

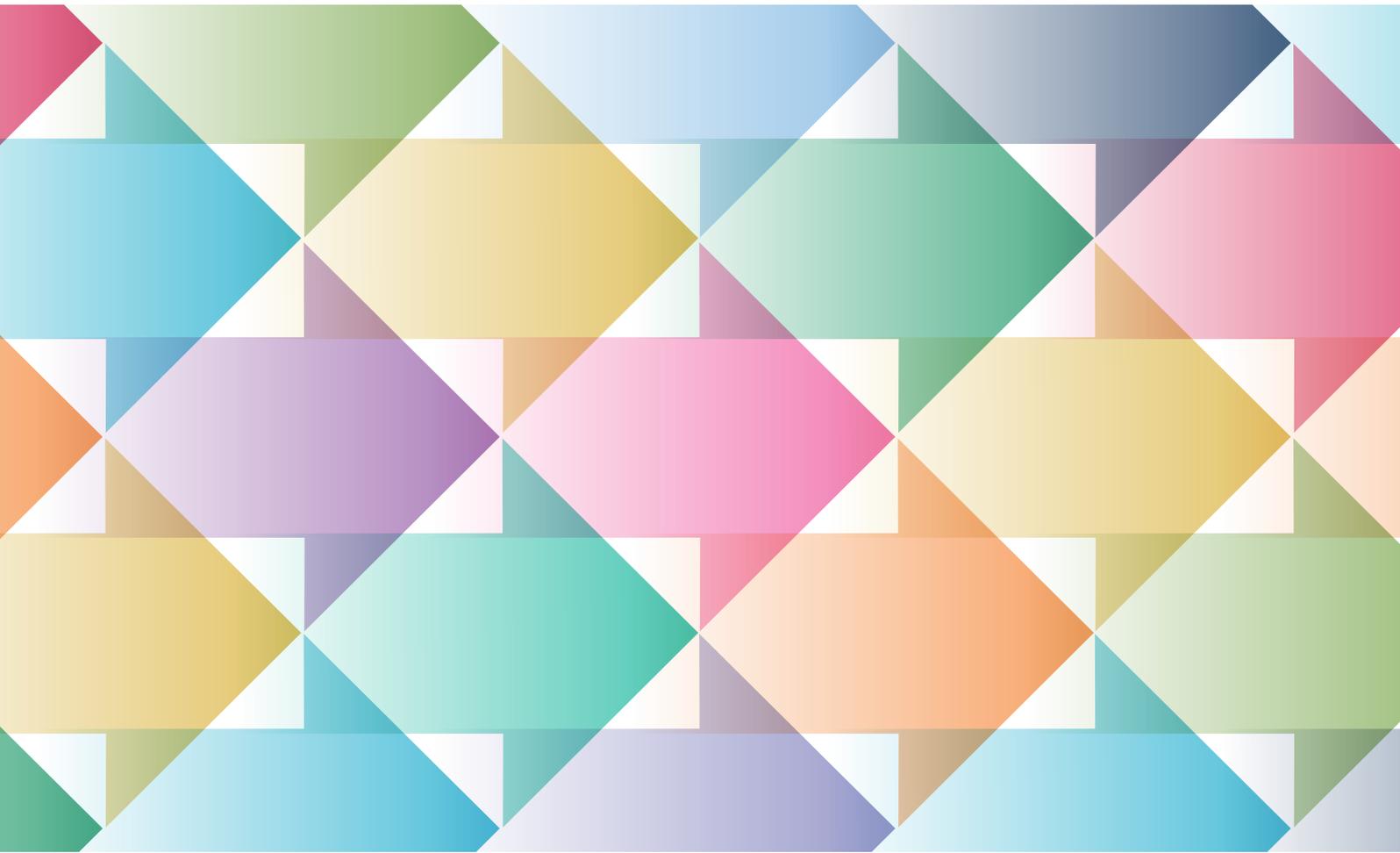


Institute  
and Faculty  
of Actuaries

# THE RISK

# GREAT TRANSFER

Campaign recommendations



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# Background

## Goals

The Institute and Faculty of Actuaries (IFoA) is a royal chartered, not-for-profit, professional body. We represent and regulate over 32,000 actuaries worldwide, and oversee their education at all stages of qualification and development throughout their careers. Our members work in many areas of finance, with a focus on the understanding of risk and uncertainty and helping members of society to manage their risks in order to assist them in leading better and less uncertain lives.

Since the start of 2020 the IFoA has been campaigning on what we have termed 'the Great Risk Transfer' (GRT). We have been exploring a trend to transfer risks from institutions – such as employers, the state and financial services providers – to individuals. Our work suggests that the causes of this trend are complex, covering a variety of factors from increasing longevity to technological advances, the low interest-rate environment and changes in financial regulation. Policymakers would certainly benefit from a deeper understanding of these factors and their interactions, but that will take time. Meanwhile, we believe there is an urgent need for practical solutions, exacerbated by the pandemic, as individuals are confronted by the need to manage risks they did not have to worry about previously.

Prominent examples of the GRT trend include the steady shift from defined benefit (DB) to defined contribution (DC) pensions and from annuities to drawdown, fewer investment products with guarantees, and insurance products that are increasingly priced based on the risk profiles of individuals as opposed to groups.

The IFoA's close professional involvement with these markets and products led us to make the educated hypothesis that these disparate examples of risk transfer might be linked. But we have gone further. Driven by our Royal Charter duty to promote the public interest, we have planned and implemented a wide-ranging campaign to investigate the GRT and, in particular, to highlight its potential negative impacts (recognising there are positive ones also).

The key goals of the campaign are:

- 1. To gather and share evidence about the GRT and its impacts across society**
- 2. To bring stakeholders together to debate that evidence and potential actions that can be taken to address the trend**
- 3. To propose recommendations for action, and to work with stakeholders, including government and regulators, to drive actions that will have a positive impact in the public interest.**

We note that sustainability risks, covering the impact on climate, environment and society, can also be considered as part of a long-term risk transfer. However, this is a topic in its own right and within our GRT campaign we focused on the goals above and transfer of societal risks within the financial services sector.



The Great Risk Transfer campaign focuses on changing the financial system to make it work better for consumers and society, which we believe is generally more pragmatic than attempting to force changes in consumer behaviours.

