Promoting personal saving

Report for Zurich Financial Services

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January 2011

A report by Warwick University,
commissioned by Zurich Financial Services

In association with

Contents

Summary:
Analysis and main recommendations

A. The problem of insufficient savings stems from:

1. labour market insecurity of young workers
2. uncertainty over savings outcomes due to market fluctuation and constantly changing regulatory rules
3. oligopolistic policy making (lack of transparency/public debate)
4. lack of clearly identified sources of independent financial advice
5. lack of a single agency to provide advice to consumers and policy-makers.

These features stem from over-reliance on rational choice as the basic mechanism for promoting savings and a lack of clear state objectives in developing pension policy

B. We propose:

1. the encouragement of savings among older workers with more resources (rather than sustaining the current focus on the young) – see Section II
2. mechanisms to encourage the voluntary pooling of household savings (rather than personal savings) to protect the very old – see Section III
3. the creation of a single accredited network of professional financial advisors and a national financial health care service – see Section IV
4. the revival of an independent permanent agency, (similar to the recently created Office of the Budget Review and the permanent Pensions Commission as proposed by Lord Turner's report), representative of all stakeholders to advise on policy – see Section V.

C. Specifically, for new pension products to be introduced, we would favour:

1. the retention of auto-enrolment (a more effective means of raising the number of people saving than tax incentives)
2. the creation of more portable pensions (than those currently planned under NEST) to promote more flexible labour markets and protect migrants
3. the development of pension products to enable income to increase at higher post-retirement ages (i.e. at 78+)
4. the promotion of shared pension saving between couples.

Introduction

In this report we address recent trends in working and pension saving, the ongoing problems posed by the extremely elderly, the possible role to be played by financial advice and we review the age-old issue of administrative complexity. We offer some suggested recommendations at the end of each section that we believe could be usefully adopted as a new approach to solve the problem of inadequate overall saving.

Post-election pension politics

Since the General Election of 2010, a new government – as part of an overall spending review – is reviewing the pension situation, changing policy by making the following commitments:

- To realign (from April 2011) the Basic State Pension with earnings: BSP will in future rise by the higher of earnings, prices or 2.5%.
- To examine the future of public sector pensions, protecting established rights while analysing future long-term viability (commission established).
- To abolish the default retirement age from October 2011 (consultation currently taking place).
- To review the phasing in of a state pension age of 66: not earlier than 2016 for men and 2020 for women.
- To 'explore the potential to give people greater flexibility' in accessing part of their pension fund in advance of retirement.
- To protect currently available benefits for older people (winter fuel allowances, free TV licences, bus travel etc.).
- To simplify the rules and regulations governing occupational pension schemes to encourage companies to offer high quality pensions to all employees, working with business and the industry to support auto-enrolment.
- To continue with auto-enrolment and the NEST (National Employment Savings Trust) Corporation.

There is apparently no change in tax relief on pension contributions for high earners and no mention has been made of any tax hikes for that sector either. The NEST system, while welcome, still has it's problems as it will leave mobile workers with a number of different pension pots on retirement, thereby implicitly discouraging the development of a more flexible and competitive labour market while creating more complexity and the possible proliferation of orphan accounts whose owners cannot be traced. Equally, no attention has been given to the issue of migrant workers and their rights. We address (broadly) issues of administrative complexity in Section V below in order to solve this problem by creating better official sources of information and advice than exist at present.

Stepping back from current debates, we should note the lack of clear objectives in any UK government pension policy in the recent past, bar a general strategy to contain public liability. Pensions (and pension funds) serve multiple purposes. They offer employers the means to attract (and retain) key personnel (thereby serving as one tool in HR management). Both state PAYG and funded schemes create revenue flows. In the UK, National Insurance Contributions (NICs) are used to buy government bonds, offering a source of general state revenue while creating public sector obligations for the future. Funded pensions serve as sources of private investment either in the domestic economy or (as more recently) in global financial markets. And, for over a hundred years, British governments have recognised the need to protect those too old to earn a living from the threat of penury. However, whether the state should undertake this task – or should sponsor other agencies to do so – has changed over time. Over the last 30 years at least, pension policy has been based on the belief that all these objectives could be combined and, since 1986 at least, political consensus that market agencies offer the best solution to pension provision has been dominant. The adaptation of market agencies to serve public welfare has, above all, offered the promise of protecting the taxpayer from the consequences of rising longevity and the growing numbers of imminent retirees (the product of the post-war baby boom). This strategy, however, has created some fundamental and very deep rooted problems for government for which solutions are still being sought.

State pensions and growing need to save

While a review of state pensions falls outside the remit of this report, attention has to be drawn to features pertinent to the question of raising savings. One major factor that discourages saving arises from uncertainty consequent on the complexity (and constant modification) of the conditions surrounding access to state pensions of various types. At the time of writing, multiple state schemes co-exist to which workers contribute and/or from which pensioners may receive income: basic state pension (BSP), state earnings related pension (SERPS), additional state pension/state second pension (S2P), stakeholder pension, pension credit. The state also subsidises contracted out approved personal pensions, company and occupational schemes. This list does not include additional benefits which those over state pension age can claim: some universal (such as bus passes, winter fuel allowances, free television licences) some means tested (housing benefits and council tax exemptions available for those on lower incomes) and some dependent on the physical frailty of the claimant (carer's allowances and disability benefits). The whole area is a minefield, replete with traps for the unwary, that badly needs simplification. The 2007 and 2008 Pension Acts made some moves in this direction by reducing the number of qualifying years needed to claim the full BSP to 30 for men and women, by promising to phase out the earnings related element of the additional state pension by 2030 and by giving a date when 'contracting out' of S2P would be abolished.

Our attention in this report will not go into the complexities of pension credit, means testing and its impact on saving as this has already been exhaustively discussed elsewhere. Suffice to say that, despite all recent changes and those promised in the immediate future, a reasonably comfortable retirement will not await those who rely solely on state benefits for their income when leaving employment for the last time. Moreover, in the current financial climate, auxiliary social services, on which many of the very elderly rely, are liable to contract rather than expand. Recent research by the Rowntree Foundation (2010) calculated an income of £275+ per week (£13,900 p.a.) as the minimum required to give an old age pensioner a 'basic but acceptable' standard of life. Even with housing benefit and council tax benefit added in, an income reliant on state benefits does not come close. Additional saving is therefore essential.

In terms of the general context, however, we note that the last government, in spite of all the efforts of Adair Turner's Pensions Commission, failed to create a simple and transparent solution to the problem of insufficient pension savings. First, we would argue that this is because there has been little clear policy thinking on saving for the future as a public good: a collective benefit to the polity as well as protection for old people themselves. The conceptual framework of rational choice that assumes a public good will be created through the collective pursuit of self interest has proved singularly wanting in this area. It appears to have given licence to selfish behaviour that prioritises the immediate satisfaction of today's desires with little or no thought for possible consequences over the longer term, let alone for future generations. Such short-termism, we believe, infects the Treasury, the pensions industry and employers just as much as it infects the population at large. Second, and more prosaically, we claim that discussion of pension savings remains too firmly rooted in the past: in particular, the reverence shown to employment-based pension schemes badly needs to be put into broader perspective. The promotion of labour mobility without penalty is fundamental to any modern society: new technologies and an efficient tax system offer the means to secure basic saving for a pension. Even William Beveridge refused to countenance the complications consequent on contracting out. No other major European economy has fostered the strategy with such persistence as the British and many of the administrative complications that currently bedevil the UK pension system are the result. Any attempt to stop history repeating itself can only be welcome and this, we think, can be achieved.

Section II: Prolonging earning and saving

Introduction

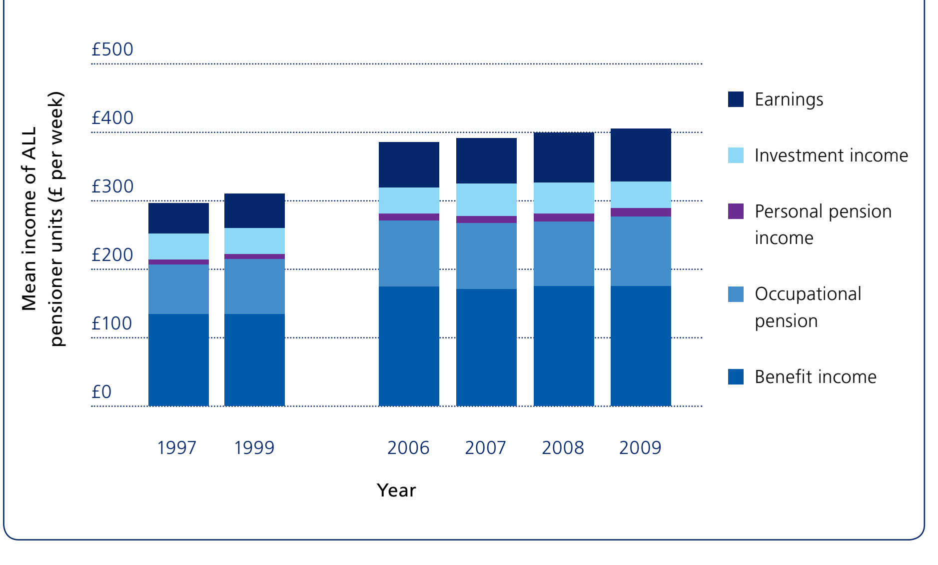
This section addresses three issues based on data central to our recommendations. First, it examines evidence of rising income among people over the State Pension Age: its distribution between income groups and in different age sectors of the retired population. Second, it argues that currently there is a misdistribution between level of income and the rising need for additional resources at very advanced ages, when physical and mental frailties increase. This evidence is used to support the case for the realignment of initiatives to persuade people to save – with a focus on later rather than earlier working lives. Third, it analyses a major cause of income inequality between sectors of the retired population and proposes different strategies of pension saving that could help to alleviate this.

