Institute
and Faculty
of Actuaries

DP19/2: Intergenerational differences

IFoA response to the Financial Conduct Authority

01 August 2019

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We strive to act in the public interest by speaking out on issues where actuaries have the expertise to provide analysis and insight on public policy issues. To fulfil the requirements of our Charter, the IFoA maintains a Public Affairs function, which represents the views of the profession to Government, policymakers, regulators and other stakeholders, in order to shape public policy.

Actuarial science is founded on mathematical and statistical techniques used in insurance, pension fund management and investment. Actuaries provide commercial, financial and prudential advice on the management of assets and liabilities, particularly over the long term, and this long term view is reflected in our approach to analysing policy developments. A rigorous examination system, programme of continuous professional development and a professional code of conduct supports high standards and reflects the significant role of the profession in society.

Intergenerational Project
Strategy and Competition Division
Financial Conduct Authority
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1 August 2019

Dear Intergenerational Project Team,

IFoA response to FCA Intergenerational Differences Discussion Paper DP19/2

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the FCA's discussion paper on intergenerational differences. The IFoA sees intergenerational fairness as a key priority for regulators and policymakers and across the financial services sector. It is therefore hugely welcome that the FCA, along with parts of Government, are increasingly looking to view public and regulatory policy decisions through an intergenerational lens. We hope that this discussion paper will help the financial services sector to consider how equitably (or otherwise) its practices currently affect different generations, and some improvements that could be made to help foster intergenerational harmony.

Summary of the IFoA's response

2. The UK's ageing population, coupled with a range of recent policy decisions, have affected the tacit intergenerational contract drawn between different cohorts. Improvements in longevity are meaning that people are spending more years, and a greater proportion of their lives, in retirement. Meanwhile, the ongoing change in the pensions landscape from defined benefit (DB) provision to a model based on defined contribution (DC) has moved the responsibility for managing a range of risks, including longevity risk, from employers and the State to individuals. This is having a disproportionate effect on younger generations, and will mean that the individual contract based pensions market has a greater role than ever before in helping people to achieve a good quality of life as they age by providing good value for money and guiding people through decisions.

3. The true effects of these changes will manifest over time, but the IFoA is concerned about the lack of understanding amongst many DC savers about how much they will need to save for retirement. It is more important than ever that individuals are on a stable financial path early enough in life if they are to experience a level of retirement security close to that offered by a DB pension. This means the pensions industry, along with the Government and regulators have an increasing responsibility to ensure that as far as possible individuals are engaged with their savings at the right time, they and their employers are saving enough, and that the products available to them are appropriate to serve their changing needs.

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4. The ageing population is also increasing demand for social care. A fair settlement for the funding of social care is urgently needed from the Government and, depending on the Government's overarching policy decision, there are a number of ways the financial services sector could help people cater for their care needs. In addition, there are innovations in the existing product market that could help people manage the costs of their care within the current environment, for example through the ongoing growth of the equity release mortgage market.

5. Finally, in the protection and general insurance markets, there are a number of intergenerational elements to the FCA's ongoing work on fair pricing and vulnerable customers. Changing practices and advancing technology have led to different generations experiencing different outcomes from the insurance market. The ability to price risk on a more individualised basis has had an effect on the risk pooling that is a fundamental feature of insurance. This is affecting the ability of some age groups to obtain or afford insurance where they represent a higher risk, as the cross subsidy involved in efficient risk pooling is withdrawn. This trend is likely to be exacerbated by widespread use of genomic data by insurers in future.

6. As with all discussions of intergenerational differences, it is important to note that no one generation is completely homogenous. The FCA and others have identified some clear and demonstrable trends that are affecting different generations in different ways, and merit further exploration. But regulatory and public policy should remain attuned to the differences that exist within generations, as well as those that exist between them, when completing this type of study.

Q1: Are there other factors driving changes in the consumer needs of different generations (in addition to those we have listed in Chapter 3 of this paper) that we should consider? What are these?

