PENSION NOTES

No. 10 - NOVEMBER, 2016

Free withdrawal of pension funds: Lessons learned from the UK experience

- **More than half of those who opted for free withdrawal have withdrawn their entire pension fund.**
- **A year after the reform was implemented, the sale of life annuities has dropped significantly.**

Executive Summary

After the implementation in the United Kingdom of the *Freedom and Choice* reform, which gives individuals absolute freedom to use their defined contribution pension funds as they see fit, several policy lessons can be gleaned for the reality of our Latin American countries.

First of all, the evidence seems to reinforce what has already been widely documented in the behavioral economics literature: that individuals prefer present consumption to future consumption. Thus, more than half of those who accessed their pension funds, requested complete lump sum withdrawal of the funds, despite the fact that only the first 25% of the withdrawn amount is tax-free. Although there are no official figures regarding the use of these funds, anecdotal evidence seems to indicate that at least part of them have been destined to consumption - including tourism.

The sale of life annuities, on the other hand, has dropped abruptly by 80% between the first quarter of 2013 and the first quarter of 2016. This evidences the so-called "life annuities paradox," proving that individuals do not voluntarily choose life annuities, unless they are induced to do so.

Secondly, more alternatives do not imply better decisions. At least in theory, having a larger number of pension fund decumulation alternatives available could favor a more efficient choice of options, in accordance with the individual requirements of each worker. Nonetheless, in order to benefit from freedom of choice, workers must understand the advantages and disadvantages of each one of the options available to them, which entails a certain degree of financial knowledge. According to the experts, this would not be the case of British workers.

Thirdly, the reality of Latin American countries with individually funded systems is very different to the British reality. In the United Kingdom, the main source of financing for the elderly is the State pension (see Graph No. 1), while the defined contribution and defined benefit plans are complementary to the State pension. So, even though individuals were to squander the money

from their defined contribution fund, they would still have other sources of income to finance their old age. This is not the case in countries like Chile and Peru, where 100% of pension savings are individually funded. The squandering of pension funds in our countries may imply that individuals have no financing alternatives for their old age. This, in turn, involves increasing the demand for benefits from the noncontributory pension pillars (social pensions), with the resulting increase in fiscal spending. It would be socially unfair to finance medium and high income individuals who have spent their pension savings, with government resources (such as for example, through a solidarity pillar).

Background

In April 2014, the Government of the United Kingdom announced the most radical change to its pension system in the last century. The reform denominated "Freedom and Choice in Pensions," allows British workers over 55 who have saved in a defined contribution (DC) system to use their pension funds in any way they want. Thus, in his speech before the British Parliament on June 19, 2014, David Cameron announced that: "*Pensioners will be free to withdraw any amount they wish from their pension funds, in any manner, and whenever they want to. Without restrictions Without withdrawal limits. Let me be clear: no one will have to buy a life annuity...*" (Berstein, Morales and Puente, 2015).

The reform came into effect on April 6, 2015, and gives workers absolute freedom to choose the way in which to use their pension funds: buy a life annuity; withdraw the funds in partial amounts; negotiate programmed withdrawals, in which the individual chooses the time frame in which he wants to exhaust his fund; withdraw the entire fund in a lump sum; or else a combination of the different alternatives. Withdrawal of the funds is tax-free for the first 25% of the fund, while the remaining 75% is taxable, depending on the level of income of the individual (with a maximum tax rate of 45%).

Prior to the reform, only individuals over 60 with pension funds of less than GBP 18,000 (USD 23,400)[1] were authorized to withdraw the entire fund in a lump sum, at a marginal tax rate. Those who had more funds and chose to withdraw the entire fund, had to pay a tax of 55% of the fund. Flexible drawdown, in turn, was only accessible to those with funds exceeding GBP 310,000 (USD 403,000). Thus, the majority of individuals were forced to buy a life annuity.

Another one of the changes introduced by the reform is that individuals contributing to defined benefit (DB) plans - provided they are not receiving a DB pension - can transfer their savings to DC plans, so they can also access the new flexible conditions.