## Evidence and insights

Between February and May 2020 we ran a call for evidence, collecting around 50 submissions and consulting with many stakeholders. Our *Interim campaign report*,<sup>1</sup> published in July 2020, brought this evidence together and looked in turn at examples of risk transfer, its causes, its impacts, and some potential solutions.

Our call for evidence was international in scope and generated a number of interesting and relevant examples of risk transfer, from retirement provision in India to the life insurance market in Singapore. However, the majority of the evidence, both in breadth and depth, came from the UK. This informed our subsequent roundtable sessions and the recommendations made in this report. The theme of risk transfer from institutions to individuals, though, is pertinent across many parts of the world, and we hope that this report will inform discussions outside the UK about how to develop policy recommendations appropriate to other countries.

In September 2020 we ran roundtable sessions with IFoA members and stakeholders, focusing on the key themes of insurance, pensions and employment. Participating organisations included the Trades Union Congress (TUC), Pensions Policy Institute (PPI), Money and Pensions Service (MaPS), the Pensions and Lifetime Savings Association (PLSA), the Association of British Insurers (ABI), the Chartered Insurance Institute (CII), National Numeracy (NN) and Fair by Design (FBD). The aim of these roundtables was to analyse the evidence we had gathered and develop the suggested solutions into practical recommendations.

We refined our initial recommendations in subsequent discussions with IFoA members. We identified some key criteria that the recommendations should satisfy to meet the overall campaign goals:

1. **We are focused on making a difference** – so the recommendations should offer a realistic chance of having a meaningful impact on policy, regulation or other practical solutions over the medium term.
2. **Actuaries have highly relevant experience and skills to inform the GRT campaign** – so the recommendations should focus on those areas of expertise.
3. **The IFoA's core strengths lie in analysing financial systems and products** – so the recommendations should focus on changing aspects of the financial / legal / regulatory system to make it work better overall for consumers.

## Our recommendations

The recommendations in this report reflect the diversity of the stakeholders that the IFoA has consulted with on the Great Risk Transfer over the course of 2020, the wide-ranging nature of the discussions we have convened, and the breadth of areas relevant to the subject of risk transfer. While it is not possible to capture every nuance of those conversations, we have identified two broad themes that capture our key policy recommendations. These are:

- **Rebalancing risks** – We think there are opportunities to ease the burden for consumers in trying to manage complex risks by shifting the prime responsibility for certain risks back towards institutions. The mechanism for achieving this is structural changes to markets, products/services, and the legal/regulatory frameworks that shape them.
- **Helping consumers manage financial risk through good decision-making** – We believe a key driver for new products and services should be to help consumers with the complex decisions involved in managing financial risks effectively and affordably. This could dramatically improve outcomes for many people – and for society as a whole.

We believe there is an urgent need for practical solutions, exacerbated by the pandemic, as individuals are confronted by the need to manage risks they did not have to worry about previously.

1 | <https://www.actuaries.org.uk/system/files/field/document/Great%20Risk%20Transfer%20Interim%20Campaign%20Report%20FINAL.pdf>

## Summary of recommendations

Section title	Recommendation
<b>Rebalancing risks</b>	
CDC schemes	We are seeking government action to show employers that CDC is an attractive alternative to DC schemes, and to address concerns employers may have, such as regulatory burdens and costs.
Decumulation pathways	We recommend that the government consider the introduction of default decumulation pathways as an option for all, and as a safety net for savers who cannot or will not engage with the decumulation process when entering retirement. Ideally this would cover not only contract-based pension schemes, but also trust-based pension schemes, since the latter may increasingly provide decumulation solutions.
Access to insurance cover	We recommend that the government, in consultation with the IFoA and others with technical and industry expertise, determines the appropriate minimum level of insurance protection needed by all – including low-income families – to be financially resilient to specific risks and unexpected shocks.
Learning from ‘Re’ schemes	The IFoA will promote research into what factors make a model like Flood Re successful, and how a similar approach could work in other areas of insurance where some groups in society are unable to access affordable cover because of factors they cannot realistically control – such as where a policyholder lives, pre-existing medical conditions, or the topical example of pandemics cover. The findings from such research could inform government action to facilitate solutions. Given the direct impact of climate change on Flood Re, this example particularly highlights the importance of embedding an understanding of sustainability risks in risk-transfer solutions.
DB scheme regulation	We recommend that the ‘bespoke’ framework in The Pensions Regulator’s DB funding code should genuinely enable consideration of each case on its own merits. Wherever possible, the existing reporting infrastructure should be used, in order to reduce the regulatory cost associated with implementing the new Code.
Post-Brexit insurance regulation	We recommend that HM Treasury should use the Solvency II review to implement regulatory changes that will enable and encourage insurance companies to offer affordable guarantees, thereby accepting a transfer of some investment risk from customers. We would, of course, not favour a new prudential regime that under-reserved for guarantees.

Section title	Recommendation
<b>Helping consumers manage financial risks through good decision-making</b>	
Pension Wise	We recommend that the Financial Conduct Authority (FCA) should set a specific and ambitious target to achieve a significant increase in take-up by individuals of Pension Wise appointments before accessing their pension.
Pension dashboards	We recommend that the Money and Pensions Service Dashboard Steering Group should give high priority to how retirement income will be estimated and presented in a consistent way on dashboards, taking account of the wide range of products in the market and assumptions adopted.
Risk transfer incentive exercises	We recommend that, following consultation, the FCA should put in place appropriate regulation or guidance to strengthen consumer protection in risk transfer incentive exercises (including for income protection insurance and Periodical Payment Orders).
Adequacy of pension contribution rates	We recommend that the government should reinvigorate its public messaging around minimum pension saving levels – particularly through workplace auto-enrolment pension schemes – to ensure that consumers are not lulled into a false sense of security on whether their pension saving will be adequate to achieve their retirement income goals. In doing so, government should use expertise and evidence on testing behavioural responses to different messages and channels, to identify those that are most effective in impacting saving behaviour.

