# Early access to pension saving: a response by the National Association of Pension Funds

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## Executive Summary

### Summary

- The NAPF supports the Government's efforts to foster a culture of saving in the UK and agrees with its aim to encourage people to take responsibility for their own pension provision.
- Given the limited amount of research and evidence available to us, we have concluded that early access would only harm overall levels of retirement saving in the UK and that it should not be considered as a policy going forward.

### NAPF's main concerns about early access

- **Early access would reduce people's overall levels of savings.** Evidence from the United States demonstrates that early access reduces people's overall levels of savings at retirement. The NAPF believes that early access has the potential to undermine the principles behind the introduction of automatic enrolment in 2012.
- **The long-term effects of early access would be difficult to communicate to scheme members.** The UK pensions system is already one of the most complicated in the world, making it difficult for people to predict with confidence what they will receive in the future and for schemes to communicate the benefits of pension saving. The NAPF is concerned that pension scheme members may not fully understand the long term effects early access could have on their final retirement income.
- **Early access would be difficult for schemes to deliver.** Early access in all its forms would be complex and expensive for schemes to administer. Schemes should not be required to offer early access to scheme members.

### NAPF's Recommendations

- Evidence suggests that auto-enrolment is more effective at increasing participation in pension saving than early access and will not threaten overall levels of saving. The Government should concentrate on making automatic enrolment a success rather than complicating the system further by introducing early access.
- To help alleviate cases of hardship, the Government should consider reforms to the insurance market to make mortgage protection, ill-health and unemployment insurance more accessible.
- The Government should work with the NAPF and the industry to improve communication and engagement with people about the importance of saving for retirement.
- The Government should consider what impact allowing early access might have on means tested benefit expenditure in the future, particularly in the absence of state pension reform.
- The Government should focus its efforts on reducing the regulatory burden on schemes in an effort to reinvigorate occupational pensions, not add to it by introducing early access.
- If early access facilities were to be permitted, schemes should not be required to offer them to their scheme members.

## Early Access – Issues for consideration

1. The NAPF and its members recognise the changing face of pension provision in the UK. There is a need to find more innovative and flexible ways to encourage people to save for their own retirement. Over recent years, interest in early access provisions has grown. Politicians and the pensions industry have recognised that public confidence in pensions is suffering and that we must work to rebuild it. In the face of other financial demands, millions of people are continuing to put off the decision to save for their retirement.

2. But the need to encourage people to save for their own retirement stems from the fact that many people simply are not saving enough, or not saving at all. The NAPF remains extremely supportive of the introduction of automatic enrolment in 2012, which will help millions of people start saving or saving more in pensions for the first time. However, we believe that allowing early access to pension saving has the potential to undermine the principles behind the 2012 reform by reducing people's' income in retirement.

3. Last year, the NAPF proposed a series of reforms to the UK pension system to encourage people to save for their retirement in the report *Fit for the Future: NAPF's Vision for Pensions*. The introduction of a single Foundation Pension along with innovations in workplace pensions would significantly increase the size of individuals' pension pots and would provide a powerful incentive to people by ensuring that it pays to save for their own retirement.

4. The NAPF wants to work with the Government to fulfil its commitment to "reinvigorate occupational pensions" by developing policy and testing new ideas. This is why we set up the recently created Workplace Retirement Income Commission to find ways the UK can radically change its approach to workplace retirement income saving.

5. In thinking about early access as away to encourage people to save more for their retirement, we have used overarching three principles to guide our thoughts:

### Early Access – Principles for Evaluation:

1. **Early access must not reduce overall levels of retirement saving.** The introduction of automatic enrolment is a major step forward. But with mandatory contributions set at a modest 8%, we must be careful not introduce any policies which could undermine the principles behind the 2012 reforms or which could reduce people's income in retirement.
2. **Early access must not put additional administrative burdens or costs on pension schemes.** Pension schemes are already facing an increasing administrative burden over the next few years, in particular due to the pensions tax regime changes and the introduction of auto-enrolment. Early access must be limited to help contain administration and cost for schemes.
3. **Early access must be designed to encourage people to repay any monies they have accessed before retirement.** People are not saving enough for their retirement and this trend will place increasing pressure on public finances. Any system allowing early access

must encourage people to repay the money they have accessed early so they can enjoy an adequate and secure retirement.

6. In the sections below, we have outlined three concerns about early access. We would urge the Government to think carefully about the effect early access could have on overall levels of saving in the UK. Given in the limited amount of research and evidence available to us, we have concluded that early access would only harm overall levels of saving in the UK and that it should not be considered as a policy going forward.

