PENSIONS POLICY INSTITUTE
**PPI**

# Response to the Government's White Paper, *Personal Accounts: a new way to save*

Niki Cleal, Director, on behalf of the Pensions Policy Institute

Summary

I. There is widespread support for the principle of auto-enrolment and broad agreement that the proposed levels of contribution to Personal Accounts (4% individual, 3% employer and 1% from tax relief) are reasonable.

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

III. PPI analysis has shown that:
- People in their twenties in 2012 who remain opted-in may be at low risk of Personal Accounts being unsuitable;
- Single people who rent in retirement are likely to be at high risk of Personal Accounts being unsuitable;
- Some low-earning individuals in their forties and fifties in 2012 with no additional savings are at medium risk of Personal Accounts being unsuitable. This is because they may lose entitlement to means-tested benefits as a consequence of saving in a Personal Account.

IV. This does not mean that people should not be auto-enrolled, but does imply that people will need very clear information to help them make informed decisions about whether they should stay in or opt out of Personal Accounts.

V. An important test of the Personal Accounts policy will be whether it is possible to design information and generic advice in a simple and easy to understand way to help people decide whether they should opt-out of Personal Accounts.

Pensions Policy Institute
King's College, 4th Floor, Kay House, 7 Arundel St, London, WC2R 3DX
Email: niki@pensionspolicyinstitute.org.uk

President: Baroness Greengross OBE Chairman: Tom Ross OBE Director: Niki Cleal
www.pensionspolicyinstitute.org.uk
Registered address: 21 Holborn Viaduct London EC1A 2DY Company no: 4145584 Registered Charity no: 1087856

## Summary of response to the Government's specific consultation questions. (Only questions within the PPI's area of expertise have been answered.)

**Q1: whether to not auto-enrol specific groups eg those close to state pension age or low earners?**

1.1 The arguments as to whether either low earners or those approaching state pension age in 2012 should be auto-enrolled are finely balanced. Neither low earnings nor being close to state pension age will automatically mean that individuals will receive a low return from Personal Accounts.

1.2 By not-auto-enrolling either of these two groups as a whole, there is a risk that individuals who would benefit from saving in a Personal Account do not join.

1.3 Ideally the Government could project the possible range of outcomes from auto-enrolment and the potential number of individuals in each group likely to be affected by any change in auto-enrolment policy.

1.4 The Government may also want to consider other approaches to dealing with the possible low incentives to save for these groups. Possible alternative policies might include:

- increasing trivial commutation limits to enable these groups to take their pensions as a lump sum
- making pensions saving invisible to means-testing for these groups
- tailoring the generic advice given to these groups to help them make the right decision.

1.5 The PPI is undertaking some commissioned work for the EOC which will examine the implication of changes to the trivial commutation and capital disregard limits for the incentives to save for certain individuals. This research will be available in May 2007.

**Q2: How can members' interests best be represented in the governance of Personal Accounts?**

2.1 PPI is conducting research on the role and objectives of the Personal Accounts Delivery Authority and Board, and options for addressing any potential issues in these areas. This work will be completed in late April 2007. Emerging findings suggest that stakeholders:

- support the aim of keeping members' interests central to the design and delivery of Personal Accounts
- recognise the need for members' interests to be considered at all stages: ie in the design stage, set up stage, and in ongoing delivery of Personal Accounts

- recognise that some other stakeholders have interests that may also need to be represented in the governance of Personal Accounts in addition to members' interests.

What information should support Personal Accounts?

2.2 Given the complexity of some of the decisions that individuals will face in relation to Personal Accounts it is essential that individuals are provided with appropriate information and generic advice to help them to make these decisions.

2.3 Previous PPI research[1] has identified some lessons from the New Zealand Retirement Commission's experience in encouraging greater financial awareness and providing generic financial advice.

- The guidance should come from a body that can be seen to be independent of Government and the financial services industry. This is essential if the advice is to be credible and trusted by consumers;
- A website is an obvious first step and New Zealand's website, ***Sorted*** may provide a useful template[2]. Other delivery channels eg telephone or face-to-face should also be considered and piloted.
- Generic advice should cover a wide range of personal finance issues not just retirement planning;
- Any other roles of the independent body should be complementary of the specific remit chosen.

Q3: The appropriate method of charging members for Personal Accounts

3.1 PPI research[3] has investigated in detail the impact of five alternative charging structures for Personal Accounts against five criteria suggested by the Government[4].

3.2 The research has concluded that overall, no single charging structure, or combination of charging structures, has all of the desirable attributes. Each charge structure has advantages and disadvantages and there are trade-offs that have to be made.

[1] PPI (2006) ***Lessons from New Zealand's Retirement Commission for UK policy on financial awareness and advice***
[2] See www.sorted.org.nz
[3] PPI (2007) ***Charging structures for Personal Accounts***, co-funded by the Department for Work and Pensions, AEGON and Standard Life. A full version of this report has been submitted to DWP alongside this response
[4] DWP (2006) ***Personal accounts: A new way to save*** page 96

## Q5. Waiting periods in exempt schemes

5.1 The impact of a waiting period for exempt schemes on an individual's final pension compared to what they would have received in a Personal Account with no waiting period will depend on:
(1) the extent to which the employer contributes more than 3% in the exempt scheme; and
(2) how long the individual stays in the same job after the end of the waiting period.

5.2 The longer an employee stays in a job, the more likely they will be to get more from the employer's scheme with a waiting period than if they had been auto-enrolled into a Personal Account with no waiting period.

5.3 Many employees do not spend long periods of time with the same employer. Half of new jobs last for less than 15 months[5].

5.4 If a new employee stays in work for 15 months, an employer would need to contribute 8% after an initial waiting period of 6 months, rather than 3% from being auto-enrolled into a Personal Account with no waiting period, to provide the same final pension fund as in a Personal Account.

## Q8: Contribution Caps and alternatives

8.1 An annual contribution limit of £3,000 (or indeed much lower) would be enough to allow an individual who is 25 in 2012, is in the target group (low to median earnings) and who has a full contribution record to reach the 'desirable' replacement rate suggested by the Pensions Commission.

8.2 Even allowing for some caring breaks (and therefore breaks in contributions) a relatively low cap would enable most individuals in the target group to make sufficient contributions to reach the 'desirable' replacement rate. Median earners might require a cap of just above £3,000, but well below £5,000 to be able to make the required contributions in every year.

8.3 However, if the annual contribution limit were set at £3,000, median earners aged 40 or older in 2012, and with some caring breaks, would not be able to make sufficient contributions to reach the 'desirable' replacement rate if they had no existing pension savings. They might need a contribution limit of £5,000.

[5] Gregg and Wadsworth (2002) ***Job tenure in Britain, 1975 -2000. Is a job for life or just for Christmas?*** In Oxford Bulletin of Economics and Statistics, 64 , 2 (2002) pp 111 - 134

8.4 There may be a case for allowing higher contribution limits for individuals who are self-employed, as:

- Earnings from self-employment may be more uncertain and more irregular than earnings from employment
- State pension accrual is lower during periods of self-employment, as the self-employed do not accrue S2P. Self-employed individuals would therefore need a higher contribution to achieve a target replacement rate than employees
- There is no existing employer scheme to protect.

Alternatives to an annual limit

8.5 There may be other ways to allow individuals flexibility in the amount they contribute to Personal Accounts while still going some way to limit (though not avoid completely) the potential detrimental impact on existing provision:

- Use a lifetime limit approach rather than an annual limit: This would be more in line with changes to the regime for the tax treatment of pensions introduced in April 2006, and allow individuals/employers to decide when they are best able to make a contribution.
- Allow unused annual allowances to be carried forward into future years. This is a hybrid approach between the lifetime and annual limits.
- Allow higher contributions from specific sources, such as divorce settlements or inheritances. This would allow one-off additional contributions to be made rather than

8.6 The Government should investigate these options further to see which strikes the appropriate balance between flexibility and focusing on the target market.

