PENSIONS POLICY INSTITUTE

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Would allowing early access to pension saving increase retirement income?

Introduction

The UK pension system is currently undergoing reform in response to the challenges posed by an ageing population and widespread under-saving. The Government has introduced reforms to require employers to automatically enrol employees into pension schemes from 2012. The Government expects these reforms to result in 6 to 9 million more people saving into a work based pension scheme.[1]

Currently in the UK, people cannot withdraw any money, or access any portion of their pension fund before the age of 50 (rising to 55 from 2010). Some stakeholders have suggested that allowing early access (withdrawing money from a pension fund before a defined age) to pension savings, for example, for first-home purchase or in situations of financial hardship, could further increase the number of people saving into a pension fund and the total amount saved.

Some potential savers in the UK have cited a lack of early access to pension saving as a barrier to saving. In a survey in 2007,[2] 4% of respondents cited the lack of early access options as their reason for not taking out a pension and 7% said they would save more in their current pension if they were allowed to withdraw money early.[3]

This note summarises the findings of a report published by the PPI. The original report was commissioned by B&CE Benefit Schemes and Legal & General as an initial, independent assessment of a potential policy of early access to pension saving in the UK.

Chart 1: Summary of early access policy models

Loans and Withdrawals	Based on the 401(k) model of early access to pension savings that is used in the US. People are permitted to take loans from their own pension funds, which they must then pay back with interest. In cases of hardship they can also take permanent withdrawals from their pension fund
Permanent Withdrawals	Based on the KiwiSaver model of early access to pension savings that is used in New Zealand. People can withdraw funds permanently under certain circumstances with no obligation to repay.
Feeder Funds	A combination of a pension fund and an individual savings account. Any contributions a saver makes to their feeder fund go first into the liquid/savings element of the account and when that reaches a fixed limit any subsequent contributions divert into the pension fund.
The Early Access to Lump Sums Model	Permits early access to 25% of people's pension pot at any age if the pot size is above a pre-set floor amount and below a pre-set ceiling amount. This model is based on the existing provision for people to access 25% of their pension savings tax free from the age of 50.

Advantages and disadvantages of early access

The arguments for and against allowing early access to pension savings centre around a trade-off between making pension saving more attractive to encourage greater saving levels, but discouraging excessive access which could leave less money available to provide retirement income.

Some studies have indicated that allowing early access to pension saving might encourage savers to contribute higher percentages of their income even if they do not necessarily intend to withdraw money.[4] This is evident in the US 401(k) system where people who save in 401(k) plans which permit early access voluntarily contribute from 0.6% to 3%[5] more salary to their pension fund than those in plans without early access.

Early access could also help with home buying, encourage people who don't already save to start saving, assist with job training and education, it could appeal to behavioural economics or provide cash-flow advantages to savers.

However, early access also has the potential to reduce individual's income in retirement:

- If early access is not regulated carefully;
- If the funds are accessed later on in life, since this would leave less time to repay the loan;
- If the funds are taken as a loan, and individuals do not continue to contribute to their pension fund whilst repaying their loan;
- If individuals don't contribute greater percentages of their income to their pension fund as a result of being allowed early access to their pension fund.

Furthermore, permitting early access to pension funds could also increase the scope for tax avoidance and generate greater complexity in pension fund administration which could lead to higher management charges.

PPI Briefing Notes clarify topical issues in pensions policy.

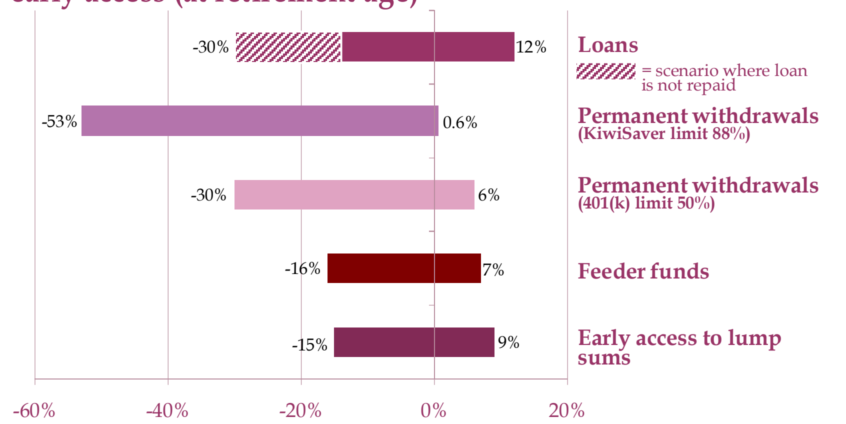
Policy models to consider

This note examines the potential effects of four different policy models of early access to pension savings (Chart 1):

