Like it or lump it: Retiree attitudes to tax-free cash

LGIM

Tax-free cash is king, but is it wearing the emperor's new clothes? We look at why, how and which people take tax-free cash – and if there is a better way to do it

Contents

Nothing is certain in life, except death and taxes. So, when Chancellor Osborne defied the old adage in 2015's Freedom and Choice reforms by allowing retirement savers to access 25% of their pots tax-free without buying an annuity first, tax-free cash quickly became the UK's most popular and well-known pension perk. A 2020 LGIM study found that taking a lump sum was the number one reason people accessed their pensions.[1]

However, are savers now discovering the wisdom of another truism: all that glitters isn't gold? Created to incentivise scheme members to save more into their pensions during their working lives, has tax-free cash had the opposite effect in practice, encouraging them to spend more quickly when they retire? With this in mind, LGIM ran a study of over 1,500 savers to uncover what savers are doing with their lump sum, and to find out who -- if anyone -- is using the money to its fullest tax-efficient potential. We also looked at whether a gender gap exists, as in other areas of retirement savings and employment. The results tell us how people's attitudes about their pension's purpose have changed with the advent of this feted but misunderstood benefit.

Our methodology

1. Qualitative research of 50 one-hour interviews with three core groups of non-advised defined contribution (DC) pension scheme members:
   - **Group 1:** Over 55-year-olds who had accessed tax-free cash and moved into some form of drawdown
   - **Group 2:** Over 55-year-olds who had not yet started to access any of their DC pensions
   - **Group 3:** 50-54-year-olds who were starting to think about what to do with their DC pots

Quotas were set to screen out people with small pots of less than £10,000, those with large defined benefit (DB) provisions in their household, and those who had decided to generate their pension income from a buy-to-let portfolio. All interviews were conducted in July 2020.

2. Quantitative research took place in August 2021 among 1,526 DC members:
   - **Group 1:** 417 respondents aged 55-70 who had taken a cash lump sum out of a DC pension in the last five years
   - **Group 2:** 560 respondents aged 55-70 who hadn't yet accessed any of their DC pensions
   - **Group 3:** 549 respondents aged 50-54 with a DC pension in accumulation

[1] [The 'silver squeeze': Tackling decumulation dilemmas for retirees-to-be December 2020 (lgim.com).]

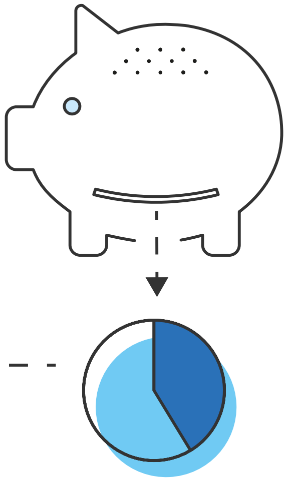
Section 1

How to spend it

Over

40%

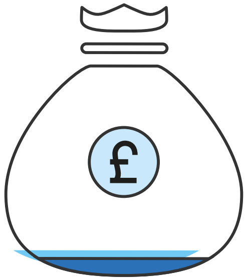
have **accessed their pension solely** to **take their lump sum**



Only

3%

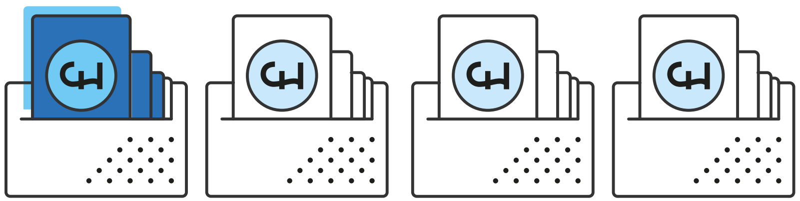
of **savers** with **pots under £10,000** would **invest** their **tax-free-cash**



Only

24%

intend to use their **tax-free cash** for **retirement income**



In the years since Freedom and Choice, it's clear that elements of their pension have been transformed from a retirement vehicle into a savings account for many savers.

Even though nearly three-quarters of those who have accessed their tax-free cash agree that the main purpose of their pension is to provide an income for life, tax-free cash has become decoupled from the rest of their pension in savers' minds.

Less than a quarter (24%) agree that they would need to use the cash lump sum to provide them with an income. This is a far cry from how many initially conceptualised their retirement when they began saving for it:

"I thought it would just be (receiving) money every month, you know, as if I was still working full time. That's the way it was sold to me at the time",
Female, age 55, taken tax-free cash

Instead, 41% have accessed their pension solely to take their lump sum, and the most popular choice across the board of what to do with it (27%) was to spend it on home repairs and improvements. Just 3% of those with less than £10,000 in their pots would invest their tax-free cash, preferring to pay down debts or spend it.

