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The benefits of automatic enrolment and workplace pensions for older workers

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The benefits of automatic enrolment and workplace pensions for older workers

Executive Summary

Under automatic enrolment, employers are required to enrol their employees into a qualifying pension scheme. A key feature of the reforms is harnessing the effects of inertia, by making saving into a workplace pension scheme the default for those eligible individuals with earnings above the automatic enrolment threshold of £10,000 per annum (in 2014-15).

Individuals have the opportunity to opt out of saving into a pension scheme, but must do so within the first month of being automatically enrolled if they are to receive back the pension contributions they have made. Research carried out by the Department for Work and Pensions (DWP) found that opt out rates for larger company employees aged 50 and over were between 25% and 50% higher than those of other age groups. A typical example is an employer where the opt out rate was 8% for employees under 30, 9% for 30-49 year olds and 15% for those aged 50 and over.[1] The main reasons cited by older workers for choosing to opt out were that they had made other provision for their retirement, that they believed they had insufficient time to build up pension savings, and that they perceived the contribution rates as being too low.

This report analyses how suitable automatic enrolment is for older workers, based on ensuring that individuals who stay automatically enrolled in a Defined Contribution (DC) pension scheme (i.e. who do not opt out) do not lose out as a result of their saving. This compares the difference between the amount saved into a workplace pension and the likely amount eventually received as additional pension income in retirement. It uses the internal rate of return (IRR) to calculate the returns from savings, expressing these as an annual interest rate and calculating the rate of interest per year that an individual might receive on his or her pension contributions. It aims for there to be at least a minimum return on saving. For the purposes of identifying individuals who might be at high risk of automatic enrolment not being suitable for them, we assume a rate of return is required at least in line with inflation, such that they at least receive back the inflation protected value of their own contributions. We do not look into other factors that might otherwise make it unattractive to save into a workplace pension, for example having unaffordable debt.

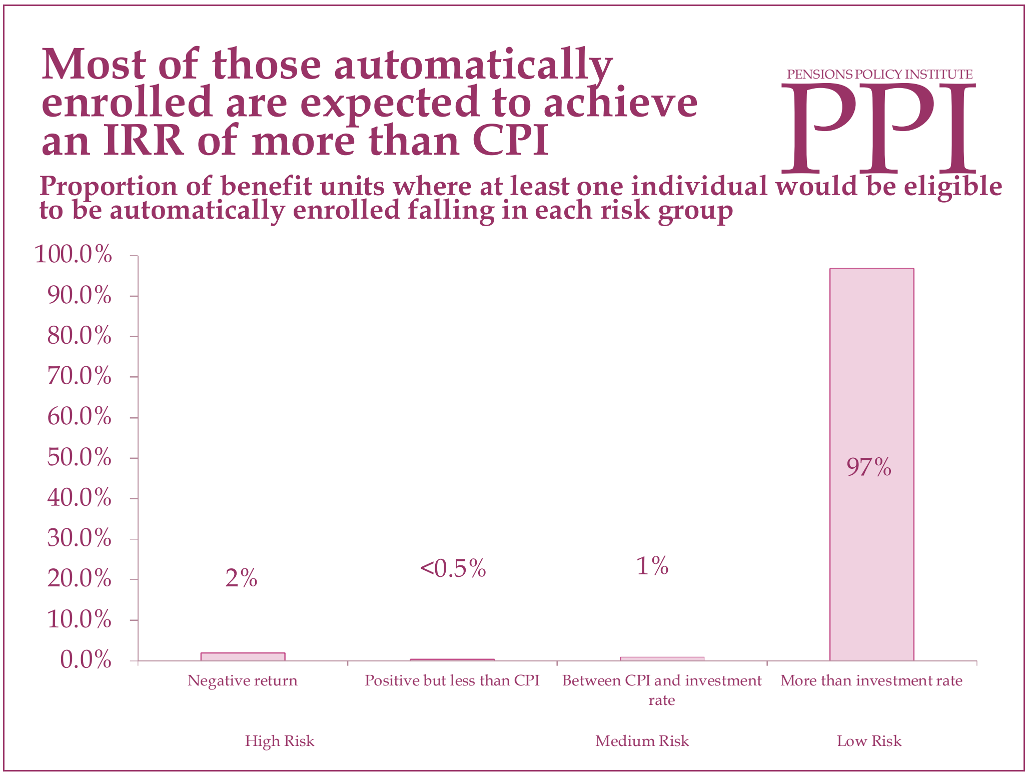
In addition to illustrating examples of the types of individual older workers who might be at high risk of automatic enrolment being unsuitable for them, this report uses dynamic modelling based on data collected in the English Longitudinal Study of Ageing (ELSA) to explore rate of return at a household level. So, for example, where one or more individuals in an older worker household are expected to be automatically enrolled, the dynamic model would consider the circumstances of the household (rather than just the individual) to calculate a rate of return. This is important as entitlement to means-tested benefits in retirement is a key driver of low rates of return and

[1] These figures should be treated as indicative as they are based on a small number of employers who were able to provide detailed age breakdowns to DWP

entitlement is calculated at a household level based on combined income and assets.

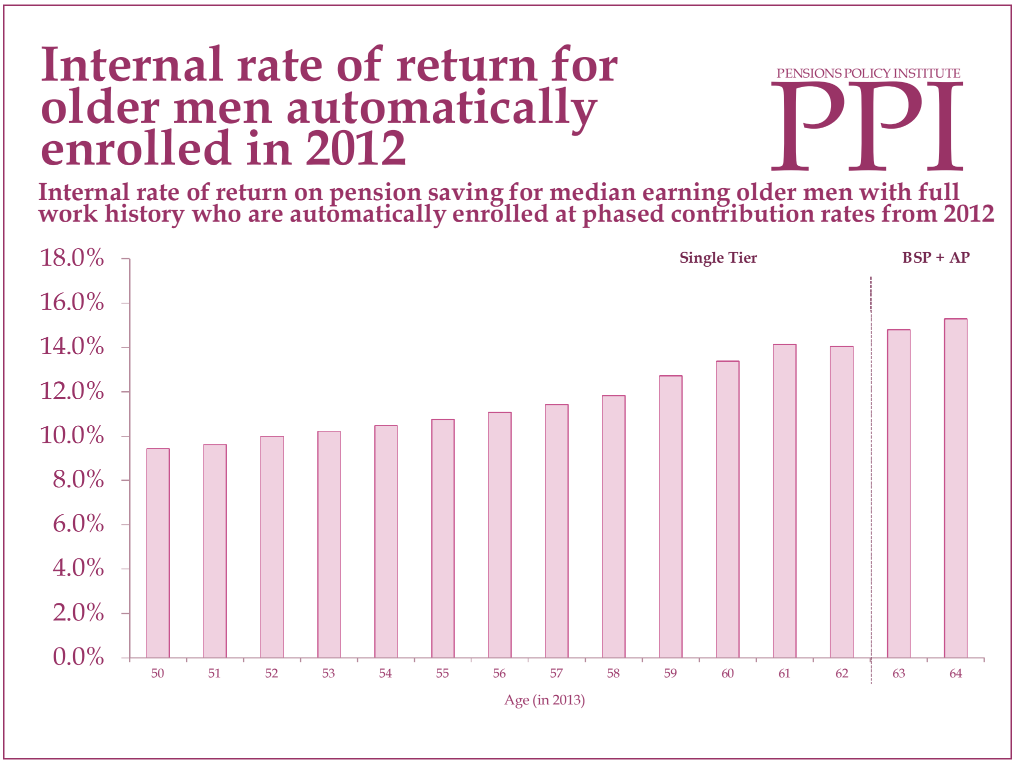
Despite the higher opt out rates seen so far amongst older workers, the vast majority (over 95%) of this group are likely to receive good value on their pension contributions from staying automatically enrolled. Many individuals are expected to see rates of return on their contributions well above the thresholds for them to be at low risk of it not being good value to stay automatically enrolled. The household analysis finds that over 95% of the individuals identified as eligible for automatic enrolment are expected to see a rate of return on their pension contributions above the benchmark investment return of 6%, even after the effect of means-tested benefits and taxation has been taken into account.

Chart A



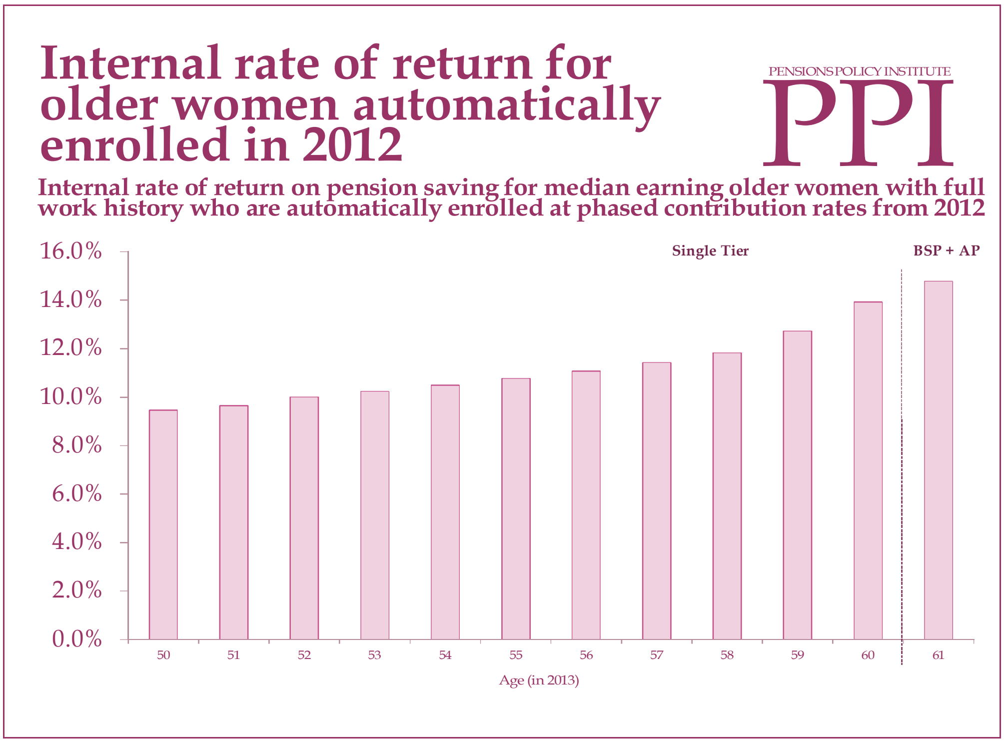
Recent changes in the pensions landscape, including the phased introduction of minimum contributions for automatic enrolment, and the introduction of the single-tier state pension in April 2016, are expected to improve rates of return for older workers. For example, the employer paying a higher share of contributions in the early years of phasing will boost the return an individual sees on their own pension contributions. The oldest men in this group, who see a higher proportion of their total pension contributions made while the phasing of contributions is taking place, see the greatest benefit to their rate of return.

Chart B



A similar pattern can be observed for older women, with those who see a higher proportion of their total pension contributions made while the phasing of contributions is still taking place receiving the highest rates of return.

Chart C



The introduction of the single-tier state pension is also expected to lift many of those who would have otherwise been eligible for the Guarantee Credit above the threshold. Assuming the single-tier pension remains uprated by the triple-lock[2] in future years, this will ensure those individuals' incomes stay above the Guarantee Credit throughout their retirement and so any increase in their private pension income from staying automatically enrolled will not be offset by reductions in means-tested benefits.

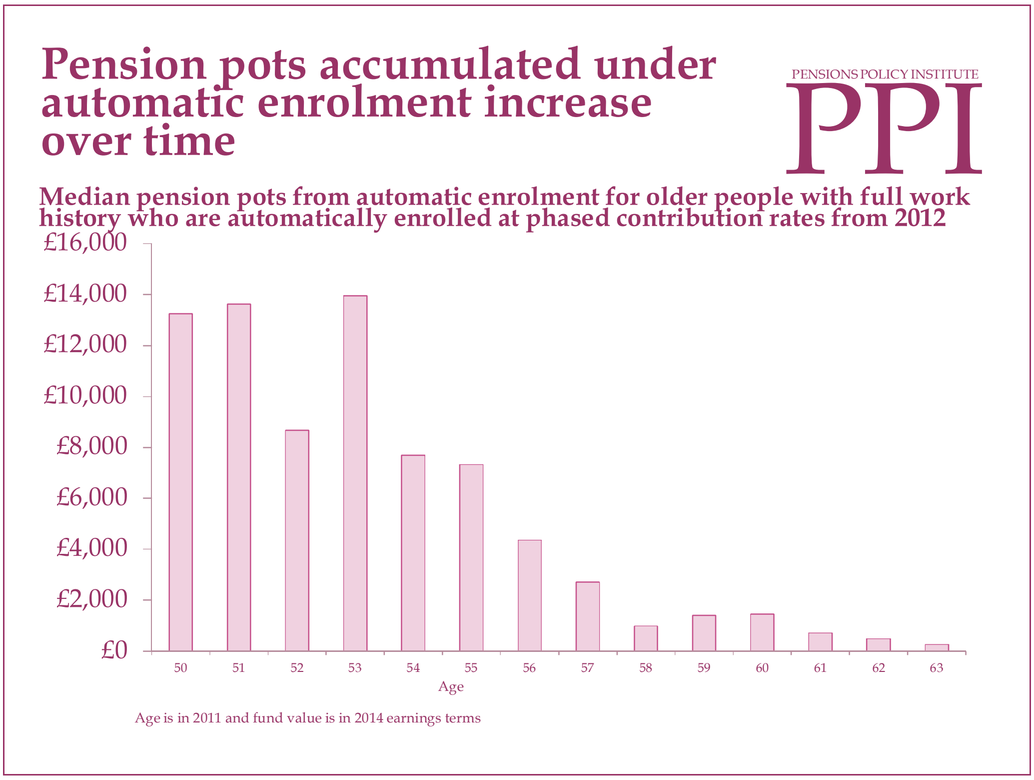
While the rates of return for older workers are generally very positive, it is important to bear in mind that the pension pots being built up by older workers, particularly those on low earnings, are still likely to be relatively small. Our analysis of the ELSA data suggests that the median 50 year old in 2011, automatically enrolled in 2012 and making the minimum level of contribution, builds up a DC pot of £13,250 by State Pension Age (SPA). However, an individual aged 50 in 2011, also enrolled in 2012, and at the 10th percentile of earnings, only builds up a DC pot of £2,870. An individual of the same age at the 90th percentile of earnings builds up a much larger DC pot of £32,880.

This analysis assumes that individuals and their employers contribute at the minimum level. It also assumes that individuals currently in work are able to continue working and saving until their SPA, and they do not access their private pension saving until SPA. On retirement individuals are assumed to purchase a single life, level annuity after taking their 25% tax-free lump sum.

For the median earning 59 year old in 2011 automatically enrolled in 2012 this is lower, at £1,410. So whilst the rates of return may be very positive the actual pension pots built up under automatic enrolment are still relatively small. However, an individual aged 59 in 2011, also enrolled in 2012 but earning at the 10th percentile (and in this case a women very close to SPA), would only build up a DC pension pot of £80 while an individual at the 90th percentile builds up a pot of £3,170.

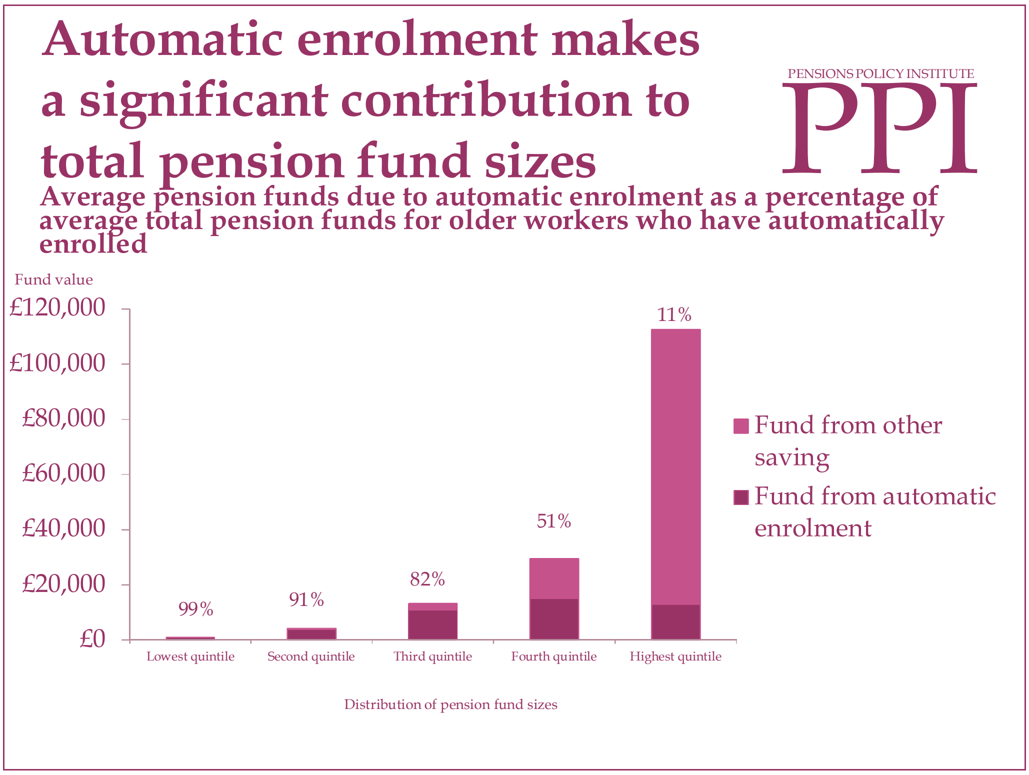
[2] Under the triple-lock the state pension is uprated by the higher of earnings inflation, the Consumer Price Index (CPI) and 2.5%.

Chart D



Household data also shows that around 60% of individuals eligible for automatic enrolment will already have some other forms of private pension saving, either in a DB pension, a DC pension, or both. Just over half of this group have some other form of DC private pension saving only. However, automatic enrolment will play an important role in boosting the pension pots of older workers. Chart E considers the distribution of pension funds by quintile. In the lower quintiles, funds due to automatic enrolment make up the majority of pension funds. However, the proportion of total pension funds that is due automatic enrolment is lower for the higher quintiles.

Chart E



The analysis of household data shows that the factors driving lower or negative rates of return at a household level are possible to identify but complex to predict with any great certainty in advance. Less than 3% of households are expected to be at risk of having low or negative rates of return from staying automatically enrolled. For example, for those households where one or more individuals have little or no state pension entitlement, and little or no private pension savings, there is a likelihood that they may still be reliant on Guarantee Credit during their retirement. And for those who are living in rented accommodation during retirement, they may also be reliant on Housing Benefit. Interactions with Council Tax Reduction and increasing retirement income above the thresholds for higher rates of personal income tax also play a role in reducing rates of return.

Even for these individuals, rates of return may be underestimated by our analysis. For example, the changes recently announced by the Chancellor in Budget 2014 provide much greater flexibility about how individuals use their DC pension pots in retirement, which may make it less likely that pension income interacts with means-tested benefits. For those saving under automatic enrolment for the first time, the majority (over 90%) would have already had access to these flexibilities via the existing trivial commutation rules, and by the increases to the trivial commutation limits from April 2014. The high profile of the Budget 2014 announcements may however make it more likely that more individuals take the route of a lump sum withdrawal rather than buying an annuity and receive guidance that encourages them to do so.

Table A: 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 due to automatic enrolment only	Individuals with a DC pot from automatic enrolment and/or existing DC and/or DB pots
% under £18k	91%	44%
% under £30k	99%	56%

The introduction of Universal Credit is also expected to see those making pension contributions during working age with low incomes receive an additional boost to their rate of return, as their Universal Credit entitlement will be based on their income after they have made pension contributions. This advantage exists now through the rules around Working Tax Credit and Housing Benefit but the treatment of pension contributions will become more explicit once Universal Credit is introduced and the incentive will be strengthened with a 100% offset of pension contributions (currently 100% for Working Tax Credit but only 50% for Housing Benefit).

Depending on how individuals respond to the changes in the Budget 2014, there may be scope for them to significantly alter how they draw their pension income in retirement. For comparative purposes this report assumes that an annuity is taken in order to generate a benchmark rate of return based on a secure guaranteed income in retirement. However, greater flexibility to take a lump sum, or to use a form of phased income drawdown, could open up opportunities to reduce the interactions with means-tested benefits and tax. On the other hand, some individuals may be at risk of paying more income tax.

Box A provides an overview of the circumstances of an individual (Individual C in Chapter 5) who is automatically enrolled. It considers the implications of the Budget 2014 proposals in terms of her tax and mean-tested benefits.

Box A: Options for drawing down pension income

Full National Insurance (NI) record, previous Defined Benefit (DB) pension, automatically enrolled in 2012. She retires at State Pension Age (SPA) in 2022 and was automatically enrolled in 2012. She receives a state pension of £154 per week (£8,009 per year), receives income of £1,005 per year from a Defined Benefit (DB) pension, £900 from savings and investments and has accumulated a pension pot of £7,328 under automatic enrolment. She owns her home. She has a rate of return of 10%, assuming that she annuitises 75% of her pension pot at SPA and is therefore at low risk of automatic enrolment being unsuitable for her.

