Written evidence from Lane, Clark & Peacock (LCP) (APS0027)

Executive Summary

- *Pension Freedoms give savers welcome additional choices but there is still work to be done to make sure that the potential for consumer detriment is minimised*

- *The wider agenda for continued work includes:*

    - *Charges in drawdown, especially as savers move from large scale, low-cost savings vehicles such as charge-capped Master Trusts to 'retail' products such as individually sourced drawdown accounts;*

    - *Helping individual savers who want to go into drawdown to choose the right provider, not just the right investment;*

    - *Poor take-up of guidance, where the evidence suggests that the proposed 'stronger nudge' will have marginal impact;*

    - *More engagement with savers further out from retirement when they are still deciding what to do rather than focusing on the point of retirement by which time many have already decided*

- *But we believe **the single biggest outstanding harm arises from the rigid way in which savers can access 'tax free cash'**; the availability of 'tax free cash' is one of the few well-known and valued features of the pension system and is a focus for many as they approach later life; the evidence is that many people access their pension pot with the goal of accessing tax free cash, only to make poor use of their remaining savings, either by cashing out entirely (and depositing the balance in a cash account) or by moving the rest into a higher cost or worse-performing investment;*

- ***We propose, in line with an earlier suggestion from the FCA, 'de-coupling' accessing tax free cash from accessing the rest of a pension pot**, making it easier to leave the rest 'where it is', being invested in a low cost and well-governed environment for continued growth;*

Introduction

The introduction of 'Pension Freedoms' in 2015 has given savers into DC pensions much greater flexibility about how they use their pension savings. Prior to pension freedoms those with the smallest pots could cash them out, those with the very largest pots could draw down from them within limits, but the large majority of people had little choice but to turn their pension pot into an annuity.

Pension Freedoms gave people new options. In particular, they enabled the majority of savers to access their pension pot more flexibly, adding the option of full encashment of larger pots and more flexible drawdown options.

Many people have used these new freedoms successfully, for example using individual pots to achieve specific objectives such as paying off debts, funding earlier retirement or supporting family members, whilst ensuring that their overall retirement income is secure.

But with only a minority of savers accessing regulated financial advice, and with concerns over the low take-up of pensions guidance, there is a concern that some unadvised savers may not be making the best use of their (often modest) pension savings. A number of outstanding issues which need to be addressed include:

- *Charges in drawdown, especially as savers move from large scale, low-cost savings vehicles such as charge-capped Master Trusts to 'retail' products such as individually-sourced drawdown accounts;*
- *Helping individual savers who want to go into drawdown to choose the right provider, not just the right investment;*
- *Poor take-up of guidance, where the evidence suggests that the proposed 'stronger nudge' will have marginal impact;*
- *More engagement with savers further out from retirement as they are still deciding what to do rather than focusing on the point of retirement by which time many have already decided*

Such concerns have, for example, led the FCA to introduce 'investment pathways' designed to nudge savers approaching retirement towards investment options which better match their goals.

However, investment pathways do not help those who have already decided to take their money out in full, where we believe there is a particular risk of adverse consumer outcomes. We believe that these lie not primarily in the risk of withdrawn pension funds being squandered but, paradoxically, rather more in the risk of unspent balances being left on deposit in accounts with ultra low rates of return.

In this note, we therefore focus specifically on what more can be done to help those who cash out pension pots in their entirety. In some cases this may be the right strategy (for example, where an individual pot is just a small part of overall pension saving). But there is a risk that savers who do not need to access all of their funds are doing so prematurely, perhaps particularly motivated by the lure of 'tax free cash'. We therefore propose a specific policy reform which could reduce this risk.