In it for the short haul

Moreover, despite the same number of those with both the best and worst-funded DC pensions seeking an income from their lump sum (26%), there is an uneven level of planning as to how to get it. The wealthiest lead the pack. Nearly seven in 10 (68%) of those with pots of over £250,000 and who have already taken some or all of their tax-free cash, have ensured that they've left sufficient funds in place to provide a retirement income. This compares to only one in 10 (13%) of those with less than £10,000 in DC savings, 65% of whom haven't yet worked out what monthly income they will need in retirement.

Similarly, those with smaller pots are more focused on the short to medium term. Nearly double the number of savers with pots of between £10,000 and £20,000 (62%) than those with pots of over £250,000 (34%) focus their planning on just the first decade of retirement, believing it's too difficult to look beyond it. This latter group was also doubly likely to have a plan for long-term care as those with smaller pots.

Unsurprisingly, those who are financially savvy in one area are also more capable of long-term planning in others. But even among richer savers, there is an aversion to keeping their tax-free cash invested in their pension. While nearly half (48%) of those with pots of over £250,000 say they believe their lump sum is something to 'invest elsewhere, for better returns', those with pots of over £250,000 are three times more likely to keep their tax-free lump sum in cash rather than invest it (54% in cash savings versus 18% in a stocks and shares ISA or other investments). Additionally, those with the most savings are already the most likely to convert their lump sum into more savings. Therefore, those with larger pots are still likely missing a trick when it comes to eking out the maximum investment return, rather than leaving their lump sum languishing at a lower interest rate.

A stitch in time

Useful intervention begins far earlier than the wake-up packs at 50 and 55. For providers, part of building confidence in pensions, even with this wealthier and more informed group, comes with better accessibility and communication throughout the accumulation journey, and again when it comes to drawing down:

"With a cash ISA or a bank you go online or you go to your app or whatever ...and you can see you've got the money there...in one day, you can withdraw the money and you've got it to do whatever you want with. But the pension you feel that a company is keeping a hold of your pension more and they are in control of it rather than you."
Female, age 55, taken tax-free cash

Furthermore, as those with higher DC wealth are also more likely to have higher cash savings already, it's critical that providers have the right tools in place for those with less in their pots as retirement savers increasingly come to rely on their DC pensions. It was marked that those who had visited an adviser were far more comfortable with the idea of staying invested. Trustees should consider encouraging their members to look further afield when making their withdrawal decisions so that they have the confidence and the preparedness to make the best decision for their unique circumstances.

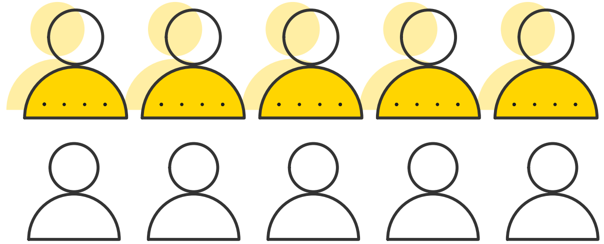
Section 2

Withdrawing, fast and slow

Over

50%

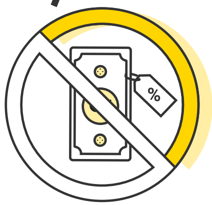
of those who had **withdrawn their lump sum** said they **did not need** to **take as much at that time**



Nearly

1/2

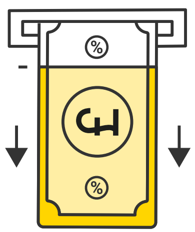
would **not** have **withdrawn** their **cash** if it had **not been tax free**



...and **tax efficiency** drove the decision to **withdraw** for nearly

70%

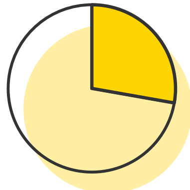
of those with **DC pots** of **£250,000+**

