PENSIONS POLICY INSTITUTE

PPI Policy Seminar

The benefits of automatic enrolment and workplace pensions for older workers

Monday 19th May 2014

Kindly hosted by

PRUDENTIAL

The benefits of automatic enrolment and workplace pensions for older workers

Mel Duffield and Melissa Echalier

Pensions Policy Institute

Prudential, Laurence Pountney Hill

Monday 19th May 2014

www.pensionspolicyinstitute.org.uk

We'd like to thank...

For sponsoring this report and the Automatic Enrolment Series Sponsors as a whole.

The benefits of automatic enrolment and workplace pensions for older workers

PENSIONS POLICY INSTITUTE
PPI

- Older workers and automatic enrolment
- Calculating the return from saving
- Policy developments that affect rates of return for older workers
- What rates of return might older workers have?
- How might new flexibilities affect retirement choices and rates of return?

Automatic enrolment – the basics

PENSIONS POLICY INSTITUTE
PPI

- Implemented from October 2012.
- Harnessing the power of inertia by introducing a default of saving into a workplace pension.
- All workers who earn over £10,000 (2014-15) and are not participating in a qualifying pension to be automatically enrolled – **but are able to opt out**.
- Contributions are payable on an employee's salary between the lower earnings limit, £5,772, and the upper earnings limit, £41,865, in 2014-15.

Older workers have been more likely to opt out of automatic enrolment

PENSIONS POLICY INSTITUTE
PPI

- DWP research: average opt-out rates for older workers are 15%, compared to 9% across all workers.
- Key reasons :
  - have made other provision;
  - insufficient time to build up pension savings;
  - contribution rates considered too low.
- Participants had a good understanding of automatic enrolment and knew their employer's contribution level. **But** hadn't made a calculation of their own retirement income needs /suitability of remaining enrolled.
- **May be some older workers opting out when remaining enrolled would be beneficial to them**?

Source: Department for Work and Pensions (2014) *Automatic enrolment: experiences of workers who have opted out – a qualitative research study*

Previous PPI research found that older workers were likely to have lower returns

PENSIONS POLICY INSTITUTE
PPI

Those automatically enrolled in their forties and fifties were expected to see lower rates of return than those in their twenties :

- Less likely to have benefited from S2P and improvements in state pension coverage;
- More likely to be eligible for Pension Credit (Savings Credit);
- Fewer years of contributions under AE – and less time to build up a pension income above the means tested thresholds;
- Less time to build up compound investment returns;
- Lower investment returns if assumed they are placed into a lifestyle fund (not explicitly modelled).

Recent policy changes, including the Budget 2014 changes, may have changed the benefits of saving into a workplace pension for older workers.

Source: Pensions Policy Institute (2006) *Are personal accounts suitable for all?*

The benefits of automatic enrolment and workplace pensions for older workers

PENSIONS POLICY INSTITUTE
PPI

- Older workers and automatic enrolment
- Calculating the return from saving
- Developments that affect rate of return for older workers
- What rates of return might older workers have?
- How might new flexibilities affect retirement choices and rates of return?

Calculating the returns from saving in a workplace pension

PENSIONS POLICY INSTITUTE

PPI

- Alternative approaches: **Net Present Value** or **Internal Rate of Return** (IRR).

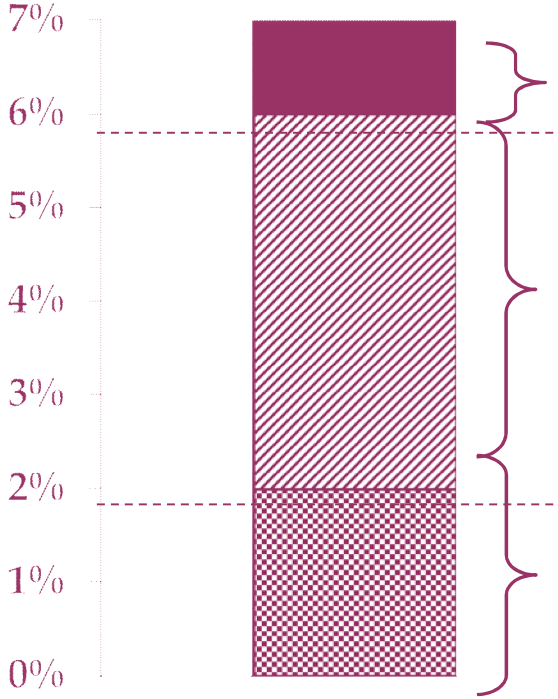
IRR is expressed as an annual interest rate and calculates the rate of interest per year that an individual receives on his or her pension contributions

- IRR compares the difference between the amount saved (outflows) and the amount likely to be received (inflows) as pension income.
- If there is at least a minimum return on saving being automatically enrolled is considered **"suitable"** for an older worker.
- IRR takes account of employer's and government contributions (i.e. tax relief), investment returns, charges, means-tested benefits, and income tax.

