

Summary

The UK is in the midst of an economic crisis that is unprecedented in recent decades. The government and the Bank of England are taking extreme measures to stimulate aggregate demand. A temporary VAT cut has been introduced, costing over £12 billion, interest rates have been cut to record low levels and the Bank of England has started 'quantitative easing' – buying up government debt in exchange for cash. Overall, public debt is set to double by 2012.

At a household level, things are no better. House repossessions are soaring. Unemployment has already reached 2 million, and is expected to grow to 3 million in 2010. Households are desperately paying down debt – forcibly, or by choice.

At the same time as the national economy is short of aggregate demand and many households are in dire financial straits, there is a huge pot of money tied up by government rules which could be released to tackle both problems. That money lies in the pension funds of individual workers.

The suggestion of 'raiding' pension funds to fix a short term economic problem may seem irresponsible. While such an approach could help now, the UK also faces a long term pension crisis and, it could be assumed, a policy of this sort would only make matters worse.

But, because of a quirk of the British pension system, the reality is rather different. Most people are already able to draw up to a quarter of their accumulated pension when they retire, in the form of a tax free lump sum. The exact rules vary between types of scheme, but the vast majority of people saving through a pension are entitled to this lump sum.

If this lump sum were made available to people before retirement, it could make a huge contribution to their individual finances. The value of the lump sums that have already been accrued could, if drawn down and used for current spending, produce a huge stimulus for the domestic economy. For example, in 2007/08 the value of lump sums drawn by those who had reached their scheme pension age was over £11 billion. The sums our proposal could free up are potentially many times this size, though much would depend on where the cap is set for withdrawals.

Setting pensions free

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CENTRE:FORUM

It could be argued that this will damage future pensions and leave people in poverty in old age. But since around three-quarters of people already go for the lump sum option, the impact on pension income will be limited. And the Treasury will not lose out because the money would not have been taxed in any case.

There are potential problems with this proposal, including the administrative burden on pension schemes; these would need to be considered when drawing up plans for detailed implementation. If these issues can be resolved, this scheme could transform both individual lives and our national economy – providing a way to stimulate the economy without piling up more government debt. It would offer short term relief from the current economic crisis but could also change the way we think about savings in the long term.

1. The current context

The economy and public finances

The UK economy is in one of its worst periods of recession since World War Two. The collapse in financial services has led to a slump both in employment in that sector and in personal and corporate tax revenues. Unemployment is expected to exceed 3 million people within a year. As a result, government spending on benefits is increasing rapidly.¹ The public sector deficit is projected to exceed 10 per cent of national income in 2009/10, and the accumulated public debt is soaring.²

The authorities have sought to stimulate the economy through a variety of monetary and fiscal policies. The Bank of England's base rate stands at just 0.5 per cent, down from 5 per cent a year earlier. The Bank of England has also begun a £75 billion programme of 'quantitative easing' and will provide another £75 billion if needed.

The government has sought to provide a major one-off stimulus of more than £12 billion through a temporary cut in the main rate of VAT from 17.5 per cent to 15 per cent, and has brought forward public sector capital projects to try to stimulate the economy.³ However, the Chancellor has announced medium term tax rises in order to bring the spiralling public sector deficit under control in later years.

In addition to these aggregate measures, the government has also introduced a wide variety of special schemes to help particular sectors of the economy. It has spent huge sums supporting the banking system, while a variety of measures have been introduced to encourage bank lending. The government has also unveiled special measures designed to prop up the motor industry and house building, and to slow housing repossessions.

Commentators remain divided on whether these measures will work and exactly how long and deep the recession is going to be. Speaking just weeks before his 2009 Budget, the Chancellor admitted that his autumn 2008 projections for the economy were too optimistic. The governor of the Bank of England advised caution when considering further fiscal stimulus based purely on public borrowing. It is vital that any further economic stimulus does not lead to a substantial further increase in public debt.

1 CBI Economic Forecast February 2009.

2 IFS, 'Budget 2009: tightening the squeeze?', April 2009.

3 Pre-Budget Report, November 2008.

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Mortgage arrears and repossessions

As the economic situation deteriorates, house repossessions are rising. Around 40,000 homes were repossessed in 2008, and the Council of Mortgage Lenders projects that there will be a further 75,000 repossessions over the course of 2009. Over 200,000 households are at least three months in mortgage arrears.⁴ As Table 1 shows, the average level of mortgage arrears for those behind with their mortgage repayments had risen to £5,500 at the end of 2008.

