and 26% had an overdraft[72].

A recent report by Scottish Widows corroborates this finding. It found that 42% of all households are carrying credit card debt from the previous month[73]. There is also some evidence to suggest younger people and people with lower household incomes are more likely not to pay off their full monthly credit card balance[74].

[72] ABI (2006 SN) page 21
[73] Scottish Widows (2006) page 6
[74] See also Citizens Advice (2003) for a similar finding

Chart 15[75]



The Financial Services Authority has warned that ***Personal Accounts may not be suitable*** [for] ... ***people with significant high interest debt (where the costs of servicing the debt outweighs the likely return on Personal Accounts).***[76] It is not necessarily always advisable to completely pay off debt before starting saving, because of individual preferences on consumption smoothing.

Affordability of Personal Account contributions

Affordability is often cited as the biggest single obstacle for saving in retirement. For example, in a recent survey by the Association of British Insurers (ABI) , 53% of non-pension savers gave having no spare money as a reason[77]. This was by far the most popular response.

Affordability is more usually cited by lower income people as a large obstacle for saving than by higher income people. For example, in the ABI survey, 65% of non-savers on less than £10,000 gave lack of money as a reason, compared to 17% of those on more than £50,000 a year[78].

[75] DTI (2006) Figure 9
[76] FSA WP response paragraph 12
[77] ABI (2006) page 10. See also Scottish Widows (2006) page 5.
[78] ABI (2006) page 11. See Scottish Widows (2006) page 5 for a similar finding.

However, affordability may be a more difficult consideration for a generic advice regime to consider than debt because it depends on individual preferences on current expenditure and saving. As the Financial Services Authority has argued, ***consumers themselves are in the best position to make decisions about the level of contributions that they can afford.***[79]

The minimum contributions to Personal Accounts would be a lower proportion of earnings for lower earners than for median earners. This is because, under the White Paper proposals, contributions would be payable on earnings between the Primary Threshold and the Upper Earnings Limit (£5,035 and £33,540 a year in 2006/7).

However, whether even small contributions are judged affordable depends on individual preferences on expenditure. Lower earning people may be more cash constrained than higher earning people. Contributions may also be less affordable at certain stages of life, for example, when individuals have large amounts of student debt to repay, or when they are supporting children.

This chapter has considered the implications of debt and affordability on the decision about whether to stay opted in or to opt out of Personal Accounts. It is important to note that there may be other groups for whom Personal Accounts are not suitable, such as the terminally ill (who may not live to take retirement benefits) and those who will be living and working in the UK for a short time[80].

[79] FSA (2006) paragraph 17
[80] FSA (2006) paragraph 12

Chapter 6: Summary and next steps

This paper has shown that auto-enrolment into pension provision has potential advantages and should lead to an increase in the number of people saving for retirement. Personal Accounts will give many people access to an employer contribution for the first time, which means that returns from Personal Accounts should be higher than returns from the current Stakeholder pensions for many people.

This paper has highlighted a variety of factors that can affect returns from saving in Personal Accounts, including, marital status, working and savings patterns and whether individuals rent or own their home in retirement. In addition, levels of personal indebtedness and the affordability of Personal Account contributions could be important factors for many people.

Some of these factors will affect returns from saving in any pension product, and not just Personal Accounts. They do not necessarily mean that individuals should not be auto-enrolled. But they do have important implications what information is needed to help people make informed decisions about whether they should opt out.

Of course, some of the factors that will have an impact on returns from saving in Personal Accounts could be more problematic than others to predict at the point at which savings decisions are made. No-one can predict with certainty their future life circumstances or marital status and it may be difficult for an individual to predict whether he or she will be renting in retirement.

While this paper has identified the factors that may affect the suitability of Personal Accounts for individuals, further work is needed to investigate what is the appropriate design of information for Personal Accounts. By its nature, generic advice cannot ensure that all individuals make the right decisions. But can it cover the most important factors that are relevant to the savings decision?

Appendix: Modelling assumptions and sensitivities

This appendix:

- Describes the key assumptions used in the modelling of net present values and internal rates of return.
- Contains full tables of the estimated net present values and internal rates of return for the hypothetical individuals analysed in this paper.
- Describes the likely impact of assuming different assumptions to those used in this main part of this paper.

