NAPF

Securing the future of pensions

Closing the gap: the choices and factors that can affect private pension income in retirement

A summary of Pensions Policy Institute research commissioned by the NAPF

February 2012

Summary of Findings

1. New research commissioned by the NAPF from the Pensions Policy Institute (PPI) finds that an individual's private pension income in retirement can be significantly enhanced by a series of positive choices, decisions and factors.

2. When saving for retirement in a Defined Contribution (DC) pension scheme there are a number of choices that an employee and their employer will make. These can have an impact on the final income received in retirement by the employee. Employee choices include: increasing employee contributions; whether to opt out of pension provision; when to retire; how much of the pension fund to convert into an income and which retirement income product to use to convert a pension fund into an income in retirement. Other factors include employer choices regarding the level of employer contributions and the level of charges of the pension scheme.

The individual impact of positive and negative choices and factors

3. The research shows the impact of certain specific choices and factors for a median earning man and woman, and their potential to either reduce or enhance private pension incomes.

4. The modelling shows that making sacrifices earlier on in life such as increasing contributions into a pension, or later on in life by working and saving for longer, or annuitising some or all of the 25% tax free lump sum, can significantly enhance your pension (Chart 1). For example:

    - Saving a total of 12% of band earnings[1] (rather than the 8% of band earnings minimum under auto-enrolment, and above the current average for a DC occupational scheme of 6% employer contributions and 3% employee contributions[2]) into your private pension can increase private pension income by 50%;
    - Retiring 2 years after state pension age and continuing to save in that time has a positive two-fold effect through saving more and deferring annuity purchase and can enhance private pension income by 20%;
    - Opting out between the ages of 30 and 40 and starting to save ten years later can reduce private pension income by 32%;
    - Retiring 2 years before state pension age and starting to draw down your pension can reduce private pension income by 18%.

[1] Band earnings is the earnings range over which employee and employer pension contributions are made. Under auto-enrolment, band earnings will be earnings between £5,715 and £38,185 in 2010/11 earnings terms for those earning over the auto-enrolment threshold which is equal to the standard personal tax allowance (£7,475 in 2011/12).

[2] ONS (2011), Occupational Pension Schemes Survey 2010.

Chart 1[3] - Impact on private pension income for the median earning man on reaching SPA in 2055, percentage difference from the baseline