## About the NAPF

7. The NAPF is the leading voice of workplace pension provision in the UK. We represent some 1,200 pension schemes and 400 businesses providing essential services to the pensions industry. Our members provide pensions for 15 million people. Collectively they own assets of £800 billion. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

## Specific areas of concern

8. The NAPF supports the Government's efforts to foster a culture of saving in the UK. We agree that there is a need to increase flexibility and efficiency within the pensions industry and encourage people to take responsibility for their own retirement saving. However, we have a number of concerns about early access and the impact it would have on overall levels of saving in the UK. Our specific concerns are:

- **Early access would reduce people's overall levels of savings.** Evidence from the United States demonstrates that early access reduces people's overall levels of savings upon reaching retirement. The NAPF believes that early access has the potential to undermine the principles behind the introduction of automatic enrolment in 2012.

- **The long-term effects of early access would be difficult to communicate to scheme members.** The UK state and private pensions systems are already some of the most complicated in the world, making it difficult for people to predict with confidence what they will receive in the future and for schemes to communicate the benefits of pension saving. The NAPF is concerned that pension scheme members may not fully understand the long term effects early access could have on their final retirement income.

- **Early access would be difficult for schemes to deliver.** Early access in all its forms would be complex and expensive for schemes to administer. Schemes should not be required to offer early access to scheme members.

9. Each of these three concerns is explained below in more detail, along with NAPF recommendations addressing each concern.

## Early access would reduce people's overall levels of savings

10. The Government has expressed a desire to foster a culture of saving in the UK, but allowing early access would reduce overall levels of retirement saving and could increase spending on means tested benefits if limited pension saving is spent prior to retirement.

***NAPF concern:*** *We believe early access has the potential to undermine the success of automatic enrolment by reducing people's overall levels of retirement income and risks sending mixed messages to savers. Evidence from the US demonstrates that the use of early access facilities can reduce a low earning person's pension 'pot' by as much as $30,000. Other tools such automatic enrolment, matching employer contributions, and auto-escalation (where employee contributions are increased automatically in line with pay increases) would be more effective in encouraging people to save and increasing incomes in retirement. UK survey data from the NAPF and ABI shows a similar pattern. 44% of respondents to a 2010 NAPF survey said that early access would make no difference to the amount they saved for retirement. We can only conclude that early access would have, at best, only a small positive impact on retirement saving.*

*The Government is committed to introducing auto-enrolment in 2012 to encourage people to save and save more for their retirement. At the same time the Government is exploring early access to pension saving, which could result in a reduction of overall retirement saving. We urge the Government to consider the mixed messages this would send out to savers, especially to those in the "target" groups for which auto-enrolment is designed.*

**NAPF Recommendation 1: Evidence suggests that auto-enrolment is more effective at increasing participation in pension saving and will not threaten overall levels of saving. The Government should concentrate on making automatic enrolment a success rather than complicating the system further by introducing early access.**

**NAPF Recommendation 2: To help alleviate cases of hardship, the Government should consider reforms to the insurance market to make mortgage protection, ill-health and unemployment insurance more accessible.**

## The long term effects of early access would be difficult to communicate to scheme members.

11. The UK pensions system currently made up of a complex mix of the Basic State Pension, the State Second Pension, means tested benefits and workplace pensions, making it difficult for people to predict with confidence what income they will receive in the future. HM Treasury has already expressed in the call for evidence document a concern that people may not fully comprehend the impact early access could have on their retirement income.

***NAPF concern:*** *The NAPF is committed to improving communication about and member engagement in pension saving. But we are concerned that people will find it difficult to understand the effects early access could have on their retirement income later in life. While the* *issue of employee understanding could be largely overcome by more effective communication and engagement with scheme members, the Government must recognise that the risk of employees making inappropriate decisions despite receiving information will remain. A 2008 Pension Policy Institute (PPI) report concluded that "Allowing early access to pension saving could expose individual savers to more risk of making the wrong decision than less flexible systems."*[1] *People who decide to access their pension saving before retirement despite receiving information and advice, risk not just a lower income in retirement but also risk falling back on means tested benefits in later life.*

**NAPF recommendation 3: The Government should work with the NAPF and the industry to improve communication and engagement with people about the importance of saving for retirement.**

**NAPF recommendation 4: The Government should consider what impact allowing early access might have on means tested benefit expenditure, particularly in the absence of state pension reform.**

**Early access would be difficult for schemes to deliver**.

12. In the Coalition Agreement, the Government pledged to "simplify the rules and regulations relating to pensions to help reinvigorate occupational pensions."

