The Financial Returns to Retirement Saving

Robert Laslett, Chief Economist

20th February 2007

Department for Work and Pensions

Outline

- Pension Credit entitlement estimates
- Financial Incentives to Save
- Conclusion

Context

“The Government has a responsibility, in introducing automatic enrolment, to be confident that savings in a pension can be expected to benefit a large majority of those eligible for automatic enrolment, and that there are clear opportunities for those who want to opt out, and we believe those tests are met by this policy.”

(Financial incentives to save for retirement, DWP)

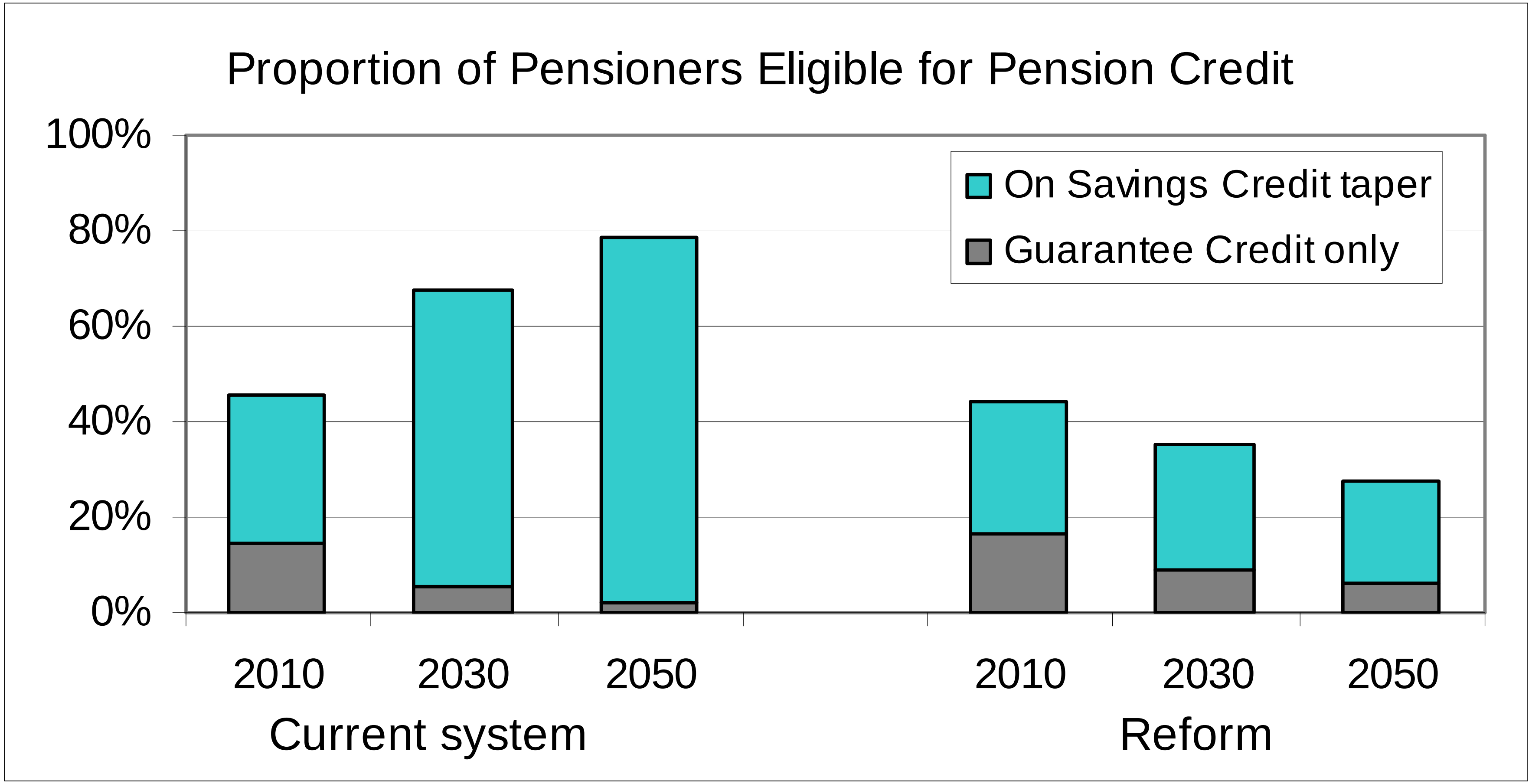
Want to provide simple information, to allow people to make a choice about whether Personal Accounts are suitable for them.