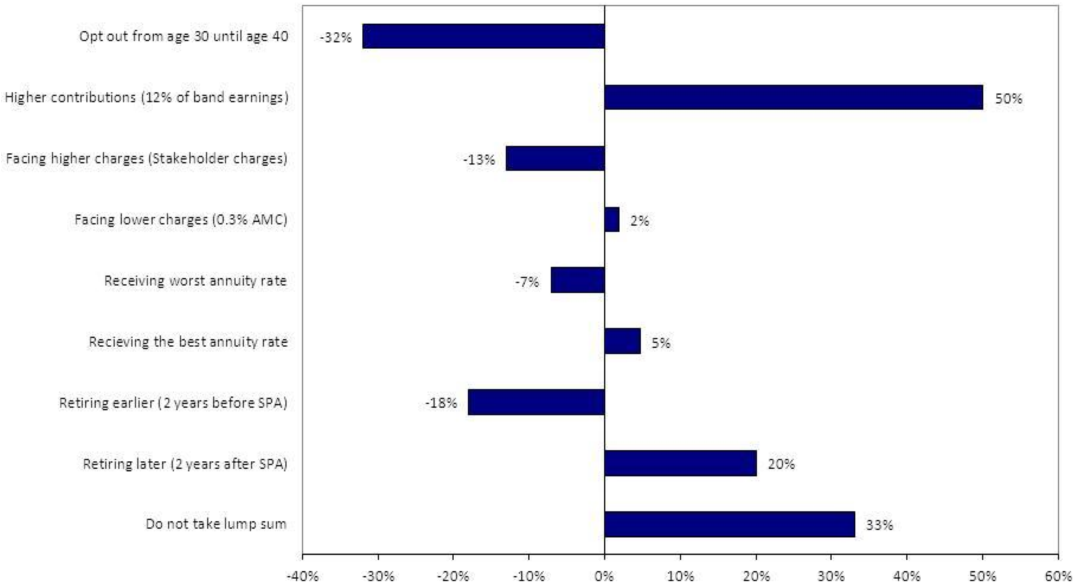
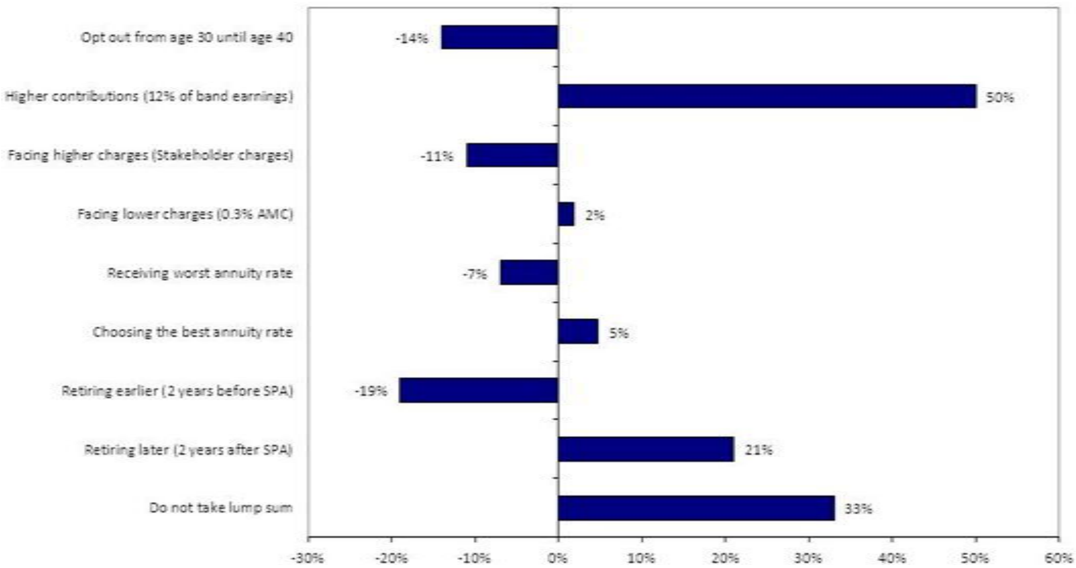


Chart 2[4] – Impact on private pension income for the median earning woman on reaching SPA in 2055, percentage difference from the baseline



5. The research also demonstrates the adverse impact of an individual being a member of a pension scheme with higher charges, or from an individual not 'shopping around' for the best annuity rate available on the market. These are choices and factors that, if changed, could increase

[3] PPI Modelling
[4] PPI Modelling

individual's private pension income. However, they rely on the employer securing access to a lower charging scheme, which may not be possible especially for smaller schemes, or on an individual shopping around at retirement to find an annuity on the market offering a better rate.

6. On charges, even the difference between a low charge[5] and a charge set at the level of the stakeholder cap[6] is significant. Compared to the National Employment Savings Trust combined charge[7], a lower annual management charge (AMC) at a flat rate of 0.3% increases a male median earner's private pension income by 2%, whilst charges in line with stakeholder caps reduce private pension income by 13%.

7. Securing the best single life, level annuity rate on the Money Advice Service tables[8] compared to a mid-range annuity rate can increase private pension income by 5%, whilst locking into the lowest annuity rate on the Money Advice Service tables can reduce private pension income by 7%. The example used in the modelling is for a median level annuity. In practice the variation observed for specific individuals, particularly those eligible for an enhanced annuity, can be much greater.

8. Opting out of pension saving from age 30 until age 40 has a smaller impact on private pension income for the median earning woman than it does for the median earning man. This is because the median earning woman is already assumed to care for children from age 30 to 35, so opts out from fewer years of pension saving than the median earning man.

