Strictly Financial

Was the widespread consternation surrounding Pension Freedoms justified?

Were industry experts right to worry … and were they worried about the right things?

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Our insights and observations

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Pension Freedom – solving old problems or just creating new ones?

Pension Freedom was introduced as something of a bolt from the blue in the 2014 budget by then-Chancellor George Osborne, to take effect in April 2015. As its name suggests, it gave people the ability to do what they liked with their pension after the age of 55. So what have people actually done? We take a look at some published research and consider what it really tells us about how Pension Freedom has played out so far.

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As Osborne memorably put it at the time, people could now spend all their pension on a Lamborghini if they wished - thus revealing how little he knew about the size of the average UK pension pot or the cost of a Lamborghini.

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Osborne's bizarre illustrations aside, this legislation really was revolutionary. For the first time people could spend their pension savings however they wanted to, rather than having to buy from a narrow range of pension products specifically designed to provide income in later life, of which the best known (and most complained about) was the annuity.

But as it says in the cliché, with great freedom comes great responsibility. In this case the responsibility was for people to take a more active interest in the wide range of options they now had, so as not to choose the wrong ones. The unspoken implication of this was that they also needed to understand these options far better than they had ever needed to understand pensions before, in order to make these choices well.

There was already widespread concern under the old rules that people were not engaging adequately with their pension (and with the few decisions they could make about them), and this was probably a major driver behind Osborne tearing the old rules up. But In no time at all fresh worries were being expressed: that people would make poor use of their new pension options, and would get themselves into trouble as a result. And these concerns persist.

Our viewpoint

The indications are that the doom mongers were wrong. People appear to be acting responsibly and even those who are emptying pots are doing so for good reason. After an initial 'surge' in withdrawals, rates have steadily reduced over the two years since the freedoms, and in the longer term it appears that people are accessing their retirement pots in a sensible way.

So rushing blindly into cash withdrawal does not seem to have been the new problem created by Pension Freedom that many feared it would be. Rather, it appears that 'reckless caution', rather than reckless spending could be the real issue that regulators need to address. Walking blindly into drawdown or cash savings rather than making an active product and investment choice at the point of withdrawal is a real potential problem in the making – and a growing one.

Pension Freedoms have shifted how people think about their pensions at both the accumulation and decumulation phases. The appeal of pensions as a savings vehicle has been boosted, and more than a million DC pots have been accessed under the rules, 72% by under 65s. This has precipitated a shift in how pensions are being seen and how people are using their retirement savings - arguably well overdue given the more general social and demographic shifts.

But thinking and assumptions around 'pensions' lag behind the new flexibility – this is true for all parties. Consumers need to appreciate the decoupling of withdrawals/ TFC from the act of retirement, and the implications of this in terms of product selection and management. Providers need to 'catch up' and ensure that their legacy systems have the flexibility to offer partial withdrawals (and not force total withdrawal).

And more generally, the industry does not appear to recognise the relative value that consumers place on their pension pots – having a relatively large lump sum today is more enabling (and possibly) more beneficial than having a much smaller amount annually. Their behaviour is not irresponsible – we know consumers are generally not 'blowing' the money – but is being informed by other life issues. Pension Freedoms are allowing them to 'invest' the money in something that they value more.

There have also been some unintended consequences, with Pension Freedoms opening the door to fraudsters and scammers. A ban on pension cold calling has been implemented, but according to the police about £43m in retirement savings has been lost to fraudsters so far.

There are bigger issues about managing pension pots effectively in the longer term – but this was always the case. Pensions are, and always have been, an area of low engagement – people don't read their pension statements. This has always been an issue, and needs a significant change in behaviour – but Pension Freedoms have made this issue more pressing than ever.

Drawdown provides a clear example of this. It has always been a product requiring ongoing engagement and knowledge, and/ or ongoing advice, and traditionally it has attracted consumers who understand this. But Pension Freedoms have widened the appeal of drawdown to people who reject professional advice. Even if they are engaged with the product, these people are at risk of making poor decisions – and their numbers are increasing as a result of Pension Freedoms.

