An Chomhairle Pinsean
The Pensions Council

How to make older people happier with their pension pot:

A paper on the retirement lump sum

January 2023

Contents

Letter to the Minister

Dear Minister

The Council recognises that there is an overarching objective for a resilient and trustworthy financial system. Pensions play an important role in this system. There are two key pension challenges: getting more people to save for retirement and helping people to save enough. Automatic enrolment will help to tackle the first challenge. This paper focuses on how pension savings could be utilised more efficiently in retirement to improve adequacy.

Under the current system, a lump sum is available as a one-off highly tax-efficient payment at the point of retirement, and it is accessed by most pension savers. While there is little Irish evidence to indicate to how the lump sum is used, the available research does suggest that it is often put into a savings account. High inflation can quickly erode the value of any savings.

TILDA research has shown that the higher the pension income, the better the quality of life in older age. Where a lump sum is taken, this may reduce the available pension income. The Roadmap for Pensions Reform 2018-2023 discussed retirement income sufficiency and suggested this could be in the region of 50% - 60% of a consumer's pre-retirement income. This is a significant challenge: to achieve a pension of 60%, a 30-year-old, earning €40,000 per annum would have to save 21.6% of their salary every year until retirement at age 66. Where a lump sum is taken, the replacement income will be lower, or the pension savings will have to be higher to compensate, all else being equal. Targeting a lump sum at the point of retirement may also have other unintended consequences, such as lower pre- and post-retirement investment returns. This is not in consumers' interests.

The Pensions Council considered the issues and recommends that consumers are given much more flexibility with regard to how and when they can draw down the lump sum when they retire. This is also aligned with the OECD views on flexibility. The Pensions Council proposes three options: (1) allow consumers to draw down the lump sum tax-free at the point of retirement, (2) transfer the full retirement savings to an ARF and allow regular drawdowns, 25% of which would be tax-free and (3) full flexibility, i.e. the lump sum can be drawn down in part or full, tax-free, at any time once the consumer has retired. The "tax-free" element would be subject to existing limits and caps.

The Pensions Council is at your service to help you or your officials with any further support or information you might need.

Yours sincerely,

Roma Burke
Chairperson

Pensions Council proposal

The Pensions Council proposes to give consumers saving for retirement through a DC scheme, PRSA, RAC or private pension more flexibility with regard to how and when they can draw down the lump sum from their pension savings. This would require an amendment to the tax system and would enable them to choose from three options in respect of the (tax relief associated with the) lump sum at retirement. This could also be extended to civil servants, public sector workers and defined benefit scheme members with relative administrative ease.

These options are expected to be broadly cost neutral from a tax perspective and straightforward to implement by pension providers:

- Option 1: Access a lump sum of 25% of the retirement savings at the point of retirement (i.e. the current situation) and take the rest as an approved retirement fund ("ARF") or annuity. No change to the current tax rules is proposed for this option.

- Option 2: Instead of taking the full 25% lump sum in one go at retirement, the retirement savings are transferred, in full, to an ARF. The retiree can then take regular drawdowns from the ARF, 25% of the drawdown would be tax free[1] and the balance would be taxed as income (as usual). The ARF imputed distribution (4% or 5% depending on the age of the retiree) would not need to be changed as there is no knock-on reduction in income tax for the exchequer.[2]

- Option 3: Put the 25% lump sum into a standalone "lump sum ARF" that could be drawn down in part or full, tax free, at any time; put the remainder of the retirement savings into a separate ARF, or used to purchase an annuity. The ARF/annuity would be taxed as income (as usual). Tax rules would need to be updated in relation the "lump sum ARF". This new "lump sum ARF" would benefit from tax-free growth and distributions would be tax free.

Under Options 2 and 3, from a tax perspective, the exchequer would be giving up tax (such as DIRT) on any returns on the lump sum part. Overall, the additional optionality may save the State money if pensioners do not over-spend their lump sum and if pensioners have healthier, happier retirements (ref TILDA research).

The background to this paper

The Pensions Council (the "Council") advises the Minister at her request or on its own initiative. This paper reflects the latter role of the Council. The Council recognises that there is an overarching objective for a resilient and trustworthy financial system, which sustainably

[1] Subject to the existing monetary caps: ie the first €200k is tax free, the next €300k is taxed at the standard rate and no tax relief on any lump sum drawdowns in excess of €500k.

