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EARLY ACCESS TO PENSION SAVING

James Lloyd

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By James Lloyd

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Retirement has more potential with
PRUDENTIAL

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EXECUTIVE SUMMARY

Discussion of enabling early access to pension savings has been a feature of UK pension policy debate for some years. However, this discussion has come into sharper focus in light of the global financial crisis, and its potential impact on the attitude of UK households to locking away saving for many years.

The strategic objectives of UK pension policy are for everyone to have a retirement income that meets their expectations and aspirations and, as much as possible, for this retirement income to be pension-based, i.e. to insure individuals against longevity-risk. To encourage pension saving, such savings benefit from uniquely generous tax-relief in respect of both income and capital gains. Commensurately, pension saving is subject to strict rules preventing access to pension saving before someone reaches their 50s, which comprise the longstanding UK 'annuities deal'. Nevertheless, the problem of under-saving for retirement is both significant and persistent. Ongoing reform to the UK pension system is focused on increasing the incentives for pension saving, ensuring universal access to a decent pension scheme and overcoming behavioural barriers to saving. However, commentators have consistently pointed to rules on pension saving as deterring people from undertaking pension saving, and therefore propose replacing these rules with some model of early access pension saving in order to increase savings rates.

Many factors determine pension participation and contribution rates, besides rules on access to pension saving, such as attitudes to risk and financial capability, etc. However, consumer surveys and empirical evidence of household wealth do not indicate any deterrence effect impacting pension saving, when considered against other more liquid savings products. Rather, pension under-saving appears to be symptomatic of a broader problem of under-saving affecting all types of liquid and illiquid saving, and in the context of this under-saving, there is no evidence that current pension rules deter pension saving.

Commentators on rules governing access to pension savings also argue that these rules could prevent individuals from smoothing their income in response

to financial hardship, with potentially 'perverse' outcomes. However, although in hypothetical terms, it would be possible for someone to experience significant financial hardship while unable to their access pension savings, evidence does suggest possession of different types of wealth is positively correlated, so most individuals with pension savings do have access to other savings. In relation to the commonly cited situation in which an individual might face home repossession despite having pension savings, there is simply no data available indicating how many of the 46,000 repossessions that took place in 2009 could have been prevented if households had had access to their pension saving.

In addition to serious questions around the potential for improved pension saving rates in response to more flexible rules, policymakers considering implementing a policy of enabling early access to pension saving confront a complex challenge around how to design a new regime and define success for any reform. Potential design choices for an early access regime include:

- The amount that individuals are able to withdraw;
- Whether withdrawals are permanent vs. temporary;
- The types of pension scheme (DB, DC) applicable;
- How tax-relief and employer contributions should be treated;
- Whether access to pension saving should be allowed for existing pension savings or only for new saving;
- Whether early access should be universal or limited to certain groups;
- What conditions should be applied to early access to pension savings and how this should be administered.

Some key criteria for evaluating different models of early access to pension saving include:

- Effect on pension saving contribution and participation rates across the population;
- Effect on the value of total pension savings for individuals;
- Scope for tax avoidance;

- Complexity;
- Effect on investment returns;
- Whether two-tier systems would result;
- The scope for unintended consequences to occur.

Using these design choices and evaluation criteria, it is possible to examine some of the principal models of early access to pension saving that have been proposed. These include:

- Flexible lump sum pensions;
- Unrestricted flexible pension saving;
- Income smoothing 'hardship pension';
- Loan-based models of early access;
- Feeder fund pensions;
- Low-income flexible pensions.

However the likely effect of any of these models on pension saving is highly uncertain. Each model is subject to significant implementation and feasibility problems, including difficulty of administration, potential for unintended consequences, and the likelihood of increased costs that would have to be borne by savers. No model provides a convincing pathway for reform.

Instead, policymakers concerned about any deterrence effect on pension savings rates resulting from pension rules should instead focus on the efficacy of current savings policy, and the 'life course' risks that individuals confront, but which are not properly addressed by the safety net of the state or private sector insurance.

Overall, while promoting early access to pension saving might be an eye-catching idea, and one which undoubtedly coheres with economic theory, there is simply no case for unwinding the UK's 'annuities deal'. Rather, policymakers must address the efficacy of savings policy and risk-pooling provided by the state and private sector, as the foundations on which UK pensions policy rests.

CHAPTER 1: INTRODUCTION

The proposal to enable 'early access' to pension saving has different proponents and comes in different forms, but has been a feature of UK pension policy discussion since at least the 1980s. For some years now, a number of commentators have suggested that pension rules, and the inaccessibility of pension saving until the age of 55 (previously 50),[1] deters individuals from saving into a pension, reflected in the longstanding problem of under-saving. Other commentators have noted that in some situations, pension rules may prevent individuals from smoothing their income (and consumption) across the life course in response to unexpected changes in income and expenditure, with associated perverse consequences; an example commonly cited is of an individual unable to access pension savings whose home is threatened with repossession.

In recent times, this ongoing discussion has been brought into sharper focus as stakeholders across government and the pension industry consider the effect on UK households of the international financial crisis that began in 2007, and ensuing credit crunch, global recession and fiscal crisis. These events, which caught policymakers and much of the financial industry entirely by surprise, may potentially have made households far more intolerant of risk and more acutely aware of the potential for unexpected adversity. In particular, even those UK households that did not experience unemployment during the recession of 2008–2009 will have experienced heightened job – and income – insecurity, potentially resulting in a more precautionary attitude to the future, and a desire for more liquid, accessible savings.[2]

Interest in enabling early access to pension saving has also been visible at a political level. Theresa May MP, Conservative Shadow Secretary of State for Work and Pensions said in 2009: "Not being able to access your own money, even in an

1 From April 6th 2010, the minimum age for taking a lump-sum changed from 50 to 55.

2 For example, a YouGov poll commissioned by Deloitte found that 54% of respondents reported being less willing to lock their savings away for longer periods of time. See: https://www.deloitte.com/view/en_GB/uk/news/news-releases/press-release/dc02b2737efd5210VgnVCM200000bb42f00aRCRD.htm.

emergency, is hugely off-putting. That is why we are looking at models of early access to pension funds, such as those implemented in New Zealand and the USA. Any such system in the UK would need to ensure that proper safeguards were in place so that the scheme remained worthwhile. But it is clear that offering people greater flexibility could be an important means of reinvigorating long-term saving."[3]

Proposals for early access to pension savings are clearly in the spotlight of pension policy discussion. This report therefore seeks to contribute to and inform this discussion by exploring and evaluating different potential models of early access to pension saving against the objectives of UK pension strategy, and examining the evidence that pension rules deter saving.[4]

In Chapter 2, current rules on pension saving and the rationale behind them are examined along with ongoing reforms to the UK pension system.

Chapter 3 explores the theory behind arguments for greater flexibility in pension saving and the available evidence to support such arguments.

In Chapter 4, the principal choices around the design of any early access rules are outlined, such as whether early withdrawals from pension saving should be permanent or temporary.

Chapter 5 sets out criteria for evaluating models of early access to pension saving, such as levels of complexity.

Some key models of early access to pension saving, including overseas examples, are summarised in Chapter 6, with the arguments for and against each model described.

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3 Speech to Tax Incentivised Saving Association, November 18th, 2009. See http://www.tisa.uk.com/slides/116_RtHonTheresaMayMP.pdf.

4 Through this report, models of early access discussed ignore the suggestion that has been made by some commentators that individuals should have access to pension saving for items such as home purchase. This is because such an approach effectively confuses saving for a pension with saving for other expenditure. As such, this proposal is not about early access to *pension* saving, so much as the extent of tax relief granted to saving for approved types of expenditure, such as home-ownership.

In Chapter 7, conclusions are drawn regarding the potential introduction of early access to pension saving in the UK.

Key points

- Discussion of enabling early access to pension saving has been a feature of UK pension policy debate for some years.
- However, this discussion has come into sharper focus in light of the global financial crisis, and its potential impact on the attitude of UK households to locking away saving for many years.

CHAPTER 2: PENSION RULES, THE 'ANNUITIES DEAL' AND THE EFFECTIVENESS OF CURRENT PENSION POLICY

In order to begin an analysis of early access models of pension saving, this chapter looks at the design of current pension rules, their rationale, the effectiveness of current pension policy in terms of savings rates, and ongoing reforms.

Pension policy in the UK is framed by longstanding strategic objectives for:

- Individuals to have an adequate retirement income that meets their expectations and aspirations.
- Retirement income to be derived from a pension that pays out an uninterrupted income until whenever death occurs.
  - In short, for individuals' retirement income to be insured against 'longevity risk', which is the uncertainty that every individual confronts regarding how long they will live for and what their total retirement income needs will be.

The key incentives deployed in UK pension policy to encourage saving into a pension scheme remain the generous tax-relief associated with this type of saving:

- For workplace pensions, employers normally make pension contributions from a person's salary before deducting tax, so that income taxes are only paid on what is left. For personal pensions arranged outside the workplace, pension providers claim tax back from the government at the basic rate of 20%. Higher rate taxpayers are currently able to claim any difference via their tax return or by contacting HMRC.
- Tax is not paid on any capital gains or investment income derived from pension saving.

In this way, pension saving is subject to distinctively generous tax-relief, compared to other types of financial savings and investment products. Although retirees are subsequently liable for income tax on their pension income, they benefit from a higher tax-free personal allowance than working-age individuals.