Table 1: Residential loan arrears in the UK, 2007-Q3 to 2008-Q4

	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4
Number of loan accounts in arrears	273,541	288,384	299,389	309,634	340,770	376,556
Amount of arrears (£m)	1,152	1,328	1,433	1,523	1,832	2,056
Average arrears per account	£4,211	£4,605	£4,785	£4,918	£5,377	£5,459

Source: Financial Services Authority, mortgage lending administrative return statistics

There is a strong public policy case for reducing the number of repossessions. As well as the turmoil faced by individual families when they lose their homes, there is a public expenditure cost to repossessions, especially where those affected use public sector temporary housing. Repossessions also have a depressing effect on the overall housing market and, particularly in an era of negative equity, can leave families not just homeless but still burdened by debt. This aspect of the problem will become more severe as house prices decline further.

4 Council of Mortgage Lenders, 'Arrears and possessions in 2008', February 2009.

Just as rising house prices helped to fuel consumer spending, as consumers released equity for current consumption, falling house prices and falling consumer confidence are leading to downward pressures on the economy.

There are also problems with the system of support for those who are unable to meet their mortgage liabilities. In principle, the government pays mortgage interest costs after a period of three months of unemployment. Given that mortgage lenders are being encouraged not to take action to repossess when arrears are less than three months, this ought to put a floor under the mortgage market.

However, there are a number of gaps in mortgage support which mean that repossessions are continuing to rise.

First, only those who are entitled to means-tested Income Support (and related benefits) are eligible for mortgage assistance. One of the tests for eligibility is that no one in the household is working. For a two income household in which one person loses their job, no state support has hitherto been available. If two wage packets are needed to support the mortgage, arrears can mount rapidly. The government recently announced a scheme allowing people in this situation to defer their mortgage payments, underwritten by the taxpayer, but it is too early yet to know how effective this scheme will be.

Second, even for those who qualify, there are limits to what is covered. For those with a repayment mortgage, the support does not include any capital repayment, so will not cover the full monthly cost of the loan. For those with an endowment mortgage, the state does not meet the

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endowment premium. There is also a cap both on the total value of the mortgage (although this has recently been increased) and on the interest rate which will be paid by the state. A 'standard' interest rate is covered by the benefits system, which may be advantageous to those with below average interest rates, but leaves people who are locked in to higher interest rates to build up arrears.

Thus while mortgage support has been significantly expanded in recent months, it is of limited value for most people. It helps to cushion the impact of recession on mortgage arrears, but households which face the long term unemployment of one or more members are still likely to find themselves in difficulty.

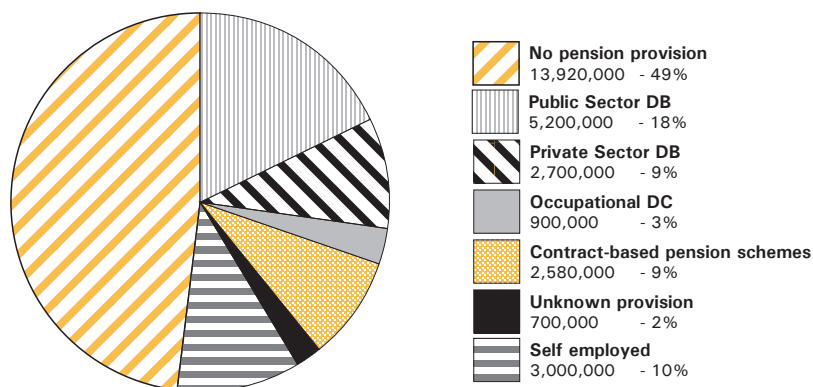
The current pattern of pension provision and use of lump sums

Many people have significant financial assets which might, with a suitable legislative change, be used to help repair their finances: their pensions. Chart 1 shows the breakdown of different types of pension provision among current workers.

There are 2.7 million workers who are active members of 'defined benefit' (DB) pension schemes in the private sector.⁵

The value of an employee's DB pension is determined by salary and the number of years of service. For each year with their employer, they accrue pension rights based on a fraction of their salary, commonly 1/60th or 1/80th of final pensionable salary. These pension funds are overseen by trustees, and the sponsoring employer faces a range of legal duties to keep scheme funding at an adequate level. In the event of the sponsoring employer becoming insolvent, a 'Pension Protection Fund' exists to ensure that at least 90 per cent of pension benefits are honoured.

Chart 1: Total UK workforce by type of pension provision (active members)



Source: Office of National Statistics, National Association of Pension Funds

⁵ This figure excludes those who have built up such rights from previous periods of employment but who are no longer active members of such a scheme.

As well as providing for a future income, pension schemes generally allow scheme members to draw a lump sum from their pension fund on retirement

A further 5.2 million workers in the public sector are also in DB pension schemes. Many of these are 'unfunded' schemes, where current pensioners are paid out of current resources. The main exception to this is the Local Government Pension Scheme (LGPS) which does have an accumulated fund, although the next round of revaluations of schemes is widely expected to show very substantial deficits in these funds.