The reform also allows people who have bought life annuities to sell them, creating a secondary market for such instruments. This aspect of the reform is still not operative to date.

[1] The exchange rate of 1 GBP = 1.30 USD on 01.10.2016 is used for calculating all figures.

Together with the introduction of these new flexible conditions, the government also undertook to provide free and impartial advice to workers regarding their decumulation options, and their impact. This service is called "*Pension Wise: Your Money, Your Choice*"[2].

Furthermore, the new state pension came into effect on April 6, 2016. The state pension provides a maximum amount of GBP 155.65 per week (approximately USD 809 per month) to people reaching retirement age (65 years for men and 63 for women). 35 years of contributions to National Social Security (or credits) are required for accessing the full amount. Individuals with fewer years of contributions can access a proportional amount, provided they have at least 10 years of contributions. However, low income pensioners can qualify for a Pension Credit (after a prior assessment of their income and capital), which will guarantee them a minimum pension of GBP 151.20 per week (approximately USD 786 per month). It is worth mentioning that the State pension is the main source of old age financing in the United Kingdom. As can be seen in Graph No. 1, more than half of the average pension in the United Kingdom comes from the State pension.

Full freedom to use the pension funds entails the imminent risk that many individuals will make poor use of their pension funds and exhaust their money before they die, or else make bad financial decisions and end up living in poverty during their old age, which would not only be regrettable at an individual level, but society as a whole would be affected, since such individuals could appeal to certain social benefits that are financed through taxes. In view of this risk, the Department of Labor and Pensions issued a decree[3] explaining how the requirements for access to social benefits vary[4] with the introduction of the pension reform.

In the case of those who request a Pension Credit (or other social benefit), and have made withdrawals from their pension fund, this money will be taken into consideration when assessing whether or not they qualify for this social benefit. If, for example, the individual withdrew his fund and opted not to buy a life annuity, the Department of Labor and Pensions will assume that that individual has a monthly income equivalent to the income he would have obtained from a life annuity, when assessing his situation.

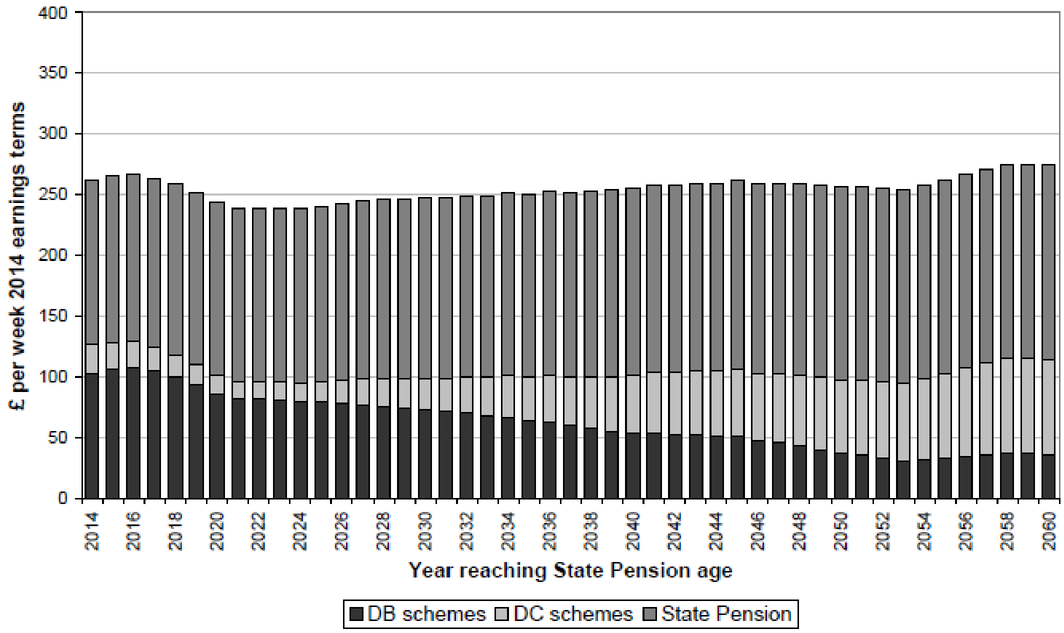
[2] www.pensionwise.gov.uk

[3] Available online: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/417473/pension-flexibilities-dwp-benefits.pdf

[4] For example: housing, unemployment or Pension Credit benefits.