The cumulative impact of positive choices and factors

9. The research also demonstrates the cumulative impact that such choices and factors can have on an individual's private pension income in retirement. For example, a median earning man who remains opted-in to pension saving from age 30; contributes an extra 1% of band earnings and receives an extra 1% contribution from their employer; is in a scheme with low charges; works an extra year after their state pension age; and who annuitises their lump sum and shops around for an annuity could have a private pension income that is three times higher (£7,710 a year compared to £2,200 a year) than a median earner who makes different choices and is subject to different factors (Chart 3).

10. The case for an individual to not take their tax-free lump sum at retirement and annuitise it instead is not clear cut - given the beneficial tax treatment of the lump sum and the resulting impact on overall income and capital at, and during, retirement. However, even if the impact of not taking the lump sum is stripped out of the modelling, annual private pension income is still two and a half times higher under the high income scenario at £5,780 instead of £2,200 a year (Chart 4).

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5 In line with a long term NEST rate of 0.3% AMC

6 An Annual Management Charge of 1.5% for the first ten years falling to 1.0%.

7 A 1.8% contribution charge and a 0.3% Annual Management Charge

8 Money Advice Service annuity comparison tables are available at tables.moneyadviceservice.org.uk/Comparison-tables-home/Annuities/Compare-Annuities/

Chart 3[9] – Annual private pension income for the median earning man on reaching SPA in 2055, £ per year in 2011 earnings terms

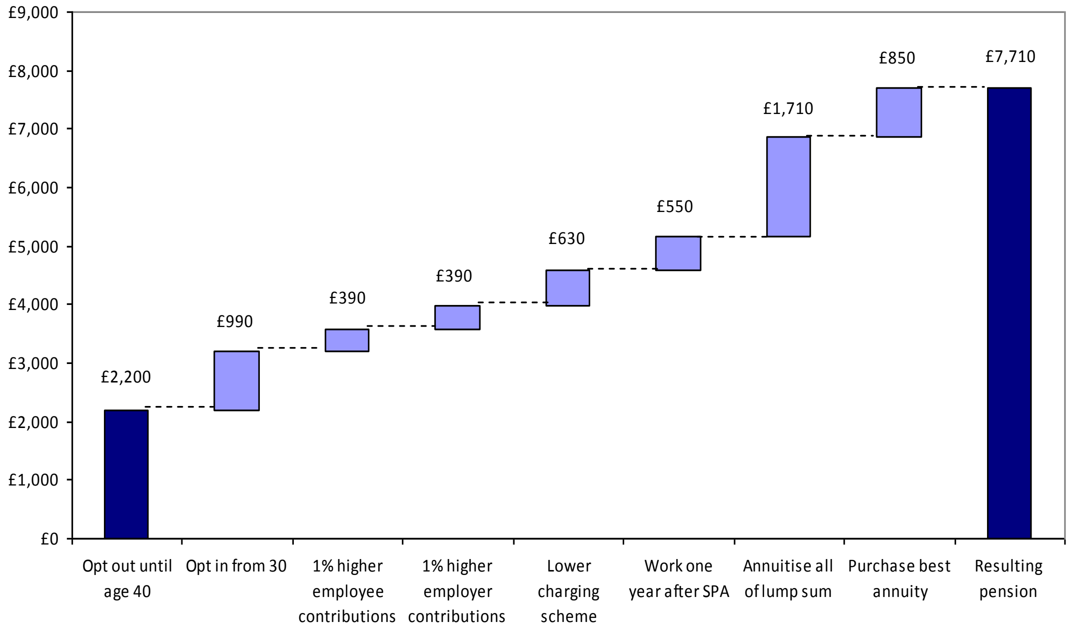
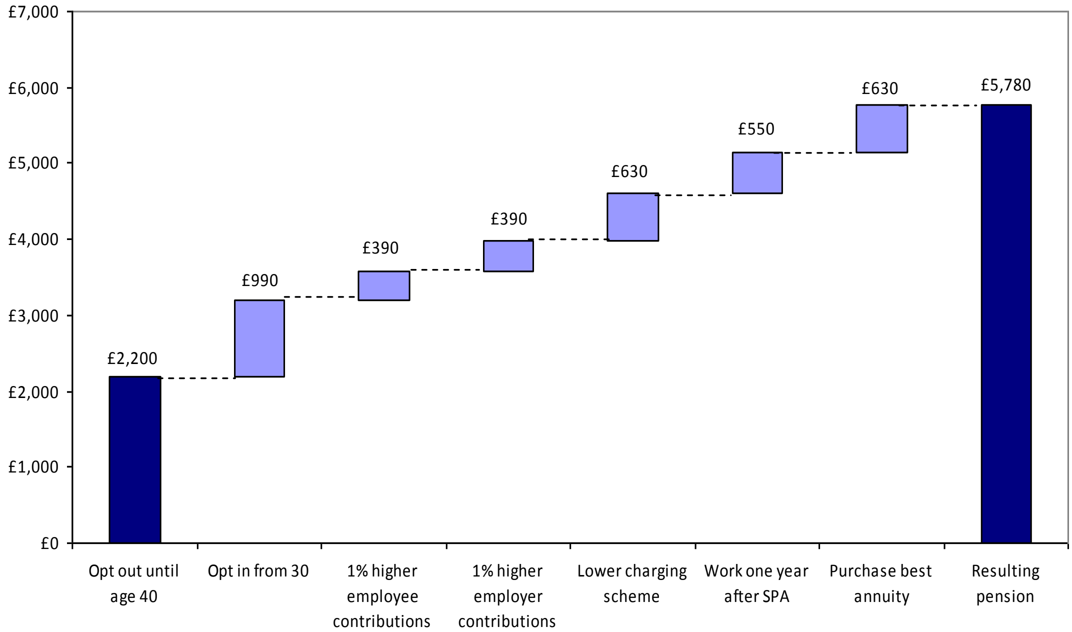