[2] If the consumer decided to purchase an annuity with some or all of the ARF, it is envisaged that the tax treatment would be consistent with that of the ARF route.

serves the needs of the economy and consumers, in which firms and individuals adhere to a culture of fairness and high standards. Pensions play an important role in this system.

The Council is aware of two key pension challenges: getting more people to save for their retirement and helping people to save enough for a decent retirement (adequacy). Automatic enrolment will help ensure that people who were not previously included in occupational pension schemes will have the opportunity to save for retirement.

In respect of the second challenge, the focus is typically on getting people to save more. This is generally via generous tax breaks and education/information. This paper considers how Defined Contribution ("DC") and indeed Personal Retirement Savings Account ("PRSA") / personal pension savings, once built up, could be utilised more efficiently in retirement so that consumers have a better chance of a sustainable and adequate retirement. It proposes a more flexible approach to accessing the lump sum at/in retirement. We do not look at trivial commutation which generally allows the payment of a lump sum benefit where the pension value is less than €30,000.

There is also the challenge of ensuring that the market provides competitive and value-for-money products at retirement, however we believe that challenge should be addressed by a free and functioning market with competition driving value-for-money options for those wishing to purchase an annuity or Approved Retirement Fund ("ARF") at retirement. Consideration of this challenge is outside the scope of this paper.

A brief summary of the current pension system

Consumers can save for retirement by putting contributions into a retirement savings vehicle (such as a DC scheme, PRSA, Retirement Annuity Contract ("RAC") or private pension). These contributions, along with employer contributions, where applicable, grow tax-free over the period to retirement in line with investment returns. Public sector workers, civil servants and members of defined benefit ("DB") schemes typically accrue benefits based on years of service and salary.

At retirement, consumers are eligible to take part of their benefits as a one-off tax-efficient lump sum. Public sector and civil servant retirees as well as members of certain defined benefit schemes receive a lump sum plus pension at retirement; members of defined benefit schemes have the option to "commute" i.e. exchange part of their pension for a lump sum, while members of DC schemes, PRSA or RAC holders and those with private pensions can take a portion (25%, or higher in limited cases) of their accumulated retirement savings as a lump sum. The balance is used to set up an ARF and/or purchase an annuity, with the latter providing a guaranteed level of income until death. An ARF or annuity means that pension savers may not have to solely rely upon the State pension and other supports from the State in retirement.

The lump sum is highly tax efficient: any lump sum up to €200k is tax free, while the next €300k is taxed at the standard rate. As a consequence, the "tax-free" lump sum as it is often called, is an important and significant benefit for retirees. Most retirees take the maximum lump sum at the point of retirement.

There is a concern that, at present, many consumers are taking the entirety of the lump sum at the point of retirement, but they may then be keeping the sum in cash and plan to draw down on that cash over a long period of time. It may not be in the best interests of the consumer to move assets which are invested in a mix of investment classes fully into cash when the consumer may be planning to hold off on drawing down for a period of time. This is particularly the case at present when there is high inflation. Consumers may be struggling to reinvest these lump sums and most certainly would have to pay further fees on the investment of same (as an individual retail customer) which may not be as competitive as those in their original pension arrangement.

What is the lump sum used for?

There is very little evidence-based Irish information about how lump sums are applied by consumers once they have retired. In preparation for this paper, the Council contacted several life assurance companies to ask if they had any available research. Irish Life reported that it had carried out some research and found that there were a variety of uses for the lump sum including; put it into savings (Post Office and Prize Bonds were popular), house renovations, financial help for children, new car, and buying a house for children going to college. Irish Life also provided some individual retiree feedback:

"I think my lump sum was around about €200,000 or there abouts. I have some of it still saved with the post office because it is state guaranteed. Some of it I spent on renovations to the house and getting a new car. I distributed some of it to my children in particular my last daughter who was getting married."

"We put a new kitchen into the house so that took €20,000. That was the only thing we splashed out on I suppose."