Graph No. 1

Weekly average pension amounts by type of pension system and the year in which the legal retirement age is reached (GBP of 2014)



Source: Hargreaves Lansdown (2016).

The decree also states that those individuals who deliberately spend their pension funds to access social benefits, will be treated as if they were still making use of the pension fund. Nonetheless, the decree does not define how the Department of Labor and Pensions will be able to determine that an individual has acted deliberately in exhausting his pension fund. Critics question how cases of individuals who make bad financial decisions, or victims of fraud, would be assessed.

The figures one year after the reform was implemented

According to information published by the Financial Conduct Authority (FCA)[5], in the first 9 months after the reform was implemented, people have overwhelmingly chosen to withdraw their entire pension fund in a lump sum, but at a decreasing rate (see Table No. 1). Shortly after the implementation of the reform (April to June, 2015), 60% of individuals who accessed their pension funds withdrew the total amount of the fund in a lump sum. In the third quarter of 2015 this number was 58% of the total number of funds accessed for the first time, and in the last quarter of 2015, it dropped to 52%.

It is worrying that more than half of the people who choose to access their pension funds, making use of the new freedoms provided, have decided to withdraw the entire fund.

[5] Further details at the following link: https://www.fca.org.uk/publication/data/data%20bulletin%20suppl%20apr%2016.pdf

Table No. 1

Alternatives chosen by individuals

	Apr-Jun. 2015	**Jul-Sept.** 2015	**Oct-Dec.** 2015
Total number of funds accessed for the first time during the quarter	218,296	197,443	127,094
Number (and % of funds) of life annuity purchases	13,787 (6%)	23,385 (12%)	21,289 (17%)
Number (and % of funds) of drawdown withdrawals (includes programmed withdrawals)	70,435 (32%)	n.a.	37,150 (29%)
Number (and % of funds) of partial drawdowns	3,154 (1%)	n.a.	3,045 (2%)
Number (and % of the funds) of total lump sum fund withdrawals	130,920 (60%)	113,100 (58%)	65,610 (52%)

Source: Financial Conduct Authority.

A positive aspect is that 64% of those who chose to withdraw all of their funds in a lump sum during the last quarter of 2015, had funds of less than GBP 10,000 (USD 13,000), whereas only 7% had funds exceeding GBP 100,000 (USD 130,000) (Table No.2).

Table No. 2

Number of total lump-sum fund withdrawals by size of the fund: October to December 2015 *

Size of the fund	Number of funds	% of funds of this size
Less than GBP 10,000	40,584	61.9%
GBP 10,000 - GBP 29,000	18,704	28,5%
GBP 30,000 - GBP 49,000	4,186	6.4%
GBP 50,000 - GBP 99,000	1,783	2.7%
GBP 100,000 - GBP 149,000	223	0.3%
GBP 150,000 - GBP 249,000	84	0.1%
More than GBP 250,000	46	0.1%
Total	65,610	100%

