NEST Insight

Liquidity and sidecar savings

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NEST Insight is a research unit set up by NEST Corporation to help understand and address the challenges facing NEST members and the new generation of defined contribution (DC) savers.

NEST Corporation

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With the route to retirement becoming increasingly complicated, Vanguard believes that improving the understanding and accessibility of the UK pension system will be vital in generating practical solutions to the challenges ahead.

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Liquidity and sidecar savings

Auto enrolment is creating a new generation of savers across the UK. Millions of people are building retirement savings, often for the first time, yet many of them have little or no money on hand to protect them from the effects of unexpected financial shocks. An innovative new behavioural approach may offer a solution.

Policy and social context

For some time, policy-makers have promoted initiatives to encourage, on the one hand, liquid short-term savings, and on the other, illiquid retirement savings. These two types of initiative are generally considered and undertaken in isolation, without a clear sense of how they might interact. At best this treats the two timeframes as independent. At worst it suggests that they must be traded off in a zero-sum game, where each competes for a fixed share of an individual's assets.

In the UK, the public policy response to the challenge of encouraging retirement saving is relatively advanced. We offer people a comprehensive system of incentives and regulation to get them to save for retirement and to protect those savings. Recently, this has been strengthened by the introduction of auto enrolment which requires all UK employers by law to enrol their eligible workers into a workplace pension scheme that meets certain standards. This has resulted, so far, in over 8 million people newly saving, or saving more, for their retirement. By almost any measure, the initiative has been a huge success.

By contrast interventions to encourage greater levels of liquid saving have been less comprehensive and the results patchier, especially at lower incomes.

Initiatives include:

- **Financial inclusion**: A focus on financial inclusion has dramatically reduced the number of people defined as 'unbanked', ensuring access to at least basic current account functions for around an additional 1.1 million people as at 2010.[1]
- **Increased tax-free savings allowance**: The introduction of cash and maxi-ISAs, and more recently a general increase in the tax-free savings allowance, has sought to increase access to, and the desirability of, shorter-term and more liquid savings accounts.
- **Offering a credit match on savings:** The Savings Act 2017 introduced a savings credit match for those on lower incomes along similar lines to that tested through the Savings Gateway pilot in the 1990s. The Lifetime ISA which was subsequently launched in April 2017 offers a significant government matching element to a product that has, in part, a nearer-term goal.

[1]Elllison, A., Whyley, C. and Forster, R. (2010). *Realising Banking Inclusion: the achievements and challenges.* London: HM Treasury

In spite of these initiatives to incentivise liquid savings, 26 per cent of working-age adults have no rainy-day savings, and only 42 per cent have £500 or more on hand.[2] This leaves many people at risk of short-term financial shocks which can have a severe impact on their lives.

High-cost and unpredictable one-off expenses such as the breakdown of a household appliance can cause acute short-term financial hardship for people whose disposable income after essentials is low.[3] In addition, financial shocks among low income groups can lead to debt spirals which can cause acute financial stress. Any severe or persistent pressure on liquidity can have significant health effects, which can in turn affect productivity and earning capacity.[4]

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Four in ten workers say money worries have made them feel stressed over the last year.

A quarter (25 per cent) say they have lost sleep over money worries.

One in eight workers report that money worries have affected their ability to concentrate at work.

One in twenty workers (6 per cent) have missed work in the last year due to money worries.[5]

Less dramatically, relatively small-scale financial shocks can still take many months to fully recover from. While we are aware of only limited equivalent evidence in the UK, research in the US suggests that the impact of even relatively small short-term financial shocks can still have an impact on household finances as much as a year later.[6]

[2] Money Advice Service (2016) *UK Financial Capability Strategy for working-age people*. London:Money Advice Service. Department for Work and Pensions (2017) *Family Resources Survey*. London: Department for Work and Pensions
[3]See for instance: Money Advice Service (2016) *UK Financial Capability Strategy for working-age people*. London: Money Advice Service. Packman, C. (2017) *Savings for the Future: Solving the Savings Puzzle for Low Income Households*. London: Toynbee Hall
[4]Money Advice Service, op cit; Chartered Institute of Personnel and Development (2017) *Financial well-being: the employee view*. London: Chartered Institute of Personnel and Development
[5]Social Market Foundation (2016). *Working well: how employers can improve the wellbeing andproductivity of their workforce*. London: Social Market Foundation.
[6]JPMorgan Chase Institute (2017) *Coping with Costs – Big Data on Expense Volatility and Medical Payments*. London: JPMorgan Chase & Co.