Assumptions used

This paper is based on the proposals contained in the May 2006 White Paper[81] being introduced in full, with the Basic State Pension being indexed to average earnings from 2012.

The existing link between the Lower Earnings Limit (LEL) and the level of the Basic State Pension is assumed to be retained, so that the LEL increases in line with average earnings from 2012. If instead the LEL continued to be increased with prices, rather than with average earnings, then:

- The amount accrued in State Second Pension (S2P) by those people who qualify could be higher.
- People could qualify for State Second Pension (S2P) with lower earnings. However, all of the individuals in this paper earn enough to qualify for S2P while in work, so if the LEL increased with prices rather than with average earnings, this would not mean more years qualification for S2P for the individuals in this paper.

In its end of October 2006 response to the White Paper consultation, the Government said that it is ***exploring whether it would be possible to replace the accruals-based flat-rate element of State Second Pension with a flat rate and fixed amount immediately at the same time as we link the basic State Pension to rises in average earnings.***[82] This possible further reform has not been included in the reforms modelled in this report. If this idea is taken forward, then it could affect outcomes for the individuals analysed. However, the extra change is unlikely to have a large impact, as this is largely a technical simplification of S2P[83].

[81] DWP (2006 WP)
[82] DWP (2006 WPCR) page 71
[83] See PPI Briefing Note 35 for an analysis of this possible further reform

The internal rate of return and net present value calculations are based on the following assumptions:

- Future annual price inflation of 2.5%.
- Future annual earnings growth of 2.0% in excess of prices.
- Expected investment returns of 3% in excess of prices, before charges, corresponding to a mixed equity / bond fund[84].
- Annual charges in Personal Accounts of 0.5% of assets under management.
- Life expectancies are assumed to be in line with the most recent cohort life projections by the Government Actuary's Department.

All of the individuals analysed are assumed to use their Personal Account funds to buy a single-life, level annuity fixed in cash terms at retirement (unless they trivially commute their Personal Accounts saving). This means that their income from Personal Accounts would decline quickly during their retirement, especially when considered relative to average earnings.

Most annuities bought today are level annuities[85]. If the individuals analysed in this paper were assumed to use their Personal Account fund to buy an annuity which increased in line with the Retail Prices Index, rather than a level annuity, then the estimated internal rates of return would be lower. This is because a greater proportion of income from Personal Accounts would be taken later in life, when the individuals are likely to be in receipt of greater entitlements to means-tested benefits[86].

Assumptions are made regarding future annuity rates. The assumptions used are:

- Mortality follows the PMA92 / PFA92 mortality tables, adjusted for future mortality improvements using the "medium cohort" projection in CMIB (2002).
- Post-retirement investment returns are 1% in excess of prices.
- Calculated annuity rates are multiplied by a factor of 1.04 to allow for expense charges.

These assumptions are broadly similar to those required for the calculation of annuity rates for the purpose of Statutory Money Purchase Illustrations (SMPIs)[87]. As noted above, a level annuity is assumed to be bought for the purpose of the case studies rather than an RPI annuity as required for SMPIs.

[84] This corresponds to assumed equity returns of 7% a year, assumed bond returns of 4% a year, and a portfolio of 60% equities and 40% gilts, Curry (2003) page 25

[85] Canon and Tonks (2006)

[86] PPI analysis using the Individual Model

[87] Actuarial Profession (2006) TM1 Version 1.2, coming into effect 1 November 2006. Note that TM1 requires annuities to be calculated using a market interest rate. This varies over time, and would be 1.2% real for illustrations dated between 6 April 2005 and 5 April 2006, and 0.8% real for illustrations dated between 6 April 2006 and 5 April 2007. The case studies use an assumption of 1.0% real.

As an illustration, on the assumptions used in the case studies, the rate for a single-life, level annuity is 6.5% for men at age 65 in 2006. Equivalent available market rates are currently between 6.3% and 7.4%[88].