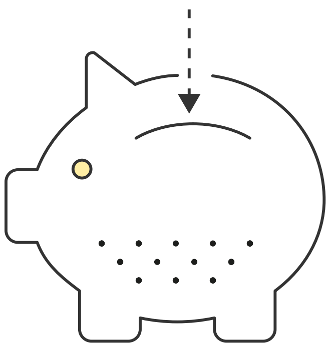


...yet **tax inefficiencies abound:**

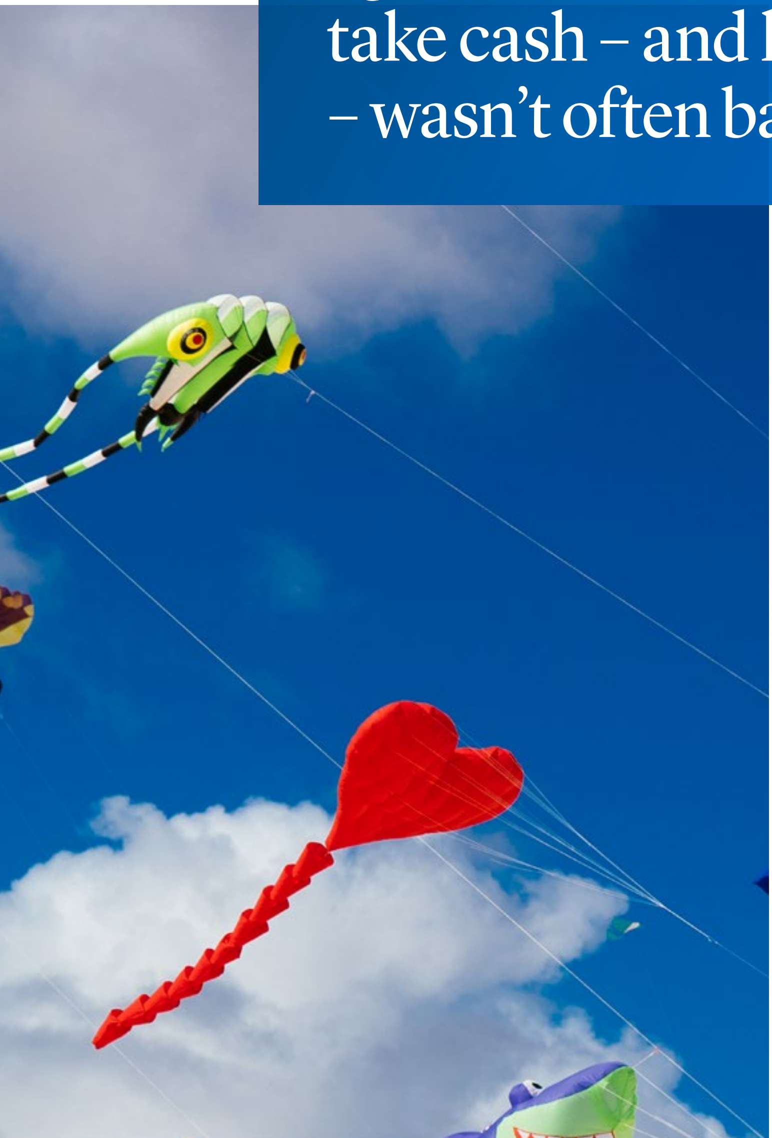
28%

of those who've **withdrawn** are **still contributing to a pension**



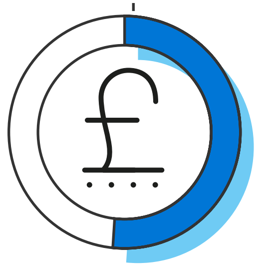


With over a quarter (26%) withdrawing their lump sum at aged 55, the decision of when to take cash – and how much to take – wasn't often based on necessity:



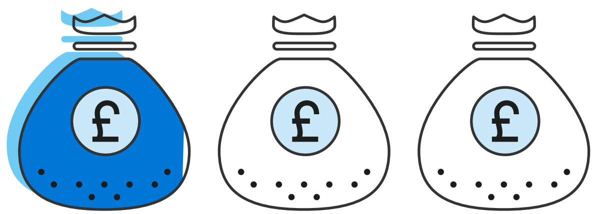
Over **1/2**

who had **withdrawn their lump sum** said they **did not need as much at that time** and that **they could have taken less**, a view which was **more common** among those **with larger pots**



Nearly **1/3**

said that they could have **used their savings** instead of **taking their tax-free cash**



Instead, how much and when savers withdrew the benefit depended on their psychological perception of the lump sum's purpose. Across the board, those who saw the cash as retirement income were more likely to take 25% or less.

By contrast, those who saw the perk as just another form of savings were more likely to surpass 25% in their withdrawals. Over half (53%) of those with pots of less than £10,000 agreed with the statement that that tax-free cash is 'there to spend, like a bonus or a windfall' compared to less than a third (30%) of those with pots of over £250,000. This group was over five times more likely than those with the largest pots to withdraw more than 25%. So, what causes this mindset?