Mental accounting

In practice, people's finances are highly interconnected. It is true that people tend to manage their finances in distinct 'jars' for distinct goals, either literally or metaphorically. This is known in the literature as mental accounting.[7] But the goals themselves are not independent and there are clear risks that the breakdown of one can negatively impact others.

When finances are squeezed and an unexpected expenditure is required, cancelling pension contributions is one way to free up cash. In an extreme case, one could imagine for example, a short-term financial shock such as the inability to afford a car repair having dramatic knock-on consequences such as loss of earnings and increased debt.

Because these goals are interconnected, people need to be able to move resources between jars. In practice, where they cannot, the outcomes can often be sub-optimal. In the absence of liquid savings, the most common mechanisms for funding unexpected peaks in consumption or falls in income are borrowing, through credit cards, personal loans or 'payday' loans, or from friends and family or, where possible, reductions in 'essential' spending. All these mechanisms can be sensible parts of an overall financial 'portfolio'[8], but are often at best inefficient. These methods can, for example, result in people simultaneously servicing a high-cost debt while incurring relatively lower offsetting returns on any savings that do exist.

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The interaction between retirement saving and liquid saving

Auto enrolment has extended participation in workplace pensions by more than 8 million people. A significant proportion of these people are those on lower and moderate incomes, who are the most at risk of a lack of liquidity.

NEST's membership has an average income of around £18k, compared to the national median of £24k. Before auto enrolment, the average income among active pension savers was £35k. This throws into sharper relief the mismatch between long- and short-term savings.

[7]Thaler, R. H. (1985) *Mental accounting and consumer choice*. Marketing Science, 4(3), 199-214.
[8]See for instance: Gathergood, J., Guttman-Kenney, B. and Hunt,S. (2015). *How do payday loans affect UK consumers?* United States: The National Bureau of Economic Research.

To add to this, 42.3 per cent of NEST members fall into the Money Advice Service's (MAS) 'squeezed' segment compared to a national average of 24.9 per cent. Amongst other characteristics, this group of people are described by MAS as follows:

- Many are financially insecure, though few recognise the reality of their situation and do not consider themselves in need of help.
- They're unable to cope with unexpected costs, even relatively minor ones, because their monthly budgets have very little 'give' and typically they have nothing in reserve.
- Though some lack discipline to save regularly, many have few or no savings because a large proportion of their household income is directed to the servicing of debts.
- It's also often the case that they can only cope with unforeseen expenses by taking on additional debt.
- They often ignore their money related issues, which if addressed could improve their financial situation. Examples include extravagant behaviour, such as frequently eating expensive takeaways or going out when they cannot really afford to, or ignoring background issues such as large credit card balances and big overdrafts which roll on year after year.[9]

People in this group, and the broader demographic, are starting to build up meaningful savings, yet they still lack the liquidity to manage even relatively small financial shocks and subsequent debt spirals.

This has, on occasion, led to suggestions that the defined contribution (DC) retirement system should be opened up by introducing some element of pre-retirement liquidity. This might perhaps be achieved through hardship withdrawals or a loan facility along similar lines to the US 401k system.

When HM Treasury issued a call for evidence on this topic in 2011 they concluded it should not be pursued. This was predominately because the evidence in support of allowing early access was limited and inconclusive, and there were concerns that doing so would negatively impact retirement outcomes, particularly because of the risk of leakage. At the time of the consultation there were also a number of pension reforms already underway, most notably the implementation of auto enrolment, and the impact of the changes remained to be seen.[10]

However, given the clear need for greater emergency savings in this population, and the build-up of their assets facilitated by auto enrolment, the issue continues to be at the forefront for many.

