Written evidence from Institute for Fiscal Studies (APS0022)

The Work and Pensions Select Committee of the House of Commons issued a call for evidence on the issue of 'Accessing pension savings' as part of its inquiry into "Protecting pension savers: five years on from the Pension Freedoms". The call posed relatively specific questions relating to the pension options people have access to, the role of the Money and Pensions Service, and how individuals can be helped to make informed choices. What follows is a brief response that highlights some important issues to consider in this context. For ease we group the questions posed by the call into two areas.

Executive Summary

ES1. Pension freedoms removed the mandated purchase of longevity insurance with defined contribution pension wealth. However to understand the importance of this, and the implications of the decisions people are making, it is vital not to consider an individual's defined contribution pension in isolation, but to factor in the wider household wealth portfolio. Other assets, such as state pension income, housing, and other annuitised pension wealth – potentially also including these held by a partner – are important sources of longevity insurance.

ES2. Pension freedoms gives people greater ability to spend their accumulated wealth at a time that suits them. Spending needs may change through retirement. For example, less money may be needed at older ages if declining health and/or changing preferences reduce desired spending on certain leisure activities. Relative rapid drawdown early in retirement may therefore not be a cause for concern for everyone.

ES3. Individuals need both a lot of information and the ability to process that information to make good decisions about accessing their retirement wealth. This is the case not just when people first access their funds, but throughout retirement – which may present problems at older ages as people's cognition declines.

ES4. There is an important role for the Money and Pensions Service as a trusted source of information and independent guidance. However, initiatives to nudge individuals in the direction of appropriate decisions – such as Investment Pathways – could be beneficial and should be explored, given the financial inexperience of many who are accumulating pension funds and the complexity of the choices they will face.

What are people's "needs for later life"?

Do people have access to a range of pension options to meet their needs for later life and how these might change in future?

Are there other pension options, not currently available in the UK, which would better meet people's needs in later life?

Are there barriers to providing other pension options which meet a need and are not currently available in the UK?

1. To answer these questions, it is important to be clear about what people's "needs for later life" are. One way of interpreting this is individuals being able to best allocate their accumulated retirement resources over their remaining years so as to smooth their standard of living through retirement, in the context of uncertainty – in particular, uncertainty about how long that life will be, and the state of their health in future years.

Longevity insurance

2. Uncertainty about the length of remaining life can make it difficult to plan how to draw down retirement assets and not run out of money. For example, a 65-year-old male in 2021 can expect to live an additional 20 years of life, but there is considerable uncertainty around this: one in ten are not expected to survive more than another seven years, while one in ten can expect to live for another 31 (ONS, 2020).

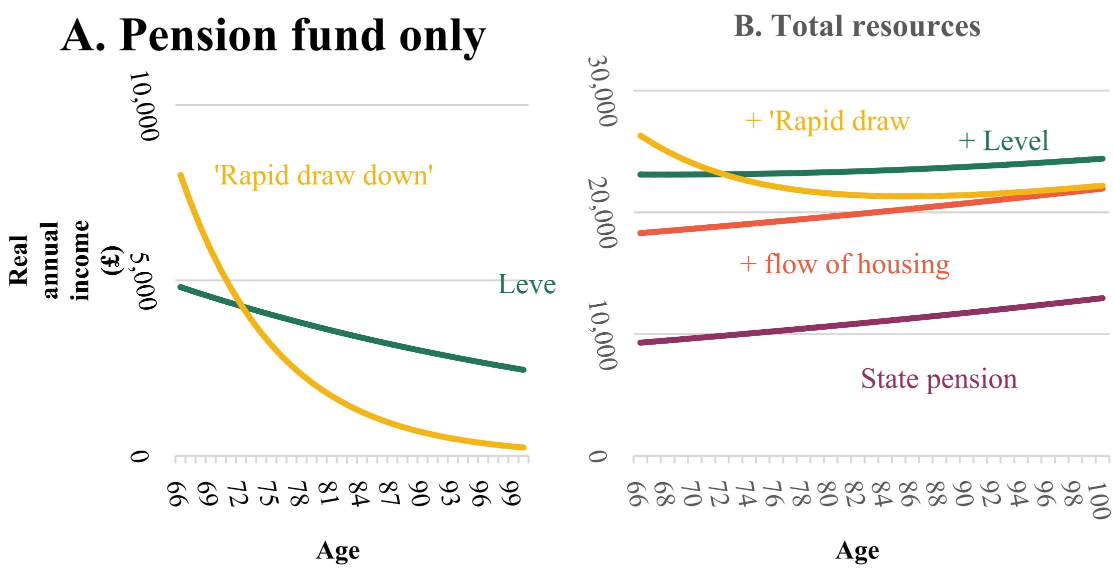
3. Until the introduction of pension freedoms, longevity insurance was built into private pensions through the effective mandatory purchase of annuities, which provided a guaranteed stream of income for as long as the person lived. Now that only a tiny minority of funds accessed for the first time are used to purchase an annuity (6% in 2019-20), and many plans where the holder made regular partial withdrawals are seeing high annual withdrawal rates (26% had an annual withdrawal in 2019-20 of 6% or more) (FCA, 2020), there is concern that people are at risk of poverty at older ages.