Rising pensioner income and its sources

Pensioner income has risen steadily over the past decade as Figure 2.1 below demonstrates. Pension income has increased at a faster rate than wages. This is a welcome development and is consistent with recent official attention given to the elimination of pensioner poverty.

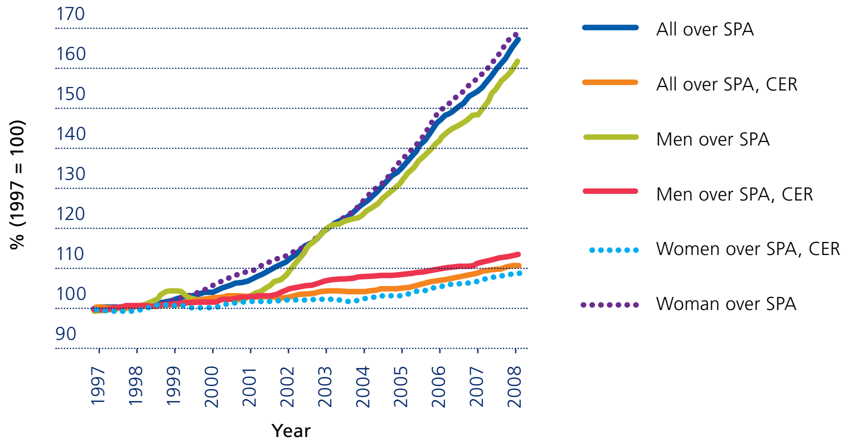
As Figure 2.1 shows, part of this growth is explained by rising levels of state benefits. This is possibly the result of greater numbers being able to claim SERPS and S2P. It may also be partly explained by growing longevity, its impact on physical frailty – and hence on state benefits paid for social care and associated services. However, the greater part of this rise appears to have taken place between 1999 and 2005 and could well reflect the consequences of the recession of 2001-2 for poorer pensioners and the consequent growing numbers of means-tested claimants for Pension Credit (unfortunately data for the years 1999-2005 is not available). If this explanation is correct, it emphasises how recession impacts on benefit supplements for the retired and we must expect to see a further major escalation in such expenditure over the long run as a result of the much larger crisis in 2008-9. With reference to other, private sources of pensioner income, the 25 per cent rise in occupational pensions can be explained by the growth in company pension schemes during the 1960s and 1970s. The significance of personal pensions has risen, but other evidence suggests that numbers covered remain very low. Investment income has remained more or less unchanged (many pensioners claim very small weekly amounts from savings).

Figure 2.1 Average income of pensioner units since 1996-7



The amount contributed by earnings, however, to the income of pensioner households has almost doubled. Retirement appears not to mean complete labour withdrawal from economic activity for increasing numbers of people. Growing labour market participation, under a variety of forms, reflects an increasing acceptance of working after State Pension Age (SPA). As Figure 2.2 demonstrates, the employment rate in this age group has risen much more than among younger age cohorts, particularly among women (but recall that the SPA for women is 5 years lower than for men in the period covered here).

Figure 2.2 Labour market participation rates among workers over state pension age

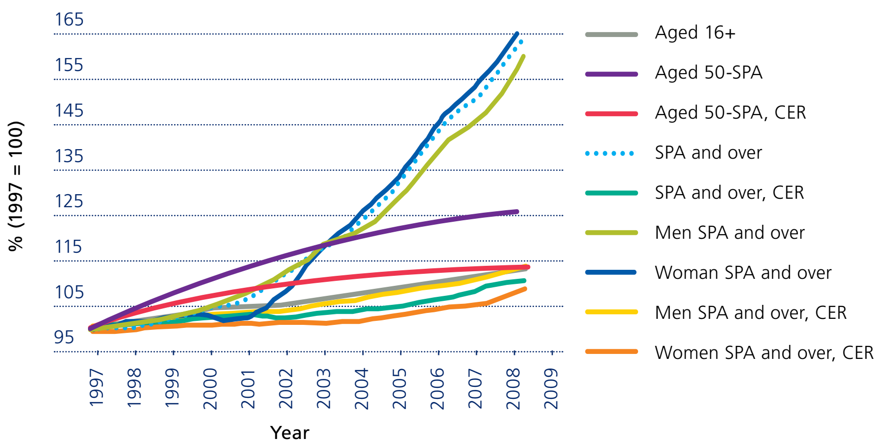


The constant employment rate shows what would have happened if numbers working had been determined only by changes in the size of the population of relevant age groups since 1997 – i.e., no change in propensity to work.

Source: ONS: Labour Force Survey, Key: CER = Constant Employment Rate

This graph must be interpreted with care as the vertical axis represents real figures, not a percentage of the total population above SPA. Nonetheless, there is an observable increase in the propensity of older people to undertake waged work. The labour market participation rates of older workers have risen more markedly than that of other age groups over the last decade, as the following graph indicates:

Figure 2.3 Labour market participation rates by age group



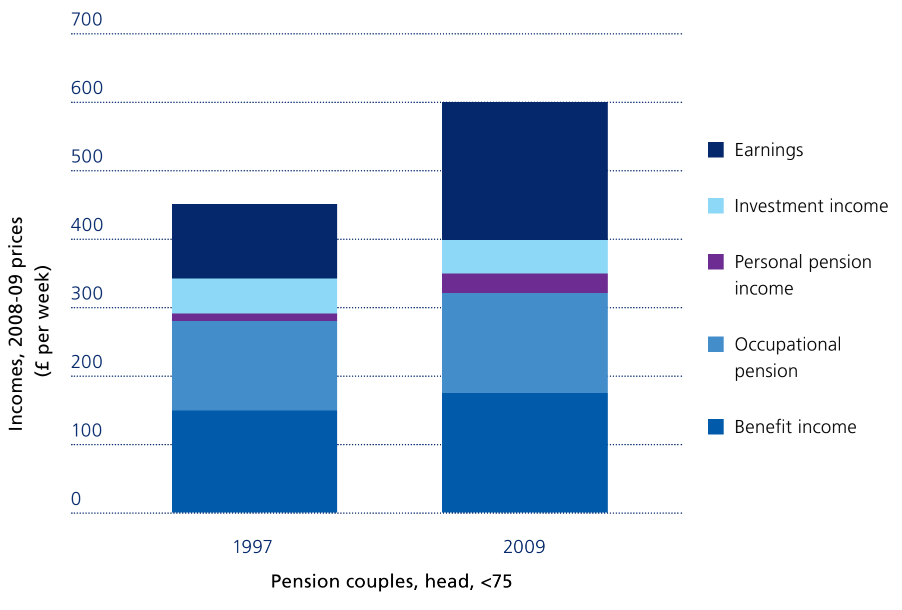
The constant employment rate shows what would have happened if numbers working had been determined only by changes in the size of the population of relevant age groups since 1997 – i.e., no change in propensity to work.

Source: ONS: Labour Force Survey, Key: CER = Constant Employment Rate

While general rates of employment increased gradually over the decade 1997-2008, the rate among older workers and especially among those over retirement age increased more markedly. The recent decision of the present coalition government to abolish the default retirement age and to accelerate the rise in the state pensionable age (SPA) will encourage this trend. This policy of raising labour market activation among older people reflects a strategy promoted not only by the previous British government, but also by the European Union and the OECD. Delayed retirement has been one of the principle measures widely advocated as the means to solve the pension crisis.

We should not, however, assume that rising labour market activity among those of pensionable age indicates a propensity to stay on in the same job. First, the data presented here precede the abolition of the default retirement age: there is no reason to believe that employers have developed a sudden leniency towards those over SPA and pressed them to stay in work. Second, opposition from trade unions indicates that postponing withdrawal from the labour market is not a particularly popular option. Those holding jobs that are highly stressful, or demand physical strength, or are simply boring may look forward to leaving them on retirement. All of this points to the conclusion that, following withdrawal from their previous employment, people look for other ways of supplementing a reduced income that may use acquired skills – possibly through consultancy, for example. Around 90 per cent of post-retirement employees work in non-standard jobs or part-time and, for many, the income earned is very small. Even so, the amount earned has approximately doubled during the period of the last government, among younger retired cohorts, as Figure 2.4 demonstrates.