- The 'loans and withdrawals' model is based on the 401(k) model of early access to pension savings that is used in the US. In the 'loans and withdrawals' model people are permitted to take loans from their own pension funds, which they must pay back with interest. In cases of hardship they can also take permanent withdrawals from their pension funds.
- The 'permanent withdrawals' model is based on the KiwiSaver model of early access to pension savings that is used in New Zealand. In this model people can withdraw funds permanently under certain circumstances with no obligation to repay.
- The 'feeder funds' model is a combination of a pension fund and an individual savings account. Any contributions a saver makes to their feeder fund go first into the savings element of the account and when that reaches a fixed limit any subsequent contributions divert into the pension fund. Therefore people saving into a pension fund also have access to a certain amount of liquid savings.
- The 'early access to lump sums' model permits early access to 25% of people's pension pot at any age if the pot size is above a pre-set floor amount and below a pre-set ceiling amount. This model is based on the existing provision for people to access 25% of their pension savings tax free from the age of 50.

Chart 2: Early access could reduce or increase individual pension pot sizes

Ranges of increase and decrease in individual pot sizes from what they would have been without early access (at retirement age)



Analysis of Policy Options

To assess the possible impact of early access options, four hypothetical individuals were considered for each of the policy models. The potential effects on the aggregate size of pension funds were also looked at for two of the policy models.[6]

All the models of early access have the potential to increase or decrease individual pension pot sizes (Chart 2).

- The 'loans' model has the most potential for increase in individual pension pot sizes in the most optimistic scenarios; however, if individuals don't repay their loans then it has the potential to decrease the size of individual pension pots at retirement age by around 30% in the most pessimistic scenarios.
- The 'permanent withdrawals' model has the most potential for decreasing individual pension pot sizes, and the least potential for increase. However, the extent of decrease can be reduced by limiting the amount available for withdrawal. Two scenarios have been considered; one where individuals are allowed to withdraw up to 50% and the other up to 88%.
- The 'feeder funds' and 'early access to lump sums' models have the least variation in outcomes, with potential reductions in individual pot sizes at retirement age limited to around 15% and potential increases of up to 9%, in the most optimistic scenarios regarding higher contribution rates.

Early access effects on the aggregate size of pension funds

Implementing a 'loans and withdrawals' model of early access could potentially increase the aggregate size of pension funds up to 30% by 2050, around £400 billion (in 2008 earning terms) in the most optimistic scenario regarding additional participation and contribution rates. However, if people stop contributing while repaying their loans, then a 'loans and withdrawals' model of early access could decrease the aggregate size of pension funds by up to 7%, a fall of around £70 billion.

Implementing a 'permanent withdrawals' policy model could potentially increase the aggregate size of pension funds by around 24%, around £300 billion, in 2050 (in 2008 earnings terms) in the most optimistic scenario regarding additional participation and contribution rates. However, implementing a 'permanent withdrawals' policy model also has the potential to reduce the aggregate size of pension funds by 11%, around £100 billion, in the most pessimistic scenario.

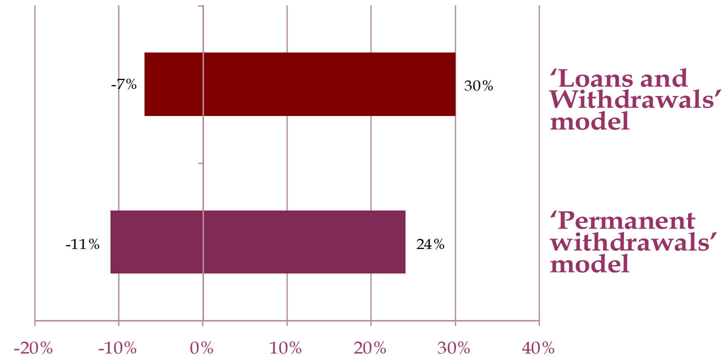
It has not been possible to analyse the potential effects of the 'feeder fund' and 'early access to lump sums' models on the aggregate size of pension funds due to data limitations. More research on the possible effects of implementing these models in the UK would need to be done in order to determine whether these models have the potential to reduce or increase the aggregate size of pension funds to greater or lesser degrees than seen in the 'loans and withdrawals' and 'permanent withdrawals' models.

Policy objectives

The most suitable model to be used depends on the policy objectives of the Government. This could be to increase pension pot sizes for individuals, to increase contribution rates or to increase the aggregate size of pension funds. If the Government's overriding policy objective is to increase the amount that individuals save for retirement, then the 'loans' model might be the most appropriate choice as it seems to offer the greatest scope for a positive impact on individual's retirement income.