So are people better or worse off than pre Pension Freedoms? In our view, they are (on balance) better off. Pension Freedoms have given them different choices and faced with them different responsibilities – this has both potential benefits and potential risks, but then so did the status quo ante.

But have Pension Freedoms fixed the old problems of pensions – under-investment, under-engagement, not shopping around? Will the level of control bestowed by Pension Freedoms increase engagement throughout the life of the product? No, these remain unsolved, and indeed unaddressed, by Pension Freedoms. Plus ça change…

In our view, addressing these issues will need a significant behavioural and attitudinal shift from consumers, and one which is unlikely to happen overnight. Therefore, it is incumbent on all parties (regulator, providers and advisers) to educate and encourage consumers to take more interest in, and responsibility for, their retirement income.

So the real problem with Pension Freedoms doesn't lie with what they have done. It lies with what they haven't done.

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Read on for a more detailed discussion of the issues raised above, the evidence driving our views about them, and why George Osborne was wrong about the Lamborghinis.

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What are the worries about Pension Freedoms?

It took no time at all for worries to be expressed about the (then) new legislation - people would make poor use of their new pension options and would get themselves into trouble as a result.

The concerns about Pension Freedoms fell into two main areas:

- The ability of people to make informed decisions about their pension pots
- Their access to advice given the increased complexity (and importance) of the choices facing them

We looked at these broad areas nearly three years on, to explore whether these concerns were (and are) justified.

Making informed decisions

The concerns
The fundamental concern is that people will make poor decisions about what to do with their new-found Pension Freedoms. These poor decisions could be to spend the retirement provision unwisely or too soon, leaving insufficient funds for later life or for particular needs such as long-term care; or they could be to make a poor choice of product or provider, when shopping around might have provided a better outcome.

And of course, any action they take now may well impact on future entitlements – for example, the State will take the initial value of any pension savings into account when calculating benefit eligibility, even if the individual has spent all those savings. In effect their State 'safety net' could be a lot emptier – but are people aware of this?

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But these are just the new concerns. They come on top of worries that already existed (and were growing) before the introduction of Pension Freedoms, and which Pension Freedoms do nothing to address.

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There was already real concern under the old rules that people were not engaging adequately with their pension, and the new rules throw this concern into even sharper relief. With more options and decision points than before people need to become – and to remain – more in touch with their pension than when the choices were fewer and simpler. In crude terms this means a requirement to be better informed about the pros and cons of the various options, and to do so for as long as there are options available – possibly well beyond the age of 75. Given that people were already unengaged under the old system, what evidence is there to suggest that people's behaviour will change as a result of Pension Freedoms?

Add to this disquiet about how people have been under-funding their retirement pots for years, underestimating how much money they will want/ need in retirement, how far this money will go as inflation devalues it over time, and how long they will need it for, i.e. how long they will live in retirement. And concerns that people were not shopping around (e.g. for an annuity) as much as they could, and were losing out on retirement income as a result.

What actually happened in the months following the introduction of Pension Freedoms?
Both the Pension & Lifetime Savings Association (PLSA) and the Financial Conduct Authority (FCA) published figures covering the first period of Pension Freedoms. This

was the period which many were most concerned about, as they feared consumers would rush to cash in and spend pensions which they would need in later life.

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There was a real fear that Osborne had got it wrong in allowing people to take more control over their pensions, in effect that people could not be trusted and would get themselves into a mess.