7. Technology is another factor that is having a sizable impact on consumer needs, and affecting different generations in subtly different ways. Technology has opened the financial services sector to a number of important innovations in banking, insurance and long-term saving, helping people to manage and engage with products and shop around for those that best meet their needs. It also has the ability improve this further, for example by engaging individuals with their pensions through pensions dashboards. For younger age groups in particular, online and mobile platforms will be the primary way consumers engage with their financial products, and it will be crucial that the industry continues to serve this need in order to maintain its relationships with younger customers. But the increasing use of technology for communication also has the ability to leave vulnerable groups behind, in particular the elderly, and this should be considered as firms attempt to make the most of the opportunities technology represents.

8. Another key driver not mentioned in the discussion paper is the impact that climate change will have on the financial services industry. The changing climate will affect everything from general insurance to pensions through the physical risks it represents, as well as the impact we are already seeing it have on investment practices. Younger and future generations will be more greatly affected by the changing climate as it manifests over time and it is important that their products and investments adapt to the changing physical and financial situation. There is also evidence that younger generations place a greater importance on the issue and, for example, the sustainability of their investments (according to Barclays, Millennials are the

generation most active in impact investing at present)[1], and this may affect the way they choose to purchase and engage with financial services in future. Regulatory policy is already adapting to changing attitudes and placing additional responsibility on financial services to play their role in tackling climate change. It would perhaps be helpful for the FCA to recognise the inherent intergenerational implications of these changes in its work on climate change and green finance.

Q2: Are there other ways in which the factors we have identified as driving changes influence how individuals from across different age groups build up and access wealth?

9. The Discussion Paper rightly points to demographic change as one of the key drivers of change in different generations' financial needs. The increased proportion of older people in the population, increasingly likely to live to advanced ages, will be a huge driver of how people organise their finances, particularly in later life. And for those in younger generations, funding later life necessities and aspirations will need to become a more active process than has been the case for previous generations, with a degree of planning starting much earlier in life.

10. Demand for social care will increase as life expectancy continues to increase while healthy life expectancy rates fail to keep pace. The increased demand for care and increased time spent in care could lead to greater demand for financial products to insure against the associated risks. However, as mentioned in our answer to Q7 this will depend on the outcome of a number of broader policy decisions. Certainty in this area will help to determine how these specific products develop.

11. The Discussion Paper touches on the costs of residential care, but it is also important to consider the costs associated with domiciliary care. This is another area that existing financial products such as equity release mortgages can help individuals to fund.

12. The Discussion Paper also highlights changing labour patterns as a driver of change. The move towards 'portfolio careers' will also have implications for people's pensions as they switch jobs more frequently, and possibly lack the traditional employer-employee relationship upon which automatic enrolment is built. This is likely to affect the number and size of pension pots individuals accumulate and could particularly affect younger generations if this type of employment pattern becomes more common. These people will need help to keep track of a potentially large number of pension pots. We discuss how ongoing initiatives could help to facilitate this in answer to Question 5.

Q3: To what extent are financial services providers currently meeting the changing needs across different age groups? How could innovation in product design help meet changing consumer needs of different age groups?

13. As the population ages, there are a number of ways that individuals can use existing financial products to fund any eventual care needs in later life. The IFoA has explored this in detail in a number of research reports since 2015[2]. We have found that there are a range of both insurance- and savings-based financial products, which already exist in the market, that could be suitable for certain segments of the population, depending on their wealth, assets, risk

[1] Barclays, Investor motivations for impact: A behavioural examination, July 2018, https://www.barclays.co.uk/content/dam/documents/wealth-management/investments/impact-investing-product/investor-motivations-for-impact.pdf

[2] Available at https://www.actuaries.org.uk/news-and-insights/public-affairs-and-policy/ageing-population/social-care

appetite and health. There are a number of demand-side explanations as to why take-up of these products, such as disability-linked or immediate needs annuities, is currently low. Many of these centre around concerns that people do not understand the division of responsibility between themselves and State to meet the costs of their care. As alluded to in Q7, this is an issue probably more appropriately dealt with by Government. However it will be important that if and when demand for these products increases, they continue to be suitable and meet consumer needs.