> "I definitely want the 25% because I just feel that I want to have it in my hands, rather than being tied up. It's a small-mindedness. A bird in the hand is worth two in the bush. Everything is just so uncertain about money and I just feel that I want it in my own hands now. I've lost my trust"
>
> Female, age 55, taken tax-free cash

Money, that's what I want (now)

We observed a sense of disconnectedness between respondents' different sources of wealth combined with a lack of understanding about how to maximise their value. For example, a third (34%) of savers with the least DC wealth used their tax-free cash to pay down a debt or a loan. This could be an eminently sensible financial decision, if members fund it in a way which has a minimal impact on future outcomes, such as their retirement, for example by using the cash in the bank. Yet our qualitative discussions revealed that people often didn't consider their total wealth in this way and had often earmarked relatively liquid assets such as savings accounts and cash ISAs for short-term, discretionary spending instead:

"The money in the bank, that's possibly an old-fashioned attitude, that was where the disposable income was."
Female, age 60-64, taken tax-free cash

Another key concern fuelling smaller savers' close-fistedness, cited by over 60% of this group (61%), was short-term policy and the concern that the benefit would be taken away. This propelled them to take it now, a worry which was abated for wealthier segments (45% of the over £250,000 group).

I'm the taxman

But for many, it is existence of the tax benefit itself which drives them to withdraw. Nearly half (46%) would not have withdrawn their cash if it had not been tax free.

This view was driven by the wealthiest segment, held by 63% with pots of over £250,000, and falling to 24% of those with pots of less than £10,000. Indeed, half of the wealthiest DC savers in the study (49%) stuck to withdrawing the tax-free amount versus just a quarter (24%) of those with the least in their pots.

That tax-efficiency drives withdrawals is supported in the percentage of those who said their decision to withdraw was based on trying to minimise the amount of tax they had to pay. This consideration increased for those with cash savings of over £250,000 (69%) and decreased for those with savings of less than £10,000 (37%), with 84% of the DC richest cohort having considered taking it out in chunks to reduce their future tax bill.

In terms of minimising tax, however, there are still vast efficiencies to be made. Whatever their intentions, in reality, just one in 10 DC savers withdraw their tax-free cash in chunks, with less than half of those from the richest cohort who say they were considering it following through (39% overall). In addition, with half of those who access their tax-free cash still working, and a third (34%) full time, a surprisingly large number have withdrawn a lump sum while still paying into a pension. 28% of our respondents overall are still contributing despite having withdrawn a lump sum or an income. Withdrawing as they accumulate means they are compromising their Money Purchase Annual Allowance (MPAA), which reduces the annual amount they can pay in, tax-free, from £40,000 to £4,000.

> "The chancellor at the time opened the door and said at 55 plus you can take out 25%. Whoopee do! And away I went and I took out 25%".
>
> Male, age 68, accessed tax-free cash