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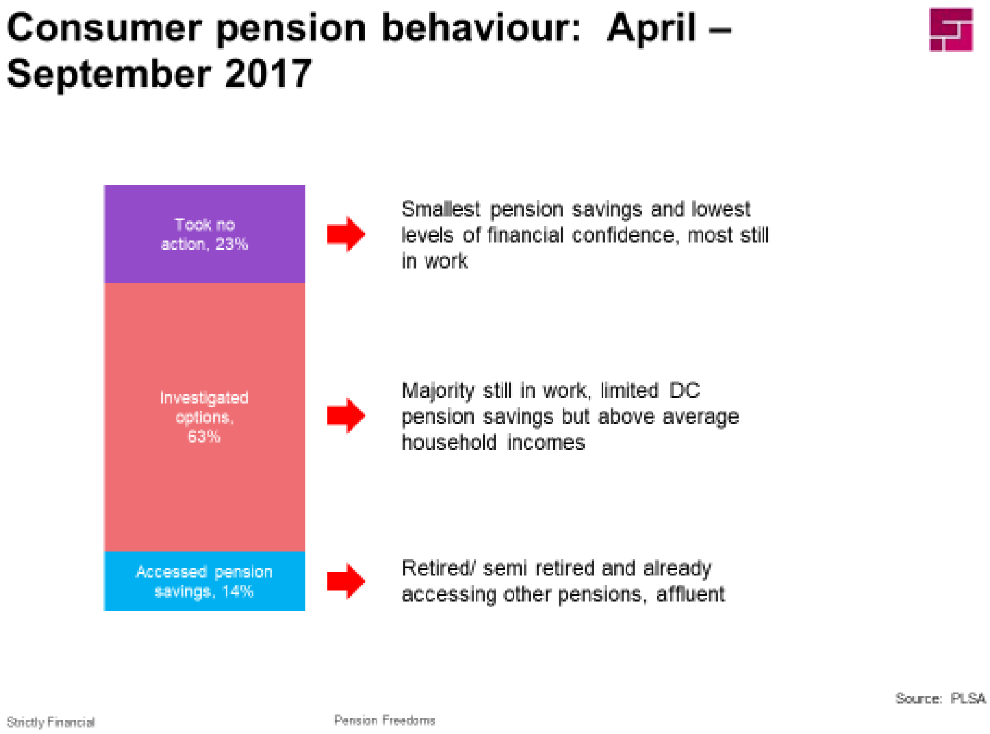
So did they?

According to research published in October 2015 by the Pension & Lifetime Savings Association (PLSA) covering the first six months of Pension Freedoms, there were 2.8m people aged 55-70 with at least one DC pension they had not yet accessed.

The PLSA estimated their average overall pension size (including any non-DC pensions held) to be £85,000. This is above the national average, and in George Osborne's terms equates to roughly half the street value of a lightly used two-year-old bottom of the range Lamborghini.



In the first six months following the introduction of Pension Freedoms, 400,000 people (14% of that 2.8m) accessed their pension savings, while a further 1.75m (63%) started investigating their pension options. The remaining 630,000 people (23%) did nothing about their pension during that period.

The PLSA view is that the 400,000 who accessed their pensions were untypical of the population as a whole. Many of them were already retired or semi-retired (and were already accessing other pensions), and they were more affluent than average: in illustration of this, 40% already had experience of SIPPs and drawdown, which have traditionally been the preserve of the professionally advised better off.

To a lesser degree the 63% investigating their options were also at the affluent end of the spectrum. The majority were still in work and had limited DC pension savings but above average household incomes (and so scope to increase their pensions before retirement). Three quarters of them had not yet consulted a professional adviser, and only 10% had used Pension Wise.