Some 3.5 million workers are in employer based occupational defined contribution (DC) schemes or contract based pension schemes (such as group personal pensions). In this type of pension, the final value depends on the level of investment returns at the point at which an individual begins to draw their pension and on prevailing annuity rates.

Self-employed people who are active scheme members account for just under 10 per cent of the workforce, and these will typically be active members of personal pension schemes based on DC (money purchase) arrangements. For roughly 2 per cent we have no information, and the remaining 49 per cent of today's workers are not active members of any pension scheme at present, though many may have past pension rights built up from previous jobs.

The numbers who are not active members of a pension scheme will drop sharply after 2012 when those who are not part of existing workplace provision will be 'auto enrolled' into either an existing employer scheme or a 'personal account', with the right to opt out. This is expected to lead to a substantial increase in the number of people who are starting to build up funded pension rights.

In addition to the current workforce represented in Chart 1, there are many other people, such as the early retired or the recently unemployed, who have also accumulated pension rights. For example, there are more than 6 million

people who are former employees with preserved pension entitlements, mostly in a company DB scheme, who are not yet receiving their pensions but have a deferred entitlement.⁶

As well as providing for a future income, pension schemes generally allow scheme members to draw a lump sum from their pension fund on retirement. The rules for taking a lump sum vary according to the type of scheme as follows:

- **DC schemes:** in general, one quarter of the accumulated fund can be withdrawn as a tax free lump sum. This applies to schemes such as personal pensions and stakeholder pensions, as well as employer sponsored defined contribution schemes. This type of pension is becoming more common as firms close their final salary schemes to new members (and in some cases to existing members); they will become more common still as individuals are auto enrolled into new personal accounts which will be on a defined contribution basis.
- **Funded DB schemes:** the pension that an individual receives is linked to their 'pensionable salary' which may be their final salary on leaving the scheme or some sort of career average; the capital value of the fund (used to work out the size of the available lump sum) is defined as "20 times the annual value of the pension payable to the member in the first 12 months" of their retirement.⁷ In most private sector schemes, individuals can take a lump sum which is the lower of 25 per cent of the pension fund value or, for very wealthy members, of the lifetime allowance, which is £1.75 million in 2009/10; meaning that the maximum tax free lump sum that could be paid would be £437,500 (a quarter of the lifetime allowance). If an individual takes part of their pension as a lump sum, ongoing pension payments are generally reduced to reflect this.

While funded DB schemes are largely run by private sector companies, the LGPS also falls within this category.

- **Unfunded (public sector) DB schemes:** in these schemes no pension 'pot' is accrued, because contributions from today's workers pay the pensions of

6 Office of National Statistics, 'Occupational pension schemes survey', table 3.3, 2007.

7 IDS Pension Service, 'Pensions tax and regulation', June 2006.

current pensioners (as with the state pension). The main pension funds in this category are the NHS, teachers, civil service, armed forces and police pension schemes. If members of unfunded schemes made an early claim on their tax free lump sum, it could create a short term cash flow problem for the public sector, since no assets have been set aside to meet this future liability. This proposal may therefore be inappropriate for members of unfunded public sector schemes. However, these people are less likely to become unemployed than their private sector counterparts.

Current size of pension lump sums

A recent parliamentary answer indicated that the government does not know exactly how many people take advantage of the 25 per cent tax free lump sum from their pension pots on retirement.⁸ This is partly because one person may have access to more than one lump sum from different schemes.

However, it is possible to build a rough estimate from tax data. In 2007/08 HM Revenue and Customs (HMRC) estimated the value of tax relief on lump sums to be £400 million for unfunded schemes and £2.1 billion for funded schemes. These figures assume tax relief at the basic rate. In 2007/08, the value of lump sums drawn down was £1.9 billion for unfunded schemes and £9.5 billion for funded schemes, £11.4 billion altogether.⁹ This suggests that, if people of any age were able to draw down a lump sum, the potential cash injection could run into tens of billions of pounds (depending on the exact terms of the scheme).

Lump sums on retirement

In terms of the individual amounts that people draw on retirement, a poll by YouGov for Prudential found that 75 per cent of people took a lump sum from private or company pensions as they reach retirement, and the average amount was about £24,000.¹⁰ If this is typical, it suggests that about 400,000 individuals draw their lump sum each year.