As a condition of tax-relief on pension savings, strict rules apply to UK pension saving that seek to ensure pension savings are used to fund retirement income alone, and that – although with some flexibility – this retirement income comprises a pension-derived income, i.e. it insures against longevity-risk. The key rules applying to the use of pension savings are:

- Individuals cannot access their pension saving until the age of 55 (previously 50);
- From the age of 55, individuals may take a tax-free lump-sum of up to 25% of the value of their pension saving. Before the age of 75, an individual may also take the option of 'income drawdown', in which pension savings remain invested and the person takes an income each year, between a minimum (£0) and a maximum (120% of a pension calculated according to tables produced by the Government Actuaries Department). However, by the age of 75 the remainder must be used to purchase an annuity, or moved into an 'alternatively secured pension'.

The restrictions on access to pension saving distinguish it from other types of saving vehicles. Commensurately, the tax-relief granted to pension saving is uniquely generous compared to other financial products, notably Individual Savings Accounts (ISAs), into which individuals can pay up to £10,200 each year.[5] Although tax is not paid on interest or investment gains in ISAs, total annual contributions are capped, and contributions from income are made after a person's income has been subject to income tax.

In this way, the tax-relief granted to pension saving represents an explicit *quid pro quo*: pension savings are granted uniquely high levels of tax-relief; however, such savings can only be used for the purposes of deriving a secure retirement income.

This 'annuities deal' was restated by the government in 2006: "In return for the generous tax relief on pensions saving, the Government requires individuals to turn their pension fund into a secure retirement income. This longstanding requirement

5 Prior to April 2010, this threshold was £7,200.

dates back to the 1920s."[6] Support for this 'annuities deal' was also underscored by the Pensions Commission, which stated: "Since the whole objective of either compelling or encouraging people to save, and of providing tax relief as an incentive is to ensure people make adequate provision, it is reasonable to require that pensions savings is turned into regular pension income at some time."[7]

More generally, various stakeholders inside and outside the pensions industry regard the 'annuities deal' as vitally important, and see the generous tax-relief on pension saving as a necessary incentive to induce individuals to engage in sensible financial preparation, saving for the long-term and deferring consumption, as well as pooling the longevity risk associated with their retirement income needs. Without rules restricting access to pension saving, it is argued that individuals could be tempted into using pension saving to fund other types of consumption before retirement. In addition, when given the opportunity to purchase a life annuity with cash, many individuals are resistant, reflecting demand-side barriers to the purchase of annuities, and underpinning the need to lock retirement savings into a structure that compels individuals to pool longevity risk.

Nevertheless, some commentators have argued that rules on securing a pension are excessively restrictive, in particular, the requirement to buy an annuity as opposed to having more choice over how pension savings are used to fund retirement. As a result, the Conservative Party announced in February 2010 that if elected, a Conservative government would scrap the rule requiring investors to buy an annuity when they reach the age of 75. The current alternative to buying an annuity at 75 is to move into an 'alternatively secured pension' (ASP), which is subject to higher tax charges. Indeed, since the introduction of ASPs in 2006, only around 2500 have taken this option.[8]

6 HM Treasury (2006) *The Annuities Market*, HMSO, London.

7 The Pensions Commission (2006) *The Second Report of the Pensions Commission*, London.

8 http://www.ft.com/cms/s/2/4a828126-1284-11df-a611-00144feab49a.html.

EFFICACY OF UK PENSION RULES AND POLICY

The strategic objectives of UK pension policy are clear, and the 'annuities deal' remains a transparent policy framework to encourage pension saving. Nevertheless, levels of pension saving in the UK have consistently been below that which would be required to meet the strategic objectives of pension policy. Various studies have identified a 'pension savings gap'. For example, recent research from the ABI found that half of the working population (over 13 million people) were either not saving in a pension at all, or were not saving enough.[9]

What is the cause of under-saving? One explanation is ongoing changes to the infrastructure of UK pension saving, with the availability of 'defined-benefit' (DB) workplace pension schemes declining, relative to the growing proportion of 'defined-contribution' (DC) schemes, in which levels of pension income received directly reflect total contributions by an individual. The number of members of DB schemes has declined from 5.6m in 1991 to 3.3m in 2006. Crucially, contribution rates to a pension by individuals and employers typically vary between DB and DC schemes, as shown by table 2.1, which in part accounts for the ongoing problem of under-saving for retirement:[10]

Table 2.1 Contribution rates to private sector occupational pension schemes: by benefit type, contributor and status, 2004–2006[11] [12]

	Members		Employer		Total	
	Open	Closed	Open	Closed	Open	Closed
DB						
2004	4.6	3.9	12.1	17.1	16.8	21.0
2005	4.9	3.6	13.9	18.8	18.8	22.4
2006	4.9	4.5	14.2	15.0	19.2	19.5

9 ABI (2008) *State of the Nation's Savings*, London.

10 Levy S (ed.) (2007) *Occupational Pension Schemes Annual Report*, Office for National Statistics, HMSO.

11 Includes schemes with zero contributions.

12 Schemes with 12 or more members.

	Members		Employer		Total	
	Open	Closed	Open	Closed	Open	Closed
DC						
2004	2.9	3.1	6.2	4.2	9.1	7.3
2005	2.7	2.6	6.0	8.0	8.7	10.6
2006	3.0	2.52.5	5.8	5.4	8.9	7.8

Policymakers have long been concerned with the problem of under-saving for retirement, and in 2002 the government set up the Pension Commission to examine options for reform. Following the Pension Commission recommendations, the government published two White Papers: Security in Retirement[13] and Personal Accounts,[14] which were succeeded by the Pensions Acts of 2007 and 2008.

In order to improve pension saving rates in the UK, these ongoing reforms focus on changing several features of the pension system. The key components of this major raft of reforms are:

- From 2010, the number of qualifying years needed to receive a full Basic State Pension will be 30 years for men and women. The Basic State Pension will be linked to rises in earnings, rather than prices, from around 2012 onwards.
- The State Pension Age will increase between 2024 and 2046 to 68 for both men and women.
- From 2012 it is planned that all eligible workers who are not already in a good quality workplace scheme will be automatically enrolled into either their employer's pension scheme or a new savings vehicle, NEST (National Employment Savings Trust), formerly known as 'personal accounts'. Employees will retain the right to 'opt-out'; however, they will be automatically re-enrolled every three years.
- To encourage participation, employees' pension contributions will be supplemented by contributions from employers and tax relief. For the first

13 DWP (2006) *Security in retirement: towards a new pensions system*, TSO, London.

14 DWP (2006) *Personal accounts: a new way to save*, HMSO, London.

<?> Levy S (ed.) (2007) *Occupational Pension Schemes Annual Report*, Office for National Statistics, HMSO.

time all employers will be required to contribute a minimum of 3% (on a band of earnings) to an eligible employee's workplace pension scheme. This will supplement the 4 % contribution from the employee and around 1 percent from the government in the form of tax relief.

In this way, ongoing reforms to pension policy are seeking to increase pension saving rates by increasing the financial incentives to save into a pension, ensuring universal workplace access to an acceptable pension scheme, and deploying automatic enrolment to overcome widely recognized behavioural barriers to saving for retirement, such as inertia and procrastination.

Pension policy in the UK is therefore in a transitional stage. The longstanding problem of under-saving is widely recognised, and the government, following a thorough independent review, is engaged in far-reaching reform to the pension savings infrastructure.

At no point in this reform process aimed at increasing savings rates has the UK's 'annuities deal' or the core rules governing pension saving come under significant pressure. The core elements of this arrangement – strict restrictions on savings in return for generous tax-relief – still command general support. However, this is beginning to change as political observers anticipate heightened income insecurity as a result of the global recession of 2008–2009.

Nevertheless, some commentators continue to argue that the restrictions on access to pension saving before 55 actually contribute significantly to the problem of under-saving. They also point out that under certain circumstances, rules on access to pension saving could create perverse outcomes, such as individuals with substantial pension savings whose home is repossessed during a time of financial hardship, but who are unable to use their pension saving to prevent repossession due to strict rules preventing access before the age of 55.

The next chapter therefore examines the theory and evidence on pension saving rules and their effect on savings rates.

Key points

- The strategic objectives of UK pension policy are for everyone to have a retirement income that meets their expectations and aspirations, and as much as possible, for this retirement income to be pension-based, i.e. to insure individuals against longevity-risk.
- To encourage pension saving, such savings benefits from uniquely generous tax-relief in respect of both income and capital gains. Commensurately, pension-saving is subject to strict rules on access, which forms the longstanding 'annuities deal'.
- Nevertheless, the problem of under-saving for retirement is both significant and persistent.
- Ongoing reform to the UK pension system is focused on increasing the incentives for pension saving, ensuring universal access to a decent pension scheme and overcoming behavioural barriers to saving.

CHAPTER 3: PENSION SAVING RULES, SAVING RATES AND INCOME-SMOOTHING

Proponents of early access models of pension saving deploy two distinct arguments. The first is that the inflexibility of pension saving rules deters individuals from saving because they will not be able to access this saving if they experience financial hardship, and these rules are therefore a cause of under-saving. The second is that under some circumstances, pension saving rules can create perverse consequences if individuals suffer an unexpected drop in income, and are therefore left exposed to poverty or home repossession despite possessing savings they could have used to smooth their income. This chapter examines the theory and evidence underpinning these perspectives. It first examines the range of factors determining pension saving, and then examines the available evidence of any deterrence effect arising from rules governing such saving. It then examines the theory and evidence behind suggestions that pension rules can, under certain circumstances, create perverse outcomes.