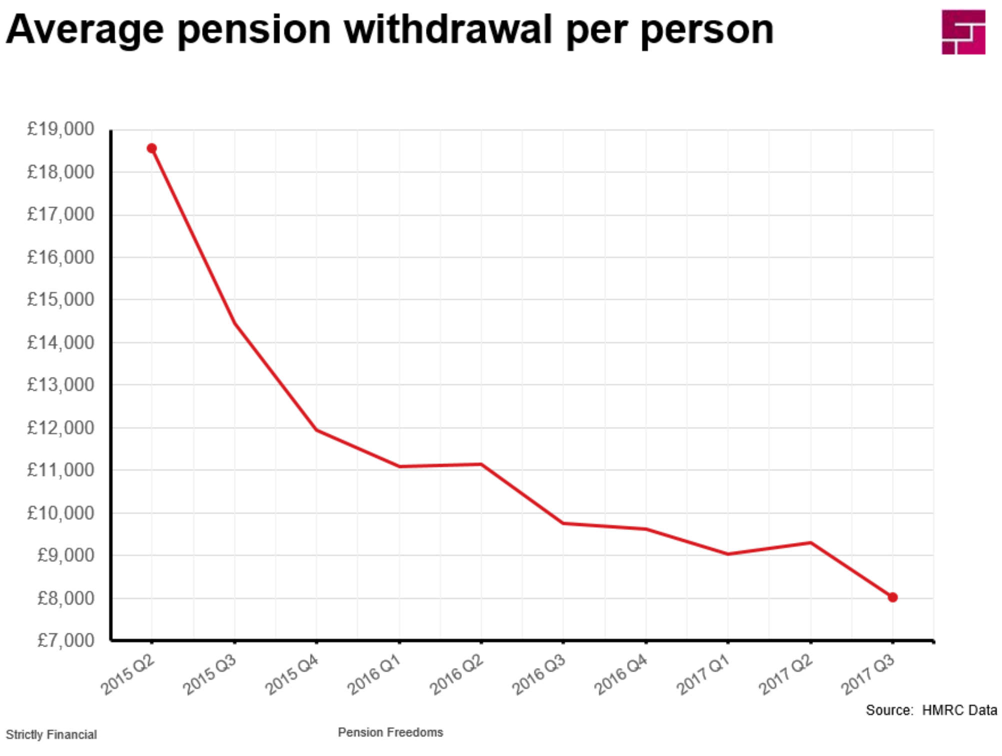
The 23% who had taken no action at all had the smallest pension savings and lowest levels of financial confidence. Most of them were still in work, so the possibility of increasing their pension savings exists, but their tranche of the market is not attractive to IFAs and they themselves may baulk at the fees charged for advice on their modest pension pots. This could put them in a position where they may be (sometimes self-) excluded from professional financial advice.

Unsurprisingly the FCA has also been keeping a close eye on the situation, and they conducted a review of retirement outcomes which was published in July 2017. Whilst 1m pension pots of the over 55s had been accessed, more than 5m remained intact.

The highest level of first time pension access was in the first quarter after Pension Freedom came in. In April-June 2015, nearly 220,000 pots were accessed, according to FCA figures. This can be seen as something of a rush, as the doomsayers had predicted. But it was followed by a decline of over 40% by the end of the year - down to 125,000 in the period October-December 2015.

And the initial rush was for cash withdrawals, again as was feared. But this also saw a sharp decline in the months that followed - down 42% in the fourth quarter compared with the period July-September, and compared with a decline in annuity purchase of only 9% over the same period.

This trend is also mirrored in the amounts being withdrawn, which according to HMRC figures have declined by more than half between April 2015 and September 2017.



The FCA's own research showed that over 1 million pension pots had been accessed since Pension Freedoms, and that over half of these pots were emptied. However, 90% of these pots were less than £30,000 in value (classed by the FCA as 'smaller pots'), and 60% of these (i.e. around 540,000) were smaller than £10,000. And 94% of consumers making full withdrawals had other sources of retirement income beyond the state pension. The research also shows that most of those with larger pots did take financial advice before deciding to take their money out, and even amongst those with more modest savings (£30-50,000), three in five took advice.

