



The Actuarial Profession

making financial sense of the future

Consultation response **Workplace Retirement Income Commission**

Call for evidence

April 2011

About the Actuarial Profession

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Shiona Charlery
Workplace Retirement Income Commission
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28 April 2011

Email: wric@wricommission.org.uk

Dear Ms Charlery

WRIC Call for evidence

I am writing on behalf of the Actuarial Profession in response to the Workplace Retirement Income Commission's call for evidence.

The Actuarial Profession represents the members of the Institute and Faculty of Actuaries, the UK based chartered professional body for actuaries. Actuaries work in pensions, insurance healthcare, investment and banking as well as in the management of risk, and so are directly involved in the provision of different sorts of financial products designed to support people in retirement.

We welcome the work of the Commission and would like to offer our support. In addition to our Pensions Practice Executive Committee, we have a number of practitioner and research groups who are actively looking at some of the consumer and provider issues that the Commission is seeking to address. These include:

- **Defined contribution working group**

This group is planning to carry out quantitative and qualitative research with key stakeholders (trustees, providers, advisers, employers and scheme members) to develop an understanding of their views on the following key risk areas: understanding, advice, contributions, employer involvement and engagement, outcomes versus expectations, employee risk attitude, saving versus pension, early access, retirement income shape and longevity.

- **Sleepwalking into retirement working group**

This group is focusing on the fact that people in general have high aspirations for their quality of life in retirement, but are at risk of making significantly inadequate provision for that lifestyle. The role of this group is to develop some further thinking on both sides of this issue and to provide research and ideas to contribute to the debate on saving for retirement.

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- **Consumer information working group**

This group has been formed to explore the information needs of different people at different life stages and how those needs could be better met - focusing in particular on long-term savings and investments. The team is looking at better ways of providing consumers with engaging information, which works with their known behavioural traits, to increase their propensity to save and so narrow the long-term savings gap.

The Actuarial Profession would be very happy to offer, or facilitate, support where appropriate and to share the thinking of some of our members in these groups as the Commission develops its recommendations.

Our responses to some of the questions posed in the consultation are set out in the attached appendix A. Please note that we have not responded to questions where we believe it is appropriate for comments to come from other bodies closer to the issues raised. In our answers we have focussed more on how one might go about dealing with these issues rather than providing specific opinions or predictions at this stage.

We hope you find our comments helpful. We wish the Commission success with its important initiative and we would be very happy to explore with you further our offer to support your work going forward if you wish.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ronnie Bowie', with a stylized flourish at the end.

Ronnie Bowie
President
Institute and Faculty of Actuaries

Question 1: Is this the right assessment of the state of retirement saving provided through the workplace and elsewhere today – any likely future trends?

The overview chapter represents a reasonable view of the state of workplace retirement savings. We suggest that it is important to consider workplace retirement savings within the context of state pension provision. In this regard, the Actuarial Profession welcomes moves to simplify the state system so it is fair, simple, easy to understand and transparent, making it easier for people to make informed decisions about their financial future.

In 2009, the Actuarial Profession published a book entitled *100 years of state pension: learning from the past*. This may also be a useful reference source for the Commission.

The Turner and Hutton reports both contained valuable and, in many ways, consistent analysis. We would encourage the Commission to consider using these as foundations on which to build its thinking. For example, both reports consider the question of “adequacy” and reach similar conclusions which we would argue are helpful.

Solvency II further builds the financial backing which must exist for insured savings products. The work of The Pensions Regulator is building security for members’ benefits in DB pension schemes. Thus, in most circumstances, savers/members’ benefits should be safe (and are covered by substantial safety nets in extreme cases).

As a result, “risk” is increasingly fully priced. However, some believe that this is a mixed blessing. Yes, exiting benefits are more secure, but this may lead to insurers and scheme sponsors becoming increasingly cautious about taking on risk. As a consequence, individuals may be asked to bear or manage their own risks, but currently many may be poorly equipped to do this. Improving the general levels of financial literacy to address this successfully will be a significant challenge.

