Institute
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Household finances: income, saving and debt inquiry

IFoA response to Treasury Committee

22 December 2017

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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.

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Rt Hon Nicky Morgan MP
Chair of the Treasury Committee
House of Commons
London
SW1A 0PW

22 December 2017

Dear Ms Morgan

IFoA response to Household finances: income, saving and debt inquiry

The Institute and Faculty of Actuaries (IFoA) welcomes the Committee's inquiry into household finances. Members of the IFoA who work in pension funds and annuity providers have been involved in drafting this response. As such our response focuses on household saving and pension provision. We have provided a answers to a selection of questions where our membership has direct expertise.

- **What is the "right" level of saving for households and the UK economy more widely, in view of prevailing and potential future economic conditions?**

Recent pension reforms, such as automatic enrolment and the pension freedoms, signal a fundamental change in policy. AE has increased the number of people saving into an occupational pension and the freedoms give individuals greater flexibility to manage their pension savings to fit their personal circumstance. This however is not without risk.

The type of pensions that people hold has also changed. Previously, people had Defined Benefit (DB) pension arrangements, these guarantee, providing employer solvency, an employee a pre-agreed income in retirement for the rest of their lives. Whereas many of today's and future retirees have an increasing proportion of their pension in Defined Contribution (DC) arrangements. This has transferred inflation, investment and longevity risk away from the employer to the individual.

In assessing what is the 'right' level of pension saving for households, it is important that we understand the impact of these changes on whether individuals will have an adequate income throughout the duration of their lifetime. What one person might consider an adequate retirement income might not be adequate for another.

One way that we have suggested in order to measure whether individuals are saving "right" amount is to have a Bronze, Silver and Gold rating to help provide a framework for people to assess their readiness for retirement. To achieve Bronze, the individual would need to be able to meet all of their necessary outgoings. To achieve Silver and Gold, the individual would have sufficient savings to be able to afford additional non-essential items, or have enough savings to protect them against an unforeseen cost, such as if they experience ill health.

We suggested linking the Bronze level to the Joseph Rowntree Foundation's work on Minimum Income Standards.[1] This is a benchmark of income adequacy based on its analysis of what the public consider necessary for a minimum acceptable living standard and is calculated by specifying baskets of goods and services required by different types of households in order to meet these needs and to participate in society. It covers more than basic survival, but does only cover necessities and not luxuries.

We would expect that the State Pension should provide a minimum income standard for those reaching retirement, and our analysis has shown that for an average UK citizen, the State Pension at its current level provides just above this.[2]

We would also highlight the inadequate level of funds being set aside for shorter term household savings intended for other needs besides retirement. We believe that protection products play a vital role to fill the gap in household savings in the event of illness.

The question also asks what is the 'right' level of saving for the good of the UK economy as a whole. This question is linked to the issue of whether savings are being channelled by institutions like pension funds and insurance companies into appropriate long-term investments. The IFoA participated in the Bank of England's Working Group on Procyclicality, which published a report[3] in 2014 that highlighted evidence of procyclical investment behaviour by insurance companies and possibly also by pension funds. Procyclicality refers, in the long term, to a tendency by institutions to invest in line with economic cycles, so that the willingness to bear risk diminishes in periods of stress and increases in upturns.

The Working Group's report argued that policy on long term savings issues needs to give as much priority to financial stability as it does to policyholder protection. We convened an expert panel[4] on the report chaired by Stephanie Flanders, which highlighted a marked decline in the willingness of pension funds and insurance companies to take on investment risk, with much lower equity holdings in recent years.

- **What policies could support households in achieving appropriate levels of saving? Are current policy interventions (e.g. ISAs) well targeted?**

Automatic enrolment has been incredibly successful to date with almost 7 million workers enrolled in a workplace pension scheme since its implementation.[5] This will undoubtedly have a positive effect on the long term savings of the majority, with more people than ever saving something towards their retirement. However, contribution rates at their current levels are unlikely to be high enough to provide a sufficient income for life for many individuals, and there is a risk that people are unknowingly heading towards inadequate retirement provision.