## Glossary

**Annuity** – A financial product that pays a guaranteed income for a fixed period or for the rest of the holder’s life. A retiree can choose to use some or all of their pension savings to buy an annuity.<sup>2</sup>

**Collective defined contribution (CDC) scheme** – In CDC schemes both the employer and employee contribute to a collective fund from which retirement incomes are drawn. The funding risk is borne collectively by the members – similar to a DC scheme, the employer carries no ongoing risk. CDC schemes offer a target income at retirement rather than a specified income like a DB scheme.<sup>3</sup>

**Decumulation** – The phase during which a consumer or member converts their pension savings into a retirement income, or makes a withdrawal from their pension pot.<sup>4</sup>

**Drawdown** – A way of using a pension pot to provide a regular retirement income by reinvesting it in funds specifically designed and managed for this purpose. The income will vary depending on the fund’s performance.<sup>5</sup>

**Investment risk** – A measure of the level of uncertainty of achieving the investor’s expected returns.<sup>6</sup>

**Longevity risk** – The risk that people outlive their retirement savings, or underspend their savings, leading to a lower income over retirement.<sup>7</sup>

**Reserving** – Assets that insurance companies set aside to mitigate the risk of declines in the value of investments they hold. This helps ensure that the policyholders are paid for claims and that annuity holders receive income even if an insurance company’s assets lose value.<sup>8</sup>

2 | <https://www.pensionbee.com/pensions-explained/pension-types/what-is-a-pension-annuity>

3 | <https://commonslibrary.parliament.uk/research-briefings/cbp-8674/>

4 | Definition given by The Pensions Regulator in e.g. p26 <https://www.thepensionsregulator.gov.uk/-/media/thepensionsregulator/files/import/pdf/freedom-choice-pension-flexibilities-report-march-2016.ashx>

5 | <https://www.moneyadvice.service.gov.uk/en/articles/income-drawdown>

6 | <https://economictimes.indiatimes.com/definition/Investment-risk>

7 | <https://www.actuaries.org.uk/system/files/field/document/Policy%20summary%20-%20Longevity%20Risk%20A4%20V02%20WEB.PDF>

8 | <https://www.investopedia.com/terms/v/valuation-reserve.asp>

# Rebalancing risks

Our work on the Great Risk Transfer has demonstrated that this trend is deep-seated and long-term in nature, and rooted in ‘megatrends’ such as demographic and technological change, as well as changes in social attitudes.

We therefore believe it is not appropriate to think in terms of reversing the whole risk transfer phenomenon. However, as the recommendations described in this section show, we can still consider opportunities to rebalance risks from consumers to institutions in specific areas, where this is likely to benefit society as a whole in the long run. This is important because risk transfer has often been driven by governments or companies seeking to reduce their risks, not necessarily reflecting the widespread needs of less-powerful consumers and longer-term impacts on society.

## Innovation in financial products and services

Before discussing the recommendations dealing with rebalancing risks between consumers and institutions, we want to mention the important role played by innovation in financial products and services. We support the development of a new generation of products that reflect changing consumer needs, but note that current innovation efforts in this space are not always sufficiently aligned with those needs. Sometimes the issue is that providers are too focused on capital preservation at the expense of meeting customer needs. In other cases new products may not succeed in harnessing technology to balance the risks borne by institutions and consumers.

Some firms are also hesitant to innovate, due to the actual or perceived ‘conduct risks’ of doing so, including the impact of misselling scandals in recent years, especially relating to pensions. The costs of previous misselling issues, coupled with increasing product governance duties upon firms and directors, has also seen professional indemnity and directors and officers’ insurance costs rise significantly in recent years. Dialogue with government and regulators could help to address these obstacles, including exploring the potential for establishing

‘safe harbours’ in how regulation is applied to certain products that meet agreed standards and address priority consumer needs. Our first recommendation discusses an innovative pension product that has attracted much discussion in recent years – collective defined contribution (CDC) schemes.

## CDC schemes

Collective defined contribution (CDC) schemes are expected to offer better outcomes for individual savers than traditional defined contribution (DC) schemes. Because members pool their retirement savings into a single fund, they also pool and share the risks associated with uncertainty about the performance of their investments and about how long they will live. This risk sharing allows the scheme to invest in assets with higher expected returns.

CDCs also have their challenges. For example, employer contributions are fixed. They do not adjust as investment performance changes, which means that pension levels (or how fast they increase) will vary – and may reduce in some years. This could be seen as a risk transfer to members, compared with defined benefit or individual DC with insured annuities. However, CDC schemes share risk between members, and use that feature to smooth market volatility to achieve fairly stable pension levels. A 2013 study by AON<sup>9</sup> estimated that CDC schemes would have delivered more stable retirement income than DC over the previous 50 years: a steady 28% of salary, as opposed to a range between 17% and 61%. It is worth noting that the smoothing process introduces the risk of intergenerational unfairness, but this can be managed through an appropriate scheme design to ensure smoothing is not carried out to excess.

A 2013 study by AON<sup>9</sup> estimated that CDC schemes would have delivered more stable retirement income than DC over the previous 50 years.

9 | [https://www.aon.com/getmedia/a745af28-9106-4e25-a09a-bdf4f5ead150/The-Case-for-Collective-DC\\_update\\_2020.aspx](https://www.aon.com/getmedia/a745af28-9106-4e25-a09a-bdf4f5ead150/The-Case-for-Collective-DC_update_2020.aspx)

The UK is currently legislating to introduce CDC schemes, a measure that has considerable cross-party support. CDC secondary legislation is expected to be consulted on in spring 2021, with authorisation by The Pensions Regulator (TPR) to be required for each CDC scheme.

There are open questions on how CDC schemes will be used in practice – for example, how many employers will offer them, what is the minimum scheme size for viability, whether they will be used as an ‘upgrade’ on DC or a ‘downgrade’ of DB, and the variety of CDC designs that will emerge, such as new multi-employer or master trust schemes. One key area is how CDC could be used at the decumulation stage, when pension savings are converted to retirement income, as a way to manage the risks of that process.



**We are seeking government action to show employers that CDC is an attractive alternative to DC schemes, and to address concerns employers may have, such as regulatory burdens and costs.**

Our proposed recommendation on CDCs focuses on employers because their buy-in will be essential for it to have a long-term use and impact. We therefore seek government<sup>10</sup> support in the UK Pension Schemes Act 2021 for multi-employer and master trust CDC schemes, so that smaller employers can have cost-effective access to CDC.

In addition the IFoA will:

- Engage with key stakeholders, such as employers and master trusts, to determine what conditions would be necessary for widespread use of CDC schemes
- Engage with employers on options for new scheme designs, and the associated benefits and costs.

Actuaries can add unique value while working with others to achieve these goals. Actuarial skills are very relevant to the challenges of designing CDC schemes in such a way that the benefits are continually adjusted to reflect the funding health of the scheme, and to ensure fairness between different generations of members.<sup>11</sup> We are keen to contribute to current independent research projects which aim to encourage use of CDC schemes to deliver better retirement outcomes for many across our society.