Welcome a discussion on what this information should look like.

DWP Department for Work and Pensions

- Pension Credit entitlement estimates
- Financial Incentives to Save
- Conclusion

Reforms will reduce Pension Credit eligibility



Department for Work and Pensions

Why will Pension Credit eligibility fall?

- Earnings uprating: BSP will maintain its earnings value.
- Flat rating: S2P will be more valuable to low and moderate earners.
- Improved coverage:
  - The % of women retiring with full BSP will rise from 30% without reform to 70% in 2010.
  - The % of people accruing Additional Pension has risen from 55% under SERPs to 70% under S2P. Reform will increase it further.
- Savings Credit reform: means Pension Credit does not go as far up the income distribution.

DWP estimation approach

- Dynamic microsimulation:
  - Project social, demographic and labour market outcomes for individuals, based on trends.
  - Model how they build up state and private pension rights over their lifetimes, including the wider coverage of BSP/S2P over time.
  - Use this to build up the future income distribution for pensioners.
- Institute of Fiscal Studies has audited the underlying methodology of the model, and it was used by the Pensions Commission.

Uncertainty in the results

- Plausible changes in assumptions raise or lower PC entitlement estimates by only a few percentage points.
- Need to reduce private pension and S2P income by 30% each for around 40% of pensioners to be eligible for PC, and 10% to be on GC only.
  - Even reducing private pension income by 50% increases eligibility by only around 10 percentage points.
  - If S2P outcomes were 20% lower, PC eligibility would only increase by 2-3 percentage points.
- **Plausible range of uncertainty around projections unlikely to be more than +/- 5 percentage points.**

On Guarantee Credit only by 2050?

- A single person needs to be earning or be caring for less than half their adult life to be above GC on retirement.
- Easier for couples to be above GC on retirement – e.g. 20 years work by one partner and 12 years caring by the other.

- The majority of the small group on GC only will have been outside scope of auto-enrolment for most of their working life:
  - Self-employed;
  - Inactive (not working or caring); or
  - Working part-time on earnings below the LEL.

- Overall only one in 50 would retire on GC only – and many of those could take a lump sum.

Pension Credit as an Insurance for Life Events

Many of the reasons people have low incomes in retirement are difficult to predict in advance:

- Illness or disability making it difficult to work;
- Low profits for self-employed meaning they're unable to save privately; and
- Living to a very old age.

Guarantee Credit ensures a minimum income if everything else goes wrong. A safety net for the poorest should not stop people saving.

- Pension Credit entitlement estimates
- Financial Incentives to Save
- Conclusion

What is the payback on saving?