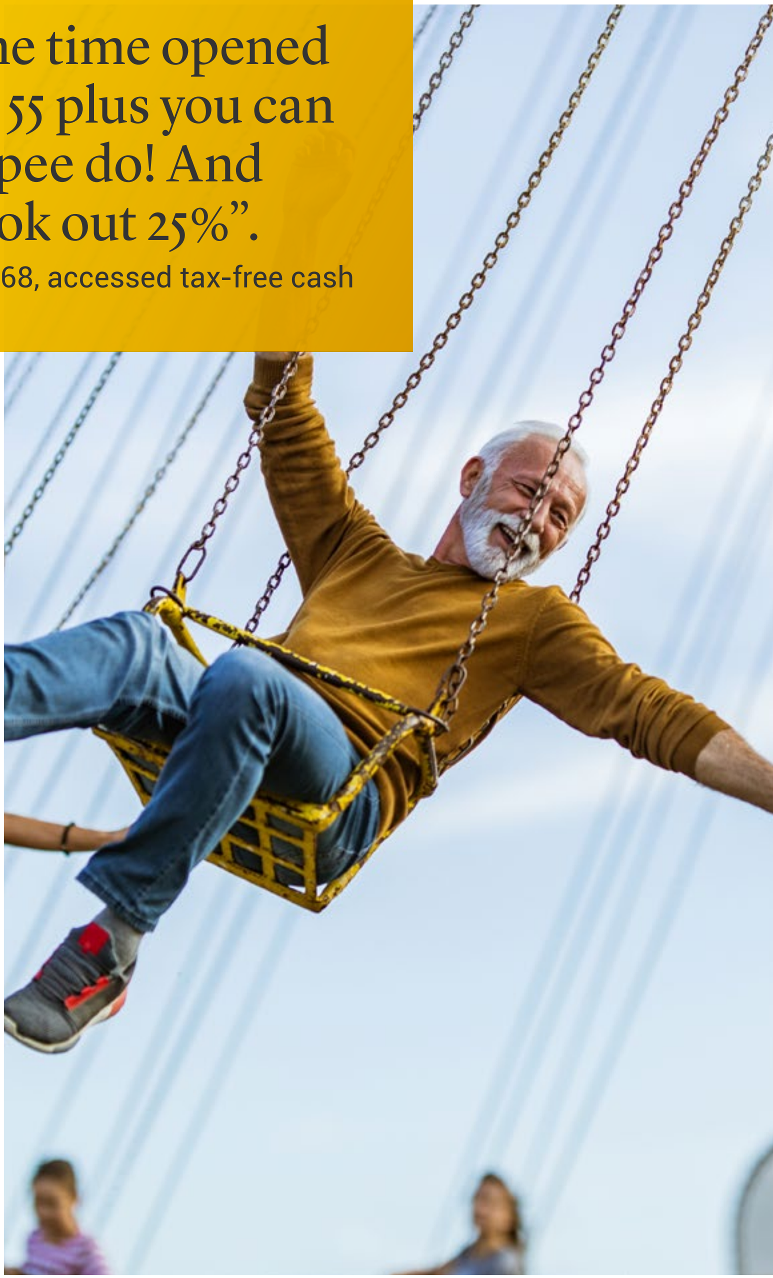
Time is on my side

It's clear that the messaging around the purpose of the 25% lump sum needs to change.

The pensions industry must work to change members' perception that money which was intended for retirement when they began saving into a pension is now burning a hole in their pocket because of a (possibly false) incentive to withdraw it at age 55. Provider education must lead the way in reassuring savers, reinforcing the idea that it is intended to be used as part of members' retirement provision and encouraging them to consider different ways of slicing the pie.

For savers of all income levels, clear pointers about tax traps such as the MPAA will be critical. Simple decisions such as the consequences of withdrawing could be costing members of all income brackets years' worth of contributions.

More broadly, policymakers will need to think about how to help members 'join the dots' between what can be a confusing array of assets, giving them a holistic picture of their money. This will enable them to get the most bang for their buck by withdrawing from the right place now, rather than missing out on benefits later down the line.



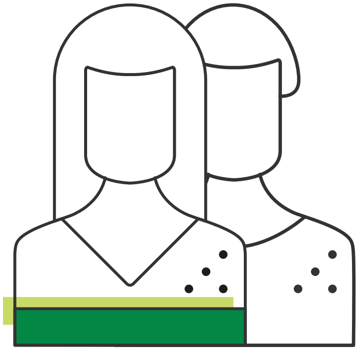
Section 3

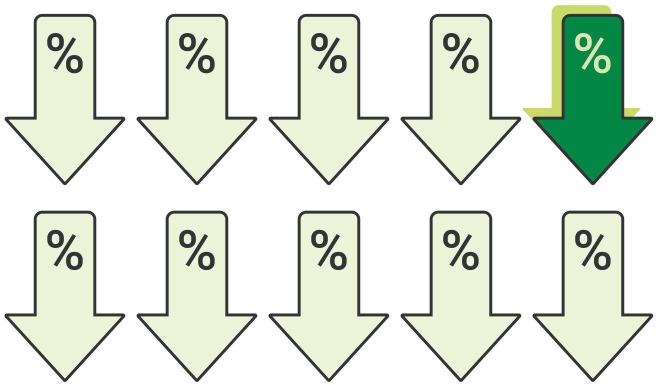
Men united? Squaring the field for female finances

Women are over

10%

more likely to **sacrifice returns** by **taking cash** at **55 instead** of **later**





They are also

10%

more likely to **plump for** a **low-interest savings account**

If I were a rich man

Whether due to a tendency to overstate their abilities or because they have larger pensions on average, men display greater confidence in their financial planning.
Men say they are:

more likely to plan so that **taking their lump sum** still allows them an income in retirement

73%

....vs **58%** of women

more likely to plan for **long-term care**

27%

....vs **19%** of women

more likely to plan to **take their money** so as to **minimise income tax** over time

53%

....vs **32%** of women

10% less likely to **admit** to **not having worked out** if they can **afford to spend** the **cash lump sum now**

34%

....vs **45%** of women

So, does this confidence translate into prudence when it comes to crystallising their pot? For men, tax efficiency is an important consideration. Half of men would not have withdrawn as much had it not been tax free, versus 39% of women. Nearly three-quarters (72%) of men said they were already aware they could take their tax-free cash in chunks before the survey, versus half of women.