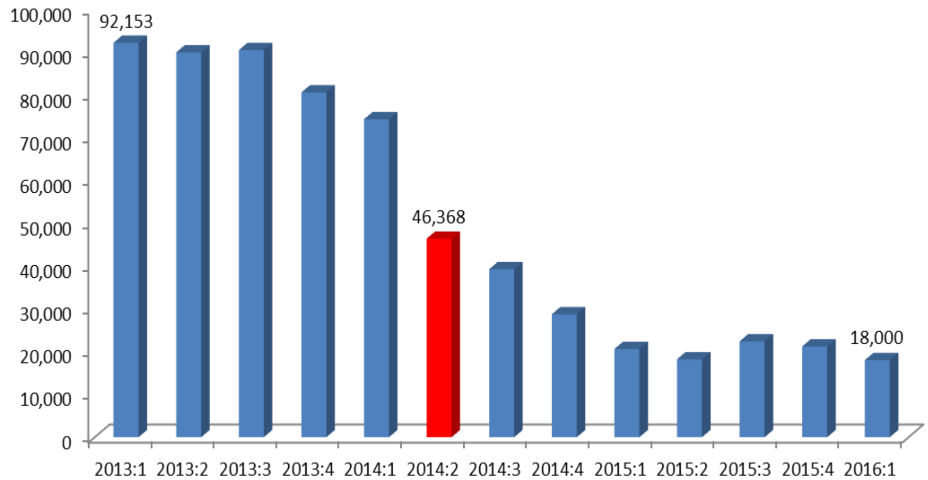
* Funds accessed for the first time during that quarter.

Source: Financial Conduct Authority.

Regarding the purchase of life annuities (LA), the FCA's figures indicate that only 6% of those accessing their funds for the first time purchased a life annuity in the first following the implementation of the reform (April to June of 2015). The figure spiked considerably in the two following quarters, reaching 12% and 17%, respectively.

Nonetheless, on comparing pre and post-reform LA sales, it can be seen that they plummeted after the announcement of the reform in April 2014 (see Table No. 2). In accordance with the information provided by the Association of British Insurers (ABI), 92 thousand life annuities were sold in the first quarter of 2013, whereas only about 46,000 were sold in the second quarter of 2014 (after the reform was announced), and only 18,000 were sold in the first quarter of 2016 (a drop of 80% compared to the first quarter of 2013). This drop is even greater if one considers the increase in the number of individuals who can make use of their pension funds, as a result of the reduction in the age at which pension funds can be accessed (from 60 to 55).

Graph No. 2
Sale of life annuities *



*** The second quarter of 2014 is highlighted in red, which was when the reform was approved.**
Source: In-house, based on ABI data.

Regarding the total amounts assigned to the different alternatives available to individuals for using their funds, the ABI data shows that in the first year following the implementation of the reform (April of 2015 to April of 2016):

- Cash withdrawals totaled GBP 4,300 million (USD 5,590 million) (see Table No. 3), with a total of 300,000 withdrawals (individuals could have made several withdrawals each), with the individuals with the smallest funds mostly tending to request cash withdrawals. Thus, the average amount of withdrawn funds is GBP 14,500 (USD 18,200).
- A significant number of individuals opted for drawdown withdrawals of their funds. In all, there have been more than 1 million drawdown withdrawals (individuals could have made several withdrawals each) totaling GBP 3,900 million (USD 5,070 million), with an average payment of GBP 3,800 (USD 4,940).
- On the other hand, the larger funds continue to be used for purchasing pension instruments (life annuities or programmed withdrawals). In the first year after the implementation of the reform, 90,700 programmed withdrawals were requested, totaling GBP 6,100 million (USD 7,930 million) invested in this pension mode. Those who opted for programmed withdrawal had an average fund balance of GBP 67,500 (USD 87,100).
- Life annuity sales totaled GBP 4,200 million (USD 5,460 million), with a total of 80,000 transactions; the average amount of the funds invested in this pension mode is GBP 52,500 (USD 68,250).

A positive point is that cash withdrawals have been declining since the implementation of the reform: in the first quarter of 2016 nearly GBP 750 million (USD 975 million) were withdrawn, compared to GBP 1,400 million (USD 1,820 million) in the second quarter of 2015 (the quarter immediately following the implementation of the reform).