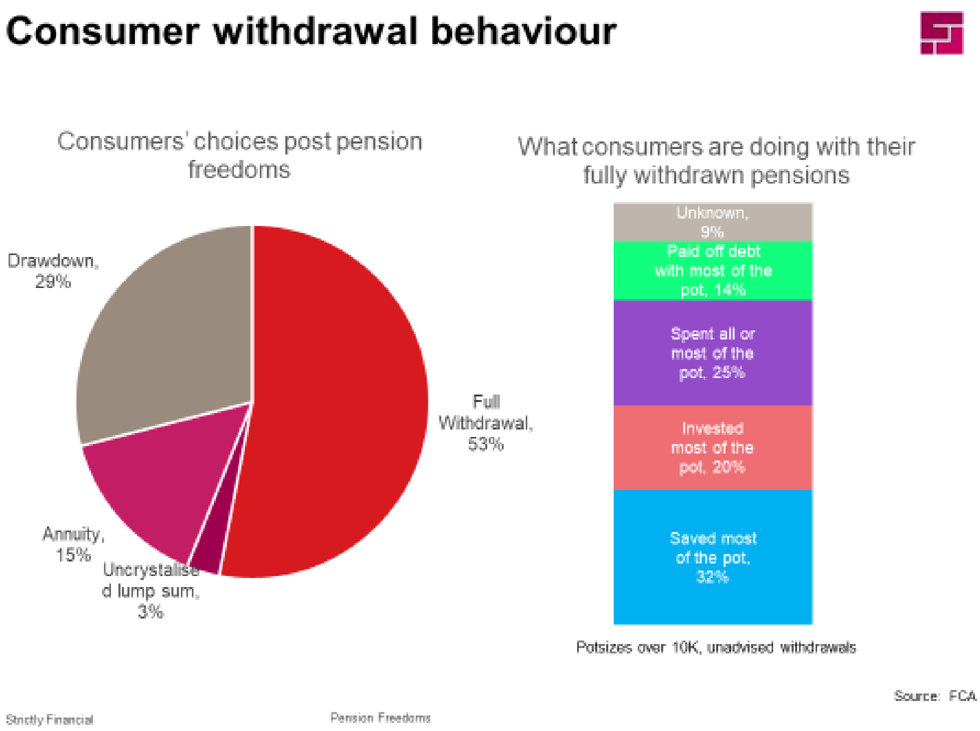
But what has happened to this money? Have people 'blown the lot' as predicted? If not, where has the money gone?
The FCA's figures from the retirement outcomes review report[1] showed that 29% of consumers moved their pension pots into drawdown products and only 15% into annuities – a massive drop from the 90% of pots moving into annuities pre-Pension Freedoms. The increase in the popularity of drawdown is marked, and it raises the question of whether those individuals are able or willing to manage their drawdown effectively in the long term.

The major changes that are occurring in the advisory market bode well for this - at least amongst clients who take advice. The increasing professionalism and the refocus on client goals that have happened as a result of RDR mean that 'advice' is now the main product that is sold, and this in turn means that clients are becoming more involved and knowledgeable. The FCA figures indicated that 70% of those opening a drawdown account did so following advice – which again shows that consumers were acting responsibly. It is unclear what those who are unadvised will do, or what their level of longer term engagement will be – but the FCA report does state that consumers have welcomed the changes (they like having control), and there is evidence to suggest that the new flexibilities have rekindled interest in pensions – but only time will tell.

Looking purely at those who have fully withdrawn their pots, the FCA and PSLA research is remarkably similar. The PSLA research among those who accessed their pension pots showed that most of the cash taken was put into savings or investments rather than being spent.

Others have used the money accessed to pay down debt. This could be seen as putting short term interests ahead of long term ones, which lies at the heart of the concerns raised about Pension Freedoms. However, successive generations of savers, spenders and anyone else seeking financial advice have been told ad nauseam that the priority with money is to pay down any outstanding debt – so this behaviour is understandable and logical, and it has traditionally been seen as laudable.

[1] https://www.fca.org.uk/publication/market-studies/retirement-outcomes-review-interim-report.pdf



Digging deeper, the FCA found that half of the fully withdrawn pots were not spent but transferred into other savings and investments. Oher research published by Fidelity suggests that many are simply moving retirement savings into current accounts and leaving them there, rather than spending them. Even amongst those who take a drawdown product, providers estimate that 60-80% of new drawdown customers are in zero income drawdown.

This raises the question: why withdraw at all?