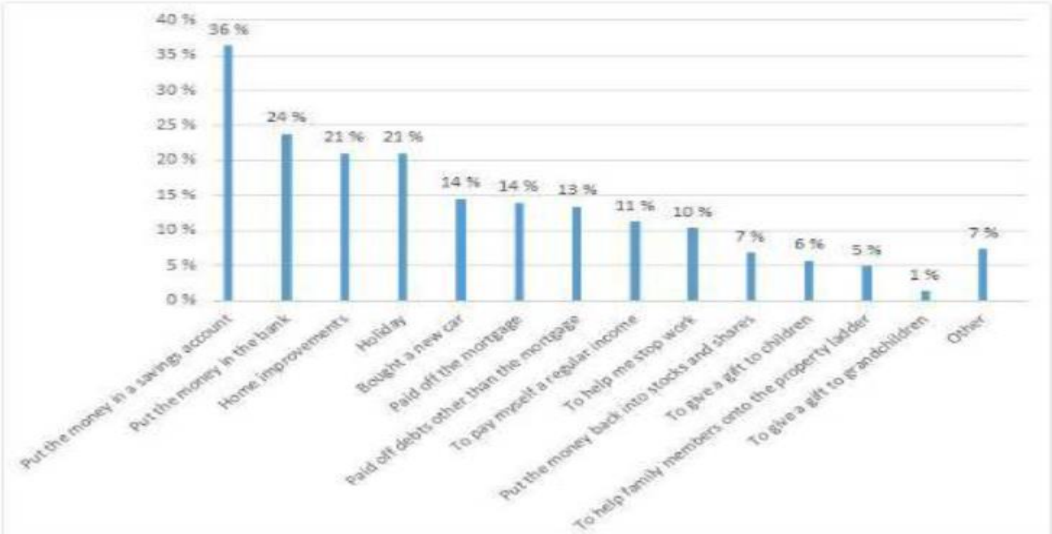
"I think my tax-free lump sum was about 90 at the time. I put it into the credit union."

"We bought a house in the centre of Dublin. It was mainly a house that our children could use while they were in college. The tax-free lump sum was used to repay the mortgage on that house."

"I did spend some of the money, I bought a brand-new car."

Canada Life carried out a survey in the UK in 2019[3] and they reported similar findings:

What have people used their cash lump sums for?



The Canada Life graph shows that the majority of retirees surveyed put some/all of their lump sum into a savings or bank account (60%), 48% carried out home improvements, paid off the mortgage or other debts, 35% went on a holiday and/or bought a car, 21% used the lump sum to provide an income/help give up work while 19% gave gifts/financial support to family members. While there is a plethora of uses which consumers have spent the lump sum on, it is clear that the majority in this survey took the lump sum and placed it in a savings account or with the bank. This may provide retirees with a level of comfort that they have readily available cash should they require it, and they have a visual representation in their bank account of their many years of hard work and saving.

In 2022, The Harris Poll on behalf of MetLife conducted an online survey[4] within the U.S. covering 1,911 US adults between the ages of 50 and 75. Metlife reported that one in three retirees who took a lump sum from their defined contribution plan depleted their lump sum, on average, in five years. They also found that more than one in three lump sum recipients (35%) gave away a significant portion of the money to at least one person or group and more than three-quarters (79%) made at least one major purchase within the first year of withdrawing the money (including luxury spending such as vehicles, vacations, and new or second homes). While these are US findings, they are relevant for understanding the possible direction of travel.

---

[3] https://www.actuarialpost.co.uk/article/what-people-have-spent-their-pension-cash-lump-sum-on-15827.htm

[4] https://www.metlife.com/content/dam/metlifecom/us/homepage/ris/home/MetLife-2022-Paycheck-or-Pot-of-Gold-Study-Final.pdf

How does pension income affect retirement?

Retirees can spend their lump sum in any way that they consider appropriate. In saying that, there are certain things that a retiree can do to act in his / her best interest. TILDA, The Irish LongituDinal Study on Ageing is a large-scale, nationally representative, longitudinal study on ageing in Ireland. In 2016, it researched the relationship between retirement income and quality of life and found that[5]:

- Income is positively associated with quality of life in older age.
- All aspects of quality of life (control, autonomy, self-realisation and pleasure) increase consistently with household income.
- Higher income is associated with higher quality of life for people transitioning into retirement.

TILDA therefore found that the higher the pension income, the better the quality of life in older age. In its research, TILDA defined pension income as income from the State Pension, Occupational Pensions and Private Pensions. It explicitly excluded the lump sum, saying *"As the RR (replacement rate) aims to capture the permanent income, one-off payments from pension lump sums (in first year of retirement) are not included in the calculation of pension income."* While taking a lump sum payment may reduce the pension income available to consumers it is clear that the lump sum is a key part of the retirement benefits and this is evidenced by the fact that most consumers will take the lump sum at the point of retirement.