Figure 2.4 Income of pensioner couples with head <75



Source: DWP, Pensioner Income Series, 2008-9

Pensioner units in lower age ranges can include couples with one partner still in work, but there is no reason to assume that the numbers of such couples have increased markedly over the past decade. The growth in pensioner earning power is not an unwelcome development. It is only after 1948 that receipt of a pension was made conditional on total withdrawal from the labour market and both at that time and since, social research has suggested that such a sharp end to working life is undesirable. The sudden loss of personal identity damages self worth and upsets the routine imposed by a structured daily/weekly timetable, leaving the individual disoriented and bereft. A more gradual withdrawal from the labour market has been deemed to sustain healthier outcomes. Such research has recently received more attention as it supports policies of labour market activation among older workers and there are signs that more people would prefer a gradual withdrawal from the labour market as opposed to sudden redundancy.

The changing employment profile of those of pensionable age creates different problems as it reinforces an undesirable relationship between growing frailty and falling income, as the major income differential between pensioner households under and over the age of 75 derives from earnings:

Figure 2.5 Average income for all pensioner household units by age

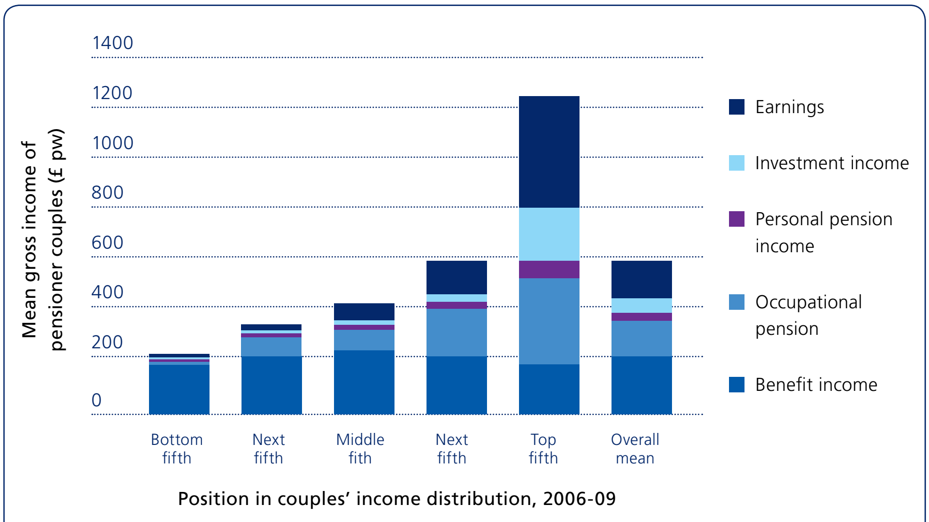
Based on data from the FRS (£ per week, 2008-09 prices)

Source: DWP: Pensioner Income Series 2008-9

Figure 2.5 above illustrates how pensioner income falls at a point when pensioners enter their later, more vulnerable years. Although there may be cohort effects at work here (Figs. 2.2 – 2.4 show that, ten years ago, fewer people worked once reaching pension age and this cohort age would now be largely 75 or over), lost earnings reflect how physical and mental fragility force complete withdrawal from the world of work. However, other factors are involved. Within the retired age group, occupational pensions currently make their largest contribution to younger age cohorts. In 1979, 40 per cent of pensioners could claim an occupational pension, a figure rising to 57 per cent in 1996-7 and to 68 per cent in 2008-9. Older cohorts have lower incomes from this source, partly because coverage is lower but mostly because widows retain the right to only 50 per cent of their deceased partner's occupational pension (currently, 1.85 million of 2.5 million pensioners over 75 are female). Further, company and occupational pensions are inadequately indexed (although they perform better in this regard than do single life annuities under personal pension plans): hence their value falls over time. As occupational pension cover is now contracting, its contribution to future pensioner income will diminish. Personal pensions will have to expand to fill the gap: although coverage is growing, neither median nor mean income is doing so, pointing to persistence problems.

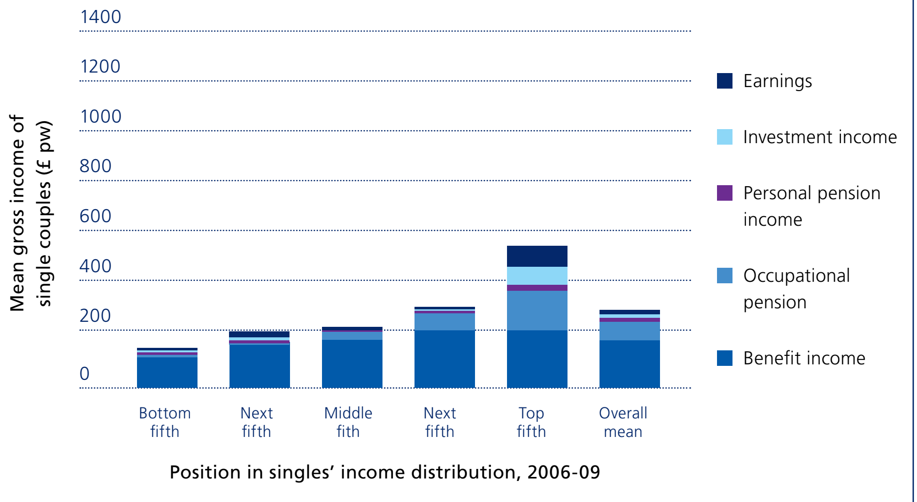
Although earnings have played a new and fast expanding part in raising pensioner income, distribution across the income range is not even. Like occupational pensions – and personal pensions – they are both more common and higher among pensioners at the top end of the income scale, as the following figures show:

Figure 2.6 Income of pensioner couples by income quintiles



Based on data from the FRS (£ per week, 2008-09 prices)

Figure 2.7 Income of single pensioners by income quintiles



Based on data from the FRS (£ per week, 2008-09 prices)

Source (both figures): DWP Pensioner Income Series 2008-9

Of course these figures are self referential: those who earn more are more liable to belong to the top income quintile. Even so, they display a number of interesting and pertinent features. First, the much higher income differentials between married pensioner couples than between single pensioners reflects the fact that pensioner couples may still contain a wage earner below retirement age. It may also demonstrate the propensity for professional women to marry professional men, creating pensioner households with double occupational retirement income and double the retirement earning potential. Second, the disproportionately lower income for single pensioners when compared to couples reflects their higher average age and the preponderance of females – as these are largely widows (and widowers). Finally, while state pension benefits are distributed in compensation to lower income pensioner couples, the reverse is the case for single pensioners, where higher income pensioners receive more state benefits than those lower down the scale. This is probably because class discrepancies in life expectancy create a higher average age in the top earning quintile than in the rest, who are therefore more likely to be in receipt of state disability benefits and associated allowances supplied to compensate for increasing frailty and incapacity (as well as higher winter fuel allowances for the very old).

Overall, these figures reflect how the growing gap in incomes between the very rich and the middle and lower income groups, much remarked on by the media, continues from working life into old age. This is hardly surprising. It is well beyond the remit of this report to say whether, or how, this state of affairs should be remedied. It is, however, worth noting how easy it has been to persuade the top fifth to save for old age, compared with those further down (much further down) the income scale. Second, the problem of insufficient saving focuses attention on single pensioner households, which are addressed in a separate section below.

Recommendations: saving in later life

The figures produced above reflect the propensity for professionals and some others to continue working after retirement – although official figures must omit varying types of self-employment for small amounts of money that pass below the tax threshold. As argued above, hypothetically, the tax-free lump sum received on retirement may have reverted to its original purpose of funding the means to secure a new type of working life*. This opens the door not only to postponing the liquidation of a pension, but also to continuing to contribute to pension savings, to protect against any sudden collapse of income in very old age (due to the death of a spouse) when social and health needs are rising swiftly, household costs do not necessarily contract very much and there is little possibility of earning an income of any sort.

Currently, as occupational pension cover is falling and retirement ages rise, the focus has been on persuading younger people to save for their old age. Yet while commentary has stressed constantly the need for 'working longer', the postponement of retirement has been more than matched by the rising average age of entry into the labour market. Until comparatively recently, the majority of the male population entered employment on leaving school at 15 or 16 and experienced roughly half a century in full time work. As approaching 50 per cent of school leavers now try to go to university, the age at which a permanent full time job is sought can rise by five or six years and, as the labour market has tightened, so the possibility of permanent employment on graduation has receded. Further, it is difficult to persuade younger cohorts to save, particularly for a pension which appears as a distant and uncertain prospect when compared to more immediate financial concerns – the repayment of student (and other) debt – due to rise steeply in the future, the need to secure a foothold on the housing ladder, even the need to find and hold down a regular job that offers a regular income. As family formation these days can follow immediately on success in the job market, pressure on household income is not eased as small children and their care reduce the ability to sustain a dual income. When respondents to surveys say that they 'cannot afford to save' we might guess that they fall within the under 45 age group.

* The earliest pensions offered to members of the armed forces on reaching a predetermined age were lump sums designed to enable the recipient to purchase a small holding or alternative business to secure an income in his declining years. They did not offer an annual stipend for life.