Another way of looking at the likely size of accrued lump sums is to look at survey data on older workers. The ONS estimates that the mean value of individual private pension wealth for men aged 50 to 54 in 2002 was £151,000. For women of the

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same age it was £66,000.¹¹ The average is almost the same for those aged 55 and over. A crude average for men and women together of around £100,000 would again point to a typical lump sum on retirement in the vicinity of the £24,000 sum quoted above.

Given that the average figure for mortgage arrears is £5,500, this would suggest that access to even half or a quarter of the eventual lump sum from a pension scheme could make a real difference to those facing financial pressures. In some cases it may be that family members help each other through accessing their lump sum. For example, a couple in their early 50s might wish to draw the accrued lump sums from their pension pots early to help their children, who were facing mortgage arrears.

Lump sums for current workers

If this scheme allowed people to access the lump sum that they had accrued to date, for a defined contribution pension this would simply be one quarter of the pension pot to date. For defined benefit schemes, however, the calculation would be more complex.

All defined benefit pensions have what is known as a 'cash equivalent', which is the capital sum which would (for example) need to be paid into another pension scheme to buy the same level of benefits. A calculation of this sort is made for the purposes of pension sharing on divorce, and this helps us to estimate the lump sums that current workers might have built up in different jobs and pension schemes.

Table 2 (overleaf) shows the amounts that a public sector worker with a long period of public sector employment might expect to have accumulated at different ages.

8 Hansard, House of Commons written answer c1294W, 19 Mar 2009.

9 House of Commons library data.

10 YouGov Prudential poll, 9 June 2008.

11 ONS, Pension Trends, 2009. The survey data is seven years out of date.

Assuming that people would be allowed to take up to one quarter of their accrued valuation as a lump sum, even someone in their mid-30s would have access to a very substantial lump sum in this kind of pension scheme.

A good private sector scheme (of the sort still provided by many FTSE 100 companies), where workers accrue a pension of 1/60th of final salary per year, would provide slightly smaller valuations, but a quarter of the valuation would still represent a substantial lump sum, even for relatively young workers (see Table 3).

Those working for smaller private sector firms might be members of a less generous scheme offering a pension of 1/80th of final salary per year. Table 4 shows some illustrative valuations of accrued pension pots for this group of workers (see table 4).

While these figures are the lowest of the three categories of workers that we have considered, even someone in their late 30s would be able to access a lump sum, under our proposals, of around £12,000 – which could make a real difference to reducing their mortgage or rent arrears.

2. A policy proposal

The rules on access to pension funds need to be relaxed, so that individuals can access the tax free lump sum. For DC schemes this part of the fund would be up to 25 per cent of the capital value of the fund to date. For DB schemes this would be up to 25 per cent of the 'cash equivalent' transfer value of the scheme benefits to date. This would apply to all funded pension schemes, including funded public sector schemes such as the LGPS, but not to unfunded public sector schemes.

There are precedents for this reform both in the UK and abroad, which can offer a guide to the potential benefits and costs. The exact rules of the scheme would, of course, have to be implemented carefully to prevent tax avoidance and a negative impact on saving.

American and New Zealand precedents

The idea of offering early access to pension savings has precedents in both the USA and New Zealand.¹²

¹² Pensions Policy Institute, 'Would allowing early access to pension savings increase retirement incomes?', 2008.

Table 2: Old public scheme - in service

	Case A	Case B	Case C	Case D
Current Age	36	44	52	60
Current earnings	£25,000	£30,000	£35,000	£40,000
In scheme (yrs)	15	20	25	30
Valuation	£62,890	£119,152	£212,076	£339,670

Table 3: Good private scheme - in service

	Case A	Case B	Case C	Case D
Current Age	36	44	52	60
Current earnings	£28,000	£35,000	£40,000	£45,000
In scheme (yrs)	10	15	20	25
Valuation	£56,513	£126,427	£233,561	£379,029

Table 4: Average private scheme - in service

	Case A	Case B	Case C	Case D
Current Age	39	46	53	60
Current earnings	£25,000	£29,000	£34,000	£39,000
In scheme (yrs)	12	17	21	25
Valuation	£48,081	£96,306	£156,456	£243,821

Source: *Sharingpensions.co.uk*

The USA offers a model called 401(k) which allows people to take loans from their own pension funds. Individuals' pension contributions are taken out of their pre-tax income. These loans are tax free but have to be paid back with interest and generally within five years to avoid a penalty payment. People are allowed to take a loan at any time, although some plans only allow them for specific purposes, such as a deposit on a house. If the loan is taken as a down payment for a home, it may be repaid over 15 years. Permanent withdrawals are permitted, up to the value of the whole pot, if people are in particular hardship. These are taxed as income with an additional 10 per cent penalty tax. In certain emergency situations, including disability or medical debt, the 10 per cent penalty may be waived. These schemes are offered to private sector employees at the discretion of their employers, and access is allowed to the lower amount of 50 per cent of the fund or \$50,000.