The Pensions Council proposal is not to reduce the lump sum available to consumers but to give more flexibility in how consumers use same. The Council believes that granting additional flexibility is timely especially now that previous restrictions such as the minimum income requirements on ARFs have been removed, and the risk of high inflation eroding the purchasing power of the lump sum where invested fully in cash deposits.

The State's view on retirement adequacy

The Roadmap for Pensions Reform 2018-2023[6] states that private savings, when combined with the State pension, aim to replace a "sufficient proportion" of a person's pre-retirement earnings so as to enable the person to maintain a reasonable standard of living after retirement. The Roadmap indicates that a "sufficient proportion" is, for example, 50% - 60% of a person's pre-retirement income. The Roadmap goes on to acknowledge that *"a high percentage of the working population is not saving enough, or is not saving at all, for retirement. This in turn will impact negatively on the ability of such people to maintain their desired standard of living".*

[5] https://tilda.tcd.ie/publications/reports/pdf/Report_IncomeAdequacy.pdf
[6] https://www.gov.ie/en/publication/abdb6f-a-roadmap-for-pensions-reform-2018-2023/

The Roadmap pointed to a specific macro-economic risk that arises as a consequence of inadequate retirement saving: *"as pensioners account for a growing proportion of our population, [this will] reduce consumer spending in our economy."* The Roadmap does not reference the lump sum or indicate if/how it is taken into account when identifying the "sufficient proportion" of pre-retirement income.

The retirement challenge

Saving for retirement is a big challenge. Annual contribution requirements to target varying levels of pension at retirement as calculated using the Pensions Authority pension calculator[7] are set out in Table 1.

Age the person starts to save for retirement	Starting Salary	Target Pension at age 66 (inclusive of the State Pension)	Annual contribution required (before tax) as % of salary	Revenue age related limit for tax relief on pension contributions
30	€40,000	60% of salary	21.6%	20%
40	€40,000	60% of salary	33.4%	25%
30	€80,000	60% of salary	34.7%	20%
40	€80,000	60% of salary	53.8%	25%

Table 1: the contributions by age required to target a pension of 60% salary at age 66, inclusive of the State Pension.

As can be seen in Table 1, if you start to save for retirement at age 30, you will need to set aside a minimum of 21.6% of salary every year until age 66 in order to secure an estimated pension of 60% of salary (€24,000 pa in today's money, including the State Pension). If the pension is commuted to provide a lump sum, either the pension pot (and contributions) will have to be higher, or the pension income at retirement will be less than 60%. It is clear that consumers, even with employer support, may not be able to save a sufficient sum due to the need to meet other living expenses, and (to a lesser extent) the Revenue age-related earnings limits on contributions. Having more flexibility to draw down pension benefits may attract more consumers to save or to save more.

Faced with such challenges, the Pensions Council recommends more flexibility for consumers to assist with pension engagement and empowering them to save more.

[7] https://www.pensionsauthority.ie/en/lifecycle/useful-resources/pension-calculator/ The output from this calculator was effective at December 2022. The results will change as assumptions and/or the State Pension changes.

Defined Contribution (DC) saving: Investment risk and reward

Retirement savings vehicles (DC scheme, PRSA, RAC or private pension) typically offer a choice of ways to invest a person's savings before retirement. Life-styling is a popular investment approach in which savings are invested more heavily in higher-risk growth-seeking investments at younger ages and then gradually switched automatically to lower risk, more stable investments as the person nears retirement. The idea behind life-styling is that when a person is younger it is assumed that they can afford to take greater risk in expectation of greater returns. As they approach retirement it is assumed that this appetite for risk reduces and it is therefore more appropriate for a person's retirement savings to be invested more conservatively.

The OECD is in favour of life-styling for pension saving. The *Recommendation of the Council for the Good Design of Defined Contribution Pension Plans*[8], published in 2022[9], says *"life cycle investment strategies can be well suited to encourage members to take on some investment risk when young, and to mitigate the impact of extreme negative outcomes when close to retirement.*"

Life-styling is hugely popular amongst Irish pension savers. In 2020, the Irish Association of Pension Funds (IAPF) carried out a survey of DC schemes[10]. The survey covered 93,000 pension savers and found that 80% (or over 74,000) of these savers were invested in a life-styling approach[11].

The approach taken by some providers and pension schemes who offer life-styling is to target a mixture of cash plus other assets (often a conservative mix of bonds, equities, alternatives, property and cash), the rationale for this approach is usually cited as directing the pension savings into investments funds that best match the benefits that the person is most likely to take on their retirement.