***NAPF Concerns:*** *The Government has committed to "reinvigorate occupational pensions" and to ease the burdens placed on businesses. Early access flies in the face of both commitments. Pension schemes in the UK are already facing an incredible amount of change over the next few years especially around the pensions tax system and the introduction of automatic enrolment. Early access would be expensive and administratively complex for schemes to deliver and would only add to the increasing administrative and regulatory burden with which schemes are currently grappling. We estimate the initial set-up costs to be around £100,000 per scheme.*

*Early access would be particularly disruptive for pension schemes' long term investment strategies. For example, schemes set investment strategies knowing when members are likely to draw benefits (which would be unpredictable with early access) and they would also need to hold a larger percentage of liquid assets.*

*HM Treasury's consultation document looks at four types of early access: loans, permanent withdrawals, early access to the 25% tax free lump sum, and feeder funds. Each of these models will increase complexity and costs, and in the end, will simply add to schemes' administrative burden. In particular, we would be extremely concerned if scheme administrators or trustees were to be required to make judgements about individual cases of hardship as it would require extensive research into and verification of people's financial circumstances.*

**NAPF recommendation 5: The Government should focus its efforts on reducing the regulatory**

[1] Pensions Policy Institute, "Would allowing early access to pension saving increase retirement incomes?", 2008.

**burden on schemes in an effort to reinvigorate occupational pensions and should not add to it by introducing early access.**

**NAPF recommendation 6: If early access facilities were to be permitted, schemes should not be required to offer them to their scheme members.**

**NAPF**
**February 2011**

## Answers to specific questions

### Early access as an incentive to save

**1. Is early access likely to have a net positive effect on retirement outcomes for individual?**

Evidence from the United States, where early access is already permitted, suggests that early access has a negative affect on retirement outcomes for people who use the facilities.

In 2009, the US Government Accountability Office (GAO) conducted research into the long-term affects of "leakage" or early access on people's retirement savings. Of the types of early access being considered in this call for evidence, $9 billion was withdrawn from 401(k) plans in 2006. A further $561 million was lost in 2006 when people failed to repay loans taken from their 401(k) plans.

The GAO concluded that 401(k) scheme participants who used hardship withdrawals experienced significant reductions in their retirement savings over their lifetimes, particularly among low income and younger savers. A low earning 35 year old taking a $5,000 hardship withdrawal would lose 12% or around $30,000. In contrast, a higher earning 35 year old would experience a 5% reduction in his or her pension pot upon retirement.[2] A 2008 PPI report also concluded that permanent withdrawals or hardship withdrawals is the model which has "the potential for decreasing people's income in retirement the most."[3]

Loan provisions could have less an impact on people's overall level of saving upon retirement. In the US, people who take loans from their 401(k) plans can repay the loan through regular instalments to the plan. However, in 2006 $561 million was lost from 401(k) through loan defaults.[4] The GAO calculates that a median-income 35 year old person who defaults on a $5,000 loan after one year could reduce his or her overall pension pot by $21,000 or 4%. The same PPI report calculated that a person who does not repay their loan could reduce their overall pension pot by as much as 30% in the worst case scenario.[5]

In the US, the number of people using early access facilities has been steadily increasing over the past 10 years. A 2010 report by Fidelity found that 2.2% of actively participating 401(k) plan members had taken hardship withdrawals. Of these members, 45% had taken hardship withdrawals in both 2009 and 2010,[6] further reducing their overall pension pot.

Using early access facilities also incurs costs. In most cases of early access in the US, the 401(k) plan member must bear the costs of loan origination fees, tax penalties, and income tax. The

[2] GAO, "401(k) Plans: Policy Changes Could Reduce the Long-term Effects of Leakage on Workers' Retirement Savings", 2009.
[3] PPI, 2008.
[4] GAO 2009.
[5] PPI, 2008.
[6] Fidelity, "Plugging the leaks in the DC system: Bridging the gap to a more secure retirement," 2010.

GAO found that these additional costs can compound the permanent loss of retirement income caused by hardship withdrawals and loan provision.[7]

Earlier this year, the NAPF conducted a survey of pensions professionals to gauge their feelings on the impact early access would have on people's overall retirement income. While 59% of respondents thought early access might increase the amount people save into a pension, the overwhelming majority of respondents (77%) thought that early access would reduce people's overall retirement income.[8]

One of the objectives of the Turner reforms is to increase the number of people saving in pensions. But another objective is to increase the overall level of savings in pensions. We need more savers *and* more savings. The NAPF does not believe early access can deliver both.

2. **Would early access have particular benefits or risks for groups who traditionally under-save, including those on low incomes?**

Many groups of people traditionally under-save or do not save at all for their retirement, including people on low incomes, women, carers, and the self-employed. According to the ONS, only 18% of men and 29% of women earning less than £300 were saving in a pension in 2009.[9] Between 2005 and 2009, there was a decrease in the number of employees saving in pensions across all income levels.