Different benchmarks are used to place individuals in risk brackets

PENSIONS POLICY INSTITUTE
PPI

Estimated Internal Rate of Return (IRR)



An individual with an IRR in this range is classified as <u>low risk</u>

An individual with an IRR in this range is classified as <u>medium risk</u>

6% = assumed investment returns

An individual with an IRR in this range is classified as <u>high risk</u>

2% = assumed inflation

Estimated internal rate of return

Long-term CPI assumed to be 2% per annum, expected investment returns 6% per annum (equity/bond mix)

Comparing Individual and Household IRRs

PENSIONS POLICY INSTITUTE
PPI

- Modelling in the report uses the PPI's individual and dynamic model (based on ELSA data) for those aged 50-SPA in 2011-12:
  - **Individual IRRs** – *illustrative* individuals automatically enrolled in 2012 with phased contributions, retiring at SPA. IRR calculated based only on their *individual circumstances* (age, earnings, state pension and private pension income and assumptions on whether rents or not in retirement).
  - **Household IRRs** – uses *ELSA data* to identify individuals eligible to be automatically enrolled in 2012 (based on age, existing pension provision, employment and earnings). IRR calculated for each individual but is based on *household circumstances* (state and private pension incomes, observed housing tenure, and household eligibility for means-tested benefits).

The benefits of automatic enrolment and workplace pensions for older workers

PENSIONS POLICY INSTITUTE PPI

- Older workers and automatic enrolment
- Calculating the return from saving
- Policy developments that affect rates of return for older workers
- What rates of return might older workers have?
- How might new flexibilities affect retirement choices and rates of return?

The staging and phasing of automatic enrolment is important

PENSIONS POLICY INSTITUTE
PPI

- Staging is not explictly modelled here as we do not have information on employer size. In practice, some older workers will be automatically enrolled after 2012 and so will build up smaller pots.
- Phasing is modelled here and will affect the level of contributions (and size of pot) but also the employer match.

	Employer Minimum Contribution	Total Minimum Contribution	Employer's contribution as % of total contribution
Until October 2017	1%	2%	50%
October 2017-October 2018	2%	5%	40%
From October 2018	3%	8%	37.5%

Note: Minimum Contributions relate to band earnings of £5,772-£41,865 in 2014-15

Single-tier reforms should reduce reliance on means-tested benefits

PENSIONS POLICY INSTITUTE
PPI

- Timings mean that this will interact with the implementation of automatic enrolment to affect different groups in different ways.

Date of automatic enrolment	Date reach SPA	Current or single-tier pension	Automatically enrolled (if eligible)?	Age range in April 2014
Group 1 After April 2016	Before April 2016	Current	No	Men 63-65 Women 61-63
Group 2 Before April 2016	Before April 2016	Current	Yes	Men 63-65 Women 61-63
Group 3 **Before April 2016**	**After April 2016**	**Single-tier**	**Yes**	**Men up to 63** **Women up to 61**
Group 4 After April 2016 and after their SPA	After April 2016	Single-tier	No	Men up to 63 Women up to 61
Group 5 **After April 2016 and before their SPA**	**After April 2016**	**Single-tier**	**Yes**	**Men up to 63** **Women up to 61**

- Eligibility for Pension Credit expected to fall to 5% by 2060. Eligibility for Housing Benefit and Council Tax Support less so.

Eligibility for means-tested benefits is expected to affect rates of return

PENSIONS POLICY INSTITUTE
PPI

Guarantee Credit

- Safety-net of a minimum level of income. This is **£148.35pw for single people** and **£226.50pw for couples** in 2014-15. Reduces the benefit received by £1 for every £1.

Housing Benefit (for renters) and Council Tax Support

- Income above the Housing Benefit Personal Allowance (HBPA) reduces the benefit received by 65p for each £1 over this. HBPA is £72.40 for people under state pension credit age, £148.35 for people over state pension credit age and under 65, and **£165.15 for people aged 65 and over**.
- But during working life, **50% of pension contributions will be deducted** from the purposes of HB calculations.

Working Tax Credit

- During working life, 100% **of pension contributions will be deducted** for the purposes of calculating tax credits.

Universal Credit

- Fully implemented from 2017-18 and will replace Housing Benefit, tax credits and other working age benefits. **100% of pension contributions will be deducted.**