## Introduction

### The role of the Pensions Policy Institute

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI does not make policy recommendations, or support any one reform solution, but exists to contribute facts and analysis to help all commentators and policy decision-makers.

2. The Government set out the broad details of its pension reform package in its May 2006 White Paper: ***Security in retirement: towards a new pensions settlement.*** The PPI gave written and oral evidence to the Work and Pensions Committee's inquiry into Pension Reform[6] and published a detailed evaluation of the Government's White Paper state pension reforms in July 2006.[7]

3. In December 2006 the Government published the details of its plans to introduce a new national scheme of Personal Accounts in its second White Paper ***Personal Accounts: a new way to save.***

4. This response:
   - Gives PPI's analysis of the Government's proposals to introduce a new national scheme of Personal Accounts
   - Identifies areas where we feel there is a need for further research/ work
   - Provides a PPI response to some of the Government's specific consultation questions

5. This response draws on the further analysis that the PPI has conducted since its response to the DWP's White Paper: ***security in retirement*** in September 2006. This includes:
   - A stocktake of key stakeholders' views on the Government's White Paper proposals;[8]
   - An assessment of the suitability of Personal Accounts for all.[9] and
   - An analysis of the implications of alternative charging structures in Personal Accounts.[10]

---

[6] PPI (2006) ***Submission to the Work and Pensions Committee's inquiry into pension reform.*** All PPI publications are available on the PPI's website www.pensionspolicyinstitute.org.uk.
[7] PPI (2006) ***An evaluation of the White Paper state pension reform proposals***
[8] PPI (2006) Briefing Note 34, ***Pension reform: is there consensus?*** The PPI mapped the White Paper responses of 24 organisations, including charities, unions, pension providers, and representative bodies for consumers, business and the pensions industry.
[9] PPI (2006) ***Are Personal Accounts suitable for all?***
[10] PPI (2007) ***Charging structures in Personal Accounts***

## Personal Accounts

6. 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[11] 1% contribution of band earnings from the Government and a compulsory[12] 3% contribution of band earnings from the individual's employer.
   - Low charges, aiming for an annual charge of 0.3% of assets under management.

7. The Government's stated objective for Personal Accounts is to "***radically improve access to affordable, low-cost pension saving for many on moderate to low incomes who do not currently save in a private pension.***"[13]

8. Personal Accounts will offer many people in the target market (those on low to median earnings) access to a low cost, portable pension with an employer contribution for the first time.

9. The Government estimates that between 6 and 10 million people could eventually save in Personal Accounts. The actual participation rate will depend on a number of factors including how employers and individuals react to the proposals, which are difficult to foresee in advance.

## Stakeholders' views

10. The PPI conducted a stocktake of key stakeholders' views on the main elements of the Government's pension reforms in October 2006.[14] The stocktake revealed broad support for the principle of auto-enrolment, with 22 out of 24 organisations surveyed in favour.

11. 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[15].
    - 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[16].

---

[11] 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
[12] For employees who do not opt out of Personal Accounts
[13] DWP (2006) ***Personal Accounts: a new way to save***, p5
[14] PPI (2006) Briefing Note 34, ***Pension reform: is there consensus?*** The PPI mapped the White Paper responses of 24 organisations, including charities, unions, pension providers, and representative bodies for consumers, business and the pensions industry.
[15] DWP (2006) White Paper: ***Security in retirement***, p. 63
[16] Deloitte (2006) ***Employer pension contributions and pension reform***, ABI research paper 2, page 17. Based on a survey of private companies with at least five employees, It should be noted that other factors

12. There is also evidence that employers and individuals are in favour of automatic enrolment[17].

13. The majority of organisations in the stocktake supported the proposed minimum levels of contributions to Personal Accounts (4% employee contribution, 3% employer contribution and 1% from the Government through tax relief).

14. However, two major concerns were raised about the risks involved with introducing a new system of Personal Accounts:
    - The risk of employers 'levelling-down' their contributions to existing pension provision in response to the increased costs that they may face from the increased participation rates. Three-quarters of the organisations in the PPI stocktake raised concerns about levelling-down.
    - The risk of employees being auto-enrolled into a product which may not be suitable for them. 11 out of the 24 organisations in the PPI stocktake had specific concerns regarding the suitability of auto-enrolment into Personal Accounts for all employees. For example, organisations expressed concerns about people with low incomes, high levels of debt and/or people currently over a certain age, say 45, whose accounts may not have enough time to mature.

Levelling-down

15. Levelling-down refers to the risk that, in response to the Government's proposals, employers may decide to close existing occupational pension schemes that offer more generous pension benefits to their employees and instead enrol employees into the new Personal Accounts.

16. Levelling-down is an important policy issue. Although the Government's proposals to limit transfers into Personal Accounts will prevent individuals transferring existing pensions into the new Personal Accounts, it is not at all clear how employers will react or respond to the potential increase in costs that some will face, even if the proposals are phased in.

17. ***It is essential that the Government undertakes or commissions further research to understand how employers and employees are likely to respond to the new proposals in order to estimate the possible risk of levelling-down.***

---

than the existence of auto-enrolment could be affecting participation rates, such as whether employees receive encouragement to save from their employer, see PPI (2006***) Response to the Government's White Paper, security in retirement***, paragraph 3.29.

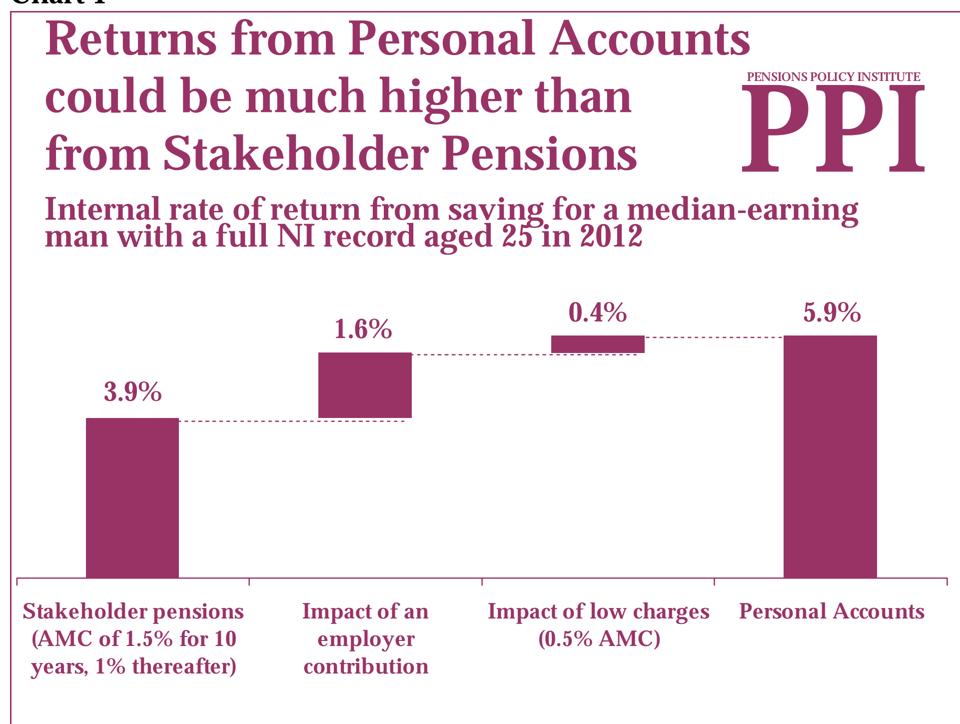
[17] DWP (2006) White Paper: ***Security in retirement***, p. 63