Start with £1 the employee contributes

Add

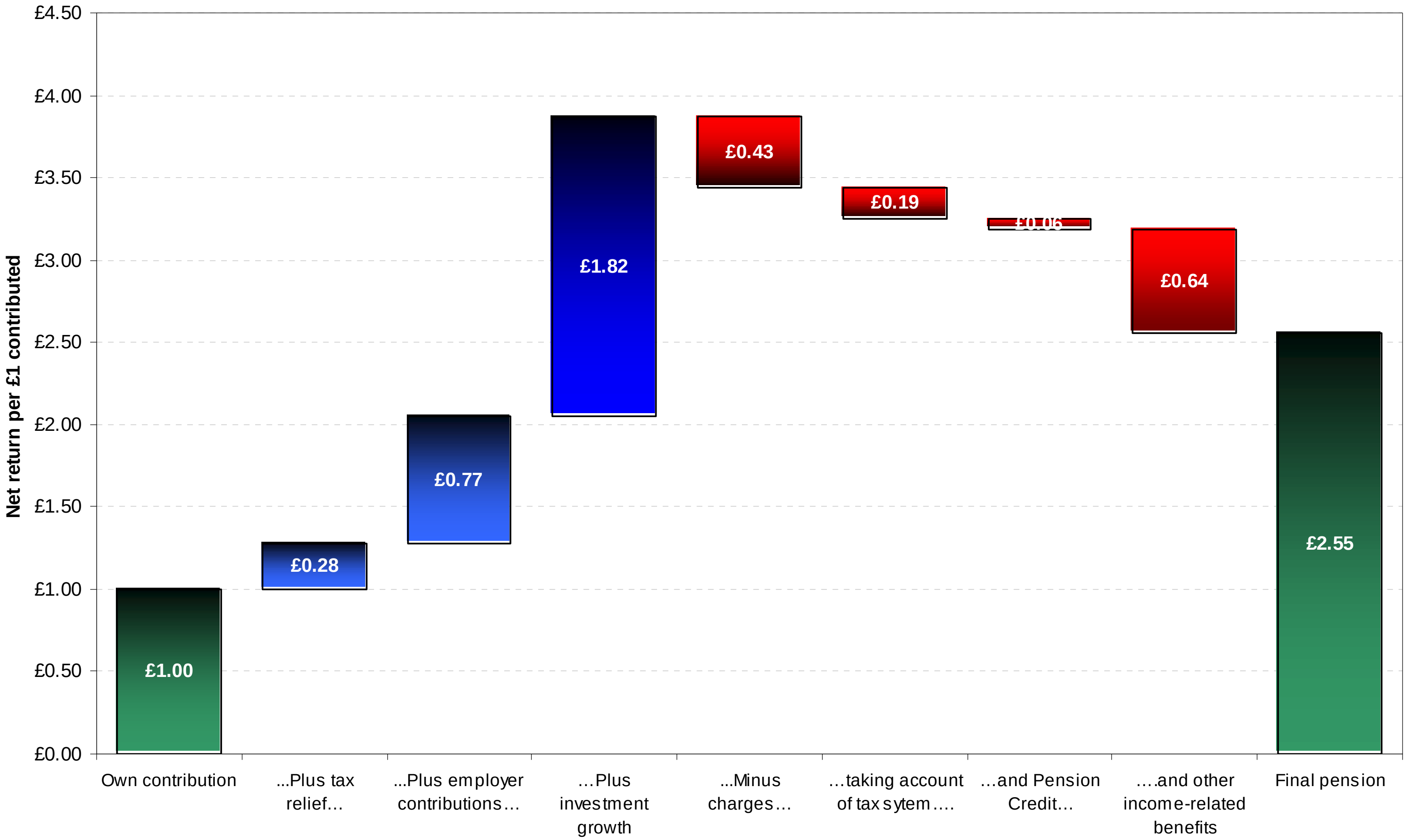
- tax relief
- employer's contribution
- investment growth (assumed 3.5% real)

Deduct

- fund charges (0.5%)
- tax on retirement income
- benefit offsets in retirement

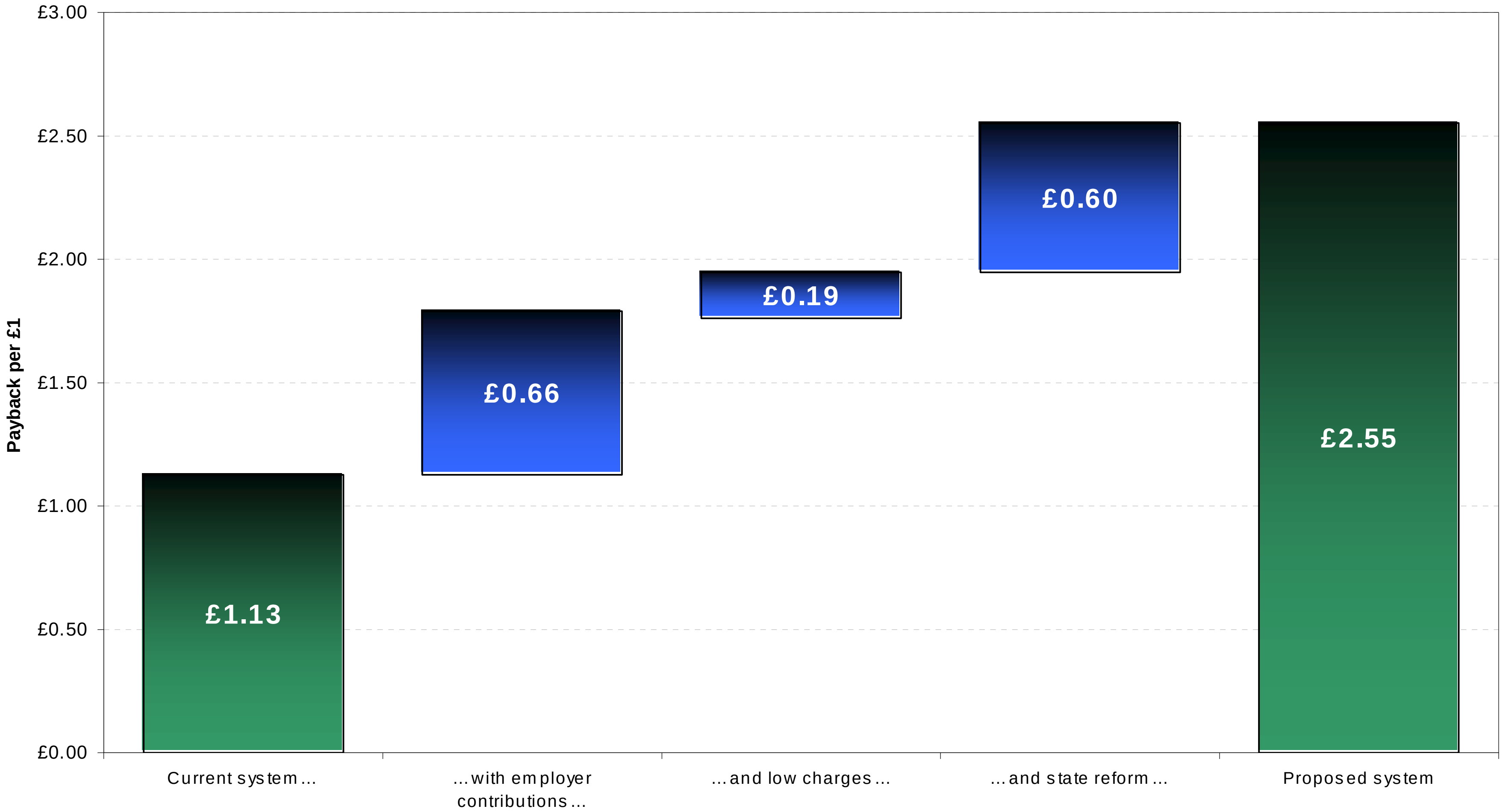
The payback is the resulting amount they receive in pension income in the course of an average retirement. (After inflation.)