The benefits of automatic enrolment and workplace pensions for older workers

PENSIONS POLICY INSTITUTE

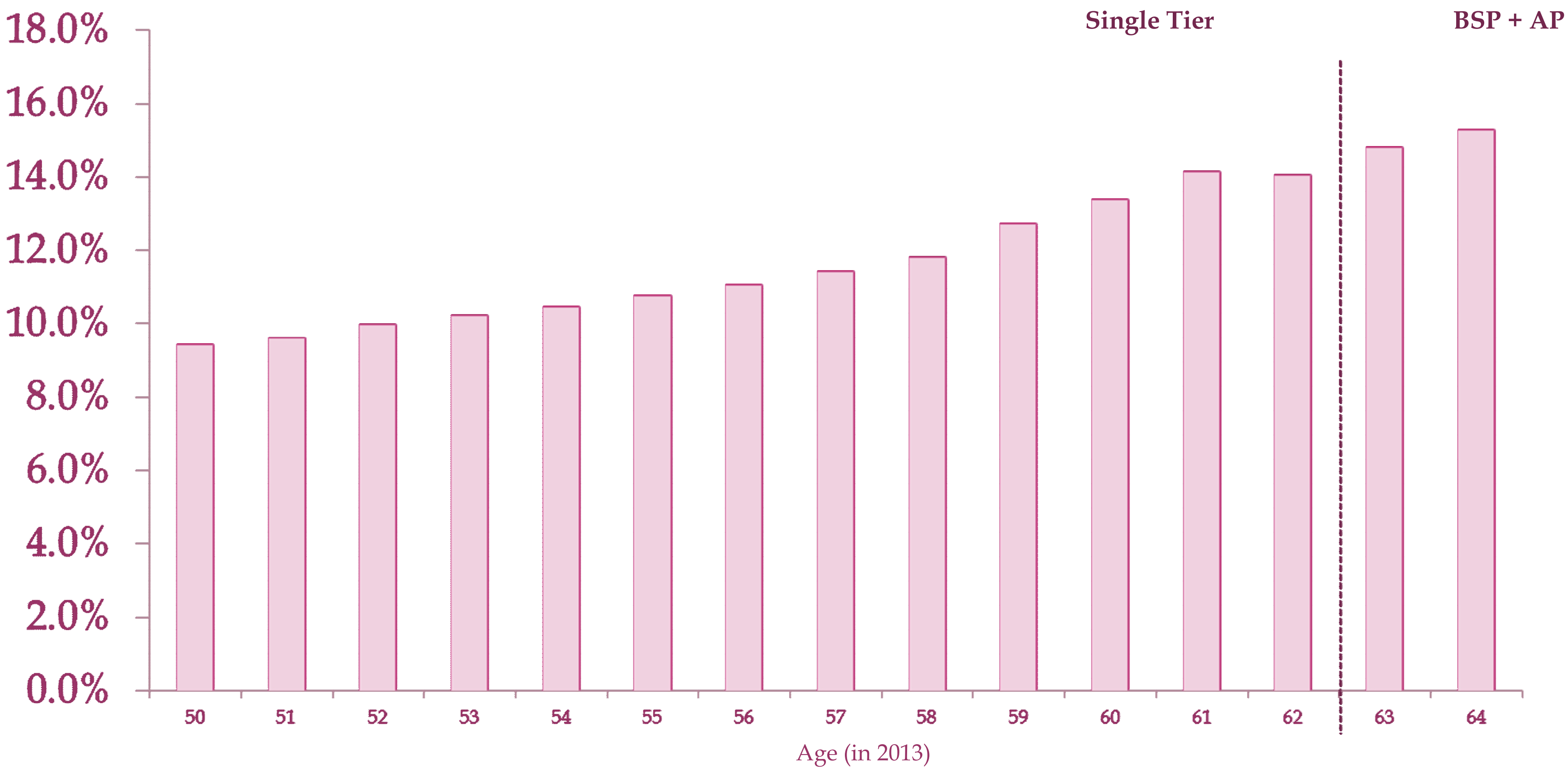
PPI

- Older workers and automatic enrolment
- Calculating the return from saving
- Policy developments that affect rate of return for older workers
- What rates of return might older workers have?
- How might new flexibilities affect retirement choices and rates of return?

Individual IRRs for older men automatically enrolled in 2012 place them at *low risk*