However, opportunities remain for changes to AE that would remove complexity from the system and address concerns regarding fairness. We suggest that adequacy could be improved by removing the age criteria in automatic enrolment (only those aged between 22 and SPa are eligible). Employers

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[1] Joseph Rowntree Foundation, A Minimum Income Standard for the UK in 2015, 2015

[2] Using the Joseph Rowntree Foundation's calculator a single pensioner living in an urban location outside of London would need £7,740 per year to meet the minimum income standard – this is very similar to the amount a pensioner receiving the full New State Pension would receive per annum, in fact if they do have full entitlement they would receive above the amount needed to meet their minimum income standard from their state pension alone.

[3] Procyclicality and structural trends in investment allocation by insurance companies and pension funds: A Discussion Paper by the Bank of England and the Procyclicality Working Group

[4] https://www.actuaries.org.uk/news-and-insights/media-centre/media-releases-and-statements/what-procyclicality

[5] Department of Work and Pensions, Automatic Enrolment evaluation report 2016, December 2016, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/576227/automatic-enrolment-evaluation-report-2016.pdf

could also be encouraged to reward individuals who are saving over the minimum contribution rate in some way. We also suggest that introducing a method of auto-escalation, such as the 'Save for Tomorrow' scheme used in the USA would help to further harness the innate behavioural biases that have helped to make automatic enrolment a success. This scheme encourages savers to commit to increasing their contribution rate when they reach some future event such as a pay rise, making the change to their take-home pay less noticeable.

We are supportive of initiatives that encourage people to save more for their retirement, and were encouraged by the Government's attempt to grapple with this problem, particularly amongst younger generations and the self-employed by introducing the Lifetime ISA (LISA). However we argued at the time of introduction how important it was that any new initiative truly strengthens the overall retirement savings framework.

The aim of the LISA policy is to encourage people to save for the long term but offer a degree of flexibility of access, with the account balance and Government bonus withdrawable before 55 for a first home purchase. However the charges for early withdrawal of any other kind are punitive and the Financial Conduct Authority expressed concern earlier this year about how well investors would understand what the 25% early withdrawal charge actually means.[6] It is easy to see how gaining a 25% government bonus and then being charged 25% on early withdrawal could be misinterpreted as leaving the saver with the same amount of money deposited. In fact, it represents a 6.25% charge, on top of the loss of any bonus or investment returns.

Although the industry offering of new LISA products has been small, with only four providers of stocks and shares versions, and just one cash ISA on the market to date, early reports suggest that they are popular with budding first-time buyers. Of the 42,000 cash products opened at Skipton Building Society between June and October 2017, 83% of customers said they did so in order to buy a first home.

Clearly the LISA could provide valuable help for those hoping to get onto the property ladder, a potentially valuable asset for their future, it is vital that the introduction of the LISA does not undermine the success of automatic enrolment in increasing the number of people saving into occupational pensions. Those foregoing pension saving to save into a LISA would also be foregoing the range of additional benefits associated with occupational pensions. The role of the employer, which separates the LISA from traditional pension saving, is crucial. Not only can the employer contribute a significant monetary amount to an employee's pension pot, which they would miss out on if opting for ISA saving instead, but employers are also as a trusted source of information about their pension.

There are also tax implications for those opting for the LISA compared to occupational pensions. The IFoA has completed analysis of the tax treatment of the various types of saving which found that the employer contribution to a pension is the most tax efficient means of saving for retirement. However once the employee has saved the minimum necessary to secure their employer's contribution, the pension only remains the most tax efficient vehicle if there is a chance that the employee will transition from a higher to basic tax payer between work and retirement (i.e. if they pay a high tax rate on their income in employment, but receive tax relief on their pension income at the basic rate

[6]Financial Times, *Watchdog warns over Lifetime Isa exit charges*, 7 March 2017, https://www.ft.com/content/fb1929c8-032b-11e7-ace0-1ce02ef0def9

because the income they draw from their pension falls below the higher rate band). Otherwise, the LISA is the more tax efficient savings vehicle.[7]

- **What role can and should the state pension and triple lock have in supporting lifetime household finances?**

As we have demonstrated above, the State Pension is an important safety net and has a crucial role to play in ensuring that those reaching retirement can have an acceptable basic standard of living. Therefore it is crucial that this safety net is not undermined by policy change.

