

## Chapter 5: Personal accounts and existing pension provision

- 5.1 In *Security in retirement: towards a new pensions system*, the Government made clear that personal accounts should complement, rather than compete with, existing high quality pension provision. Chapter 4 has discussed measures to make personal accounts compatible with employers' existing arrangements. This chapter describes how the reforms are designed to be compatible with existing pension provision and includes research findings on their potential impact. The policy areas discussed include options for:
- personal accounts transfer policy;
  - an annual limit on contributions; and
  - the future of stakeholder pensions.

### Personal accounts transfer policy

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- 5.2 The Department for Work and Pensions (DWP) consultation process revealed a large degree of consensus that the approach to the transfer of pension savings, both to and from the personal accounts system, would be a significant determinant of the impact of personal accounts on existing pension provision. The Government has looked at several options for the policy on transfers, which are described below. The Government concluded that there was a strong case for prohibiting both inward and outward transfers, but that these arrangements should be reviewed after the implementation of the reforms, in 2020.

## Inward transfers

### Option 1: Prohibit transfers of funds into personal accounts from existing pension vehicles

- 5.3 A prohibition of transfers into personal accounts would mean that funds from existing pension vehicles could not be transferred into personal accounts. Prohibiting inward transfers could be beneficial in many ways such as:
- avoiding administrative cost and complexity associated with transfers for personal accounts and existing providers;
  - minimising the impact on the existing market. Some start-up costs incurred when establishing pension products might not be recoverable through an ongoing annual management charge (AMC) if funds are transferred into personal accounts, worsening the current profitability of current pensions. This would be a particular issue in the shorter term when the take-up of personal accounts is uncertain;
  - avoiding the need for individuals with significant accumulated pension savings to seek regulated advice before transferring their funds into personal accounts. This would involve advice from financial advisers to compare the relative advantages of the existing scheme and personal accounts, the cost of which individuals themselves would have to bear;
  - providing an important psychological signal for employers and individuals that personal accounts are aimed at a specific market (**moderate to low earners** without access to high quality employer provision) and **current good provision** should continue. This could be an important safeguard against the 'levelling down' of existing provision; and
  - allowing unlimited transfers into personal accounts could also lead to a more rapid growth in assets managed through the scheme. This could risk undesirable financial market impacts.

- 5.4 It is unclear how many individuals in the target group for personal accounts would use the facility to transfer in funds from other pension schemes. Data from Her Majesty's Revenue and Customs (HMRC) on existing pension savings indicate that, overall, 47 per cent of personal pension funds are worth less than £5,000. Some 55 per cent of funds belonging to individuals with earnings below £20,000 are worth less than £5,000, and around two-thirds of those are worth less than £2,500. About 26 per cent of funds belonging to individuals with earnings above £30,000 are worth less than £5,000.<sup>1</sup> Data from the Association of British Insurers (ABI) on pension transfers shows that the average private pension transfer is worth over three times more than the average private pension fund.

### Option 2: Allow transfers of funds into personal accounts from existing pension vehicles

There are several arguments in favour of allowing the transfer of pension funds into personal accounts:

- pension providers may welcome the transfer out of pension funds, especially for small funds where the annual management charge does not generate sufficient revenue to cover their ongoing administration costs;
- personal accounts might benefit from economies of scale by increasing funds under management; and
- individuals would be able to consolidate their pension funds, which would help to maintain simplicity and flexibility, and also potentially assist individuals in finding better value annuities.<sup>2</sup>

### *Proposal on inward transfers*

- 5.5 The Government believes that it is appropriate to prohibit transfers into personal accounts. This would be an effective way of minimising turbulence in the personal pension market, promoting simplicity for individuals, and reducing implementation risk. However, these arrangements should be reviewed in 2020 to assess whether these assumptions have proved correct, and decide whether the ongoing prohibition remains appropriate.

<sup>1</sup> HMRC Table 7.13 Personal and Stakeholder Pension Fund Values – Number of individuals holding by employment status, earnings and fund value.

<sup>2</sup> The detailed design of the decumulation process will be the responsibility of the personal accounts board. There may be ways to allow individuals to consolidate funds at the point of retirement without requiring wholesale transfers.