We suspect that there are behavioural biases at play here. First, there is real mistrust of the industry generally, and of pensions specifically. The FCA found that a key factor in people accessing benefits early is mistrust of pensions – past experience and lack of regulatory certainty are underpinning this. Fidelity found that 59% of those making a withdrawal were concerned about Government making changes to pension policy. This leads to a desire for greater control and a greater 'certainty' over what you can/ cannot not do. For example, the future situation on possible tax-free cash is very opaque, and people are simply unwilling to take the chance that the rules may change, and that they may no longer be able to access these savings.

Against this background it may seem sensible to people to 'strike while the iron is hot' and use the Pension Freedoms to make the withdrawal while it is still possible. This is despite the fact that currently extremely low interest rates are the biggest worry (according to the Fidelity research) for those making pension withdrawals.

Provider flexibility may also be an issue here. We know that some providers struggle to allow full flexibility on some of their legacy products – for example, someone may want to withdraw more than the tax-free cash but less than the total amount, but they are unable to do this, and instead have to withdraw everything because of systems limitations. The extra money is not earmarked for a specific purpose, so no wonder it is simply ‘parked’ in a convenient account and continues to languish there.

Leaving money in a ‘conservative’ savings account/ cash ISA does open consumers up to detriment if they pay too much tax or miss out on investment growth – long term investment in cash puts people at risk of negative real returns. Ensuring that consumers understand this is a real challenge.

The new MPAA may also affect these people – especially if they are at the younger end and intend to continue saving into pensions in the future. If total pension contributions (including those of the employer) are more than £4,000 per annum, taking anything more than the tax-free cash will limit the amount that can be saved tax efficiently in the future.

According to the PLSA, the main ‘pure spending’ or discretionary use to which the money accessed has been put is on holidays or the purchase of a car. These have long been aspirational purchases of people in the first flush of retirement: the holiday now that they have the time and while they are still young enough to enjoy it to the full, and the car partly as a necessity, partly as a treat. These are genuine and sometimes quite long-term aspirations rather than impulsive decisions following a windfall. And the cars aren’t Lamborghinis.

Part of the recent concern about pension cash withdrawal has been that people are taking out unsustainable amounts from their drawdown pensions, which will compromise their incomes in the future. This may be the case for some individuals, but Hargreaves Lansdown say their typical self-managing pension investor is taking a very sensible 3.6% a year from their pension pots. This is slightly below the ‘recommended’ 4% - again showing that consumers are taking a sensible approach to managing their pensions and incomes.

So the typical withdrawal has been used to pay down debt, saved elsewhere, or spent on a major holiday or car purchase. Use simply as ‘pocket money’ does not seem to have had a role. Money that is taken as income seems to be both at a reasonable level and largely sustainable in the mid to long term.

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Post Pension Freedoms behaviour would seem to be largely unchanged from before, and therefore no more irresponsible than it has ever been.

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But there is perhaps one area where unchanged behaviour could have a bigger impact than before Pension Freedoms: longevity, and its implications for how long retirement savings will need to last.

People tend to underestimate both how long they will live in retirement and how much money they will need, particularly in later life: they will get older than they thought, and the older they get the more help, and ultimately care, they will need. Meanwhile inflation will be eroding the buying power of their savings unless they can beat it through growth.

Against this background, research by the CAB suggests that 60% of people accessing their pension between April and August 2015 had not 'planned' for future care costs, and only about 15% had 'budgeted' for it.

In fact, this tells us little about the minority who have taken the issue of future care into consideration. 'Planning' may not be the same as preparation, and 'budgeting' does not mean that enough money has been earmarked for this purpose. People may need the care for longer than they have budgeted for, and the impact of inflation over time (and specifically on care costs) could well mean that such budgeting as they have done may be inadequate.

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These figures do suggest that overall the retiring population is ill-prepared for the cost of care that they are increasingly likely to need in later life. This is a problem, but it is nothing new, and it is not directly related to the impact of Pension Freedom.

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What does this tell us about how Pension Freedom is going so far?
There were concerns that April 2015 would see a rush of people rashly cashing in their pensions in order to use the money now instead of eking it out over their retirement.