Individual C is not eligible for any means-tested benefits and, if she received her state pension, income from her DB pension only and income from savings and investments, she would receive £9,914 per year and would not be liable for income tax. On reaching SPA she could withdraw a tax-free lump sum of £1,832 from her pension under automatic enrolment without affecting her tax position.

Withdrawing her whole pension fund

If Individual C withdraws the whole of her pension fund in one year, her other income (£9,914) uses up most of her Personal Allowance (£10,000). This means that, while she could take 25% tax-free, she would pay 20% tax on most of her pension fund.

Purchasing an annuity

If Individual C uses the remaining £5,496, after she has taken 25% of her pension under automatic enrolment as a tax-free lump sum, to purchase an annuity, she might receive £237 per year – this would mean that her annual income would be £10,151 per year, giving rise to a tax liability of £30 per year.

The whole pot is placed in income drawdown

Individual C could place her whole pot in income drawdown and limit the amount taken out to avoid a higher marginal rate of tax, once she has taken her tax-free lump sum. Individual C could limit the income that she draws from her pension pot to £86 per year in the early years of retirement to avoid a tax liability, particularly if she is likely to spend the capital that is giving rise to her other investment and savings income in the early years of her retirement. Individual C may wish to increase the amount that she draws down if her spending needs increase over the course of her retirement.

The role of clear advice and guidance will be critical to ensure that those being automatically enrolled are maximising the return on their individual pension contributions. The introduction of the single-tier pension from April 2016 should make it easier to identify the groups of older workers most likely to be entitled to Guarantee Credit, Housing Benefit and Council Tax Reduction in retirement, and therefore at greatest risk of seeing a low rate of return from staying automatically enrolled. Maintaining the triple-locking of the single-tier should also give households much greater confidence that they will not fall back onto means-tested benefits later in retirement.

Clear communications about the future state pension entitlements of older workers when the single-tier is introduced in April 2016 could support the workplace pension reforms and help reduce or maintain opt out rates by clarifying how state pension entitlements interact with means-tested benefits and where individuals are likely to be above the threshold for Guarantee Credit.

As details of the Budget 2014 proposals develop between now and April 2015, guidance will need to clearly signpost where individuals might be at risk of financial detriment through poor financial planning, for example by taking their pension pot in a way that moves them onto a higher marginal tax threshold, or that generates an income in a given year or capital sum that loses them entitlement to means-tested benefits.

Given the DWP's research into older workers' reasons for opting out, the analysis in this report suggests that many older workers could still see very good returns from saving into a workplace pension, and the additional flexibilities announced at Budget 2014 about how pension saving is accessed at retirement could make it more attractive still. Communications from government, employers and industry bodies targeted at older workers could illustrate the potential gains from them staying automatically enrolled, and how easily their DC pension can be accessed from age 55 should they need it. This could help to ensure that opt out rates for older workers remain low, or even reduce, as more employers reach their staging dates and as the minimum contributions rise between now and 2018.

Greater clarity over the Budget 2014 changes and the new flexibilities on how to access pension saving at retirement may also help employers who may wish to encourage their older workers to stay saving, or save more, into a workplace pension, in order to ensure they can afford a comfortable retirement and retire at an age in line with their personal expectations.

Introduction

It has previously been estimated that, once automatic enrolment in the UK is fully rolled out, there could be around 9 million new savers into workplace pensions. The total number of new savers depends on the number of individuals who choose to opt out from their employer's workplace pension, and the Government has recently revised down its central projections of opt out rates (to 15%) and revised up its expected number of new savers (by 1 million) following early evidence on the implementation of the reforms by the largest employers.

While the average opt out rates observed so far have been remarkably low (at only 9% on average), older workers appear slightly more likely to opt out (at a rate of 15%) than younger workers. Individuals aged over 50 represent 22% of the target population of 10 million people eligible for automatic enrolment, meaning that over 2 million older people should have been automatically enrolled by 2018.[3]

Previous research has found that older workers could be at higher risk than younger workers of saving into a workplace pension not being suitable for them, particularly if they expect to be eligible for means-tested benefits in retirement.

However recent changes in the policy landscape, including the introduction of the new single-tier state pension from April 2016, have the potential to lift many pensioners out of the scope of means-testing and boost the rates of return older workers could see from staying in a workplace pension.

New flexibilities for those retiring with Defined Contribution (DC) pensions, announced in the Budget 2014 and to be introduced by April 2015, also open up new options for how a pension is accessed at retirement and how it interacts with means-tested benefits and tax. It is important for the overall success of the reforms, and for future retirement outcomes, that older workers understand the potential benefits of saving into a workplace pension and do not opt out unnecessarily.

This report considers the rates of return that older workers may receive from their pension contributions under automatic enrolment. It builds on previous research by the PPI on individual rates of return by modelling rates of return for older workers at a household level. This provides a more comprehensive picture of which groups of older workers might be most at risk of automatic enrolment not being suitable for them because it also takes into account the circumstances of their partners. By using data from the English Longitudinal Study of Ageing (ELSA) on older workers, uprated to 2012, we can project forward the likely impact of automatic enrolment on their total pension saving

[3] DWP (2013) This is based on the earnings 2013-14 earnings trigger of £9,440 and, therefore, the figure of 10 million people eligible for automatic enrolment may change as the earnings threshold has increased to £10,000 for 2014-15

at retirement, and evaluate the likely benefit to them of having stayed automatically enrolled.

Chapter one provides an overview of the policy context including the recent Budget 2014 changes to the tax regime, older workers' position in respect of pension saving, likely retirement income, and behaviour in respect of automatic enrolment.

Chapter two outlines how returns from automatic enrolment are calculated and what affects the minimum level of return that is needed for automatic enrolment to be suitable for an older worker. This also considers factors, including eligibility for means-tested benefits, that could impact on the extent to which older workers might benefit from being automatically enrolled into a pension.

Chapter three examines some illustrative individuals to identify the key characteristics or circumstances of older workers that may cause them to have a higher or lower rate of return from staying automatically enrolled in a workplace pension.

Chapter four projects forward the population of older workers eligible for automatic enrolment to calculate household rates of return (using the PPI's dynamic ELSA model) and identify the actual benefits from staying automatically enrolled that are likely to be observed in practice. It goes on to present some pen pictures of the individuals and households that appear to be at high risk of staying automatically enrolled not being suitable. Finally, it also presents new analysis on the likely size of pension pots of those reaching State Pension Age (SPA) over the next 10-15 years, including the pension pots that are expected to build up under automatic enrolment and any existing Defined Benefit (DB) and Defined Contribution (DC) pension provision.

Chapter five considers how individuals and households might be able to boost their rates of return from saving, and explores how the new flexibilities around DC pensions, announced by the Chancellor in Budget 2014, might affect individuals' options for how to access their pensions at retirement. It also highlights some potential implications for the government, industry and employers on how to encourage older workers to save into a workplace pension.

Chapter one: how does automatic enrolment affect older workers?

This chapter provides details of how automatic enrolment is being implemented, eligibility for automatic enrolment, and considers the circumstances of older workers in the context of automatic enrolment.

Automatic enrolment is being introduced to tackle the problem of undersaving for retirement

Automatic enrolment was introduced in the UK to tackle the problem of individuals undersaving for their retirement. The policy looks to harness individuals' inertia by introducing a new default of employees making contributions into a workplace pension, thereby increasing the number of individuals saving for the first time, or saving greater amounts for retirement.[4]

Automatic enrolment started in October 2012 with the largest employers starting to enrol their eligible employees first in a staged process between 2012 and 2018.

All employees who earn over £10,000 and who are not already participating in a workplace pension will be automatically enrolled

Those employees earning over £10,000 in 2014-15 earnings terms and who are not already participating in a workplace pension are eligible to be automatically enrolled. 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. However, individuals are able to opt out of their workplace pension once they have been enrolled. Provided that they opt out within a month their contribution will be returned to them; however, if they leave after this period, their contributions up to this point will remain invested in this workplace pension. Self-employed people are not automatically enrolled but are able to join NEST (National Employment Savings Trust), the scheme that has been set up to enable employers to meet their new workplace pension duties under automatic enrolment.

Minimum contributions are being phased in from the employer's staging date until 30 September 2017 total minimum contributions will be 2% of band earnings, of which the employer must contribute 1%. From 1 October 2017 until 30 September 2018 total minimum contributions will be 5% of band earnings, of which the employer must contribute 2%. From October 2018 onwards, total minimum contributions will be 8%, of which the employer must contribute 3%. Both employees and employers are able to contribute more than this if they wish. However, if NEST is the pension scheme used by the employer there is an annual contribution limit (£4,600 for 2014-15).

[4] DWP (2013)

Workplace pension schemes must meet certain conditions to be used for automatic enrolment

Employers are responsible for choosing the pension scheme in which they are going to enrol their employees. In order to be a qualifying scheme for automatic enrolment, schemes must meet certain conditions. These include providing a default fund for jobholders who do not express an investment choice and (as of April 2015) charges no higher than the equivalent of a 0.75% Annual Management Charge (AMC).

Defined Benefit (DB), Hybrid (a pension that has some of the characteristics of both Defined Benefit and Defined Contribution pension schemes) and Defined Contribution (DC) schemes can all be used by employers as qualifying schemes for automatic enrolment. However, as many DB schemes in the private sector are now closed to new members, it is expected that most employers will use DC pension schemes to fulfil their obligations.

Within DC schemes there are several factors that determine the size of pension pot that an individual might have built up at retirement, and individuals tend to bear most of the risk, unlike in DB schemes. These factors include the level and persistency of an individual's contributions, the employer's contributions, tax relief and the impact of compound investment returns and charges on the value of their pension fund.

In the past most individuals have used their DC pension savings to purchase annuities

Historically, most DC pension savings have been used to purchase an annuity at retirement and, until 2011, annuity purchase was effectively compulsory in the UK for all but the smallest pension pots.

In 2011, the Government ended the requirement to annuitise at age 75. In line with this, it is currently possible for individuals to use 'Capped Drawdown' or 'Flexible Drawdown' rather than purchasing an annuity. However, these are subject to limits. With 'Capped Drawdown' individuals are able to take income from their pension, but there is a maximum amount that they can withdraw each year – until March 2014 this was equivalent to 120% of the annuity that they could have purchased with their pension fund.[5] Under 'Flexible Drawdown' there is no limit on the amount that individuals can withdraw but they are required to have a 'guaranteed income' of more than £20,000 per year in order to qualify for this arrangement. 'Guaranteed income' is defined as income from the state pension, DB pensions, or a lifetime annuity income.

Until March 2014, the majority of individuals (75%) have purchased an annuity at retirement with their DC pension savings[6] – the income received in this way

[5] Under Capped Drawdown, the maximum amount that an individual can withdraw is known as the basis amount. The pension scheme administrator works out an individual's basis amount by using tables specifically prepared for this purpose by the Government Actuary's Department (GAD), published on the HMRC website

[6] HMT (2014)

is then taxed at the individual's marginal tax rate. There is an option for individuals to withdraw a tax free lump of up to 25% of the fund value. There are also rules, known as trivial commutation rules, which allow those individuals with smaller pension pots to withdraw their entire pension pot as a lump sum. Until March 2014, the trivial commutation limit was £18,000, while, separate to this, individuals were able to withdraw two pots up to the value of £2,000 as a single payment if certain conditions were met (for example, individuals had to take all pension pots with the same pension scheme as a lump sum). However, the Budget 2014 announced important changes from March 2014 onwards to these arrangements which are summarised later in this chapter.

Currently, any withdrawals from pensions outside of these rules are taxed at a marginal rate of 55%.

The Government has made proposals to remove any limits to the amounts that individuals can draw down from their pensions in April 2015

The Government is currently consulting on these proposals. These should give individuals more flexibility around how they withdraw their pension savings, something that should enable them, in some circumstances, to increase their return on saving. Box 1 gives an overview of these:

Box 1: Changes proposed in the Budget 2014

From 27 March 2014:

- Individuals with pension pots worth up to £30,000 in total are able to withdraw their entire pension pot as a lump sum.

- The size of additional small pension pots that can be taken as a single payment has been increased from £2,000 to £10,000. The maximum number of pension pots that can be withdrawn in this way is three. These can be withdrawn in this way irrespective of other pension pots. Therefore, together, the new rules mean that, in some circumstances, pension pots up to the combined value of £60,000 can be withdrawn.

- The maximum amount that individuals can withdraw each year from a Capped Drawdown arrangement has increased from 120% to 150% of an equivalent annuity.

From July 2014

- The ISA limit is being increased to £15,000 – with savers allowed to hold this in cash, shares or a combination of these.

From April 2015:

- Individuals will be able to withdraw the whole of their pension pot from age 55. The 25% tax-free lump sum will remain in place while any withdrawals over this amount will be taxed at the individual's marginal rate.

- In order to help people to make decisions around their retirement income, the Government is proposing that pension providers and trust-based pension schemes should be given a duty to provide face-to-face guidance to individuals on the different options available to them at retirement age.

- The Government is also consulting on whether to increase the age at which an individual can access their pension savings under the tax rules from 55 to 57 in line with the SPA increases.

There are concerns that the earnings trigger will not be sufficient to ensure that workers for whom automatic enrolment is not suitable will opt out

Workers have the right to opt out of automatic enrolment, but the expectation and evidence so far suggest that inertia will mean that many workers do not opt out.[7] There is concern that some people for whom automatic enrolment is not suitable (because they may not see a good return on their contributions or because they have other priorities such as paying down debt) will not opt out. This means that the way in which people are selected for automatic enrolment is important.

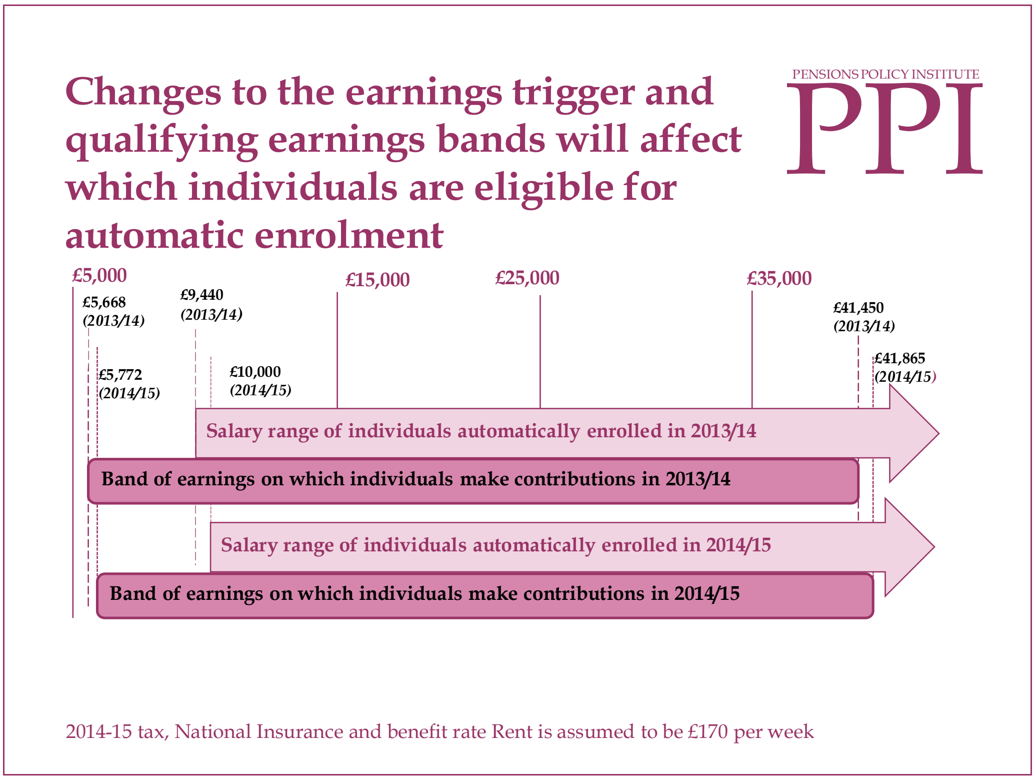
[7] Johnson, Yeandle and Boulding (2010)

The earnings trigger is an important but relatively blunt lever that is used to increase the likelihood that remaining enrolled is beneficial for the majority of workers automatically enrolled. In addition, the qualifying earnings bands look to determine that those workers who are automatically enrolled are contributing at the appropriate level. Both of these thresholds are reviewed by the Government each year, with the following three principles being used to establish the automatic enrolment thresholds:[8]

- Will the right people be brought in to pension saving?
- What is the appropriate minimum level of saving for people who are automatically enrolled?
- Are the costs and benefits to individuals and employers appropriately balanced?

The most recent review has proposed to increase the earnings trigger from £9,440 to £10,000 in line with the income tax personal allowance for 2014-15. This means that, unless wages keep pace with this increase, workers with wages between £9,440 and £10,000 will not be automatically enrolled if their employer's staging dates falls in 2014-15, whereas they would have been enrolled if their employer's staging date had fallen in 2013-14. The lower limit of the qualifying earnings band has increased from £5,668 to £5,772 in 2014-15 while the upper limit has increased from £41,450 to £41,865 in 2014-15. Chart 1 illustrates these changes.

Chart 1



[8] DWP (2013)

These thresholds are designed to exclude people from automatic enrolment where their income level makes it less likely that automatic enrolment will benefit them. This may be because the state pension may deliver a good replacement income in retirement (particularly for those with low earnings during working life) or because making pension contributions is not affordable for these individuals. However, there are also other factors, such as age and the likelihood of being reliant on means-tested benefits in retirement, which also determine how beneficial it may be to remain enrolled. It is necessary to consider the interaction of all of these circumstances to determine whether automatic enrolment would be beneficial for a particular individual or household.

There is a wide variation in older workers' circumstances

Ahead of automatic enrolment there was a wide variation in the circumstances of older workers. While only a minority of people approaching State Pension Age (SPA) were contributing to a private pension, a larger proportion of those individuals approaching SPA *and in employment* were contributing to a private pension. In 2008-10, 39% of all people aged 55-64 were contributing to a private pension.[9] However, this proportion is much higher for people in employment; in 2011-12, 60% of employees aged 55-59 and 47% of employees aged 60-64 were participating in a pension.[10] This suggests that, provided these workplace pensions comply with the rules for automatic enrolment, individuals in these circumstances will not be affected by the implementation of automatic enrolment.

In terms of existing pension wealth, there is also a wide variation in circumstances. While a minority of people approaching SPA are contributing to a pension at any one time a much larger proportion have accrued rights to or built up private pension saving at some point during their working life. 83% of men and 61% of women aged 52 and over in 2010-11 had at some point accrued rights to or built up private pension saving.[11]

Private pension wealth is unequally distributed with 26% of all households in 2008-10 not having any private pension wealth. Of the 74% of households who did have some private pension wealth, the 10% of households with the highest levels of pension wealth had almost seven times as much pension wealth as households in the bottom 50% combined.[12]

Income level and pension wealth accrued in the past may affect the extent to which remaining enrolled is beneficial

Any pension wealth accrued in the past may affect the extent to which remaining automatically enrolled is beneficial for an individual. For instance, if they have already accrued sufficient wealth to provide them with adequate income in retirement they may not need to make additional pension savings, or they may find they are no longer eligible for tax relief on their contributions

[9] Wealth and Assets Survey (2008/10)
[10] FRS (2011/12)
[11] ELSA(2010/11)
[12] Wealth and Assets Survey (2008/10)

because they have exceeded the lifetime allowance, or may face higher marginal rates of tax in retirement if they increase their private pension saving.

Those with the lowest earnings are least likely to have some existing pension wealth.[13] This means that older people in this position and who earn enough to be eligible for automatic enrolment may be likely to build up a relatively small pension pot under automatic enrolment before they reach retirement. This has potential implications for the rate of return that they are likely to receive from their pension contributions – this is considered in more detail later in this chapter.

Variations in terms of employment and housing tenure have implications for whether remaining enrolled is beneficial

Individuals approaching SPA also have diverse circumstances in terms of employment and housing tenure, both of which have implications in terms of automatic enrolment. Unsurprisingly, older individuals are more likely than younger individuals to be outside of the labour market through retirement or disability. In 2008-9, 29% of men aged 60-64 described themselves as retired while in the same year 18% of men aged 50-54 described themselves as work-disabled.[14] While higher-wealth men were more likely to describe themselves as retired, lower-wealth men were more likely to describe themselves as work-disabled. Some individuals in both of these types of groups will not be automatically enrolled as they are not currently in employment.

In households where the head of household was aged 55-64, 77% owned their house outright or with a mortgage while 16% were in social rented housing and 7% were in private rented housing.[15] It is likely that some individuals who live in rented accommodation shortly before retirement will receive means-tested benefits in retirement, in particular Housing Benefit. This is important because previous research has found that people who are likely to rent in retirement and have no additional savings have a higher risk of automatic enrolment being unsuitable for them because of the interaction of their private pension incomes with tapers for means-tested benefits.[16]

Some of the above variations will have implications for the extent to which remaining enrolled is likely to benefit different groups of individuals, something that is considered in more detail in the following sections.