About 18 per cent of people who are eligible make use of such loans, and about 4 per cent take hardship withdrawals,

although this number may increase as the US economy falters. There is evidence that people who save in plans with this withdrawal option contribute between 0.6 per cent and 3 per cent more of their salaries; and that participation rates are up to 6 per cent higher.

In New Zealand, the KiwiSaver is a national pension saving scheme that automatically enrolls people, with an opt out. Members pay 2 per cent, 4 per cent or 8 per cent of their gross earnings into the scheme, and can access their pensions early for specific purposes.¹³ For example, a fund can be withdrawn at any time for serious illness or significant financial hardship, or after three years for a deposit on a first home. People have access to their entire pot, penalty free, but there is no facility for paying back into the fund at a later stage. This is because it was designed to promote household savings rather than pension savings. Early access is straightforward because pension contributions are taken out of post-tax income, unlike in the UK, which means that withdrawals do not need to be taxed as new income and no penalty payments are necessary to prevent tax avoidance. If people take their money early to pay for a home deposit, the government will give them an additional subsidy of NZ\$5,000, which is likely to increase take-up for this option.

This scheme was set up in 2007. Employees are only auto enrolled when they change jobs, or they can choose to join the scheme. This means it is too early to say how many people will take up the early access option, but 10 per cent of people said that the option for providing them with a home down payment was the reason that they joined or stayed in the scheme. A further 16 per cent said they were thinking about joining for this reason.

Previous UK proposals

In the UK, lump sums can be taken early in cases of terminal illness. There is no minimum age limit, but the person withdrawing the money must be expected to have less than one year to live. In this case, the scheme administrator may commute any pension entitlement that member holds, and pay them their entire benefit entitlement.

UK policy makers have expressed some recent interest in allowing more people to access their pension savings early.

¹³ <http://www.kiwisaver.govt.nz>

With plans for mass auto enrolment of the British population into pension schemes from 2012, the PPI has estimated that up to 25 per cent of people will choose to opt out again. The government is seeking ways of enticing them to stay in pension schemes.

The idea of early access to a lump sum has been mooted. At the last general election, the Conservative Party proposed a 'lifetime savings account' which sought to provide, "more flexible ways of encouraging people to save, and enable them to access the money earlier if they wish".¹⁴ During the passage of the Pensions Act 2008, the then pensions minister Baroness Hollis of Heigham introduced an amendment that would give right of access to "a tax free lump sum or sums during... [a person's] working life",¹⁵ proposing to make use of the existing provision to draw a 25 per cent lump sum upon retirement. Hollis's specific aim was to help women with few savings in liquid forms but who may have accumulated pension rights.

3. Problems that would need to be addressed

A scheme for early lump sum withdrawal would have to be carefully managed to prevent: negative effects on savings rates and living standards in retirement; administrative, investment and procedural costs to pension schemes; tax avoidance; and damage to the public finances.

Uncertainty over behavioural response

There is limited precedent in the UK for this type of scheme, so it is difficult to predict how people would respond. It is unclear in the short term whether there would be a large or small drawdown of capital from schemes, which is important both from the point of view of individual schemes and also the macroeconomy. In the longer term it is unclear whether this scheme would reduce net pension savings (as people spend their lump sum on current consumption) or whether it might increase savings (as people are more willing to put their money in a savings vehicle that gives options for early access).

¹⁴ D Willetts, '2020 Vision', July 2005. J Norman and G Clark, 'Towards a lifetime of saving', 2004.

¹⁵ Hansard, House of Lords debate, 23 June 2008. Column 1272 onwards.

It might be necessary, therefore to introduce these proposals in a staged way. One possibility would be to set a relatively cautious cap on the amount that could be withdrawn, so that if the scheme is very popular, the scale of withdrawals would be manageable for pension providers.

Effects on pensioners' living standards

There is a risk that people could take their lump sums early without realising that it may have an impact on their retirement incomes. This was a concern that emerged in research for the Personal Accounts Delivery Authority, the new government body charged with setting up the system of personal accounts, as part of its preparation to implement auto enrolment.¹⁶

However, this concern could be mitigated by the provision of good advice. The Pensions Advisory Service already offers advice to people seeking to convert their pension fund to income through an annuity, which includes information on the advantages and disadvantages of taking a tax free lump sum. Additional financial advice should be provided on early withdrawal.

It should also be added that, compared with the present situation, these proposals would be unlikely to make matters worse. Since more than three-quarters of people already convert part of their pension pot into a tax free lump sum, it seems unlikely that the proportion drawing an early lump sum would be significantly in excess of this. It is also likely that the two groups would overlap considerably.