There does indeed seem to have been something of a rush, but the figures suggest that the first wave of people accessing their pensions because of the change in regulation consisted mainly of the people who could most afford to do so. But this 'rush' was short lived, as figures for the subsequent quarters suggested that fewer people accessed their pension for the first time following the initial wave in April-June.

What the figures suggest is that Pension Freedoms have done little to change the broad underlying behaviours of the population when it comes to pensions: as was the case before its introduction, the richer are more engaged and take more action, while the poorer remain unengaged and take no action.

The decoupling of tax free cash from retirement is perhaps a bigger issue – people taking TFC early but not considering or making an active choice about a retirement income product at that time … they do not consider that they are retiring, so why would it occur to them to do so? This problem is exacerbated when the remaining pot is also partially or totally withdrawn (either through need or through systems issues).

The perennial issue of lack of pensions engagement is at the root of this – it means that people are not necessarily making active product choices or investment choices at the point at which they exercise their Pensions Freedoms choices, and they may miss out on growth or incur other unappreciated penalties (tax, benefits etc). However, this issue is not specific to Pension Freedoms – it already existed – it is just the way it manifests itself that has changed.

Getting expert help?

The concerns

The obvious alternative to being well informed yourself is to take professional financial advice. But changes in the adviser landscape and regulation over the last few years have meant that pension advisers need to be more highly qualified than before, and that they must charge fees rather than being able to be paid via commission.

Whilst the quality of the advice received is theoretically better than it was in the past because of these changes, advice also appears costlier than it used to. So at a time when it can be argued that the need for financial advice is both wider and deeper than ever before, the advice itself has become ‘harder’ to obtain: more exclusive, and, as a result of greater transparency, more obviously expensive.

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The issues of advice and of its cost have created a gap in the market where people need to understand their pension options (and their implications) better, but many are unwilling or unable to pay for professional advice to help them do so.

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Pension Wise has a role to play in bridging this ‘gap’. It is a free service, open to anyone, and it is intended to help people make better decisions. However, the qualifications which need to be attained and processes which need to be gone through before advice can be given preclude Pension Wise, or any other less than fully qualified adviser, from giving consumers ‘advice’ – nor is it the organisation’s intention to do so.

Instead the role of Pension Wise is to help consumers achieve greater knowledge and understanding of their options, including their advantages and disadvantages, and to do so from an unbiased standpoint (in common with a fee-based adviser). Whilst the goal is to help people make their own more informed decisions, the onus remains firmly with the consumer, and while there is 'guidance' there is no-one telling them what they should do. By any measure other than a politician's, this is not the 'advice' George Osborne described it as when he trailed the launch of Pension Wise in his 2014 budget speech.

Are people using advice?
One area of consensus about Pension Freedoms is that it has increased the need for professional advice. Against this background, 68% of drawdown and 42% of annuity purchases were made using a professional adviser in the final quarter of 2015. Where pension pots were emptied, 37% of customers took professional advice, as did 34% of those taking UFPLS. Meanwhile, as the PLSA found, best estimates from the FCA suggest that about 20% of withdrawers used Pension Wise in some way.

Among these people taking cash, it was those with larger pots who were more likely to use an adviser. Again, it would seem that those with larger amounts in their pensions were using an adviser, which was the case before Pension Freedom was introduced – so no obvious change there.

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However, what has changed, and changed significantly, is that the 32% of drawdown buyers not using a regulated adviser compares with just 3% in 2013.

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Apart from using an adviser, the other behaviour often taken by the FCA among others as a sign of engagement with pensions is shopping around at moments of choice like annuity or drawdown selection. As regards shopping around, 53% of drawdown and 57% of annuity purchases were made by existing customers of those providers. And among non-advised sales the figures are markedly higher – according to the FCA, 94% of non-advised drawdown plans and 70% of non-advised annuities were sold to existing customers. How well informed these purchases were is unknown, but it is likely that many of the buyers did not consider wider market options.

This lack of engagement and of shopping around among consumers who are taking no advice means that they may not appreciate the need to participate in the ongoing management of their drawdown products – and they may well need further support to manage their drawdown effectively in the longer term. Unlike in the accumulation phase, there is no 'default' fund (99% of NEST members are in a default fund), but instead consumers are expected to make their own investment choices even if they do not take advice.