The option to take a tax-free lump sum from pension saving can be a significant incentive to save, since pension income is normally taxable. In this paper, all of the individuals are assumed to take a tax-free lump sum, of 25% of the value of their saving.

The impact of a lump sum on the internal rate of return depends on how the lump sum is spent. In this paper, the lump sum is assumed to be used to buy a voluntary annuity, so that income from the lump sum is spent throughout retirement, rather than all at once. This voluntary annuity is assumed to be non-taxable, and so improves the internal rate of return, relative to the option of not taking a tax-free lump sum[89].

Full results

Estimated internal rates of return and net present values for all of the hypothetical individuals used in this paper are contained in Tables A1 to A6.

In the tables, an internal rate of return of:

- More than 5.5% corresponds to the low-risk category used in this paper. These instances are coloured in green.
- Between 2.5% and 5.5% (inclusive) corresponds to the medium-risk category. These instances are coloured in yellow.
- Lower than 2.5% corresponds to the high-risk category. These instances are coloured in red.

The net present values are not been colour-coded into the risk-categories but they would correspond to the pattern for the internal rate of return. An internal rate of return of 2.5% corresponds to a net present value of £1.

It is possible for the internal rate of return to be undefined, if the amount of income received from saving is low compared to the amount of salary contributed. In these cases, the internal rate of return is marked '*'. All of these cases are in the high-risk category.

[88] For a non-smoker with a pension fund of £75,000. Annuity rate information is taken from the FSA's Comparative Tables (www.fsa.gov.uk/tables) as at 17 October 2006, for rates with unrestricted availability. © The Financial Services Authority.

[89] This is similar to the approach taken by the Pensions Commission. The Pensions Commission assumed that 5% of the voluntary annuity is subject to tax, consistent with their special tax treatment. This paper assumes that none of the voluntary annuity is subject to tax, which slightly increases the internal rate of return. Pensions Commission (2006) ***Appendices*** page 220.

Table A1: Women aged 25 by decile of the earnings distribution

	1st	3rd	Median	7th	9th
Internal Rate of Return					
Full NI record	5.5%	5.8%	5.8%	5.8%	6.3%
Caring breaks	4.8%	5.3%	5.5%	5.7%	6.1%
Unemployment	4.6%	4.8%	5.0%	5.2%	5.8%
Full NI record, renting	*	0.1%	0.3%	0.5%	1.3%
Full NI record, large other saving	6.2%	6.2%	6.2%	6.2%	6.6%
Caring breaks, small other saving	6.0%	5.9%	5.9%	6.0%	6.3%
Self-employed	2.1%	3.3%	3.9%	4.3%	4.8%
Net Present Value					
Full NI record	2.45	2.71	2.79	2.82	3.08
Caring breaks	1.88	2.12	2.27	2.45	2.67
Unemployment	2.02	2.20	2.35	2.52	3.00
Full NI record, renting	0.46	0.51	0.52	0.55	0.72
Full NI record, large other saving	3.11	3.14	3.17	3.19	3.43
Caring breaks, small other saving	2.66	2.65	2.67	2.70	2.87
Self-employed	0.92	1.26	1.49	1.68	1.96

Table A2: Men aged 25

	1st	3rd	Median	7th	9th
Internal Rate of Return					
Full NI record	5.8%	5.9%	5.9%	6.0%	6.8%
Caring breaks	5.4%	5.7%	5.8%	5.9%	6.6%
Unemployment	4.8%	5.1%	5.3%	5.5%	6.2%
Full NI record, renting	*	0.0%	0.2%	0.8%	2.3%
Full NI record, large other saving	6.4%	6.4%	6.3%	6.4%	7.1%
Caring breaks, small other saving	6.0%	6.0%	6.1%	6.2%	6.8%
Self-employed	3.2%	3.9%	4.3%	4.5%	5.5%
Net Present Value					
Full NI record	2.58	2.68	2.73	2.77	3.54
Caring breaks	2.02	2.27	2.41	2.46	3.11
Unemployment	2.14	2.31	2.49	2.65	3.47
Full NI record, renting	0.48	0.50	0.54	0.65	0.95
Full NI record, large other saving	3.03	3.09	3.12	3.11	3.93
Caring breaks, small other saving	2.48	2.57	2.62	2.65	3.33
Self-employed	1.19	1.46	1.64	1.78	2.33