Chart 4[10] – Annual private pension income for the median earning man on reaching SPA in 2055, £ per year in 2011 earnings terms *if* lump sum is not annuitised



[9] PPI Modelling
[10] PPI Modelling

Overcoming the impact of opting out, higher charges, and lower annuity rates

11. Finally, the research shows the potential implication to the individual of some of the negative choices and factors by considering what increase in contributions would be needed, or how much longer the individual would need to work and save, to reinstate levels of private pension income.

12. The modelling finds that:

- Opting out until age 40, instead of starting to contribute into a pension from age 30, would reduce the available pension pot at retirement from £59,500 to £40,600. So starting to save at age 30 could have produced a private pension income in retirement nearly 50% higher. **To make up for these lost 10 years the individual might need to contribute an extra 4% of their band earnings into their pension for the rest of their working life.**

- Being in a scheme with charges in line with the stakeholder charge cap, instead of a scheme with charges in line with the long term NEST rate of an annual management charge of 0.3%, could reduce the available pension pot at retirement from £60,600 to £52,000. Being in a scheme with lower charges would have produced a private pension income in retirement around 17% higher. **To compensate for this difference in charges the individual might need to save an extra 1.5% of their band earnings into their pension every year or could retire 3 years after state pension age.**

- Converting the pension fund to an income using the lowest annuity rate on the Money Advice Service tables, instead of securing the highest annuity rate available on the Money Advice Service tables, could reduce the pension income by around 12%. **To compensate for the lower annuity rate the individual might need to save an extra 1% of their band earnings into their pension every year or could retire 2 years after state pension age.**

Appendix – Modelling Results

Tables 1-4 set out the following results:

- the annual income from the single tier state pension,
- the annual income from private pension,
- the level of the pension fund that is converted into an annuity at retirement,
- the value of the private pension income in £ per year,
- the change in private pension income for each of the scenarios in both monetary and percentage terms (in brackets), and
- the total gross replacement rate as a result of the scenario, allowing for state benefits and private pension income.

Tables 1 and 2 set out these results for potential choices and factors that could increase income in retirement, for the median earning man and the median earning woman respectively.

Tables 3 and 4 set out these results for potential choices and factors that could reduce income in retirement, for the median earning man and the median earning woman respectively.

The tables refer to a baseline private pension. The assumptions backing this baseline scenario are as follows:

- The individuals are both eligible for the Government's proposed single tier pension.
- Employees are auto-enrolled into NEST from age 30.
- Employees and employers make minimum auto-enrolment contributions of 8% of band earnings.
- An annual management charge of 0.3% is applied. Contributions to NEST are subject to an additional contribution charge of 1.8%.
- Employees retire at their state pension age.
- At retirement employees take 25% of their pension fund as a tax free lump sum.
- The remaining fund is converted into a fixed income at the projected median rate available in the annuity market for a single life, level annuity.