In response to this marked decrease in pension saving for these "at risk" groups, the Pensions Commission recommended a set of reforms designed to get people to start saving or to start saving more. The introduction of automatic enrolment and mandatory employer contributions, together with changes to the Basic State Pension, will go some way in tackling the problem of chronic under-saving in the UK. From the start, the NAPF has recognised the significance of these reforms in helping millions of people save for the first time and has supported the 2012 reforms.

The NAPF also recognises the need to encourage people, especially those on low incomes, to save above and beyond the new statutory minimum introduced as part of the 2012 reforms. Some commentators have suggested that people belonging to "at risk" groups are less likely to save in a pension because of the inability to access their savings until reaching age 55.

However, evidence from the US indicates that early access provisions can have a detrimental effect on overall levels of retirement saving, particularly for those on low incomes (please see our response to question 1). The Government and the NAPF is committed to increasing pension saving among "at risk" groups. However, allowing early access has the potential to reduce the overall pension pots for people on low incomes, thereby undermining the principles behind the introduction of automatic enrolment.

[7] GAO, 2009.
[8] NAPF Pensions Connections survey, 2011.
[9] ONS, Annual Survey of Hours and Earnings, 2009.

This is especially disconcerting because the statutory contribution levels set by the 2012 reforms may not provide the right outcome in terms of adequacy. From 2012, employers and employees will be required to contribute a minimum of 8% of a band of earnings into a pension scheme that meets the DWP's quality requirements.

Research conducted by the NAPF suggests that, for a median earning man, 8% contributions on band earnings will provide an income worth 24% of pre-retirement income.[10] Allowing people to access their savings before reaching retirement would only reduce their income replacement rate later in life.

In other areas of pensions policy, the Government has expressed a concern about the risk of people spending their retirement savings and then falling back on means tested benefits. People who experience reduced levels of retirement income because they used early access facilities could find themselves claiming means tested benefits to make up the shortfall. The NAPF would urge the Government to consider the affects allowing early access might have on means tested benefit expenditure.

3. **Would allowing early access to pension savings in situations of acute hardship, for example where individuals face repossession of their home, help a significant proportion of people in such circumstances?**

The NAPF is not aware of any evidence suggesting that early access could help a significant number of people experiencing acute hardship. According to the Office of National Statistics (ONS) Wealth and Assets Survey, only 1% of households with mortgages on their main home were behind on one or more mortgage repayments.[11]

The Wealth and Assets Survey also found that only 13% of households are in arrears of any kind, including mortgages, personal loans, credit cards, and household bills. The mean amount owed across these types of arrears was £1,100 but half of households owed less than £400.

We recognise that people with arrears face considerable financial pressure and that home repossession is a serious problem that must be resolved. However, we do not believe the solution will be found in pensions but instead through reform of the mortgage protection, ill-health, and unemployment insurance markets.

4. **Is there an argument for early access as a way of promoting intergenerational redistribution of pensions wealth in cases where a pension saver's relatives face specific financial hardship?**

The NAPF believes that all aspects of UK pensions policy should encourage everyone to build up pension savings in their own right. Recent changes to the state pension system will make it easier for people, especially women and carers, to build up a full Basic State Pension. Additionally, the

[10] PPI Modelling for the NAPF, 2010.
[11] ONS, "Wealth in Great Britain: Main Results from the Wealth and Assets Survey 2006/08", 2009.

introduction of auto-enrolment in 2012 will ensure that everyone has access to a pension that comes with their job.

Encouraging early access as a way to distribute pensions wealth between generations has the potential to discourage saving amongst younger generations and goes against the Government's objective to encourage people to save for their own retirement.

HM Treasury points out in the call for evidence document that flexible income drawdown will be available for people over age 55 from April 2011. Using income drawdown, older generations will already be able to help younger relatives if they encounter periods of financial hardship. The NAPF does not believe an additional mechanism, which will add considerable cost and administrative complexities to the UK pensions system, is necessary.

The NAPF would be extremely concerned by the introduction of any new measures which undermine the principles behind pensions tax relief. Pensions tax relief acts as a powerful incentive for people to save in pensions and further erosion of the pensions tax relief system would only harm the long-term prospects for reinvigorating UK pensions.

**5. Would this create more risks for an individual's income in retirement?**

International experience shows that allowing early access to pension saving reduces people's income in retirement. Please refer to our answer to question one for more information on the effects of early access on people's income in retirement.