PENSIONS POLICY INSTITUTE
PPI

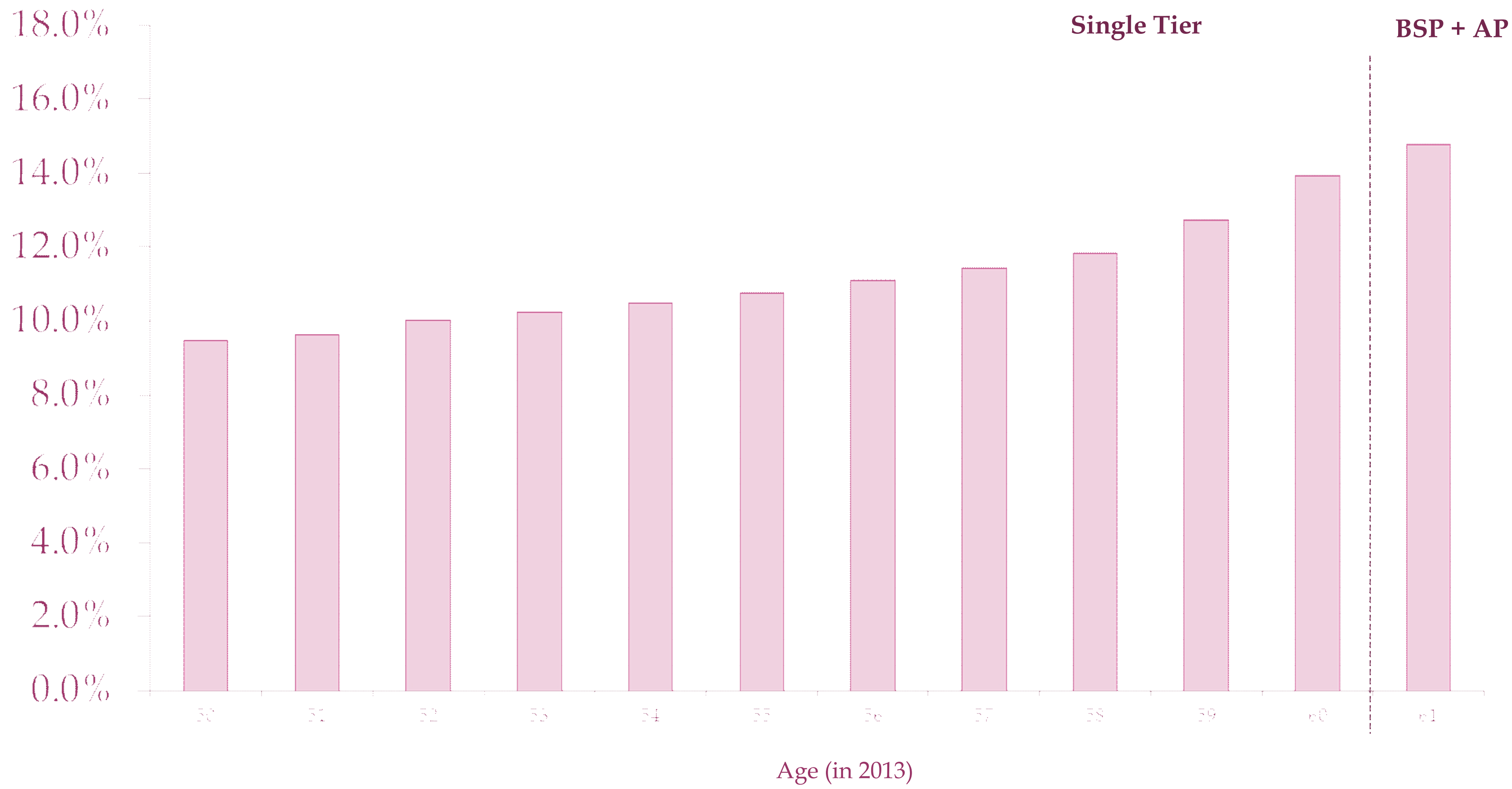
Internal rate of return on pension saving for median earning older men with full work history who are automatically enrolled at phased contribution rates from 2012



Individual IRRs for older women automatically enrolled in 2012 are very similar

PENSIONS POLICY INSTITUTE
PPI

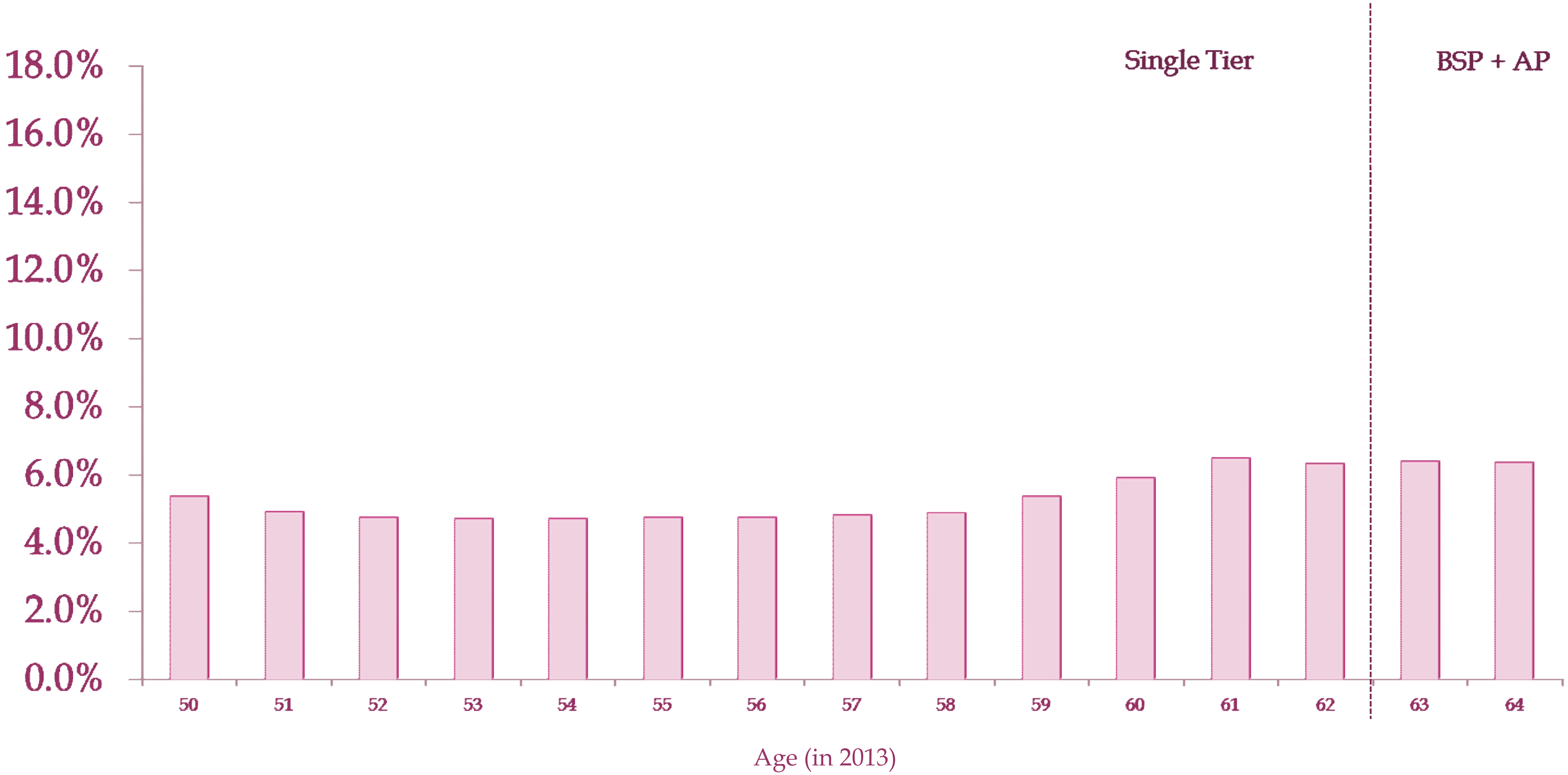
Internal rate of return on pension saving for median earning older women with full work history who are automatically enrolled at phased contribution rates from 2012