As a reminder, the target replacement rate for the median earning man under the Pension Commission benchmarks[11] is 67% of gross earnings and the target replacement rate for the median earning woman is 70% of gross earnings.

[11] Pensions: Challenges and choices - The first report of the Pensions Commission (2004) p143

Table 1 – the impact on post retirement income of choices and factors that are likely to increase private pension income for a median earning man[12]

	Annuitised Pension Fund	£ per year	Change in Private Pension	Replacement Rate (incl State Pension)[13]
Single Tier Pension		£8,150	£0	36%
Baseline Private Pension	£59,500	£4,100	£0	18%
Total Pension	£59,500	£12,250	£0	54%
Impact on private pension				
Higher pension contributions (12%)	£89,300	£6,150	+£2,050 (+50%)	63%
0.3% AMC	£60,600	£4,180	+£80 (+2%)	54%
Best annuity rate on Money Advice Service tables	£59,500	£4,290	+£190 (+5%)	55%
Retire 2 years later than SPA	£62,700	£4,940	+£840 (+20%)	58%
Whole fund is annuitised, no lump sum taken	£79,300	£5,470	+£1,370 (+33%)	60%

Table 2 – the impact on post retirement income of choices and factors that are likely to increase private pension income for a median earning woman[14]

	Annuitised Pension Fund	£ per year	Change in Private Pension	Replacement Rate (incl State Pension)
Single Tier Pension		£8,150	£0	42%
Baseline Private Pension	£29,900	£1,910	£0	10%
Total Pension	£29,900	£10,060	£0	52%
Impact on private pension				
Higher pension contributions (12%)	£44,800	£2,860	+£950 (+50%)	57%
0.3% AMC	£30,400	£1,950	+£40 (+2%)	52%
Best annuity rate on Money Advice Service tables	£29,900	£2,000	£90 (+5%)	52%
Retire 2 years later than SPA	£32,100	£2,320	+£410 (+21%)	54%
Whole fund is annuitised, no lump sum taken	£39,900	£2,550	+£640 (+33%)	57%

12 PPI Modelling

13 Post retirement income for replacement rates is taken as being the income at retirement

14 PPI Modelling

Table 3 – the impact on post retirement income of choices and factors that are likely to reduce private pension income for a median earning man[15]

	Annuitised Pension Fund	£ per year	Change in Private Pension	Replacement Rate (incl State Pension)
Single Tier Pension		£8,150	£0	36%
Baseline Private Pension	£59,500	£4,100	£0	18%
Total Pension	£59,500	£12,250	£0	54%
Impact on private pension				
Opt out of pension until age 40	£40,600	£2,800	-£1,300 (-32%)	48%
1.5% AMC for 10 years 1% thereafter	£52,000	£3,580	-£520 (-13%)	52%
8th best annuity rate on Money Advice Service tables	£59,500	£3,820	-£280 (-7%)	53%
Retire 2 years before SPA	£56,300	£3,360	-£740 (-18%)	49%

Table 4 – the impact on post retirement income of choices and factors that are likely to reduce private pension income for a median earning woman[16]

	Annuitised Pension Fund	£ per year	Change in Private Pension	Replacement Rate (incl State Pension)
Single Tier Pension		£8,150	£0	42%
Baseline Private Pension	£29,900	£1,910	£0	10%
Total Pension	£29,900	£10,060	£0	52%
Impact on private pension				
Opt out of pension until age 40	£25,800	£1,650	-£260 (-14%)	50%
1.5% AMC for 10 years 1% thereafter	£26,700	£1,710	-£200 (-11%)	51%
8th best annuity rate on Money Advice Service tables	£29,900	£1,780	-£130 (-7%)	51%
Retire 2 years before SPA	£27,700	£1,550	-£360 (-19%)	49%

[15] PPI Modelling
[16] PPI Modelling