### Possible models for early access to pension savings

**6. What are the relative merits of the early access models outlined above, or any alternative options the Government should consider?**

We have compared each of the models outlined in HM Treasury's call for evidence against the three principles. Below is a summary of our analysis:

<u>Principle 1</u> **- Early access must not reduce overall levels of retirement saving.** Of the four models, the permanent withdrawal model would be the most damaging to overall levels of retirement saving. The feeder fund model is probably the least damaging.

<u>Principle 2</u> **- Early access must not put additional administrative burdens or costs on pension schemes.** We believe all the models included in the call for evidence document will impose significant administrative burdens on schemes, especially DB schemes. Pension schemes have not been designed as short term savings vehicles and would face additional record-keeping and communication requirements.

<u>Principle 3</u> **- Early access must be designed to encourage people to repay any monies they have accessed before retirement.** As long as people are incentivised to repay their loans, the loan

model fits this principle. Of course, these models could be combined to encourage repayment. For example, the 25% tax free lump sum could be taken as a loan.

In our response to previous questions we have outlined how types of early access could reduce overall levels of income in retirement. As we described briefing above, each of the models above presents a number of extremely complex and expensive administrative difficulties for schemes, We have concentrated on this area in our answer for this question. The problems associated with each model are described below.

**The loan model.** In the US, scheme members must apply for a loan from their 401(k) accounts. Scheme administrators then have to approve or reject the application. If the application is approved, scheme administrators must send a cheque for the loan amount to the scheme member within two days together with a notice for the tax penalty liable for the loan amount. This system raises several issues for UK schemes.

- who would service the loan? In the US, scheme members must pay an upfront fee for taking out the loan, further impacting their overall levels of saving.
- at what level of interest would the loan be repaid? Schemes should not be required to amend paperwork or notify scheme members if interest rates change.
- how would the loan be repaid? Members of 401(k) plans in the US repay their loan through monthly deductions in their pay packets. Schemes and employers would be faced with the additional costs of amending payroll details and setting up new systems.

**The permanent withdrawal model.** When members of a 401(k) plan request a hardship withdrawal, scheme administers approve or reject the application based on the Internal Revenue Service's (IRS) definition of hardship. Scheme members must then pay income tax, in addition to a 10% tax penalty, on the monies withdrawn.

The NAPF would be extremely concerned if schemes in the UK were required to assess cases of hardship, even if the Treasury provided a definition within tax law. Pension scheme trustees are required by law to act in the best interest of all beneficiaries. DB scheme trustees would have to consider whether allowing permanent withdrawals would impact scheme funding levels or future accrual rates or contribution levels.

In addition, schemes would have to sift through members' other financial details to determine whether other resources were available before accepting a permanent withdrawal based on hardship. Once making a determination, scheme members might be tempted to initiate legal action if their request was rejected.

**Early access to the 25% tax free lump sum.** Allowing access to the 25% tax free lump sum before age 55 will present some difficult challenges for schemes, HM Treasury and HMRC.

- **The UK pensions tax regime**. For early access to the 25% tax free lump sum to work as a means of alleviating hardship (as opposed to a tax loophole), a system would need to be in place to ensure that the tax-free lump sum was not recycled back into a pension or other tax-efficient arrangements. Preventing scenarios of tax-free lump sum recycling would be very difficult and lies well beyond the responsibility of pension schemes.

Early access to the 25% tax free lump sum might also interact with a person's annual allowance. In the year a person takes their lump sum, would their annual allowance be reduced by 25% to prevent pensions tax relief recycling? The Government is already making significant changes to the annual allowance and we would argue against any further changes.

- **Record-keeping**. Recording when the lump sum was accessed and how much was accessed would be relatively straightforward. But when person moves jobs or move home frequently, it would be extremely difficult for schemes to determine whether the lump sum has already been taken. Schemes may be required to notify HMRC when a lump sum is accessed early, but this only adds to schemes' record-keeping burdens, especially considering the huge challenge they are facing ahead of 2012.

- **Communication**. For early access to the 25% tax free lump sum to work, schemes must have clear messages to communicate to their members. The call for evidence does not specify how schemes would calculate the lump sum. Would it be 25% of the pot's current value? Or would it be 25% of the projected value? The value of a person's DC pot may vary from year to year depending on the stock market and gilt prices. Would people have to take the entire 25% at one time?

**The feeder fund model.** The feeder fund model could be less complicated for schemes to administer, especially if the fund were offered as a package by the same provider or administrator. Innovation in this area is already developing and many pension providers such as Scottish Widows and Fidelity have already launched workplace ISAs. However, the different tax regimes associated with ISAs and pensions would make it difficult to join these two specific types of saving vehicles. The Government needs to consider:

- how feeder funds would work within the existing tax regime;
- whether existing savings would be treated differently from new saving; and
- how savings held in feeder funds would interact with other pensions tax rules such as the Lifetime Allowance and Annual Allowance.