## Suitability and incentives to save

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

19. Personal Accounts could give as many as 10 million people access to a low-cost pension savings product with an employer contribution for the first time.[18] As a result of the low charges and employer contribution, incomes from saving in Personal Accounts are likely to be higher than incomes from saving in Stakeholder Pensions for many people. (Chart 1)

Chart 1[19]



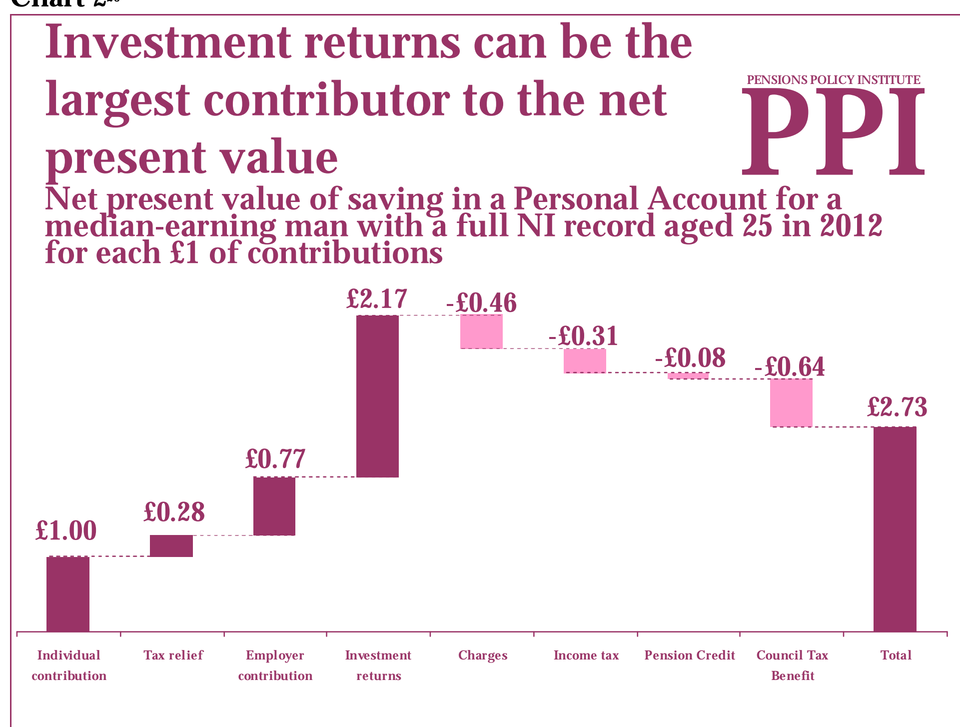

20. However, auto-enrolment inevitably raises questions about the suitability of Personal Accounts for the employees who are auto-enrolled. The value of an individual's Personal Account depends on the complex interaction of a number of factors and will vary depending on an individual's particular circumstances.

[18] DWP (2006) ***Security in retirement: towards a a new pension system***, Fig 1.xi.

[19] PPI (2006) ***Are Personal Accounts suitable for all?*** p. 18. Assumes Stakeholder contributions are equivalent to the minimum employee contribution to Personal Accounts, with no employer contribution. The 'internal rate of return' is the nominal interest rate that the individual receives on his or her individual contributions to Personal Accounts, after allowing for the effects of tax relief, employer contributions, investment returns, charges, income tax and means-tested benefits. It is the same as the 'effective rate of return' used by the Pensions Commission and should not be compared with investment returns on other forms of saving.

21. The employer's contribution, tax relief and investment returns all increase the value of an individual's Personal Account but charges, income tax and any eligibility to means-tested benefits that an individual may forego as a consequence of saving in the Personal Account will reduce the total value. How these combined factors interact will depend on an individual's particular circumstances. (Chart 2)

**Chart 2**[20]




22. In the PPI's analysis, Personal Accounts are defined as being 'suitable' if individuals do not lose out as a result of their saving. This is a less stringent definition than ensuring that saving in Personal Accounts is the right thing for all consumers, which would be more consistent with the FSA's definition of 'suitability'.

23. 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.

[20] PPI (2006) ***Are Personal Accounts suitable for all?*** p.12. In this example we assume the man remains opted in to Personal Accounts for his entire working life. The 'net present value' of an individual saving £1 in a Personal Account is the total amount received in pension income during retirement as a result of that saving in today's prices. This man loses entitlement to some Pension Credit and Council Tax Benefit as a consequence of saving in a Personal Account. He does not lose any entitlement to Housing Benefit because we assume that he owns his own home.

24. 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.

25. 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.

26. 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. These people are likely to qualify for less means-tested Housing Benefit as a consequence of saving in a Personal Account.
    - Although they would not be auto-enrolled, single people in their forties and fifties in 2012 on low to median incomes who are self-employed.

27. No single definition of 'suitability' is likely to be appropriate for the circumstances of every individual. For some people, it may be rational to save even if they have a low return on their saving, for example, if they have a strong preference to smooth consumption over their lifetime. On the other hand, some people may require a high return, for example, if they are very risk-averse or have high levels of debt. Returns from saving in a Personal Account could be higher for people who are married at some point in their retirement than for single people.

28. The Government's test is that individuals should get back at least the value of their own contributions (but not necessarily the value of their employer's contributions, real investment returns or the tax relief) protected for inflation.[21] This suggests that the Government would only be concerned about individuals in the PPI's high-risk group.

---

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

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

Generic advice

30. Some of the factors that affect the suitability of Personal Accounts could be more problematic than others to incorporate into a system of information and generic advice. Clearly, nobody can predict with certainty all of their future life circumstances when making a savings decision.

31. Some factors may be relatively straightforward to reflect in a system of generic advice, 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.

32. These findings 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.
- Any system of generic advice will need to be able to cope with providing advice to a wide range of individuals with different characteristics and financial circumstances.

33. Factors that have an impact on the likely return that an individual may receive from a Personal Account (and hence their decision to stay in or opt out) include their:
- Age
- Current and projected future earnings
- Whether they have taken, or plan to take, time off work
- Level of employer contribution (if not self-employed)
- Investment returns
- Tax treatment
- Level of other savings and wealth (eg home ownership) that they have accrued
- Eligibility for any means-tested state benefits in the future

34. Other factors which don't directly affect the likely return from the Personal Account but may need to be considered by individuals in their decision about whether or not to opt-out include the affordability of their contributions, their level of indebtedness and their preference to spend rather than save.

35. The Government has asked Otto Thoresen, CEO of AEGON to research and design a national approach to generic financial advice, taking account of Personal Accounts, and to publish an action plan by the end of 2007.

36. ***It will be essential for the Thoresen review to establish whether or not it is feasible to design information and generic advice that will assist people to make the decision about whether or not to opt-out of Personal Accounts. If it is not possible to provide information and generic advice in a short, simple and easy to understand way then this suggests that the Personal Accounts policy needs to be revisited.***

Further analysis

37. The PPI is planning to conduct further analysis to consider the impact of possible policy options that might improve the incentives to save for some of the individuals in the high and medium risk groups identified.

38. Policy options that may be analysed include how increases to the trivial commutation and capital disregard limits may affect incentives to save in Personal Accounts.

**The Government has asked for views in a number of specific areas. Where the PPI has evidence or analysis that is relevant we have answered these questions below. The PPI has not addressed all of the Government's questions.**

## Q1: With regard to the target group for personal accounts:

**Whether there should be a cohort of employees approaching State Pension age at the time personal accounts are launched who should not be automatically enrolled into personal accounts.**

**Are there arguments for not auto-enrolling other groups, e.g. those with earnings between £5k and £10k?**

**Whether in practical terms, this might adversely affect the interests of this group, because they would be less likely to exercise the positive choice to opt in.**

1.1 Of the groups identified by PPI research as being more at risk of low returns from being auto-enrolled into Personal Accounts, not all of them could easily be excluded from auto-enrolment. For example, employers will not necessarily know if individuals live in rented accommodation, or if they have previously been self-employed.