Meanwhile, women are more likely to withdraw earlier (33% women versus 22% men at aged 55) and to put their tax-free cash in a savings account, current account, or cash ISA to keep for a rainy day (29% women to 19% men) leaving them vulnerable to accepting a low cash interest rate instead of an investment return in their pension for longer.

Making things fair for the 'fairer sex'

Women's lack of financial confidence is certainly affecting their willingness to stay invested for longer. There is a higher level of mistrust among female savers in their provider. Less than 40% (39%) disagreed with the statement 'I don't trust pension companies, so I wanted to have the money under my control', versus nearly 60% (58%) men. Overall, more than 70% (71%) of men trusted their pension provider, versus 57% of women.

However, it's not all doom and gloom for female savers. Despite declaring a lack of trust, in practice, women are more likely than men to find out for the first time that they could withdraw a cash lump sum from information their pension provider or their employer sent them (20% women versus 10% men) rather than any other source, such as the media. This may point to a solution for lower levels of financial confidence and planning: targeting communications towards women about their options to reassure and encourage them.

Improving retirement outcomes without breaking the bank

As much as retirement saving, our survey threw up that people's attitude towards retirement spending has changed. For many, particularly the most vulnerable savers, the existence of tax-free cash has changed pensions in people's mind from a retirement accumulation vehicle into a savings account, where this portion of their pension is concerned. Near, rather than long-term goals predominate and for the vast majority of savers, particularly those who have smaller pots, we are still missing key pieces of the puzzle about their total wealth. As in other areas of pensions, there is a gender gap, where women's caution is costing them.

Even those who have amassed larger pensions are at risk of losing out on benefits as they begin to draw down, favouring low-risk cash and not opting for the most tax-efficient withdrawal strategy.

The challenge will be ensuring that savers consider their whole financial picture, including their existing savings, as possible sources of wealth. In this, we think the Pensions Dashboard will be critical in presenting a comprehensive picture of savers' total pension wealth. In time, open finance will hopefully bring with it the possibility of an even broader view of savers' assets.

But this cannot be achieved by one method alone, and providers can help. There is a need to create targeted communications which help ensure each group of savers is getting the very best out of their pensions but also encourages members to seek paid-for guidance where necessary – if only to give them the confidence to not opt for the 'cash under the mattress option'. Part two of our research explores strategies providers can use to boost members' confidence in making a decision that maximises their tax-free cash benefit in the existing framework, whether that is staying invested for longer or withdrawing in a more tax-efficient way.

In this, we can all help open up the discussion of how to use tax-free cash – or not, as the case may be, and give members more financial freedom for longer.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

LGIM talks

The LGIM blog

Important information

Important information Past performance is not a guide to future performance. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

This document is designed for the use of professional investors and their advisers. No responsibility can be accepted by Legal & General Investment Management Limited or contributors as a result of information contained in this publication. The information contained in this brochure is not intended to be, nor should be construed as investment advice nor deemed suitable to meet the needs of the investor. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision. The views expressed here are not necessarily those of Legal & General and Legal & General Investment Management Limited may or may not have acted upon them. This document may not be used for the purposes of an offer or solicitation to anyone in any jurisdiction in which such offer or solicitation is not authorised or to any person to whom it is unlawful to make such offer or solicitation. No party shall have any right of action against Legal & General in relation to the accuracy or completeness of the Information, or any other written or oral information made available in connection with this publication. Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon. There is no guarantee that any forecasts made will come to pass. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be solely relied on in making an investment or other decision. Contact us for further information about LGIM, please visit lgim.com or contact your usual LGIM representative As required under applicable laws Legal & General will record all telephone and electronic communications and conversations with you that result or may result in the undertaking of transactions in financial instruments on your behalf. Such records will be kept for a period of five years (or up to seven years upon request from the Financial Conduct Authority (or such successor from time to time) and will be provided to you upon request.

Registered in England and Wales No. 02091894. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 119272 Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA Authorised and regulated by the Financial Conduct Authority.

D001949

LGIM