[9] The Money Advice Service (2016). *The Squeezed Segment*. London: Money Advice Service
[10] HM Treasury (2011) *Early access to pension savings: a summary of responses to the call for evidence*. London: HM Treasury

Although intuitively attractive, allowing people access directly to their retirement pots creates a number of issues:

- Individual DC accounts are investment products which, for most of a working life, should have a relatively high risk exposure. They are not designed to be instantly accessible and seeking to access them in an emergency could lead to very bad value if done at a low point in asset values. If anything, the trend in institutional DC investment is towards greater illiquidity as DC schemes try to mimic some of the strategies employed by successful large defined benefit (DB) plans.
- There's a risk that savers could withdraw an excessive amount of their pension pot pre-retirement, leaving them very little for later life.
- Administering withdrawals from administration systems not designed for the purpose may well introduce significant costs, which could erode the value of what savings are left. If withdrawals are conditional, for example based on hardship, someone has to verify that conditions are met and this adds further cost.
- The tax treatment of pensions is designed to suit deferred consumption, that is, you are taxed at the point you receive the money as income. In an early withdrawals model, where the money has been saved tax-free, some kind of tax payment or penalty would presumably be required on the withdrawal.

Hybrid products

Allowing early access to retirement savings seeks to make a product designed for one purpose instead serve multiple purposes. An alternative is to think about how to create an experience which fits with the customer's psychology and preferences, for example one which feels like a single 'product' but contains within it distinct 'jars' for different purposes. That in turn enables the underlying product design to reflect different purposes in different design treatments. This is the idea behind 'hybrid' financial products, a concept advanced by, among others, the Aspen Institute in the US. They describe hybrid financial products in the following way:

> 'Traditional financial products have typically been designed around single financial functions—borrow, save, pay, transact, invest, or insure. "Integrated" and "hybrid" solutions combine two or more financial functions to enable consumers to address their financial needs as they arise.'

While the description of this category of product is new, the idea itself is not. Offset mortgage and savings products could be thought of as hybrids. In the retirement space, the 'retirement income blueprint' published by NEST in 2015 proposes a hybrid structure for paying income from a DC pension through a product that incorporates invested drawdown, insurance and short-term liquidity functions.

Applying the hybrid concept to emergency and retirement savings

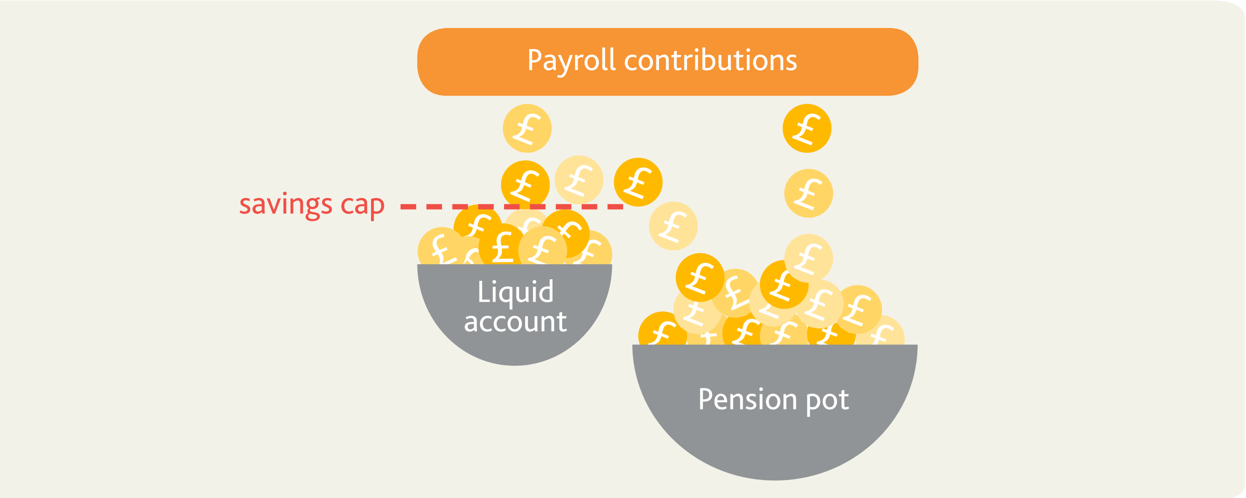
In the US, unlike the UK, people do have pre-retirement access to their DC pension savings, either in the form of hardship or other loans, or complete access at the point of a job move. The consequence of this has been a considerable amount of leakage from the US DC system. Some estimates[11] suggest as much as 40c in every $1 saved leaks from the system pre-retirement.

