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

Rita Butler-Jones considers the impact the 25 per cent tax free lump sum at retirement has had on pensioner spending

Nothing is certain in life, except death and taxes. So, when former Chancellor George Osborne defied the old adage in 2015's Freedom and Choice reforms by allowing retirement savers to access 25 per cent 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.

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. The results tell us how people's attitudes about their pension's purpose have changed with the advent of this feted but misunderstood benefit.

How to spend it

Tax-free cash has become decoupled from the rest of their pension in savers' minds. Less than a quarter (24 per cent) agree that they would need to use the cash lump sum to provide them with an income. Instead, 41 per cent 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 per cent) was to spend it on home repairs and improvements. Just 3 per cent of those with less than £10,000 in their pots would invest their tax-free cash, preferring to pay down debts or spend it.

Withdrawing, fast and slow

With over a quarter (26 per cent) 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- Over half who had withdrawn their lump sum said they did not need as much at that time
- Nearly one-third (29 per cent) said that they could have used their savings instead of taking the lump sum out of their pension

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 per cent or less.

By contrast, those who saw the perk

as just another form of savings were more likely to surpass 25 per cent in their withdrawals. Over half (53 per cent) of those with pots of less than £10,000 agreed with the statement that tax-free cash is 'there to spend, like a bonus or a windfall' compared to less than a third (30 per cent) of those with pots of over £250,000. So, what causes this mindset?

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. Our qualitative discussions revealed that people often didn't consider their total wealth and had often earmarked relatively liquid assets such as savings accounts and cash ISAs for short-term, discretionary spending instead.

A key concern, cited by over 60 per cent of this group (61 per cent), 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 per cent of the over £250,000 group).

Useful intervention begins far earlier than the wake-up packs at 50 and 55. For providers, part of building confidence in pensions comes with better communication throughout the accumulation journey, with the right tools in place for those with less in their pots as 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.

I'm the taxman

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

In terms of minimising tax, however, there are still vast efficiencies to be made. Whatever their intentions, 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 per cent overall). In addition, with half of those who access their tax-free cash still working, and around a third (34 per cent) full time, a surprisingly large number have withdrawn a lump sum while still paying into a pension.

Men united? Squaring the field for female finances

The gender gap observed elsewhere in pensions is also in evidence here. 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.

Women are more likely to withdraw earlier (33 per cent women versus 22 per cent 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 per cent women to 19 per cent men) leaving them vulnerable to accepting a low cash interest rate instead of an investment return in their pension for longer.

It's not all doom and gloom for female savers. 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 per cent women versus 10 per cent men) rather than any other source, such as the media. This may point to a solution for lower levels of financial confidence: targeting communications towards women about their options to reassure and encourage them.

Improving retirement outcomes without breaking the bank

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.

The challenge will be ensuring that savers consider their whole financial picture, including their existing savings. In this, we think the pensions dashboards and open finance developments will be critical in presenting a comprehensive picture of savers' total wealth.

But this cannot be achieved by one method alone, and providers can help. There is a need to create targeted communications that 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, whether that is staying invested for longer or withdrawing in a more tax-efficient way.

Written by LGIM co-head of DC, Rita Butler-Jones

In association with LGIM

Source: LGIM research, took place in August 2021, 1,526 quantitative interviews and 50 qualitative interviews with DC pension members over the age of 55