## Decumulation pathways

Whatever the potential benefits of CDC pensions, they will not make up a significant proportion of the pensions landscape for the foreseeable future (at least not in the UK). The DC universe has become the dominant one in terms of scheme membership – and increasingly in terms of assets.

Our 2020 GRT call for evidence generated much comment on the risk transfers arising from the shift from DB to DC over recent years. Many respondents mentioned the increased risk of running out of money in retirement since the government’s ‘Freedom and Choice’ policy was implemented in 2015. This meant people were no longer required to use pension savings to secure a guaranteed retirement income by buying an annuity. As one IFoA working party has noted:<sup>12</sup> “It is clear that income drawdown approaches, in particular, have replaced annuities as the retirement vehicle of choice for many with larger retirement savings pots; while a full cash withdrawal is often the favoured option for those accessing smaller amounts of savings.”

Reflecting the increased complexity of the decisions retirees have faced since the introduction of Freedom and Choice, the FCA’s 2019 *Retirement Outcomes Review*<sup>13</sup> aimed to simplify the choices by setting out investment pathways for providers to offer. The pathways were implemented on 1 February 2021. They are available for consumers with DC pensions who have already decided to take a retirement income through drawdown, but are unable or unwilling to take professional advice.<sup>14</sup> Providers must make investment options available to meet four scenarios that consumers could envisage over the next five years: to buy an annuity, leave their pot in its current investment funds, begin drawdown, or convert their savings to cash.

Less-engaged consumers who opt for income drawdown are likely to accept their own provider’s default product, as opposed to shopping around. However, many consumers could get a better outcome if they were able to separate the drawdown decision from purchasing a product. One way to help achieve this would be to provide automatic Pension Wise advice sessions at retirement, as we discuss in a separate recommendation further on.

Helping non-advised consumers to plan ahead for their retirement income is a positive step, but we would like to see the government go further by offering pathways as a default option for all, not just those with DC pensions who have already decided to take a retirement income through drawdown.

10 | CDC research by the Pensions Policy Institute (PPI) is focusing on decumulation only (=collective annuity).

11 | From Simon Eagle blog (IFoA Chair CDC WP) <https://www.actuaries.org.uk/news-and-insights/news/here-cdc>

12 | <https://www.actuaries.org.uk/system/files/field/document/Research%20paper%20-%20Investor%20Behaviour%202019.pdf>

13 | <https://www.fca.org.uk/publications/policy-statements/ps19-21-retirement-outcomes-review-feedback-cp19-5>

14 | <https://www.actuarialpost.co.uk/article/what-investment-pathways-will-mean-for-pension-drawdown-19153.htm>

Ideally, most DC retirees should make choices about the use of their pension pots that put them within a 'safe corridor', in which they minimise the risk of either running out of money or neglecting their welfare through unnecessary under-spending, out of fear of destitution. Providing default pathways for the decumulation period, when pension savings are converted into retirement income, could help to ensure that more people reach this safe corridor. Although others such as NEST have looked at this, product development in this area has been slow.

Evidence from the FCA<sup>15</sup> suggests that most consumers accessing larger pots over £30,000 are doing so using partial drawdown, a combination of drawdown and an annuity. This suggests that analysis of the most effective combinations of these two options would be worthwhile. The IFoA's 2018 policy briefing *Can we help consumers avoid running out of money in retirement?*<sup>16</sup> explores this in more depth.

We are conscious that introducing default decumulation pathways needs very careful thought in order to take account of the wider range of financial goals people have during retirement compared to before retirement. Pre-retirement, there is a common aspiration to accumulate money while balancing risk. During retirement, wider considerations come into play, including health and life expectancy, the relative importance of security of income versus the flexibility to be able to change plans, the desired pattern of income with advancing age, and the link between level of financial capability and vulnerability. This means a 'one size fits all' product may be unrealistic and inappropriate.

Decumulation pathways can reduce the chance that individuals will run out of money in retirement. They do this by managing both their level of retirement income and their investments, while ensuring the provision of later life protection through longevity pooling. They could also incentivise individuals to save more in the pre-retirement phase once they feel relieved from worries about future longevity risk.



**We recommend that the government consider the introduction of default decumulation pathways as an option for all, and as a safety net for savers who cannot or will not engage with the decumulation process when entering retirement. Ideally this would cover not only contract-based pension schemes, but also trust-based pension schemes, since the latter may increasingly provide decumulation solutions.**

Through its Decumulation Pathways Working Party, the IFoA will be carrying out further work to explore how DC pension pots can be automatically shielded from poor decision-making

due to low financial capability and understanding of pensions, and low ability to manage the financial journey through retirement. One important consideration will be whether there should be a default mechanism requiring opt-out, or something people choose to opt into. A second is to clarify the potential costs of any reform, including regulatory compliance and the costs to providers/master trusts in developing products.

## Access to insurance cover

Just as the scope of the Great Risk Transfer has led us to make recommendations across the range of pension provision, similarly we have identified a broad range of examples of risk transfer in insurance.

One striking trend here is that a combination of market forces and technological developments is encouraging more granular insurance risk pricing. Premiums are being set for smaller and smaller subgroups of the population, and ultimately for individuals. This is resulting in losers as well as winners. Since smaller risk pools are more reflective of precise risk profiles, those with lower risk enjoy lower premiums while those at higher risk pay more. Pricing may be dictated by factors realistically outside people's control, such as living in a high crime area and being unable to afford to move. In motor insurance younger and/or poorer drivers may be priced out of cover. Those with multiple health issues are among the most vulnerable.

In many cases it is those who need insurance cover the most who may be unable to access it, and there is evidence that low-income households are more likely to be without cover.

The ability to price individual risk in such a way that significant subgroups of the population are excluded from affordable insurance is a long-term systemic issue demanding systemic solutions.



**We recommend that the government, in consultation with the IFoA and others with technical and industry expertise, determines the appropriate minimum level of insurance protection needed by all – including low-income families – to be financially resilient to specific risks and unexpected shocks.**

Putting this recommendation in context, as actuaries involved in the design of insurance products, we appreciate that insurers are commercial organisations with a legitimate need to manage their business, and that pricing should reflect risks. We therefore believe that the government has the key role in identifying and protecting vulnerable groups.