Table 3: Use of pension funds April 2015 - April 2016

Method	Number of Applications	Total Amount	Average amount
Cash withdrawals	300,000	GBP 4,300 million (USD 5,590 million)	GBP 14,500 (US$ 18,200)
Drawdown withdrawals	1,030,000	GBP 3,900 million (USD 5,070 million)	GBP 3,800 (USD 4,940)
Drawdown sales	90,700	GBP 6,100 million (USD 7,930 million)	GBP 67,500 (USD 87,100)
Annuity Sales	80,000	GBP 4,200 million (USD 5,460 million)	GBP 52,500 (USD 68,250)

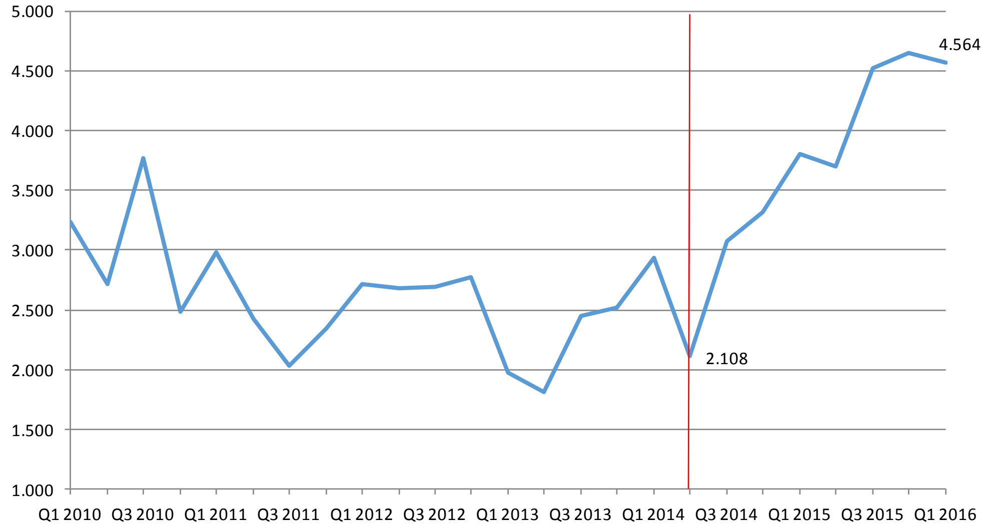
Source: ABI, Pension freedom statistics - one-year-on factsheet, March 2016.

Although there is no official information regarding the use of the withdrawn funds, anecdotal evidence would indicate that the sale of luxury cars has not increased, as was originally presumed[6]. However, on analyzing the consumption data for the United Kingdom, it can be seen that net spending on tourism has risen considerably since the announcement of the reform (second quarter of 2014). Graph No. 3 shows that between the second quarter of 2014 (announcement of the reform, red line) and the first quarter of 2016, net spending on tourism more than doubled, rising from slightly more than GBP 2 million (USD 2,7 million) to more than GBP 4.5 million (about USD 6 million).

[6] See for example: http://www.telegraph.co.uk/pensions-retirement/annuities/pension-freedoms-withdrawal-figures-dispel-fears-of-lamborghini/

Graph No. 3

Net expenditure on tourism (thousands of GBP, seasonally adjusted)



Source: Office for National Statistics UK.

Meanwhile, a survey conducted in November 2015 by Hargreaves Lansdown (2016), revealed that 27% of those who withdrew their pension funds keep the money in cash (in current accounts); 22% have invested in shares; 22% keep their money in savings accounts; 20% have spent it on consumption and 14% have paid off mortgages or other debts. I.e., 34% of those who withdrew their pension funds have not assigned them for pension purposes (neither savings nor investment).

Some effects of the reform

During the year in which the reform has been in force, a series of effects have been observed, most notably the following:[7]:

i. The most evident effect of the reform, as previously mentioned, has been the **drastic drop in the sale of life annuities** (see Graph No.2). At the same time, **the emergence of new social security products** that combine the security of a life annuity with the flexibility of drawdown withdrawals, has been evidenced. However, these new products can be very complex and therefore more expensive.

ii. **Fraud and scams.** The implementation of the reform has made retirees easy targets for swindlers. According to Citizens Advice, a nonprofit organization, nearly 11 thousand consumers have been contacted without their authorization, and offered recommendations regarding their pensions.