Researchers at the Behavioural Insight Group at the Harvard Kennedy School in the US have offered[12] an alternative prescription to this early access model but with more of a hybrid-style solution. They present evidence that there is a potentially optimal balance between liquid and illiquid savings, and go on to propose greater integration between these systems. Their proposed mechanism, the 'sidecar' account, builds on the success of auto enrolment by additionally introducing an optimised level of liquid savings.

The sidecar model

In a sidecar structure, contributions would be managed through a mechanism designed to create an optimal level of liquid savings, while also maximising long-term savings. This would be administered as follows:

1. Contributions paid into the combined account structure would at first be distributed between the liquid and illiquid accounts.
2. When the balance in the liquid account reaches a predetermined threshold level, known as the 'savings cap', all contributions would start 'rolling' into the illiquid retirement account.
3. If at any point the saver withdraws funds from the liquid account, and so reduces the balance to a level below the savings cap, future contributions would once again start being divided between the liquid and illiquid accounts.



[11] Bipartisan Policy Center (2016). *Securing our financial future: Report of the commission on retirement security and personal savings*. United States: Bipartisan Policy Centre.
[12] See for instance: Beshears, J., Choi, J., Clayton, C., Harris, C., Laibson, D. and Madrian, B. (2014). *Optimal Illiquidity.* United States: University of California.

Benefits of the sidecar model

This relatively simple mechanism offers a number of potential attractions.

First, it reflects the logic of a hybrid product by recognising that different financial products with different financial goals are likely to have different design features. This model allows a risk-taking investment strategy in the pensions element without the risk of unexpected liquidity requirements, while allowing a more traditional savings or deposit account model for the liquid element.

Secondly, while creating distinct products for retirement and shorter-term liquidity, the sidecar model could mimic a number of the features that have already been proven to help increase retirement savings. Most notably such a product would be offered through payroll deduction in the workplace, leveraging the idea of 'set and forget' to create a persistent flow of contributions to savings.

Thirdly, such a system helps serve the varying needs of different savers. For instance, it caps the level of liquid savings, while maintaining a relatively open-ended rate of retirement contributions. In this way it seeks to generate an appropriate balance of liquidity for each individual saver. The researchers argue that this will enhance the overall financial wellbeing of individual savers, both in the short term and through into retirement. For instance if an individual puts money into a liquid 'rainy day' savings account, and then spends it in the short term, this might lead to a lower retirement account balance than if they'd invested this money into a pension plan. However, if their short-term saving enabled them to avoid a damaging short-term financial shock, avoid costly personal debt, or secure home ownership, the benefits of this short-term saving should continue to be felt right through into retirement.

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And finally, a combined savings structure may also be both more suitable and more attractive to individuals than either short- or long-term savings products on their own.[13] The Aspen Institute's work explicitly points to the potential for hybrid products to aid financial resilience among low income groups because they enable differentiated products to fit more naturally with the financial lives and preferences of individuals than would be the case for several disparate products.[14] Hybrid products might therefore help increase overall savings levels.

[13]This hypothesis will be tested in the qualitative element of the project's formative phase.

[14]Lucas McKay, K. (2017) *Two birds, one stone: using hybrid financial products to manage income volatility.* United States: Aspen Institute

Such an approach is also highly consistent with the behavioural literature in a number of ways. In particular:

- It fits with the idea of mental accounting, with people most comfortable thinking about their finances in distinct goal-based 'pots'.
- As a mechanism for increasing retirement saving specifically, it fits with the logic behind 'auto-escalation' schemes.[15] It makes use of procrastination bias, by allowing people to make a commitment without having to surrender that money straight away.
- It also helps manage short-term bias and hyperbolic discounting. That is, people are likely to be more comfortable saving to cover short-term risks than to cover far-future consumption.