We are enabling people to choose between a lump sum on retirement or a (partial) lump sum now. While this may mean that individuals have lower capital in retirement, if the lump sum is spent in a way that enables a family to avoid repossession and means that they end up with a valuable asset in the form of a family home when they retire, this proposal may actually enhance the living standards in retirement of many families.

General costs and administrative burdens on pension schemes

When Baroness Hollis put her proposals to the House of Lords, the Minister Lord McKenzie objected to the potential additional costs that would be laid on

pension schemes.¹⁷ He was concerned that schemes would need to absorb the administrative costs of allowing people to exercise early access, which might also require changes to scheme rules.

However, such costs could be limited if the arrangements were kept as simple as possible. The early access model need not require specific circumstances in which a lump sum could be taken, nor need it require repayments to be made. The Pensions Policy Institute points out that "there is little data on the potential magnitude of an increase in charges" but that any charges might be offset by an increase in contribution rates, if people were incentivised to save more by early access options, as examples from abroad suggest might be the case.¹⁸

Particular issues for DB schemes

The administration of DB schemes is complex, and consultation with the industry would be needed to establish the difficulties involved and whether they could be overcome. The PPI notes that early access in other countries is often limited to DC schemes, because of the challenges involved with DB rules.

However, because there are fewer DC than DB schemes, and because people tend to have lower levels of pension savings in DC schemes, confining early access to DC funds would greatly limit the impact of the proposal (although the relative size of the DC sector is growing). In 2007, private sector DB schemes saw average contribution rates of 5.5 per cent by employees and 15 per cent by employers. For DC schemes, contributions were much lower: on average just 2.6 per cent by members and 6.4 per cent by employers.¹⁹

Some issues for DB schemes would be:

- Valuation: DB schemes are often based upon a person's final salary, and it would obviously be difficult to work out an early draw down amount based in part on future earnings. Therefore, the sums would probably need to be calculated as if someone was going to retire tomorrow, based on their current salary and their current accumulated service. The amount that was drawn down at this stage would then be taken

¹⁶ Personal Accounts Delivery Authority, 'Building personal accounts: securing a retirement income', December 2008.

¹⁷ Hansard, House of Lords debate, 8 Dec 2008.

¹⁸ PPI, 'Would allowing early access to pension savings increase retirement incomes?', 2008.

¹⁹ ONS, Occupational pension schemes survey, 2007.

into account when their pension was finally calculated at retirement age.

- **Guaranteed Minimum Pension (GMP):** A further complication is the requirement that DB schemes provide a GMP in respect of rights accrued between 1978 and 1997. A GMP can only be taken as a lump sum in certain circumstances: either as a 'trivial commutation lump sum' (if the total value of all a person's pension savings is below a certain amount - £17,500 in 2009/10); or as a 'serious ill health lump sum' (which may be payable in cases where the pension scheme member is expected to live for less than one year).
- When an individual requests an early access lump sum, it might not be clear whether or by how much their final pension entitlement will exceed their GMP. Therefore, it may not be obvious that they are eligible for a lump sum at all. However, the government is aiming to simplify the scheme rules around the GMP, and the Pensions Act 2007 introduced changes that allow GMPs to be converted into scheme benefits of an actuarially-equivalent value instead. This passed through both Houses of Parliament in March 2009, and makes it optional for schemes to use the conversion facility. This should make it easier to calculate benefits for those who do decide to use it.
- **Scheme funding requirements:** Taking money early from a DB fund could reduce the value of the fund and potentially have an adverse effect on other scheme members and the scheme as a whole. However, it should be borne in mind that when someone takes an early lump sum they are simultaneously reducing their future claim on the scheme, and so the net effect on the overall funding level of the scheme should be neutral.
- **Run on the fund:** In extreme cases, there could be a loss of confidence in a pension fund, perhaps where the sponsoring employer was in financial difficulty. In such a case, there could be wholesale access to early tax free lump sums by employees as a means of maximising the proportion of accrued benefits that could be salvaged. In the days before the introduction of the Pensions Protection Fund (PPF) this might have been a particular concern, but given that occupational pension

rights are now largely insured through the PPF this is probably less of a problem.

Use of lump sums for tax avoidance

One concern about any reform to the pension system would be if it created unintended opportunities for tax avoidance. Tax free lump sums could be recycled into a new pension scheme – with the addition of tax relief. In effect, tax relief would then be given on income that had not been taxed in the first place.