We would strongly advocate shifting the focus for pension saving from the younger to older age cohorts. For, in contrast to younger age cohorts, older workers are commonly in a more stable situation in which to plan for the future. In later years households have greater assets and fewer debts: earnings commonly approach their peak as employees reach their 50s or early 60s. Further, with old age imminent, the possibility of future debility and the years when earning capacity will completely disappear cease to be a distant prospect. Evidence indicates that older workers are more eager to save for their old age and more concerned about resources at their disposal to support a decent retirement. A recent survey found that 57 per cent of people planning to retire this year would be willing to continue working to secure a higher pension (Prudential, June 2010). While this on-line survey drew on those already in the habit of saving, evidence produced above also suggests that complete withdrawal from the labour market on reaching retirement age is not as common as it once was and other surveys have demonstrated that older people are more prone to save for the future, not only in their own interest, but also to pass an inheritance to their children. As the link between 'retirement' and complete withdrawal from the labour market is weakened, it should prove possible to foster saving in later working years, with the view to offering better quality of life in extreme old age.

This is probably more necessary now than it has ever been before. First, labour market activation has reduced (and will continue to reduce) the numbers of middle age women free to take care of a frail elderly parent (and recall that female retirement ages are being pulled up to parity with men at 65 and both are due to rise further in the near future). Second, in part a consequence of rising levels of female labour market participation, families are increasingly geographically dispersed thereby adding to the complications of assuming that adult children will perform the role in the future that they undertook in the past. Third, current government budget cuts are not going to be reversed overnight (if at all). While the National Health Service arguably enjoys a protected status, local social services do not and this means that local support for cleaning, catering and generally caring is going to be more severely reduced in the future than it has been in the past. The ability of charities to cope with rising demand as the population ages is questionable. If we want to persuade more people to save more for their retirement, it is the older working age cohort that is most likely to respond.

This section establishes three key points. First, more people over the current state retirement age are earning some sort of income than ever before. Second, as currently structured, pensioner income declines with advancing years when bereavement and growing frailty both suggest that it should increase Third, older workers are more willing and able to save for retirement, making incentives to save for the 45+ or 50+ age group potentially more worthwhile than trying to convince the young.

Other factors affecting the ability or willingness to save are examined in the following section, which addresses the correlation between gender and extreme old age.

Section III: Extreme age and gender: solving income disparities

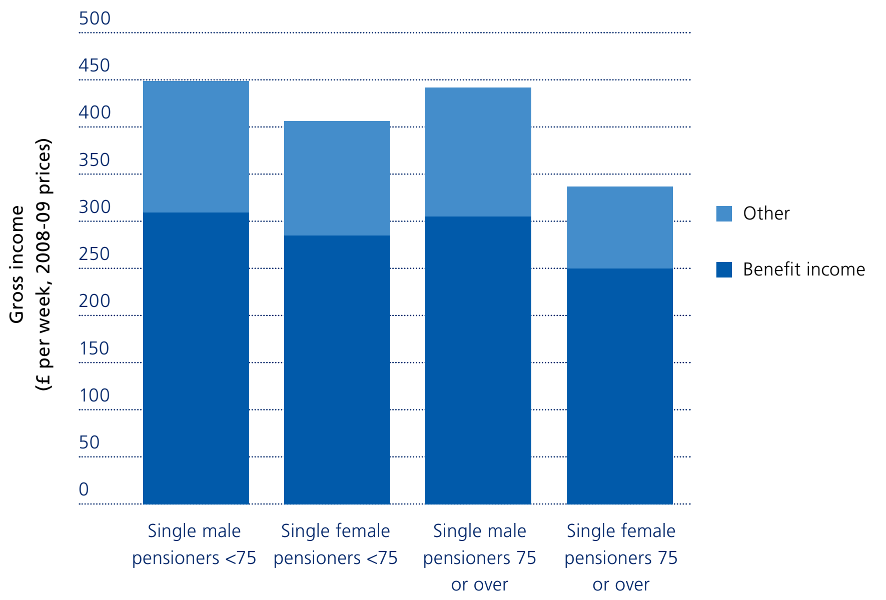
Introduction

This section returns to the issue of growing numbers of frail elderly who cannot work or earn but who suffer reductions in their incomes. It explores the reasons underpinning the discrepancies between male and female pension income in old age – and its consequences for those surviving into extreme old age. It then evaluates whether, taking recent labour market changes into account, discrepancies between married partners are likely to continue. Finally, it offers some suggestions designed to alleviate the problem of poverty in extreme old age through modifications of savings vehicles that could win government approval.

Exploring reasons for pension inequalities

As established in Section II above, survival rates into extreme old age are increasing and currently around 74 per cent of pensioners over the age of 75 are female. This generates a close relationship between gender, extreme old age and falling income, as Figure 3.1 shows:

Figure 3.1 Pensioner income by age and gender



Source: DWP Pensioner Income Series 2008-9: Table 2.6

This figure does not include pensioner couples (the data does not distinguish one member from two member SPA households) but single pensioners, categorised by gender and by age group. The difference between men and women overall is explained by men having higher occupational and personal pension income than women. The table also shows that pension income declines in later life, when the need for more income to pay for social care and associated expenses is liable to grow. Further, this decline is more marked in females than in males (where it is marginal), even though women receive higher state benefits than men at 75+ (in part a compensation against poverty, but also including the disability and social care allowances consequent on rising frailty in extreme old age as women dominate this age group). Reduced household income among the very old is a major problem, not least because it is the very old who absorb the greater part of state budgets on social care and it is their rising numbers that form the major public expenditure burden that government is currently seeking to address. Falling income among the very old has several causes:

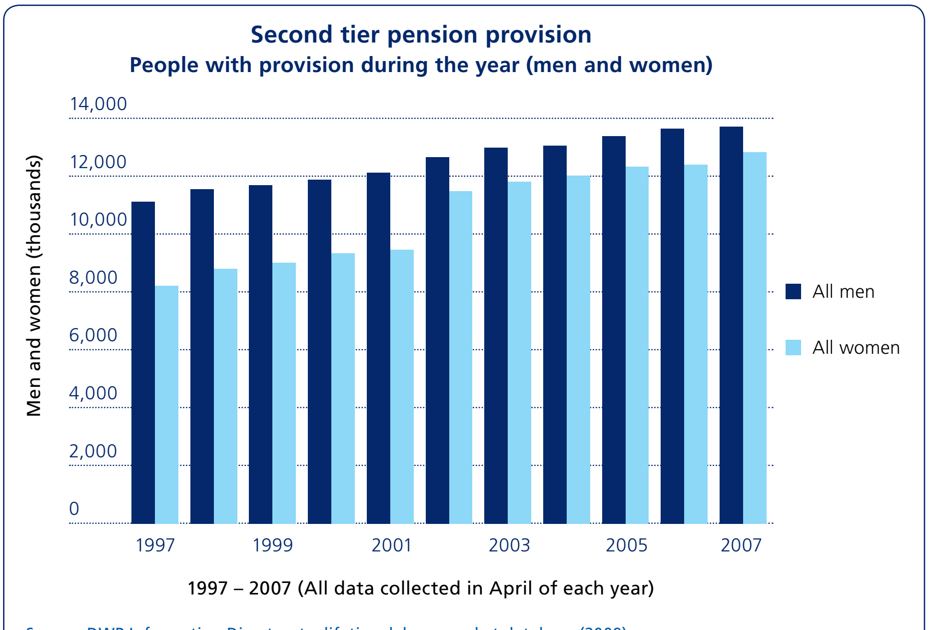
- **Loss of earnings.** As demonstrated above, there has been a rise in economic activity rates among pensioners in recent years – and this rise is to be found mostly among the newly retired. Advancing years necessarily reduces physical and mental ability to earn. (see also Figure 2.5)

- **Reduced real value of private pension income.** Pension income diminishes in value over time, as both public and occupational pensions are indexed to prices, not wages. This trend for pension value to diminish over time is exacerbated in the case of money-purchase schemes. DC schemes require the purchase of an annuity by the age 75 (soon to be 78)[†]. The UK has the most sophisticated annuity market in the world, but the choices on offer are not well understood and currently 66 per cent of annuity purchases default into simple single life annuities that offer higher rates of income in the short term but are not indexed to the cost of living. Hence, over time, their value falls. The closure of company DB schemes and their replacement by DC alternatives (including NEST products) indicates that this problem is going to be most marked among lower income earners and future generations of pensioners, unless all annuities are indexed (an expensive option). This issue reflects the consequences of the general change from DB to DC pensions.

- **The slow disappearance of the survivor's pension.** This is not so much a problem at present (even though the lower gross pension depicted in Figure 3.1 above for women aged 75+ probably reflects the results of an influx of widows into the category) than for the future, thanks to weaker indexation requirements and the spread of single life annuities mentioned above. The shift from DB (generally more generous and required to offer a survivor's pension at 50 per cent) to DC will see the disappearance of survivor's benefits from private pensions, taken that the 66 per cent preference for single life annuities is sustained. The abolition of contracting out will broaden the cover of the state second pension, which incorporates a survivor's pension but, as indicated in our Introduction, S2P rates are low, are due to become a flat-rate pension supplement – and 50 per cent of a small pension does not necessarily raise the recipient out of poverty. In future, therefore, there is a strong risk that growing numbers of pensioners, mostly women, will continue to experience a sudden (possibly worse) loss of income on the death of their partner/spouse at an age where they can do very little to ameliorate their situation.