[13] Johnson, Yeandle and Boulding (2010)
[14] ELSA (2008/9). This was a self-reported status in the survey and, therefore, there is no standard definition of work disability. Around half of men aged 50-54 who described themselves as work-disabled were in paid work.
[15] FRS (2011/12)
[16] PPI (2006)

There are concerns that, under automatic enrolment, older people's pension funds will have less time to build up savings and benefit from investment returns

In 2012, median weekly full-time earnings for employed people aged 50 to 59 were estimated to be £536[17] (equivalent to £27,872 per year), meaning that a large proportion of people in this group may be eligible for automatic enrolment, provided that they are not already participating in a workplace pension. However, individuals in this group may be more likely than younger people to receive a lower rate of return on their investment because they have less time to build up their savings and benefit from investment returns. The phasing of employers' contributions also means that individuals within 10 to 15 years of SPA at this point in time are likely to build up a smaller pension pot than younger groups. If members of this age group have built up smaller pension pots than younger groups, there is a risk that, if converted to an income, a greater proportion of their pension pot will be offset by reductions to means-tested benefits.[18]

At the same time, individuals who choose to opt out will not benefit from employer contributions. They may also find that, where employers seek to absorb the additional costs of automatic enrolment by offering lower wage increases to employees in future, they will also lose out over time through lower wage growth (as employers cannot offer financial incentives for employees to opt out or treat these workers differently)[19]. All of the above highlights the need for information to help people make informed decisions about whether they should opt out.

Being a tenant is a strong predictor of who will choose not to participate in a workplace pension

Previous research identified single people who are likely to rent in retirement and who have no additional savings as being at high risk of automatic enrolment being unsuitable for them.[20]

Research around pension contributions before the introduction of automatic enrolment considered the characteristics of those employees who were eligible for a workplace pension but chose not to participate despite the availability of employer contributions. It found that being a tenant was the strongest predictor of being an 'eligible non-saver'.[21] This finding is also interesting because there is a concern, to be explored later in this report, that automatic enrolment will not be suitable for older workers who are tenants and who expect to be in receipt of Housing Benefit in retirement.

The position of individuals who failed to participate in workplace pensions before the introduction of automatic enrolment is similar to that of individuals who opt out of automatic enrolment in that both types of individuals are not

[17] Annual survey of hours and earnings (2012)
[18] Johnson, Yeandle and Boulding (2010)
[19] Johnson, Yeandle and Boulding (2010)
[20] PPI (2006)
[21] SSC, ISER (2014)

benefitting from employer contributions. However, inertia may mean that some individuals who would not have taken active steps to join their employer's pension may now remain enrolled.

Rates of opt out from automatic enrolment have been lower than expected

Rates of opt out from automatic enrolment have been low compared to the Department for Work and Pensions (DWP) expectations. Analysis of the impact of automatic enrolment to date suggests that older workers have been more likely to opt out. Rates of opt out[22] for larger company employees aged 50 and over were between 25% and 50% higher than those of other age groups. A typical example is an employer where the opt out rate was 8% for employees under 30, 9% for 30-49 year olds and 15% for those aged 50 and over.[23] It is not known whether the older workers who have opted out of automatic enrolment are those for whom remaining enrolled would not be advantageous. Preliminary analysis suggests that opt out rates are slightly higher in a small number of larger employers where initial employee contributions were introduced above the minimum (i.e. above the phasing rate of 1%), and also, surprisingly, that level of salary may not have an impact on opt out.[24]

Some workers who are opting out of automatic enrolment might benefit from remaining enrolled in a workplace pension

Qualitative research was conducted on behalf of the Department for Work and Pensions (DWP) to explore reasons behind opting out of automatic enrolment.[25] This research found that there was no association between opting out and gender or location. However, these findings did provide some insight into the reasons why older workers are more likely to opt out. It identified six types of individuals who opted out, with older workers typically falling into three of these as follows:

[22] Opt out refers to those individuals who left the pension scheme within one month of being automatically enrolled

[23] DWP (2013)

[24] DWP (2013)

[25] DWP (2014)

Box 2: Types of individual who opted out

Workers who had made other provision
These workers were usually aged in their 50s and 60s, with higher incomes, who had invested in a range of savings vehicles. These workers tended to expect to rely principally on another workplace pension or property in retirement, with some workers feeling that they had already made enough provision.

Workers with insufficient time to build up pension savings
These workers were typically aged over 50 and felt that they would not save a sufficient pension because they may not be working for long enough. The majority were planning to retire within the next 3-5 years, although these plans tended to be vague. This group included people with little or no savings.

Workers who perceived the contribution rates as being too low
These workers were usually aged over 40 and earned over £20,000. They felt that the contribution rate under automatic enrolment was too low, regardless of how long they would be saving into this. They often compared the pension to alternative savings products. Nearly all workers in this type had some kind of savings; stocks and shares or ISAs were specifically named.

It initially appears that the research participants had a good understanding of automatic enrolment as they had taken account of the employer's contribution and most knew their employer's contribution level. However, it does not appear that this had translated into a calculation around their retirement income needs to arrive at a decision around the suitability of remaining enrolled – and some of the findings at first appear counter-intuitive.

For instance, even among the group who opted out because they had made other provision there were some people who did not state that they had made sufficient provision for retirement. This suggests that there may be some people who are opting out of automatic enrolment when remaining enrolled in a workplace pension would be beneficial to them.

Other developments within automatic enrolment and wider pensions policy will influence how likely workers are to benefit from automatic enrolment
This report looks to identify the different types of circumstances and characteristics which will determine whether an older person or older household is likely to benefit from remaining enrolled in a private pension. It is important to take into account the following developments both within automatic enrolment and within wider pensions policy, as these will have an impact on the extent to which workers are likely to benefit from automatic enrolment.

Automatic enrolment is being introduced in stages
Automatic enrolment is being introduced in stages from October 2012 until February 2018. Large employers with 250 or more employees enrolled their employees between 1 October 2012 and 1 February 2014. Medium-sized

employers with 50 to 249 employees have staging dates between 1 April 2014 and 1 April 2015. Small employers with fewer than 50 employees will have staging dates from 1 June 2015 to 1 April 2017.

The effect of staging and phasing of contributions may affect the extent to which automatic enrolment is advantageous for some older workers, particularly those close to SPA, as this may lead to contributions being lower and being made from a later date, thereby further restricting the accrual of investment returns and leading to smaller pension pots. However, at the same time, the phasing arrangements effectively give individuals a higher rate of matched contributions from their employer in the earlier years of automatic enrolment, something that may work to reduce the impact of lower contributions (for example, until 30 September 2017, 50% of minimum contributions must be paid by the employer, while this decreases to 40% from October 2017 and to 37.5% from October 2018).

In addition, current trivial commutation rules mean that many individuals with small pension pots will be able to withdraw their entire pension pot as a lump sum, something that may increase their return on saving. Proposals outlined in the 2014 Budget that will apply from April 2015 will allow individuals aged 55 and over much greater flexibility to choose how they access their pension pot; again this may enable them to increase their return on saving. The staging dates for automatic enrolment also mean that the majority of workers who are automatically enrolled will be affected by the introduction of the state single-tier pension, to be implemented from April 2016.

The single-tier pension will affect those individuals who reach SPA from April 2016

On 9 May 2013, the Government introduced the Pensions Bill 2013-14 to Parliament. The Bill proposes to implement a new single-tier state pension from April 2016 that will replace the current Basic State Pension (BSP) and the State Second Pension (S2P). Automatic enrolment and the single-tier state pension were intended to complement each other and, as such, the introduction of the single-tier state pension has implications for the roll-out of automatic enrolment. The majority of those employees who are aged over 50 and eligible to be automatically enrolled will reach SPA under the single-tier state pension.

Box 3 summarises some of the principle elements of the single-tier pension:

Box 3: Introduction of the single-tier pension

In May 2013, the Government published its Pensions Bill, which at the time of writing has been debated in Parliament and is awaiting Royal Assent. The single-tier pension will be set at a level above the standard minimum guarantee level, which is currently £148.35 per week.

There are important differences from the current system; 35 years of National Insurance Contributions (NIC) or credits will be required for an individual to receive the full pension, and there will be a minimum qualifying period which is expected to be set at 10 qualifying years.

People who reach Sate Pension Age (SPA) from April 2016 onwards will receive the single-tier pension. Those people who reach SPA after April 2016 will benefit from the comparison of their accrued rights under the current system with what they would have accrued under the single-tier pension—and take forward the higher of the two amounts. In contrast, people who reach SPA before April 2016 will not benefit from this comparison.

Under the single-tier pension there will not be provisions for individuals to receive a state pension based on their spouse's or partner's contributions. However, there are some transitional arrangements in place for those people who have expected to receive a Basic State Pension (BSP) based on their partner's contributions, which are likely to affect those individuals who will reach SPA during the ten years following the introduction of the single-tier pension. For example, there are transitional provisions for employed married women who, between 1948 and 1977 chose to pay reduced rates of National Insurance (NI) and receive a derived pension based on their husband's contributions.

Currently, Defined Benefit (DB) schemes can be contracted out of the State Second Pension (S2P), and employers receive a rebate on their National Insurance Contributions. Under the single-tier state pension S2P will be abolished in April 2016 and there will be no contracting-out.

The state pension is currently uprated by the triple-lock – this is the higher of the growth in average earnings, the Consumer Price Index (CPI), or 2.5%. However, this is only guaranteed until the end of the current Parliament. After this date, while the expectation is that the single-tier will remain uprated by the triple-lock, the law only requires the single-tier pension to be uprated annually in line with earnings.

The single-tier state pension reforms aim to make it easier for people to understand the expected level of their state pension. In turn, this should make it simpler for people to understand what level of private pension saving they will need to make in order to ensure an adequate level of income in retirement.

However, some employers will have automatically enrolled their workers before the introduction of the single-tier pension; as such, many older people will not have received the information about what level of state pension they can expect before they are automatically enrolled and may have made some pension contributions without the full information about the likely level of their state pension. Moreover, there is a complex transition to the single-tier with a minority of individuals receiving the full single-tier pension when it is first implemented - DWP's estimates of entitlement to the single-tier suggest that in 2016 61% of those reaching SPA will have below full entitlement to the single-tier, whilst 13% qualify for the full amount and 27% have above full entitlement.[26] This will be more straightforward for younger groups as a larger proportion of those reaching SPA will qualify for the full amount of the single-tier in future.

The introduction of the single-tier and automatic enrolment will interact to have different effects on groups of older workers

In practice, the implementation of both the single-tier and automatic enrolment over the next few years means that different groups of older people in work will be affected in different ways. Table 1 overleaf provides an overview of the five groups who will be affected by either the single-tier pension, automatic enrolment or both.

Those employers with fewer than 30 employees have a staging date between January 2016 and April 2017, depending on the last two characters in their PAYE reference. As the implementation date for the single-tier pension is April 2016, automatic enrolment will interact with the single-tier pension in different ways for those employees who work for an employer with fewer than 30 employees, depending on the employer's PAYE reference.

If an individual reaches their SPA before April 2016 they will be assessed under the current state pension system. Some individuals who reach SPA before April 2016 and work for an employer with fewer than 30 employees will not be automatically enrolled. Therefore, this group will be unaffected by both the single-tier state pension and automatic enrolment. This is shown as Group 1 in Table 1.

However, if an individual who reaches SPA before April 2016 works for an employer with over 30 employees, they may be automatically enrolled before they reach SPA (provided they have sufficient earnings and are not already a member of an eligible pension scheme) and will receive the current state pension. Some individuals who work for employees with fewer than 30 employees will also fall in this group as some employers with fewer than 30 employees have their staging date before April 2016 (this is because employers' phasing dates depends on the last 2 characters in their PAYE reference number). This is shown as Group 2 in Table 1; if individuals within this group remain enrolled, they may make pension contributions for a very short period of time, leading to a low value pension fund.

[26] DWP (2013)

All of those individuals who reach SPA after April 2016, who will receive the single-tier pension, will be automatically enrolled, provided that their automatic enrolment staging date falls before April 2016. This is shown as Group 3 in Table 1. While most of this group will work for employers with more than 30 employees, some will work for employers with fewer than 30 employees (or new employers).

An individual who reaches SPA after April 2016 will not be automatically enrolled if they reach SPA shortly after April 2016 and their staging date falls after they reach SPA – this is shown as Group 4 in Table 1. This group is made up of individuals who work for an employer with fewer than 30 employers.

However, the majority of older people in employment (and who are not already contributing to a pension) who reach SPA after April 2016 and receive the single-tier pension will also be automatically enrolled – shown as Group 5 in Table 1.

Table 1 summarises the position for different groups of workers.

Table 1: Summary of automatic enrolment groups

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

Depending on how they access their pension, all of those older workers who are automatically enrolled will be at greater risk of automatic enrolment being unsuitable for them if they receive means-tested benefits and, in particular, Housing Benefit. While the single-tier state pension is designed to lift pensioners out of means-tested benefits (where an individual is eligible for the full single-tier pension), they will remain an important part of people's retirement income particularly during the years that follow the introduction of the single-tier pension. This is explored further in Chapter 2 and Annex 2.

Summary

- Under automatic enrolment, employers are required to enrol their employees into a qualifying pension scheme.
- This looks to harness the effects of inertia by making saving into a pension the default for eligible employees who earn £10,000 or more per annum.
- It is expected that most employers will use Defined Contribution (DC) schemes to fulfil their obligations.
- In the past most individuals have used their DC funds to purchase an annuity. However, this may change as the Government has made proposals to remove any limits to the amounts that individuals can draw down from their pensions in April 2015.
- Individuals are able to opt out of saving into a pension but must do so within the first month of being enrolled if they are to receive back the pension contributions they have made.
- The earnings trigger is a lever that is used to increase the likelihood that remaining enrolled is beneficial for the majority of workers automatically enrolled. However, there are concerns that this will not be sufficient to ensure that workers for whom remaining enrolled is not suitable will opt out.
- Rates of opt out for larger company employees aged 50 and over were between 25% and 50% higher than those of other age groups. A typical example is an employer where the opt out rate was 8% for employees under 30, 9% for 30-49 year olds and 15% for those aged 50 and over.
- The main reasons cited by older workers for choosing to opt out are because they have made other provision for their retirement, because they believe they have insufficient time to build up pension savings, and because they perceive the contribution rate as being too low.
- There is wide variation in older workers' circumstances, in terms of income and wealth level, pension wealth accrued in the past, and employment and housing tenure. These factors have implications for the extent to which remaining enrolled is likely to benefit different individuals.
- There are concerns that, under automatic enrolment, older workers' pension funds will have less time to build up savings and benefit from investment returns.
- Other developments, such as the phasing of contributions and the introduction of the single-tier state pension, may influence how likely people are to benefit from automatic enrolment.

Chapter two: calculating the return from saving

This chapter describes how the return from saving into a workplace pension is calculated in this report, and provides an overview of how the interaction of means-tested benefits and tax in retirement and in working life can influence the return from saving.

The combination of compulsory employer contributions, government contributions (tax relief) and expected investment returns could make saving into a workplace pension relatively attractive for some employees. However, income in retirement would be taxable, so some of the government contribution may be reclaimed as income tax in later life. In addition, where any savings result in the loss of mean-tested benefits, or higher marginal tax rates, in retirement, this could put some employees at a risk of a low return.

Criteria to assess suitability of remaining automatically enrolled
Two possible criteria that could be used to assess the suitability of remaining automatically enrolled are as follows:

1. That a workplace pension is the best thing for individuals who stay automatically enrolled. This condition would not be met if spending the money, paying down debt or using another savings product would have been preferable, even if an individual would not strictly lose out from saving in a workplace pension.

2. A less stringent condition is that individuals who stay automatically enrolled should not lose out as a result of their saving. This compares the difference between the amount saved and the likely amount eventually received as pension income. It aims for there to be at least a minimum return on saving.

Automatic enrolment may not be suitable for some employees for a variety of reasons. Where an individual makes pension contributions, they may be accepting a lower standard of living during their working life in order to enhance their standard of living in retirement. Their circumstances may not meet the first criterion and, therefore, saving into a workplace pension may not be suitable for them where they cannot afford to sacrifice income during their working life or where the enhancement to their standard of living in retirement is not sufficient to justify acceptance of a lower standard of living during their working life. This might be because the individual is likely to receive a low return on their saving, because pension contributions are unaffordable or the individual has significant amounts of personal debt.[27] This will also depend on personal preferences.

The original recommendation of the Pensions Commission was that a low-cost default scheme be introduced alongside automatic enrolment, as there was a

[27] PPI (2007)

supply gap in the market for a low-cost pension saving product.[28] NEST was established to meet this need and a number of other qualifying pension schemes being used by employers for automatic enrolment, including master trusts, have similarly low charges. This low level of charges means that those employees who are automatically enrolled have been receiving generic and informal advice rather than advice tailored to individuals' detailed circumstances, which would be far more costly to provide. It would be very difficult to use generic sources of information to determine whether remaining enrolled would be the best thing for an individual. However, it should be possible to use generic sources of information to determine whether an individual would be **at risk** of a poor return from remaining enrolled. Therefore, this paper adopts the second of the suitability criteria as the definition of 'suitability'. This paper compares the difference between the amount saved through automatic enrolment and the likely additional retirement income, and if there is at least a minimum return on an individual's saving, treats automatic enrolment as being suitable for the individual.

Individuals' circumstances may not meet this criterion where any savings are likely to be offset by other factors, such as the loss of mean-tested benefits in retirement or higher marginal rates of taxation.

This report treats automatic enrolment as being suitable for the individual if there is at least a minimum return on an individual's saving

This report explores the benefits of older workers remaining automatically enrolled by comparing the difference between the amount saved and the likely amount eventually received as pension income in retirement in order to calculate a rate of return on pension contributions for that individual. If there is at least a minimum return on saving it treats automatic enrolment as being suitable for the individual.

Box 4: Calculating returns from saving in a workplace pension

This report takes into account the interaction between all elements: the employer and government contributions (tax relief) and means-tested benefits to calculate the expected returns from remaining automatically enrolled in workplace pensions.

In order to calculate rates of return on saving into a workplace pension it is necessary to make an assumption on how income is drawn in retirement. As it is useful to consider the level of income that the individual can be **guaranteed** to receive in retirement, the analysis has assumed that pension pots accrued under automatic enrolment are annuitised at State Pension Age (SPA) (after a 25% tax-free lump sum has been taken). However, the final chapter of this report uses individual examples to explore alternative approaches to drawing a pension particularly in the context of the proposals set out in the Budget 2014 consultation document 'Freedom and Choice in Pensions'.

[28] Pensions Commission (2005)

One measure used to calculate the return from saving, which takes into account all of the elements described above, is the **net present value**[29] of an individual saving £1**.** This calculates the total amount received in pension income during retirement as a result of the £1 saving, in today's prices.

An alternative to the net present value is the **internal rate of return**. This is similar to the net present value but is expressed as an annual interest rate and calculates the rate of interest per year that an individual receives on his or her pension contributions. This allows for the effects of tax relief, employer contributions, investment returns, charges, income tax and means-tested benefits.

This report will use the internal rate of return to estimate returns from the savings made by older people into workplace pensions because it enables a simple and consistent comparison for different age bands over different time periods. A specific advantage of the internal rate of return is that it shows the gains from saving on an annual basis.

What level of return is acceptable?
The rate of inflation may be the lowest acceptable rate of return tolerated by savers as this would mean that pension saving has not made them worse off in strict financial terms than had they spent the money today. However, this supposes that all potential pension savers make this type of calculation, something which is unlikely in practice.

In addition, the level of return that is acceptable will vary by individual. Two individuals with very similar circumstances, in terms of retirement provision, may deem different levels of return to be the minimum level that they are willing to accept. As well as financial circumstances, such as levels of debt and previous pension saving, individuals' preferences and expectations about their likely personal circumstances in retirement will have a bearing on their outlook.

In turn, their current financial circumstances may have an impact on an individual's preferences. For instance, an individual with a high salary and low level of accrued pension wealth may prefer to smooth consumption in order to make up for this disparity and may, therefore, accept a lower rate as the minimum acceptable rate of return.