However, HMRC has rules in place to levy an 'unauthorised payments charge' because this possibility exists already (for example, when someone draws a lump sum at age 55 and seeks to put the money into another pension scheme). There is nothing to stop people from recycling their lump sums, but they are liable for 'unauthorised payments charges' that may be based on the full amount of the recycled lump sum. There could, however, be additional compliance costs for HMRC if there was widespread take-up of the early lump sum option.

It could be argued that there would be a wider risk that this scheme could be used by well advised and richer individuals who would put money into their pensions with tax relief and then immediately draw a quarter tax free to spend on whatever they wished. The existence of the cap and an administrative charge would help to diminish this problem, but it would still need to be monitored. Though it would introduce greater complexity further rules might be necessary to safeguard against abuse, for example, that the money must be in the fund for a minimum period before it could be withdrawn, or that the scheme must be open for a minimum period.

Possible public expenditure impact

The introduction of this scheme could also have an impact on public expenditure in two key ways:

- While most people take a tax free lump sum, a minority do not. This money is turned into a pension which can then be taxed. Therefore, if more people took an early lump sum, tax revenue might be lower.
- A tax free lump sum counts as capital for pension credit purposes. If people have already taken it, concerns have been raised that they might end up on

The lump sum withdrawal scheme should be designed to ensure the costs are borne by the people who use it

means tested benefits to boost their income in retirement. In other words, if more people take part of their pension pot as a lump sum prior to retirement, the benefit authorities will measure a lower level of capital on retirement when the means tested assessment takes place. However, this possibility could be avoided by keeping a record of how much someone had taken and enabling it to be counted as 'imputed' capital if they subsequently claimed pension credit.

These concerns are outweighed by the potential savings to the taxpayer from a decrease in home repossessions and less pressure on temporary housing during recessions, and from the gains to the taxpayer from the economic stimulus. This would swamp any loss to the Treasury from reduced tax revenue on pensions.

Impact on pension scheme investments

If large numbers of individuals suddenly withdrew billions of pounds from their pension funds, this could have a disruptive effect on schemes, especially where their investments were of a long term nature. In addition, during a recession the financial pressures on schemes are likely to be greater and this is the time when people would be most likely to take up their right to draw down a tax free lump sum.

In practice, however, the impact need not be dramatic. Pension funds already have substantial inflows and outflows every year. Billions of pounds are coming in to schemes each year in new contributions and similar sums are going out in the form of pensions in payment or annuity purchases. If scheme members started to seek to take early lump sums, scheme administrators could use the cash received from current contributions to pay out lump sums without needing to disturb current investments. Much would, of course, depend on the scale of withdrawals, but with a capped scheme such as this, the cash flow consequences are likely to be manageable.

Closed DB funds may be more problematic: in these schemes there are less regular injections of cash and early access to lump sums might involve cashing in scheme assets prematurely. However, schemes tend to have a mix of short term and long term investments and so would be able to release capital through the sale of assets that had little or no penalty for early access. Research may be needed into the actual investment mix of different sorts of schemes to see whether any special provisions might need to be made.

4. Scheme design

The lump sum withdrawal scheme should be designed to ensure the costs are borne by the people who use it. There are several other questions of design that should be addressed. Should such a scheme operate only in recessions? And should the government control the number and size of withdrawals?

Who should meet the costs of the scheme?

It would be unfair on those scheme members who chose not to access their lump sum if they had to meet the administrative costs of dealing with those who did. Schemes should therefore be allowed to make an administrative charge when an early withdrawal is made. One possible model would be a lump sum charge per withdrawal (to reflect the fixed administrative costs involved) and a percentage charge based on the amount withdrawn (so that the penalty on early withdrawal in respect of modest sums was not prohibitive). A charge of this sort would also discourage repeat withdrawals of relatively trivial amounts of money.

Should the scheme only apply in a recession?

The priority should be to implement this policy quickly, as part of a wider package aimed at tackling the recession. But if it worked well and was extended as a longer term scheme, this could revolutionise the way we think about savings and pensions. If such a scheme became permanent, any limits on the amounts people were allowed to withdraw could be increased during a recession and reduced during a boom, as part of a more general counter-cyclical economic policy.

It may be that in the longer term a more sophisticated structure could be devised for encouraging savings in a way that still provided access at times of need. However, a model that ensures that 75 per cent of the savings is untouchable and 25 per cent is accessible, albeit with a fee to discourage flippant withdrawals, has the merit of simplicity and, by building on a familiar feature of the tax system, is more likely to be taken up.

Should this right be exercised repeatedly or only once during the life of a pension?