Individual IRRs for older men in receipt of Housing Benefit in retirement could place them at *medium risk*

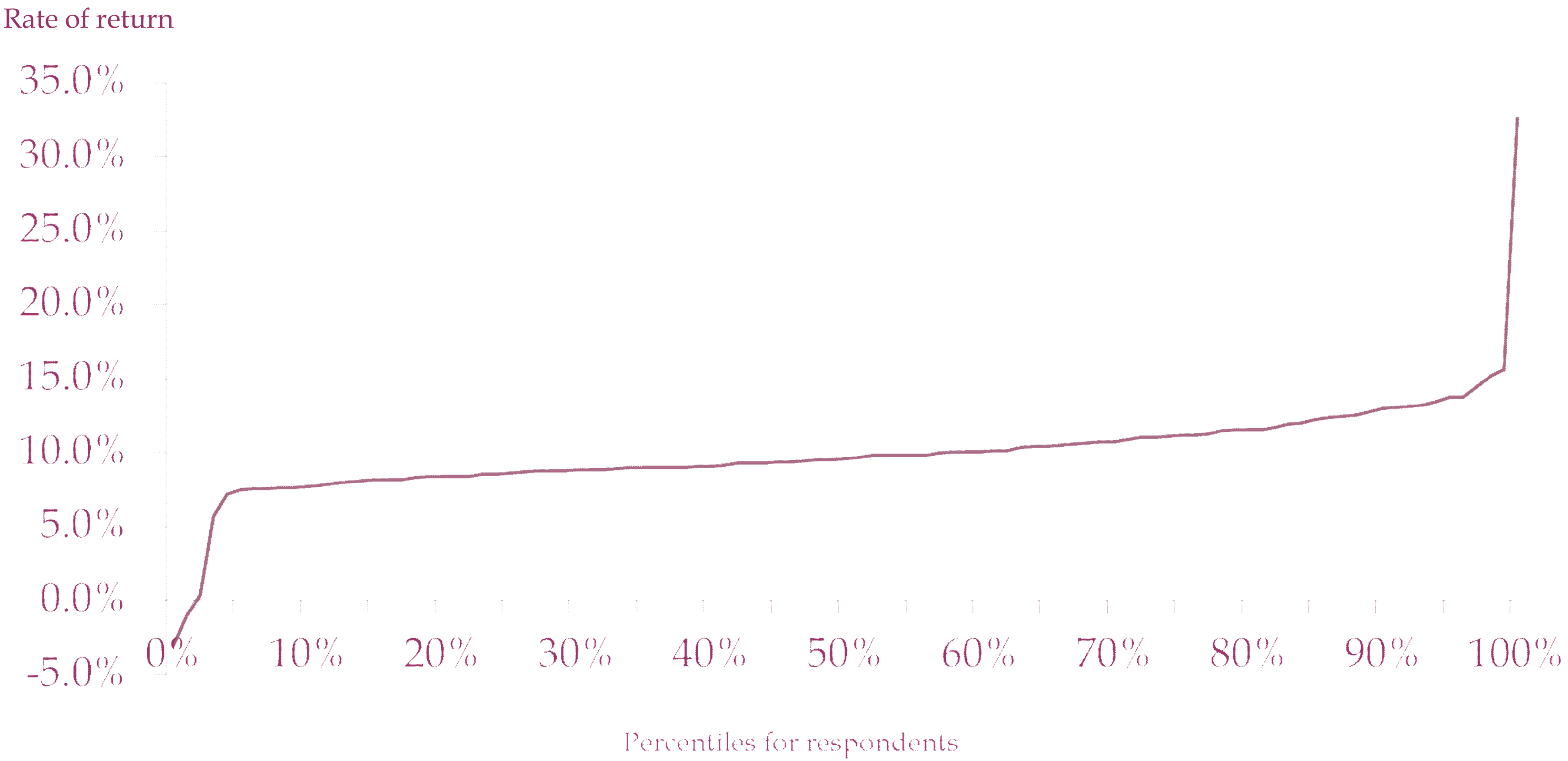
PENSIONS POLICY INSTITUTE
PPI

Internal rate of return on pension saving for older men with full work histories who are automatically enrolled at phased contribution rates from 2012 and who are eligible for Housing Benefit in retirement