In this case, the onus in the short term is likely to be on providers and employers to devise products which are sufficiently simple and which are capable of adequate communication so that employees are encouraged to save. To achieve this, employers and providers may need more encouragement from Government to take on this role. As outlined in our covering letter, the Profession, as chartered body acting for the public interest, is contributing on a number of fronts in this regard and we will be happy to provide more details if these would be helpful.

In addition, the Commission may wish to consider how levels of certainty around future tax treatment and the potential impact on eligibility for means tested benefits may affect people’s confidence in the ultimate rewards of saving for retirement.

From the actuarial perspective, we would also make the point that some of the statistics quoted are averages and these rarely tell the full story. It might be helpful to invest some time in understanding the distributions that underlie these averages so that the solutions can be better targeted.

It might also be helpful to consider that the changing shape of the population profile is likely to have an adverse impact on the amount of housing wealth that might be realised to fund retirement in future. The point here is that when the generation that has, arguably, overpaid for housing attempts to downsize, it will be selling to a generation that is likely to contain substantially fewer people, unless immigration increases.

Question 6 Where are the remaining gaps in coverage both in terms of types of worker who will be at risk of undersaving for retirement and sectors of the labour market? What are the potential policy solutions?

To answer this question it might be helpful to define undersaving, and we refer to our response to question 7 for more thoughts on this.

Once each individual (or their employer) has a clear idea of what they require in retirement, they remain at risk of undersaving if:

- they fail to take appropriate steps to implement suitable savings arrangements (whether through pensions or other savings)
- they can't afford to save the required amounts, perhaps because of loss of employment
- they don't have sufficient discipline to continue with saving in the face of competing demands for their money
- they make inappropriate assumptions (about things like future state benefits, private investment returns and longevity expectations)
- they experience unfavourable outcomes (such as investment downturns, future annuity rates or expensive health care needs)
- their estimate of their requirements was too low.

Types of worker could be categorised by socio-economic group, because the gaps in coverage may differ between those groups. We are looking into research on whether savings gaps increase with the progression from socio-economic group A to group E.

One age group that may be at particular risk are those over 40 who still see retirement at 65 as a goal, but have made inadequate provision. The argument might go: "My father paid 6% to his pension scheme for 40 years and he is very well off in retirement. I have put 6% aside therefore..." These people are potentially the most affected undersavers.

We have yet to see the first large group of defined contribution pension scheme members experience at first-hand how much smaller their pensions are for a working lifetime of savings compared to their final salary pensioned elders. This may be a contributing factor behind many workers and their employers not fully understanding the implications of not saving.

There are also those with debts and credit card bills for whom the only sensible policy is to pay off debts rather than save for a pension. But the behavioural economic factors which got them into debt in the past may well counteract future savings initiatives. Most would argue that the question of encouraging retirement saving comes second to encouraging people to live within their means.

It is perhaps also worth making the general point that a strong economy (bringing increased employment) and improving levels of health (bringing the ability for people to continue to be employed) will have an impact on undersaving at a macro level.

Question 7: What level of income should individuals be targeting in retirement?

When considering target income in retirement, it is important to distinguish between needs and aspirations. The Actuarial Profession's 'Sleepwalking into retirement' group is looking into research on how much current retirees actually spend, with the aim of breaking this down into needs and wants. We also note that retirements (sometimes spanning some 30 years or more) also have different phases where expenditure may increase or decrease depending on health and energy levels (early retirement, mid-retirement, late retirement and end of life).

The Pensions Commission proposal of a 45% replacement rate for those at average earnings levels might be enough to allow individuals to maintain what they would consider a basic living standard – for example, being able to retain their current home – but there is a risk that for many it may fall short of their aspirations.