**7. What evidence is there of the likely impact on individuals' participation and level of pension saving, and broader outcomes in retirement of any given option?**

Early access can increase participation rates in purely voluntary retirement saving systems. In the US where automatic enrolment is not mandatory, 401(k) plans that allow early access typically see around a 6% increase in participation versus schemes that do not offer early access.[12] According to the GAO, schemes are not required to offer loan or permanent withdrawal facilities.

[12] GAO, "401(k) Plans: Loan Provisions Enhance Participation But May Affect Income Security for Some.", 1997.

Survey data in the UK suggests that people are not necessarily inclined to increase their levels of pension saving because of early access. A 2010 omnibus survey conducted by the NAPF showed that 23% of respondents would be willing to increase their pension contributions if they could access their savings early.[13] However, 44% of respondents said early access would make no different to the amount they saved in their pension.

Other survey results confirm these findings. A 2009 survey from the Association of British Insurers asked respondents what would encourage them to start saving or to save more in a pension. Less than 5% of respondents said early access would encourage them to save more.[14]

Alternative tools such as automatic enrolment, matching employer contributions and auto-escalation are far more effective at increasing participation and levels of saving:

- **Auto-enrolment.** 2009 study by the GAO found that automatic enrolment is powerful behavioural tool to increase employee participation. Some 401(k) plans using automatic enrolment experience participation levels of 95%.[15] Auto-enrolment is especially effective for low income and younger employees. The GAO reports that a 2007 Fidelity Investment survey found that 30% of employees aged 20 to 29 were members of 401(k) schemes without automatic enrolment. Plans that did use automatic enrolment saw participation levels of around 75% amongst 20 to 29 year old employees.

  The effectiveness of auto-enrolment in increasing participation rates was one of the main reasons why the Pensions Commission recommended its introduction in its second report. According to the Pensions Commissions' research, auto-enrolment can normally achieve participation rates of between 60-80%.[16]

  From 2012, all UK pension scheme will be required to use automatic enrolment. This will be a huge step forward and will bring millions of people into pension saving. The UK pensions system will already have a mechanism in place to increase participation rates. Permitting early access on these grounds will be superfluous.

- **Matching employer contributions.** A 1997 GAO report found that US schemes that provide matching employer contributions experienced increased participation rates by 20%.[17] Schemes that provide matching employer contributions but do not allow early access achieve participation rates of around 75%. 60% of DC schemes responding to the 2009 NAPF Annual Survey already use matching contributions to encourage member participation.

- **Auto-escalation.** Like auto-enrolment, auto-escalation harnesses savings inertia to increase pension contributions. Schemes that use auto-escalation increase their members' pension

[13] NAPF Workplace Pensions Survey, 2010.
[14] ABI, Savings and Protection Survey Q1 2009.
[15] GAO, "401(k) Plans: Several Factors Can Diminish Retirement Savings, But Automatic Enrollment Shows Promise for Increasing Participation and Savings," 2009.
[16] Pensions Commission Second Report, "A New Pensions Settlement for the Twenty-First Century", 2005.
[17] GAO, 1997.

contributions concurrently with salary increases and remuneration package revaluations. Research conducted by the Employee Benefits Research Institute (EBRI) in the US shows that auto-escalation can increase low income people's income in retirement by 11 to 28%.[18]

Schemes in the UK are already using these tools to increase member participation and saving rates and further innovation is evident. Of course automatic enrolment will be mandatory from 2012, but the NAPF is aware of some UK schemes who have adopted auto-escalation successfully. For example, one scheme has introduced an annual automatic 1% contribution increase (which employees can opt out of). The NAPF is happy to facilitate meetings between HM Treasury and schemes who use innovative tools such as auto-escalation.

**8. What would the key costs and potential burdens be of providing any of these early access options on individuals, pension providers, or schemes (including if limited to cases or hardship)?**

The NAPF has outlined below what we envisage the key costs and burdens of providing early access facilities would be for individuals, providers and schemes. However, it is important to remember that the UK pensions system has no experience of early access and there might be additional costs and burdens which we are unable to predict.

***Cost to individuals*.** In the US, scheme members are sometimes required to pay origination fees for taking from their 401(k). Taking a hardship withdrawal or defaulting on a loan also incurs a tax penalty charge. People who use early access must pay income tax on hardship withdrawals. The tax penalty charge adds to the cost of early access, but in the US it is recognised that the charge acts as an important disincentive to use early access.