## Outward transfers

- 5.6 By definition we have no evidence on whether individuals may want to transfer their personal account funds into other pension vehicles. The personal accounts scheme could allow transfers out in two ways:
- when an individual moves to an employer who runs an exempt scheme; or
  - if an individual builds up a fund in personal accounts, and then transfers it into another pension vehicle.
- 5.7 It is estimated that during any single year, 1–1.5 million individuals within the personal accounts scheme (around 16 per cent of the total) will move employers, and will perhaps encounter the transfer issue. A proportion of this group will move to another employer offering personal accounts and will be able to continue contributing to their existing personal account through the clearing house. However, others will move to an employer with an exempt scheme and may want to transfer their built up personal account funds into the new arrangements, for example to keep all their pension provision in a single place.<sup>3</sup> Individuals who choose to keep their pension funds in personal accounts will, however, continue to benefit from investment growth and the low charges applied to funds.

### Option 1: Prohibit outward transfer of funds from personal accounts into existing pension vehicles

- 5.8 A prohibition of transfers out of personal accounts would mean that funds could not be transferred into other pension vehicles. Restricting outward transfers would have several advantages such as:
- promoting administrative and operational simplicity;
  - limiting any market turbulence in the initial post-implementation period;
  - allowing the personal accounts scheme to build up a larger fund, reducing the AMC; and
  - providing an important psychological signal for employers and individuals that personal accounts are aimed at a specific market (moderate to low earners without access to high quality employer provision) and that current good provision should continue. This could be an important safeguard against the levelling down of existing provision.

<sup>3</sup> There is currently no way of estimating how big these respective groups might be, as it will depend on patterns of job moves and whether employers chose to provide exempt schemes.

### Option 2: Allow outward transfer of funds from personal accounts into alternative pension vehicles

- 5.9 There could be benefits from allowing transfers from personal accounts into other pension funds:
- pension portability is an important feature for individuals, and will be automatic when individuals move between employers who both offer personal accounts. Research with individuals showed that portability was seen as a real advantage of the scheme. Participants believed that people are more likely to change jobs frequently now and a scheme which takes account of these changing circumstances is to be welcomed. This feature was also seen to increase levels of ownership over the scheme and thus, ensure that people take greater personal responsibility for providing for their retirement;<sup>4</sup>
  - allowing transfers out could make a personal account a 'stepping stone' to wider provision; and
  - individuals would be able to consolidate their pension funds outside of personal accounts, which would help to maintain simplicity and flexibility.

#### *Proposal on outward transfers*

- 5.10 Although there could be advantages to allowing outward transfers, the Government believes that they should be subject to the same restrictions as inward transfers. This should be reviewed in 2020 along with the prohibition of inwards transfers. Such a prohibition will help minimise up-front administrative and operational costs and reduce market turbulence and implementation risk.

<sup>4</sup> Hall S, Pettigrew N and Harvey P, 2006, *Public attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 370.

## Contribution limit

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- 5.11 The Pensions Commission proposed an annual limit on the total value of contributions into a personal account of around £3,000 a year, twice the default contribution for a median earner. The rationale was that the more attractive the personal accounts scheme is to employers and higher income individuals, the more likely they are to move from their own schemes and join personal accounts instead. This would then adversely impact on existing provision. A contribution limit would help ensure a clear distinction between personal accounts and existing schemes. If the limit is set at an appropriate level it will allow moderate to low earners in the target group for personal accounts to save for retirement, without making the scheme unnecessarily attractive to higher earners who have access to other forms of pension provision.
- 5.12 The Government has proposed an overall minimum contribution rate of 8 per cent of total contributions on a band of earnings from the Primary Threshold to the Upper Earnings Limit for National Insurance contributions which are currently around £5,000 and £33,000, respectively. The total contribution consists of:
- 3 per cent from employers;
  - 4 per cent from employees; and
  - 1 per cent from the State in the form of basic rate tax relief under the current rules.
- 5.13 The 8 per cent default contribution rate is designed to enable a median earner with a reasonably full contribution history to achieve a 45 per cent replacement rate, assuming that annuity rates and constant rates of return remain in line with current expectations. Therefore, if individuals have different earnings patterns or higher retirement aspirations they may want to make additional contributions. For example, if a median earner wishes to reach the two-thirds replacement rate identified as a benchmark replacement rate by the Pensions Commission's first report then they would probably need to make significant additional contributions above the default level.
- 5.14 The options are to have a contribution limit: either set at the level recommended by the Pensions Commission or at a different level; or to not have a contribution limit at all. The Government has concluded that a total contribution limit set at about £5,000 would be appropriate, but should be reviewed in 2020 alongside the policy on transfers.