4. However, it is important not to focus too narrowly on private pensions in isolation. People's needs in later life will met by the total resources of the household, and other parts of a household's portfolio may provide longevity insurance. This has been discussed as one reason for low demand for annuities in other countries (see, for example, Dushi and Webb (2004), Inkman et al (2011)).

5. To illustrate this stylistically, consider someone reaching retirement with a £100,000 pension fund. (Note this is larger than the current average amount held. Figures from the Wealth and Assets Survey in 2016-2018 suggest that among those aged 55-59 with one or more defined contribution pensions and no defined benefit pension, the median total amount held was around £27,000 and the mean around £86,000.) How the individual accesses that fund (and how they invest it if they do not purchase an annuity) can have a large impact on their private pension income through retirement. For example, if their purchased a level

annuity, their real income would decline gradually through retirement from around say £5,000 per year at age 67 to around £2,500 per year at age 100. In contrast if they held their pension fund in cash (and got no nominal return) and withdrew 8% per year, their real income would decline from around £8,000 per year to less than £1,000 per year by their late 80s. This sort of profile would often be interpreted with alarm as running out of money. These profiles are shown in panel A of Figure 1. But context is crucial here. Suppose that individual had a full new state pension entitlement, which is worth around £9,300 (and triple lock indexed, implying increasing in real terms through retirement unless inflation persistently exceeds earnings growth and 2.5%). Furthermore, they are an owner occupier, and benefit from a flow of housing services – assumed to be equal to a 'rental yield' of 5% of the value of their £180,000 house each year. Then the 'rapid drawdown' scenario for their pension fund would imply their total real terms annual resources falling from £26,000 per year to around £22,000 per year. This is potentially a much less alarming decline. The individual has far greater longevity insurance when their total resources are taken into account, rather than just their private pension income.

Figure 1: Illustrative illustration of the importance of wider household wealth on the effect of pension choices on longevity insurance



Notes: Simulations for illustrative purposes only. Assumes: 2% per year inflation, state pension increases by 3% (nominal) per year, pension fund held in cash gets 0% nominal return, level annuity based on current market rates. Consumption value of housing is 5% per year of a £180,000 property.

6. Understanding people's wider portfolio position is therefore important when considering the pension options people might want, and the appropriateness of their drawdown decisions. Quantifying the importance of people's DC pension decisions for

longevity insurance given their wider household wealth portfolio, is the subject of current empirical research at IFS, funded by the IFS retirement saving consortium.