This is an appropriate approach where the person intends to purchase an annuity or set up an Approved Retirement Fund at retirement. However, directing a significant portion (perhaps 25% or more) of the pension pot towards cash may not be appropriate, particularly if there is no immediate use for the cash on the person's retirement date.

The Council investigated the default investment strategies offered by five life assurance companies to understand the types of investment fund they target at retirement age. Of the five companies researched, three offered life-style strategies that targeted at least 25% cash at retirement[12].

[8] https://legalinstruments.oecd.org/en/instruments/OECD-LEGAL-0467%20
[9] The original version was issued in 2012: https://www.oecd.org/finance/private-pensions/50582753.pdf
[10] https://www.iapf.ie/_files/list/DC%20Scheme%20Survey%202020.pdf
[11] Specifically, the IAPF survey found that 80% were invested in the scheme default investment strategy and in all cases, the default was a lifestyling fund.
[12] All information was available on the life companies' websites and accessed on 8 November 2022.

The findings suggest that the "tax-free" lump sum option, available as a one-time only option at the point of retirement may be influencing the investment decisions of providers, pension scheme trustees and ultimately pension savers.

Targeting and accessing cash at the point of retirement can have the following negative effects on pension savers:

- **Lower investment returns pre-retirement**: A life-styling design that, in the run up to retirement, allocates pension savings progressively towards cash in order to target a "tax-free" lump sum can result in lower returns and a smaller pension pot at retirement.
- **Lower investment returns after retirement**: Lump sums are often transferred to bank accounts (see Canada Life Survey), where they earn low (or nil) returns and are at significant risk of being eroded by inflation.
- **Post retirement investment returns subject to tax**: Where the lump sum is put into a bank account, any interest is subject to DIRT (33%). Where the lump sum is invested, the gains are subject to gross roll-up (41%), or capital gains (33%), depending on how it is invested.

Protecting against longevity - OECD recommendation

In its 2022 recommendations, the OECD identified the importance for retirees to have income throughout their retirement. In meeting this objective, the OECD say that "*Flexibility could be provided by allowing for partial, deferred or delayed lifetime income combined with programmed withdrawals. Full lump-sums should be discouraged in general, except for low account balances or extreme circumstances*"

The Pensions Council agrees with the OECD and recommends introducing lump sum flexibility along with the use of ARFs and/or some form of annuitisation rather than full lump sums. This will reduce the risk of consumers exhausting all their retirement benefits prematurely by underestimating their lifespans or knowing they can rely on means tested Government supports at a later time.

Pensions Council discussions

The Council agreed that a well-designed pension system encourages members to join, to save and continue to save (knowing that they are acting in their best interest in the long term), has flexibility, and also inbuilt design features that act in consumer interests.

- **Income in retirement**: The more people save for retirement, the better off they will be when they retire. The TILDA research showed that all aspects of quality of life for retirees increase consistently with household income. The State has suggested a target post-retirement income of 50%-60% of pre-retirement income. This is a formidable challenge. People have to start early and save consistently to achieve this level of retirement income and indeed they may never reach this. Therefore, they should be incentivised by as much flexibility as possible.

- **Tax:** The option to take 25% of the pension pot as a one-off lump sum at retirement is a major life decision. It offers valuable tax benefits, but this option can influence consumers' investment decisions pre- and post-retirement, potentially leading to lower financial returns and quality of life overall.

- **Lump sum vs ARF or annuity:** Consumers may wish to take the lump sum payment rather than use it to purchase an annuity so that they have cash in their estate to leave to family on death rather than using it to purchase an annuity (which will lapse on their death unless they have also purchased a dependent's pension).

- **Longevity**: Most retirees avail of the lump sum at retirement. When taken, the post-retirement pot drops significantly, meaning that retirement income will be much lower. While some people may use the lump sum to "top up" their retirement income, there is no real evidence of this. Some people may give it away or spend it. It can be difficult for a retiree to comprehend that a pot of savings may need to last them maybe 20 years or more.

- **Flexibility:** A flexible approach may protect consumers as it can reduce the risk of overspending, giving the lump sum away or being eroded by inflation if it is put on deposit. The OECD is in favour of flexibility. The Council also observed that a flexible approach would be aligned with the changing nature of the transition from work to retirement. In future, it is much less likely to be an abrupt transition. It is envisaged that future pension reform will allow consumers to work past their normal retirement age under occupational pension schemes or beyond the age at which they will be entitled to draw the State pension. If there was more flexibility as to how they could access the lump sum this would contribute to the more holistic view which will be taken to income in retirement in the future.