PENSION SAVING RULES AND SAVINGS RATES

Numerous factors determine the decisions of individuals and households regarding:

- Whether to save for retirement;
- Whether to save for retirement through pension saving; and,
- The proportion of income to save in a pension at different points in the life course.

These factors include: housing tenure; attitudes to investment risk; availability of tax and other incentives; housing and living costs; and, financial capability. Indeed, it is worth noting that (future) home ownership is arguably a necessary condition for pension saving, given that otherwise, pension income will merely substitute means-tested housing benefits in retirement. In addition, most households would be expected to have access to some 'buffer'/'precautionary' savings against uninsured risks, before undertaking pension saving. This could be in the form of savings accounts, ISAs, income insurance, or informal financial support such as the resources available from family networks.

However, for some years, commentators have suggested that the inflexibility associated with pension savings actually acts as a deterrent to pension saving, in that the prospect of 'locking away' saving for up to 40 years has a negative effect on pension saving. In effect, two hypotheses are advanced:

- Pension rules reduce the proportion of savings that individuals put into pension saving – (individual) contribution rates;
- The inflexibility of not being able to access pension saving deters some individuals from saving into a pension at all – participation rates.

Why would pension rules deter saving? A theoretical explanation for this hypothesised 'deterrence effect' on participation and contribution rates could cite a number of factors. First, individuals may attach a value to flexibility and choice, preferring flexible savings products over less flexible pension saving. Individuals may also prefer 'simple' savings over 'complex' pensions. As a result, individuals may be willing to pay the price for this flexibility: the loss of potential tax-relief that would have accrued to saving into a pension.

Second, individuals may be aware that their life course income and expenditure needs are unpredictable, may fluctuate, and therefore be averse to the 'bet' that pension saving represents, i.e., that such savings will not be needed during a period of financial hardship before they can be accessed from the age of 55.

On the *income* side, most individuals – particularly from lower socio-economic households – may be aware of the potential for 'critical life events' which *temporarily* or *permanently* lower income resulting in financial hardship, for example:

- Unemployment;
- Caring responsibilities, whether to a disabled child, partner or elderly relative;
- Relationship-breakdown;
- Death of a partner;
- Ill-health.

It is worth highlighting that some commentators argue gender is a key consideration since women may have a more unpredictable life course income than men. First, many younger women may fully expect to have irregular contact with the labour market during the working-age period of their life as a result of child-rearing, and may also be aware that their earning potential may be lower following extended periods out of the labour market. Second, public expectations around marriage and partnership formation are changing, and social attitude surveys show a growing awareness of the likelihood of partnership breakdown. For example, evidence from the British Social Attitudes survey suggests that 34% of individuals see marriage as risky because of the high likelihood of divorce, especially those who are themselves separated or divorced, of whom 47% report this attitude.[15] As such, women may consider it risky to save into a pension and rely on a partner's income before retirement age given they may subsequently be raising children alone, and may not be active in the labour market. It is therefore argued that locking away savings until retirement age may be especially risky for women compared to men, who may have comparatively higher expectations of long-term permanent employment, with income unaffected by any partnership breakdown. As a result, it has been argued that structures for pension saving and pension rules are biased toward men.[16]

On the *expenditure* side, income needs over the life course may fluctuate in response to changes in a person's preferences, changing circumstances or unexpected external events:

- The potential for changes in preferences might see individuals reluctant to lock away money in case they subsequently decide to spend more before reaching retirement, e.g. having the flexibility to take an expensive cruise at the age of 50.

15 Duncan S and Phillips M (2008) "New families? Tradition and change in modern relationship" in Park A et al. (eds) *British Social Attitudes: the 24th Report*, London: Sage.

16 However, it is important to consider womens' propensity to save for a pension and risks to income over the life course in the context of other mechanisms to support child-rearing. For example, it could be argued that raising the level of child-benefit, and means-testing this benefit, might reduce the number of women who see locking away saving as a risky activity.

- Individuals may be unsure how their income needs will change and develop over their life course, e.g. what the future costs of child-rearing will be.

In truth, all of these factors will to some extent be incorporated into every individual's decision as to whether to undertake pension saving, and how much of their income to save.

However, there will be wide variations in the effect of these factors on individual pension saving decisions, and therefore the extent to which the inflexibility of rules around pension saving does act to drag down contribution and participation rates on pension saving. The effect of these factors will vary according to:

- Expectations of future income and expenditure;
- Attitudes to consumption and 'living for today';
- Attitudes to risk, including investment risk and the risk of critical life events occurring;
- The availability of other income sources and savings to cushion against external shocks, for example, potential transfers from family networks that would be available in the event of unemployment.

Given such variations among individuals, any 'deterrence effect' arising from the inflexibility of rules around pension saving will vary accordingly across the population. In the current climate it also worth emphasising the potential effect of external events. As described in the first chapter, the severe recession and rise in unemployment experienced in the UK during 2008–2009, which followed a long period of sustained economic growth, may make individuals more sensitive to the risk of unemployment, and therefore, averse to locking away savings in a pension.

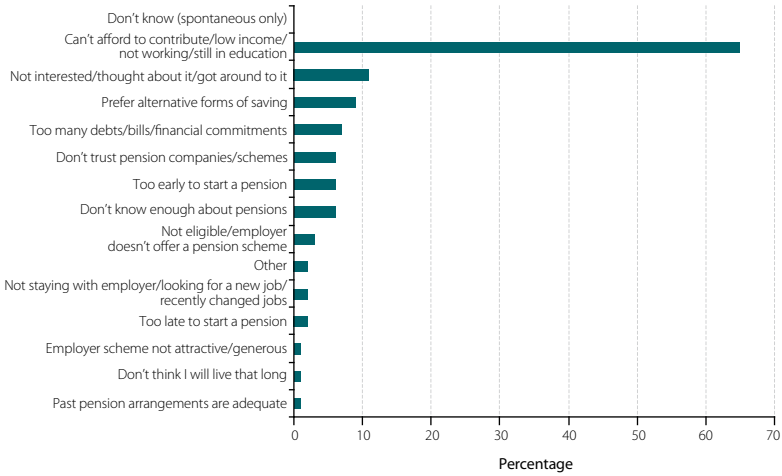
So there are theoretical grounds for suggesting that the inaccessibility of pension savings may to some extent lower participation rates and contribution rates in UK pension saving. However, any such deterrence effect is only one of a number of factors affecting pension saving, and will be subject to multiple mediating factors. What is the evidence for such a 'deterrence effect' on pension saving?

EVIDENCE ON PENSION RULES AND PARTICIPATION IN PENSION SAVING

Various surveys of consumer opinion regarding access to pension saving have been undertaken. For example, a survey by the Association of British Insurers found that 4% of individuals cited the lack of early access options as their reason for not taking out a pension, and 7% said they would save more in a pension if they were enabled to withdraw pension savings earlier.[17]

However, consumer opinion surveys on access to pension saving are problematic as a source of evidence given individuals who are under-saving may use the available responses in a survey to justify their under-saving. Responses may also mask underlying reasons for not saving into a pension, e.g. housing costs or the absence of buffer savings.[18]

Table 3.1 Reasons for not saving into a pension: 2006/08, Great Britain[19]



Source: Wealth and Assets Survey, Office for National Statistics.

17 Association of British Insurers (2007) *State of the Nation's Savings*, London.

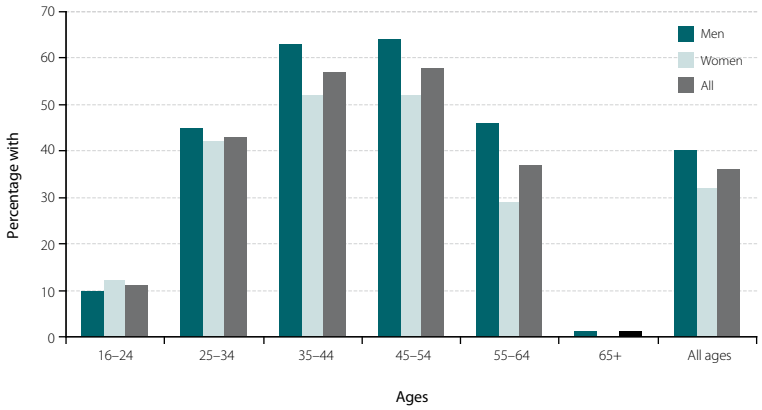
18 Indeed, in contrast to consumer surveys, qualitative research undertaken for the government, using group discussion, that explored the issue of 'liquidity', found participants generally against allowing individuals early access to pension saving (DWP: 2006). Participants believed that strict criteria were needed governing how pension saving is used to ensure that less responsible people do not squander their savings.

19 Individuals aged under 60 not paying into a pension and not receiving a pension.

It is also important to look at the broader range of reasons why individuals do not save for a pension. Data from the UK Wealth and Assets Survey[20] demonstrate that income constraints are typically reported as by far the most significant reason for not undertaking pension saving, as Table 3.1 shows.[21]

Interestingly, preferring other forms of saving is cited by only 9% of respondents as a reason for not saving for a pension, suggesting that the characteristics and rules governing pension saving play only a limited role in causing individuals not to contribute to a pension.

