Incentives to save in personal accounts

Note of the seminar on Tuesday 20th February 2007, 5-7pm

1. James Purnell, Minister for State for Pension Reform, set out the purpose of the seminar: to discuss whether it pays to save in personal accounts. He gave a brief overview of the Government's analysis of the pension reform package:
   - a lifetime saver could expect £2.50 payback for every £1 they invest in a personal account;
   - the Government expects entitlement to Pension Credit to fall from the levels in 2010; and
   - people entitled to Pension Credit can get good returns from saving – long-term savers on the Savings Credit taper can expect payback of £2 for £1[1].

2. Lord Turner set out questions for the seminar to consider, including: whether reform had improved savings incentives; the effect of different benefit tapers on returns to saving; and what solutions to low returns the government could consider.

3. Robert Laslett presented the DWP's analysis on Pension Credit eligibility and payback from personal accounts[2]. Among the points he made were:
   - Pension Credit does not prevent people getting good returns from saving, those on the Savings Credit element and not on multiple benefits tapers could expect to see a good return.
   - State reforms all tend to reduce the proportion of pensioners on Pension Credit. The reforms mean that working or caring for half a normal working life accrues enough state entitlement to avoid being entitled to Guarantee Credit only. The benefit would be acting as an insurance against unpredictable and severe life events.
   - Pension Credit estimates were generated by Pensim2, an approach that generated an income distribution through modelling the working lives and pension accrual of individuals. Projecting the income distribution forward based on today's working age population was important as the current pensioner income distribution was based on generations where, for example, participation rates for women in the labour market were much lower, and additional state pension accrual was more limited. Reform means the income distribution in the future will look very different.

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[1] The Minister noted that payback will depend on factors such investment returns, and variation from the underlying assumptions will lead to different results. More details of the payback modelling and assumptions can be found in the 'Financial incentives to Save for retirement' publication.

[2] Presentation slides are available on the DWP website at http://www.dwp.gov.uk/pensionsreform/. For a full analysis see *Projections of Pension Credit entitlement,* DWP; *Pensions Bill: Regulatory impact assessment,* DWP, (November 2006) and *Financial incentives to save for retirement,* DWP – all available on the DWP Pensions Reform website.

- The range of uncertainty in the DWP projections was limited. A number of sensitivity tests had been undertaken, which suggested a range of around 5 percentage points either side of the central estimate, even with substantial changes to the assumptions.
- Information and the ability to opt out will be key.

4. Niki Cleal and Chris Curry presented the PPI's analysis.[3] Among the points they made were:
   - People faced a range of different returns from saving, depending on their personal circumstances. The PPI divided these into three groups:
     - low risk, which included people in their twenties in 2012 who worked and contributed to their personal account throughout their lifetime;
     - medium risk, which included:
       - people in their twenties in 2012 with low earnings and broken work histories (not covered by NI credits);
       - older people in their forties and fifties with low earnings and full working histories; and
       - some self-employed people; and
     - high risk groups, including people eligible for Housing Benefit in retirement.
   - The system post-reform delivers better returns than the pre-reform system.
   - 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 implications for what information is needed to help people make informed decisions about whether they should opt-out.
   - A number of other factors, including debt, affordability, and people's preferences to spend today rather than save, affect whether saving is worthwhile.
   - In order to project future eligibility to Pension Credit one has to first project the future growth and the distribution of income for future generations of pensioners from a number of sources (including from the state pensions, private pensions and other earnings and income.) As a result all projections of future Pension Credit eligibility are inherently uncertain and should be presented as a range of possible outcomes. [4]

5. A number of points were made in discussion. **On the level of eligibility for means-tested benefits** the following points were made:
   - Some people felt that the pension system would have too high a level of means-testing in 2050 if 30% of pensioners were entitled to Pension Credit.

[3] Again slides on the DWP website. For a full analysis see *Are Personal Accounts suitable for all?* PPI, (November 2006) *www.pensionspolicyinstitute.org.uk*
[4] For a description of the PPI's Pension Credit projections see *Incentives to save and means-tested benefits,* PPI, (February 2007)

- Others thought that the proportion eligible for Pension Credit was not central to whether reform would work. The point was made that it was reasonable that people in highest need got more support in retirement.
- Several people thought that the number of people facing multiple benefit tapers in retirement, especially the Housing Benefit taper, was a more central issue than numbers entitled to Pension Credit.
- There was a concern that the target group for personal accounts might be more likely than the rest of population to be eligible for means-tested benefits in retirement, and that further work should focus on the proportion of this group eligible for means-tested benefits.
- There was a desire to understand how likely people were to end up on multiple benefit tapers, and the sort of life histories that led to these circumstances.
- Several people emphasised that policy would have to deal with the uncertainty of how the future may turn out, they emphasised that the benefit system was not immutable, so there maybe some scope for dealing with problems depending on how the system evolved.

6. On **the level of payback from personal accounts**, the following points were made:
   - For personal accounts to be a success a number of people felt that - for the large majority of people - saving into a personal account should clearly be beneficial. Some people cited a return of £2 for £1 as a desirable message, if we could say it was true for most people.
   - It was noted that the default contributions which attracted an employer match may have a better return than additional contributions.
   - There was interest in how many people were likely to fall into PPI's low, medium and high risk groups, and how likely they were to be auto-enrolled for substantial periods of their working life.
   - Pension Credit might reduce returns from saving so that some people would not see the full benefit of their tax relief at the margin. This may make personal accounts, and other pension saving, less attractive because it is less flexible than non-pension saving.
   - Outcomes will vary with life circumstances, and will be determined by the benefit system at the point of exit.

7. The way the majority of people actually made decisions to save was raised, given the limited knowledge of the pensions system many people have. One simple message was that if you wanted more than £114 a week (the level of the standard minimum guarantee) you would need to save for retirement.

8. Several people raised **possible ways of addressing** the fact that some people may see lower returns:
   - The possibility of not auto-enrolling high risk groups was raised, although it would not always be possible to predict who would not benefit from personal accounts saving.
   - A higher basic state pension would reduce the level of means-testing; although this could be costly. A large increase in the basic state

pension would reduce the numbers of people on means-tested benefits below the levels suggested by the current reform proposals. However, in either scenario this could still leave significant numbers on means-tested benefits due to extra amounts for those with disabilities and housing costs.
- Increases in the trivial commutation limit, and potentially the Pension Credit capital disregard.
- Good generic advice to enable people to decide whether personal accounts were suitable for them.
- The scheme would not be compulsory: people would have the opportunity to opt-out

9. Lord Turner summed up the discussion, setting out the areas he thought were important – although he acknowledged there was not total agreement on all of these. He said that:
   - Reforms will improve incentives to save for the large majority of people.
   - Personal accounts will provide a better return than other forms of long term financial saving[5].
   - For the most part Government should not be worried about people with 40% withdrawal rates as they will generally see good returns.
   - People with higher withdrawal rates may see lower payback from saving. Two main groups were identified:
     - Those on the Guarantee Credit only, although many who ended up in this situation would not be auto-enrolled for substantial periods of their life, and being on Guarantee Credit only could not easily be predicted in advance; and
     - Those on multiple tapers, including the Housing Benefit taper. Lord Turner suggested that more work needed to be done to explore who these people were and what sort of working life they had experienced.

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[5] For some people an ISA may be more attractive given its flexibility, but would not provide a long term pension income.