The Council considered if introducing flexibility would have additional costs to the consumer, pension providers or the State. On balance, and having investigated it, the Council's view is that the cost to all stakeholders would be nil or minimal. Indeed, it may save the State money if pensioners do not over-spend their lump sum and if pensioners have healthier, happier retirements (ref TILDA research).

The Council discussed and debated the above issues in the context of providing flexibility regarding the drawdown of the lump sum post retirement. The Council agreed that introducing flexibility would give retirees time to make important financial decisions. Pension decisions are shaped by life events and personal preferences including for example, health, spending levels, attitude to investment risk and tax position. Flexibility can allow access to ''rainy-day'' money when needed or be used to help meet retirement income needs as a person ages.

The Pensions Council agreed that allowing flexibility with regard to access to the lump sum at retirement would be in consumers' interests, would encourage people to join, to save and to continue to save for retirement, it could reduce the risk of overspending and give people time to make important decisions and lead to better financial outcomes for retirees. This will result in a pension system that contributes to a resilient and trustworthy financial system, which sustainably serves the needs of the economy and its customers.

Pensions Council proposal

The Pensions Council proposes to give consumers saving for retirement through a DC scheme, PRSA, RAC or private pension more flexibility with regard to how and when they can draw down the lump sum from their pension savings. This would require an amendment to the tax system and would enable pension savers to choose from three options in respect of the tax relief associated with the lump sum at retirement.

These options are expected to be broadly cost neutral from a tax perspective and straightforward to implement by pension providers:

- **Option 1**: Access a lump sum of 25% of the retirement savings at the point of retirement (i.e. the current situation) and take the rest as an approved retirement fund ("ARF") or annuity. No change to the current tax rules is proposed.
- **Option 2**: Instead of taking the full 25% lump sum in one go at retirement, the retirement savings are transferred, in full, to an ARF. The retiree can then take regular drawdowns from the ARF, 25% of the drawdown would be tax free and the balance would be taxed as income (as usual). The ARF imputed distribution (4% or 5% depending on the age of the retiree) would not need to be changed as there is no knock-on reduction in tax for the exchequer.
- **Option 3**: Put the 25% lump sum into a standalone "lump sum ARF" that could be drawn down in part or full, tax free, at any time; put the remainder of the retirement savings into a separate ARF, or use to purchase an annuity. The ARF/annuity would be taxed as income (as usual). Tax rules would need to be updated in relation the "lump sum ARF". This new "lump sum ARF" would benefit from tax-free growth and distributions would be tax free.

Under Options 2 and 3, from a tax perspective, the exchequer would be giving up tax (such as DIRT) on any returns on the lump sum part. Overall, the additional optionality may ultimately save the State money.

Next steps

The Pensions Council proposes to speak with Departmental Officials to provide more details on its proposal or to assist in any way it can.

Appendix: A brief summary of the UK pension system

The UK and Irish systems have moved broadly in tandem over the years, however this has not always been the case. In 2015, the UK took a significant step when it enacted the Pensions Freedom legislation[13]. Prior to this legislation, DC pension savers were restricted in how they could access their benefits; lump sums were restricted to 25% of the pot value and the remaining part could be taken via an annuity or draw-down product (i.e. similar to the Irish situation).

The Pension Freedoms legislation enabled consumers to flexibly access their DC pension savings and use the funds for a wider range of options. Tax liabilities were also reformed. Under Pensions Freedom, consumers with DC pension savings can still take up to 25% of the pension pot as a one-off tax-free lump sum at retirement, however they can also:

1. leave their DC savings untouched;
2. taking the whole DC savings pot;
3. buy an annuity;
4. take out a flexi-access drawdown product;
5. take a series of lump sums – known as uncrystallised funds pension lump sum (UFPLS); or
6. a combination of the above.

The UFPLS is an option through which consumers can access their pension savings in a flexible manner. Under UFPLS, consumers can take partial or full withdrawals of cash from their accumulated pension savings. When making partial withdrawals, 25% of each withdrawal is tax-free, with the remaining 75% of each withdrawal subject to tax.

[13] https://www.gov.uk/government/publications/pension-freedoms-a-qualitative-research-study-of-individuals-decumulation-journeys/pension-freedoms-a-qualitative-research-study-of-individuals-decumulation-journeys