With reference to this final point, some general observations should be made about women's pensions and savings. First, it is commonly asserted that, thanks to their growing participation in the formal labour market, women today are unlike their mothers, are more committed to staying in work and hence can earn pensions in their own right. On the face of it, the coverage of second tier pensions in gender terms is becoming more equal and gender inequalities in terms of pension rights appear to be a dwindling problem.

Figure 3.2 Membership of second tier pension schemes by gender

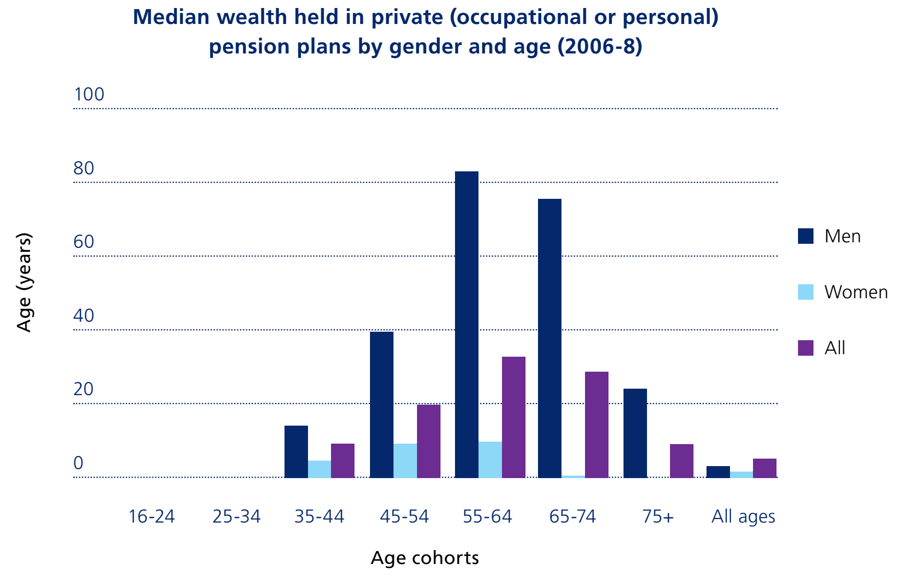


Source: DWP Information Directorate: lifetime labour market database (2009)

[†]The coalition government have announced their intention of abolishing this obligation. However, this is likely to depend on an assessment of the retiree's other income resources: annuities will probably remain a requirement for some.

The impression of growing equality may be misleading; Figure 3.2 tells us nothing about persistence, or amount, of contribution and motherhood pushes women into part-time work which translates into a part-time second tier pension and worse career prospects in lower paid work. The result is reduced pension savings among women aged 30-50 when occupied by unwaged child care.

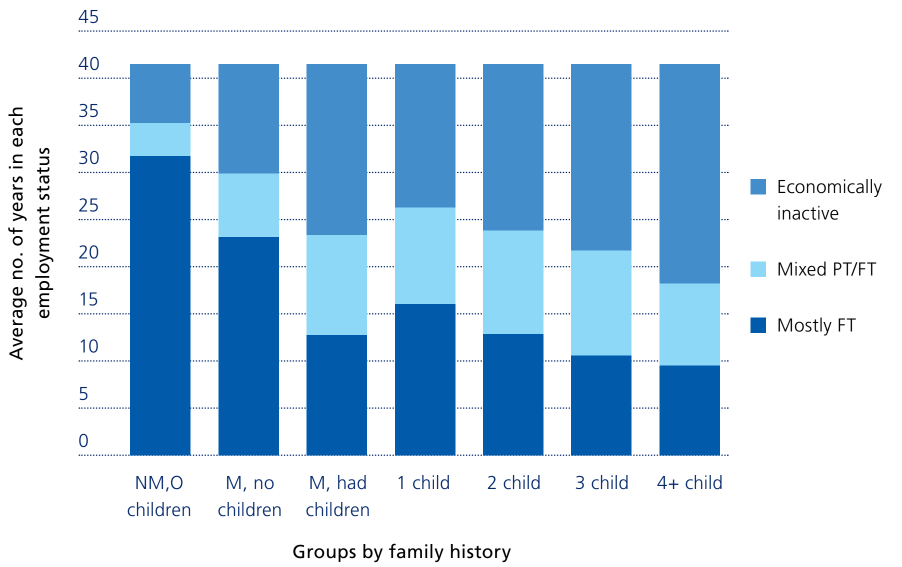
Figure 3.3 Private pension savings by age and gender



Source: Wealth and Assets Survey, Office of National Statistics, (Dec 2009) Table 6.9.

The most recent published research into the pension incomes of older women in the UK demonstrates the penalty women pay on retirement for years spent either caring full time for young children or in part-time work (not covered by private schemes).

Figure 3.4 Employment record of retired women by family history

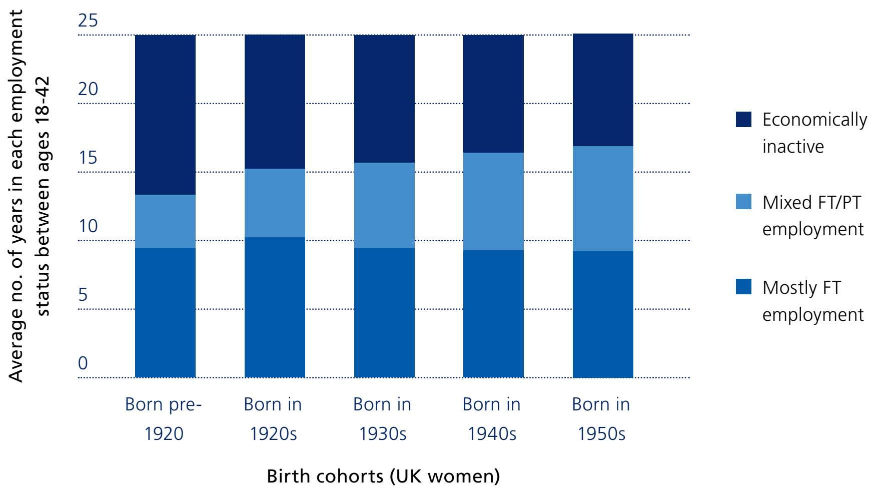


Source: DWP, Pensioner Income Series 2008-9 Key: M = Married, NM = Not Married, 2 child = 2 children, etc.

Thanks to the growth of contracted out occupational or private company pension schemes in the 1960s, today's widows are relatively well protected against the effects of partial and incomplete working lives as such schemes offer a 50 per cent survivor's pension. Since 1997, 59 per cent of pensioner households have been in receipt of an occupational or company pension. Derived pension rights for widows from this source are currently large in comparison with the retired wife's own entitlements (the deceased was on a higher rate of pay and in more regular employment). Supplemented by widows' pension rights under the BSP and S2P, research shows that, for today's pensioners, little difference in pension income exists between a widow who has never worked and one who worked part-time, taken that the husband sustained a full contributory record (Sefton et al, 2010). Thanks to past expansion in occupational and private company pensions, discrepancies in women's pensions have expanded. Most notably, women with qualifications had and have every incentive to stay in work and contribute to a pension while, conversely, the non-qualified and low paid are better advised to stay out of the labour market and not contribute to a pension as any savings are liable affect rights to future means-tested benefits. Marginal tax rates for those with small savings or minimal pension rights remain very high. Overall, retired women with less than 15 years of full time employment or predominant histories of part-time work do not benefit in pension terms from their previous working life. Motherhood was and remains the dominant factor in reducing women's pensions, thanks to a shift to part-time work and/or a subsequently less promising career while caring for children and associated responsibilities take priority.

Although economic activity rates among women have increased since the 1970s, nearly all this increase has been in part-time employment.

Figure 3.6 Changes in women's employment by age cohort (all women)



Source: Evandrou et al. (2009)

This data illustrates the changing work experience of different birth cohorts among a sample of retired women in Britain today (note the impact of the Second World War on the generation born in the 1920s). It illustrates two key points. First, the current retired generation still includes women with very limited years in work (although the experience of the oldest generation is distorted by higher middle-class life expectancy whose female members did not expect to work once married). What is striking is the fact that, across different generations, years spent in full time employment do not vary very much at all (and it is full time employment that offers the best hope of a decent pension). However, as a report published last year noted, if change is happening it is slow. Women over 50 today are half as likely to be in full-time work as those aged 30-50 (c. 20 per cent as opposed to c. 40 per cent), in both cohorts these tend to be qualified professionals (Scottish Widows, 2009). Note that the majority in both age cohorts are not in full time work. We have no data to predict the number of years younger female cohorts will complete in full-time employment. For the foreseeable future, however, women reaching retirement will include substantial numbers with insufficient years in full time work to have amassed significant contributions towards a decent pension in their own right.

Finally, we should note that, in comparative terms, treatment of women pensioners in the UK is not good. A recent review of pension schemes in the European Union (EU, 2010a) has noted that Britain is nearly unique among member states in not offering credits to second tier pension accruals (outside the public scheme) for career breaks due to child rearing, unemployment or the provision of social care. In consequence, the 'at risk of poverty age 65+' index, which stands at 16 per cent for men and 22 per cent for women across the EU as a whole, displays a 10 per cent+ gender disparity in the case of the UK.