In principle, there is no reason why this right could not be exercised more than once during an individual's membership of a scheme. Each withdrawal should be subject to a charge, as outlined above, and this should discourage frivolous withdrawals. An overall limit for the number of withdrawals should be discounted: this would add considerably to the complexity of the proposal. Withdrawals from an individual scheme should be limited to one per year: the cap could otherwise be circumvented by an individual making multiple simultaneous withdrawals.

Would there be a minimum or maximum amount that could be withdrawn?

As schemes could apply a fee for withdrawal, this would be likely to discourage very small withdrawals. As a result, it is probably not necessary to apply a minimum to the amount that could be withdrawn.

Regarding the maximum amount, there are two main considerations. First, an individual could only withdraw that part of their pension which would – over time – have the possibility to be turned into a tax free lump sum. Once a withdrawal had been made, a person would have two parts to their pension fund: the part from which they had drawn a tax free lump sum, and the contributions since that date. These contributions would form a new, untouched pension pot.

As soon as a person drew a lump sum, the remaining 75 per cent of that pot should be allocated to the 'already drawn down' section and could no longer be touched. The pension fund would thus be divided into an 'accessible' portion and an 'already accessed' portion.

Beyond this, it may be necessary to specify a maximum amount, not least in

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case the take-up level was very high and the tens of billions of pounds involved had a destabilising effect on both pension funds and the economy. This maximum could then be used as a macroeconomic lever, lowered in times of boom, and raised in times of recession. The exact amount would need to be based on a more detailed analysis of accrued pension rights than is possible in this paper. However, one benchmark could be the size of mortgage arrears (as the initial aim of the scheme is to tackle this problem). Average mortgage arrears are currently around £5,500, although many households will have greater arrears than this. A tentative figure for a cap could therefore be £10,000 for any withdrawal. Further analysis might suggest a higher limit.

How would the value of the lump sum be calculated in DB pension schemes?

In a final salary scheme, the value of the lump sum depends on a person's final salary, and on the number of years that they have been in the scheme, both factors which are unknown before they retire. Therefore, the sums should be calculated as if someone was going to retire tomorrow, based on their current salary and their accumulated service. Specifically, as described above, the accumulated fund should be valued by using the 'cash equivalent transfer value' of the accrued pension rights to date.

DB scheme rights increase quickly as an individual nears pension age. Early drawdown of an accrued lump sum will therefore still leave individuals with a considerable further lump sum that could be used on retirement.

Would there be any constraint on what the money could be used for?

Liberals should be reluctant to constrain people's spending choices. People in desperate need would use it to tackle priority debt such as mortgage arrears. But to stimulate the economy, people should be free to spend it on what they choose.

There would be considerable economic benefits if the scheme allowed people to spend the money as they choose. For example, it would boost the housing market if potential homebuyers could afford a deposit by using some of their accrued lump sum. The same is true of the depressed car market: people could use their lump sums for new car purchases.

Currently, there are no limits on what people who draw a lump sum (in some cases under current rules as early as age fifty) do with the money. It would be inconsistent to place restrictions on an extended scheme.

A lack of restrictions would also keep the scheme simple, and minimise administrative costs. If the state regulated how people could spend their lump sum, a whole system of verification and approval would be necessary, slowing down the implementation of the scheme and adding costs.

Conclusion

With the UK economy in recession, unemployment rising and house prices falling, many families are facing severe financial pressures. This year tens of thousands of families will see their homes repossessed because of mortgage arrears. At the same time, many families have large capital sums tied up in their pension funds which would be enough to clear their mortgage arrears and see them through the recession, while also stimulating the economy as a whole.

These restrictions are no longer justified. Rather than force people to wait until they retire, they should be allowed to access their accrued lump sum at once. There should be no restrictions on what the money is used for, though people would probably use it for larger capital items such as clearing debt, financing the deposit on a house or for larger consumer purchases like cars. In each case, the potential benefits to the UK economy are clear.

Early access to lump sums has worked in other countries, and could be easily allowed in the UK. It would build on "the much loved but anomalous" tax free lump

sum, as former Chancellor Nigel Lawson put it; creating a more flexible way to save for the future. This proposal is timely, not only in fighting the recession, but also in preparation for the auto enrolment of millions of workers into personal accounts in 2012. These are defined contribution pension schemes which would, in due course, lend themselves well to early lump sum access. Millions of workers will have to decide whether to accept or revoke their auto enrolment into these accounts; an early access feature could make such accounts a more attractive savings vehicle and could tip the balance for those who are unsure whether to have such a pension or not. More broadly, early access could make pensions a more popular product, especially for those who currently have little or no pension provision.

There are powerful reasons to introduce a scheme for early access to tax free lump sums. For the benefits of individual families in need and for the good of the wider economy, it is time to think creatively about the pension system and to trust people to be the best judge of when they should employ their savings.

About the authors

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