Table 3.2 Member's with private pension: by age and sex, 2006/08, Great Britain



Source: Wealth and Assets Survey, Office for National Statistics.

It is also worthwhile comparing participation rates in pension saving, with saving using other financial products. In relation to participation in pension saving, it appears that levels of participation are not substantially below that of other savings products,

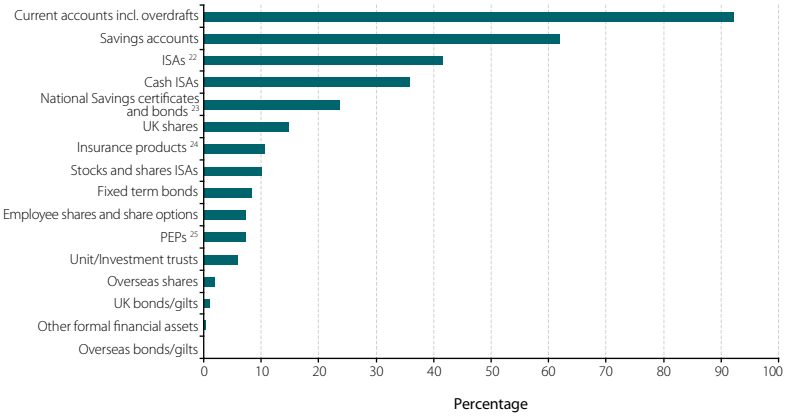
20 The Wealth and Assets Survey is a new longitudinal survey of private households in Great Britain. The Wealth and Assets Survey collects information about the economic well-being of households and individuals, in particular the survey asks people about their assets and liabilities in order to estimate household and personal wealth. This includes information on; property, financial, physical and private pension wealth; savings, debt, borrowing and arrears. Findings presented in this report are drawn from the report of the first wave of the survey which was conducted between July 2006 and June 2008.

21 Daffin C (ed.) (2009) *Wealth in Great Britain: Main Results from the Wealth and Assets Survey 2006/08*, Office of National Statistics.

when life course variations in pension saving are taken account of. Active and inactive participation in pension saving can be shown by the proportion of households possessing pension saving, which varies by age group, as shown in table 3.2.

As table 3.2 shows, among those groups aged 35–54 who would be most likely to engage in pension saving, participation is over 50%. Arguably, this compares well with alternative types of savings vehicle as shown in table 3.2:

Table 3.3 Proportion of households with formal financial assets by type: 2006/08, Great Britain



Source: Office for National Statistics/Wealth and Assets Survey (2009).

Interestingly, ISAs, which are typically viewed as the most tax-efficient rival savings product to pensions, show average participation rates of only 41.7%. Such data does not therefore provide any prima facie evidence that rules on pension saving are causing lower rates of participation in pension saving comparative to more liquid forms of saving.

22 Individual Savings Accounts; note that households may have both cash ISAs and stocks and shares ISAs, so total is not the sum of cash plus stocks and shares ISAs.

23 Including Premium Bonds.

24 Excluding life insurance policies which only pay out in the event of death.

25 Personal Equity Plans.

EVIDENCE ON PENSION RULES AND CONTRIBUTION RATES

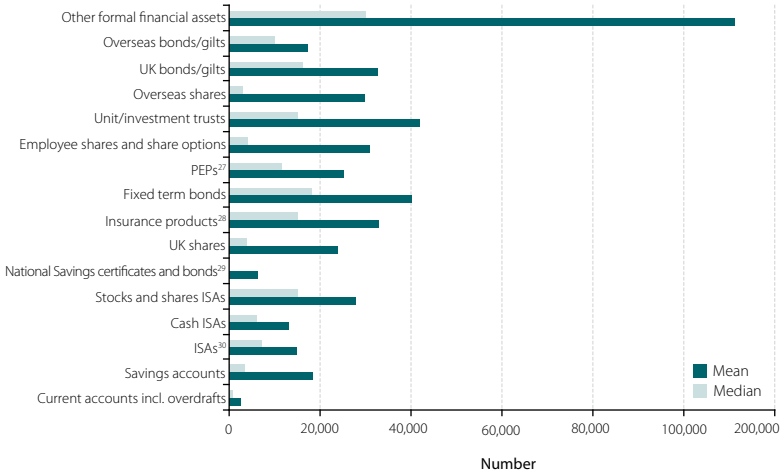
Besides surveys around participation in pension saving, is there evidence that the inflexibility of pension saving rules reduces contribution rates? Does the illiquidity of pension saving encourage individuals to put savings into more liquid savings products?

Evidence to answer this question is extremely limited. Overseas evidence, where more flexible regimes are in operation, has only limited relevance for the UK, because trends in pension saving at a population level cannot be divorced from wider tax regimes, labour relations, household costs, etc.

One way to examine pension contribution rates is to explore the usage of other more liquid savings products and the amounts saved in them. This is because individuals who wished to save for retirement confront a choice between a number of more liquid saving and investment products that could be used for this purpose, rather than relatively illiquid pension saving. Indeed, although the tax-relief provided to other types of saving and investment product is less generous, regulatory changes that came into force on 'A-Day' in 2006 now enable individuals to transfer large sums of money (up to 100% of the value of earnings) into private pensions in any tax year, capped by an Annual Allowance of £245,000 for 2009/10, above which tax is paid at 40% on the excess. Although a relatively recent change, this does mean that *in future*, individuals could save for retirement using liquid savings products if they face uncertainty around future income, expenditure or credit constraints. For example, individuals could save using their annual ISA allowance for a number of years, before depositing this saving into a pension.

However, among households using different types of financial products, there is wide variation in the value of such products. Given high levels of wealth inequality among households, it is essential to distinguish between the *mean* amounts held in financial products, and the *median*, which is the 'middle value' of a financial product owned across all households that hold such a product.

Table 3.4 Formal financial assets: summary statistics, 2006/08, Great Britain[26]



Source: Office for National Statistics/Wealth and Assets Survey (2009).

Crucially, the median value of the most widely used liquid savings products – savings accounts (£3500), and ISAs (£7000) – indicate that many households, particularly those below the median, have relatively small levels of liquid saving. This fact is borne out by examining levels of net household financial wealth among different age groups.

26 Results exclude households without this type of asset (zeros).

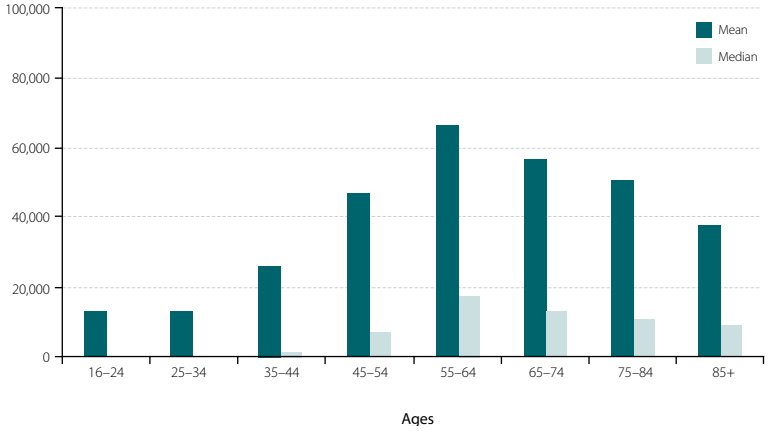
27 Personal Equity Plans

28 Excluding life insurance policies which only pay out in the event of death.

29 Including Premimum Bonds.

30 Individual Savings Accounts.

Table 3.5 Distribution of net household financial wealth: by age of household head, 2006/08, Great Britain[31]



Source: Wealth and Assets Survey, Office for National Statistics.

Looking across the range of liquid financial assets that individuals can hold, this evidence suggests that rather than pension rules limiting access to pension savings causing individuals to prefer other types of tax-efficient savings, there is in fact a more generalised and widespread problem of under-saving. This is significant for proponents of early access pension saving for two reasons. First, such evidence suggests that households do not hold significant levels of precautionary/'buffer' savings, which households might be willing to put into pension saving if they knew it would be accessible at a time of crisis. Second, such evidence suggests that rather than pension saving rules deterring individuals from putting savings into a pension, the problem of pension under-saving is actually symptomatic of a much wider problem of under-saving.

In short, empirical data on household financial wealth does not suggest any deterrence effect on participation and contribution rates toward pension saving arising from pension rules. Such evidence does not disprove the existence of such a 'deterrence effect', and as discussed above, the inflexibility of pension rules is likely to play a part

31 Results exclude households with zero net financial wealth.

in pension saving decisions by individuals along with many other factors. In future, if savings rates were to increase significantly with higher saving reflected in increased liquid saving, this situation may change. However, at present, there is no empirical evidence to suggest that the inflexibility of pension rules deters pension saving.

PENSION SAVING RULES AND INCOME SMOOTHING

In addition to arguments around pension saving rates, proponents of early access to pension saving cite potential situations in which individuals may suffer an unexpected drop in income, or increase in expenditure, and thereby find themselves suffering significant financial hardship, despite being in possession of pension saving which they nevertheless cannot access.

Prompted in part by the recent UK recession and associated increase in the number of homes repossessed, the hypothetical example frequently cited by proponents of early access to pension saving is an individual with pension saving at risk of losing their home.[32] In short, the second argument put forward for early access to pension saving is that the inflexibility of pension rules prevents individuals from smoothing their life course income in response to unexpected changes in income and expenditure.