15 | (via Deloitte) <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-retirement-innovation.pdf>

16 | <https://www.actuaries.org.uk/system/files/field/document/Policy%20Briefing%20-%20Helping%20Consumers%20-%20WEB.PDF#:~:text=Consumers%20can%20reduce%20the%20risk,to%20generate%20from%20their%20pot.>



### Genetic conditions and underwriting

In recent years there has been a rapid growth in the quantity and accessibility of information available to individuals about their genetic propensity to various health conditions. Should insurers have access to (some of) this information in order to ensure that its implications for rates of mortality or ill health are reflected in the premiums charged to individuals? The Council of Europe's Committee on Bioethics has set out recommendations that aim to safeguard "fundamental rights of individuals whose personal data are processed for insurance purposes, while recognising the insurer's legitimate interest in assessing the level of risk to be covered".<sup>17</sup>

One example where insurers arguably do have such a 'legitimate interest' is their concern about adverse selection. This is the tendency for individuals with knowledge of their genetically-based health risks to buy life or health insurance products. If insurers remain ignorant of these health risks, they will be exposed to a greater-than-expected probability of paying future claims in relation to these health conditions. Actuaries have studied the impact of adverse selection on the solvency of insurance companies in order to assess how reasonable or otherwise it may be for them to seek genetic information on policyholders.<sup>18</sup>

Governments have taken a variety of approaches to this issue. In some countries, such as Australia and Canada, insurers may ask those applying for cover to disclose results of previous genetic tests, to request new tests and to take account of this information in setting premiums. By contrast,

countries such as France and Italy do not allow insurers to do any of these things. There are also intermediate positions: for example, in the Netherlands and Switzerland, insurers can use test results if they have them, but individuals do not have to provide such information.<sup>19</sup>

In the UK, the Code on Genetic Testing and Insurance (2018) is a voluntary agreement between the government and the Association of British Insurers (ABI), which commits insurers signed up to the code never to require or pressure any applicant to undertake a predictive or diagnostic genetic test. Insurers may only consider the result of a predictive genetic test for a very small minority of cases. According to the Code, such a condition must be: "inherited in a clear and measurable manner and which has a high probability that those with the particular gene variant will develop the condition, leading to a materially increased likelihood of significant morbidity and/or mortality". In fact, at present the only condition included is Huntington's disease, and then only in applications for life insurance cover over £500,000.<sup>20</sup>

This brief survey of genetic testing and underwriting illustrates how insurers are sometimes unable to use certain types of data on individual policyholders' risk profiles, because the sensitive nature of the information means they do not have automatic or easy access to it. In particular, it demonstrates the power of legislation and regulation to implement what government and Parliament determine is appropriate use of personal data, and an appropriate allocation of risk.

Premiums are being set for smaller and smaller subgroups of the population, and ultimately for individuals. This is resulting in losers as well as winners.

17 | [https://search.coe.int/cm/Pages/result\\_details.aspx?ObjectId=09000016806b2c5f](https://search.coe.int/cm/Pages/result_details.aspx?ObjectId=09000016806b2c5f)

18 | [https://www.actuaries.org/ASTIN/Colloquia/Berlin/Lemaire\\_MacDonald.pdf](https://www.actuaries.org/ASTIN/Colloquia/Berlin/Lemaire_MacDonald.pdf)

19 | Ibid. This reference is undated but likely to be from the early 2000s, so some specific country approaches may have changed.

20 | [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/751230/code-on-genetic-testing-and-insurance.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/751230/code-on-genetic-testing-and-insurance.pdf)

## Learning from 'Re' schemes

One Canada-based respondent to our call for evidence<sup>21</sup> portrayed this conflict very effectively with an example from his local area. On one hand there is risk pooling:

*“Take a simple example. An Amish barn burns down taking with it 40 milking cows. What is the response of the Amish community? Within a matter of days, neighboring farmers (let’s say 39) and their families gather to rebuild the lost barn. But each such neighbor also brings one milking cow. By the end of a long day, the Amish farmer who was the subject of the barn fire is virtually whole. He has a new barn and 39 healthy milking cows. The rest of the community has contributed one day’s work and one milking cow to the collective, well within their level of economic risk (variance of economic outcome).”*

On the other, there is the impact of competition:

*“The insurance industry is highly competitive. Consumers look for low prices. Insurers look for profit margins. If I can find a new way to refine my risk classification system that allows the ‘best’ risks to buy my products at a lower price, then I can increase my market share with profitable business. If my competitor across the street does not refine its risk classification system, then my worst customers will move to their book of business (because their ‘average’ price will be lower) and their best customers will move to my book of business (because of my more-refined risk classification system). That seems laudable. Better customers pay lower prices and worse customers pay higher prices. And this is based on sound underwriting and risk classification principles. I can find no reason to argue against this natural evolution. Certainly, I cannot state that it is ‘wrong’. However ... I think that its ultimate outcome is the demise of the collective and, therefore, the demise of the private individual insurance industry.”*

One approach to resolving this conflict is to study examples of risk transfer away from the prevailing direction, ie from consumers to institutions. Is there potential to apply this approach to areas where consumers face risks for which they are not able to access affordable insurance?



Insurance cover for high flood risk

Flood Re is a recent UK example showing how it is possible to enable the affordable insurance of otherwise unaffordable risks to individuals. Set up in 2016, Flood Re is a reinsurance scheme designed to promote the availability and affordability of home insurance including cover for flood damage for eligible homes, particularly for those whose homes are at the highest risk of flooding. Every insurer that offers home insurance in the UK must pay into the Flood Re Scheme. This levy raises £180m every year and is used to cover the flood risks in home insurance policies. By 2019, four out of five households with a history of flood claims had seen prices drop by 50%. Flood Re is due to run until 2039, at which point the market is currently due to transition to risk-reflective pricing for household flood insurance. There is concern that home cover, including flood risk, could become uninsurable again after 2039 unless inherent levels of flood risk can be reduced, based on changes to how the risks are managed. To help prevent this, Flood Re provides information to home owners about taking action to reduce flood risk, and supports initiatives to better manage flood risk and to make homes more resilient to future flooding and flood damage.



The IFoA will promote research into what factors make a model like Flood Re successful, and how a similar approach could work in other areas of insurance where some groups in society are unable to access affordable cover because of factors they cannot realistically control – such as where a policyholder lives, pre-existing medical conditions, or the topical example of pandemics cover. The findings from such research could inform government action to facilitate solutions. Given the direct impact of climate change on Flood Re, this example particularly highlights the importance of embedding an understanding of sustainability risks in risk-transfer solutions.