Research (<http://www.yougov.co.uk/pdf/specialisms-financial-case-widows.pdf> page 17) suggests that the average income consumers aspire to in retirement is close to their average income when working, although this is looking more and more unrealistic for most types of worker. We also point out the dangers of relying too much on average figures – as we have said above, an average rarely tells the whole story.

One way forward would be to consider the role of Government to be to help people reach the income which meets their needs and then to educate them on what may be required in addition to meet their aspirations. The combination of the proposed unified state pension and the minimum contribution under automatic enrolment may be argued to address the first question, but more work appears to be required on the education side.

One way of educating people on these long term issues may be to present people with individualised pictures of how life will be in retirement based on their current saving plans and follow this up with setting out how much people might need to save to meet what they want in retirement.

To that end, the Actuarial Profession's 'Sleepwalking into retirement' working group is looking at developing more engaging methods to show people what their retirement will look like based on their current savings levels.

Question 8: Is an 8% total contribution enough to achieve the desired outcomes? If not, what are the potential policy responses and how might these be delivered?

As outlined in our response to question 7, individual savers may have very different requirements in terms of income in retirement.

They also may have very different attitudes to risk, as well as different capacities and desires to work and save as their careers and family lives play out. As a result, a general statement about how much to save as a percentage of current income may not be appropriate.

One alternative way of considering the question might be to look more at the target replacement ratio at retirement. Depending on the level of income, target replacement ratios between 60-100% might be needed, with lower earners being at the higher end.

For savers at the lower end of the earnings spectrum, many might believe that 8% might be sufficient to provide this, taking account of state benefits and assuming contributions over the bulk of the working life.

For the majority of employees, many might consider that it is unlikely that 8% will be enough, especially if individuals are unfortunate in their timing – for example, if they save and retire during a period of low returns and high annuity rates.

It might be helpful for policy responses to focus on sectors where specific problems are occurring. One way to achieve this would be to:

- identify the sectors of the population who are not saving enough to meet the desired outcomes, and
- identify the key barriers to retirement saving for these particular sectors and target specific policy responses/campaigns towards the most significant of these barriers.

Some would argue that the most difficult challenge for public policy is that for some sectors of the population affordability makes saving difficult. A wholesale shift in societal norms may be required to increase the importance of retirement savings in relation to other use of income.

Increasing the total amount saved to more than 8% may help. This may be achievable over a longer time frame using concepts like 'save more later' (for example the Superannuation program in Australia increased employer contributions from 3% in 1992 to the current 9%). However, in the short term, policy makers might expect significant employer resistance. Within the 'Sleepwalking to retirement' working group we are having internal discussions about targeted ideas such as savings warnings on payslips and credit card statements.

Question 13: In saving for retirement, how much risk is it appropriate for the employee to bear, and how much is appropriate for the employer to bear? Could risks be shared differently or more equitably? Does the capacity for risk alter with firm size?

Before answering this question, it may be worth listing what the main risks are in terms of saving for retirement. These include, but are not limited to, the following:

- Longevity and health – risks of people outliving their capital, or high health costs
- Inflation
- Legislation – for example, changes to tax rules, state pension rules, accessibility
- Counterparty and advice risks – people need to be able to trust their product providers and the quality of the advice they are given
- Investment risk and annuity prices

The main concerns relating to transferring these types of risks onto the individual include:

- Individuals cannot benefit from the pooling of risks in the way institutions can. They therefore cannot ride out the rough with the smooth as well as pooled arrangements
- Once retired, individuals have no further access to capital or resources in the way that institutions (employers) might have

- Individuals might not have the skills to manage these risks and might not have access to good advice.

It could be argued that the first two issues above mean that even if individuals did have the skills and advice to make well calculated planning decisions, each individual would have to plan on a 'worst case' basis (allowing a suitable buffer/reserve if he or she ends with one of the worst percentiles) rather than on a 'best estimate' basis that is appropriate for a group that can smooth out experiences over the longer term.