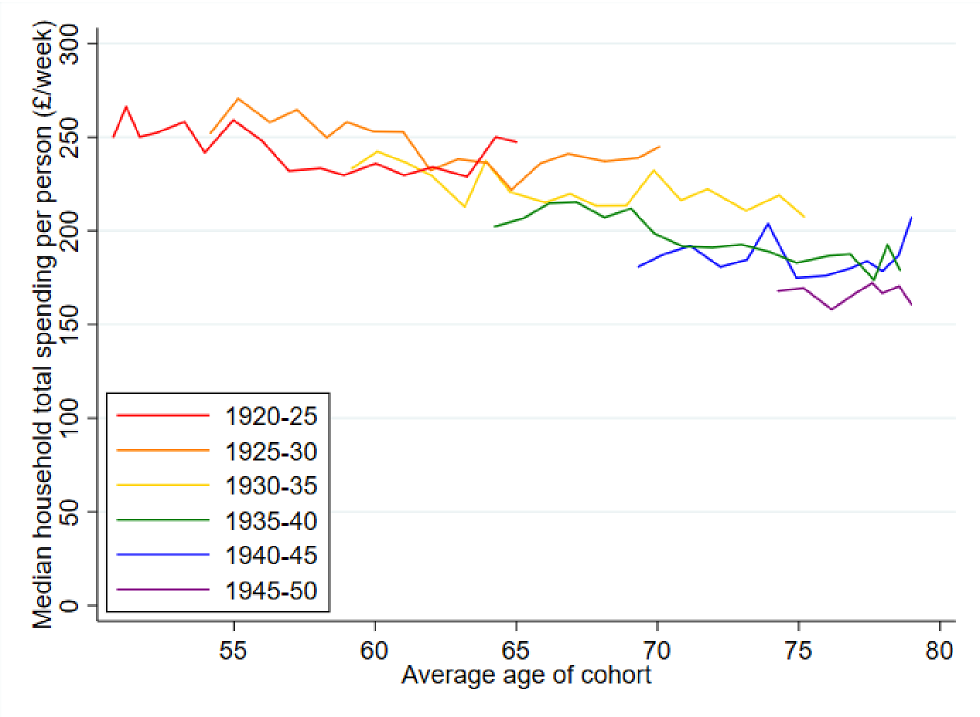
Spending desires

7. A potential benefit of pension freedoms is that it gives people greater flexibility to spend their resources at a time that gives them the greatest benefit in terms of improving their standard of living. This may be more ‘front loaded’ in retirement than would have been possible with the income stream provided by even a level annuity and an initial lump sum withdrawal.

8. One reason for such a profile could be if the enjoyment people derive from spending money declines as health declines – for example, if declining health precludes a person from engaging in activities that they previously spent money doing. Estimating the effects of health declines on the ‘marginal utility of consumption’ is challenging (see Finkelstein et al (2009)), but a recent paper (Blundell et al, 2020) has identified that temporary health shocks do reduce the value individuals put on consumer spending.

9. Empirically in the UK household spending does appear to decline at older ages in a manner not driven by declines in income (Brancati et al, 2015). For example, Figure 2 uses data from the Living Costs and Food Survey to illustrate how average household spending per person changes with age for different generations defined by 5-year birth intervals. On average, spending gradually declines with age. An important caveat to this simple analysis (or Brancati et al, 2015) is that it does not control for sample selection effects caused by mortality – i.e. the fact that those who live to older ages are a selected sample who may have had quite different average spending earlier in retirement to the population average (specially they are likely, on average, to be wealthier and therefore had higher spending). However, the likely path of spending, and therefore income, that people might want through retirement is important for understanding the profile (and level) of resource needs. A careful examination of spending patterns at older ages, controlling for mortality bias, and considering what we can infer from these about the potential benefits of pension freedoms, is a topic on ongoing research at IFS, funded by the IFS retirement saving consortium.

Figure 2: A provisional analysis of average household spending per person – by age and generation – suggests total spending declines with age



Notes: Spending is adjusted for inflation and expressed in 2019 prices.

Source: Expenditure and Food Survey 2001-2007, Living Costs and Food Survey 2008-2017.

Understanding incentives

10. It is also worth noting that individual incentives with respect to the drawdown of their wealth may not always align with those of the government. For example, individuals who exhaust their wealth early in retirement and then become eligible for benefits such as housing benefit or state funded social care may be taking the course that leaves them financially best off and not making a mistake, even though it has financial consequences for the taxpayer. In a similar vein, the absence of income tax on the pensions of those who die before age 75 means that individuals with a bequest motive now have an incentive to draw on other financial resources before their pension if they can, which increases the cost to the government of pensions tax relief.

Consumers' ability to make good choices

Are people receiving the guidance and advice they need to make informed decisions about how they access their pensions?

What role should the Money and Pensions Service have in supporting people accessing their pensions for the first time, including through pension dashboards?

Should the Money and Pensions Service offer enhanced guidance or limited advice for people making decisions about their pensions?

Can the success of auto-enrolment in helping people save into pensions be replicated for people in retirement through investment pathways?

Including costs, what information do consumers need about different retirement products to make an informed choice?