People approaching state pension age

1.2 A group that could, in theory, be excluded from auto-enrolment include older people approaching state pension age in 2012.

1.3 PPI analysis has shown that individuals aged 40 and aged 55 in 2012 could be at medium or low risk of finding Personal Accounts unsuitable depending on the level of their earnings, their contribution history and the level of their additional savings. For example:

- Men and women aged 55 in 2012 will be in the PPI's low risk category if they have both a full contribution history and large other savings irrespective of their earning level. These people are likely to benefit from auto-enrolment.

1.4 However, people in their forties and fifties with combinations of low earnings and broken work histories may be at medium risk of Personal Accounts being unsuitable. People in their forties and fifties who are likely to rent in retirement are at high risk of finding Personal Accounts unsuitable.

1.5 Individuals older than this, say in their 60s in 2012, may also be at medium risk (or worse) of finding Personal Accounts unsuitable. Individuals who are close to state pension age in 2012 will be more

at risk of unsuitability, as they will be more likely to have lower state pension entitlements than people reaching state pension age further in future.

1.6 There are over 10 million employees currently aged between 40 and state pension age[22] (5.5 million men and 4.5 million women) earning more than £5,035 a year. This is potentially a very large group.

1.7 Even if approaching state pension age is taken to mean those over aged 50 in 2012, a large group of individuals could be removed from auto-enrolment. There are currently almost 5 million people aged between 50 and state pension age (almost 2 million women and 2 ¾ million men) earning more than £5,035 a year.

1.8 Many people in these older age groups already have existing pension saving. Whether this existing pension saving is enough to significantly improve the value of saving in a Personal Account will depend on a number of detailed characteristics, such as age, earnings and the amount of state pension that has been built up. Having existing pension saving does not necessarily mean the being auto-enrolled into Personal Accounts would automatically be beneficial.

1.9 In England, 64% of people in employment aged between 50 and state pension age have enough pension saving to provide a private income (so above the current lump sum limit for trivial commutation of £15,000) that could help improve the value of saving in a Personal Account (Table 1).

**Table 1[23]: Employees aged between 50 and State Pension Age by pension wealth and earnings, England 2002**

| Earnings band | Pension wealth less than £15,000 | Pension wealth more than £15,000 |
|---|---|---|
| None | 45% | 55% |
| £0 - £4,999.99 | 64% | 36% |
| £5,000 - £9,999.99 | 57% | 43% |
| £10,000 - £14,999.99 | 43% | 57% |
| £15,000 - £19,999.99 | 31% | 69% |
| £20,000 or more | 14% | 86% |
| All employees | 36% | 64% |

[22] 60 for women, 65 for men
[23] PPI analysis of wave 1 of the English Longitudinal Study of Ageing. Marmot, M. et al. , English Longitudinal Study of Ageing: Wave 0 (1998, 1999 and 2001) and Waves 1-2 (2002-2005) [computer file]. 6th Edition. Colchester, Essex: UK Data Archive [distributor], January 2007. SN: 5050. The National Centre for Social Research, University College London, Institute for Fiscal Studies and the UK data archive bear no responsibility for their further analysis or interpretation.

1.10 This does not imply that all people between 50 and State Pension Age will benefit from a Personal Account but it does suggest that many people in this age group could potentially benefit from automatic enrolment. It also highlights the practical difficulties involved in introducing a strict age cut-off.

Low earners

1.11 A second group who do have specific characteristics that could, in theory, be used to exclude them from auto-enrolment are low earners. There are 2 million employees earning less than £5,035 (1.5 million women and 0.5 million men) and a further 2.7 million earning between £5,035 and £10,000[24].

1.12 The PPI's analysis shows that the returns that low earners are likely to receive from Personal Accounts depend on their particular characteristics – in particular their age, contribution history and whether or not they have additional savings. For example:

- Low earners of all ages that the PPI analysed (age 25, 40 and 55) are at low risk of Personal Accounts being unsuitable if they have <u>both</u> a full working history and large additional saving[25]
- Low earners of all ages with an incomplete working history (whether due to periods of unemployment or uncredited caring) are likely to be in the medium risk category
- Low earners in their forties and fifties who are likely to rent in retirement are likely to be in the high risk category.

1.13 However, not all low earners would find Personal Accounts unsuitable. In particular, those:

- With existing pension savings
- With a partner
- Who have had higher earnings in the past or
- Who may have higher earnings in future

could all see higher returns from Personal Accounts than a single person who spends their working life in low paid work.

1.14 This highlights the potential practical difficulties involved in introducing a low earnings cut-off level. It would be difficult to introduce an earning cut-off that takes account of the other factors that will affect a low earner's likely return from a Personal Account.

[24] PPI analysis of the Labour Force Survey March to May 2006. Office for National Statistics. Social and Vital Statistics Division and Northern Ireland Statistics and Research Agency. Central Survey Unit, Quarterly Labour Force Survey, March - May, 2006 [computer file]. Colchester, Essex: UK Data Archive [distributor], August 2006. SN: 5412. ONS and the UK Data Archive bear no responsibility for their further analysis or interpretation. Crown copyright material is reproduced with the permission of the Controller of HMSO and the Queen's Printer for Scotland Crown copyright material is reproduced with the permission of the Controller of HMSO and the Queen's Printer for Scotland

[25] Low earners are defined here as the first to third deciles of the income distribution

Auto-enrolment cut-offs

1.15 The arguments as to whether either low earners or those approaching state pension age in 2012 should be auto-enrolled are finely balanced. Neither low earnings nor being close to state pension age will automatically mean that individuals will receive a low return from Personal Accounts.

1.16 By not-auto-enrolling either of these two groups as a whole, there is a risk that individuals who would benefit from saving in a Personal Account do not join.

1.17 It is not possible to say how many individuals within these groups would opt-out of Personal Accounts if they were auto-enrolled, or how many might opt-in if the groups were excluded from automatic enrolment.

1.18 Given the evidence that auto-enrolment increases participation rates it is likely that not auto-enrolling this group may lead to more of this group remaining opted-out of Personal Accounts.

1.19 Whether the lack of participation by this group is a good or bad thing depends on the view taken about the minimum acceptable level of effective return individuals should receive from their Personal Accounts.

1.20 Ideally the Government could use PENSIM2 to project the possible range of outcomes from auto-enrolment and the potential number of individuals in each group likely to be affected by any change in auto-enrolment policy.

1.21 The Government may also want to consider other approaches to dealing with the possible low incentives to save for these groups. Possible alternative policies might include:

- increasing trivial commutation limits to enable these groups to take their pensions as a lump sum
- making pensions saving invisible to means-testing for these groups – meaning that pension income from Personal Accounts would not disqualify these individuals for being eligible for means-tested benefits
- tailoring the generic advice given to these groups to help them make the right decision for their circumstances.

1.22 The PPI is undertaking some commissioned work for the EOC which will examine the implication of changes to the trivial commutation and capital disregard limits for the incentives to save for certain individuals.

1.23 The Thoresen review will need to consider the specific needs of these groups in designing generic advice.

**Whether three years is the right period for repeat automatic enrolment of employees who have opted out of personal accounts.**

**How this would affect employers and employees.**

1.24 There are a number of different changes in circumstances that could lead to individuals being more or less likely to remain auto-enrolled in Personal Accounts:
- Changes in jobs
- Promotion or wage increases
- Paying off debt, such as student loans, personal loans or a mortgage
- Changes in family structure, such as marriage or cohabitation, the birth of a child, divorce, separation or widowhood, or children leaving home

1.25 Without repeat automatic enrolment, only the first of these would result in an individual being automatically enrolled in Personal Accounts, suggesting that re-enrolment would be desirable.