1. What are people doing with their DC pots?

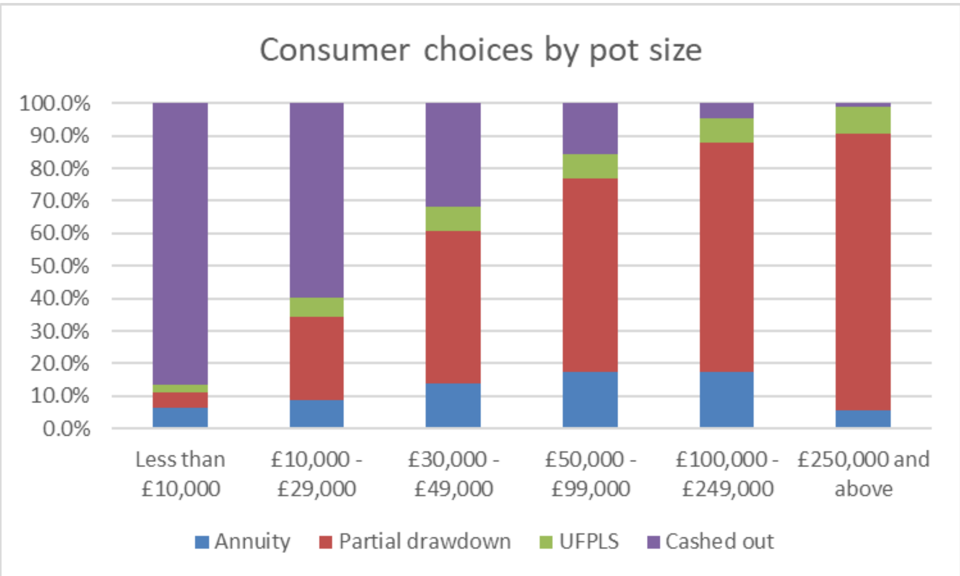
The most recent quarterly data from the FCA shows that full encashment is the most popular option when people access pots for the first time:

	Oct 2019 - Mar 2020			
	Number	**AUA value (£000)**	**Number of firms**	**% of policies accessed in this way**
All pots **Of which:**	**317,213**	**18,850,115**	**115**	
Annuity purchase	31,138	1,848,102	20	10%
Flexible Drawdown, partial withdrawal	95,493	13,499,680	97	30%
UFPLS (drawdown in chunks), partial withdrawal	16,167	1,403,911	65	5%
Full encashment	174,415	2,098,423	91	55%

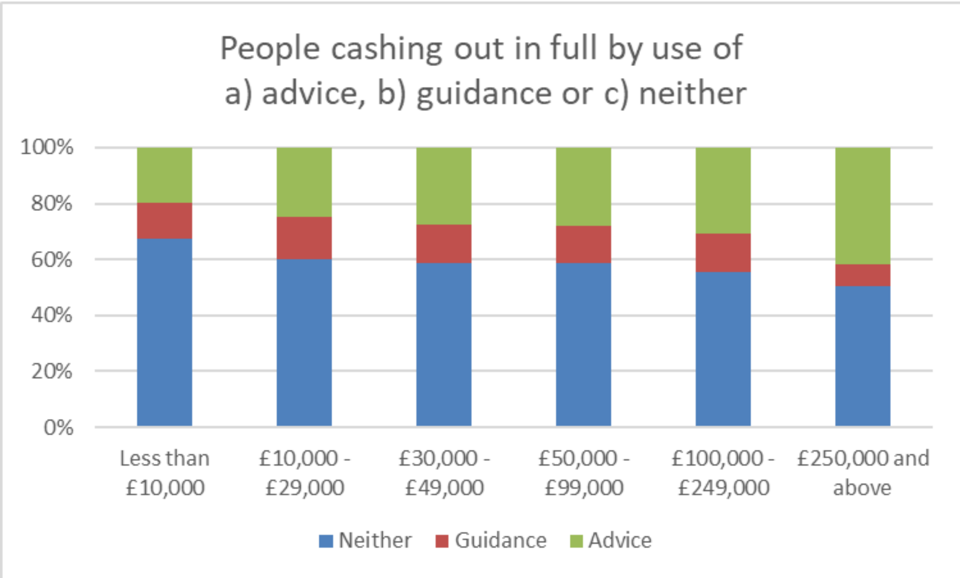
Source: FCA Retirement Income Market Data

Just over half of all pots accessed for the first time were fully cashed out, and therefore making a success of pension freedoms must involve looking in particular at this group.

Not surprisingly, full encashment is much more common for smaller pots as shown in the following chart, again based on the latest FCA data. Around 5 in 6 pots worth under £10,000 is taken as cash, whilst 3 in 5 pots in the range £10,000-£30,000 is also cashed out in full.



The FCA data also shows that the majority of people cashing out in full *at all pot sizes* are more likely than not to take neither financial advice nor guidance. Regulated financial advice is, as would be expected, more common at higher pot size levels. But it is startling that amongst the admittedly small number of those with pots of a quarter of a million pounds or more who encash them in full (192 people in the latest quarter), a majority did not take financial advice before doing so.

