Strengthening the saving safety net

How to keep families out of problem debt by getting them saving

Executive Summary

This paper summarises and responds to Pensions Policy Institute research commissioned by StepChange Debt Charity analysing the impact on retirement income of creating an accessible savings pot within a private pension.

Why do we need to boost savings?

2.9 million people are struggling with severe debt problems. The effects are devastating. For example, nine in ten parents in debt have cut back on essentials for children to keep up with debt repayments.

But if a family has £1,000 in accessible savings, it reduces their chances of being in debt by 44%[i].

This is because savings serve as a buffer when families suffer an income shock, such as a job loss. Savings allow people to get through a financially uncertain period without turning to credit.

Income shocks remain a fact of life for many and the primary driver for problem debt **- 73% of people in problem debt experienced an income shock in the last year[ii].** If people cannot respond to an income shock with savings they risk a debt spiral.

Yet 14.5 million British adults have had nothing spare for rainy day saving. How can we help them save?

Pension auto-enrolment

Pension auto-enrolment already helps millions of low-to-median earners save. But these savings are not available when a crisis hits. **If people had a savings pot of a £1,000 within their pension to help in an emergency this would help stave off problem debt.**

StepChange Debt Charity supports the creation of such Accessible Pension Savings (APS).

Our 2015 report, *Becoming a nation of savers*, illustrated how an APS system might work. A discrete pot of £1,000 within a pension would be created that must be filled by diverting a proportion of pension contributions (individual, employer, state) into it. Once the money in this is used in an emergency then the pot must be refilled before it can be used again. The majority of contributions would continue to go into the inaccessible pension fund.

Analysis of the Wealth and Assets Survey in *Becoming a nation of savers* showed APS could reduce the number of families at risk of problem debt by 500,000.

In essence, APS represents a trade-off between financial stability during working life and pension income. However, **research we commissioned from the Pensions Policy Institute (PPI), summarised in this paper, shows an emergency savings pot of £1,000 within a pension would not have a huge impact on retirement income, even if used multiple times.**

The research

The PPI found the impact on low-to-median earners of using APS in an emergency situation would be minimal, meaning no greater than a 2.1% reduction in weekly retirement income. **The trade-off between averting a debt crisis and a minor reduction in pension income appears acceptable and would be welcome in most cases.** The impact of ceasing pension payments altogether would be far greater.

This research clearly demonstrates the achievability of the policy approach we have suggested, allowing the creation of an accessible emergency pot within a pension.

Next steps

The DWP should consider this proposal as part of its review of the auto-enrolment system. Therefore, as well as modelling the effects of this policy, we asked the PPI to use its expertise to suggest how the policy could be implemented. These suggestions are included in this response paper.

We are keen for stakeholders to engage with us on this policy proposal and support our call on the auto-enrolment review. If you are interested in discussing this further, please contact joseph.surtees@stepchange.org.

Scenarios

The PPI looked at how individuals might use Accessible Pension Savings (APS). For each the model examined:

1. What the impact on pension income and size would be if the individual accessed:
   a. Their entire £1,000 APS once at age 40
   b. Their entire £1,000 APS four times between the ages of 35 and 50
   c. Half their £1,000 APS once at age 40
   d. Half their £1,000 APS four times between the ages of 35 and 50

2. How long it would take to build a £1,000 APS

The model then analysed the impact on pension size and pension income if these individuals, instead of paying into a pension and APS, ceased to contribute for either three years or nine years.

Impact on retirement income of using APS

The impact on a low-to-median earners' pension income of APS is small, even if they take the whole £1,000 multiple times.

If a low-earner (10th percentile of women's earnings distribution) takes out her entire APS four times between the ages of 35 and 50 the reduction in her weekly retirement income at age 68 is just 2% (£4). If she uses the whole APS once the reduction in her weekly retirement income is only 0.8% (£1.5).

The impact on a median-earner (median level of women's earnings distribution), is similar. Four uses of her whole £1,000 APS between 35 and 50 reduces her retirement income by only 2.1% a week when she reaches retirement (£5). If she uses the £1,000 once the reduction in weekly retirement income is only 0.7% (£1.6).

When you factor in pension credit, the reduction in retirement income is less still. If a low-to-median earner (30th percentile of man's earning distribution) eligible for pension credit accesses his APS four times between 35 and 50 the reduction in weekly retirement income is just 0.4% (£1)[1].

---

1 If this policy approach was implemented it would be important to ensure that the use of an accessible pot does not affect eligibility for Pension Credit due to 'deliberate deprivation' rules. DWP rules state that if pensioners take advantage of the pension freedoms they will

Stopping pension payments

The impact on an individual's retirement income of ceasing to make pension payments is much higher than using APS multiple times. Looking at our median earner again we see that if she ceases to make pension payments for nine years at age 40 this reduces her weekly retirement income by 5.2% (£12.4). This illustrates the importance of people maintaining pension contributions.