Research has suggested that particular groups are less happy to make high risk investments. Research around savings has shown that people on low incomes prefer accounts where their savings are not at risk.[30] There also appears to be a particular regional pattern in terms of willingness to take risks with money. In 2012, respondents in Scotland (15%), Wales (12%), the North West (20%) and the North East of England (13%) were less likely to say that they were willing

[29] For a detailed explanation of the net present value, see PPI report, *Are personal accounts suitable for all* (2006), p.11
[30] Kempson, Finney (2009)

to take calculated risks with money, as long as there was potential for a good return, than those in other regions.[31]

It is possible to designate groups who are at risk of workplace pensions being unsuitable for them

While these preferences mean that several factors affect the minimum level of acceptable return, these demonstrate that it is impossible to designate, **with certainty**, groups for whom saving into workplace pensions is suitable, even where an individual's circumstances mean that saving into a workplace pension would be advantageous in financial terms. Therefore, this report classifies individuals, based on the internal rate of return, in terms of being **at risk** of remaining enrolled into a workplace pension being unsuitable for them:

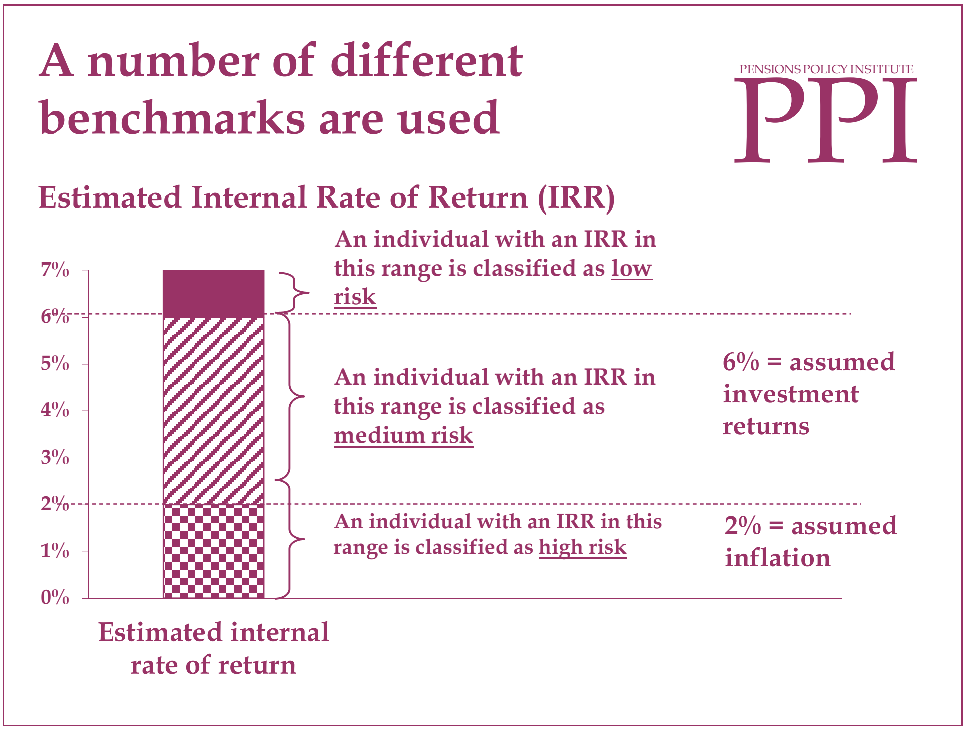
- An individual is classified as **high-risk** if he or she has a return of less than inflation measured by the Consumer Price Index (CPI). This is assumed to be 2% in this report. An individual in this situation would not receive the inflation-protected value of his or her own individual contributions back from his or her workplace pension.

- An individual is classified as **medium-risk** if he or she has a return of more than inflation (CPI) but lower than the expected investment return. This level is assumed to be 6% in this report. An individual in this situation would receive the inflation-protected value of his or her own individual contributions plus some credit (but not necessarily total credit) for the real investment returns earned by investing those contributions.

- An individual is classified as **low-risk** if he or she has a return that is higher than the expected investment return, assumed to be 6% in this report. An individual in this situation would receive the value of his or her own individual contributions plus full credit for the real investment returns earned by investing those contributions. In addition, he or she would receive back some (but perhaps not all) of the value of the employer contribution, the government contribution and investment returns on the employer and government contributions.

[31] DWP (2012)

Chart 2



Interactions with the tax and benefit system and the impact on rates of return

Three specific factors have an impact on rates of return and may make it difficult for individuals to understand whether it would benefit them or not to remain automatically enrolled. They are:

- Means-tested benefits in retirement
- Means-tested benefits during working life
- Tax treatment of pension income and trivial commutation

Pension income can interact with means-tested benefits in retirement to lower individuals’ rates of return from saving

The main means-tested benefits for pensioners are Pension Credit (made up of Guarantee Credit and Savings Credit), Housing Benefit and Council Tax Reduction.

Box 5: Means-tested benefits for pensioners

Pension Credit: Guarantee Credit. The age at which individuals receive this is gradually increasing from 60 to 66. It is a benefit paid if other sources of income do not reach a certain level. If claimed, it provides a safety-net of a minimum level of income. This is £148.35pw for single people and £226.50pw for couples in 2014-15.

Pension Credit: Savings Credit aims to ensure that those who have made some private provision for retirement, or who have made provision in excess of the Basic State Pension (£113.10 in 2014-15) are rewarded for this. The maximum amount payable is capped and payments are also 'tapered' down where someone has additional income above the Guarantee Credit level. In this way, in the current system, pension saving which leads to additional retirement income can also lead to the loss of Savings Credit which impacts on the rate of return on savings.

Housing Benefit is paid to people in both social and private rented sector housing on low incomes who rent their homes. It is designed to help with housing costs, including rent and some accommodation-related service charges.

Council Tax Reduction is a rebate scheme to provide help with up to 100% of an individual's council tax.

In 2012-13, there were 12.8 million state pensioners in Great Britain, of which around 2.5 million received Pension Credit. A similar number received Council Tax Benefit (now Council Tax Reduction) while approximately 1.5 million received Housing Benefit.[32]

In 2011-12, around a quarter of households where the head of household was aged 65 or over rented their home, while 15% of households where the head was aged 65 or over received Housing Benefit.[33]

For lower earners, pension contributions are likely to represent a significant sacrifice during their working life and, for this reason, it is particularly important that they do not make contributions to a pension where this would deliver little benefit because of the interaction with means-tested benefits in retirement. For example, even if they take their pension as a lump sum, if a pensioner has savings of more than £10,000, they receive lower levels of Guarantee Credit – this is currently reduced by £1 per week for each £500 of savings.

Guarantee Credit guarantees a minimum level of income for pensioners; this is £148.35pw for single people and £226.50pw for couples in 2014-15. In practice this means that, for individuals whose income would otherwise be under the threshold for Guarantee Credit, extra private pension income would replace Guarantee Credit, £1 for £1, meaning that the individual, in effect, would not

[32] House of Commons Library (2013)
[33] DWP (2013)

receive any additional retirement income as a result of being automatically enrolled.

Both Housing Benefit and Council Tax Reduction are means-tested with the amount of benefit depending on an individual's income and savings. For private housing tenants costs that are eligible to be covered by Housing Benefit will be calculated using the Local Housing Allowance for their area – this is based on rental prices in their area and the number of rooms they need, based on the size of their household. For social housing tenants, eligible housing costs are based on their eligible rent – this means the reasonable rent for suitable property in their area, including service charges, such as lift maintenance.[34]

In most cases, those people who receive Guarantee Credit receive the full amount of Housing Benefit and Council Tax Reduction. There may be exceptions to this where, for example, the individual is living with an individual other than their partner or carer.

While the single-tier pension is intended to make individuals less reliant on means-tested benefits, the level of entitlement to Housing Benefit and Council Tax Reduction amongst those people who will reach State Pension Age (SPA) after the introduction of the single-tier pension is not estimated to change significantly.

In contrast, those people who are not eligible for Pension Credit or who are eligible for Savings Credit only are not eligible for Housing Benefit or Council Tax Reduction if they have savings in excess of the capital limit of £16,000. Similarly, if they have income in excess of a particular amount, known as their 'applicable amount', their Housing Benefit is reduced at a rate of 65p for each pound of income that they receive over this. The applicable amount is made up of personal allowances and premiums that reflect an individual's circumstances – this also varies according to an individual's age and living arrangements. For example, the Housing Benefit Personal Allowances rates for 2014-15 are £72.40 for people under state pension credit age, £148.35 for people over state pension credit age[35] and under 65, and £165.15 for people aged 65 and over.

As the single-tier pension will be set at above the level of the Guarantee Credit, individuals in receipt of a full single-tier pension and aged over state pension credit age and under 65 will have income in excess of the Housing Benefit Personal Allowance. They may still receive some Housing Benefit but their income level may lead to them being on the Housing Benefit 'taper' where their Housing Benefit is reduced at a rate of 65p for each pound of income that they receive over this.

[34] https://www.gov.uk/housing-benefit/what-youll-get

[35] The state pension credit age is rising in line with women's SPA and is currently 62

For people over state pension credit age, Council Tax Reduction is calculated in the same way as Housing Benefit, with this being reduced at a rate of 20p for each pound of income that they receive over the applicable amount.

The above means that, if pension contributions made under automatic enrolment lead to an individual's income in retirement being in excess of the Guarantee Credit threshold, this may lead to their savings being assessed for their Housing Benefit. Where these savings are higher than £16,000 or their income is more than their applicable amount, they may no longer be eligible for Housing Benefit and Council Tax Reduction or may receive reduced amounts of these benefits. In this way, remaining automatically enrolled may lead some individuals to lose some benefits in retirement and may deliver little or no additional income.

There are plans to reform Pension Credit and Housing Benefit so that Housing Benefit for pension age claimants will eventually become the Housing Credit Element of State Pension Credit. Some older workers who are being automatically enrolled are expected to be impacted by these changes. Details are not yet available of how this will work in practice; however, Department for Work and Pensions (DWP) has stated that Housing Benefit for pension age claimants will remain in place until at least 2017-18.

Pension contributions can also interact with means-tested benefits during working life to increase individuals' rates of return from saving

Means-tested benefits and credits during an individual's working life can also have an impact on individuals' rates of return from saving. In some cases, pension contributions reduce the income to be taken into account in order to assess an individual's eligibility for means-tested benefits and credits, and can increase the value of saving. This effectively increases the rate of return on their pension saving. The main means-tested benefits that will be affected by pension contributions for older workers are Housing Benefit, Council Tax Reduction and Working Tax Credit. In these cases, pension contributions reduce the individual's assessed income, meaning that they may be eligible for higher amounts of benefit as a result of their pension contributions. This, in turn, may increase the likelihood that pension contributions are beneficial overall.

However, it is likely that a significant proportion of Housing Benefit recipients will not be automatically enrolled because they are not employed or do not have earnings in excess of the automatic enrolment threshold.

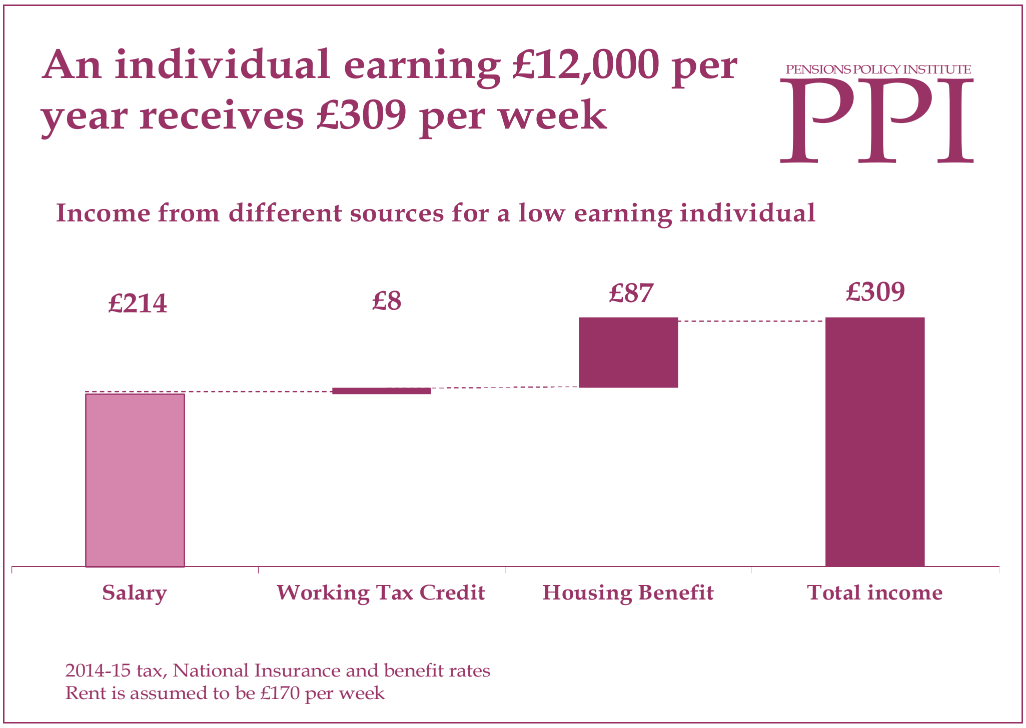
43% of Housing Benefits recipients are in receipt of Income Support, Jobseekers Allowance or Employment and Support Allowance (see Annex 2). In order to be eligible for these benefits, individuals must generally work 16 hours or less per week – therefore, it is unlikely that many of these individuals will have earnings from employment of more than £10,000, the threshold for automatic enrolment. To illustrate this, an individual who works 16 hours per week would have to earn at least £12.02 per hour to reach the threshold for automatic enrolment, well above the National Minimum Wage of £6.50 per hour in 2014.

This means that those individuals who qualify for Housing Benefit and are eligible for automatic enrolment are likely to fall in the group of individuals for whom their entitlement to Housing Benefit is not due to their entitlement to other benefits such as income support (i.e. they are not likely to be 'passported' to Housing Benefit).

Figures show that, in November 2013, around 1.04 million people were in this group. It may be that some single individuals who do not have a family and are not eligible for Housing Benefit disability-related premiums will not earn enough to be automatically enrolled. However, these figures do not enable an assessment of whether this is the case. In addition, particular groups of individuals, such as lone parents, are able to have higher earnings while still receiving Housing Benefit. These groups may be eligible for automatic enrolment. More information about means-tested benefits and the interaction with pension contributions is in Annex 2.

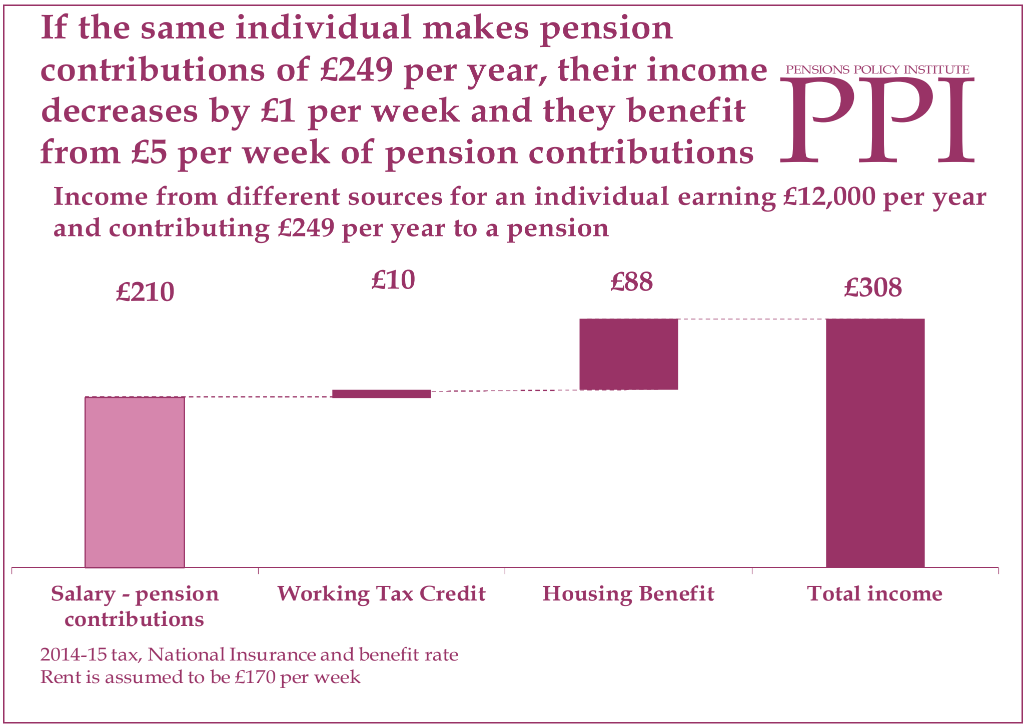
Where an individual in receipt of Housing Benefit makes pension contributions, 50% of these will be deducted from the amount of income that is compared to their applicable amount for Housing Benefit. In this way, pension contributions may increase the amount of Housing Benefit received by an individual. Housing Benefit for working age people works in the same way as for people over SPA. However, the Housing Benefit Personal Allowance for people under state pension credit age is lower, at £72.40 for 2014-15. Charts 3 and 4 show the income, including means-tested benefits, that would be received by an individual who earns £12,000 per year. Chart 3 provides an illustration of the individual's income if they do not contribute to a pension. They would receive a total income of £309 per week.

Chart 3



In contrast, if the individual makes pension contributions of £249 per year (4% of their income between the lower limit and £12,000) they receive £308 per week and benefit from £5 worth of pension contributions. This is shown in Chart 4.

Chart 4



The interaction of pension contributions with Council Tax Reductions and Working Tax Credit can also affect individuals' returns on saving
Individuals with low incomes can also receive a Council Tax Reduction, a scheme which replaced Council Tax Benefit in 2013 for working age people. However, the individuals shown in Charts 3 and 4 receive too much income to receive Council Tax Reduction. Under Council Tax Benefit, rules were similar to those for Housing Benefit with 20p of Council Tax Reduction being withdrawn for every £1 of earnings over the applicable amount. Under the new Council Tax Reduction scheme each council is responsible for setting their own rules. However, for many councils, tapers tend to work in a similar way to those for Council Tax Benefit in the past, although this may change in the future though the level of support available has been reduced in many areas. As with Housing Benefit, if the individual makes pension contributions, 50% of these will be deducted from the amount of income that is compared to their applicable amount.

Working Tax Credit is for working people on a low income. Again, the amount of benefit depends on an individual's circumstances but a working person aged 25 or over, with no dependants, needs to work for at least 30 hours per week to qualify for it. 100% pension contributions are disregarded when assessing the amount of credit that an individual should receive. Again, this means that making pension contributions may lead to an individual receiving higher amounts of Working Tax Credit.

Working age benefits will be replaced by Universal Credit
However, for working age people Housing Benefit, tax credits and other benefits, such as Jobseeker's Allowance are due to be replaced by Universal Credit, although Council Tax Reduction will continue to exist outside of Universal Credit. Universal Credit has already been introduced in some areas, with plans to move most existing claimants to Universal Credit by the end of 2017. The amount of Universal Credit will depend on people's circumstances. However, pension contributions will be treated as they are for Working Tax Credit – with 100% of pension contributions being disregarded when assessing the amount of credit that they should receive. In this way, pension contributions may increase the amount of benefits received by some individuals to a greater extent than they do currently.

Trivial commutation may enable an individual to increase their return on saving
Existing trivial commutation rules mean that some individuals with small pension pots are able to withdraw their entire pension pot as a lump sum and, provided that it is under capital limits, this would have no negative impact on any benefit entitlement that they might have.[36] Until March 2014, trivial commutation rules allowed an individual to convert a small pension into a one-off cash payment provided that the total value of pension funds held by them amounted to no more than £18,000. This limit was increased to £30,000

[36] Johnson, Yeandle and Boulding (2010)

from 27 March 2014. If an individual uses his or her saving to purchase an annuity, all of the income from that annuity would count in the Pension Credit calculation. In contrast, the first £10,000 of capital is not included in the Pension Credit calculation and, therefore, if an individual trivially commutes a fund that is valued at less than £10,000 and has no other savings then none of this will count in their Pension Credit calculation. In this way, trivially commuting their pension pot may enable an individual to increase their return on pension saving.

As mentioned in Chapter 1, the Government has announced plans to remove any restrictions on the value or proportion of a pension pot that can be accessed as a lump sum from age 55 from April 2015 onwards. Depending on how Defined Contribution (DC) pension pots are drawn down in future, there may be significant implications for how much individuals are taxed. For example, taking the whole pension pot as a lump sum at retirement could push an individual onto a higher marginal tax rate in that year. Similarly, drawing down more income early on in retirement, if other sources of income are also higher in early retirement, could also push an individual onto a higher marginal tax rate.

Summary

- This report compares the amount saved and the likely amount eventually received as pension income and, if there is at least a minimum return on saving, treats automatic enrolment as being suitable for the individual.
- The report uses the internal rate of return to calculate the rate of interest per year that an individual receives on his or her pension contributions. This allows for the effect of tax relief, employer contributions, investment returns, charges, income tax and means-tested benefits.
- An individual is classified as high-risk of saving into a workplace pension being unsuitable if he or she has a return of less than inflation measured by the Consumer Price Index. An individual is classified as medium-risk if he or she has a return of more than inflation but lower than the expected investment return, assumed to be 6% in this report. An individual is classified as low-risk if he or she has a return that is higher than the expected investment return.
- Interaction of pension contributions with the tax and means-tested benefits system can have an impact on the rate of return from saving. For lower earners, pension contributions are likely to represent a significant sacrifice during their working life and, for this reason, it is particularly important that they do not make contributions to a pension where this would deliver little benefit.
- The main means-tested benefits for pensioners include Pensions Credit (Guarantee and Savings Credit), Housing Benefit and Council Tax Reduction. The drawing down of pension funds that have accrued due to automatic enrolment can interact with these benefits to decrease individuals' rate of return on saving.

- Pension contributions can interact with means-tested benefits, such as Housing Benefit and Working Tax Credit, during working life to increase individuals' rate of return on saving.
- Existing trivial commutation rules may enable individuals to increase their return on saving.