1.26 There will not be a single period of repeat automatic enrolment that will be right for everyone, or necessarily coincide with the events likely to trigger a change in the desire to stay enrolled in a Personal Account. But the impact on employees and employers will depend on the length of period chosen.

1.27 The impact of the re-enrolment period on individuals will depend on how many individuals remain employed by the same employer for more than the re-enrolment period, and how many opt-out when starting employment.

1.28 Currently just under two-thirds of employed men and women earning more than £5,035 have been in their current job for more than 3 years, and around half for more than 5 years (Table 2).

**Table 2[26]: Length of time spent in current employment by gender, employers earning more than £5,035, 2006**

| | Men | Women |
|---|---|---|
| More than 1 year | 83% | 83% |
| More than 2 years | 72% | 70% |
| More than 3 years | 67% | 62% |
| More than 5 years | 50% | 47% |

[26] PPI analysis of the Labour Force Survey March to May 2006

1.29 If the re-enrolment period was set at 3 years, up to 2/3 of employees might have to go through the re-enrolment process if they opted-out of the initial enrolment process. Up to a half of employees could potentially be affected if the re-enrolment period was 5 years.

1.30 The impact of re-enrolment will vary by age, with older employees more likely to face re-enrolment. 78% of employees earning £5,035 or more aged 50 to 54 have been in their current job for 3 years or more, compared with only 63% of 30 to 34 year olds[27].

1.31 The impact on employers will largely be in the administrative cost of monitoring and handling repeat auto-enrolments, and potentially the additional employer contributions of people remaining enrolled.

1.32 Larger firms are likely to have more employees staying long enough to be re-enrolled than smaller firms[28]. The administrative burden of re-enrolment may therefore be higher for larger firms.

1.33 Different industrial sectors are also likely to be affected in different ways. Business sectors with low turnover such as agriculture and fishing are most likely to have employees potentially subject to the re-enrolment process. Employers in these sectors may face a higher administrative burden from re-enrolment than other industries.

1.34 Employees in industries such as construction, distribution, hotels and restaurants and banking, finance and insurance have higher average turnover and employees have generally spent shorter periods of time in their current job[29]. These sectors are therefore less likely to be affected by re-enrolment.

[27] PPI analysis of the Labour Force Survey March to May2006
[28] PPI analysis of the Labour Force Survey March to May 2006. See Appendix 1 for more details.
[29] PPI analysis of the Labour Force Survey March to May 2006. See Appendix 1 for more details.

## Q2: Delivering personal accounts:

**How can members' interests best be represented in the governance of personal accounts?**

2.1 PPI is conducting research on the role and objectives of the Personal Accounts Delivery Authority and Board, and options for addressing any potential issues in these areas. This work will be completed in late April 2007.

2.2 The research is considering what should be the objectives, structure and membership of the Personal Accounts Delivery Authority and the Personal Accounts Board. The research will also consider how stakeholders can be represented in the governance of Personal Accounts, lines of accountability and measures of success for both bodies.

2.3 The PPI is seeking stakeholder views on the best ways to represent members' interests and other stakeholders' interests as part of this research.

2.4 The research is at an early stage and only a small number of stakeholders have been consulted at this point. Emerging findings suggest that stakeholders[30]:

- support the aim of keeping members' interests central to the design and delivery of Personal Accounts
- recognise the need for members' interests to be considered at all stages: ie in the design stage, set up stage, and in ongoing delivery
- recognise that some other stakeholders have interests that may also need to be represented in the governance of Personal Accounts in addition to members' interests.

2.5 The PPI research project will explore in more detail alternative options for ensuring members' and other stakeholders' interests are represented in the governance of personal accounts.

2.6 Individuals will have a number of decisions that they will need to make once the new Personal Accounts are introduced. These include

- whether to stay-in or opt-out
- whether to contribute more than the minimum amount
- whether to stay in the default fund or make a fund choice (if offered)
- who should provide their annuity

[30] These findings remain provisional as PPI is still conducting fieldwork with stakeholders.

**What sort of information should support personal accounts and the responsibilities of different organisations in communicating this information?**

2.7 Given the complexity of some of these decisions it is essential that individuals are provided with appropriate information and generic advice to help them to make these decisions.

2.8 Factors that have an impact on the likely return that an individual may receive from a Personal Account (and hence their decision to stay in or opt out) include their:

- Age
- Current and projected future earnings
- Whether they have taken, or plan to take, time off work
- Level of employer contribution (if not self-employed)
- Investment returns
- Tax treatment
- Level of other savings and wealth (eg home ownership) that they have accrued
- Eligibility for any means-tested state benefits in the future

2.9 Other factors which don't directly affect the likely return from the Personal Account but may need to be considered by individuals in their decision about whether or not to opt-out include the affordability of their contributions, their level of indebtedness and their preference to spend rather than save.

2.10 Previous PPI research[31] has identified some lessons from the New Zealand Retirement Commission's experience in encouraging greater financial awareness and providing generic financial advice.

- The guidance should come from a body that can be seen to be independent of Government and the financial services industry. This is essential if the advice is to be credible and trusted by consumers;
- A website is an obvious first step and New Zealand's website, ***Sorted*** may provide a useful template[32]. Other delivery channels eg telephone or face-to-face should also be considered and piloted.
- Generic advice should cover a wide range of personal finance issues not just retirement planning;
- Any other roles of the independent body should be complementary of the specific remit chosen.

[31] PPI (2006) ***Lessons from New Zealand's Retirement Commission for UK policy on financial awareness and advice***
[32] See www.sorted.org.nz

# Q3: Appropriate method of charging members for personal accounts:

**What overall charge structure is most appropriate?**

3.1 The charging structure in Personal Accounts could take a number of forms. Options include an Annual Management Charge (AMC), a joining fee, an annual flat fee, a contribution charge, and combinations of these alternatives.

3.2 PPI research[33] has investigated the impact of five alternative charging structures for Personal Accounts on:

- Different types of individuals, with different work patterns, earnings and contributions to Personal Accounts.
- The financing of Personal Accounts, such as when income from charges becomes equal to the cost of running the system.

3.3 The research also evaluated the advantages and disadvantages of each charging structure against five criteria suggested by the Government[34].

3.4 The research has concluded that overall, no single charging structure, or combination of charging structures, has all of the desirable attributes. Each charge structure has advantages and disadvantages and there are trade-offs that have to be made.

3.5 Depending on what the main priority is, different charging structures might be chosen[35]:

- If fairness was the main priority, then the choice of charging structure would depend on the definition of 'fairness' being used. For example:
  - If it meant that everybody should pay the cost of running their fund, then this might suggest an annual flat fee is the best structure.
  - If it meant that everybody should lose the same proportion of their fund value to charges, then a contribution charge may be appropriate.
- If reducing financing costs was the main priority, then this may lead to a hybrid between a joining charge and an AMC.
- If being simple and easy to understand was the main priority, then there may be different views on which structure is the most appropriate:
  - An AMC may be the easiest to compare to existing Stakeholder Pensions.

[33] PPI (2007) ***Charging structures for Personal Accounts***, co-funded by the Department for Work and Pensions, AEGON and Standard Life. A full version of this report has been submitted to DWP alongside this response
[34] DWP (2006) ***Personal accounts: A new way to save*** page 96
[35] These findings are summarised in Table A1 of Appendix 1 to this response.