The 'perfectly rational' individual who occupies economic theory would never be caught out by the inflexibility of pension saving, as they would undertake precautionary liquid saving or have recourse to family wealth transfers, and would insure themselves against potential income shocks, for example, by purchasing various forms of mortgage insurance. To what extent do individuals behave in this way?

In fact, one of the most striking features of asset ownership is that possession of different types of wealth is positively correlated. This effect is clearly observable amongst individuals aged 50+ who are well advanced in the accumulation stage

32 This example is particularly pertinent given that any individual that does not expect to own their own home in retirement arguably has no reason to save for retirement, since any pension income will disqualify them from means-tested financial support for help with the cost of rent. As such, home-ownership is generally seen as a precursor to pension saving.

of their life.[33] Evidence is also available showing a strong association between pension saving specifically, and holding liquid savings. Analysis from the Institute for Fiscal Studies shows clearly that those choosing to undertake pension saving maintain positive net liquid financial wealth, compared to those choosing not to.[34]

Table 3.6 Median net liquid financial wealth at the family level by detailed individual pension status, 2005

All	**£1,000**
All offered employer's pension	**£1,500**
. . . and joined	£2,800
. . . and refused	£0
. . . refused and joined PP	£4,000
. . . refused and no PP	£0
Not offered employer's pension	**£0**
. . . and PP	£3,800
. . . and no PP	£0

Source: British Household Panel Survey.

In relation to the most commonly cited situation in which pension saving rules may stop individuals from smoothing their income – housing repossessions – it is unclear how many individuals have experienced this precise situation. According to the Council of Mortgage Lenders, 46,000 households had their home repossessed in 2009, up from 40,000 in 2008.[35] More generally, around 188,300 mortgages ended 2009 with arrears equivalent to at least 2.5% of the outstanding mortgage balance. However, no data is available pertaining to how many of these households possess pension saving that could have prevented repossession or

33 For example, see: Banks J et al. (2005) *Prepared for Retirement? The Adequacy and Distribution of Retirement Resources in England*, Institute for Fiscal Studies, London; Banks J et al. (2008) *Asset ownership, portfolios and retirement saving arrangements: past trends and prospects for the future*, Financial Services Authority, London.

34 Emmerson C & Wakefield M (2009) *Amounts and Accounts: Reforming Private Pension Enrolment*, Institute for Fiscal Studies, London.

35 Council of Mortgage Lenders (2010) *Mortgage arrears and possessions declined in fourth quarter of 2009*, Press Release, http://www.cml.org.uk/cml/media/press/2541

arrears, i.e. enabled mortgage repayments until such a time as income is restored. Indeed, it is important to observe that the most highly leveraged individuals in terms of mortgage debt to housing wealth are typically younger individuals who would also have had limited time to build up significant pension saving.

For policymakers, such evidence and observations raise fundamental questions around savings policy and individual responsibility. In particular, are UK households undertaking sufficient precautionary saving to provide a buffer against unexpected shocks to income? As such, this issue should be framed not just in terms of pension rules, but in terms of the efficacy of UK savings policy and associated issues, such as the usage of personal credit. In addition, if individuals do not undertake sufficient liquid saving, such that they are caught out by the inflexibility of pension saving rules, is this a matter of individual responsibility or does it merit a revision to pension rules applicable to all? Again, this issue should be framed not just in terms of pension rules, but in terms of financial decision-making, and associated issues, such as the availability of financial advice.

Overall therefore, it is clear that, in hypothetical terms, it would be possible for individuals to find themselves experiencing significant financial hardship despite being in possession of pension saving. However, it is unclear how many individuals actually find themselves in this situation, and whether this is an issue for pension rules and pension policy, or an issue for savings policy and individual financial behaviour.

Key Points

- Many factors determine pension participation and contribution rates, besides rules on access to pension saving, and any 'deterrence effect' is likely to vary widely across the population.
- Consumer surveys and empirical evidence do not suggest any deterrence-effect impacting pension saving, relative to other types of more liquid savings products. This is true of both participation and contribution rates. Rather, pension under-

saving is symptomatic of a broader problem of under-saving affecting all types of liquid and illiquid saving.

- In hypothetical terms, it would be possible for someone to experience significant financial hardship while unable to their access pension saving. However, evidence suggests possession of different types of wealth is positively correlated, so most individuals with pension savings are likely to have access to other savings.
- Some individuals facing home repossession may have been able to delay or prevent this if they had access to pension saving. However, there is no data available indicating how many of the 46,000 repossessions that took place in 2009 could have been prevented if households had had access to their pension saving.
- If pension rules do prevent individuals from adjusting their income and consumption in response to unexpected financial hardship, it is unclear that this raises questions for pension rules, as opposed to UK savings policy, and the role of individual responsibility.

CHAPTER 4: DESIGN CHOICES IN MODELS OF EARLY ACCESS PENSION SAVING

The previous chapters have considered current UK pension rules, the theoretical case for enabling early access to pensions, and the evidence underpinning such arguments. This chapter focuses on the detail of how any policy of early access to pension saving would be designed. Multiple models of early access pension withdrawal can be conceived, and many different alternatives have been proposed by commentators. What are the principal design choices involved?

TOTAL AMOUNT OF PENSION SAVING WITHDRAWN

The key choice for early access models of pension saving concern the amount that individuals may withdraw, whether measured as a cash amount or as a proportion of total pension savings. Both approaches could be set using minimum and maximum limits. In addition, rules would have to determine whether repeated withdrawals were allowed, before or after any original sum withdrawn had been repaid.

PERMANENT VS. TEMPORARY WITHDRAWALS

Early access models could be built around individuals making *permanent* or *temporary* withdrawals from pension saving. Permanent withdrawals might be invoked when individuals suffer a permanent loss of income, for example, owing to the onset of disability during working life resulting in a permanent (lower) adjustment to their projected life course income. Temporary withdrawals, or temporary loans against pension saving (see next chapter), could be appropriate in instances when individuals suffer a temporary loss of income, and would see individuals compelled or be expected to repay their withdrawals.

EARLY ACCESS TO DEFINED-BENEFIT (DB) VS. DEFINED-CONTRIBUTION (DC) SAVING

In a defined-benefit (DB) pension scheme, the pension income paid out is determined by preset formula. DB schemes that are 'unfunded' see no wealth set aside or invested; rather pension incomes are paid directly by current workers

(pay-as-you-go) – including taxation for some public sector schemes – or out of the organisation's operating income. As such, most organisations with unfunded workplace DB pension schemes would find it prohibitively difficult to offer early access to pension entitlements.

In 'funded' DB schemes, a large pension fund is operated into which employers and (usually) individuals pay contributions. Proponents of early access have suggested that individuals could have access to savings into a funded DB scheme. However, it is unclear whether such early access could work on a practical level, given potential difficulties with calculating entitlement to a pooled investment fund, and the risk that multiple individuals seek to access their pension savings simultaneously.

As a result, an important choice in developing a policy of early access to pension saving is whether such access would apply to both DB and DC schemes. Indeed, it is worth noting that any rule changes, for example, in relation to DC schemes, might affect attitudes and participation in DB schemes, if those in DB schemes unable to access their savings early felt that this was unfair, in the context of DC pension savers who could.

TAX-RELIEF AND EMPLOYER CONTRIBUTIONS

A key question for any model of early access pension saving is how such withdrawals should be treated for tax purposes; in particular, whether the state should seek to reclaim the value of tax-relief granted on earnings and savings already invested, if such pension saving is not in fact used for retirement income. If such tax-relief is clawed back from individuals experiencing financial hardship, such actions could be perceived to be penalising those experiencing misfortune. In addition, any attempt to reclaim tax-relief would create administrative costs and complexity for providers and the state.

A second related issue is how employer contributions to an individual's pension saving should be treated if such pension savings were in fact accessed before retirement age.

ALLOWING EARLY ACCESS TO EXISTING PENSION SAVING (BACKDATING ENTITLEMENTS)

If any policy of early access to pension saving were to be implemented, a critical design choice for policymakers would be whether such an option, however framed, was effectively 'back-dated' to include existing pension savings.

If access to existing saving were not allowed, this may be perceived as unfair to those who have already saved for retirement. However, backdating entitlement to early access would impose significant administrative and management costs that would be have to be borne by pension providers or individual savers. In addition, backdating an entitlement to existing pension saving would not actually achieve the stated policy objective of increasing participation and contribution rates in new pension saving.

Nevertheless, if the objective of changing pension rules is to enable early access to pension saving under conditions of financial hardship to better enable individuals to smooth life course income in response to unexpected changes in income and expenditure, backdating of pension saving would be logical.

UNIVERSAL VS. LIMITED EARLY ACCESS TO PENSION SAVING

New rules applicable to pension saving, and the right to early access in whatever form, could be applied universally to all pension savers, with the purpose of making pension saving more attractive to all. A universal – effectively mandatory – approach may create new costs for pension providers and workplace schemes, reflected in rule changes, member literature changes and administration costs. Alternatively, entitlement to early access could be limited to certain groups. On either approach, various design choices would have to be made around when individuals could have access to pension saving, such as minimum contribution periods or minimum thresholds of accumulated saving. However, these questions do create complexities given the potential for investment-related fluctuations in the value a pension fund around a threshold level.