Chart 3: Early access could reduce or increase the aggregate size of pension funds

Ranges of increase and decrease in aggregate size of pension funds under management from what they would have been without early access (in 2050)



If the policy objective is to implement an early access policy model which has little potential for a negative impact on individual's pension pots then either the 'loans', 'feeder funds' or 'early access to lump sums' models might be the most appropriate choice as all three models have less potential for reductions than the 'permanent withdrawal' model. However, if people do not repay their loans then the 'loans' model could put individual's pension funds at risk of reductions similar to the levels seen in the 'permanent withdrawals' model.

The 'loans and withdrawals' model also has the most potential for increasing the aggregate size of pension funds (when accompanied by higher contribution levels), and the least potential for decreasing the aggregate size of pension funds.

The 'permanent withdrawals' model only has the potential to increase the aggregate size of pension funds when accompanied by higher contribution levels.

However, both run the risk of reducing the aggregate size of pension funds if people do not contribute more to their funds as a consequence of being allowed early access to their pension saving, or if they cease to contribute to their funds whilst repaying their loans, or do not repay their loans at all.

It is important to remember that the illustrations of the 'loans and withdrawals' and 'permanent withdrawals' policy models use data from the US on participation and contribution rates. Implementing a similar model of early access in the UK may produce very different outcomes. If, for instance, people in the UK repaid their loans at a higher or lower rate than seen in the US, or did not contribute a higher percentage of their salary to their pension fund, then the aggregate size of pension funds could be higher or lower than seen in some of these illustrations.

Policy implications of early access

What the illustrations indicate is that permitting early access to pension saving could reduce *or* increase the aggregate size of pension funds. Because of the potential for early access to decrease savings, it would be important for the Government to think very carefully about how any early access policies were designed.

In order to attempt to minimise the reduction that an early access model could have on the aggregate size of pension funds, there are a few options which could be considered. Firstly, a possible minimum, mandatory contribution level, for people whose plans offer early access options, of 1% above the standard rate (i.e. 5% minimum employee contribution rather than 4%) could mitigate the potential reduction in the aggregate size of pension funds which early access could cause. Alternatively, there could be a requirement that people contribute at 1% over the standard rate for a period of time (e.g., 5 years) before being allowed early access to their fund.

Conditions could be placed on the circumstances in which a loan or withdrawal would be allowed, for instance, loans or withdrawals might only be permitted in the case of financial hardship, unemployment or disability. This could limit the access most people have to their pension funds and minimise the negative impact on retirement income. Conditions could also be placed on the time an individual would have to save for in order to be allowed early access, thereby ensuring that a certain level of savings is built up before any loan or withdrawal is taken.[7]

To ensure that as many loans were repaid as possible (if a 'loans and withdrawals' policy model is used) a system for ensuring repayment of loans could be implemented that did not negatively impact on people with low incomes or people experiencing financial hardship. One possibility could be mandatory deduction of loan repayments from salaries once a person reaches a certain income.

It may also be worth considering some policy options for dealing with the tax issues that are thrown up by early access:

- Applying a penalty tax, as is done in the US, could prevent people from using early access to avoid paying taxes, but may impact heavily on people with lower incomes.
- Another option would be to limit withdrawals strictly to situations of financial hardship where tax evasion is least likely to be an issue, and to write off a small level of tax revenue.

Conclusion

Allowing early access to pension saving could increase or decrease the aggregate size of pension funds under management in the UK. The overall effect will depend on the extent to which allowing early access encourages individuals to save more and the extent to which individuals actually exercise their right to withdraw funds early. A 'loans and withdrawals' model seems to offer greater scope for a positive overall impact on levels of pension saving than a model which permits permanent withdrawals only.

If it is decided that early access if desirable, the most appropriate policy option to adopt will depend on what is the Government's policy objective. If the policy objective is to increase the amount that individuals save for retirement, then allowing loans might be the most appropriate choice as it seems to offer the greatest scope for a positive impact on individual's retirement income.

If the policy objective is to minimise the potential reduction in the value of individual pension funds, then allowing loans, feeder funds or early access to lump sums seems to have less potential for reduction in individual pension fund size than allowing permanent withdrawals.

Overall, whilst allowing loans has slightly more potential for increasing individual pension pot sizes than allowing feeder funds or early access to lump sums, if people do not repay their loans then allowing loans could put individual's pension funds at risk.

[1] DWP (2008) *Pensions Bill – Impact Assessment*
[2] ABI (2007) *The State of the Nation's Savings 2006/07.*
[3] ABI (2007) *The State of the Nation's Savings 2006/07.*
[4] ABI (2007) *The State of the Nation's Savings 2006/07.*
[5] Munnell, Sunden & Taylor (2000), US GAO (1997), Holden,s., and VanDerhei, J., (2001)
[6] A full description of the hypothetical individuals is given in PPI (2008) *Would allowing early access to pension savings increase retirement incomes?* Chapter 3
[7] Baroness Hollis, House of Lords, Hansard, 23 June 2008, Column 1275

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