Chapter three: how do different characteristics affect rates of return for older workers?

This chapter considers some illustrative examples of older workers to identify who might be at risk of automatic enrolment being unsuitable for them because they receive a low rate of return on their contributions.

Many factors affect the internal rate of return, and some of these are relevant in the pre-retirement phase while others are relevant after retirement:

Pre-retirement factors that affect an individual's rate of return include:
- Employer contributions
- Government tax relief
- Investment returns
- Charges
- Period and pattern of contributions (matching the phasing of automatic enrolment contributions)
- Interaction with means-tested benefits and, income tax and tax credits during working life

Post-retirement factors that affect an individual's rate of return include:
- Annuity rate (assuming an annuity is taken)
- Length of life
- Interaction with means-tested benefits during retirement
- Tax paid on pension

This chapter focuses on four factors to explore how these influence older individuals' internal rates of return. Other factors, including household circumstances, existing pension provision, and other sources of income and wealth can also interact with the factors above and impact on rates of return. These will be explored further in the household level analysis in the next chapter.

Three key pre-retirement factors are:
- Age at which the individual is automatically enrolled and the interaction with the phasing of contributions
- Different salary levels and marginal tax rates
- Means-tested benefits in working life

The post-retirement factor considered here is:
- Whether or not the individual is eligible to receive Guarantee Credit, Housing Benefit and Council Tax Reduction in retirement

This chapter focuses on these factors as initial analysis has indicated that these are likely to have the biggest impact on older workers' internal rates of return on their pension contributions due to automatic enrolment. In addition, individuals may have a choice or may be able to structure their income in relation to some of these factors. For instance, as pension contributions during working age reduce individuals' qualifying income for the calculation of means-tested benefits individuals may choose to remain enrolled in order to maximise their income over the course of their lives (the extent to which this might be an advantageous arrangement for different types of older workers is explored later in this report).

In contrast, some of the other factors such as the actual rate of tax relief received on pension contributions, charges paid and investment returns received by an individual are more or less fixed. Where an individual chooses to remain automatically enrolled they have to stay in the pension scheme selected by their employer and, in this way, the investment return that they receive (assuming they remain in the default fund) and the charges they pay are largely outside of their control.

Similarly, while some higher rate taxpayers may be able to organise their finances to maximise the total amount of tax relief that they receive, many individuals who are automatically enrolled will be basic rate taxpayers and will not be able to alter their finances to benefit from higher rate tax relief.

As it is useful to consider the level of income that the individual can be **guaranteed** to receive in retirement, the analysis has assumed that 75% of the pension pots accrued under automatic enrolment are annuitised (excluding the tax-free lump sum). However, in practice individuals can currently choose whether to trivially commute their pension fund provided that it falls within the trivial commutation limit, now set at £30,000 for one single pot until April 2015. In addition, in the Budget 2014, the Government announced proposals to remove any limits on how much of a Defined Contribution (DC) pot can be withdrawn from April 2015. This may have an impact on their rate of return and these options are explored in the last chapter of this report.

Analysis in this chapter has used short-term economic assumptions for Retail Prices Index (RPI), Consumer Prices Index (CPI) and annual earnings growth in line with Office for Budget Responsibility projections. It has also assumed expected investment returns of 6% in nominal terms, before charges, corresponding to a mixed equity/bond fund in the ratio of 60% equities, 40% bonds. However, this could overstate investment returns if the older workers are placed in more bond heavy, lower risk funds.

Phasing arrangements are likely to boost the rates of return of the oldest workers

Chart 5 shows that the older workers within the over 50s group are estimated to have higher rates of return than younger workers within the over 50s group. This is likely to be influenced by the phasing arrangements for automatic enrolment (while both employers and employees can contribute more, many are only expected to contribute the minimum amount). These arrangements mean that, in the early years of automatic enrolment, employers are required to make a larger proportion of each employee's pension contributions. This would be expected to increase the rate of return that they receive on their own personal contributions. Until October 2017, the total minimum contributions must be 2% of band earnings, with the employer contributing an amount equal to at least 1% of the employee's band earnings. This means that employer contributions must account for 50% of pension contributions. From October 2017, the total contributions must be 5% of band earnings, with the employer contributing an amount equal to at least 2% of the employee's band earnings. This means that the employer's contribution falls to 40% of total pension contributions. Finally, in October 2018, the total contributions must be 8% of band earnings, with the employer contributing an amount equal to at least 3% of the employee's band earnings. This means that the employer's contribution again falls, this time to 37.5% of the total pension contributions.

Chart 5 indicates that rates of return from pension saving under automatic enrolment for median earning men, enrolled in 2012, are well over the benchmark investment return of 6% irrespective of their age and proximity to SPA.

This analysis assumes that individuals and their employers contribute at the minimum level. It also assumes that individuals currently in work are able to continue working and saving until their SPA, and they do not access their private pension saving until SPA. On retirement individuals are assumed to purchase a single life, level annuity after taking their 25% tax-free lump sum. The distribution of rates of return is explored further in Chapter 4.

Chart 5

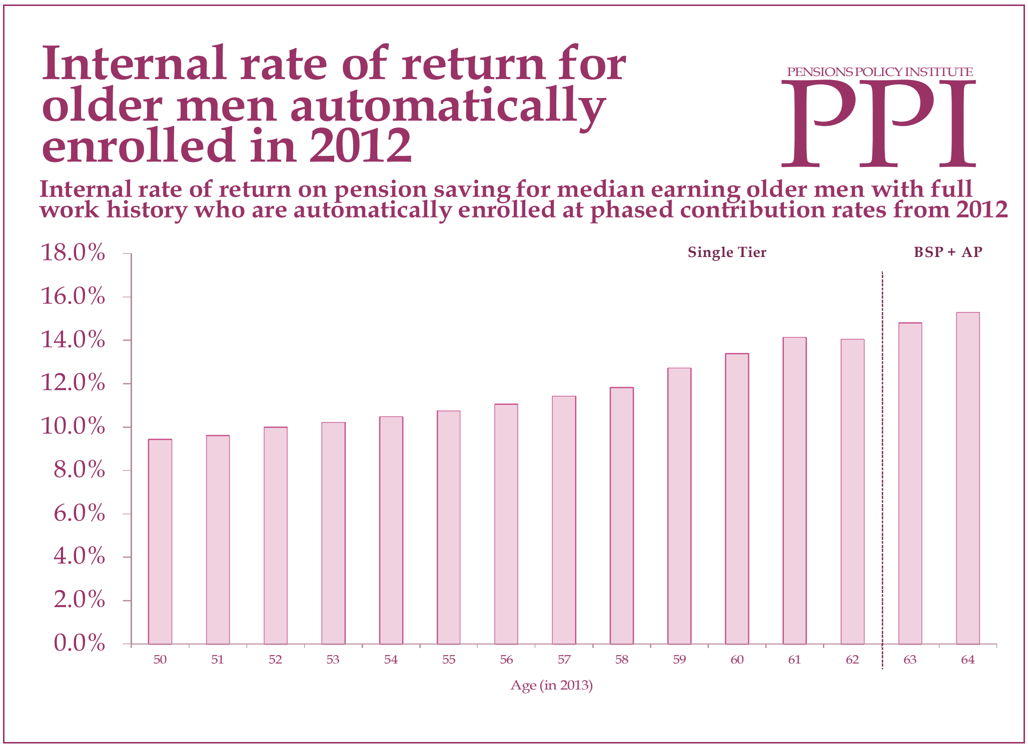
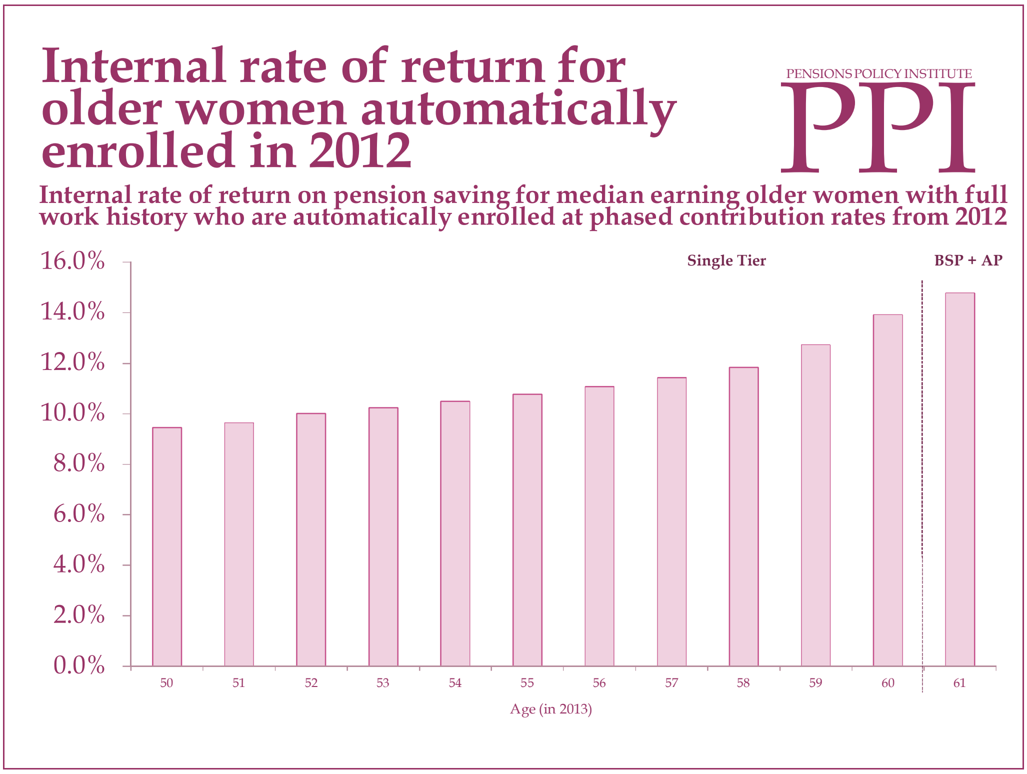


Chart 6 indicates that this is also the case for older women – rates of return from pension saving under automatic enrolment for median earning women, enrolled in 2012, are well over the benchmark investment return of 6% irrespective of their age and proximity to SPA.

Chart 6



Earnings levels are also likely to have an impact on individuals' rates of return

While the phasing of contributions is likely to have an impact on rates of return, other factors also explain some of the variation within each age band. Earnings levels are likely have an impact on individuals' rates of return. The main drivers are the fact that any pension savings made by lower earners can replace means-tested benefits while higher earners can receive tax relief on their pension contributions at the higher rate (currently 40%). If they pay basic rate tax on their retirement income, and take a 25% tax free lump sum, this represents a tax advantage and provides a boost to their rate of return. This regime means that, relative to other types of saving such as ISAs, high levels of financial benefit can accrue to the individual through tax relief on pension contributions.

Chart 7 compares the rates of return for a woman who pays basic rate tax and an individual who pays higher rate tax. This assumes that they pay basic rate tax in retirement. Again, rates of return are high in both cases; a woman aged 59 earning £30,000 has a rate of return of 12.7% compared to a woman of the same age who earns £55,000 per year – this individual has a rate of return of 14.4% Table 2 compares the rates of return for women at particular ages.

Chart 7

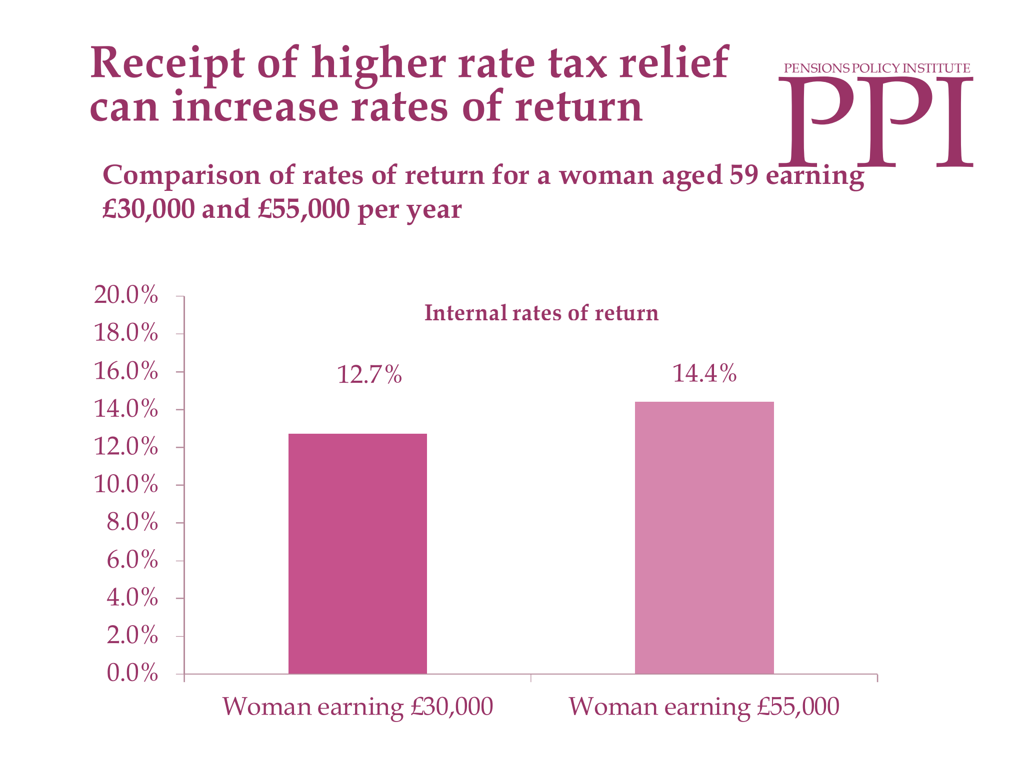


Table 2: Rates of return for a woman paying basic rate tax and a woman paying higher rate tax at particular ages

Age	Woman earning £30,000 per year	Woman earning £55,000 per year
50	9.5%	11.5%
53	10.3%	12.2%
56	11.1%	12.6%
59	12.7%	14.4%

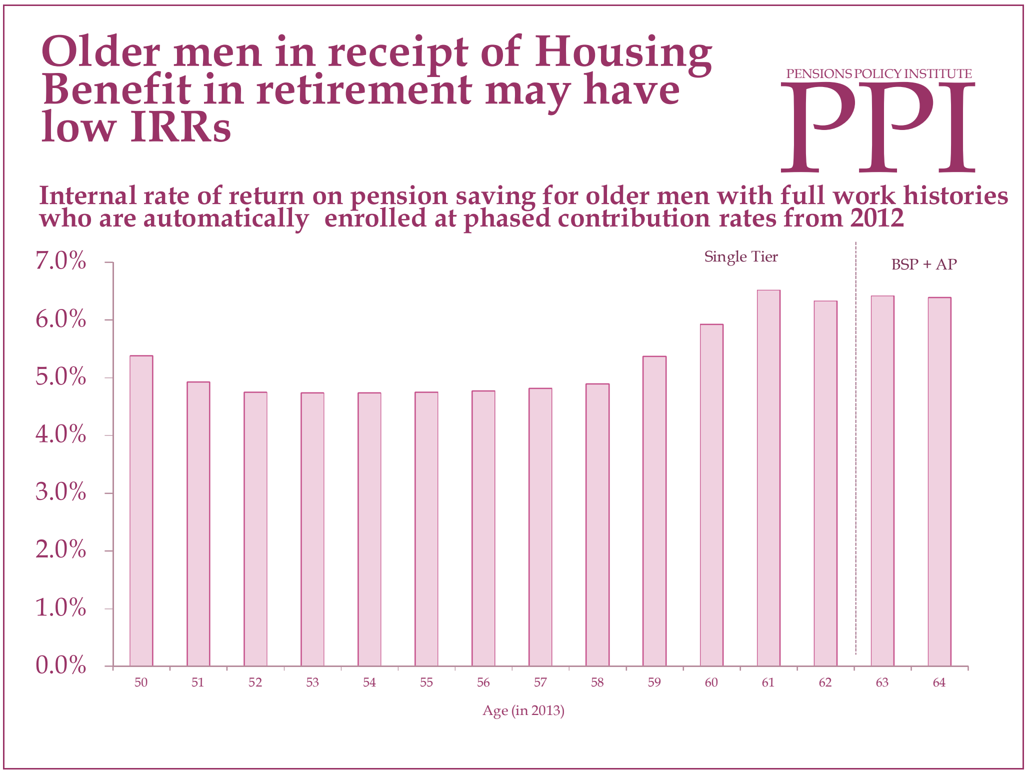
Individuals with low incomes who are likely to rent in retirement could be at high risk of remaining enrolled being unsuitable for them

For workers on low incomes contributing to a pension could mean a large reduction in future entitlement to Housing Benefit (if they rent in retirement).

The interaction between private pension saving and Housing Benefit can reduce retirement income received as a result of saving. Every £1 of income above the Housing Benefit Personal Allowance (HBPA), currently £165.15 for individuals over 65 (see Box 5 in chapter 2), reduces an individual's Housing Benefit received by 65p.

Chart 8 shows internal rates of return for median earning older men with full work histories and who would be eligible for Housing Benefit in retirement.

Chart 8



Years of SERPS/S2P accrual can mean that individuals' state pension income is higher than the Housing Benefit Personal Allowance

Chart 8 indicates differences in the rate of return, according to their age, for men in receipt of Housing Benefit in retirement. The interaction of automatic enrolment with the state pension system and means-tested benefits can explain some of the differences in rates of return.

People who reach SPA under the current state pension system, and who have years of additional state pension (SERPS/S2P) accrual, may receive state pension income that is close to, or exceeds, the Housing Benefit Personal Allowance. Similarly, people who reach SPA after April 2016 may have a foundation amount higher than the full weekly value of the single-tier state pension if they had already built up higher state pension entitlement under the current system which is then protected. This could again mean that their state pension income is close to, or exceeds, the Housing Benefit Personal Allowance. Any additional private pension savings may then take them onto the Housing Benefit 'taper' where their Housing Benefit is reduced by 65p for every additional £1 of private pension income that they have. If this is the case, all or a relatively large proportion of their gain from savings may be reduced to 35p for every £1. Figures, shown in Chart 8 suggest that, for men aged 50 and over who receive Housing Benefit in retirement, this can lead to rates of return that are lower than average for older men as a group, placing them at medium risk of staying in a workplace pension not being suitable for them.

The interaction of Guarantee Credit and pension saving can be complex
While one of the main means-tested benefits received by older individuals is Guarantee Credit, the fact that individuals who are automatically enrolled are in employment means that their state pension is likely to be in excess of the individual's Guarantee Credit threshold, currently £148.35. In turn, this means that they do not lose any Guarantee Credit as a result of saving into a private pension. However, in couples where the other partner is not accruing rights to the state pension, the couple's Guarantee Credit threshold of £226.50 may interact with their private pension saving, under automatic enrolment, to reduce their rate of return. This is explored further in Chapter 4.

In addition, it is possible to be entitled to Housing Benefit and Council Tax Reduction and Pension Credit at the same time. In this situation, the combined amount received in these means-tested benefits can be withdrawn at a rate of 91p for each additional £1 of income. An individual in this situation who saves enough to receive £1 of income from automatic enrolment may lose 91p of this in reductions to Housing Benefit, Council Tax Reduction and Pension Credit.[37]

For individuals in receipt of Housing Benefit or Tax Credits during their working life pension contributions can interact with means-tested benefits to increase individuals' rates of return on saving
Individuals at lower earnings levels may be eligible for Housing Benefit during their working life. If they make pension contributions, 50% of these will be deducted from the amount of income that is compared to their applicable amount for Housing Benefit. In this way, pension contributions can increase the amount of Housing Benefit received by an individual, increasing their rate of return on saving. Chart 9 compares the rates of return for a man aged 59 earning £10,000 per year in receipt of Housing Benefit in working life with a man in the same situation but who is not renting and therefore not in receipt of Housing Benefit. This assumes that both men will receive Housing Benefit in retirement. While a man who receives Housing Benefit in working life may have a rate of return of 18.0% a man who does not receive Housing Benefit may have a rate of return of 12.7%. Table 3 compares the rates of return for men at particular ages.

The rates of return for the lower earner in Chart 9 are higher than for the median earner in Chart 8 because the median earners are expected to have foundation amounts of state pension entitlement that are higher than the single-tier pension. In turn any additional private pension income is likely to interact with the taper for Housing Benefit so that a larger proportion of their private pension income is replacing Housing Benefit. In contrast, in most cases, individuals who receive Housing Benefit in working life have low levels of earnings. This means that they will not have built up such high levels of additional state pension. Compared to the individuals in Chart 8 the rates of return are higher for them because the additional private pension income is not

[37] £1 of additional income would reduce Guarantee Credit by £1 but would also lead to an additional 60p Savings Credit. This in turn would reduce Housing Benefit by 39p (65% of 60p) and Council Tax Reduction by 12p (20% of 60p). So the net impact of £1 additional income on means-tested benefits is 91p (-£1 + 60p-39p-12p).

high enough to lift the individuals' income above the Housing Benefit personal allowance and onto the taper.