KEY = Low risk =Medium risk = High risk

Table A3: Women aged 40 by decile of the earnings distribution

	1st	3rd	Median	7th	9th
Internal Rate of Return					
Full NI record	4.3%	4.5%	5.1%	5.8%	6.4%
Caring breaks	4.6%	4.4%	4.4%	4.9%	5.9%
Unemployment	4.0%	4.7%	4.7%	4.5%	5.2%
Full NI record, renting	*	*	*	*	*
Full NI record, large other saving	6.4%	6.4%	6.5%	6.5%	7.1%
Caring breaks, small other saving	5.7%	5.9%	6.0%	6.0%	6.5%
Self-employed	*	*	1.3%	2.4%	3.0%
Net Present Value					
Full NI record	1.51	1.57	1.80	2.10	2.38
Caring breaks	1.65	1.57	1.56	1.73	2.11
Unemployment	1.41	1.75	1.81	1.70	1.96
Full NI record, renting	0.53	0.32	0.34	0.39	0.46
Full NI record, large other saving	2.38	2.42	2.44	2.48	2.70
Caring breaks, small other saving	2.04	2.17	2.25	2.29	2.46
Self-employed	0.15	0.54	0.79	0.98	1.11

Table A4: Men aged 40

	1st	3rd	Median	7th	9th
Internal Rate of Return					
Full NI record	4.5%	5.4%	5.8%	6.0%	7.4%
Caring breaks	4.5%	4.6%	5.0%	5.5%	6.9%
Unemployment	4.8%	4.8%	4.6%	4.8%	6.0%
Full NI record, renting	*	*	*	*	*
Full NI record, large other saving	6.7%	6.7%	6.7%	6.7%	8.0%
Caring breaks, small other saving	6.2%	6.1%	6.1%	6.2%	7.4%
Self-employed	*	1.5%	2.4%	2.6%	3.9%
Net Present Value					
Full NI record	1.55	1.88	2.10	2.20	2.86
Caring breaks	1.58	1.61	1.78	1.96	2.62
Unemployment	1.75	1.83	1.72	1.77	2.37
Full NI record, renting	0.33	0.35	0.39	0.42	0.57
Full NI record, large other saving	2.46	2.50	2.54	2.56	3.26
Caring breaks, small other saving	2.24	2.30	2.32	2.33	2.95
Self-employed	0.42	0.82	0.98	1.03	1.35

KEY = Low risk =Medium risk = High risk

Table A5: Women aged 55 by decile of the earnings distribution

	1st	3rd	Median	7th	9th
Internal Rate of Return					
Full NI record	4.6%	3.9%	3.4%	4.9%	6.7%
Caring breaks	3.8%	5.2%	4.6%	3.8%	3.0%
Unemployment	2.7%	4.8%	4.9%	4.0%	4.2%
Full NI record, renting	2.9%	*	*	*	*
Full NI record, large other saving	6.9%	7.0%	7.1%	7.2%	7.8%
Caring breaks, small other saving	3.5%	3.2%	3.9%	5.4%	6.5%
Self-employed	*	*	*	1.9%	1.3%
Net Present Value					
Full NI record	1.38	1.24	1.15	1.39	1.83
Caring breaks	1.15	1.39	1.31	1.18	1.07
Unemployment	1.02	1.44	1.48	1.30	1.32
Full NI record, renting	1.07	0.47	0.21	0.26	0.34
Full NI record, large other saving	1.85	1.88	1.91	1.95	2.07
Caring breaks, small other saving	1.14	1.10	1.19	1.38	1.59
Self-employed	0.05	0.46	0.73	0.91	0.82