    - A contribution charge has the most consistent impact on the proportion of final pension funds lost to charges.
    - An annual flat fee may be the easiest to understand in terms of how much is being paid each year.
- None of the charging structures seem to directly incentivise members to help keep costs down, although some of the charging structures may encourage participation in Personal Accounts more than others.
- If incentivising the scheme operator to maximise the fund value was the main priority, then a charging structure with a substantial AMC component may be appropriate.

3.6 ***The Government should commission some market research into how the target market's behaviour is likely to be affected by alternative charging structures and in particular whether different charging structures may have different impacts on the overall participation in Personal Accounts.***

**How much flexibility should the personal accounts delivery authority or the personal accounts board have in deciding the charging structure?**

3.7 The actual costs of setting up and running Personal Accounts will not be known for certain in advance, nor will the number of members of Personal Accounts. This may have implications for both the size of the charge needed and the appropriate charging structure. There may be a case for delaying decisions about the final charging structure and level until after more detailed work about the scheme design has been undertaken.

3.8 There are a number of possibilities for who could set the charging structure
- In a well functioning market providers decide what prices they will charge for their goods and services and consumers exert downward pressure on prices by shopping around for the best deal;
- In a regulated market the Government or an economic regulator may set prices. For example OfCom is the regulator for the UK communications industries, with responsibilities across television, radio, telecommunications and wireless communications services. Ofcom will intervene where there is a specific statutory duty to work towards a public policy goal which markets alone cannot achieve. This can include price regulation.

3.9 The Government is effectively introducing a form of product regulation with Personal Accounts, so there could be a parallel with OfCom and the role of the Personal Accounts Board as an economic regulator.

3.10 If the Personal Accounts Board were to be given powers to determine the charging structure and levels then it will be essential to mitigate against any possible conflicts of interest that could arise. There would be a clear conflict of interest if a member of the Personal Accounts Board were to have a responsibility for setting charges while simultaneously being an active industry provider with a commercial interest in Personal Accounts.

**Are there particular circumstances or activities where it is appropriate to make an additional charge?**

3.11 One rationale for charging for particular activities is to help keep the costs of administering Personal Accounts low. For example, a charge based on the number of telephone calls made by the member each year could be introduced to try to keep administration costs low.

3.12 Similarly, if individuals choose their funds an additional charge could be incurred as exercise of that choice is likely to increase the fund management costs. However, charging for specific activities may also add complexity and may discourage members from doing what is in their best interest. More detailed analysis as to the impact of these types of charges is required.

## Q5: In relation to waiting periods in personal accounts:

**The Government is not proposing a formal waiting period for personal accounts, although it recognises that there will be a short period before the automatic enrolment process is completed. This is an area in which the Government continues to welcome views.**

5.1 Any formal waiting period in Personal Accounts needs to strike a balance between the disadvantage faced by employees changing jobs frequently or doing seasonal work, and the desire to keep the costs of administering the enrolment process for Personal Accounts low.

5.2 As demonstrated by DWP analysis[36] even the introduction of a 6-month waiting period could reduce the final value of pension savings considerably.

5.3 8% of employees have been in their current job for less than 6 months[37] and so would not currently be auto-enrolled to Personal

[36] DWP (2006) ***Personal accounts: A new way to save*** page 120

Accounts if a 6-month waiting period were in operation. However, 42% of these employees work for small firms[38], who may find administering the auto-enrolment process more expensive than larger employees on a per member basis. Concentrating on streamlining the auto-enrolment process may be an alternative to allowing waiting periods.

**In relation to waiting periods and scheme exemption, the Government is interested in views on:**

**Whether employers with exempt schemes with contributions that are higher than the minimum level, could operate a short waiting period, of perhaps three or six months, to encourage them to continue to offer good-quality schemes.**

**What is the minimum level of scheme contributions above which a waiting period is acceptable.**

5.4 The impact of a waiting period for exempt schemes on an individual's final pension compared to what they would have received in a Personal Account with no waiting period will depend on:
(1) the extent to which the employer contributes more than 3% in the exempt scheme; and
(2) how long the individual stays in the same employment after the end of the waiting period.

5.5 The longer an employee stays in a job, the more likely they will be to get more from the employer's scheme with a waiting period than if they had been auto-enrolled into a Personal account with no waiting period.

5.6 Many employees do not spend long periods of time with the same employer. Half of new jobs last for less than 15 months[39].

5.7 However, the average length of all jobs is currently 5 years. Once employees stay in a job more than a year their chances of leaving reduce significantly[40].

5.8 The shorter the period of time spent in a job, the higher the employer contribution would need to be to ensure that the employee gets at least as much from the employer scheme with a waiting period than they would have done from being auto-enrolled into a Personal Account with no waiting period (Table 3).

---

[37] PPI analysis of the Labour Force Survey March to May 2006
[38] PPI analysis of the Labour Force Survey March to May 2006.
[39] Gregg and Wadsworth (2002) ***Job tenure in Britain, 1975 -2000. Is a job for life or just for Christmas?*** In Oxford Bulletin of Economics and Statistics, 64 , 2 (2002) pp 111 - 134
[40] Gregg and Wadsworth (2002) ***Job tenure in Britain, 1975 -2000. Is a job for life or just for Christmas?*** In Oxford Bulletin of Economics and Statistics, 64 , 2 (2002) pp 111 - 134

**Table 3[41]: Size of employer contribution required to give the same final pension outcome as immediate enrolment to a Personal Account at the minimum level of contributions, assuming a 6 month waiting period**

| Length of employment | Required employer contribution (% of band earnings) |
|---|---|
| 15 months | 8% |
| 23 months | 6% |
| 5 years | 4% |

5.9 If a new employee stays in work for 15 months, an employer would need to contribute 8% after an initial waiting period of 6 months, rather than 3% from being auto-enrolled into a Personal Account with no waiting period, to provide the same final pension fund as in a Personal Account (Table 3). Anyone staying longer than 15 months at this contribution level would do better in the employer scheme than in Personal Accounts. Anyone staying less than 15 months would have been better off in a Personal Account.

5.10 The White Paper highlighted the number of schemes and scheme members where the employer contribution is 6% or more[42]. An individual would need to remain in the same job for 23 months in order to get the same from a 6-month waiting period and a 6% employer contribution as from immediate enrolment into a Personal Account (Table 3). As most new jobs end before this, a contribution of more than 6% would be needed to protect most employees.

5.11 If an employee stayed in a job for 5 years, an employer would need to contribute 4% after an initial waiting period of 6 months, rather than 3% from the start of employment, to provide the same final pension fund as in a Personal Account (Table 3). Anyone staying longer than 5 years at this contribution level is likely to do better in the employer scheme than in Personal Accounts. Anyone staying less than 5 years would have been better off in a Personal Account.

5.12 DWP suggest that only 16% of open workplace schemes currently operate a waiting period[43]. However, around 80% of these schemes, representing around 320,000 members, have a waiting period of 1 year or more. So even allowing a short waiting period of 3 or 6 months would require some change in scheme design for these employers.

5.13 Having a short waiting period and a minimum employer contribution level of 6% may not therefore meet the objectives of protecting employees interests or avoiding changes in existing provision.

---

[41] PPI analysis
[42] DWP (2006) ***Personal accounts: A new way to save*** page 121
[43] DWP (2006) ***Personal accounts: A new way to save*** page 120

## Q8. Given the twin aims of focusing the scheme on the target market and allowing sufficient flexibility for individuals within the scheme:

**Should the annual contribution limit be set higher than £5,000? If so, at what level?**

8.1 The level of any contribution limit will affect the impact of Personal Accounts on individuals, employers and pension providers.

8.2 Not having any limits on contributions other than those used for any form of pension saving[44] would provide the most flexibility for individuals saving in Personal Accounts. However, this would run the risk of attracting pension contributions from existing savers and individuals outside the 'target market' of low to median earners for Personal Accounts.