14. One product where the market is already rapidly growing is equity release. There is a sizeable group of older people on low income for whom moving house would be impractical but for whom a higher income could significantly help improve their day-to-day life and wellbeing – particularly older retirees who live alone and may have current or impending care needs.

15. Equity release products are becoming increasingly popular with those looking to fund their later life. They are increasingly allowing those who have benefitted from high house price inflation to release that accumulated wealth and can be a helpful product for those who need to free up some equity to pay for long term care.

16. A current limitation of these products is funding the care needs of those who have to leave their home to move permanently into a care home. For those receiving care in their own home, the products currently available do not support people to withdraw smaller amounts of equity, in part because of the cost of acquisition for financial advisers. The average commission on an equity release mortgage is around 3.5% with the average amount borrowed £70,000. Finding a way to improve the availability and feasibility of these products for those who want to release lower amounts would make them better able to support more people.

17. Issues around care, housing and inheritance are closely intertwined in this space, and the particularly emotive nature of these issues should be considered as part of the wider conversation about intergenerational transfers of wealth. Research on these emotional factors, in particular from the University of Birmingham,[3] is helpful in going some way to explain the way consumers interact with products. The decline in home ownership amongst younger generations, if sustained into later life, is also likely to have an effect on how these trends evolve in future.

18. In addition to these products, the pension reforms of 2015 have the potential to influence how people pay for their care. On one hand the freedoms enabled individuals with DC pension pots the flexibility to access money from their pension to help pay for social care. However, whilst it is too soon to know the impact of the reforms, policymakers should be alive to the risk that the 'Freedom and Choice' agenda could in fact create a greater burden on the social care system, particularly if individuals draw down their pension pot too quickly, make poor investment decisions or underestimate their need for care later. It will then fall to younger generations to pick up the bill for State-funded care for this group of people. They are also likely to experience a quality of care that is poorer than they might expect.

19. This is one of the many reasons why innovations in the DC market in particular will become increasingly important as the pensions and long-term care markets are likely to become increasingly intertwined in future. The efficiency of the DC decumulation market will be

[3] Overton et al., *Thinking Home: Interdisciplinary Dialogues*, The emotional dimension of trading on home in later life: Experiences of shame, guilt and pride (2018), https://research.birmingham.ac.uk/portal/en/publications/the-emotional-dimension-of-trading-on-home-in-later-life(2908cdb3-9520-4184-8dda-5526f5ec8528).html

crucial as those from younger generations, many of whom will rely solely on DC arrangements to fund their retirement, age.

Q4: Are there any barriers (including FCA regulatory barriers or barriers to competition) that are adversely affecting access to, and use of, financial products that would meet new and changing consumer needs? Are these affecting particular age groups? If so, in what way? How should we address these while ensuring consumers still receive an appropriate degree of protection?

20. When it comes to products to help individuals fund their social care, general awareness and access to advice are two of the main barriers to consumers. The whole system of social care funding is extremely complicated, and this is a barrier to people even seeking information on products that could be highly valuable to them. Once people do seek out information or pay for advice, what they find is ever more complexity and the obstacles can quickly put people off exploring further. In addition because there are only a very small number of qualified advisers in the market, the cost of this specialist advice is also prohibitively high for many. Solving these problems would again rely on awareness-raising amongst the general public, and better, simpler guidance on existing products is needed for those who would not naturally seek paid-for financial advice.

21. Elsewhere, in the pensions industry, the barriers to providers creating new drawdown and annuity pathways are well documented and the FCA noted in its Retirement Outcomes Review final report that it would give the retirement market time to develop before taking action on DC product innovation. Issues around the definition of personal recommendation continue to cloud this space, making it risky for the industry to be truly innovative in the area of DC drawdown pathways.

22. As with the various other pensions issues mentioned, barriers to innovation in the DC market will disproportionately affect younger generations who will rely more intensely on their DC savings to fund their retirement in the absence of more valuable DB benefits enjoyed by some members of older generations. More generally, the decline in popularity of annuity products is a concern, as they represent an effective way to manage longevity risk, which will become more important for DC savers. Better education will be needed in order to highlight the issue of longevity risk, and the valuable role that an annuity can play in managing this. Innovation in design of annuities would also be very welcome, for example allowing equity based annuity products that provide longevity risk sharing whilst at the same time providing access to equity investment opportunities, or an increase in pathways that have an element of deferred annuitisation.