If a universal approach to enabling early access to pension saving were adopted, this far-reaching reform would likely require substantial changes to asset allocation

by investment managers. As such, this may impact levels of investment return and management charges across the pension industry.

If the option of early access is limited to certain groups, a further design choice presents itself around how these groups are defined. A *choice* vs. *merit*-based entitlement to access pension saving early can be identified:

A choice-based approach to early access would see individuals 'choose' to have the option of early access as a characteristic of a pension saving product. On this approach, enabling individuals to 'opt-in' to a more flexible savings vehicle would potentially increase saving among those who would otherwise save less into a pension. However, this choice might also be exercised by those who would have saved into an existing non-flexible pension scheme, given that any extra choice and flexibility is frequently valued by consumers across the board. In response, regulators and pension providers could put a price on this choice, by imposing charges or management fees, in order that those valuing flexibility identified themselves, and tax-relief was reclaimed. The Pensions Policy Institute has suggested that a possible minimum mandatory contribution rate on top of the minimum contribution level could be imposed under such an approach.[36] In addition, it is worth noting that the higher liquidity of savings implied would also likely see lower investment returns on savings.

The second merit-based approach to enabling early access to pension saving would see individuals deemed to 'merit' the right of early access. This could be an *ex-ante* entitlement because of their characteristics (e.g. lower-income, gender, age), or *ex-post* entitlement, because they have experienced financial hardship arising from a drop in income or increase in expenditure.

EX-ANTE CONDITIONALITY APPLIED TO INDIVIDUAL SAVERS

Enabling early access to pension saving for certain types of 'targeted' individuals or households who may be likely to be cautious about locking away savings would

36 Silcock D et al. (2008) *Would allowing early access to pension savings increase retirement incomes?*, Pensions Policy Institute, London

require classifications to be made based on criteria such as income, gender, and possession of other savings. In this way, the entitlement to early access would be for targeted low-income groups to encourage higher savings rates. However, such targeting would create complexities.

EX-POST CONDITIONALITY APPLIED TO HARDSHIP WITHDRAWALS

On this approach, the entitlement to early access to pension saving in response to financial hardship is effectively an entitlement granted by regulators and pension providers as a mechanism of encouraging higher rates of pension saving among those who might otherwise view locking away money as too risky. Policymakers would then confront various choices around how to make early access to pension saving conditional on individuals experiencing hardship. In short:

- What hardship conditions would see individuals able to access their pension saving early?
- How should this conditionality be administered?

In the US, the Internal Revenue Service permits early access to pension saving in relation to "immediate and heavy financial need" defined as:

- Expenses for medical care previously incurred by the employee, the employee's spouse, or any dependents of the employee or necessary for these persons to obtain medical care;
- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- Payment of tuition, related educational fees, and room and board expenses, for the next 12 months of postsecondary education for the employee, or the employee's spouse, children, or dependents;
- Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;
- Funeral expenses; or
- Certain expenses relating to the repair of damage to the employee's principal residence.

For the UK, a number of critical life events could be used as trigger points for being able to access pension saving early. These include:

- Extended unemployment;
- Relationship breakdown;
- Death of a partner;
- Ill-health;
- Caring responsibilities.

However, several of these conditions may result in moral hazard, for example, ending a relationship in order to access pension savings or withdrawing from employment. Some form of means-testing would also be required given that, for example, many individuals providing care to elderly parents do in fact have higher than average levels of wealth.[37]

Administering and policing the entitlement to early access to pension saving in response to hardship would therefore also pose a significant challenge. Various proponents of early access to pension saving have suggested that pension providers could effectively use data and 'triggers' from other administrative systems. Three such potential sources of data and 'triggers' have been identified:

A first approach would be for pension providers to use entitlement to welfare benefits for income (Income Support) and disability (Disability Living Allowance), as the conditions for an individual being able to access their pension saving. However, as a mechanism to encourage higher levels of pension saving, this approach would be flawed in relation to higher-income households who would likely want to have access to pension saving during financial hardship long before their income and wealth was reduced to levels that would entitle them to Income Support. In addition, a key issue that would have to be resolved would be whether funds released early from pension saving would then disqualify individuals from receiving income-related means-tested benefits. As such,

37 Ross A, Lloyd J and Weinhardt M (2008) *Living and Caring? An Investigation of the Experiences of Older Carers*, ILC-UK, London.

tying conditionality for early access to pension saving to the receipt of welfare payments would be highly problematic.

A second approach, relevant to ill-health and disability, would be for pension providers to enable early access to pension saving in response to medical certificates administered by doctors. Despite data confidentiality issues, this approach does have some precedent, as at present, some pension plan providers do, if a person is forced to effectively retire early due to ill-health, enable individuals to take up to 25% of the fund value as a lump sum, with the balance used to provide a pension.

A third approach, relevant to the threat of individuals losing their homes to repossession, would see pension providers use administrative data from mortgage lenders, such as the issuance of final mortgage arrears demands, as the trigger for enabling individuals to access their pension saving. However, as described above, it is unclear what proportion of repossessions could be averted if individuals had access to their pension saving. In addition, given the scope for individuals to deliberately forgo mortgage repayments in order to access their pension saving, any such system would require further policing and means-testing. Lenders may also be incentivised to bring forward the issuance of final arrears demands in order utilise households' pension savings to bolster the quality of their loan-books.

Alternative approaches to administering conditionality of early access to pension saving would rely on pension providers undertaking themselves to means-test individuals and formally record the occurrence of financial hardship. However, the complexity and cost of such an approach would appear significant.

Key Points

In formulating a policy to enable early access to pension saving, a number of design choices would confront policymakers. These include:

- The amount that individuals are able to withdraw;
- Permanent vs. temporary withdrawals;

- The types of pension scheme (DB, DC) applicable;
- How tax-relief and employer contributions should be treated;
- Whether access to pension saving should be backdated to existing savings;
- Whether early access should be universal or limited to certain groups;
- What conditions should be applied to early access to pension savings and how this should be administered.

CHAPTER 5: EVALUATION CRITERIA FOR MODELS OF EARLY ACCESS PENSION SAVING

The previous chapter set out some of the principal design choices for policymakers considering implementation of early access pension saving. In the next chapter, some of the key models of enabling early access pension saving, including some schemes deployed overseas, are described and reviewed. However, any change of policy by decision-makers will involve an assessment of the costs and benefits associated with different reforms, and a judgement as to whether the burden of transition to a new system is proportionate to an expected outcome. This chapter therefore sets outs some of the principal criteria that should be used to evaluate models of early access to pension saving.

EFFECT ON PENSION SAVING CONTRIBUTION AND PARTICIPATION RATES ACROSS THE POPULATION

The most important criteria for evaluating models of early access to pension saving is whether there is a positive effect on contribution and participation rates. Given the enormous number of complex factors determining saving rates, the true impact of greater flexibility may only be measurable through pilot schemes rather than universal rule changes.

However, given that the option of early access to pension saving, if targeted toward certain groups, may affect saving among other groups, policymakers would need to be clear about how participation and contribution rates among across the population would be measured, and how the population-level measure would be defined.

EFFECT ON THE VALUE OF TOTAL PENSION SAVINGS FOR INDIVIDUALS

The ultimate objective of increasing pension saving participation and contribution rates is to increase the value of pension funds available to individuals to convert into a retirement income. This will depend on how early access is designed (e.g. permanent withdrawal vs. loan), the effect on contribution and participation rates, and the extent to which pension savings accessed early are repaid.

SCOPE FOR TAX AVOIDANCE

A significant risk for models of early access pension saving is that individuals develop mechanisms for gaming the rules in order to use pension saving as a tax-efficient form of general saving. As such, the extent of tax avoidance, and wider fiscal effects of reforms, would have to be key evaluation criteria.

COMPLEXITY

Levels of complexity for consumers associated with any model of early access pension saving is a key criteria for evaluation. In recent years, there has been growing recognition that complexity in financial products is negatively correlated with their take-up. Simplicity is recognised as being valued by consumers, but also as an attribute of financial products that increases take-up and participation. Indeed, financial capability and complexity matter to pensions saving. Research by the Institute for Fiscal Studies found a positive association between numeracy and membership of a private pension.[38]

In this context, existing pension saving rules already present a level of complexity to consumers that is a potential barrier to pension saving. Introducing limited or conditional early access to pension saving would arguably increase this level of complexity, potentially cancelling out any positive effect on rates of pension saving that enabling early access would achieve. In addition, extra complexity increases the likelihood that individuals misunderstand their entitlements and choices. As such, the extent to which models of early access pension saving introduce complexity is an important criteria for policymakers evaluating such schemes.

EFFECT ON INVESTMENT RETURNS

It is important to evaluate models of early access to pension saving for their potential effect on investment returns for individuals and across the population. In particular, given that reductions in asset prices may coincide with certain types of critical events, particularly higher levels of unemployment, there is a risk that

38 Banks J & Oldfield Z (2007) "Understanding Pensions: Cognitive Function, Numerical Ability and Retirement Saving" in *Fiscal Studies*, Vol. 28, No. 2, p143–170.

enabling early access to pension saving at such times would see individuals 'lock-in' investment losses or poor returns.