An additional appeal of APS therefore is it could function as a way to engage consumers and help them maximise savings. For example, if individuals know they are able to access savings in an emergency they may be more willing to dedicate disposal income to a pension, especially if they are on a low income. Alternatively, falling into debt and having to maintain credit repayments may minimise willingness to keep up pension contributions.

As with retirement income, the impact on size of a private pension pot of ceasing pension payments is greater than if you use your APS. This is because for low-to-median earners the majority of pension payments come from state pension and guaranteed pension credit

If our low-earner ceases paying into her pension for nine years at age 40 this reduces the size of her private pension pot by 21% at retirement age. However, if she uses the entire £1,000 APS four times between 35 and 50, this reduces the pot by 20%. If she uses it just once this only results in a 7% reduction in the size of her pension pot.

Length of time taken to build accessible pot

The PPI modelled how long it would take to build an accessible pot using assumptions based on StepChange's initial policy work[iii].

It takes a median earner (median level of male earnings distribution), only two years to get to £1,000. For our low earner it could take up to seven years, so government may want to consider how our proposal provides an opportunity to integrate low-income savings schemes, such as Help-to-Save, to accelerate the process.

Questions for policymakers

---

be treated as though they still have it for the purposes of calculating means-tested benefits. This could perhaps apply to the use of APS.

We asked the PPI to suggest potential issues with our approach. This will allow policymakers to avoid problems during implementation to ensure the success of the scheme.

Tax status

For taxation purposes, the accessible pot could be treated in one of two ways – withdrawals could either be taxed at an individual's marginal rate or withdrawals could be tax free if treated as part of the existing 25% tax-free allowance.

Obviously the latter of these would be preferable from the individual's point of view. It would maximise their precautionary savings and provide a greater incentive to save into the APS. However, in the long term it would be better to legislate so the £1,000 is tax free separately from the existing 25% tax-free lump-sum. The government has already made moves in this direction by introducing the Pension Advice Allowance, which allows people to withdraw £500 up to three occasions from their pension pots tax-free to put towards the cost of pensions and retirement advice. It could extend this idea to emergency situations.

Withdrawal

There is potential for APS could be used for a non-emergency purpose or for avoiding tax. Therefore, policymakers may wish to consider putting into place restrictions around the use of an accessible pot (for example, only in the event of an emergency) or the number of drawdowns allowed.

Although, there might be have to be further considerations around this point. The long-run costs of restricting withdrawal could outweigh any advantages due to the creation of costly bureaucracy. There would be questions too surrounding who decides what an emergency constitutes, the DWP or financial services providers.

The Saving for Education, Entrepreneurship and Downpayment (SEED) Initiative in the United States also illustrates that placing too great a restriction on the use of funds can serve as a disincentive to saving[iv].

Defined Benefit schemes

The mechanism explored in this research is based on a Defined Contribution (DC) scheme. As with Freedom and Choice it may not work as well within the confines of a Defined Benefit (DB) scheme.

There are potential solutions to this. If an individual in a DB scheme wished to take advantage of an accessible pot potentially a proportion of their pension payments could be diverted from the pension pot to an associated saving account[2]. This would make it similar to a workplace savings scheme but with additional automation and the advantage of associated tax relief.

Alternatively, they could choose to make Additional Voluntary Contributions (where individuals make contributions in excess of those required by the scheme in order to enhance pension income) and have these make up the APS. Although taking this approach would of course undercut one advantage of our approach to saving, which seeks to make the process as automated as possible.

Some DB schemes could also create an APS for members if they are a cash balance plan[3], although withdrawal from this may have the same tax implications as a DC scheme.

Next steps

We are keen for the Department for Work and Pensions to consider our proposal as part of its current auto-enrolment review. If you would like to join us in this call please contact Joseph Surtees on joseph.surtees@stepchange.org or on 0207 391 4582 to discuss it further.

[2] Further considerations would be associated with DB approaches. For example, a) whether the individual who does not use the APS is able to use it to buy back the lost service years, b) protections in the event of the employer becoming insolvent, and c) what happens when people leave their job.

[3] A cash balance scheme is a form of defined benefit pension under which what is promised to the member is not a defined amount of pension at retirement but a defined lump sum

References

[i] StepChange Debt Charity (2015), Becoming a nation of savers
[ii] StepChange Debt Charity (2016), Navigating the new normal
[iii] StepChange Debt Charity (2015), Becoming a nation of savers
[iv] Beverley A Searle and Stephan Köppe (2014), Assets, savings and wealth, and poverty: A review of evidence