The median IRR when calculated at a household level is over 9%

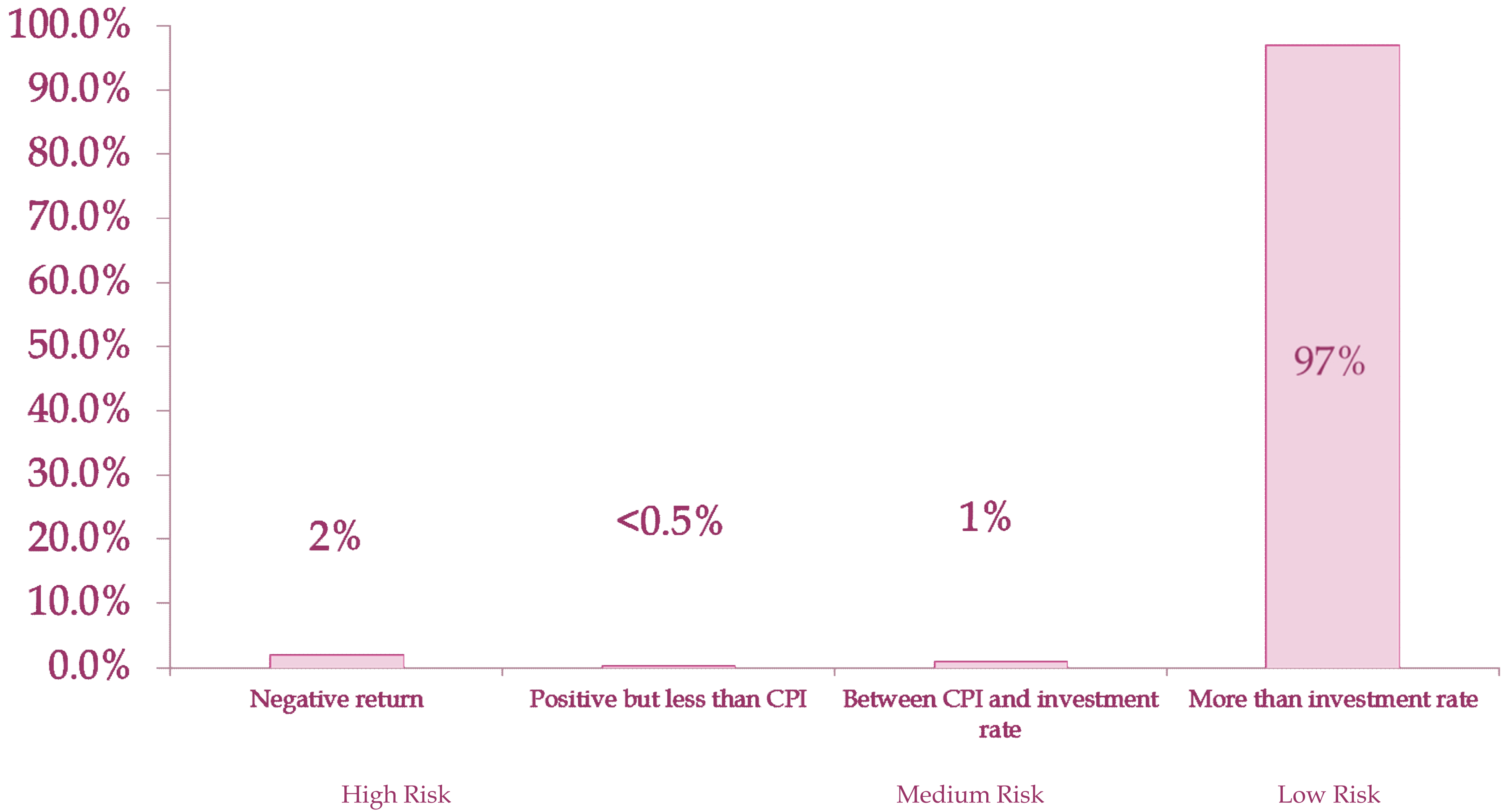
Distribution of the internal rate of return on pension saving for benefit units in the ELSA dataset where at least one person would be eligible to be automatically enrolled in 2012



The vast majority of those automatically enrolled are expected to achieve an IRR of more than 2%