Investment returns are also determined by the annual management charges set by pension scheme providers, reflecting the administrative costs involved and their need to make a profitable return. Various models of early access to pension saving would likely require extra work and administration by pension saving providers, creating extra costs that would have to be borne by savers. The level and incidence of these costs is a key consideration for early access models, particularly in relation to lower-income households who may only ever build up small pension pots. Research from the Pensions Policy Institute found that a 0.1% rise in management charges could cost a saver 2% of their total pension fund over 40 years.[39] Indeed, in this regard, early access pension models are effectively at odds with the government's proposed new system of 'personal accounts', which specifically seek to provide low-income savers with a low-cost pension savings vehicle, driving down annual management charges by bridging the savings gap.

TWO-TIER SYSTEMS

A positive attribute of any rules on pension saving is that they are universal and treat all individuals equally. If not, rules may appear arbitrary, unfair and thereby promote resentment and disengagement. For example, if early access to pension saving were conditional on the application of defined income thresholds, those just above such thresholds who would nevertheless wish for early access to pension saving, may feel that this is unfair. Sharp 'cliff-edges' in rights and entitlements may also result, which necessarily create arbitrary outcomes. As such, early access models should be evaluated for the extent to which they risk creating two-tier systems.

UNINTENDED CONSEQUENCES

Any reform of pension saving to encourage increased rates of saving through the introduction of early access to pension saving would have to take account of the risks of pernicious secondary effects. Three potential risks deserve highlighting:

39 Pensions Policy Institute (2007) *Charging Structures for Personal Accounts – PPI Briefing Note Number 45*, London.

- If pension providers and the government seek to increase pension saving by advertising entitlements to early access following critical life events, this may only serve to remind and reinforce in the mind of potential savers the fact that such adverse events may occur. This may in turn actually further deter individuals from locking away savings in a pension.
- If only selective groups are given the right of early access, this may affect the perception and attitude toward pension saving among those without this entitlement. For example, higher income households may be less tolerant of the inflexibility of pension saving, and therefore undertake less saving, if lower income households have the option of early withdrawal. In effect, increasing pension saving among lower income households might then result in lower pension saving among wealthier households.
- By softening rules around pension saving, even under strict hardship conditions, this small unpicking of the 'annuities deal' may nevertheless "open the barn door" to a gradual erosion of other rules around pension saving. Indeed, demands for greater flexibility are already taking effect on political debate on rules around decumulation and annuitisation.

Key Points

- Policymakers need to be clear about how success would be defined under a flexible pension saving regime.
- Some key criteria for evaluating different models of early access to pension saving include:
  - Effect on contribution and participation pension saving rates across the population;
  - Effect on the value of total pension savings for individuals;
  - Scope for tax avoidance;
  - Complexity;
  - Effect on investment returns;
  - Whether two-tier systems would result;
  - The scope for unintended consequences to occur.

CHAPTER 6: MODELS OF EARLY ACCESS PENSION WITHDRAWAL

The previous chapters have explored the theory and evidence behind proposals for enabling early access to pension saving, as well as the design choices and evaluation criteria that policymakers would confront. This chapter examines in detail some of the principal models available.

A. FLEXIBLE LUMP-SUM PENSION

Rationale

At 55, individuals are able to take a tax-free lump-sum of up-to 25% of their pension saving. To encourage higher pension saving rates, this age-limit could be lowered (e.g. to 40) or abolished altogether. The 25% threshold could also be varied according to the age of a person at the time of withdrawal, so that the later the withdrawal, the higher the amount that can be withdrawn.

Outline

- Withdrawal of lump-sums could, as now, be an unrestricted entitlement for individuals, or made conditional on financial hardship.
- To ensure individuals did not repeatedly withdraw pension savings, thereby effectively decumulating the pension fund before retirement, restrictions would have to limit the total number or size of withdrawals; indeed, individuals could be restricted to one 25% withdrawal, so that the remaining pension saving has to be used to secure a pension.
- A further condition could be added that individuals would have to have built-up a defined level of saving, e.g. £10,000, or five years of regular saving, before being able to take any lump-sum.

Pros

As a variation of the current system, flexible lump-sum entitlements:

- Would be relatively simple for savers to understand;
- Would not require major regulatory change, and would pose a relatively simple administrative challenge to pension saving providers;

- Would be unlikely to change wider pension saving behaviour, but would introduce a 'token' level of flexibility that may prove attractive to some individuals.

Cons

- If applied universally, such a change would have far-reaching implications for asset allocation across the entire UK pension industry, potentially changing investment returns on some asset classes.
- If access to the lump-sum was unconditional, individuals may take lump-sums to fund trivial consumption such as a holiday or new car, but subsequently experience hardship. However, applying hardship-conditions to taking the lump sum would pose significant administrative challenges.
- As an inducement to save more into a pension, individuals may feel that 25% is a relatively low proportion of pension saving to have flexible access to, and its likely effect on pension saving rates is unclear.
- Individuals taking a lump-sum may be poorly informed or badly advised, for example, not realising the ultimate effect on retirement income.
- For new pension saving, providers may have to impose a higher annual management charge if early lump-sum withdrawals are projected.
- For existing pension saving, if large numbers of people took the early lump-sum option from existing savings, this would have significant financial implications for providers and their annual management charges.

B. UNRESTRICTED FLEXIBLE PENSION SAVING

Rationale

Given that the inflexibility of pension saving rules must deter some individuals from saving through a pension, individuals should be given the option of being able to withdraw up to 100% of their pension saving at any time if they so wish, with tax-relief deducted. In effect, the UK 'annuities deal' would be scrapped, and pension schemes would function as savings vehicles, but with tax-relief only retained by savings that remained within the pension account.

Outline

- This model is similar, but not identical, to New Zealand's Kiwisaver model, in

which pension savings are made from post-tax income, and withdrawals are conditional on savings being used for certain purposes (e.g. home purchase).

- Withdrawals could be dependent on first reaching a defined level of saving, or having made regular contributions for a period of time, in order to embed a savings habit.

Pros

- Total flexibility over withdrawals may incentivise more individuals to save into a pension, reflected in both higher contribution and participation rates.

Cons

- The evidence that total flexibility in pension saving would increase pension savings rates is far from clear. In particular, it is uncertain whether the positive effect on pension savings rates of increased flexibility may be cancelled out by individuals exploiting the flexibility to spend savings on other things.
- Under such a flexible model, it is unclear how employer contributions into pension schemes would be treated.
- Given uncertainty over the extent to which individuals would withdraw savings, pension providers would have difficulty in setting annual management charges or the application of surrender charges.
- Although tax-relief may be deducted from pension savings when withdrawn early, and would therefore be revenue-neutral for the state, this would nevertheless pose a significant administrative challenge for pension saving providers and tax-collectors, potentially requiring an increase in annual management charges.
- During periods of economic contraction when asset prices have dropped, individuals choosing to withdraw pension saving early, for example, in anticipation of redundancy, may 'lock-in' investment losses.

C. INCOME SMOOTHING 'HARDSHIP-PENSION'

Rationale

Income and expenditure can fluctuate unexpectedly across the life course resulting in financial hardship. For this reason, individuals experiencing hardship should be given early access to their pension saving. Not only would this better

allow those experiencing misfortune to smooth their income across the life course, the existence of such an entitlement would also address any deterrence effect on rates of pension saving arising from the inflexibility of current rules.

Outline

- In this model, individuals are entitled to access their pension saving, conditional on experiencing financial hardship resulting in a permanent or temporary drop in income.
- If a person's income is restored, for example, re-employment after two years outside the labour market, entitlement to withdraw pension saving is lost.
- If loss of income or increased household expenditure are permanent, individuals would effectively be able to draw down all their pension saving early.
- As above, entitlement could be restricted by age, and by individuals having first saved a defined amount.

Pros

- Allowing individuals to manage pension saving so that it more closely matches their life course income would enable them to better smooth consumption. This entitlement would be attractive to those wary of locking away savings in a pension.

Cons

- As described in previous chapters, significant administrative challenges would ensue from making early access conditional on critical events occurring.
- Given that certain events, such as widespread unemployment, could see many individuals simultaneously seeking to make withdrawals, this could create severe problems for pension fund managers, as well as potentially locking-in investment losses or poor returns.
- If the cost of administering early withdrawals were reflected in the AMCs of all pension savers, this could be seen as unfair to those who have undertaken precautionary saving.
- This model may have the perverse consequence of encouraging individuals not to undertake any precautionary saving and rely entirely on pension

savings as their only savings vehicle, or to rely on pension saving as opposed to purchasing income insurance.

- The ultimate effect on pension saving rates remains unclear. Evidence from providers in the US, albeit in the context of IRS rules on hardship withdrawals, suggests take-up of 'hardship withdrawals' is so low as to raise questions about the value of implementing similar entitlements in the UK.[40]

D. LOAN MODELS OF EARLY ACCESS

Rationale

In order to preserve pension savings, and to avoid administrative costs associated with other models of early access pension saving, individuals experiencing temporary financial hardship are given the option of using a loan made available on the basis of their pension saving.

Outline

- In this model, individuals make loans directly from, or against the value of, their accumulated pension saving. These loans could be made in any situation, or conditional on financial hardship occurring.
- This model is similar to US '401k' pension schemes, in which individuals can take untaxed loans, but the loans must be repaid with interest. A penalty charge could be imposed on the value of withdrawals to discourage usage.