Stepping back from the data, it is apparent that the heart of the discrepancy between male and female pension saving and pension income stems from the continuing close relationship between a male working life and earnings profile and the acquisition of pension rights. Pension policies have been designed to fit the needs and requirements of a minority of the retired population in general and an even smaller minority of the frail and very old in particular. Financial incentives to save depend on an ability to conform to this 'normal' working life and do not work the same way for mothers as for single women and men (and, thanks to labour market changes in recent decades, not necessarily very well for them either). Such discrepancies neither promote economically rational behaviour nor sustain common conceptions of social justice as pension outcomes are increasingly unpredictable, more so for women than for men (unless they remain single). Current trends towards individual pensions, as epitomised by NEST's future remit, are encouraging the survivor's pension to disappear. While this does not materially affect today's pensioners, it will impact on tomorrow's cohorts: action is needed now to improve protection, specifically to help pension income to rise (not fall) at higher ages.

Recommendations: equity in pension saving and protecting the very old.

One way out of the current conundrum is to revert to understanding savings made by couples when one is earning and the other's employment is reduced (by domestic, training or caring responsibilities) as joint savings. In our recommendations we sustain this perspective. We argue that this would encourage extra saving overall while protecting the surviving spouse from suffering a sudden drop in income at the same time as bereavement at an age when health is increasingly fragile.

One way forward could be to develop voluntary joint pension savings accounts to accommodate couples where one is earning and the other is not, or is only working part time. Savings in such an account should be offset against the higher earner's tax bill as an incentive. This arrangement acknowledges the value both to partner and the public purse of the unwaged work undertaken by the low (or no) earner, through caring for dependents/children and domestic responsibilities. We should recognise that pushing women into full time waged work creates real risks of higher levels of public expenditure, notably during the years of transition when large numbers of elderly women without savings of their own turn to public social services and means-tested pension supplements for help as their offspring are all in full time employment and unable to care for them. In Sweden, the EU member state with the highest levels of female labour market participation, the situation is only sustained by extensive state-funded social services – and markedly higher taxation.

In addition, there ought to be a legal requirement for both parties, witnessed by a legal advisor, to sign off any rights to their partner's pension in the event of a divorce. Currently (to use the more usual gender pattern) his pension rights are commonly regarded as his property as they are held in his name. She has the right to claim a portion on separation, but – as the value of a pension in its earlier years is low in contrast to the nominal value of the family home – she commonly acquires the house and he keeps the pension. In the long run, this settlement appears inequitable and both parties should be made aware of that.

We would stress that these suggestions are tentative, but the current situation is in urgent need of attention. There is a problem of pensioner hardship that is not going to disappear in the immediate future and it is largely made up of very old women. We would recommend that this situation be referred to the revived pension authority recommended in Section V. The only other possibility would be to offer state credits to a DC pension for absence from work for those unemployed, or caring for children, along European lines. However, in the current financial climate such a recommendation has been excluded as not politically plausible.

Section IV: Providing financial advice about saving

Introduction

Individuals and families are faced with a myriad of ways in which they can make savings. They are also given a variety of incentives to save more. However, it is widely agreed that people are confused by what is available and that their preferences and priorities often lie in other places than in making savings for a distant future. Despite exhortations, savings rates seem uninfluenced by most macro and micro policy initiatives. In so far as individual policies have had an impact, many have done no more than to switch the form that saving has taken; few if any have had an impact upon its level.

This section examines whether savings might be enhanced if people received more information, education and advice about why saving was important and how saving might be undertaken. Whilst it is recognised that there are barriers to saving that are the result of immediate consumption needs having to be met out of immediate income, the propensity to save is not fixed and might be changeable. A better understanding of the importance of saving, and of how it might be effected, might change behaviour. Financial advisors might have a role in this process. However, their responsibilities, status and the manner of their remuneration might need to be changed fundamentally.

The need for advice

The barriers to saving are often listed in terms of product complexity and myopia. Choosing a product is difficult and time-consuming, and the benefits of devoting time to planning savings are enjoyed only in the future. It is widely recognised that individuals rarely initiate long-term savings plans; they have such plans initiated for them. Many people join pension schemes simply because the opportunity is offered as part of their employment. Even if, unprompted, they make a decision to consider starting a long-term savings plan, people quickly resort to intermediaries for information and advice. Moreover, even if people make commitment to save, their commitment is often fragile. Few show an interest in sustaining and developing their saving commitment and many abandon it at the minimum provocation and with little regard for the consequences. Financial advisers might have a contribution to make in guiding individuals towards starting to save, maintaining saving and adapting saving patterns. There are those who argue that, in the past, this was the role played by 'the man from the Pru', or 'the rep', who visited customers at home on a regular basis, would stay as their contact for years and, thus, who knew them and their circumstances intimately. Moreover, although many commentators have stressed the importance of enhancing 'financial literacy, research indicates that decision support is as important as any training and that it is when the latter is complemented by the former that successful outcomes might be expected (Carlin and Robinson, 2010).

To understand the functioning of long-term savings products, and to be able to appraise them, is beyond the capacity of most consumers. It requires not only that consumers understand relatively advanced mathematics, whilst few actually can even understand percentages, but also that they appreciate the interaction of a multiplicity of factors and the probability of their occurring. This they had to do even before the world entered into a period in which the outlook was 'unusually uncertain' (Bernanke). The information and the analytic abilities required means that the value of any single product is difficult to assess. Moreover, in many cases its actual value will be apparent only much later. In as much as the role of financial advisors involves assisting in explaining why acquiring a savings product might be worthwhile and how one product differs from another, they can play an important role of supporting individuals when they are having to make savings decisions.

The importance of confidence

There is evidence that consumers both wish for and value support when they are considering purchase of complex products. Equally, those who supply such products recognise that, if support is offered to purchasers, this can enhance their loyalty not only to the particular product but also to the supplier of it. Through the provision of support, it offers the supplier the opportunity to sell further products and reduces the costs of doing so. Much of the analysis of the value to suppliers of providing support is couched in terms of 'relationship marketing'. Much of the 'support' that is offered consists not of the mere presentation of the technical qualities of a product but of the process of explanation itself and, thus, of the generation of confidence – both in the product and in the person and organisation that is supplying it. When seeking to describe how financial services companies could improve their performance, some analysts talk of trying to turn financial advisors from merely being 'hunters' – essentially, people whose principal objective is to acquire new customers – into also being 'farmers' – essentially, people who are responsible for looking after the servicing needs and new product requirements of existing customers (see, inter alia, Alexander and Colgate, 2000;Davlin, 2000; Gaskell and Ashton, 2008; Krah, 2009; Llewellyn, 2005; White, Lemon and Hogan, 2007).

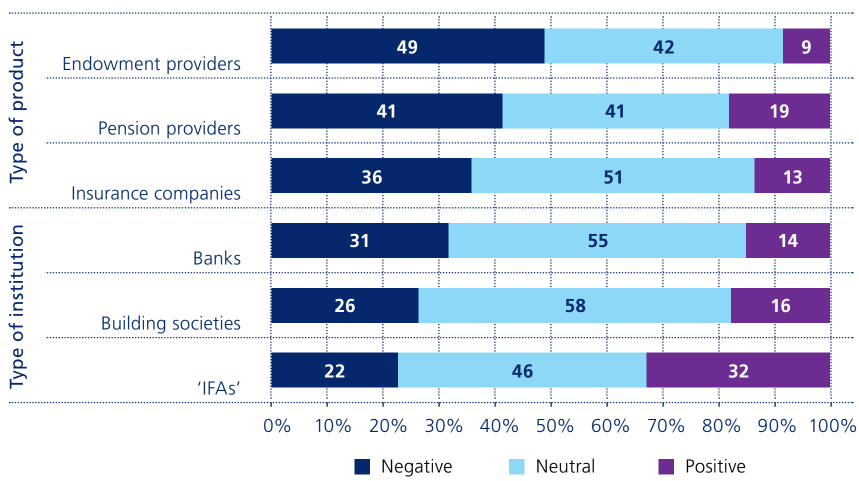
Nonetheless, all examinations of the relationship between buyers and sellers of complex products, whether financial or other, recognise that it is an unequal one.

Whatever preferences or wishes the former have, the latter have a better understanding of the product. The seller acts as, and is expected to act as, the 'agent' of the buyer, who is the 'principal'. It is not always the case that the interests of the two parties coincide. If the relationship is a one-off one, agents can realise benefits from the transaction for themselves, even if the transaction proves to be less advantageous to the principal that it was initially presented to be or was assumed to be. It is only if the particular interaction is part of an ongoing process that principals can sanction agents – by withdrawing from the processes. However, potential principals might recognise that they have neither the capacity to judge the product, nor – because its value cannot be measured until much later – the information on which to make that judgement. Accordingly, they might well be wary of entering into the relationship at all, or if they do enter into it, entering into it in any depth. This applies regardless of the specific nature of the complex product, but it is well known that it applies to financial products.