## Option 1: Impose an annual contribution limit

- 5.15 When considering the level of any possible limit, the market impact considerations in the previous paragraphs need to be balanced with the needs of a range of individuals in the scheme. Table 5.1 illustrates the effects of different annual contribution limit levels on different income levels. The table assumes that each individual is contributing the default level of 8 per cent of salary on the band of earnings of between £5,000 and £33,000.

**Table 5.1: Effects of different annual contribution limit levels on different income levels**

Annual income level (£)	Default contribution rate (8%)	Potential additional voluntary contributions given different contribution limits		
		£3,000 (£)	£5,000 (£)	£8,000 (£)
15,000	800	2,200	4,200	7,200
23,000	1,450	1,550	3,550	6,550
35,000	2,300	700	2,700	5,700

Source: DWP modelling

- 5.16 For the lower earner on £15,000, hitting any of the limits requires significant additional contributions. The median earner could be somewhat constrained by a limit of £3,000, particularly if their employer contributed more than the minimum. The higher earner would find a £3,000 limit restrictive if the employer wished to contribute more than the minimum.
- 5.17 Within the current tax regime, individuals with earnings below £3,600 are able to make pension contributions which, including tax relief, amount to £3,600. Thus, a limit of £3,000 would prevent some individuals from making the maximum allowable contribution under tax rules, increasing the complexity about pension saving options for individuals.
- 5.18 The Pensions Commission set a benchmark replacement rate of 67 per cent for a median earner. DWP analysis<sup>5</sup> shows that with an annual limit of a £3,000, a median earner would be able to reach their benchmark 67 per cent replacement rate about 75 per cent of the time.<sup>6</sup> A median earner, to be more certain of achieving a 67 per cent replacement rate, would have to contribute up to £5,000 annually. A higher earner would need to contribute between £7,000 and £8,000 annually to be more certain of reaching a 67 per cent replacement rate (although the benchmark replacement rate for higher earners was set at 60 per cent).

<sup>5</sup> Using a stochastic model of investment returns, we were able to simulate a lifetime of pension saving for an individual taking into account the potential variation in investment returns according to asset allocation.

<sup>6</sup> 25 per cent of the time they would be unable to reach their target due to poor rates of return.

- 5.19 DWP analysis demonstrates that the £3,000 contribution limit recommended by the Commission is probably too restrictive to allow a range of individuals within the target group sufficient room to make additional contributions and reach a 67 per cent replacement rate. This analysis suggests that any limit needs to be at least £5,000.
- 5.20 Table 5.2 illustrates the average annual contribution made by individuals into current personal pension schemes.

<b>Table 5.2: Personal and stakeholder pensions: average contribution by status and earned income in 2005/06</b>			
		<b>Average annual contribution (employees) (£)</b>	<b>Average annual contribution (self-employed) (£)</b>
<b>Employees</b>	£0-£10,000	1,030	1,090
	£10,000-£20,000	1,200	1,260
	£20,000-£30,000	1,820	1,640
	£30,000 and over	3,970	4,460
	<b>Total</b>	<b>1,840</b>	<b>1,970</b>
<b>Overall average</b>			<b>1,860</b>

Source: National statistics produced by HMRC, Pensions Table 7.10 Personal and stakeholder pensions – Number of individuals contributing and average contribution by status and earned income, November 2006, <http://www.hmrc.gov.uk/stats/pensions/menu.htm>

- 5.21 This table demonstrates that for current pension savers earning up to £30,000 a year a contribution limit of £5,000 would be significantly higher than individuals' current levels of pension saving. For those earning over £30,000, however, the average contribution is nearly £4,000 a year, suggesting a limit of £5,000 might discourage a significant proportion from participating in personal accounts and discourage any move away from existing products tailored to higher earners. Approximately 14 per cent of our target group for automatic enrolment into personal accounts earn above £30,000.<sup>7</sup>

<sup>7</sup> Source: DWP analysis based on *Employers' Pension Provision Survey 2005*, *Small and Medium-sized Enterprise (SME) Statistics 2005*, *Annual Survey of Hours and Earnings 2005* and *Family Resources Survey 2004/05*.