[7] For further details see https://www.ft.com/content/0fb8549c-f1aa-11e5-9f20-c3a047354386

iii. **Failure of free consulting (Pension Wise).** According to FCA figures, only 17% of individuals that have withdrawn their pension funds have requested the advice of Pension Wise, which is extremely worrying since those individuals are acting on their own, without considering recommendations regarding their financial choices.

iv. **Increased withdrawals at the age of 55.** Prior to the reform, individuals could not use their pension funds before they turned 60. After the reform, they are allowed to use them ten years before retirement age (65), resulting in a large number of individuals withdrawing their pension funds before reaching retirement age, with the imminent risk of recklessly spending them. According to FCA figures, in the last quarter of 2015, people between 55 and 59 years of age are the ones with the highest fund withdrawal rates. 11% of those in this age bracket who make withdrawals without exhausting the entire fund, withdraw more than 10% of their funds.

Lessons from the British experience

The United Kingdom has one of the most developed life annuity markets in the world, so one would expect individuals to be culturally predisposed to having a guaranteed pension income, even after the introduction of the new freedoms. However, the evidence has shown otherwise: life annuity sales plummeted after the announcement of the pension reform providing freedom of choice to individuals. According to Franklin (2014), the reason for this behavior is the low degree of financial education of the British, due to which many would not understand the benefits of having an income guaranteed for life when presented with multiple options.

The evidence observed in the United Kingdom would seem to reinforce something that is well known in behavioral economics: that individuals prefer present consumption to future consumption. The behavioral economics literature points out that people tend to consider events occurring in the distant future to be less important than those occurring in the near future. This tendency may result in people opting for small immediate rewards, instead of a greater reward at a later date. Hence, there is the so-called "life annuity paradox," which asks why individuals do not voluntarily purchase a life annuity, if it is to their personal benefit to have a guaranteed lifetime income. In general, there is a high demand for these instruments only in countries where policies induce individuals to buy a life annuity (as in the United Kingdom prior to the reform).

In theory, the new freedoms granted to contributors should favor the choice of more efficient options based on the individual needs of each worker. Nonetheless, in order to benefit from freedom of choice, workers must understand the advantages and disadvantages of each one of the options available to them, which entails a certain degree of financial knowledge. According to experts, this is not be the case among British workers (in fact, this situation of lack of basic financial knowledge is global). Thus, for example, according to FCA figures, in the last quarter of 2015, 57% of those who purchased life annuities, and 52% of those who requested programmed withdrawals, did so from their current pension provider, without taking the time to quote and see which agency offers the best option for their retirement. Chilean reality is different, since the

Pension Amount Consultation and Offers System (SCOMP)[8]offers members free and complete information on pension modes and pension providers, facilitating an informed decision.

Finally, it must be pointed out that the reality of Latin American countries with individually funded systems is very different to the British reality. In the United Kingdom, the main source of financing for the elderly is the State pension (see Graph No. 1), while the defined contribution and defined benefit plans are complementary to the State pension. So, even though individuals were to squander the money from their defined contribution fund, they would still have other sources of income to finance their old age. This is not the case in countries like Chile and Peru, where 100% of pension savings are individually funded. The misuse of pension funds in our countries may lead to individuals not having financing alternatives for their old age. This, in turn, involves increasing the demand for benefits from the noncontributory pension pillars (social pensions), with the resulting fiscal spending it entails. It would be socially unfair to finance medium and high income individuals who have spent their pension savings, with government resources (such as for example, through a solidarity pillar).

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Franklin, Ben (2014). "Freedom and choice in pensions: risks and opportunities." International Longevity Centre. Available online.

Hargreaves Lansdown (2016). "Pensions in 2016" Presentation available online.

[8] The purpose of SCOMP is to enable retirees to make queries regarding pension offers, and receive, in the form of a certificate, clear, complete and comparable information regarding the pension amounts offered by the different pension providers (life insurance companies and pension fund managers) under the different pension modes.