The status of financial advisors

Even before the onset of the current crisis, the financial services industry and financial service professionals were not held in the public regard that they might have wished for. Problems associated with the mis-selling of personal pensions and endowment mortgages – and, to a lesser extent, of equity release products – coloured popular perception. Research conducted for the Financial Services Consumer Panel in 2005 (FSCP, 2006) showed that, in retrospect, only nine per cent of those who had experience of purchasing, or trying to purchase an endowment mortgage and 19 per cent of those who had experience of purchasing a pension trusted the source that had advised them, whilst 49 and 41 per cent respectively distrusted it. Such a finding shows that there are trust problems with financial services but also that people trusted independent financial advisors (IFAs) more than insurance companies, banks or building societies (see, also, Ennew, 2009).

Figure 4.1 Consumers evaluation of experience with financial products and financial service institutions

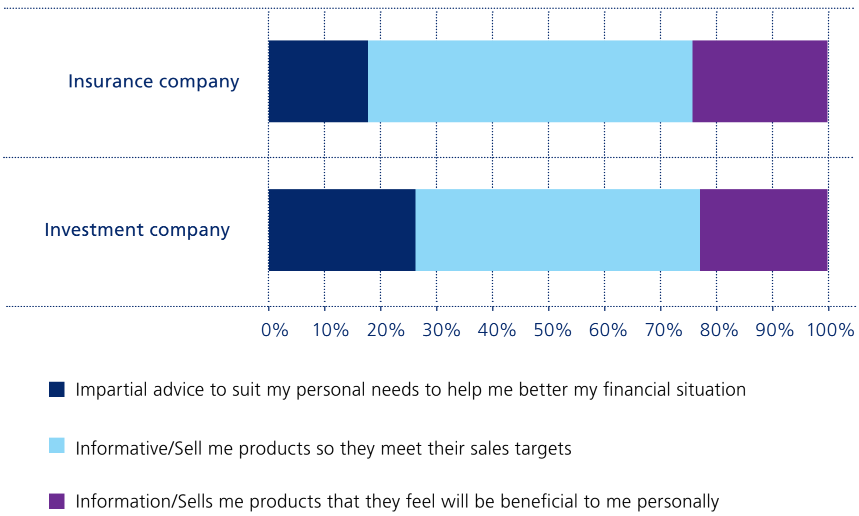


Note: higher positive experience with respect to 'IFAs' is statistically significant if the sample was truly random.

Source: FSCP, 2006

Unfortunately, negative images of one occupation rub off on other, closely related occupations, and negative images of the financial services industry as a whole rub off onto individual branches and sub-sectors of it. As a result, it is not surprising that a survey of the extent to which consumers trusted various industries resulted in the financial services sector as a whole being placed fourteenth equal out of 20 in terms of consumer trust (Corporate Culture, 2007). Equally, a recent survey of customer satisfaction with specific financial services – but not IFAs per se – showed that many did not trust the body with which they had contact to be acting in their own interests (DMA, 2010). This is a good illustration of the 'principal-agency problem'.

Figure 4.2 Consumers evaluation of experience with selected financial institutions (proportion who believe "my insurance company/investment company gives me …")



Note: shares are the average of four surveys taken in Dec. 08, Jun. 09, Dec. 09 and Jun. 10.
Respondents for whom the question was not applicable or who had none of the three views are excluded.

Source: DMA, 2010

Box 1: Recognised confusion of terms

Much of the discussion about financial advice recognises that the terms 'information' and 'advice' are used interchangeably. Consumers seldom distinguish between the two and describe the same process using both terms. In the same way, 'advice' and 'planning' are confused. Although there exist separate occupations of 'financial planners' and 'financial advisors', it is not clear that consumers differentiate one from another, and they might well conflate the two.

On top of this, some financial planners and advisors carry the title 'independent' The term is acknowledged to offer 'brand value', but there is no precise definition of what it means. There is the impression and, indeed, the aspiration, that independent advisors are those who can give information on services and products regardless of the originator, are not influenced by the product provider, chare fees rather than are paid on commission, and operate according to professional standards. However, they do not have to be (see FSA, 2007).

Nor do consumers know how to make the distinction. Many 'refer to any advice they had received as independent financial advice or, more to the point, advice received from an independent financial adviser, even when the advice was provided by a tied financial adviser or even bank sales staff… This is not to say that consumers perceive all advice they receive as independent, more that given the confusion between the different types of advice 'IFA' is a handy catch-all term to refer to financial advice… Accordingly, there seems to be a real lack of clarity and transparency over the differences and barriers that exist between bank sales staff, financial advisers and IFAs. Although this lack of understanding exists across the board it is more pronounced amongst those with less financial sophistication and expertise'. (FSCP, 2008)

Those seeking to promote the status of independent financial advice recognise that people are often unsure whether it is getting impartial advice or being sold a product. 'Research from IFA Promotions reveals 84% of UK adults admit they do not understand the roles and qualifications of the [financial service institutions]s who claimed to be offering some form of 'advice'. Indeed the ambiguity of financial services jargon misleads consumers and so perpetuates a feeling of mistrust in the sector' AIFA, 2009). Accordingly, it is difficult to interpret that data which does exist about the people's use of, or appreciation of, financial advisors. It even if the questionnaires used refer to 'independent' advisors or distinguish between 'advisors' and 'planners', it is by no means clear what respondents are thinking of when they give their answers. As one major polling company said, "survey respondents were not given further detailed descriptions, one of the limitations of long consumer surveys. It was up to the respondents to answer – based on their own perception/knowledge of the titles".

(Interview, 20-8-10).

Recasting the role of the advisor

Some of the goods or services that people consume/purchase are of more importance than others. Equally some of the providers/sellers of services are more trusted than are others. Medical services are both important and, in general, those providing or selling them are trusted. Estate agency services are important, but consumer trust in estate agents is often not high. The purchase of a lottery ticket is not one on which most consumers place high importance, but most consumers trust the process through which they purchase their lottery ticket. Equally, there might be goods that people purchase that are of low importance and where they are not particularly concerned that the product might not turn out to be what it is presented as – supposed 'designer goods' sold on street markets (Llewellyn, 2005).

Financial services, including financial advisory services, are services for which the importance to the consumer is high. Moreover, when making a purchase, consumers ought to be able to feel they can trust the supplier of them. If they cannot, they will tend to reduce their consumption of them or even fail to consume them at all. The challenge for the providers of financial advice is to align themselves with providers of medical services not with providers of estate agency services. Moreover, those who are providing advice face a further challenge consequent upon the fact that many consumers do not, or cannot, distinguish between those who are providing them with information, those who are providing them with advice and those who are selling them something (see Box 1). Consumers might well think of them as 'advisors', but unless they have taken deliberate steps to inform themselves, and have engaged in very deliberate search for assistance, they will seldom distinguish between 'advisors' and 'Independent Financial Advisors'. Even the IFA label may be damaged by association with other less trusted parts of the industry, as consumers fail to differentiate between its components. This is something that many analysts of the retail distribution process, but also the body representing IFAs, have recognised (see, McGaugh, 2010; AIFA, 2009).

Attempts to improve the confidence that consumers of financial products might have in the products they are purchasing, and the way in which those who are selling to them are treating them, have taken a variety of forms over time. For a considerable period, the UK government relied upon setting rules that determined how those marketing financial products should operate. Over time, it realised that such an approach was recognised as less than fully effective. This was because rules are static, cannot adjust to new circumstances and, as preferences and technologies change continually, have to be added to. It was also because rules can be 'gamed' – they can be satisfied in letter rather than in spirit, manipulated by redefinition of terms or evaded through the exploitation of loopholes. In response, the emphasis on prescription was changed to an emphasis on setting out broad principles. Instead of trying to dictate providers' behaviour in detail, the government – and latterly the FSA operating on its behalf – sought to give providers the responsibility to decide how best to align their business objectives and processes with what were deemed to be desirable outcomes. These desirable outcomes were that financial consumers – and, here, 'unsophisticated' financial consumers – were treated 'fairly' and that they could be assured they were being treated so. Implicitly or explicitly, the intention was to shift the relationship between buyers and sellers from one that consisted of ad hoc transactions to one of that was more durable and from which both parties would benefit (Llewellyn, 2005; FSA, 2007b).

A close examination of the relationship between buyers and sellers has been undertaken in the context of the FSA's retail distribution review. This, in turn, has led to suggestions for a revision of training and an obligation of practitioners to possess nationally approved qualifications. It has also led for calls for the establishment of new bodies to control membership and set standards, including the proposal for financial advisors to be given a 'chartered status' (see, inter alia, McGaugh, 2010). The FSA, itself, drafted an occupational structure that included the category of 'professional financial planner' (FSA, 2007a). Those with such a title would be equipped with appropriate and recognised qualifications and remunerated on a fee-for-service basis.

The term 'professional' has its own connotations and is not used lightly – it is repeatedly found in the background documents for the retail distribution review. Professionals, as the term is commonly understood, 'supply expertise to society for the good of society'. It is not only what they know that is important, but how they use what they know, and how, in doing so, they respect widely accepted professional codes. Doctors are the archetypal example of a professional, and as professionals, they are held in high esteem. Indeed in a survey that has been carried out for over 25 years, doctors have always topped the list of occupations that people trust (IPSOSMori, 2009).