## Option 2: Do not place an annual limit on contributions

5.22 Although a limit on contributions could be an effective way of positioning personal accounts, and restricting the appeal and growth of the scheme, there are clearly disadvantages to having a limit. These include:

- it could restrict pension saving, clashing with the wider objective to promote personal responsibility;
- although it is unlikely that there will be many higher income individuals within personal accounts, there may be instances of individuals within the scheme who want to save above a limit of say, £5,000. For example, any member who enjoys a windfall, or who works for an employer with a more generous default contribution rate, or who has higher pension aspirations, or wants to make up for 'lost' saving years. Increased flexibility for individuals to time pension contributions was introduced as part of the 'A-Day' tax reforms introduced in April 2006;
- specific scheme rules, such as a limit on contributions, increase the complexity of the scheme, and the difficulty for individuals of making straightforward decisions. There may also be additional compliance burdens. To create scheme specific rules would run counter to the spirit of the 2006 'A-Day' reforms to have a uniform set of pension tax rules; and
- the presence of a limit is likely to be potentially confusing for individuals, notably if an individual wished to make a one-off payment but was unable to do so, or if a large lump sum payment made earlier in the year constrained the extent of potential additional contributions as a proportion of salary later in the year.

### *Proposal on an annual contribution limit*

5.23 In order to focus the personal accounts scheme on the target market, and restrict the growth of the scheme so that it does not compete with existing provision, the Government believes that it is appropriate to place an annual limit on contributions into personal accounts. It should be no lower than £5,000, and the personal accounts board will review, on a regular basis, the contribution limit amount according to several criteria, including earnings growth and wider market developments. To ensure the limit is suitable and achieving the desired effects, the limit should be reviewed in 2020 when the market impacts of the 2012 reforms are better understood.

- 5.24 The Government, however, believes that there is a strong case for a higher contribution limit in the first year of operation of personal accounts in 2012. A £10,000 limit in the first year of operation would allow individuals to deposit liquid savings accumulated in the years up to 2012 into personal accounts while still allowing them to make the default and additional contributions of up to £5,000 in contributions in that year. This additional allowance for the first year of personal accounts will allow individuals who currently do not have access to high quality pension provision to save in other products before 2012 and move them to personal accounts. This will not act to undermine current pension provision, in conjunction with the prohibition on transfers.

## Removal of stakeholder designation

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- 5.25 Stakeholder pension designation requirements were designed to be as straightforward for employers as possible. Providers of stakeholder pensions are registered with the regulator and the employer should therefore be able simply to choose a provider, without needing to have a detailed knowledge of pensions. However, research suggests that smaller employers lack the confidence or understanding to make a good choice of provider; they are concerned about taking on this responsibility and (incorrectly) believe that they can attract liability.<sup>8</sup>
- 5.26 Currently, employers must designate a stakeholder provider unless they have fewer than five employees or offer an occupational pension or personal pension with employer contributions of 3 per cent or more of basic salary. Alongside the introduction of the new scheme of personal accounts, the Government also proposes to remove the current requirement on most employers to designate a stakeholder pension in 2012. This could lead to some savings for new firms with five employees or more or those newly moving up to the five employee threshold as well as firms who currently have schemes with no members, which could be set against the administrative costs of having to provide access to personal accounts.
- 5.27 DWP estimates indicate a saving to employers of around £4.3 million each year from removing the requirement for firms to designate a stakeholder pension scheme. This estimate is based on the assumption that all firms who currently do not contribute into their stakeholder pension and who have no members in their schemes, would not operate a stakeholder pension if designation is removed, as each firm would have a small administrative saving each year.