11. To make 'informed choices' consumers require a considerable array of information. This includes:

- What retirement products exist and how these products operate (not just in terms of pension products, but also other financial products like equity withdrawal)
- The expected financial returns, costs, tax implications and risks offered by different product options
- What other retirement resources they have (such as their state pension entitlements, or other private pensions they may have accumulated)
- How long they can expect to live, and the uncertainty around that
- What their retirement income needs may be, including the risk of health shocks that may reduce the value they get from leisure spending and/or affect their health care and social care costs

12. There is considerable existing evidence that knowledge of these is far from complete (see Lusardi and Mitchell (2014) for a survey of international evidence). Recent contributions using UK evidence from IFS researchers include Sturrock and O'Dea (2018) who show that people misperceive their life expectancies, Crawford and Karjalainen (2020) who find that awareness of state pension entitlements is low, and Crawford et al (2020) who show that only just over half of those approaching retirement feel they understand enough about pensions to make decisions about saving for retirement.

13. Furthermore, if people are to make good decisions about how to access their pensions, then they need not just information, but to be 'financially literate'. The OECD defines financial literacy as 'a combination of awareness, knowledge, skill, attitude and behaviour necessary to make sound financial decisions and ultimately achieve individual financial well-being' (OECD 2012). In other words, people do not just need knowledge and understanding of financial concepts and risks, but also the skills, motivation and confidence to apply that understanding in decision making.

14. It is also important to acknowledge that pension freedoms means many people will now be having to manage their pension draw down through their retirement, rather than just at the point they access their fund for the first time (as would be the case if people

annuitised). This raises concerns about how well individuals will cope with that responsibility as their cognition declines at older ages (Agarwal et al, 2009). Previous IFS research (Banks, Crawford and Tetlow, 2015) has documented the decline in cognition at older ages (in the context of exploring the role of cognition in annuity choices before pension freedoms were introduced). The risk of making financial 'mistakes' is particularly an issue for those who are not aware of their cognitive decline (Mazzonna and Peracchi, 2020).

15. Given the complexity of pension choices, and the likely lack of financial literacy among consumers, it is potentially concerning how many pension funds are accessed for the first time without the holder having received any guidance or advice (half of funds in 2019/20 (FCA, 2020)).

16. The Money and Pensions Service has an important role to play in informing individuals about their choices and the factors they need to consider when making their decisions. However, given not all those accessing pension funds are financially literate (i.e. have the ability and confidence to make good decisions even once informed), the provision of limited advice may further improve individuals' outcomes. However, this would come at a cost to the government, and it is not clear that the provision of this service alone would necessarily ensure it is taken up by those who would most benefit from it – not least given current low take up rates of free guidance. Research from the US has found that it is he more financially literate and cognitively able who seek advice from professionals (Kim et al 2020).

17. There remain concerns about whether consumers accessing their pension wealth can be adequately informed, and whether this would be sufficient to ensure good outcomes in any case given levels of financial literacy. Indeed it is striking that in the accumulation phase of retirement saving, government policy has opted for taking advantage of inertia in decision making, rather than solely trying to increase saving for retirement through mechanism such as improving financial literacy and strengthening saving incentives, while in the decumulation phase recent policy has increased the choices available and assumes people are able to make appropriate choices. Some individuals face these opposing strategies at the same time: older employees can be automatically enrolled into a workplace pension that they are completely free to access.

18. It may be that behavioural 'nudges' can help people who are not financially literate get better outcomes. For example, this could be through defaulting people into guidance before pension funds can be accessed, or initiatives such as Investment Pathways. It is early days in terms of understanding how individuals are responding to the latter, but this is potentially a good policy to help those with limited financial experience to hold investments that match their plans, and encourage people from away from being over invested in cash due to a lack of understanding of the effects of inflation. However, there are legitimate concerns, including the risk of individuals feeling they are being advised when they are not,

and a lack of diversification, which could even distort economic growth with consequences for the welfare of society (Bhamra and Uppal, 2019).

19. Going forwards it is very important that leadership is shown over the development of policy in this area. The introduction of pension freedoms unexpectedly, and fundemantally, changed the environment in which the majority will have to access and manage their retirement resources. Ensuring this policy is a success is vital, and should not be the sole responsibility of the Financial Conduct Authority – the FCA, Department for Work and Pensions, HM Treasury, and the Money and Pensions Service will need to work together in a coordinated and effective way.

About the author

Rowena Crawford is an Associate Director at the Institute for Fiscal Studies and leads IFS research on pensions, savings and retirement behaviour. She has over a decade of experience of conducting academically rigorous research to answer policy relevant questions. Her own research interests focus on household saving behaviour, the design of public and private pension systems, and the implications of increasing longevity.

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