The payback for a median earner



DWP Department for Work and Pensions

How pension reform raises the payback



How does the payback on retirement saving compare with alternative investments?

- No other investment is likely to attract an employer match.
- Other investments will also have impacts on benefits.
- The payback from an ISA for the 25 year old median earner is £1.56, after state reform, compared to £2.55 in a personal account.
- Paying off debt could give higher short-term returns…
- …but have to consider the whole lifetime of the investment.

Would a higher State Pension help?

A higher state pension would improve payback for some, but would be very expensive. However, it does not eliminate income related benefits:

- Some people on Pension Credit get extra amounts, eg people with severe disabilities can get extra £46.75.
- Increasing basic State Pension to Guarantee Credit level cuts numbers entitled to income related benefits by about a quarter.
- Even doubling basic State Pension leaves a quarter of those currently entitled to income related benefits still entitled.

Is there a feasible alternative policy?

- Lower Guarantee Credit? Would expose more pensioners to poverty.
- Less Savings Credit? Would expose more low income pensioners to high withdrawal rates.
- More Savings Credit? Potentially effective, but against the aim of a clearer savings environment.
- No auto-enrolment? Continued high levels of undersaving.

- Pension Credit entitlement estimates
- Financial Incentives to Save
- Conclusion

Reasons for saving:
Financial incentives and income smoothing

- Saving for retirement usually produces good returns – much more than £1 out for £1 in – adjusted for inflation.
- But it <u>can</u> make sense to save even if it you just get back the £ you put in.
- This is because it prevents the fall in consumption that would otherwise occur at retirement.

“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.” (Are Personal Accounts Suitable for All, PPI)

DWP Department for Work and Pensions

It is reasonable to auto-enrol most people

- The system will be simple and cheap to administer.
- Most people will get good returns:
  - People who will probably end up on the Savings Credit taper will still get a good return.
  - People who may fall onto Guarantee Credit very late in life – they will have already had a good return from saving.
- Returns for some people will be harder to predict:
  - People who might fall onto Guarantee Credit unexpectedly – it is a vital insurance for them.
  - People on multiple benefit tapers – mainly depends on housing tenure.

Conclusion

- Most people need private saving to achieve the living standards they want in retirement.
- Personal Accounts offer a better return on saving, especially for those on low and moderate income, than other products.
- People who receive Savings Credit could still expect a positive return from their savings.
- Difficult to predict in advance exactly who will retire onto the Guarantee Credit.
- Important to provide the right information.

DWP Department for Work and Pensions