8.3 If a key objective is to focus the scheme on the target market, some mechanism may be needed to limit the participation of those outside the target market. An annual contribution limit would mean that higher earning individuals who may be more likely to make large annual pension contributions would need to make alternative pension arrangements for at least part of their pension contribution.

8.4 On the other hand, employers with relatively generous pension schemes may want to make the same level of contributions to a Personal Account as to an existing employers scheme. An annual limit on contributions may prevent them from doing this for some employees.

8.5 This would mean that some individuals and employers would need to remain outside of Personal Accounts, or have alternative arrangements alongside Personal Accounts, or reduce contributions to be within the limits.

8.6 In many cases individuals in the target market (low – to median earners) looking to achieve a desired replacement rate would be able to make the necessary contributions within a limit lower than £5,000 (Tables 5, 6 and 7). However, individuals currently in their 40s, higher earning individuals, and in particular those with broken work records[45] may need to contribute more than this to achieve a desired replacement rate.

[44] A lifetime limit of £1.5 million and an annual contribution limit of £215,000 or annual salary, whichever is the lower, for 2006/7. See PPI (2006) ***The Pensions Primer*** for more information.
[45] So with potentially lower state pension entitlement and fewer contributions to Personal Accounts

**Table 5[46]: Required saving to hit Pensions Commission target replacement rates: for men with a full work history, aged 25 in 2012**

| | Decile of the earnings distribution | | | | |
|---|---|---|---|---|---|
| | 1st | 3rd | Median | 7th | 9th |
| Target replacement rate | 70% | 70% | 67% | 67% | 60% |
| Savings required | | | | | |
| Savings rate from age 25 (% of band earnings) | 7.7% | 9.9% | 9.5% | 11.4% | 18.4% |
| Range of amount of saving required each year | £500 to £800 | £1,000 to £1,600 | £1,200 to £2,100 | £1,900 to £3,300 | £4,600 to £5,200 |
| Average amount of saving required each year | £700 | £1,400 | £1,800 | £2,900 | £5,200 |

8.7 An annual contribution limit of £3,000 (or indeed much lower) would be enough to allow an individual who is 25 in 2012, is in the target group (low to median earnings) and who has a full contribution record to reach the 'desirable' replacement rate suggested by the Pensions Commission.

8.8 Individuals in the top 30% of earners would not be able to make the contributions required to reach their 'desirable' replacement rate with a £3,000 limit, but could almost do so within a £5,000 limit (Table 5).

[46] PPI analysis using the Individual Model. Required savings include contributions made by employees, employers and the state through tax relief. Employers are assumed to contribute 3% of employees' band earnings. Employees are assumed to contribute the same percentage of their band earnings from 2012 until retiring at state pension age. The contribution rate required by employees is calculated so that their income at state pension age reaches the Pensions Commission target replacement rates. Here, 'income' includes income from saving from Personal Accounts, Basic State Pension, SERPS and State Second Pension and Pension Credit. The amount saved varies from year to year according to the earnings profiles used, which are derived from the Labour Force Survey. Annual investment returns are assumed to be 3% in excess of prices. The shaded area represents the target market.

**Table 6[47]: Required saving to hit Pensions Commission target replacement rates: for women with caring breaks, aged 25 in 2012**

| | Decile of the earnings distribution | | | | |
|---|---|---|---|---|---|
| | 1st | 3rd | Median | 7th | 9th |
| Target replacement rate | 70% | 70% | 70% | 67% | 60% |
| Savings required | | | | | |
| Savings rate from age 25 (% of band earnings) | 4.5% | 17.5% | 23.1% | 26.4% | 29.3% |
| Range of amount of saving required each year | £200 to £300 | £1,300 to £1,900 | £2,200 to £3,400 | £2,900 to £5,700 | £6,500 to £8,400 |
| Average amount of saving required each year | £200 | £1,600 | £2,900 | £4,700 | £7,900 |

8.9 Even allowing for some caring breaks (and therefore breaks in contributions) a relatively low cap would enable most individuals in the target group to make sufficient contributions to reach the 'desirable' replacement rate. Median earners might require a cap of just above £3,000, but well below £5,000 to be able to make the required contributions in every year (Table 7.)

[47] See footnote to Table 5. The women have short two career breaks for caring: one that lasts for six years in their twenties to care for a child and one that lasts for five years in their fifties to care for an elderly relative. They work part-time for five years after their first period of caring. They save in a Personal Account from 2012, except when they are caring or working part-time. The second period of caring does not qualify for credits to state pensions.

**Table 7[48]: Required saving to hit Pensions Commission target replacement rates: for women with caring breaks, aged 40 in 2012 with no prior saving**

| | Decile of the earnings distribution | | | | |
|---|---|---|---|---|---|
| | 1st | 3rd | Median | 7th | 9th |
| Target replacement rate | 70% | 70% | 70% | 67% | 60% |
| Savings required | | | | | |
| Savings rate from age 25 (% of band earnings) | 12.4% | 26.9% | 31.9% | 34.1% | 36.8% |
| Range of amount of saving required each year | £600 to £700 | £2,000 to £2,900 | £3,100 to £4,700 | £4,000 to £7,300 | £8,800 to £10,500 |
| Average amount of saving required each year | £600 | £2,500 | £4,000 | £6,200 | £10,200 |

8.10 However, if the annual contribution limit were set at £3,000, median earners aged 40 or older in 2012, and with some caring breaks, would not be able to make sufficient contributions to reach the 'desirable' replacement rate if they had no existing pension savings (Table 7). They might need a contribution limit of £5,000.

8.11 There may also be other circumstances in which individuals would like to contribute larger amounts to a Personal Account, but may not be able to under an annual limit:

- If savings are built up in another form of savings (for example a product with easier access) before being transferred to a Personal Account
- If a lump sum is inherited, or received as part of a divorce settlement
- If earnings are very varied from year to year
- If saving in a pension scheme is only affordable later in life

8.12 The impact on providers of existing pension provision will depend on the behavior of individuals and employers. The higher the contribution limit and the more provision employers and individuals make through Personal Accounts, the lower the contributions that might be made into existing types of pension provision.

[48] See footnote to Table 6

8.13 The setting of the contribution limit therefore involves a trade-off: a higher contribution limit could increase the flexibility for individuals and employers to use a single pension product, but increases the potential negative impact on the providers of existing types of pension provision.

8.14 There may be a case for allowing higher contribution limits for individuals who are self-employed, as:

- Earnings from self-employment may be more uncertain and more irregular than earnings from employment
- State pension accrual is lower during periods of self-employment, as the self-employed do not accrue S2P. Self-employed individuals would therefore need a higher contribution to achieve a target replacement rate than employees (Table 8)
- There is no existing employer scheme to protect.

**Table 8[49]: Required saving to hit Pensions Commission target replacement rates: for men who are self-employed for their entire working life, aged 25 in 2012**

| | Decile of the earnings distribution | | | | |
|---|---|---|---|---|---|
| | 1st | 3rd | Median | 7th | 9th |
| Target replacement rate | 70% | 70% | 67% | 67% | 60% |
| Savings required | | | | | |
| Savings rate from age 25 (% of band earnings) | 19.6% | 17.6% | 15.3% | 15.8% | 22.4% |
| Range of amount of saving required each year | £1,200 to £2,100 | £1,800 to £2,800 | £1,900 to £3,400 | £2,700 to £4,500 | £5,600 to £6,400 |
| Average amount of saving required each year | £1700 | £2,400 | £2,900 | £4,000 | £6,300 |

8.15 However, an annual limit of £3,000 cap would almost be sufficient for 25 year-old self-employees in 2012 with low-median earnings to reach a 'desirable' replacement rate (Table 8).