21 | From Robert L Brown 'The Power of the Collective; the Death of the Collective' <https://uwaterloo.ca/waterloo-research-institute-in-insurance-securities-and-quantitative-finance/sites/ca.waterloo-research-institute-in-insurance-securities-and-quantitative-finance/files/uploads/files/2010-04.pdf>

## The impact of regulation

Our interim report drew attention to the impact of regulation – at times unintended – in either increasing or reducing risk transfer.

For example, suppose a life insurer wishes to offer meaningful protection to consumers by offering a product that includes a guarantee, for example an annuity providing guaranteed income to a pensioner. A government or regulator might insist that the insurer put enough capital aside to enable it to meet that guarantee in a range of economic conditions, both common and more extreme scenarios.

This is known as capital reserving and is an essential safeguard for insurance companies and their customers. However, in recent years the regulatory framework for capital reserving has aimed to provide greater financial protection for pensioners and insurance policyholders. Insurers have been required to hold larger capital reserves than previously, with the result that they are not prepared to take on much more risk. The consequence of an onerous solvency regime, requiring insurance companies to hold high reserves of capital, can result in a perverse outcome where insurers do not offer guarantees to consumers at all. Thus, a regulatory regime that is designed to offer protection to consumers can ultimately expose those very consumers to more risk.

When government and regulators are assessing required levels of capital reserves for insurers, they are understandably concerned that setting reserves too low may leave consumers exposed to disappointment if the company cannot honour the guarantee. However, we would encourage them to also be mindful that setting reserves too high may leave consumers without access to the risk-mitigating products they need.

## Defined benefit (DB) pension scheme regulation

We have discussed CDCs and DC decumulation pathways, but should not lose sight of DB schemes and the need to ensure their regulation is proportionate and fair, as otherwise the demise of DB schemes might accelerate, leading to more risk transfer to individuals.

In March 2020 TPR issued a consultation on a Defined Benefit Funding Code of Practice.<sup>22</sup> TPR is “seeking to create a sustainable regulatory framework, which provides the right balance between the security of member benefits and the costs to employers.” The consultation proposed a twin-track

approach to scheme valuations – ‘fast track’ for schemes that can meet quantitative compliance guidelines, and ‘bespoke’ for schemes that are unable or unwilling to comply in full and would be required to provide evidence about how additional risks are managed. Analysis from Hymans Robertson indicates that 70% of DB schemes could fall short of TPR’s ‘fast-track’ approach as proposed in the Code.<sup>23</sup> In the IFoA’s consultation response<sup>24</sup> we welcomed the twin-track approach but highlighted potential unintended consequences and the need to mitigate these. They included increased compliance costs (without improving member security), financial pressure that could lead to corporate insolvencies, and closure of schemes that would otherwise have been viable.

The risk of scheme closures is significant for the DB sector as a whole, because although many DB schemes have closed to new members in recent years, those that remain open tend to be larger in terms of membership. According to the Pension Protection Fund (PPF),<sup>25</sup> open schemes still comprise 24% of DB scheme members.



**We recommend that the ‘bespoke’ framework in the Pensions Regulator’s DB funding code should genuinely enable consideration of each case on its own merits. Wherever possible, the existing reporting infrastructure should be used, in order to reduce the regulatory cost associated with implementing the new Code.**

We will continue to engage with TPR to help shape the next stage of consultation on the DB Funding Code, which is due in the second half of 2021.

## Post-Brexit insurance regulation

The role of regulation was a recurring theme in the responses to our call for evidence and contributions to later discussions. Any regulatory framework can contain features that help or hinder risk transfer.

In the first instance, a prudential regulatory regime must give consumers confidence that they can rely on insurance when they need it. However, if the regime is too onerous it may deter providers from taking risk on their own balance sheets. As a result, products that carry higher levels of risk protection for consumers may become less common.

22 | <https://www.thepensionsregulator.gov.uk/en/document-library/consultations/defined-benefit-funding-code-of-practice-consultation#087b72f2d598406389322c95f94ae35d>

23 | <https://www.hymans.co.uk/media-centre/press-releases/70-of-db-schemes-would-not-meet-tprs-fast-track-requirements/>

24 | <https://www.actuaries.org.uk/system/files/field/document/09-23%20IFoA%20response%20to%20TPR%20DB%20Funding%20Code%20-%20FINAL.pdf>

25 | PPF Purple Book, p4 [https://www.ppf.co.uk/sites/default/files/2020-12/PPF\\_Purple\\_Book\\_20.pdf](https://www.ppf.co.uk/sites/default/files/2020-12/PPF_Purple_Book_20.pdf)

Large numbers of consumers could benefit if changes to the Solvency II framework in the UK made it profitable for providers to offer more investment guarantees.

As evidenced by the sector's performance in the last 12 months, the Solvency II regime has contributed to insurers' resilience. But we note that since the introduction of Solvency II, and the prior regimes based on similar principles, risk-bearing products have become less common, with several providers eschewing them in favour of 'capital light' strategies.

Those risk-bearing products that are still offered by insurers may carry unattractive charges for consumers, to compensate the insurers for the capital reserves they need to hold. Consequently, this generation of consumers typically uses products that leave them more exposed to risk than previous generations.

Risk-bearing products have historically provided consumers with a combination of insurance cover (protection against risks such as death or diagnosis of a critical illness), alongside the potential for beneficial investment opportunities. While these 'with-profits' investment products provided reassurance to investors, they have declined in popularity for a number of reasons over the last few decades, not least because of capital requirements. For similar reasons, another product line that offered reassurance to investors – guaranteed products – has also declined in popularity.

Large numbers of consumers could benefit if changes to the Solvency II framework in the UK made it profitable for providers to offer more investment guarantees. We recognise that companies will only pass on the benefits of any regulatory changes to consumers if they have an expectation that this will be beneficial to them also.

The capital impact on insurance companies of offering investment guarantees can be seen as a significant impediment. The IFoA Long Term Guarantees Working Party has suggested that regulators could consider a different standard model under Solvency II that is more reflective of the economics of offering investment guarantees.

HM Treasury recently issued a call for evidence to review Solvency II (an EU framework) in the light of Brexit. We encourage policymakers to favour revisions that facilitate the delivery of risk-bearing products. For example, the one-year value at risk methodology underpinning the solvency capital requirement may not be the most appropriate approach to assess risk within long-term institutions offering long-term products.