Crucially, such an approach might work better than simply encouraging saving into an existing or standard banking product because of the psychological component of labelling the sidecar account as 'for emergencies'. Workers can be encouraged to leave sums within fully liquid accounts until they are needed to cover genuine financial emergencies. There would be no structural barrier to participants accessing the contents of a sidecar account at any time. So there is the need for an element of self-control if they are to build up and maintain a suitable level of savings to cover future unexpected events. But there are reasons for optimism that this would work in practice. Previous studies[16] have shown how framing sums as emergency savings can significantly impact the extent to which they are drawn upon for non-emergency purposes, even among very low income groups.

[15] Thaler, R. H. and Benartzi, S. (2004). *Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving*. United States: The University of Chicago Press.
[16] Soman,D. and Cheema, A. (2011) *Earmarking and Partitioning: Increasing Saving by Low-Income Households*. Journal of Marketing Research. United States: American Marketing Association.

Challenges and questions

The sidecar concept is attractive in principle, but there are a number of questions about how and whether it might work in practice. For instance:

- Within the UK context, contributions would need to be over and above the default minimum for auto enrolment. Consequently, questions arise about the appropriate and affordable contribution level.
- Equally, auto enrolment into a liquid savings product is not currently legal, and most employers are unlikely to consider it affordable to match over and above what they already do for pension contributions. Given this, it's not clear to what extent workers might be persuaded to enrol voluntarily into a sidecar structure.
- To the extent that people do use the account, could they limit themselves to 'emergency' use of the sidecar account or would it become another current account?
- Would balances reach the savings cap and lead to increased retirement savings?
- Would the availability of the sidecar account lead to more optimal responses to financial emergencies, such as reducing reliance on high-cost debt?

There are also key design questions; most notably:

- How much will people feel able to contribute through deductions from their monthly or weekly pay?
- At what level should the 'savings cap' be set to ensure that it is sufficiently low to be a realistic goal for the saver, whilst also being sufficiently high to provide protection against financial shocks?
- How much control should the individual have over these default levels?
- What happens to the sidecar account when the saver leaves employment with the employer who has given them access to it?

It's essential that these challenges and questions are addressed, in order to judge whether the sidecar approach will realise the benefits suggested by the theoretical work done so far. To understand the behavioural impact of the sidecar account, it will be necessary to conduct further research into the real-world applicability and effect of the approach. This will include measuring its impact on people's savings behaviours, and their wider financial wellbeing.

Testing the sidecar concept

The sidecar approach has the potential to lead to better financial outcomes in retirement for low- and moderate income savers. At NEST Insight we believe there's real merit in testing the concept at scale in an academically robust trial. That's why we're working in partnership with Professor Brigitte Madrian, at Harvard Kennedy School, and the Money Advice Service to construct such a trial. The Harvard team will lead on the technical design of the research study, and on the analysis of the resulting data.

We're currently conducting feasibility and design work and hope to put the trial itself live in the first half of 2018. The trial itself will be run over a two year period, allowing us to measure the impacts of the sidecar account over time. It will be designed to test a range of factors, including:

- take up rates for the liquid account
- levels of savings within the liquid account
- impact on participants' financial well-being.

To run the trial, we intend to partner with a range of employers using NEST and with a provider of a savings product that's suitable to work as a sidecar account.

For each employer, we'll use payroll data and management information from the pension and liquid savings providers to monitor the initial and longer term participation behaviours and savings rates of participants. We'll also track the groups through a series of re-contact surveys over two years. The surveys will include wellbeing measures selected in the stage one research to understand whether their financial wellbeing and likely retirement outcomes differ according to the availability of a liquid account.

In keeping with NEST Insight's overall approach, if we are successful in developing this trial, the results will be made widely and freely available so as to maximise their reach and the potential benefit to all lower income savers. We are also aware that the sidecar idea is just one of a number of approaches to addressing the shorter-term liquidity of savers. We see this as an important issue for the retirement outcomes NEST members face, and so are intending to look at other possible approaches, alongside this one, in our future programme of work.

For further information please contact the NEST Insight unit:
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