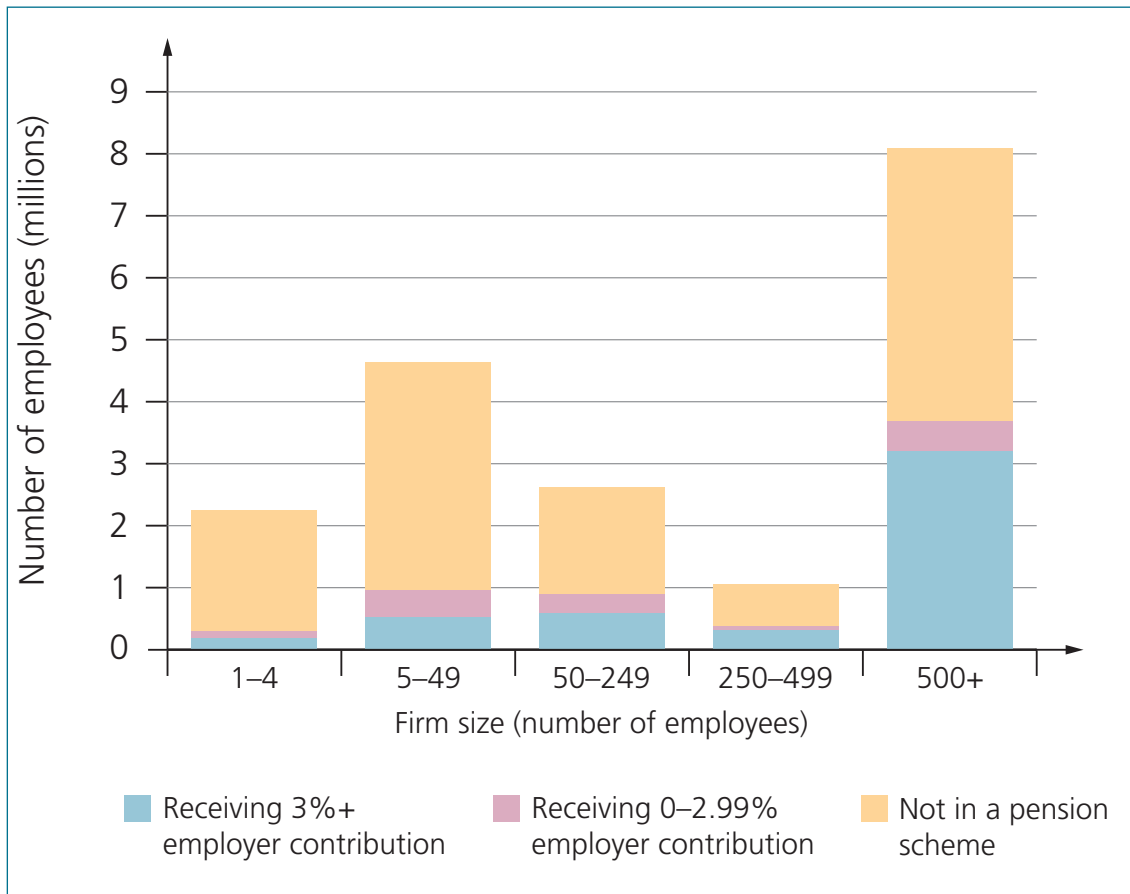
<sup>8</sup> Marshall H and Thomas A, 2006, *Employer attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 371.

## Supporting employer-sponsored provision

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- 5.28 As already stated, the Government's intention is that the reforms of automatic enrolment and personal accounts will complement existing employer-sponsored provision. The package of recommendations detailed above will help achieve that. The Government believes that keeping the scheme targeted will help to ensure that personal accounts will have minimal impact on existing provision.
- 5.29 However, some stakeholders have raised concerns that the effect of the Government's pension reforms, in particular, automatic enrolment, a minimum employer contribution of 3 per cent and the introduction of a new system of personal accounts, may damage existing employer provision. Parts of the pensions industry have suggested that employers currently running schemes might react to the new requirements by 'levelling down' their current pension provision either as a result of cost control or a due to a 'signalling' effect, ie where the minimum employer contribution level becomes 'the norm'. This may mean more savers (through automatic enrolment), but not necessarily more money being saved.
- 5.30 Data on the existing pensions landscape shows that employees working in large firms are much more likely to be in a pension scheme and to be receiving relatively generous employer contributions compared to employees working in small and medium-sized firms. This is illustrated in Figure 5.1.

Figure 5.1: Existing pension provision: scheme membership by firm size



Source: DWP analysis based on *Employers' Pension Provision Survey 2005*, *Small and Medium-sized Enterprise (SME) Statistics 2005* and *Annual Survey of Hours and Earnings 2005*

5.31 Analysis carried out for the May White Paper, based on internal analysis and commissioned research that has since been published, did not indicate that 'levelling down' of contributions would be a common response.<sup>9</sup> DWP analysis shows that only around £700 million of the £2.8 billion cost to employers of a 3 per cent contribution would fall on firms currently contributing 3 per cent or more.<sup>10</sup>

<sup>9</sup> *Security in retirement: towards a new pensions system – Regulatory impact assessments and technical appendices*, May 2006.

<sup>10</sup> Source: DWP analysis based on *Employer's Pension Provision Survey 2005*, *Small and Medium-sized Enterprises (SME) Statistics 2005* and *Annual Survey of Hours and Earnings, 2005*.