PENSIONS POLICY INSTITUTE
PPI

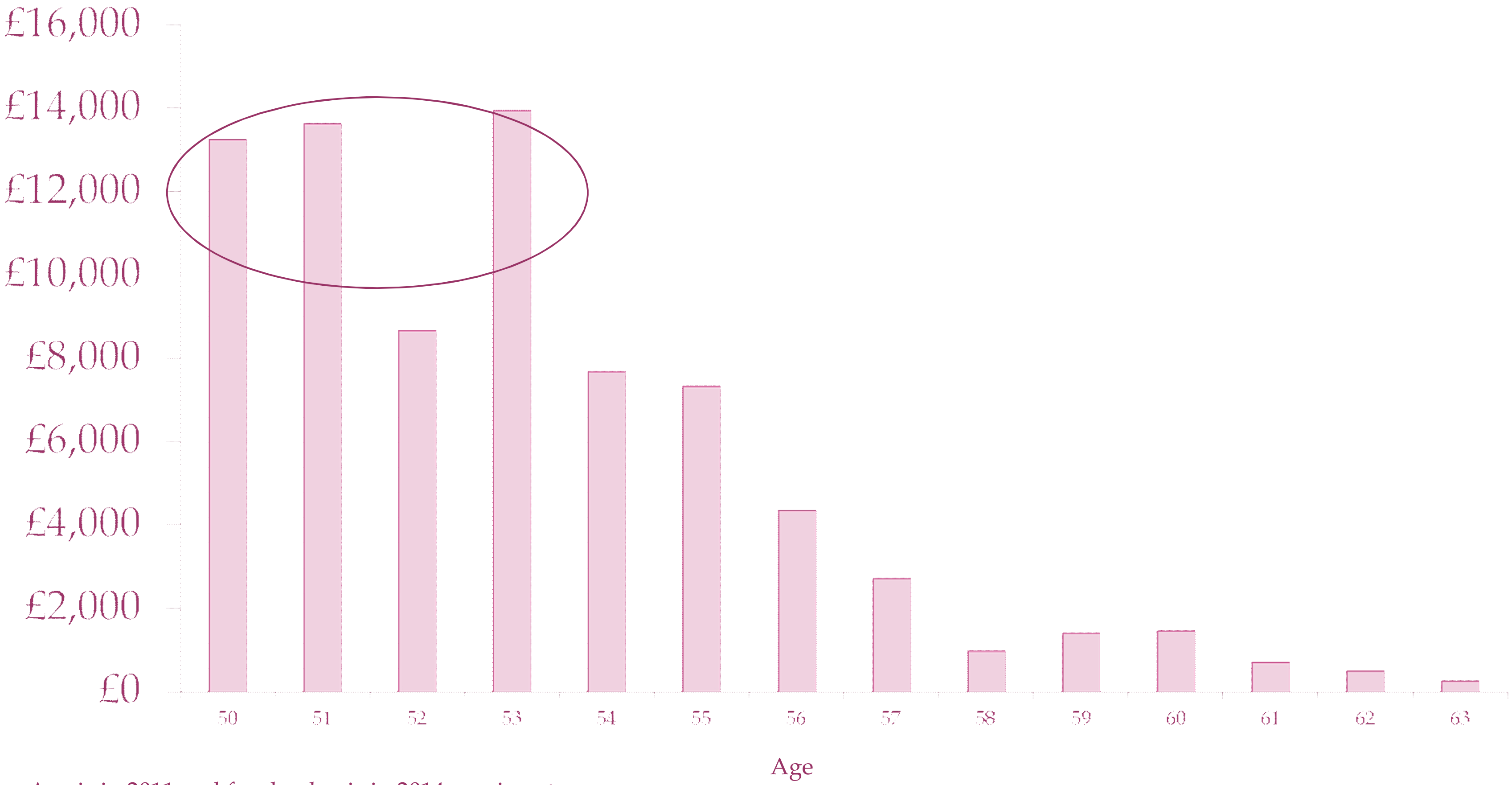
Proportion of benefit units where at least one individual would be eligible to be automatically enrolled falling in each risk group



Median pension pots are around £13,000 for those automatically enrolled in their early 50s reaching SPA

PENSIONS POLICY INSTITUTE
PPI

Median pension pots from automatic enrolment for older people with full work history who are automatically enrolled at phased contribution rates from 2012