Table A6: Men aged 55

	1st	3rd	Median	7th	9th
Internal Rate of Return					
Full NI record	4.0%	3.3%	4.3%	6.5%	8.4%
Caring breaks	5.2%	4.5%	3.6%	2.9%	5.2%
Unemployment	4.6%	4.9%	4.1%	3.5%	5.1%
Full NI record, renting	*	*	*	*	*
Full NI record, large other saving	7.3%	7.4%	7.5%	7.6%	10.0%
Caring breaks, small other saving	3.0%	4.5%	5.8%	6.7%	9.6%
Self-employed	*	*	1.8%	1.2%	2.1%
Net Present Value					
Full NI record	1.24	1.12	1.27	1.73	2.19
Caring breaks	1.35	1.27	1.15	1.05	1.36
Unemployment	1.36	1.46	1.28	1.17	1.48
Full NI record, renting	0.60	0.21	0.24	0.32	0.41
Full NI record, large other saving	1.85	1.89	1.92	1.97	2.58
Caring breaks, small other saving	1.06	1.23	1.39	1.56	2.11
Self-employed	0.26	0.70	0.90	0.82	0.94

KEY = Low risk =Medium risk = High risk

Possible effect of employers' reducing salaries on returns from saving in Personal Accounts

In a recent study by Deloitte, 34% of employers said they expect to recover the additional expense of the compulsory contributions by introducing wage freezes[90]. This could affect expected returns from saving in Personal Accounts, depending on how the wage freezes were introduced:

Option A: If an employer recovered the expense of the compulsory contributions by introducing lower wage increases for every employee, regardless of whether or not they stay opted in to Personal Accounts, then this would not significantly affect expected returns from saving in Personal Accounts. The decision to stay opted in or to opt out would not directly affect an employee's salary, since the employee would receive the smaller wage increase anyway[91].

Option B: However, if an employer recovered the expense of the compulsory contributions by introducing lower wage increases for only those employees who stay opted in to Personal Accounts, and not for those who opt out, then this could significantly affect expected returns from saving in Personal Accounts. In this situation, if an employee stayed opted in, then they would receive a lower salary as a result, which would make saving in Personal Accounts less attractive.

This paper assumes that employers recover the expense by reducing salaries in line with option A above, or by some other means, such as reducing profits or increasing prices.

If employers recovered the expense of compulsory contributions by reducing salaries in line with option B above, then the impact on expected returns from saving in Personal Accounts could be significant, particularly for today's older workers (Table A7).

Today's older workers' expected returns from saving could be affected relatively more by the reduction in salary, as they would not receive as many years investment returns on their contributions as today's younger workers, so would be relatively more dependent on the employer contribution for a good incentive to save.

[90] Deloitte (2006) page 5. The employer would be compelled to contribute for employees who do not opt out of Personal Accounts.

[91] There may be a secondary effect, whereby if an employee decides to opt out of Personal Accounts, then the total expense of compulsory contributions for the employer would be lower, so the employer would have to reduce wage increases by a smaller amount. However, if the employer were to recover the expense from all employees, then the saving resulting from one individual employee deciding to opt-out would be spread over all employees, so may not affect the individual employee's salary to a significant extent.

Table A7[92]: Estimated internal rates of return for median-earning men with full NI records, of different ages in 2012, for different assumptions on the percentage of the compulsory contribution that employers pass on to the employee through lower salary

	Aged 25 in 2012	Aged 40 in 2012	Aged 55 in 2012
0% - assumption made in this paper	5.9%	5.8%	4.3%
50%	4.8%	4.4%	1.8%
100%	4.0%	3.3%	*

KEY = Low risk =Medium risk = High risk

Impact of different expected investment returns

This paper assumes that expected investment returns are 3% a year in excess of prices, corresponding to a mixed equity / bond fund[93]. Higher or lower expected investment returns could result from:

- An individual choosing a different asset allocation. For example, he or she might invest a higher or lower proportion of his or her fund in equities than assumed in this paper; or
- Different expected investment returns from equities and / or bonds. For example, an individual may take the view that equities are likely to achieve a higher or lower return than assumed in this paper.