Chart 9

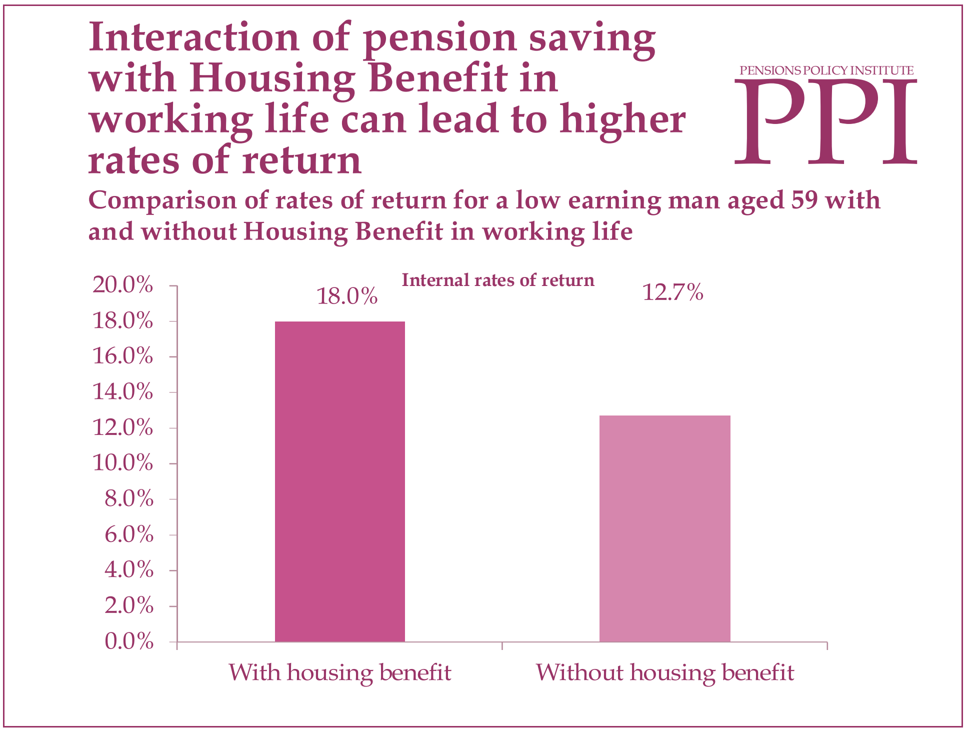


Table 3: Rates of return for a man with Housing Benefit and a man without Housing Benefit during working age

Age	Man with Housing Benefit	Man without Housing Benefit
50	10.7%	7.5%
53	13.2%	9.4%
56	15.1%	10.8%
59	18.0%	12.7%
62	20.9%	14.8%

This means that the interaction of Housing Benefit and pension contributions in working life may increase the rates of return for individuals also in receipt of Housing Benefit in retirement. However, this does not guarantee that these individuals are not at risk of automatic enrolment being unsuitable for them.

This chapter has assessed the impact of factors, such as age and the receipt of means-tested benefits on rates of return. Chapter 4 considers the distribution of rates of return across households.

Summary

- Phasing arrangements are likely to boost the rates of return of the oldest workers because the employer is making a higher proportion of the contribution.
- Earnings levels are also likely to have an impact on individuals' rates of return. Higher tax relief, in particular, contributes to the higher rates of return received by higher earnings. A woman aged 59 earning £30,000 may have a rate of 12.7% compared to an individual of the same age who earns £55,000 per year, who has a rate of 14.4%.
- Individuals with low incomes who are likely to rent in retirement could be at higher risk of remaining enrolled being unsuitable for them.
- However, for individuals in receipt of Housing Benefit during their working life pension contributions can interact with means-tested benefits to increase individuals' return on saving. While a man who receives Housing Benefit in working life may have a rate of return of 18.0% a man who does not receive Housing Benefit may have a rate of return of 12.7%.

Chapter four: what rates of return might older workers have?

This chapter builds on the analysis of individual rates of return in Chapter 3 by modelling the distribution of rates of return for older workers at a household level. This provides a more comprehensive picture of which groups of older workers might be most at risk of automatic enrolment not being suitable for them in practice and for couple households it also takes into account the financial circumstances of partners. This is particularly important for the rates of return analysis as eligibility for means-tested benefits is assessed at a household, rather than individual, level.

By using data from Wave 3 of the English Longitudinal Study of Ageing (ELSA) on those benefit units with at least one individual aged 50 we can project forward the likely impact of automatic enrolment on the total pension savings of older workers at retirement. This in turn allows us to evaluate the likely benefit to them (in terms of additional income during retirement) of having stayed automatically enrolled and making pension contributions.

The PPI's Dynamic Model (see Annex 1 for more detail) uses data collected on over 10,000 respondents (selected to be representative of the English population aged 50 and over) and assesses their earnings and existing pension arrangements to identify over 850 older workers who would be potentially eligible for automatic enrolment in 2012. As this is a relatively large sample, any analysis based on the whole sample is likely to be robust and, as a result, it is possible to generalise from these findings to the population of individuals in England eligible for automatic enrolment and aged over 50. However, more detailed analysis on smaller groups (e.g. by individual age bands) should only be treated as illustrative of how the impact of automatic enrolment might differ between individuals and households, and the variation in household circumstances that might be observed.

This chapter also considers specific individuals and households identified within this sample, using pen portraits to illustrate how remaining enrolled might affect their overall financial situation in retirement. These examples are intended to provide some practical illustrations around how automatic enrolment interacts with other elements within the pension, tax and means-tested benefits systems.

Finally, it is also possible to use the outputs from the Dynamic Model to identify the expected pension pots of individuals reaching State Pension Age (SPA) over the next 10-15 years, and how they might have been affected under the existing trivial commutation rules compared to the new flexibilities on accessing Defined Contribution (DC) pension pots, announced in the Budget 2014, that are expected to apply from April 2015.

As for Chapter 3, analysis in this section has used short-term economic assumptions for RPI, CPI and annual earnings growth in line with Office for

Budget Responsibility projections. It has also assumed expected investment returns of 6% in nominal terms, before charges, corresponding to a mixed equity/bond fund in the ratio of 60% equities, 40% bonds. However, this could overstate investment returns if the older workers are placed in more bond heavy, lower risk funds.

Over 95% of households are at low risk of remaining automatically enrolled being unsuitable for them

Chart 10 shows the distribution of the rate of return on pension saving for households where at least one person would be eligible to be automatically enrolled. The majority of households are estimated to have a rate of return above the benchmark investment return of 6%, meaning that they are at low risk of automatic enrolment being unsuitable for them. The median rate of return is 9.6%, again placing the median individual in the 'low-risk' category. Despite this, a small proportion of benefit units are at high or medium risk of remaining automatically enrolled being unsuitable for them. Where a household is classified as high risk, the automatically enrolled individual or individuals would not receive the inflation-protected value of their contributions back from their workplace pension. A household is classified as medium-risk if the automatically enrolled individual or individuals are expected to receive a return of more than inflation (CPI) but lower than the expected investment return on their contributions.

This analysis assumes that individuals and their employers contribute at the minimum level. It also assumes that individuals currently in work are able to continue working and saving until their SPA, and they do not access their private pension saving until SPA. On retirement individuals are assumed to purchase a single life, level annuity after taking their 25% tax-free lump sum.

Chart 10

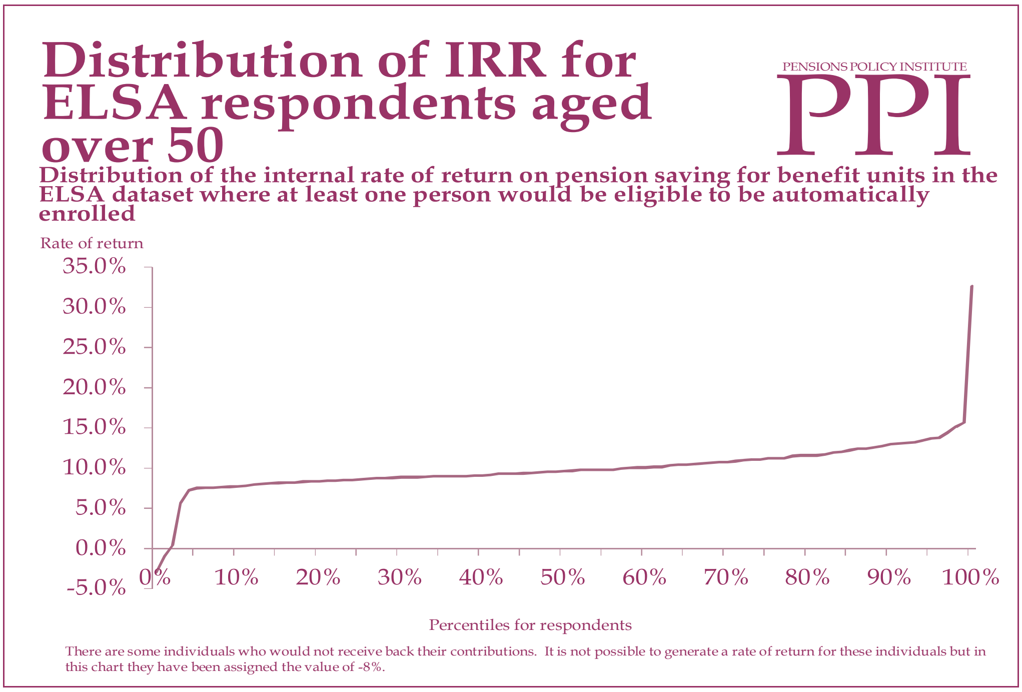
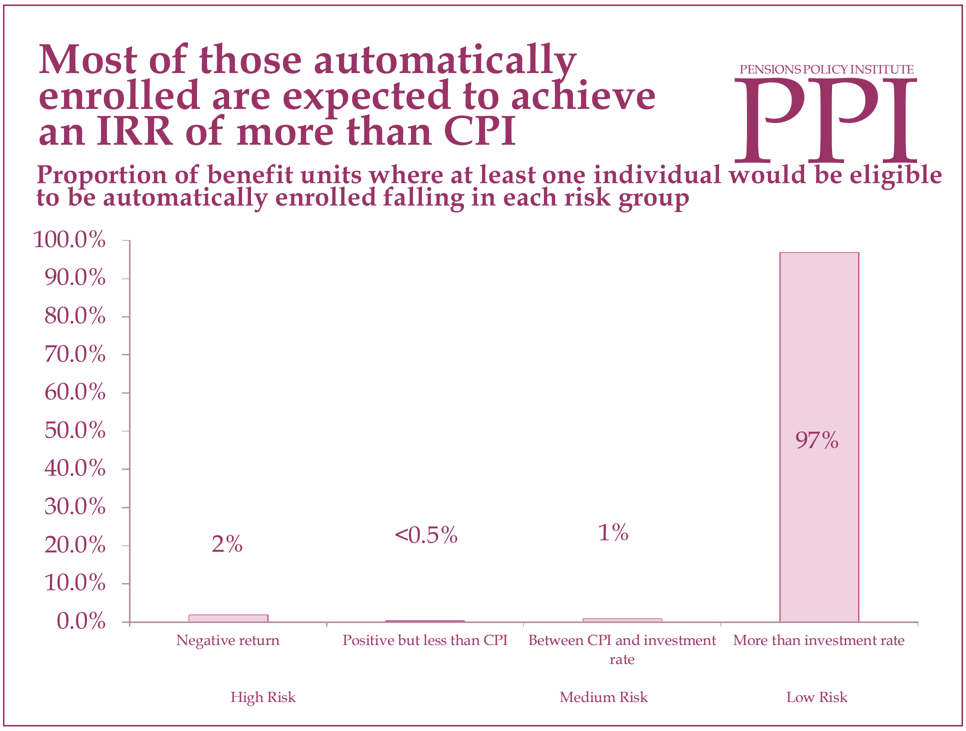


Chart 11 shows the proportion of households that fall into each risk group. The largest group is the low risk group, with over 95% of individuals falling within this group. A household is classified as low-risk if the automatically enrolled individual or individuals have a return that is higher than the expected investment return, assumed to be 6% in this report. An individual in this situation would receive the value of his or her own individual contributions plus full credit for the real investment returns earned by investing those contributions. In addition, he or she would receive back some (but perhaps not all) of the value of the employer contribution, the government contribution and investment returns on the employer and government contributions.

Chart 11



A small proportion of individuals might not receive any increase to their retirement income

Box 6 provides a description of some of those individuals who would receive negative returns on their pension saving. It should be emphasised that this affects a very small proportion of the sample only – the rates of return are very positive for over 95% of the cases, suggesting that staying enrolled is suitable for the vast majority.

The fact that Individual A's wife has not built up any state pension interacts with the couples' Guarantee Credit threshold to mean that they would have been eligible for Guarantee Credit if they had not remained automatically enrolled – this means that £1 of additional private pension income simply reduces the Guarantee Credit by £1. Ultimately, this means that, in those years, they would not receive any additional retirement income as a result of remaining automatically enrolled and making pension contributions.

For Individual B any pension due to automatic enrolment would decrease the amount of Housing Benefit and Council Tax Reduction received by her and her husband. This means that an extra £1 of private pension income in retirement decreases the Housing Benefit and Council Tax Reduction received by the couple by 85p.

Box 6: Portraits of individuals who may have a poor return from remaining automatically enrolled.

Individual A is a 60-year-old married man who is automatically enrolled in 2012 – his wife will not receive any state pension. At retirement, he has accumulated a pension fund of £3,325 under automatic enrolment. It is assumed that he takes 25% of this as a tax-free lump sum and uses the rest to purchase a single life, level annuity of £155 a year.

When Individual A retires in 2017, the couple would be eligible for couple's rate Guarantee Credit which, given their circumstances, would be at £2,820 a year if Individual A had not remained enrolled. If he does remain enrolled, the Guarantee Credit is reduced by £1 for each £1 of private pension that the couple receive. The couple's Guarantee Credit is therefore reduced by £155 a year, to £2,665 a year.

The increase in pension income of £155 a year is entirely offset by a reduction in the Guarantee Credit, leaving a net impact of zero on the couple's post retirement income as a result of making contributions to a pension. Allowing for the fact that he was able to take £830 as a lump sum, he has an internal rate of return of -1%.

Individual B is a 57-year-old woman who is automatically enrolled in 2012. At retirement, she has accumulated a pension fund of £1,245 under automatic enrolment. It is assumed that she takes 25% of this as a lump sum and uses the rest to purchase a single life, level annuity of £55 a year. She also has a DC pension from another source of £220 a year. Her husband is eligible for the full Basic State Pension upon his retirement in 2015.

The couple are not eligible for Guarantee Credit. When Individual B retires, the couple are entitled to Housing Benefit and Council Tax Reduction; however their income falls within the taper amount for these benefits, meaning that each extra £1 of private pension income reduces their means-tested benefits by 85p. While her pension due to being automatically enrolled increases her pension income by £55 a year, this also reduces the Housing Benefit and Council Tax Reduction that the couple would otherwise be eligible for by £36 and £11 a year respectively.

This means that remaining enrolled would result in a positive net impact on the family's post retirement of only £11 a year income as a result of the £1,245 pension fund – this represents a negative rate of return of −1%.

The illustrations in Box 6 assume that individuals use their pension fund to purchase an annuity, using an annuity rate in line with general modelling assumptions. However, a Financial Conduct Authority (FCA) thematic review found that those with small pension funds, defined here as £5,000 and under and to a lesser extent £10,000 and under, were generally offered lower annuity rates than those with larger funds, and have less choice of providers on the open market.[38]

However, from April 2015, irrespective of the size of their pension pot and any existing pensions, they will be able to withdraw their entire pension from automatic enrolment as a lump sum. For those individuals eligible for Guarantee Credit, providing that their total capital is not more than £10,000, this would not affect eligibility for Guarantee Credit in subsequent years.

Those individuals with very high rates of return (9% and over) tend to reach SPA by 2018 at the latest. As mentioned in Chapter 3, this is likely to be influenced by the phasing arrangements for automatic enrolment where, in the early years of automatic enrolment, employers are required to make a larger proportion of each employee's pension contributions. In turn, this means that a smaller proportion of pension contributions are paid for by each employee, something which will increase the rate of return that they receive on their contributions.

Results have assumed that individuals will use their DC pension funds to purchase an annuity while, in practice, individuals may access their pension in another way

The estimates of rates of return here have assumed that individuals will use their DC pension funds, including their fund accumulated under automatic enrolment, to purchase an annuity. However, in practice, those individuals who are able to delay accessing their pension fund until after April 2015 will have much greater choice over how they access their pension funds. This means that they may be able to access their pension in a way that minimises their income tax liability and/or maximises their entitlement to means-tested benefits. In turn, this should increase their return on saving. Some of these options are considered in the final chapter of this report.

Analysis of ELSA respondents eligible for automatic enrolment indicates that around two thirds had made some previous pension saving. Around a fifth have accrued a DB pension fund only before the implementation of automatic enrolment while around a third have accrued a DC pension scheme only. Around 8% have accrued both DB and DC pension pots.

For those saving under automatic enrolment for the first time, the majority (over 90%) would have already had access to the flexibilities outlined in the Budget 2014 via the existing trivial commutation rules, and by the increases to the trivial commutation limits from April 2014. The high profile of the Budget 2014 announcements may however make it more likely that more individuals take the route of a lump sum withdrawal rather than buying an annuity and may receive guidance that encourages them to do so. Table 4 shows the proportion of individuals reaching SPA with pension pots below the trivial

[38] Financial Conduct Authority (2014)

commutation limits in place up to April 2014 and from April 2014 to March 2015.

Table 4: Proportion of older workers automatically enrolled in 2012 with pension pots at SPA 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 due to automatic enrolment only	Individuals with a DC pot from automatic enrolment and/or existing DC and/or DB pots
% under £18,000	91%	44%
% under £30,000	99%	56%

Automatic enrolment will lead to a wide range of fund values, meaning that remaining enrolled interacts with individuals' circumstances to affect them in different ways

Chart 12 shows the median size of pension pots accrued under automatic enrolment by individuals' ages while Table 5 also shows the 10th and 90th percentiles of the distribution of these pension pots at particular ages. In these cases sample sizes are too small for any robust analysis and therefore Chart 12 and Table 5 should be treated as illustrative of how the impact of automatic enrolment can differ between individuals.

Chart 12

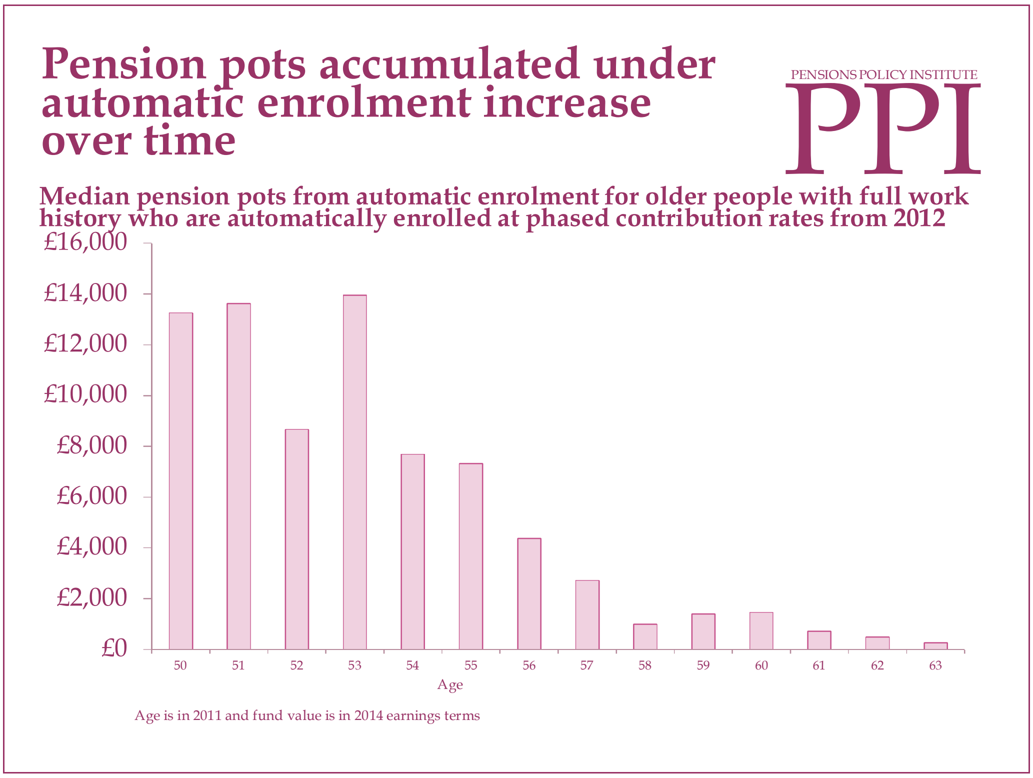


Table 5: Distribution of pension funds accrued through automatic enrolment at particular ages

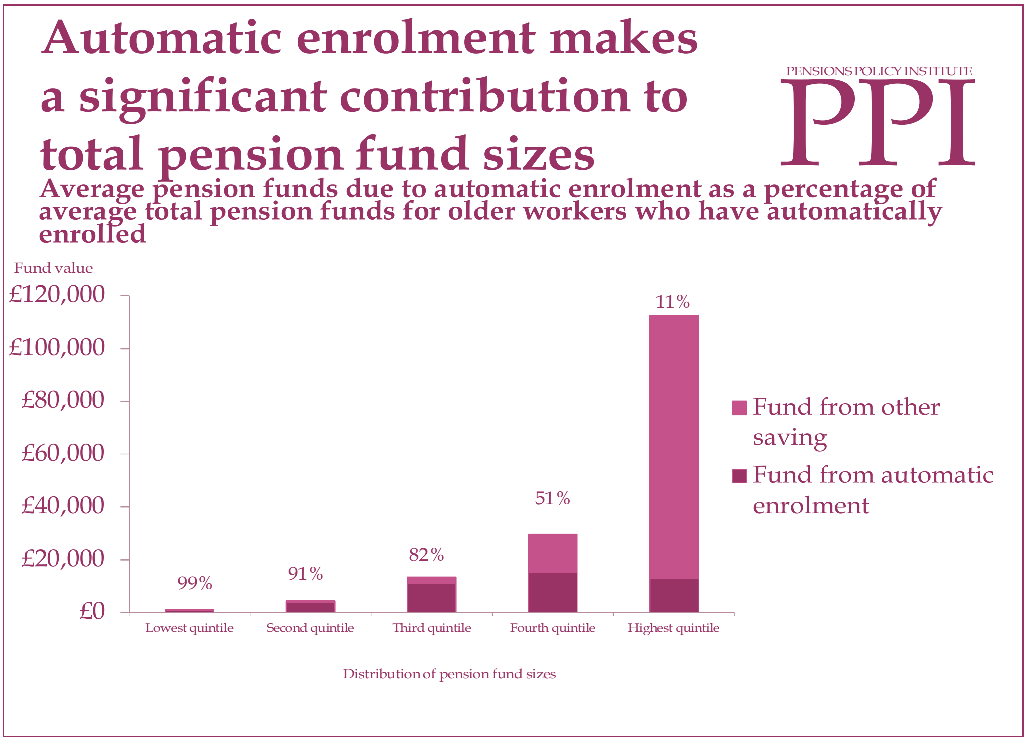
Age	Size of fund – 10th percentile value	Size of fund – median value	Size of fund – 90th percentile value
50	£2,870	£13,250	£32,880
53	£2,590	£13,950	£25,360
56	£1,270	£4,360	£15,690
59	£80	£1,410	£3,170
62	£80	£490	£1,100

For each of these ages there is a wide distribution of sizes of pension funds, reflecting the variation in earnings in the underlying population who are eligible to be automatically enrolled. For the oldest workers even the largest pots from automatic enrolment are under the previous trivial commutation limit of £18,000. Amongst the youngest workers the median pots are still well within the previous trivial commutation limit and most are within the trivial commutation limit of £30,000 that applies from April 2014 to March 2015.