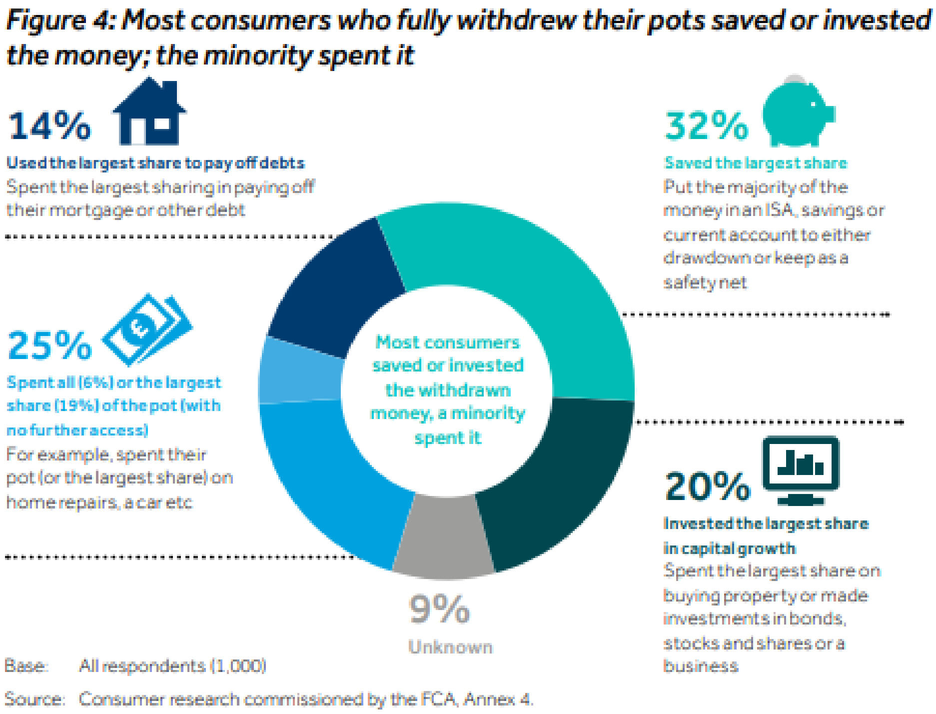


Where an individual's small DC pot is just a small part of their overall retirement wealth then whether or not they cash it in, and what they do with it afterwards, may not have a material impact on their standard of living. But for those for whom their modest DC pot is a material element in their overall retirement wealth, it becomes more important to understand why they are taking the pot out in full, and also to understand what is being done with the money.

In terms of the destination of funds, the FCA's 'retirement outcomes review' gathered data on what people are doing with withdrawals. The following chart is from the interim report of that FCA review and shows how consumers who cashed out *in full* were using those funds.

As the chart shows, just 6% of respondents spent the whole pot in one go, and a further 19% spent the largest part of the pot. Around 1 in 7 (14%) used the money mainly to pay off debts, around 1 in 5 (20%) invested it, but nearly 1 in 3 (32%) but the money mainly into a current account, savings account or cash ISA.

This last group is potentially of greatest concern to us. With headline rates on cash ISAs and similar products close to zero, these individuals are facing negative real returns on their investments. And if they have cashed out at the earliest opportunity, perhaps in their fifties, there is a risk that this money could dwindle in real value for decades.

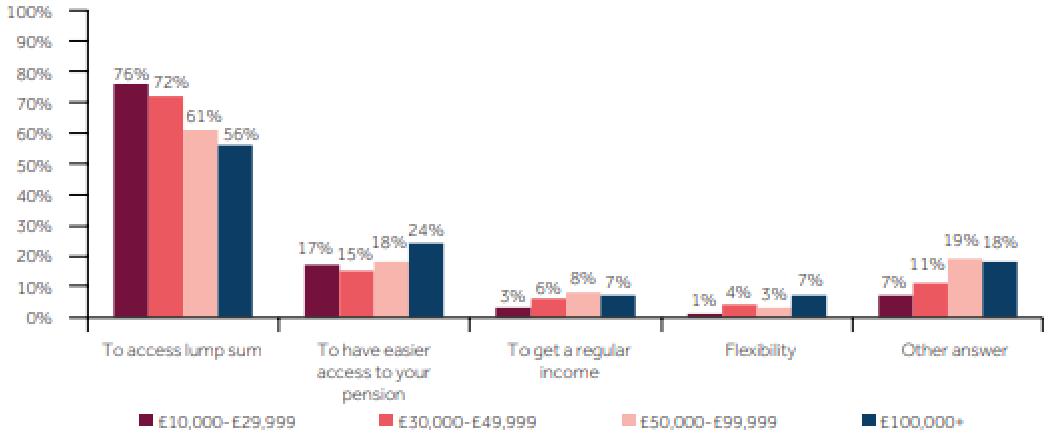


Source: FCA Retirement Outcomes Review Interim Report, 2017 ([Retirement Outcomes Review: interim report (fca.org.uk)])

It is perhaps surprising that people should move their money out of a pension in which it is being invested on their behalf in order to put the bulk of the funds into a savings account earning next to no interest.