- 5.32 BMRB carried out an extensive programme of qualitative and quantitative research for DWP on employers' attitudes and likely responses to personal accounts. This included a nationally representative survey of over 2,500 private sector employers across a range of size bands and in-depth research with 75 employers.<sup>11</sup> The sample of employers for the survey was drawn from the Inter Departmental Business Register, maintained by the Office for National Statistics, and interviews were carried out with the person responsible for making decisions about pension arrangements. About two-thirds (65 per cent) of those interviewed were the Managing Director or Chief Executive, owner or partner of the business, were at director level, the Finance director or occupied senior positions in the Finance Department. Only 10 per cent of those interviewed occupied positions within the HR department.
- 5.33 The findings of this programme of research suggest that the extent of levelling down is likely to be limited. The survey of over 2,500 private sector employers found that if employers experience additional costs as a result of pension reform, they have several ways of managing them, including: increasing prices, offering lower wage increases or absorbing the increase through existing overheads. A majority (60 per cent) of employers who would face an increase in pension contributions said they would be most likely to absorb any increase in pension contributions through either increased prices (23 per cent), lower wage increases (18 per cent) or through existing overheads (20 per cent). The option of levelling down did not emerge as a strong theme. Of those employers who currently offered access to a pension scheme, only 1 per cent reported they were likely to reduce the level of contributions to their existing scheme, and only 2 per cent suggested they might close down or introduce eligibility restrictions for their existing scheme.<sup>12</sup> Employers with relatively generous employer contributions said that they viewed their pension scheme as an important recruitment and retention tool that they are keen to keep.

<sup>11</sup> Marshall H and Thomas A, 2006, *Employer attitudes to personal accounts: Report of a qualitative study*, DWP Research Report No 371.

Bolling K, Grant C, Fitzpatrick A and Sexton M, 2006, *Employer attitudes to personal accounts: Report of a quantitative survey*, DWP Research Report No 397.

<sup>12</sup> Bolling K, Grant C, Fitzpatrick A and Sexton M, 2006, *Employer attitudes to personal accounts: report of a quantitative survey*, DWP Research Report No 397.

- 5.34 Other research has been carried out looking at the likely impact of the reforms on existing pension provision. The Government has considered all of this evidence which has produced a broad range of estimates of the likely impact of the reforms on existing provision.<sup>13</sup> Some of these estimates are fairly close to the DWP figures, others imply that DWP research may underestimate the impact of pension reforms. Research findings can vary for a number of reasons, including the sample frame used, the design of the sample, response rates, who is asked, and questionnaire design, including how questions are presented. The range of reported estimates of the likely extent of 'levelling down' does show how difficult it is for employers to say what they might do from 2012.
- 5.35 There is also scope for 'levelling up'. Employers who see strong recruitment and retention benefits from differentiating themselves in the market for good employees by offering a better pension than their competitors, might increase their contributions to maintain that differential. In DWP's quantitative survey a few employers contributing 3 per cent or more said that they would increase employer contributions to more than 3 per cent as a result of the Government's pension reforms.
- 5.36 Given the uncertainty surrounding the issue of levelling down and the importance that the Government attaches to it, the Government will continue to review the evidence on levelling down, monitor employer attitudes and likely reactions, and carry out further work to understand the drivers of employer behaviour in the run up to implementation. The Government is keen to work closely with key stakeholders as it takes this analytical work forward.
- 5.37 Employer reactions are also likely to be influenced by the final design of the personal accounts scheme itself. The White Paper explains our policy proposals for scheme design. An effective scheme design will help to ensure that personal accounts remain focused on serving the target market and encourage employers to maintain existing provision. In this way we hope to encourage employers to react positively towards the reforms so that existing high quality provision continues.

<sup>13</sup> Examples of other research include:

- Chartered Institute of Personnel Development, February, 2006, *Labour Market Outlook*.
- A survey of NAPF Pension Fund members, cited in *Quantity vs Quality? Auto-enrolment and levelling down: the evidence*, June, 2006, NAPF Research Report No 5.
- Research carried out by Deloitte for AEGON, AXA, Scottish Widows and Standard Life, *Pensions Reform in the Workplace*, key findings cited in press release of 17 August 2006, *Government must act to stop reform eroding workplace pensions*.
- *Employer Pension Contributions and Pension Reform*, ABI Research Paper 2, report by Deloitte & Touche LLP, November 2006.
- Association of Consulting Actuaries, *Small Business Survey*, cited in Placard, Issue 23, April 2006.