The IFoA has consistently argued that the State Pension 'triple lock' is unnecessary if the rate of the new State Pension, a policy aimed at creating an affordable and sustainable system over the long term, has been properly set. As we know, this policy has been one factor which has helped pensioner incomes to increase at a quicker rate than those of the working age population. Whilst the policy was clearly well-intentioned, and its success in helping to reduce the rate of pensioner poverty should be celebrated, the increase in benefits of at least 2.5% pa is out of kilter with the pay increases seen by those in work and has implications for intergenerational fairness. We suggest that 2.5% is an arbitrary figure and not in keeping with the rate of earnings increase amongst the rest of the population. It is important that pensioners are not left behind with a stagnant State Pension whilst the cost of living rises, but linking the uprating more closely to the actual experience of the rest of the population would be a more intergenerationally fair way to do this.

The importance of the State Pension means that its sustainability and affordability will be key to ensuring that future generations benefit from the same level of security that current generations experience. We are already seeing a level of pessimism amongst younger generations in their expectations of the State Pension. A recent survey report from the IFoA suggested that many UK respondents (compared with those from the USA and Australia) expect to rely on the State Pension for their retirement, and were least likely to have other savings set aside for retirement. However, only 53% of the youngest cohorts of respondents expected to receive some form of State Pension, compared to 81% of the oldest respondent group.[8]

Clearly the collapse of any Pay As You Go system such as the State Pension would be justifiably lamented by anyone who has paid in but not seen any benefit, and would be a prime example of intergenerational *un*fairness. As such anything that undermines the affordability and sustainability of the State Pension should be discouraged. Evidence from both John Cridland's review of State Pension age[9] and the Work and Pensions Select Committee's review of intergenerational fairness[10] suggest that the triple lock is increasing State Pension expenditure as a share of national income and is unsustainable over the long term.

In order for the State Pension to continue to fulfil this important function we recommend that it should be set at a pre-agreed minimum income standard and regularly reviewed against this.

- **Are retiring households receiving adequate and appropriate financial advice following the implementation of pension freedoms?**

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[7] IFoA response to Work and Pensions Select Committee on Automatic Enrolment and the Lifetime ISA, https://www.actuaries.org.uk/documents/04-18-ifoa-response-work-and-pensions-select-committee-inquiry-auto-enrolment-and-lifetime-isa

[8] IFoA Policy Briefing: Retirement Readiness Survey Report from Australia, the United Kingdom & the United States, October 2017 - https://www.actuaries.org.uk/documents/policy-briefing-retirement-readiness-survey-report-australia-united-kingdom-united-states

[9] Department of Work and Pensions, State Pension age review: final report, July 2017

[10] Work and Pensions Committee, Intergenerational fairness inquiry Committee Report, November 2016

Within the new pension 'freedom and choice' environment, there is a need to recognise that decision making is likely to increase in complexity for more people. Such decision making will require a framework of information and advice that meets individuals' needs.

The flexibility in the use of pension assets is also likely to bring into sharper focus the ways in which people will use other assets in meeting retirement needs. Having complete information that allows individuals to make better decisions using all assets will become more important. The advice framework will need to be easily accessible where individuals have already made full use of the general information services that are available.

The changes to pension legislation have meant that fewer people are buying annuities at the point of retirement. Indeed, initial experience would indicate that there has been an increase in the use of drawdown products at retirement. Consequently, many decisions taken to extinguish pension assets (e.g. buy an annuity) will be at older ages (than historically has been the case) when assets may also be required for social care. It is possible that, beyond a certain age, individuals will be less capable in making complex decisions, or could be subject to more intense pressure to take specific decisions that may not be in their best interests.

Some older clients may face challenges in proving their identities and may face challenges in clearing money laundering rules. Older clients may also effect transactions that may be subject to scrutiny if hindsight suggested alternative outcomes could have been better.

We are also aware, from the experience of members who have been involved with bringing new care protection products to market in recent years, that there is a shortage of financial advisers who are either qualified or prepared to talk about social care needs with customers. We therefore believe that adviser education is as important as consumer education here.

There is a perception that financial advice is expensive for all, even though many people will take up advice in other areas of life (e.g. legal advice) without consideration of the cost. Challenging that perception would be helpful in increasing the take up of financial advice. Such encouragement may lead to more people confronting financial challenges by obtaining advice rather than deferring decision making until it is too late to find a solution.

Should you want to discuss any of the points raised please contact Catherine Burtle, Policy Analyst (catherine.burtle@actuaries.org.uk / 020 7632 1471) in the first instance.

Yours sincerely,

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Immediate Past President, Institute and Faculty of Actuaries