PENSIONS POLICY INSTITUTE

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Would allowing early access to pension savings increase retirement incomes?

Summary of conclusions

The Government is reforming the pension system in an effort to increase the number of people in the UK saving in a pension. Some stakeholders have suggested that allowing early access 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.

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 an income in retirement.

Advantages and disadvantages of early access
Permitting early access to pension saving could appeal to women, men and women on low incomes and younger people, who are amongst the groups most at risk of not saving enough to provide themselves with an income in retirement that they would consider adequate. Permitting early access to pension savings may encourage more people to save in pension funds and may encourage people to contribute higher percentages of their income.

Early access has the potential to reduce individual's income in retirement, depending on:

- Whether the funds accessed are taken as a loan or a withdrawal;
- The timing of any withdrawal or loan taken;
- Whether, if the funds are taken as a loan, individuals continue to contribute to their pension fund whilst repaying their loans;
- Whether individuals contribute greater percentages of their income to their pension fund as a result of being allowed early access to their pension fund.

However, 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.

This paper examines the potential effects of four different policy models of early access to pension savings:

- 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 then 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 the 'permanent withdrawals' 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 liquid/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 (55 after 2010).

Allowing early access and pension policy
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 does.

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.

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.

It has not been possible to model the aggregate impact of allowing feeder funds or early access to lump sums models on the total size of pension funds due to the lack of data on how individuals may respond to these policies.

There are a few policy options for potentially mitigating the reduction on savings levels that early access could cause:

- A minimum, mandatory contribution level of 1% above the standard rate could be required from people who wish to use early access options (i.e. 5% minimum employee contribution rather than the 4% that will be required for those auto-enrolled into pension saving after 2012). There could be a condition that people pay the increased contribution for a period of at least five years before they access their pension fund.
- Conditions for withdrawals, or a minimum length of contributions to qualify for access.
- The setting up of an advice system able to inform people of the risks posed by early access.
- A system for ensuring the majority of loans are repaid, if the 'loans and withdrawals' model is adopted.
- A penalty tax on withdrawals or limiting withdrawal conditions to severe financial hardship.