***Cost to schemes*.** NAPF members have indicated that the cost of allowing early access would be quite significant for schemes. We have broken the costs down into one-off set-up costs and on-going costs:

- **One-off set up costs.** Almost all schemes in the UK would have to amend their scheme rules in order to allow early access. The NAPF has previously estimated the cost of amending a single definition within scheme rules to range between £25,000 and £100,000 per scheme. However, amending scheme rules to allow early access is a more significant and fundamental change and therefore we believe the costs would fall at the higher end of the range. Scheme rules would have to account for every possible scenario, for example deaths in service and loan defaults. Employers with more than one scheme or with legacy arrangements will have to change each set of scheme rules. Schemes would also have to review scheme literature and communication strategies.

- **On-going costs.** On a day-to-day basis, schemes will have to manage early access applications which, in many cases, could require extensive research into and verification of people's financial circumstances. Once an application for early access has been approved, schemes

[18] EBRI, "The Expected Impact of Auto-Escalation of 401(k) Contributions on Retirement Income", 2007.

would have to initiate the process of releasing funds. The cost and complexity involved in releasing funds will vary from scheme to scheme, depending on design and funding level. Smaller schemes or schemes with limited cash flow (eg a closed DB scheme) may have to dis-invest assets in order to meet the early access request.

The process of dis-investing can itself be costly, especially if a scheme has invested in pooled funds or if the investments are unitised. Scheme may face a penalty charge for dis-investing early.

Our work around the Treasury's pensions tax mitigation strategy suggests the costs of releasing funds early from a DB scheme could cost upwards £2,500 per member. We have outlined the further costs and administrative burdens around early access fro DB schemes in our response to question 9.

***Cost to pension providers*.** Like schemes, pension providers will need to process and approve applications for early access, as well as providing advice to people wishing to take early access. Any cost incurred as a result of the increased administrative burden and need for individualised advice is likely to be passed to members of group personal pensions (GPPs) or personal pension holders through increased charges.

### Wider pensions tax rules

**9. Could early access be offered by defined benefit schemes, and what would the main barriers or implications be for schemes, employers, and members?**

A 2011 NAPF poll of pensions experts showed that 78% of respondents thought it would be extremely difficult or difficult for defined benefit (DB) schemes to offer early access to their members.[19] In particular, we are extremely concerned that early access would negatively impact DB scheme funding or, in extreme cases, cause further scheme closures.

DB schemes, by their very nature, are designed to plan and invest for the long term. Schemes make investment decisions knowing when scheme members are likely to draw benefits. Requiring DB schemes to offer early access facilities to their members would be severely disruptive to their investment strategy. Schemes would also have to hold a larger percentage of their assets in liquid form, thus skewing their investment strategies towards products such as bonds. In the end, schemes would be forced into less optimised investment strategies in order to cope with the unpredictability of early access requests.

Allowing early access could also hasten the closure of DB schemes, especially where the scheme is in deficit. In situations where the strength of the employer covenant is in question or when the scheme is winding up, scheme members might seek to access their pension rights early as a precaution. There is also a question as to whether the Pension Protection Fund (PPF) would be able to or would want to offer early access facilities for schemes in the PPF.

[19] NAPF Pensions Connection Survey, 2011.

Trustees of both DB and DC schemes are required by law to act in the best interest of all scheme members and beneficiaries. We predict that trustees would have to spend more time during trustee meetings discussing issues relating to early access. For example, early access has the potential to impact scheme funding levels and therefore trustees would have to exercise discretion in approving requests, considering investment strategies, and dealing with appeals.

In addition to impacting scheme funding, early access would cause considerable burdens on DB schemes:

- **Additional administrative cost.** Schemes would have to process applications, release money from the fund, and possibly revise payroll deductions and schedules of contributions. Schemes and employers might also have to contact HMRC to advise them when applications for early access are approved.
- **The need for actuarial advice.** Schemes would have to employ actuarial services to calculate scheme members' benefits and therefore the amount available for early access. The call for evidence does not specify on what basis DB schemes would calculate benefits used for early access. Schemes could calculate benefits in three ways: as a percentage of the overall fund, based on accrued rights, or based on projected rights. Each of these methods presents their own set of challenges and costs.
- **The need for legal advice.** Most schemes would have to make amendments to scheme rules to provide early access facilities. NAPF members estimate that amending scheme rules can cost up to £100,000 per scheme. Member communications would also have to be updated, and reviewed, by legal advisers.
- **Member cross-subsidy.** Contributions from scheme members who do not use early access would subsidise loans and permanent withdrawals for members who do access funds early, especially if the scheme is in deficit. The situation would be exaggerated in schemes requiring payments for past service deficits.
- **Death in service.** Scheme members who take a loan or permanent withdrawal would reduce their overall benefits, and thus death in service benefits. It is also not clear if trustees would have the power to recoup funds if a scheme member dies before repaying a loan in full.