Pros

- For loans directly out of pension saving, there is a clear obligation on individuals to make up the value of their pension saving at a later date, thereby tying individuals into pension saving.
- For loans against the value of pension saving, this approach preserves the value of these savings. In addition, allowing only a loan against the value of a pension fund prevents any risk of locking-in investment losses. Pension providers may also prefer arms-length loan-providers to be responsible for administering a loan.

40 Research found that in December 2007, hardship withdrawals were up 22% from a year earlier; however, even after this increase the absolute level of withdrawals was only 1.5%; see Nessmith W & Utkus S (2008) *Research Note: Hardship Withdrawals and the Mortgage Crisis*, Vanguard Centre for Retirement Research, Valley Forge, PA.

Cons

- As an offer to individuals who are deterred from pension saving by the prospect of not being able to access savings during financial hardship, the idea of taking out a loan precisely at this point of economic difficulty may be unappealing. For example, for someone averse to pension saving because of concerns about unemployment, the prospect of obtaining an interest-accruing loan while unemployed may be unappealing, and provide little extra incentive to save into a pension.
- The loan approach is only suitable for temporary 'income shocks' and financial hardship, not permanent changes to income, such as withdrawal from the labour market on a permanent basis to provide care for a disabled child or adult. However, under some circumstances, it will be difficult to ascertain ex ante whether financial hardship is temporary or permanent.
- Any penalty charges on loans would effectively penalise those individuals who were resorting to loans in response to hardship.
- If loans are made directly from a fund at a time of hardship, individuals may risk locking-in investment losses.
- Interest charges on loans may need to be regulated.

E. FEEDER FUND PENSION SCHEMES

Rationale

To address concerns around administration and complexity, while also giving individuals confidence that pension savings could be accessed in times of hardship, individuals make pension saving into a flexible capped 'feeder fund', with further savings subject to existing pension rules.

Outline

- On this approach, the first accumulated tranche of pension saving, e.g. £10,000, is put into a notional flexible access pension 'feeder fund', with all saving in excess of this subject to existing rules about non-access. Individuals can then withdraw up to £10,000, with subsequent savings used to top up this feeder fund before contributions are directed again at the main fund.

- For simplicity, employer contributions could be directed to the main pension fund, rather than the feeder fund.
- Withdrawals from the feeder fund could be made conditional on hardship occurring, or in fact, be entirely at the discretion of individuals.

Pros

- Relatively straightforward for providers to administer.
- Flexibility may encourage higher rates of pension saving as well as enable individuals to better smooth their income in response to changes in income and expenditure.

Cons

- Potentially complicates pension saving unnecessarily by replicating savings vehicles that already exist, in particular ISAs, albeit with the benefit of tax-relief on income.
- If money is withdrawn from a pension feeder fund, tax-relief would need to be clawed back.
- In order to preserve its value and enable withdrawal at all times, £10,000 of a person's pension fund would have to be kept in highly liquid assets, potentially affecting investment returns.
- Does not help existing pension holders until they have paid into the feeder fund.

F. LOW-INCOME FLEXIBLE PENSION

Rationale

In order to increase pension saving rates among certain individuals and households (low-income, flexible/part-time workers), a new flexible pension would be introduced that enables early access in response to financial hardship.

Outline

- Targeted individuals and households would be able to save into a pension, with the knowledge that they would be able to access saving if they were to subsequently experience financial hardship.

- If a person's situation subsequently changed – increased income/inherited wealth – their pension saving would be transferred to an orthodox pension account.
- The precedent for such a targeted financial product is the existing UK Savings Gateway scheme for low-earners.

Pros

- May make pension saving more attractive for those most deterred by current pension rules.
- Directs increased levels of flexibility around pension saving at those most likely to be deterred by current rules, but retains existing 'annuities deal' for other groups.

Cons

- Classification of target individuals and households may appear arbitrary, and therefore be resented.
- Creates two-tier system and therefore increases complexity.
- Individuals may move in and out of the target group criteria, creating significant complexity. Administering such an entitlement would also require monitoring and policing, for example, of whether a previously low-income household had seen an increase in income, and should therefore lose this entitlement to flexibility in pension saving.
- Costs of administering hardship entitlement would be borne between such lower-income savers and providers, potentially raising annual management charges for lower-income pension savers.

This chapter has reviewed the principal potential models of early access pension saving, and evaluated their respective advantages and disadvantages. The choice of any of these models by policymakers would depend on the precise objectives of policy. Overall, the analysis suggests that although multiple different models of early access to pension saving can be conceived, no single model is without significant questions regarding implementation, administration and the potential to achieve target outcomes. The effect of any model on pension savings rates is far from certain.

Key points

- A number of models enabling early access to pension saving could be explored by policy makers, including:
  - Flexible lump sum pensions;
  - Unrestricted flexible pension saving;
  - Income smoothing 'hardship pension';
  - Loan-based models of early access;
  - Feeder fund pensions;
  - Low-income flexible pensions.
- However, as described in previous chapters, the likely effect of any of these models on pension saving is highly uncertain.
- Each model is subject to significant implementation and feasibility problems, mostly pertaining to administration.

CHAPTER 7: CONCLUSION

This report has explored arguments in favour of enabling early access to pension saving, both as a mechanism to increase pension saving rates, and to better allow individuals to smooth their life course income in response to financial hardship. Such arguments have received increasing attention in recent times from both political and financial services industry stakeholders.

However, on closer examination, it is clear that no compelling evidence exists to suggest that the inflexibility of current pension rules deters individuals from saving for retirement through a pension. In addition, data from surveys of wealth and asset holdings suggests that those individuals that undertake pension saving also maintain other types of liquid savings and investments, thereby providing a buffer against unexpected income shocks.

This report has also examined the practical implications of different potential models of early access pension saving. However such a model is designed, significant administrative challenges would be created by implementing early access pension saving. Not only would such models potentially impose costs on savers, there would be a significant risk of unintended consequences on wider pension saving.

The current inflexibility of pension saving rules may depress participation and contribution rates to some extent. However, while commentators are keen to highlight this potential deterrence effect drawing on economic theory, recognising this potential effect does not mean that policymakers should proceed to implement early access models of pension saving, fundamentally altering the nature of the UK 'annuities deal' in the process.

Rather, the restrictive rules governing pension saving, and any associated deterrence effect they may generate, are part of a complex trade-off embodied in the UK 'annuities deal', representing a careful balance between incentives and coercion designed to encourage adequate long-term saving rates.

More widely, both of the principal arguments put forward in favour of early access to pension saving are actually, in essence, observations about the level of liquid saving that households have access to at times of financial hardship, and the extent to which households confront uninsured risks. Indeed, proposals for early access pension saving highlight the crucial interaction of pensions policy with both savings policy and the extent of risk-pooling (insurance) provided by the state and private sector. The effectiveness of pensions policy, and the 'annuities deal' in particular, is dependent on the efficacy of savings policy, and individuals accessing a suite of appropriate savings and insurance products such that they are comfortable undertaking long-term pension saving.

As such, policymakers concerned about any deterrence effect on pension saving arising from current rules confront a number of questions.

First, how effective is UK savings policy? Is the market sufficiently competitive and is it providing a range of appropriate savings products for consumers? What are the barriers to take-up and how effective are current government schemes for advancing financial education, financial capability and the availability of financial advice? It is also clear that policymakers must ensure that the maximum benefit of recent changes associated with A-Day, and the higher thresholds for lump-sum contributions to pensions, is extracted for pension policy. For example, how easy is it for individuals to deposit accumulated ISA savings into a pension? Is there sufficient awareness of this entitlement? One approach policymakers could explore is whether ISA savings could be granted backdated income tax-relief when they are converted into pension saving.

Second, as described above, if individuals are averse to locking away savings in a pension because of the potential for unexpected financial hardship, this suggests challenges around risk-pooling in relation to the 'life course' risks that individuals face, whether such pooling is undertaken by the state or private sector. In the fiscal context of limited state resources available to provide safety nets beyond existing welfare entitlements, policymakers must address the cost, accessibility and take-up of private sector insurance products.

Third, without unpicking the 'annuities deal' and the uniquely generous tax-relief bestowed on long-term pension saving, is tax-relief appropriately allocated across different types of liquid saving product? In addition, given varying attitudes to risk and potential financial hardship across the population, is tax-relief on savings distributed appropriately and equitably across the population? Rather than being seen in purely in the context of tax-relief on one type of saving, for example pension saving, this distribution of tax relief must be placed in a broad context, that includes progressive income tax rates, potential abolishment of higher-rate tax relief, and Working Tax Credit.

Finally, the forthcoming introduction of mandatory employer contributions to pension savings, as part of wide-ranging ongoing reform to the pension system, raises important questions around the equity and distributional impact of this regulation if lower-income groups are less likely to save into a pension, and do not receive this 3% contribution.

Overall, while promoting early access to pension saving might be an eye-catching idea, and one which undoubtedly coheres with economic theory, there is simply no case for unwinding the UK's 'annuities deal'. Rather, policymakers must address the efficacy of savings policy and risk-pooling provided by the state and private sector, as the foundation on which pensions policy rests.

Discussion of enabling early access to pension saving has been a feature of UK pension policy debate for some years. However, this discussion has come into sharper focus in light of the global financial crisis, and its potential impact on the attitude of UK households to locking away saving for many years.

This report examines the evidence that current pension rules, associated with the UK 'annuities deal', deter pension saving. The report also explores in detail the practical considerations and problems that would be confronted by the multiple 'early access' models of pension saving that have been proposed.

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