23. Conversely, the IFoA remains extremely concerned about the high uptake of DB to DC pensions transfers and the ongoing need to heighten risk warnings about longevity and investment risk in a DC environment. These issues are affecting those retiring today and it is important that these individuals are supported to make the most appropriate decision for their circumstances.

24. In the protection market, the Discussion Paper is rightly concerned about low take-up amongst mortgage holders of lifestyle protection insurances - notably for critical illness (only 29%) and income protection (19%). There is an argument that this low take-up has occurred in response to new rules introduced around point of sale designed to counter mis-selling in the wake of the PPI scandal. Whilst these were undoubtedly mis-sold by intermediaries, the underlying product was, for the right customer, often a suitable and helpful one.

25. From an intergenerational perspective, the low take up-of lifestyle protection insurances is likely to affect disproportionately the younger generations, as most Baby Boomers and some of those in Generation X will by now have paid off their mortgages. The younger groups will tend to have much larger mortgages than previous generations did, and are therefore likely to be more exposed to sudden losses of income. This is exacerbated by the move away from traditional employments to contract environments.

Q5: Is there anything more that we could do to encourage and enable positive innovation in these sectors, or to enhance competition in the interests of consumers?

26. Anything the FCA can do to help foster trust in and engagement with the pensions sector will be of use and increasingly important as those approaching retirement as well as younger pension savers are forced to take more active responsibility for managing their retirement income. The ongoing policy initiatives to create pensions dashboards and to simplify annual statements look set to help in this endeavour. They should make individuals more aware of their saving situation, with information about their pensions more accessible and easier to understand. If accompanied by guidance and tools, they should ultimately act as a nudge to get people saving more. Both will have regulatory implications as their final forms develop and it will be important for the FCA to remain involved in shaping an appropriate regulatory framework in which these initiatives flourish whilst ensuring consumers remain protected.

27. On protection insurance, the FCA could, as the deadline for PPI claims passes, reengage with the industry to consider how to encourage younger mortgage holders to purchase proper protection to cover them in the event that they are unable to meet their repayments.

Q6: Is there any market or firm behaviour that causes or may cause potential harm to consumers? For example, is industry failing to recognise varying needs of consumers from different age groups and as a consequence, of this:

a: offering products which may be unsuitable to certain age groups

28. In the pensions market, one concern is the introduction of the Lifetime ISA as a means to save for later life. It is clear that these products are beneficial to (and popular with) younger adults attempting to get onto the housing ladder for the first time and have potential to attract younger consumers to save for the future. They could also be a useful savings vehicle for the growing proportion of self-employed. According to the ONS, the most rapid growth in the self-employed population is with over 65s, with those aged 16-24 a close second. For this younger age group, the Lifetime ISA could have the dual effect of helping with a house purchase, and encouraging saving for later life.

29. There are a number of risks posed by the Lifetime ISA in its current form when compared to traditional workplace or private pension saving. For those who are employed, the misconception that an ISA product in its current form could replace pensions saving is potentially unhelpful, particularly in an environment where working-age generations will be much more reliant on what they have saved throughout life to fund their retirement. Those saving into a Lifetime ISA will miss out on employer contributions and possibly the investment returns which make pensions saving attractive. The charges on these products are also high and likely to be misunderstood. Allowing employer contributions to these vehicles whilst keeping them long-term in nature could help to make them a more robust product. It would be helpful for consumers to have access to alternative products that can compete with the effectiveness of traditional pensions, without tying them to the pension ‘brand’ which resonates less well with younger savers.

b: excluding, discriminating against, or failing to advance equal opportunity between certain age groups for no legitimate and objectively justifiable commercial reason (or where the reason is potentially legitimate but the approach is not proportionate)

30. As the FCA will have probably encountered through its ongoing projects on fair pricing in financial services, there are some intergenerational issues with the potential to be exacerbated by the insurance industry's shift towards more risk-based pricing. The ability to carry out more detailed risk assessments is eroding the level of risk pooling, meaning young drivers for example, pay more for their motor insurance than older drivers, as the insurer is able to price their risk on a more granular level. Similarly, in the travel insurance market, the FCA is currently considering how this phenomenon affects older travellers' ability to obtain travel insurance. This industry-wide move towards ever more micro-segmentation of risk is also creating ever larger uninsurable pools, whether caused by inherent risk factors (e.g. age) or by poor claims experience at the individual level within those pools.