**We recommend that HM Treasury should use the Solvency II review to implement regulatory changes that will enable and encourage insurance companies to offer affordable guarantees, thereby accepting a transfer of some investment risk from customers. We would, of course, not favour a new prudential regime that under-reserved for guarantees.**

This will be recommended both through the IFoA's response to the current Solvency II review, and through subsequent engagement with HMT.

# Helping consumers manage financial risks through good decision-making

Responses to our call for evidence confirmed that consumers have more – and more complex – financial decisions to make than in the past.

The complexity of these decisions both reflects, and adds to, the risks that consumers are increasingly exposed to. At the same time, it must be acknowledged that financial advice is not easily accessible and affordable to many consumers having to make complex risk-management decisions. We have explored these issues in depth with market participants in pensions, insurance and elsewhere. These discussions suggest that even more financially capable consumers face barriers to making good decisions about managing risks and achieving good outcomes. Our recommendations in this area therefore focus on improving the availability of high-quality, easily accessible guidance and information to better support people in making complex decisions about managing financial risks.

Of course, addressing financial capability is also essential. The IFoA launched the Great Risk Transfer campaign in January 2020 with an event featuring presentations by two organisations at the forefront of efforts to tackle these issues: the Money and Pensions Service (MaPS) and National Numeracy. More recently, the *Financial Times* has launched its own financial literacy foundation (<https://on.ft.com/2IUVDzS>).

We salute the efforts of these and other groups, while focusing our own efforts on identifying and advocating for improvements in the financial decision-making processes that consumers face, and the support they can draw on.



## Pension Wise

Pension Wise offers free pension guidance to over 50s and is provided by the Money and Pensions Service (MaPS). Free guidance is a valuable option for those who cannot afford advice, and evidence suggests that people who take Pension Wise guidance feel more confident and have better outcomes than those who do not.<sup>26</sup> However, there is concern about the low take-up of Pension Wise. In a recent Parliamentary debate the Shadow Pensions Minister, Seema Malhotra, stated that only 1 in every 33 people eligible to use Pension Wise do so.<sup>27</sup>

The government recently announced that future regulations will require trustees and managers of occupational pension schemes to present taking Pension Wise guidance as a 'natural' part of the process for members who wish to access or transfer a pension. Some argue that this behavioural or 'nudge' approach is not enough, and that individuals should be automatically booked into a Pension Wise appointment as the default. Research by MaPS into the nudge approach suggests it had less effect on those who were least engaged with pensions and therefore in most need of help.<sup>28</sup>

As we discussed in relation to decumulation pathways, less-engaged consumers who opt for income drawdown often accept their own pension provider's default drawdown product, rather than shopping around. Providing automatic Pension Wise advice sessions before retirement would help consumers to consider the pros and cons of drawdown at that stage, so that they could later look separately at the choice of which product would best meet their needs.

In December 2020 the UK government announced that the FCA should decide whether a target for automatic Pension Wise appointments should be set.



**We recommend that the FCA should set a specific and ambitious target for take-up by individuals of Pension Wise appointments before accessing their pension.**

## Pension dashboards

However good the quality and coverage of pensions advice may be (from Pension Wise or elsewhere), for this to translate into good decision-making depends on having clear, consistent, accurate and engaging financial information. Financial information needs to be provided and promoted in such a way that it enables and motivates well-informed and considered decisions that are most likely to produce good outcomes – or at least minimise the risks of poor outcomes. Solutions that are effective in promoting good behaviours and outcomes can only be identified through pilot testing. Assumptions about behavioural responses and outcomes must be avoided.

The goal of pension dashboards is to establish an online service that will enable individuals to access all of their pensions information in one place (including multiple pension savings and the State Pension), thus supporting better planning for retirement.

Developing a consistent format for information from different pension types – defined benefit, defined contribution or others – will be a major challenge, as will achieving consistency between dashboards and other sources of information. The IFoA has relevant expertise and influence in the work on developing the dashboard, with a representative on the Money and Pensions Service Dashboard Steering Group, and a Working Party generating useful evidence and insight.

One area on which the IFoA is focusing is how retirement income is estimated and presented. Consumer surveys have highlighted this as the item of information that consumers would find most useful for a dashboard to show. However, there are many inconsistencies in the way different schemes make assumptions and run calculations. If unresolved, this will lead to confusion among pension savers and increase the risk of poor retirement decisions and outcomes.



**We recommend that the Money and Pensions Service Dashboard Steering Group should give high priority to how retirement income will be estimated and presented in a consistent way on dashboards, taking account of the wide range of products in the market and assumptions adopted.**

This will help to bolster trust and good decision making, and to make dashboards as successful as possible in the impact they achieve for pension-saving behaviours and outcomes.

26 | <https://moneyandpensionsservice.org.uk/wp-content/uploads/2020/10/Pension-Wise-Service-Evaluation-report-2019-2020.pdf>

27 | <https://www.theyworkforyou.com/whall/?id=2020-12-08b.360.1>

28 | <https://moneyandpensionsservice.org.uk/wp-content/uploads/2020/07/maps-stronger-nudge-evaluation-report-july-2020.pdf>

## Risk transfer incentive exercises

Where an employer or institution offers incentives to individuals to assume more risk, it is especially important to ensure people are well supported to understand the risks they're being asked to take on. They are then in a good position to make well-informed and considered choices that are most likely to produce good outcomes. Examples include:

- A defined benefit pension scheme offering to transfer a lump sum into a defined contribution pension scheme, as an incentive to an individual to give up their right to a guaranteed income in retirement from the defined benefit scheme
- An insurer offering someone a cash lump-sum payment now to give up their right to guaranteed long-term payments from an insurance policy, resulting from a long-term sickness or injury
- An insurer offering a lump-sum cash payment to someone who has suffered a catastrophic injury in a car accident, to give up their right to guaranteed long-term payments from an insurance policy (Periodic Payment Orders).

Consumers can be at a disadvantage due to information asymmetry between them and the institutions involved – and due to inadequate financial engagement, capability and confidence. They are also less able than providers to understand the risks, due to biases and lack of specialist knowledge and sometimes, in the case of long-term sickness or catastrophic injury, due to the effect on cognition of the sickness or injury itself. They have less access to capital than institutions and can be tempted by immediate cash. Finally, they are also less able to bear those risks as individuals than if risks are pooled with others through an institution such as an insurance provider. Such cases raise a concern that individuals – often vulnerable – will deprive themselves of secure long-term income and security by accepting tempting short-term offers. Providers sometimes demand that decisions on these offers are made hastily, and the decisions are irreversible.