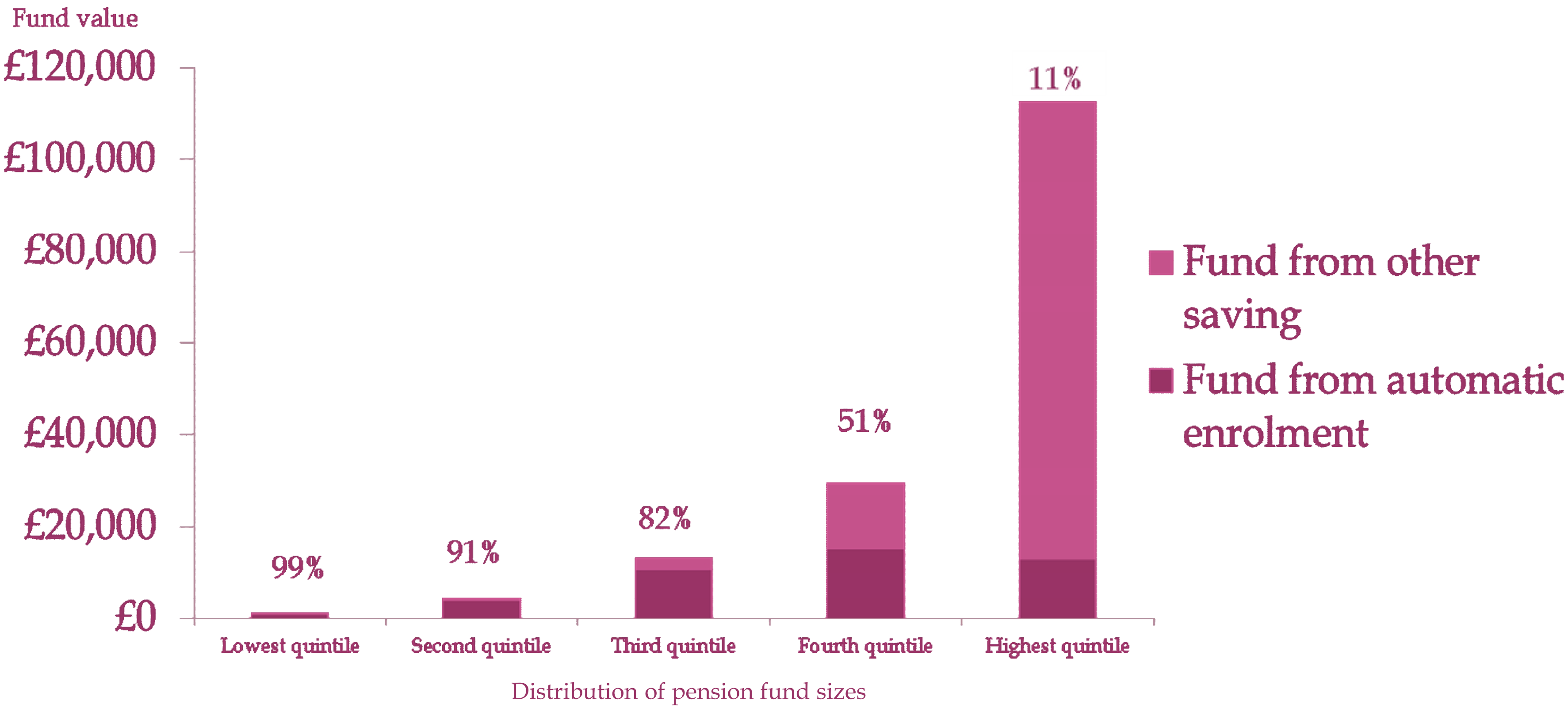


Age is in 2011 and fund value is in 2014 earnings terms

Automatic enrolment makes a significant contribution to total pension fund sizes

PENSIONS POLICY INSTITUTE

Average pension funds due to automatic enrolment as a percentage of average total pension funds for older workers who have automatically enrolled



Many older workers will have pension funds at State Pension Age below the current trivial commutation limits

PENSIONS POLICY INSTITUTE
PPI

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

	Individuals with a DC pot from automatic enrolment only	Individuals with a DC pot from automatic enrolment and/or existing DC and/or existing DB pots
% under £18,000	91%	44%
% under £30,000	99%	56%

- Over 90% of older workers saving in a pension for the first time under automatic enrolment would have been able to take their pension fund as a lump sum at SPA, even before the Budget 2014 changes.

The benefits of automatic enrolment and workplace pensions for older workers

PENSIONS POLICY INSTITUTE PPI

- Older workers and automatic enrolment
- Calculating the return from saving
- Policy developments that affect rate of return for older workers
- What rates of return might older workers have?
- How might new flexibilities affect retirement choices and rates of return?

How might new flexibilities affect retirement choices and rates of return?

PENSIONS POLICY INSTITUTE

- **From April 2015, individuals will be able to access their pension in a lump sum, by using income drawdown, by purchasing an annuity, or some combination of the three.**
- Other proposals: ability to invest up to £15,000 per year in an ISA (July 2014) and introduction of new pensioner bonds (January 2015) paying up to 4% interest per year.
- Wide range of choices about how and when DC pension saving is accessed and potentially reinvested in future.
- Interactions with means-tested benefits, tax allowances and rates will influence individuals' rates of return from their pension contributions – risk of paying higher marginal rates of tax biggest risk of consumer detriment?

Guidance will need to help savers maximise income and meet spending needs across retirement

PENSIONS POLICY INSTITUTE
PPI

- **If individuals do not purchase an annuity they will need to take into account factors that may be difficult to judge**, e.g. life expectancy and likely income requirements at different stages of retirement.
- **Employers may be well-placed to use the new flexibilities to reward/retain/retire older employees** and to encourage them to save more into a pension, e.g. employers could make larger payments into a workers pension as they approach retirement (tax-advantaged and can be accessed from age 55), or could encourage part-time working and partial drawdown.
- **If older workers fully understood the returns from saving into a pension and the flexibilities to access that pension would more be saving / saving more?**

Issues for discussion

PENSIONS POLICY INSTITUTE

PPI

- Should older workers be encouraged not to opt out?
- Will the Budget flexibilities make saving into a pension look more attractive for older workers?
- What could/should the Government, employers, pension providers and advice agencies be doing to encourage older workers to stay automatically enrolled?