31. Examination by the FCA (possibly through the ongoing fair pricing review) of the impact of micro-segmentation of risks and their impact on young drivers, in a similar way to ongoing wok on older people trying to obtain travel insurance, could be a useful step towards tackling this issue.

32. Conversely, in the household insurance market (where the perception remains that switching providers is harder than in for example the motor insurance market) older policyholders are often the perhaps unintended victims of insurance unfairness. Policies auto-renewed year-on-year attract automatic price increases that are usually discounted for new customers. As the "older" policies are by definition usually held by older (perhaps less tech-savvy) policyholders, it is this group that ends up cross-subsidising the heavy new-business discounts offered to newcomers. There is perhaps an argument pointing to intergenerational unfairness of existing customers subsidising new customers that should be considered alongside the other issues in the fair pricing review.

33. Commercial motivations for providers have changed over the decades. The move away from front-end loaded contracts to fund-based contracts means that providers and advisers now focus on those individuals with greatest accrued funds, typically those later in life. Previously, front-end loaded charges meant that it was economic for providers and advisers to support younger generations. Thus, Baby Boomers have enjoyed more access to financial services throughout their lifetimes than have subsequent generations. Whilst we don't advocate a return to front-end loaded contracts, policymakers should be aware of this impact.

Q7: Are there areas related to intergenerational issues which fall more appropriately to Government or another public body, but in which, in accordance with our objectives, we can play a role? If so, which ones and in what way?

34. The Government needs to find a workable funding solution for social care which ensures the public are aware of and understand their responsibilities, and the role of the State. This clarity will be crucial if people are to plan effectively and utilise the financial products available to them to fund their care. Certainty around the regime and funding settlement will also be important to help products in the market to develop. For example, the Government could act to insure the 'tail risk' of catastrophic care costs by introducing a cap on care costs, to allow

for a solution that help to pool people's risk effectively. This is an obvious area where the insurance industry can add value in debates about this and other highly uncertain but potentially catastrophic risks. A care cap is just one of a myriad of ideas currently being discussed, but there is an overarching need for a clearer division of responsibility between individual and state, regardless of the eventual policy outcome.

35. In the pensions and retirement landscape, the Government should continue with ongoing initiatives to engage the self-employed, and those with non-traditional working practices with pensions saving. This exercise should recognise the increasingly fluid nature of work and transitions from work to retirement. The Lifetime ISA is an attempt to respond and cater to the competing financial demands faced by Millennials and demand for products that do this is likely to grow as these pressures become more embedded. Singapore's Central Provident Fund is an emerging example of how these systems might develop, as the Fund is simultaneously available to finance retirement, healthcare and housing needs[4].

36. Elsewhere in DC pensions, ongoing initiatives around default guidance, default decumulation pathways (including the possible entrance of NEST into the decumulation space), and pensions tax reform will all need to be tackled in the coming years. The FCA can support these efforts by ensuring that the creation of any products that support this lifetime approach to saving offer suitable protections and meet the needs of savers across all generations.
37. Finally, progress is being made by the Government and regulators on tackling climate change, but more must be done to ensure the transition to a low carbon economy does not unduly affect any generation, of the cohorts alive today or those not yet born, by whom the effects of the changing climate will be most keenly felt.

Should you want to discuss any of the points raised please contact Catherine Burtle, Senior Policy Analyst (catherine.burtle@actuaries.org.uk / 0207 632 1471) in the first instance.

Yours sincerely,

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[4] https://www.cpf.gov.sg/Members/AboutUs/about-us-info/cpf-overview