But we can get some insights into why people access their pension funds from the following chart from the final report of the Retirement Outcomes Review. It should be noted that this relates to those who access their pension pot and then go into drawdown, rather than those who access their pot in full, but the results offer a pretty strong clue as to what may be going on.

Figure 4 Reasons for moving to drawdown, by pot size



Source: [MS16/1.3: Retirement Outcomes Review Final report (fca.org.uk)]

As the chart shows, by far the most common reason for moving money out of ‘accumulation’ in a pension, especially among those with smaller pots, and even for those who continue to invest through ‘drawdown’ is to access a lump sum. It seems likely that this is at least as strong a motivation for those who encash their pension in full.

Our own anecdotal evidence from pension scheme members suggests that ‘tax free cash’ is the one feature of the pension system that people understand and value, and these statistics reinforce the view that it is to ‘get their hands on’ tax free cash which is one of the most powerful drivers of behaviour at this point.

Whereas the people surveyed in the chart above have in general accessed a lump sum but left the rest to be invested in drawdown funds, our particular concern is those who go further and take 100% of their accumulated funds in order to access their 25% tax free cash. Those who are not financially sophisticated and may not have taken advice or guidance may simply put the balance in a low return savings account and suffer as a result. In addition, they may face unnecessarily large tax bills from taking all of their money in one go, and may inadvertently trigger limits (the ‘money purchase annual allowance’) which restrict future pension saving.

2. How could we reduce consumer detriment?

We take it as read that increasing access to financial advice and guidance, both at retirement and in the run up would help to reduce the potential harm from people cashing out their pensions in full, purely in order to access a tax free lump sum. But we believe that a simple policy reform could be much more effective.

If it is the case that tens of thousands of people with modest pension pots are cashing them out in full primarily to get access to their 'tax free cash', but are losing years of investment returns on the other 75% as a result, we believe that the government should explore 'decoupling' taking tax free cash from taking the rest of the money out of the pension.

Indeed, the FCA made a similar recommendation in the conclusions of its Retirement Outcomes Review, which are reproduced here for convenience:

> ***Government should consider the merits of 'decoupling' tax-free cash from other pension decisions***
>
> **1.38** We would encourage the Government to consider the merits of 'decoupling' tax-free cash from other pension decisions. Currently, some consumers who want to take a tax-free lump sum need to transfer out of their accumulation product and buy a new product with a drawdown feature. Many consumers focus solely on taking their tax-free cash at this time and do not engage with the decision of what to do with the rest of their pot. Separating the decision to take the tax-free cash from the need to move into drawdown will let consumers put off deciding what to do with the rest of their pot, until they are ready to focus on it. However, this would require major changes to the pension tax regime and we recognise that there are detailed policy and practical issues which the Government would need to consider.

Source: MS16/1.3: Retirement Outcomes Review Final report (fca.org.uk)

Whilst, as the FCA note, it is already possible in principle to take just the 25% tax free cash from a pension and move the rest into a drawdown product where it will be invested, many people do not go down this route, preferring to access the full 100%. There may be many reasons for this, but one is likely to be the complexity of moving from an accumulation product (a pension) to a decumulation product (a drawdown account), which could in principle involve signing up to a new product with new terms and conditions and even (perhaps ideally) a new provider. The route of 'least resistance' may simply be to take the whole lot out. In addition, going into drawdown just to access tax-free cash may mean moving from a low-cost environment with trustees overseeing investment options to a higher-cost 'retail' product much sooner than would otherwise be the case.

If it were easier for savers to access their tax free cash and leave the rest behind, the remaining 75% could be invested, potentially for many more years and almost certainly generating a better return than the cash ISA or savings account which would otherwise be the destination of the funds.

Decisions would of course need to be made about how the residual pension fund operated. For example:

- Would savers still be able to add the fund after tax free cash had been withdrawn?

- If so, would the saver be able to accrue new tax free cash on incremental contributions?

- Would there need to be special rules for ‘active’ pots associated with current employment and benefiting from an ongoing employer contribution?

Whilst these practical issues (and others) would need to be resolved, we believe that the benefit to consumers of allowing them to meet their desire for tax free cash without damaging the returns on the bulk of their pension pot is an idea worth pursuing.

We would, of course, be happy to discuss these ideas, and wider issues around consumer behaviour post Pension Freedoms with the Committee.

May 2021