[49] See footnote to Table 5

**Proposals for a higher annual limit in the first year of operation**

8.16 The Government has suggested that the annual contribution limit for the first year of Personal Accounts should be £10,000, in order to encourage saving before Personal Accounts become available.

8.17 A limit of £10,000 would allow almost all individuals to start to save at the minimum individual Personal Account contribution level from 2007 into an ISA, and then transfer this saving into a Personal Account in 2012 (Table 9).

**Table 9[50]: Estimated contributions made into a Personal Account in 2012 by employees who start saving in an ISA from April 2007 and then transfer their saving into a Personal Account in April 2012, in 2006/7 earnings terms**

| | Decile of the earnings distribution | | | | |
|---|---|---|---|---|---|
| | 1st | 3rd | Median | 7th | 9th |
| Accumulated value of savings transferred from an ISA[51] | £2,500 | £4,000 | £5,000 | £7,000 | £7,000 |
| Contributions made directly into a Personal Account during 2012[52] | £500 | £1000 | £2,000 | £2,500 | £2,500 |
| Total contributions to a Personal Account in 2012 | £3,000 | £5,000 | £7,000 | £9,500 | £9,500 |

[50] PPI analysis using the Individual Model for full-time male employees who are aged 40 in 2012

[51] The individuals are assumed to save an amount equivalent to the minimum employee Personal Account contribution in an ISA between April 2007 and April 2012. The employer is assumed not to contribute during this time. Annual investment returns are assumed to be 2.5% in excess of prices for the ISA. The ISA saving is transferred to a Personal Account in April 2012. At the point of transfer, tax relief is assumed to be added at the employee's marginal rate of tax. If this tax relief were not added, then the final value of the saving made between 2007 and 2012 may have been greater if it had been made directly into Stakeholder Pension, even if charges under the Stakeholder Pension were the maximum amount possible (i.e. an AMC of 1.5% for the first ten years and 1.0% thereafter).

[52] Assumes that the employer and employee contribute the minimum amount to a Personal Account in 2012

**Alternatives to an annual limit**

8.18 There may be other ways to allow individuals flexibility in the amount they contribute to Personal Accounts while still going some way to limit (though not avoid completely) the potential detrimental impact on existing provision:

- Use a lifetime limit approach rather than an annual limit: This would be more in line with changes to the regime for the tax treatment of pensions introduced in April 2006, and allow individuals/employers to decide when they are best able to make a contribution.
- Allow unused annual allowances to be carried forward into future years. This is a hybrid approach between the lifetime and annual limits.
- Allow higher contributions from specific sources, such as divorce settlements or inheritances. This would allow one-off additional contributions to be made rather than

8.19 These options should be investigated further to see which strikes the appropriate balance between flexibility and focusing on the target market.

# Appendix 1: Additional Tables

**Table A1: Summary findings from PPI (2007) Charging structures for Personal Accounts**

| | Fairness | | Reducing financing costs | Simple and easy to understand | Incentivises members to help keep costs down | Incentivises the scheme operator to maximise the fund value |
|---|---|---|---|---|---|---|
| | Same proportion of fund size lost to charges | Same absolute amount lost to charges | | | | |
| Annual Management Charge (AMC) | • Members who start saving early in life but then stop contributing pay the highest proportion of their fund value | • High earners pay more in absolute terms than low earners<br>• People with full saving histories pay more in absolute terms than people with broken histories | • £1.7-£4.5bn borrowing<br>• 15-28 year payback<br>• £900-£11,800m cost of debt | • Most comparable to existing Stakeholder Pensions | • Does not seem to directly encourage members to make fewer queries and therefore, to help keep costs down | • Yes, because charging revenue is directly related to fund value |
| Joining charge plus AMC | • Compared to a pure AMC, outcomes are worse for people with very short saving histories and slightly better for those with full saving histories | • As with the pure AMC, high earners and people with full saving histories pay more in absolute terms | • No borrowing required after 2012 | • Two components may seem less easy to understand | • May discourage people from joining Personal Accounts. By decreasing participation, fixed costs per head could be higher as they are shared between fewer members | • Yes, because most of the charging revenue is related to the fund value after the first year |
| Annual flat fee | • Low earners pay a higher proportion of their fund value than high earners | • Everybody pays the same absolute amount each year | • £700-£800m borrowing<br>• 2-3 year payback<br>• £100 to £200m cost of debt | • Could be easiest to understand the amount lost in charges each year | • Same as AMC | • Charging revenue is not directly related to fund value |
| Contribution charge | • Everybody pays the same proportion of their fund value | • High earners pay more in absolute terms than low earners | • £600m borrowing<br>• 2 year payback<br>• £0 to £100m cost of debt | • Could be easiest to understand the impact of charges on the final fund value | • Same as AMC | • Charging revenue is not directly related to fund value |
| Contribution charge plus AMC | • Members who start saving early in life but then stop contributing pay the highest proportion of their fund value (but not as much as under a pure AMC) | • High earners pay more in absolute terms than low earners | • £900m-£1bn borrowing<br>• 5-6 year payback<br>• £100 to £500m cost of debt | • Two components may seem less easy to understand | • Same as AMC | • Partially as some of the charging revenue is related to the fund value in the long term |

# Appendix 1: Additional Tables

**Table A2[1]: Length of time spent in current employment by age, employees earning more than £5,035, 2006**

| | 16-19 | 20-24 | 25-29 | 30-34 | 35-39 | 40-44 | 45-49 | 50-54 | 55-59 | 60 - 64 |
|---|---|---|---|---|---|---|---|---|---|---|
| More than 1 year | 41% | 56% | 78% | 86% | 86% | 89% | 89% | 91% | 94% | 91% |
| More than 2 years | 14% | 34% | 58% | 73% | 75% | 79% | 81% | 83% | 87% | 84% |
| More than 3 years | 9% | 25% | 47% | 63% | 68% | 72% | 74% | 78% | 82% | 78% |
| More than 5 years | 0% | 8% | 25% | 44% | 54% | 58% | 60% | 66% | 72% | 67% |

**Table A3[2]: Length of time spent in current employment by number of employees working for the employer, employees earning more than £5,035, 2006**

| | 1 - 10 | 11- 19 | 19 - 24 | DK but less than 25 | 25 - 49 | 50 - 249 | 250 - 499 | DK but 50 - 499 | 500 or more |
|---|---|---|---|---|---|---|---|---|---|
| More than 1 year | 78% | 82% | 79% | 60% | 84% | 84% | 87% | 81% | 88% |
| More than 2 years | 64% | 67% | 68% | 48% | 72% | 72% | 76% | 66% | 77% |
| More than 3 years | 56% | 58% | 59% | 43% | 65% | 64% | 68% | 59% | 71% |
| More than 5 years | 39% | 42% | 41% | 34% | 50% | 50% | 54% | 43% | 57% |

[1] PPI analysis of the Labour Force Survey March to May 2006

[2] PPI analysis of the Labour Force Survey march to May 2006

# Appendix 1: Additional Tables

**Table A4[3]: Length of time spent in current employment by industry, employees earning more than £5,035, 2006**

| | Agriculture & fishing | Energy & water | Manufacturing | Construction | Distribution, hotels & restaurants | Transport & communication | Banking, finance & insurance etc | Public admin, educ & health | Other services |
|---|---|---|---|---|---|---|---|---|---|
| More than 1 year | 91% | 82% | 85% | 78% | 76% | 87% | 81% | 88% | 79% |
| More than 2 years | 83% | 74% | 75% | 66% | 62% | 75% | 65% | 76% | 67% |
| More than 3 years | 77% | 69% | 69% | 59% | 54% | 69% | 57% | 69% | 58% |
| More than 5 years | 67% | 57% | 56% | 44% | 38% | 56% | 41% | 54% | 41% |

[3] PPI analysis of the Labour Force Survey March to May 2006