Pension funds make a significant contribution to total pension funds for all fund ranges

Automatic enrolment will play an important role in boosting the pension pots of older workers. Chart 13 considers the distribution of pension funds by quintile. In the lower quintiles, funds due to automatic enrolment make up the majority of pension funds. However, the proportion of total pension funds that is due automatic enrolment is lower for the higher quintiles.

Chart 13



Summary

- This report uses dynamic modelling based on data collected in the English Longitudinal Study of Ageing (ELSA) to explore internal rates of return (IRR) at the household level.
- Despite the higher opt out rates seen so far amongst older workers, the vast majority (over 95%) of this group are likely to receive good value on their pension contributions from staying automatically enrolled. The median rate of return when wider household circumstances are taken into account is 9.6%.
- A small proportion of individuals might not receive any increase to their retirement income from remaining automatically enrolled. This tends to be due to interaction of private pension income, due to automatic enrolment, with Guarantee Credit.
- The calculations in this chapter assume that individuals use their pension fund to purchase an annuity. However, from April 2015, they will be able to withdraw their entire pension from automatic enrolment as a lump sum. For those individuals eligible for Guarantee Credit, providing that their total capital is not more than £10,000, this would not affect eligibility for Guarantee Credit in subsequent years.
- For those saving under automatic enrolment for the first time, the majority (over 90%) would have already had access to the flexibilities outlined in the Budget 2014 via that existing trivial commutation rules, and by the increase to the trivial commutation limits from April 2014.

Chapter five: how could the new flexibilities announced in the Budget 2014 affect choices at retirement and older workers' rates of return?

The analysis in Chapters 3 and 4 suggests that the vast majority of older workers will benefit from remaining enrolled in their workplace pension. For these individuals the proposals in the 2014 Budget to remove the restrictions on the amount of their pension pot that they can access without a tax penalty, mean that the challenge is around how they can structure their retirement income so that it maximises their return on saving while meeting their income needs at different stages during their retirement.

This chapter considers particular issues that will affect the return on saving for both those groups for whom remaining enrolled is likely to be beneficial and those who are at high risk of remaining enrolled being unsuitable for them. It uses individual examples to illustrate how the way in which individuals access their pension income may interact with rules around tax and means-tested benefits to affect their rate of return overall. It goes on to consider the importance of communications around the benefit of workplace pensions given the proposals in the 2014 Budget and considers how to encourage higher levels of contributions.

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.

There is currently limited detail around how the proposals in the 2014 Budget will work in practice. Some of this will become clearer once the Government responds to the consultation and some will depend on the types of products and guidance developed by the pensions industry. This report assumes that the following options (or combination of options) are available to all individuals, although, in practice, existing income drawdown products may not be available to individuals with smaller pension pots (up to £25,000).

- The whole value of the pot can be withdrawn in one transaction from the age of 55 onwards. The individual can take up to 25% of the pot tax-free and will pay tax at their marginal tax rate on the remainder.
- The pot can be used to purchase an annuity from the age of 55 onwards, with the individual also taking the 25% tax-free lump sum.
- The pot can be placed in an income drawdown fund from the age of 55 onwards. The individual can take up to 25% of the pot tax-free at this point and the remainder is paid out of the pot and treated as taxable when the individual withdraws it from their drawdown product. At this point it is taxable at their marginal tax rate.

In practice, individuals may be able to withdraw income gradually from their pension pot without using an income drawdown product. However, these products do not yet exist, this option has not been considered in this report.

This chapter assumes that cash drawn from pension pots will be treated as income rather than capital in the year it is crystallised and that there are no timing limits around when individuals can draw down income from their pension pots. It is not yet clear how pension funds that are available but not yet crystallised will be treated in terms of means-tested benefits. However, it is assumed here that, if an individual has a pension fund that could be accessed, they receive an amount equal to an annuity from this in terms of assessing their eligibility for means-tested benefits. Similarly, the tax treatment of any withdrawals from pension pots is not yet clear. Here, it is assumed that these are taxed at the prevailing thresholds for income tax for the income received in that year.

Interactions with means-tested benefits, tax allowances and rates will influence how individuals can draw down their pension income to maximise their rates of return

The interactions with means-tested benefits and tax allowances and rates will have an impact on some individuals' rates of return. The individuals described in Boxes 7 to 9 are based on real individuals included in the ELSA database and are assumed to retire after the introduction of the single-tier pension in 2016. The following section considers the implications in terms of tax and means-tested benefits for each of these individuals.

Tax and benefit rates for 2014-15 are used while income is in 2014 earnings terms. The examples have imputed other sources of income for these individuals and also indicate the rates of return on pension saving for these individuals. The rates of return are based on pension income only (including pension income due to automatic enrolment and pension income that relates to other arrangements) and do not take into account income from other sources such as savings and property.

Where Boxes 7 to 9 consider the purchase of an annuity, these have assumed that the individual would purchase a conventional annuity. However, in practice, different types of annuities are available, including fixed-term, variable and enhanced annuities where an individual has a pre-existing health condition. An annuity rate of 5.75% is assumed, based on a search of annuity rates using the Money Advice Service website.[39]

[39] www.moneyadviceservice.org.uk

Box 7: Individual C*

Full National Insurance (NI) record, previous Defined Benefit (DB) pension, automatically enrolled in 2012. She retires at State Pension Age (SPA) in 2022 and was automatically enrolled in 2012. In 2022 she receives a state pension of £154 per week (£8,009 per year), receives income of £1,005 per year from a DB pension, £900 from savings and investments and has accumulated a pension pot of £7,328 under automatic enrolment. She owns her home. She has a rate of return of 10%, assuming that she annuitises 75% of her pension pot at SPA and is therefore at low risk of automatic enrolment being unsuitable for her.

Individual C is not eligible for any means-tested benefits and, if she received her state pension, income from her DB pension only and income from savings and investments, she would receive £9,914 per year and would not be liable for income tax. On reaching SPA she could withdraw a tax-free lump sum of £1,832 from her pension under automatic enrolment without affecting her tax position.

Withdrawing her whole pension fund

If Individual C withdraws the whole of her pension fund in one year, her other income (£9,914) uses up most of her Personal Allowance (£10,000). This means that, while she could take 25% tax-free, she would pay 20% tax of £1,082 on most of her pension fund.

Purchasing an annuity

If Individual C uses the remaining £5,496, after she has taken 25% of her pension under automatic enrolment as a tax-free lump sum, to purchase an annuity, she might receive £237 per year – this would mean that her annual income would be £10,151 per year, giving rise to a tax liability of £30 per year.

The whole pot is placed in income drawdown

Individual C could place her whole pot in income drawdown and limit the amount taken out to avoid a higher marginal rate of tax, once she has taken her tax-free lump sum. Individual C could limit the income that she draws from her pension pot to £86 per year in the early years of retirement to avoid a tax liability, particularly if she is likely to spend the capital that is giving rise to her other investment and savings income in the early years of her retirement. Individual C may wish to increase the amount that she draws down if her spending needs increase over the course of her retirement.

*Figures in Boxes 7 to 9 are in 2014 earnings terms

Box 8: Individual D

Some career breaks, no previous pension, Housing Benefit in retirement, automatically enrolled in 2012. He retires at SPA in 2022 and was automatically enrolled in 2012. He receives a state pension of £154 per week (£8,009 per year) and is eligible for Housing Benefit and Council Tax Reduction in retirement and pays rent of £110 per week. He has accumulated a pension pot of £4,374 under automatic enrolment. He rents his home from a local authority. He has a rate of return of 9% assuming that he annuitises 75% of his pension pot at SPA and is therefore at low risk of automatic enrolment being unsuitable for him.

Individual D is eligible for means-tested benefits and, if he received his state pension, Housing Benefit and Council Tax Reduction only his income would be below the Personal Allowance and therefore he would not pay any tax.

Withdrawing his whole pension fund
If Individual D withdraws the whole of his pension fund of £4,374 in one year, he would remain under the capital limit for Housing Benefit and Council Tax Reduction and, therefore, this would not affect his eligibility for means-tested benefits. However, once he had taken his 25% tax-free lump sum he would pay tax at 20% on the excess of this fund over his Personal Allowance. Therefore, he would pay tax at 20% on £1,290.

Purchasing an annuity
If Individual D uses the remaining £3,281, after he has taken 25% of his pension under automatic enrolment as a tax-free lump sum, to purchase an annuity, he might receive £189 per year (just under £4 per week) – this would not have any implications for his Housing Benefit or his Council Tax Reduction as his income would remain below the income threshold (£165.15) for these benefits for people aged over 65.

The whole pot is placed in income drawdown
Individual D could place his whole pot in income drawdown. However, this would not give rise to any advantages, in terms of means-tested benefits and tax over taking an annuity. However, he could choose to withdraw less or more in given years than he would receive as an annuity.

Box 9: Individual E

Full NI record, previous DC scheme and personal pension, automatically enrolled in 2012. He retires in 2026 and was automatically enrolled in 2012. He receives a state pension of £156.15 per week (£8,120 per year), and a combined pension pot worth £21,700 from his previous pensions. He receives income from property of £10,000 per year and income from savings and investments of £5,000 per year. He has accumulated a pension pot of £16,300 under automatic enrolment. He has a rate of return of 9% assuming that he annuitises 75% of his pension pot at SPA and is therefore at low risk of automatic enrolment being unsuitable for him.

Individual E is not eligible for any means-tested benefits and if he receives income from his state pension, property and savings investment only he would pay tax at 20% on the amount over his Personal Allowance. As the Personal Allowance is £10,000, he would pay tax of £2,624 on his £23,120 income.

Withdrawing his whole pension

If Individual E withdraws his whole pension fund of £38,000, after he had received 25% tax- free he would pay tax at the 20% rate up to the higher rate threshold (£31,865), and on the remainder he would pay 40% rate tax. This would give him a tax liability of £7,651 on his pension pots.

Purchasing an annuity

If Individual E uses the remaining £28,500, after he has taken 25% of his pension as a tax-free lump sum, to purchase an annuity, he might receive £1,639 per year. He would pay tax of £327.80 (at the 20% rate) on this.

The whole pot is placed in income drawdown

Individual E could place his whole pot, after taking 25% as a tax-free lump sum, in income drawdown, take a higher amount per year than he would receive from purchasing an annuity, and limit the amount taken out initially to avoid a higher marginal rate of tax once he has taken his tax-free lump sum. Individual E could limit the income that he draws from his pension pot to £18,745 in a tax year, without paying tax at the higher rate. This would give him a net income from private pensions in that year of £14,996. However, if he spends all of this private pension income soon after receiving it he may not have sufficient income to sustain him later in his retirement.

There is potential for individuals to manage their retirement income to minimise any tax liabilities and offsets to means-tested benefits

These examples illustrate the potential for individuals to manage their retirement income, under the flexibilities outlined in the 2014 Budget, to minimise any tax liabilities and offsets to means-tested benefits. If individuals do decide to withdraw income from their pension pots and are not planning to spend it immediately they will be able to invest up to £15,000 per year in an Individual Savings Account (ISA) from July 2014, minimising tax on any interest or investment returns that they subsequently accrue. There is also more flexibility around how this is held, with individuals able to hold their entire ISA in cash or in shares. The Chancellor has also proposed the introduction of a pensioner bond in January 2015 that will pay up to 4% interest per year.

Only the implications for tax and means-tested benefits have been considered here while other factors, such as personal preferences and the annual income that individuals require at different points of their retirement, also have implications for when they will prefer to draw down their income. However, this does require individuals to have an understanding of a range of factors and of how these factors interact with each other.

Automatic enrolment combines an initiative that looks to harness individuals' inertia with the provision of simple information that was designed to be easy to understand. This is reinforced by the combination of tax relief and employers' contributions making it financially attractive to individuals and meaning that it is possible to generalise that, in many cases, remaining enrolled will benefit the individual. The proposals outlined in the Budget 2014 mean that this is likely to be the case for an even greater proportion of those individuals who are enrolled in workplace pensions. Given this development, it is important that the benefits of saving in a workplace pension continue to be communicated to individuals.

However, the Budget 2014 proposals provide individuals with greater choice at retirement, something that makes decisions around retirement income increasingly complex. It is important that individuals receive guidance that will enable them to understand the range of options available to them throughout their retirement and the possible implications of their choices – and that they are encouraged to engage with this type of decision well ahead of and, in some cases, through retirement.

The Government has recognised the complexity of the new landscape and has proposed a duty on pension providers and trustees to provide face-to-face guidance around the options available to them at retirement. In particular it is important that individuals are provided with guidance to enable them to understand how their decisions around retirement income interact with the tax and means-tested benefits systems. Any discussion is complicated by the fact that, if individuals choose not to purchase an annuity, they will need to take into account factors that are difficult to judge, such as their life expectancy and likely income requirements in later life. Any detailed financial planning should also take into account other developments such as the higher ISA limits, the pensioner bonds on offer, and the potential costs of long-term care needs in later retirement.

Communications from government, employers and industry bodies targeted at older workers during their working lives could illustrate the potential gains from them staying automatically enrolled, and how easily their DC pension can be accessed from age 55 should they need it. This could help to ensure that opt out rates for older workers remain low, or even reduce, as more employers reach their staging dates and as the minimum contributions rise between now and 2018.

Greater clarity over the Budget 2014 changes and the new flexibilities on how to access pension saving at retirement will also help employers who may wish to encourage their older workers to stay saving, or save more, into a workplace pension, in order to ensure they can afford a comfortable retirement and retire at an age in line with their personal expectations.

The provision of this is likely to be challenging because of both the scale and the complexity of advice. There are expected to be 352,000 males aged 65 and 350,000 females aged 62 in the UK in 2014, the respective State Pension Ages for men and women.[40] While not all of these individuals will have DC pensions, the provision of advice to the group of individuals who do have them as they approach retirement is a large undertaking. Experience to date suggests that the provision of written information, such as Combined Pension Forecasts,[41] achieves limited results in terms of increasing knowledge around pensions. The provision of bespoke information, such as that provided to individuals by The Pensions Advisory Service (TPAS) has been judged to be more effective; however, this type of organisation would need to significantly expand their capacity to be able to provide advice on the scale outlined in the Budget 2014.

Increased contribution levels could increase individuals' rates of returns
Minimum employer contributions are being phased in, starting at a minimum 1% of band earnings in October 2012. The increase in minimum employers' contributions from 1% to 2% will begin on 1 October 2017. Contributions will then increase to 3% from 1 October 2018.

Overall, there is a recognition that saving the minimum contribution rate of 8% of band earnings will not ensure adequacy of retirement income. Research conducted by the PPI found that, in more than half of the scenarios modelled in the report income was below the target replacement income.[42] In many of these cases it is likely that remaining automatically enrolled will be beneficial for the individual but may still not ensure that their retirement income meets their needs. There is an additional concern around older workers currently approaching retirement. If phasing arrangements mean that members of this age group have built up smaller pension pots than younger individuals, there is a risk that, if converted to an income, a greater proportion of their pension pot will be offset by reductions to means-tested benefits.[43]

This issue could be addressed by bringing forward the increase of employer contributions for older employees. However, employers may be reluctant to discriminate between workers.

At the same time, proposals outlined in the Budget 2014 which give individuals flexibility around how they draw down their pension, alongside the favourable tax treatment of pensions, may mean that making higher

[40] ONS 2012 population projections of life expectancies
[41] DWP (2005)
[42] PPI (2013)
[43] Johnson, Yeandle and Boulding (2010)

pension contributions (more than 8% of band earnings) is attractive to many individuals. This would also contribute to the adequacy of individuals' retirement income. The specific elements and mechanisms that may make this advantageous to individuals include:

- 25% tax-free lump sum
- A larger pension pot might mean that a smaller proportion of their pension pot is offset by reductions to means-tested benefits in retirement (if their level of retirement income means that they are on the means-tested taper)
- Pension contributions may reduce their income that is compared to their applicable amount for many means-tested benefits in working life (if they are on the means-tested taper)
- Access to their pension savings from age 55 onwards, should they need it (from April 2015 onwards)
- Where they have other income, e.g. from savings and investments, scope to structure their income so that it meets their needs over the course of their retirement while minimising their tax liability.

While there is a role for both the Government and employers to encourage additional pension saving, employers may be particularly well-placed to use new flexibilities around accessing DC pensions to reward and retain older employees. This may include options such as employers making larger payments into an employee's pension as they approach retirement, or allowing employees to work part-time while drawing down some of the income from their workplace pension. More innovation in drawdown offerings within existing DC pension schemes could support this and help facilitate more flexible retirement patterns.

Individuals may also choose to increase their annual income from pensions by delaying drawing down their retirement income

Whilst the proposals allow for the pot to be accessed from age 55 onwards we assume here that SPA continues to act as a strong default for retirement behaviour and that SPA is the most likely age at which individuals will choose to access their pots. However, individuals may choose to carry on working and delay drawing their retirement income in order to increase their annual income.

For instance, an individual, automatically enrolled in 2012 and retiring at age 66 in 2024, who has made the minimum contributions under automatic enrolment, might retire with a total weekly income of £180.38 if they draw down both their state and private pensions at their SPA. However, if they continue saving and delay drawing down their private pension until 2 years after their SPA (age 68), they might receive a total annual income of £185.23.[44]

[44] Total income includes state and private pension and other payments such as Winter Fuel Allowance

Summary

- 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.
- Interactions with means-tested benefits, tax allowances and rates will influence how individuals can draw down their pension income to maximise their rates of return.
- The Budget 2014 proposals provide individuals with greater choice at retirement, making decisions around retirement income increasingly complex. The Government has recognised the complexity of the new landscape and has proposed a duty on pension providers and trustees to provide face-to-face guidance around the options available to them at retirement.
- Communications from government, employers and industry bodies targeted at older workers during their working lives could illustrate the potential gains from them staying automatically enrolled, and how easily their Defined Contribution (DC) pension can be accessed from age 55 should they need it.
- Depending on their circumstances, individuals could increase their contribution level to increase their rates of return.

Annex one: technical annex

This appendix describes the assumptions and methodology for the modelling in this report. The first part, presented in Chapter 3, uses PPI's Individual Model to consider a number of more detailed case studies. The second part, presented in Chapter 4, uses a Dynamic Model of earnings and pension saving to illustrate what being auto-enrolled might mean for respondents of the English Longitudinal Study of Ageing (ELSA). Both models were developed with grants from the Nuffield Foundation.