**10. What are the potential implications for consumer advice and ensuring individuals understand the tradeoffs around early access?**

Early access has profound long-term effects on a person's retirement income so it is important that, if early access were permitted in the UK, scheme members are given adequate information when making decisions to access pension saving early.

Research into this area suggests that employee understanding of how pensions work is extremely limited. The DWP's 2009 Attitudes to Pensions Survey found that only 6% of respondents felt they had a good knowledge of pensions issues. 29% of respondents said they knew little or nothing about pensions. A 2009 report by the DWP stated that only 10-15% of DC scheme members understand the investment risks they face.[20] A separate report by the FSA suggests that understanding of decumulation products like annuities, income drawdown and equity release remains poor. [21] For these people, the key to effective decision-making around pensions and early access will be easy-to-understand information and simplicity within the pensions system.

In the US, schemes are required by law to inform scheme members about early access at three distinct points: at enrolment, when members request early access, and at job termination. But many schemes who offer early access are wary of providing information about the long term effects of early access on members' retirement income in case it is perceived as advice.[22]

Pension schemes and employers in the UK experience similar fears around the provision of information about pensions. The 2009 *Talking Pensions* report by the NAPF found that 57% of employers have concerns about communicating with their employees about pensions. But at the same time, employees trust information provided by employers more than information provided by the Government or the financial services industry. The DWP's 2007 survey "Trust and confidence in Pensions and Pensions Providers" found that employees trust their employers the most when it comes to pensions, followed by not-for-profit organisations.

For employees to fully understand the risks involved in early access, it will be imperative that employers are provided with clear guidance about how to communicate with their employees about early access and more general pensions issues.

**11. Is there a case for introducing further flexibility in the trivial commutation rules?**

The NAPF is in principle not opposed introducing more flexibility into the UK pensions system if it will result in more saving and better outcomes for scheme members. We recognise that the needs of savers are changing:

- **Changing work patterns.** People may accumulate multiple, smaller pension pots over the course of their careers.
- **Trends in working longer.** People may not need to access their entire pension pot if they have other sources of income.
- **Increasing longevity.** The price of annuities and other income drawdown products could increase because of increasing longevity or a shortage of gilts.

The introduction of automatic enrolment from 2012 will also change the way people save. Auto-enrolled savers may accumulate small pots of pension saving, because they were auto-enrolled close to retirement, because they changed jobs frequently or because they opted out after a period of saving for financial reasons.

[20] DWP, *DC pensions,* 2009.
[21] FSA, *Finance in and at retirement – results of our review,* 2007.
[22] GAO, 2009.

These people may not experience the best income in retirement. People with small pots often do not get the best annuity rates or are unable to shop around for the best rates through the Open Market Option because providers view small pots as uneconomical. It is important that the Government takes steps to improve value for money for people who have saved, but for various reasons accumulate multiple pots.

Some stakeholders are concerned that some older workers with little or no existing pension may be caught in a means-testing trap if they start saving too close to retirement. The NAPF shares these concerns, but we believe this particular problem could be solved through state pension reform which would reduce the impact of means testing and increase incentives to save.

However, another area that could be looked at is increasing the size of a pension pots that do not have to be turned into an annuity under the trivial commutation rules. It might make more sense for more of these small pots to be taken as a lump sum rather than a pension income, as small amounts of capital often so not effect benefit entitlements. Alternatively, increasing the trivial commutation limit could reduce the likelihood that workers with multiple small pots are penalised for saving into a pension.

The NAPF has previously recommended that spouses should be able to combine their pots to purchase one joint-life annuity. We believe this would help couples achieve better incomes in retirement.

**12. What are the key barriers to transfer of small pots and are there any proposals from industry, consumer bodies, or other interested parties as to how small pot transfers could be better facilitated?**

The Making Automatic Enrolment Review led by Paul Johnson identified that transfers in the wider pensions industry are restricted by costs, including the cost of regulation and advice.[23] The NAPF is aware that transfers between schemes can be complicated, time-consuming, and even costly for scheme members if the transfer incurs a penalty or charge. Transfers from DB schemes also require actuarial calculations to determine the transfer value, which can be expensive.

With the introduction of automatic enrolment from 2012 more people will be saving in pensions, many of whom will accrue small pots as a result of frequent job changes or because financial constraints cause them to opt-out. In a post-2012 pensions world, there is no doubt that there will be a role for improved communications around transfers so people understand their options when they leave a scheme. The NAPF is happy to work with the Government to develop more effective ways of facilitating more efficient transfers.

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[23] Making auto-enrolment work: a review for the Department for Work and Pensions, 2010.