In all of these cases, we recognise that such incentives can sometimes represent a good outcome for the individual. But we are concerned about people receiving inappropriate advice before accepting them – in some cases because advisers are incentivised to achieve that outcome – and about people not receiving expert advice at all.

There is an industry Code of Practice for pension transfer incentive exercises, produced by the Incentive Exercises Monitoring Board (IEMB). Although this is voluntary, it is supported by (among others) the FCA, DWP, The Pensions Regulator and the IFoA. However, more robust government or regulatory messaging may be needed, such as Financial

Ombudsman Service decisions that have required advisers to make compensation payments for bad advice on transfers.

In the case of income protection/permanent health insurance, the situation of most concern is where the insurer has accepted a claim but offers a cash sum as final settlement, instead of the contractual payment of income for a long period. We are not aware of any specific rules or guidance in place for such offers, either in the insurance industry or the FCA. In particular, the FCA's *Insurance Conduct of Business Sourcebook* makes no specific mention of such incentive offers. In contrast, with pension transfer offers, the IEMB code covers disclosures about the reason for and value of the offer, warnings about downside risks, and the expectation that providers will pay for independent advice. Despite this contrast, there is a clear similarity in the long-term nature of pension and income protection products, in the proportion of financial income they represent, and in the risks involved in both.

An example of particular interest to actuaries is Periodical Payment Orders (PPOs), a type of compensation that pays an income for life to the injured party in a personal injury claim, based on their specific needs. By contrast with a lump sum award, it is the insurer rather than the claimant who takes responsibility for investment, inflation and longevity risk. However, insurers often prefer to offer lump-sum settlements, since providing PPOs presents the challenges of investing to match very long-term liabilities as well as managing the associated risks. The IFoA has been engaging with policymakers to explore a policy approach that answers insurers' concerns yet considers a PPO as a potential settlement option. One suggestion is a government-backed pooling scheme, since industry efforts have not so far succeeded.

In a recent speech<sup>29</sup> the FCA's Chief Executive, Nikhil Rathi, listed the long-term issues facing financial services, including "increasing pressure on the financially vulnerable, stretched or distressed".



**We recommend that, following consultation, the FCA should put in place appropriate regulation or guidance to strengthen consumer protection in risk transfer incentive exercises (including for income protection insurance and Periodical Payment Orders).**

This could draw from the experience of regulation of pension transfer incentives.

29 | <https://www.fca.org.uk/news/speeches/facing-future-challenges-priorities>

## Adequacy of pension contribution rates

Workplace pension auto enrolment is hailed as a success for getting many more people saving for their retirement. But there remains widespread under-saving and many are not on track to achieve the sort of retirement they aspire to. Further change cannot come about without more public awareness of the benefits of increased saving.

The IFoA's recent work on *Savings goals for retirement*<sup>30</sup> has addressed this challenge by exploring 'rules of thumb' that could give people an idea of the required levels of saving to achieve a certain lifestyle in retirement. This work showed that saving at the current 8% minimum auto-enrolment rate throughout working life is expected to be broadly enough to provide a minimum level of retirement income, when combined with the State Pension.

The Great Risk Transfer campaign focuses on changing the financial system to make it work better for consumers and society, which we believe is generally more pragmatic than attempting to force changes in consumer behaviours. In the case of auto enrolment, the minimum combined employer/employee contribution rates should be revisited, and potentially increased. However, we recognise that this may not be politically or economically realistic at present.

It follows that any increase in savings levels will depend on consumers' individual decisions in this case, but the signals they receive from relevant institutions are likely to have a significant influence on those decisions. In particular, employers can play an important role by paying more than the minimum, eg on a matching basis. If enough employers did so, this would help to create a public shift in the perception of 'normal' or 'adequate' contributions, albeit on a voluntary basis.

As our savings goals work argues, the 'correct' level of contributions is subjective and depends on target income and assumptions. We welcome the fact that pension providers are generally encouraging people to contribute more (which is in providers' interests also). However, in order to make a more significant change to the savings culture, and savings outcomes, we believe there is also a key role for the government.



**We recommend that the government should reinvigorate its public messaging around minimum pension saving levels – particularly through workplace auto-enrolment pension schemes – to ensure that consumers are not lulled into a false sense of security on whether their pension saving will be adequate to achieve their retirement income goals. In doing so, government should use expertise and evidence on testing behavioural responses to different messages and channels, to identify those that are most effective in impacting saving behaviour.**

30 | <https://www.actuaries.org.uk/news-and-insights/public-affairs-and-policy/ageing-population/adequacy/savings-goals-retirement>

# Conclusions and next steps

In this report the IFoA has made a number of recommendations to government, regulators and the financial services industry to address some of the negative impacts of the Great Risk Transfer.

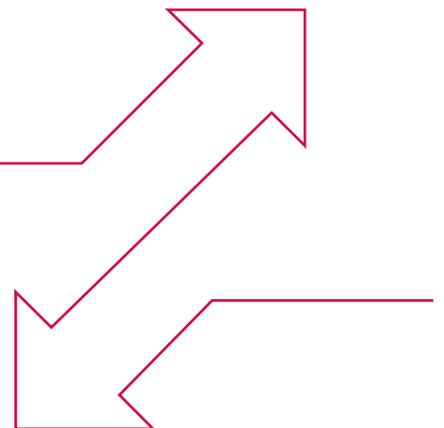
We will promote these recommendations with determination. We plan further engagement with stakeholders, and further work with IFoA members, to inform and promote action on solutions to address the issues we have highlighted in this and our *Interim campaign report*.<sup>31</sup>

We also accept that we, and the actuarial profession we represent, have a role to play ourselves in tackling these issues. One way in which we do so is by working to improve our members' understanding of how consumers experience financial risks, products, services and communications. This is not only an important part of formal actuarial training, but also an essential component of actuaries' professional skillset.

If you would like to talk to us about working to address these issues and our recommendations, please contact [\*\*policy@actuaries.org.uk\*\*](mailto:policy@actuaries.org.uk)

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<sup>31</sup> | <https://www.actuaries.org.uk/system/files/field/document/Great%20Risk%20Transfer%20Interim%20Campaign%20Report%20FINAL.pdf>



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