General assumptions

The following assumptions are used in all modelling work in this report:

- Long-term increases in the Retail Prices Index (RPI) of 3.3%;
- Long-term increases in the Consumer Prices Index (CPI) of 2%;
- Long-term annual earnings growth of 4.4% in nominal terms;
- Short-term economic assumptions for RPI, CPI and annual earnings growth in line with Office for Budget Responsibility projections.[45]
- Expected investment returns of 6% in nominal terms, before charges, corresponding to a mixed equity/bond fund in the ratio of 60% equities, 40% bonds. This could overstate investment returns if the older workers are placed in more bond heavy, lower risk funds.
- Annual management charges of 0.5% of assets under management for existing (pre-automatic enrolment) DC schemes;
- Band salary is the amount of salary on which auto-enrolment minimum contributions must be made. In 2014/15 the band salary is on earnings between £5,772 and £41,865. These are assumed to remain in line with the Lower Earnings Limit (LEL) and the Upper Earnings Limit (UEL) – this means that they are uprated by earnings).
- When auto-enrolled, individuals and their employers are assumed to contribute at the minimum levels required under automatic enrolment legislation (phased in from a combined contribution of 2% of band salary in 2012, rising to 8% of band salary in 2018 in accordance with existing regulations)
- Auto-enrolled employees are assumed to enter schemes with the equivalent of a 0.5% annual management charge.

These assumptions are the result of consultation with the PPI's modelling review board, which consists of a number of experts in the field of financial modelling.

Further assumptions, specific to different modelling and scenarios, are outlined in later sections.

[45] OBR (2013)

Internal Rate of Return
The Internal Rate of Return (IRR) is a measure of the implied return of a set of cash out-flows and subsequent cash in-flows. In financial language it is the discount rate which would make the net present value of a series of payments equal to zero. It can be thought of as the interest rate that would have to be achieved if a given series of payments (the cash out-flows) were to be invested to make a fund that would be able to exactly produce a given series of income (the cash in-flows).

The modelling in this project compares the difference between an individual's or household's circumstances if they were to remain auto-enrolled, versus opting out. In its simplest form this difference would consist of pension contributions before retirement, and a pension income after retirement. In which case the pension contributions would be the outgoing cashflows and the resulting pension income would be the incoming cashflows. The IRR would therefore be a combination of the investment return on the assets during the building up of the pension scheme, the rate of charges paid, and the rate of interest assumed in the calculation of the annuity. However other impacts, such as employer contributions, tax relief and the interaction with means-tested benefits and tax among others alter this difference-in-circumstances in various ways and therefore impact on the IRR.

The IRR is dependent upon other assumptions made in the model regarding potential outcomes, for this reason the results in this paper are considered in risk categories that are defined in relation to the other assumptions.

Individual modelling
The analysis in Chapter 3 used results obtained from the PPI's Individual Model. This model uses individual characteristics and working patterns to project retirement income from private pensions, state pensions and other benefits for hypothetical individuals.[46]

Box A1 outlines the assumptions that apply to all individual modelling work carried out in this project.

[46] For more information on the Individual Model, see PPI (2003) *The Under-pensioned*

Box A1: Individual modelling assumptions

- All individuals are assumed to purchase a single life, level annuity with their DC private pension saving.
- Individuals saving in DC schemes are assumed to purchase a single life, level annuity after taking their 25% tax-free lump sum. In order to allow for the lump sum in the IRR calculation, it is converted into a stream of income at the same rate as the pension annuity, but it does not attract tax. This approach is consistent with the approach used in the previous PPI report *Are Personal Accounts Suitable for All* but in this report we assume that the annuitised lump sum does not affect means-tested benefits.
- The current state pension system will be replaced by the single-tier pension for those reaching SPA after April 2016.
- The current system of working-age benefits are in place rather than Universal Credit.
- Individuals receive their state pensions at their SPA as currently announced and legislated for.[47]

Individuals modelled

The analysis in Chapter 3 considers the IRR for hypothetical individuals aged between 50 and 65 in 2013.

Assumptions have been made about the individuals' working and saving behaviours. These are described in Box A2, including the assumptions made under any alternative scenarios.

Box A2: Assumptions relating to median earners

Baseline assumptions

- Individuals are assumed to be single.
- Individuals are assumed to have a full working life and to retire at their SPA.
- When working, earnings are at the median of age and gender-specific earnings levels for employees.
- Employees are auto-enrolled in 2012 into a pension scheme at the minimum required contribution level, allowing for the phased increase of contributions up to 8% by 2018.
- Individuals have no previous pension saving.
- In the baseline scenario the individuals are not eligible to receive Housing Benefit or Council Tax Reduction.

Housing Benefit post retirement

- For the analysis that considers the IRR of people in receipt of Housing Benefit, it is assumed that they receive Housing Benefit of £75 per week.

[47] The Government announced in the Chancellor of the Exchequer's Autumn Statement 2011 that they would raise the State Pension Age to age 67 between April 2026 and April 2028.

Analysis of the English Longitudinal Study of Ageing
The English Longitudinal Study of Ageing (ELSA) is an on-going longitudinal study of a range of socio-economic and demographic indicators of households with an individual aged over 50 in England. Chapter 4 of this report presents aggregated analysis of deterministic projections based on current earnings and savings levels in the ELSA Wave 3 dataset (2006) made using a dynamic micro-simulation model.

The Dynamic Model uses Wave 3 data uprated to the baseline year for automatic enrolment of 2012, consistent with the approach used by the PPI in *Retirement Income and Assets: the implications for retirement income for Government policies to extend working lives*, the project that the Dynamic Model was initially created for. More recent waves of ELSA data are now available, however given the timing of new releases and the production of the report (in particular with Wave 6 just released) the Wave 3 data has been retained. A comparison of Wave 3 data and subsequent Waves suggests that the key variables, in particular around earnings and the likelihood of saving into an existing pension, have not significantly changed between Waves.

This analysis is based upon data and a set of assumptions regarding future behaviour that may not be fully representative. **As a result of this, the results of the modelling should not be taken as forecasts of future levels of retirement savings or generalised to the whole population.**

Method and assumptions
This section provides a brief description of the method and assumptions used in this modelling. The main assumptions are then summarised in Box A3.

The individuals considered in the modelling set out in Chapter 4 Ware those in the ELSA Wave 3 dataset, aged between 50 and SPA[48], belonging to a Benefit Unit[49] that has at least one member still in work, who is not currently an active member of a pension scheme and who is earning enough to be eligible to be auto-enrolled. This sample consists of approximately 3,000 individuals aged 50-SPA of which around 860 were found to be eligible for auto-enrolment.[50]

Automatic enrolment is assumed to occur in 2012 for all employees, however in reality there is staging of the automatic enrolment process between 2012 and 2017 for existing employers, based on the size of the employer's workforce. The ELSA data does not include information on the size of the workforce of an individual's employer. In the interest of simplicity and to include as many of the individuals in the data as possible, it was decided that 2012 would be assumed as the automatic enrolment date for all relevant employees in the dataset.

[48] This refers 65 for men and 60 for women.
[49] In this analysis, a benefit unit is considered to consist of either a single adult or a couple living in the same household.
[50] The criteria used for automatic enrolment eligibility was that they were in work, earning over the earrings trigger for automatic enrolment amount and not currently saving into a pension.

The financial data has been adjusted to make it consistent with 2012 earnings levels, which is taken as the base year for the model. In subsequent years of the projection, individuals are aged and their earnings increased in line with average earnings growth. Pension saving is also projected as outlined in Box A3.

In each year of the projection, potential retirement incomes for each individual are calculated, based upon the projected value of state pension entitlement, and current and deferred private pension entitlement. These are then converted into Benefit Unit incomes, by matching individuals with their partners, so that Pension Credit, Housing Benefit and Council Tax benefit entitlement can be estimated.

To calculate the IRR we use a stream of cashflows representing the difference between remaining auto-enrolled and opting out. This is achieved by running the Dynamic Model twice. The first run assumes that all of the people eligible to be auto-enrolled are auto-enrolled in 2012, and remain so. The second run assumes that all people opt out of auto-enrolment and make no contributions.

Subtracting each benefit unit's net cashflow from the "opting out" run from the "remain auto-enrolled" provides a cashflow stream that represents the impact on their annual cashflow of being auto-enrolled. In the simplest case this would be a negative impact in the early years before retirement, representing their own employee pension contribution, switching to a positive impact after retirement when their pension is annuitised into an income.

The model allows for more than just the pension fund being built up and the resulting income from that pension. The change in pension income level can affect other factors affecting post retirement income, such as means-tested benefits and income tax.

The impact on pre-retirement tax relief is, in the Dynamic Model, assumed to be limited to the government contribution to the minimum pension contribution. This is in effect 20% tax relief. The positive impact of tax relief on higher rate taxpayers is therefore understated; consequently the IRR may be understated for higher rate taxpayers. However, no higher rate taxpayers feature in the "high risk" category which this work primarily aims to identify.

Box A3: Baseline dynamic modelling assumptions

- Individuals currently in work are able to continue working and saving until their SPA.
- Individuals not currently contributing to a pension, but who will be eligible for auto-enrolment, are auto-enrolled into a DC pension at the minimum contribution rates (including phasing) required under existing regulations.[51]
- Individuals do not access their private pension savings until their SPA.
- Individuals saving in DC schemes are assumed to purchase a single life, level annuity after taking their 25% tax-free lump sum. In order to allow for the lump sum in the IRR calculation, it is converted into a stream of income at the same rate as the pension annuity, but it does not attract tax. This approach is consistent with the approach used in the previous PPI report *Are Personal Accounts Suitable for All* but in this report we assume that the annuitised lump sum does not affect means-tested benefits.
- Where appropriate, DB members are assumed to convert 25% of their pension into a lump sum.
- Individuals receive their state pensions at their SPA as currently announced and legislated for.[52]
- The current state pension system is assumed to be in place until 2016, thereafter the single-tier pension is introduced for those reaching SPA after that date.
- The 'triple-lock'[53] is assumed to remain in place for the duration of the modelled period.
- State pension entitlement not in payment is not recorded on ELSA. We have estimated entitlement, assuming all individuals receive the full amount of BSP. Average S2P/SERPs entitlement, based on PPI Aggregate Model projections is assigned to individuals by contracted out status.
- Automatically enrolled people are assumed to qualify for a full single-tier pension if they retire after April 2016. A foundation pension based on BSP and additional pension as set out above is calculated for those who reach SPA after the introduction of the single-tier. If the foundation amount is greater than the single-tier level the individual is assumed to receive a CPI linked "protected amount". Pensions in payment are, however, recorded with some respondents having responded that they received no state pension.

[51] Contributions are phased in between 2012 and 2019 to reach 8% minimum total contributions on band earnings by 2019 - between £5,715 and £38,185 (2010/11 earnings terms)
[52] The Government announced in the Chancellor of the Exchequer's Autumn Statement 2011 that they would raise the State Pension Age to age 67 between April 2026 and April 2028.
[53] The triple-lock provides an increase factor defined by the greater of the annual change in average earnings, CPI or by 2.5%

Data

The model makes use of financial variables taken from the ELSA Wave 3 dataset. The most important variables considered for each individual concern:

- Earnings
- Pension contributions
- Current and deferred pension entitlement

The required data is not always available, as ELSA contains incomplete data on the level of deferred pension entitlement. In order to estimate this, broad assumptions on average contribution levels, investment returns and accrual rates were used in conjunction with available data on pension type, dates of scheme membership and current gross salary. Where scheme membership and salary data were unavailable, values were randomly assigned using a 'hot-decking' procedure based on the financial wealth quintile of the individual. This method is the approach used by the IFS in their paper *Estimating Pension wealth of ELSA Respondents.*[54]

In addition to this, approximately 1% of the individuals included in this modelling have some form of pension entitlement from a former spouse. This has not been included in the analysis.

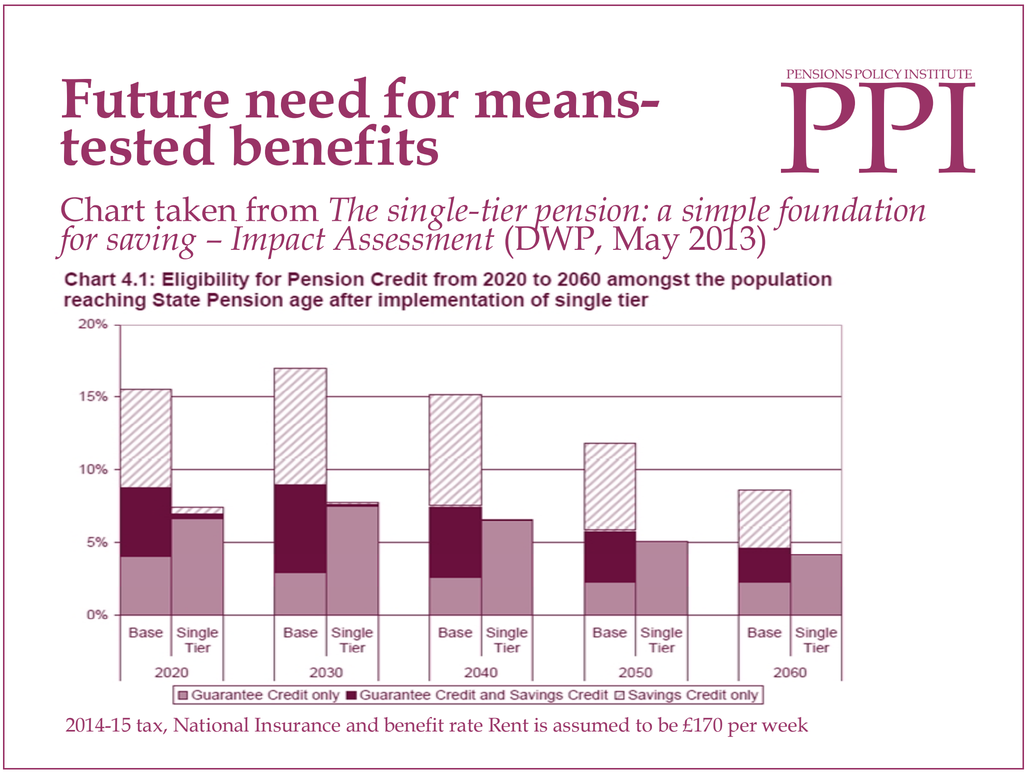
[54] Banks, Emmerson, Tetlow (2005)

Annex 2: Automatic enrolment and means-tested benefits

Eligibility for Savings Credit will decrease under the single-tier

Chart A1 shows estimates for eligibility for Pension Credit during the years following the introduction of the single-tier state pension. While people will continue to be eligible for Guarantee Credit, eligibility for Savings Credit will be removed for those reaching SPA following the introduction of the single-tier state pension. The Government has indicated that support will be retained for the 5 years following April 2016 for those people who may have otherwise received more help with their housing costs by virtue of the availability of the Savings Credit.[55]

Chart A1[56]



Level of entitlement to Housing Benefit and Council Tax Reduction is not expected to change significantly under the single-tier

In contrast, the level of entitlement to Housing Benefit and Council Tax Reduction amongst those people who will reach SPA after the introduction of the single-tier state pension is not estimated to change significantly. Therefore, private pension saving may have an impact on individuals' entitlement to these means-tested benefits. Table A1 shows the DWP's estimates around levels of entitlement to Housing Benefit and Council Tax Reduction after the introduction of the single-tier state pension. Any private

[55] DWP (2013)
[56] DWP (2013)

pension saving after the introduction of the single-tier state pension may continue to lead to the loss of some mean-tested benefits.

Table A1: Future needs for means-tested benefits[57]

Entitlement to Housing Benefit and Council Tax Reduction (amongst the population reaching SPA after the implementation of the single-tier state pension.						
		2020	**2030**	**2040**	**2050**	**2060**
Housing Benefit	Base	12%	16%	15%	12%	10%
	Single-tier	12%	15%	14%	12%	10%
Council Tax Reduction	Base	35%	37%	32%	28%	23%
	Single-tier	34%	34%	30%	26%	23%

This is likely to have more of an impact for older people as a higher proportion of households where the head of household is aged over 65 receive Housing Benefit (15% compared to 13% of the population of households overall).[58] Similarly, a greater proportion of income from their workplace pension could reduce means-tested benefits rather than increase overall income in comparison to people who started to contribute to a workplace pension at a younger age (who, on average, will have accrued a bigger pension pot under automatic enrolment).

Means-tested benefits are typically calculated at the household level. This highlights the importance of considering the circumstances of the wider family when determining whether it is appropriate for a particular individual to make private pension savings.[59] However, in February 2013, approximately 80% of Housing Benefit recipients were single adults[60], something that suggests that, for this group, wider family circumstances may have a limited impact in terms of the suitability of private pension saving.

Individuals who claim Housing Benefit when they are of working age typically claim Housing Benefit in retirement

Housing Benefit data available does not indicate whether it is those individuals who claim Housing Benefit when they are of working age who subsequently claim Housing Benefit in retirement. However, it is generally accepted that individuals' income decreases in retirement and those people who claim Housing Benefit when they are of working age typically claim Housing Benefit in retirement – while additionally some people who do not receive Housing Benefit during their working life receive Housing Benefit in retirement (e.g those people who are renting but have a high enough income in their working life not to be eligible for Housing Benefit). This is consistent with figures which show that in 2011-12 12% of those households with a head of household aged 60-64 were in receipt of Housing Benefit while this figure was 15% of households where the head was aged over 65.

[57] DWP (2013)
[58] DWP (2013)
[59] Johnson, Yeandle and Boulding (2010)
[60] DWP (2013)

A significant proportion of Housing Benefit recipients may not be automatically enrolled
Housing Benefit figures suggest that a large proportion of recipients are not currently working or may have earnings that are lower than the threshold for automatic enrolment of £10,000 (2014-15). Figures for February 2013 are below. Entitlements to benefits such as Income Support and Jobseekers Allowance can 'passport' individuals to automatic entitlement to Housing Benefit. This means that some groups are entitled to full Housing Benefit because of their entitlement to other benefits such as Income Support, Jobseekers Allowance or Pension Credit. Table A2 indicates where individuals are entitled to Housing Benefit because of their entitlement to other benefits under the heading 'Passported'.

Table A2: Housing Benefit by group[61]

Type of claim	**Number of recipients (%) (November 2013)**
Non-passported: not in employment	798,897 (16%)
in employment	1,036,816 (21%)
Passported: Income Support	692,031 (14%)
Jobseekers Allowance (income-based)	569,822 (11%)
Employment and Support Allowance (income-based)	896,400 (18%)
Pension Credit (Guaranteed Credit)	989,265 (20%)
Passport status unknown	2,271 (<1%)
Total	**4,985,502**

These figures also show that, in November 2013, 16% of total recipients were not passported to Housing Benefit and not in employment. This means that this group would not be automatically enrolled. An additional 43% are in receipt of Income Support, Jobseekers Allowance or Employment and Support Allowance.

In order to be eligible for these benefits, individuals must generally work 16 hours or less per week – therefore, it is unlikely that many of these individuals will have earnings from employment of more than £10,000, the threshold for automatic enrolment. To illustrate this, an individual who works 16 hours per week would have to earn at least £12.02 per hour to reach the threshold for automatic enrolment, well above the National Minimum Wage of £6.50 per hour in 2014.

While some individuals in receipt of Guarantee Credit may still be working, it is only paid to those individuals who have an income below £148.35 per week, the equivalent of £7,714 per year. Therefore, they would not be automatically enrolled into a pension as their earnings are less than the threshold. However, individuals whose earnings are above the Lower Earnings Limit (£5,772 in

[61] DWP Stat-Explore

2014-15) but below the eligibility threshold for automatic enrolment can voluntarily opt in to a pension scheme and must be treated the same as those individuals automatically enrolled in terms of the type of scheme they join and their employer's contributions. Those individuals who earn less than the Lower Earnings Limit can ask to join the pension scheme but the employer is not required to make a contribution.

Individuals who qualify for Housing Benefit and are eligible for automatic enrolment are likely to be in employment and not passported to Housing Benefit

This means we might expect many individuals who are receiving Housing Benefit and eligible to be automatically enrolled to be in the group of individuals who are in employment and not passported to Housing Benefit.

These figures show that, in November 2013, around 1.04 million people were in employment and receiving Housing Benefit. It may be that some single people who do not have a family and are not eligible for Housing Benefit disability related premiums will not earn enough to be automatically enrolled. Where an individual is a lone parent or receives disability related premiums they may be able to earn more and still be eligible for Housing Benefit because they have a higher Housing Benefit Personal Allowance. However, these figures do not enable an assessment of whether this is the case. In addition, particular groups of individuals, such as lone parents, are able to have higher earnings while still receiving Housing Benefit. These groups may be eligible for automatic enrolment.

However, individuals also move between groups; for instance an individual who is unemployed in February 2013 may go back to work in June 2013 and, as a result, be automatically enrolled into a pension. In November 2013, the Office for National Statistics estimated that, in each quarter of the past year, 500,000 individuals have moved from unemployment into employment while just over 400,000 have moved from employment to unemployment.[62]

[62] ONS (2013)

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