Different expected investment returns would mean different internal rates of return. However, different expected investment returns are unlikely to have a large impact on the conclusions of this paper. This is because:

- Changes in the expected investment return are likely to affect younger workers more than older workers, since there is more time for the difference in the investment returns to build up. However, this paper has shown that today's older workers are more at risk of a Personal Account being unsuitable for them than today's younger workers.
- The definition of 'low risk' used in this paper is that individuals receive back at least the value of their own individual contributions plus full credit for the real investment returns earned by investing those contributions. This corresponds to an internal rate of return equal to at least the expected investment return. Although a higher investment return would lead to a higher internal rate of return, the benchmark would also increase, thus resulting in little overall impact on risk categories.

[92] * means that the internal rate of return is so low that it is undefined

[93] This corresponds to assumed equity returns of 7% a year, assumed bond returns of 4% a year, and a portfolio of 60% equities and 40% gilts, Curry (2003) page 25

Impact of different levels of rents

Some of the hypothetical individuals in this paper are assumed to rent in retirement. For these people, saving in a Personal Account could mean a large reduction in future entitlement to Housing Benefit.

In order to analyse the impact of Housing Benefit on returns from saving in Personal Accounts, it is necessary to make an assumption on the individuals' rents. Here, rents are assumed to be £70 a week in 2006/7, which is the current average amount of rent paid by today's Housing Benefit claimants[94].

Assumptions are also made about how rents increase in future. Rents are assumed to increase in future line with average earnings (i.e. 2% a year in excess of prices). Although future rent increases are very uncertain, higher or faster future rent increases are unlikely to affect the results of this paper:

- If rents increased 1% a year more quickly than assumed, at 3% a year in excess of prices, then the internal rates of return for the examples who rent in retirement could be lower. This is because Housing Benefit entitlements could be higher, so people are more likely to see their Housing Benefit reduced as a result of saving in a Personal Account. The examples would therefore still be in the high-risk category used in this paper.
- If rents increased 1% a year more slowly than assumed, at 1% a year in excess of prices, then the internal rates of return for the examples who rent in retirement could be higher. This could mean that some of the individuals who are aged 25 in 2012 and who have high earnings could be in the medium-risk category rather than the high-risk category.

Impact of different levels of Council Tax

All of the hypothetical individuals in this paper are assumed to pay Council Tax in retirement. This means that the individuals are potentially eligible for Council Tax Benefit in retirement for help with their Council Tax, if their incomes in retirement are sufficiently low.

In order to analyse the impact of Council Tax Benefit on returns from saving in Personal Accounts, it is necessary to make an assumption on how much Council Tax the individuals pay. Here, the individuals are assumed to pay £15 a week in Council Tax in 2006/7, which is the current average amount of Council Tax paid by today's Council Tax Benefit claimants[95].

[94] DWP (2006 HB) Table HB1.5
[95] DWP (2006 HB) Table HB2.2

Assumptions are also made about how Council Tax charges increase in future. Council Tax charges are assumed to increase in future line with average earnings (i.e. 2% a year in excess of prices). Although future Council Tax increases are very uncertain, higher or faster future Council Tax increases are unlikely to affect the results of this paper:

- If Council Tax payments increased in future at 4.5% a year in excess of prices[96], rather than the 2% assumed in this paper, then internal rates of return could be lower. This is because Council Tax Benefit entitlements could be higher, so people are more likely to see their Council Tax Benefit reduced as a result of saving in a Personal Account. However, the internal rates of return would not change sufficiently for any of the individuals analysed in this paper to mean that they are in a different risk category.
- If Council Tax payments increased in future in line with the assumed growth in prices, rather than with 2% in excess of prices as assumed in this paper, then internal rates of return could be higher. This could mean that some of the individuals who are aged 25 in 2012 with career breaks could be in the low-risk category rather than in the medium-risk category. Some of the individuals who rent in retirement could move from the high-risk category to the medium-risk category, if they have high earnings.

[96] This would be the same as the actual annual growth in the average amount of Council Tax paid by Council Tax Benefit claimants over the last five years, between February 2001 and February 2006. DWP (2006 HB) Table HB2.2.

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Contact:
Niki Cleal, Director
Telephone: 020 7848 3744
Email: niki@pensionspolicyinstitute.org.uk

Pensions Policy Institute
King's College
Kay House (4th Floor)
7 Arundel St
London
WC2R 3DX

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