This has to be a real concern, and not only for the future but for the present as well.

The picture is even more interesting – or alarming, depending on your viewpoint - when age is considered. Around half of the 55 to 59-year-old consumers asked said they spent half a day or less researching their decision. By any measure, this is not much for such an important decision.

The factors consumers considered focused very much on process-related matters such as how much money was in their pension, how much they could access tax-free, how quickly they could access it, what the process involved, and whether there were any penalties or charges to pay.

Rarely was their focus on the future and any of the broader issues around how much they would need to live off, how long they might live for, and what their pension might be worth if they had left it untouched for a few more years.

This suggests that many of these consumers who are taking a lump sum withdrawal do not consider that they are 'retiring', and so they see little need for 'retirement' advice or guidance.

Has the need for advice been recognised?
Pension Freedoms mean that people must now make active choices rather than just letting their pension 'happen' to them. This brings a requirement for more knowledge and understanding to be able to make the best, or at least most informed, choice.

Even when annuities were mandatory there was a need to make informed choices, in the form of shopping around for the best annuity. There were concerns that this was not being done enough, and that retirees were disadvantaging themselves as a result – even in the face of efforts to make people more informed about their annuity options.

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Now that annuities are just a subset of a wider range of options, the need for informed decision making – and hence shopping around - is greater than before.

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Drawdown has historically been an advised product chosen by people with relatively high levels of pension savings – in effect an elite pension arrangement, and one which has been attractive to advisers because it requires their services on an ongoing basis. Along with the risk to capital, this has been one of the factors contributing to the widespread view that drawdown is best suited to those with larger pension pots, e.g. £250,000 plus.

Falling annuity rates and widespread ignorance about the benefits of shopping around were already making annuities less attractive before Pension Freedom introduced the option of not taking one at all. As a result, more people have been turning away from annuities towards drawdown (and UFPLS). This has led to people with smaller pots also considering drawdown as an option.

While it could be argued that the hitherto elite drawdown product has been 'democratised', there are also other, less positive, consequences.

Those with smaller pots have less capital and thus less ability to withstand market downturns and the pound/ cost ravaging they bring. Initial and ongoing fees for advice are also proportionately larger than for those with greater sums to invest (and all the more so after a market downturn).

The dual risk implicit in this is that people who cannot really 'afford' drawdown will nonetheless be attracted to it, and that they will be unwilling to pay for the initial and ongoing advice associated with it. They may also be less market 'savvy' than drawdown customers have been historically.

This risk seems to be borne out by the FCA's figures for the last quarter of 2015: 32% of drawdown customers did not take professional advice, compared with 3% for the equivalent period in 2013. And those who did use an adviser tended to be people with larger pension pots, i.e. the 'traditional' drawdown customer. The FCA also acknowledges that comparing drawdown products is not easy – they are highly complex products – and may well lead to cognitive overload for the consumer.

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One way of interpreting these figures is that the people most in need of professional advice about drawdown are the ones least likely to be taking it.

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But there is always Pension Wise as a fall back. Both the PLSA and FCA figures suggest that about 20% of consumers making first withdrawals from their pension savings are using Pension Wise. While the service is available via face to face meetings and telephone, the clear majority of people using it (perhaps over 90%) are doing so online. This is a far cry from the detailed and lengthy face to face meetings which professional advisers like to have with their clients.

Not all the users of Pension Wise will be going into drawdown, and some of them will be consulting Pension Wise as well as using an adviser. But even if all the 20% of Pension Wise users can be added to the 68% of drawdown users taking professional advice with no-one using both services, that would still leave around 12% of people going into drawdown doing so without using either of these important, unbiased sources of help.

In percentage terms this is still a four-fold increase in unadvised drawdown in just two years. And that could be a problem in the making.

With an aging population, pensions are going to become an even bigger issue in the years ahead, so we will be revisiting the subject from time to time as it continues to develop.