The financial advisor as the financial doctor

Attempts to draw a comparison between financial advice with medical advice are not new. Over 20 years ago, in a report on Training and Competence in Financial Services, the author suggested that an 'aspect of competence that [is required is] an understanding and interpreting of a client's needs; a diagnostic approach, similar to that of a general medical practitioner' (McDonald, 1990). General practitioners interact with clients who are unsophisticated consumers and who seek complex services. They are obliged to, and normally do, entrust a high degree of confidence in the suppliers of these services. In so far as patients – the doctors' customers/clients – pay for these, they do so via a fee or 'honorarium'. The notion of doctors being paid by results or of receiving commission for making particular recommendations is anathema – whatever might, on occasions, occur in practice.

The analogy of the financial advisor as a doctor could be taken further. In general, doctors do not have one-off relationships with their patients but an ongoing relationship. Most doctors, however, deal with patients in a reactive fashion – the patients visit them only when they are unwell. However, doctors also aspire to a preventive role – hence the notion of 'preventive medicine'. The latter reflects a recognition that the focus of clinical care is not only to cure but to take actions that avoid the onset of disease in individuals who are currently healthy. Such actions involve immunisation but they can also involve lifestyle advice. In a narrow sense, preventive medicine means averting the development of a pathological state; in a broader sense, it includes all measures that limit the progression of disease at any stage of its course. Preventive medicine strategies are based on the premise that it is crucial for clinicians to engage with patients in good times as well as bad and that their task as much as anything else is one of health maintenance and health promotion. The discourse is rich in reference to life-long relationships between the doctor and the patient.

Health promotion and health maintenance initiatives place importance on the availability of data about those who are being served. They imply the monitoring of individuals and their progress. They also imply the availability of population data that facilitate the ability of the clinician to predict whether or not particular individuals are at risk. Whilst preventive medicine might well have the enhancement of individual and collective wellbeing at its core, it is also often discussed in relation to efforts to contain healthcare costs. Here, and especially in the context of the US healthcare system, reference is also made to 'health maintenance organisations' (HMOs). The latter are supposed to take an overview of those whom they are contracted to care for and to reduce costs by avoiding the onset of catastrophic conditions. Put simply, "unplanned hospital admissions are a sign of failure" (Brimelow, 2010).

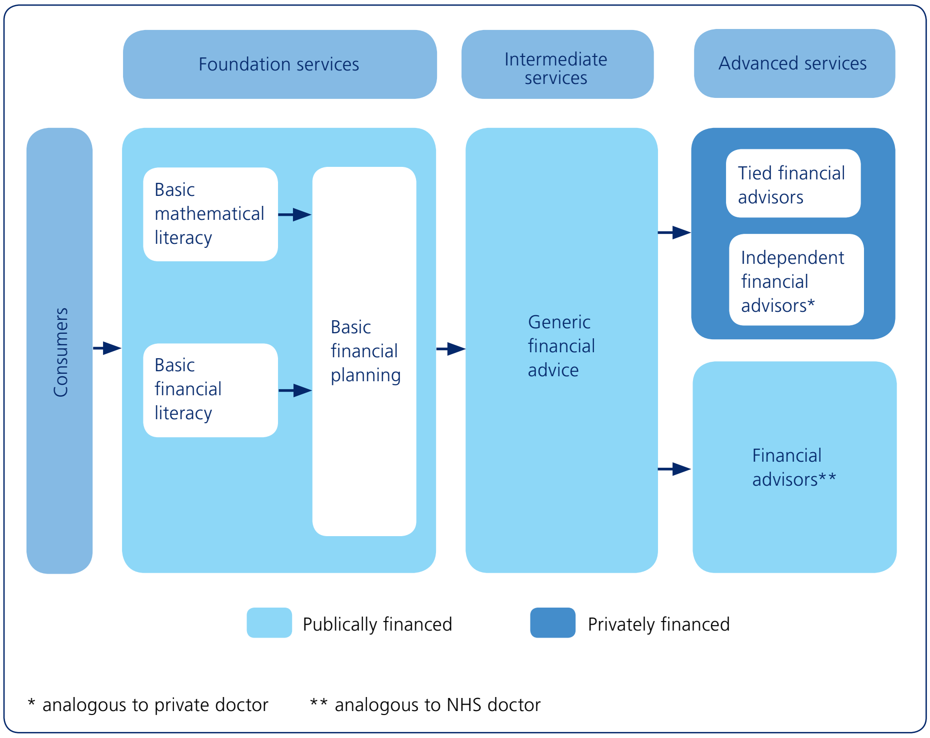
Financial health maintenance

There are plenty of commentators who speak of much of the population being in poor financial health. A case of a catastrophe of financial health could be one of a person enduring home repossession or bankruptcy, or entering retirement reliant upon means-tested benefits. Preventing such catastrophic outcomes might be the role of improved financial literacy and capability. In the same way that clinicians provide lifestyle advice, so might financial advisors. For many, financial advice comes only at the catastrophic moment. It is likely that far fewer people receive ongoing advice on how they might maintain their financial wellbeing than receive advice on how they might maintain their physical or even mental wellbeing. This is because visits to doctors are more frequent than visits to financial advisors and the former occur in times of minor ailments or even because people feel the need to obtain a medical check up. On average adults make about five visits to their GP per year, whereas fewer than one in five claim to have talked to a financial advisor (independent or otherwise) in the course of the previous year (source: ONS, GHS health utilisation data).

Preventive medicine and health promotion initiatives have not been without their critics. Some commentators have gone so far that they have the potential to turn healthy people into patients and to increase people's anxiety. Specific exercises have been criticised for concentrating on conditions that actually affect only relatively few people and for diverting doctors' attention away from more widespread diseases whose cumulative impact is greater. Some have pointed to shortcomings and inadequacies in the predictive models employed, and some have suggested that they have been less than efficient in targeting resources (for example, Gérvas, Heath, Durán and Gené, 2009; Gérvas, Starfield, and Heath, 2008). Initiatives to promote better financial health could be appraised in the same way. In addition, current arrangements might well mean that financial advisors have incentives to encourage particular courses of action because they benefit from doing so. Even if they are genuinely 'independent', they earn a fee from undertaking the consultation. Whilst doctors in private practice might be thought liable to abuse the trust placed in them by prolonging consultations or advising unnecessary treatments, the presumption is that they do not, whereas the suspicion that financial advisors might do so persists. One difference between the two is that financial advisors – even IFAs – are not subject to the sort of professional control that doctors – who are answerable to bodies such as the General Medical Council – are. The calls for the profession to be 'certified' or 'chartered' are clearly part of an attempt to overcome this problem.

Implicit in much of the discussion of the need to improve financial capability and so to improve financial health is the establishment of a 'financial health care service'. This service would be analogous to the service that deals with the physical and mental wellbeing of the population. It would, however, differ from the latter in that it would place far greater emphasis on health promotion and health maintenance. Is prime task would be prevention rather than cure. An outline of the envisaged structure is given in Figure 4.3 below.

Figure 4.3 Structure of a 'financial health care service'



Paying for the financial health care service

The analogy of financial advisors and health advisors is imperfect insofar as it ignores the manner in which the two services are financed. Although private doctors do charge a fee or honorarium, most people who use medical advisors are not billed for the service. There is much evidence of people's reluctance to pay a fee for financial advice, and this is often used to explain why many operate on a commission basis. Even if the commission is made clear, most customers seem to find remunerating the person who has been 'advising' them in such a fashion, where a payment does not take place, more acceptable than one where the cost, in the form of a bill, is made explicit. Recognition of this has led to proposals for the establishment of a service providing at least initial, basic or 'generic' financial advice that, like a service providing health advice, is free at the point of demand. Most of these proposals are predicated on the assumption that, if receipt of such advice enhances the literacy of those who receive it, this enhanced literacy will cause people to realise that paying for further advice is advantageous to them. Such advice might be provided by tied agents, as long as people are clear what these are, and it might be paid for out of commissions, as long as the commission is made clear. However, there is also the need for a service provided by advisors who are fully independent, who are recognisable as such, and who act on a 'professional' basis. Their services, like those of other 'professionals', would be paid for through a fee. It is assumed that consumers would be prepared to pay such independent advisors in the same way as they are prepared to pay lawyers or accountants.

The fact that most people do not pay directly for medical advice is relevant here. In most advanced countries – the USA is an exception – medical services are 'socialised'. They are either tax financed, as is the case of the UK, or financed through mandatory social insurance contributions. Socialisation is considered relevant not only because it smoothes costs for individuals, but also because it generates benefits for the population as a whole. Poor health has an impact not only on the individual but on wider society. Some illnesses are contagious. Sickness absence not only reduces the income of individuals it reduces the productivity of the organisations they work for and lowers overall economic output. In the same way, if individuals are in a poor state of financial health, the impact is felt not only by them. The poor state of financial health increases the number of people who are likely to have to rely upon social transfers. It has impacts upon families. Numerous studies have sought to value the social as well as the individual benefits of improved financial literacy and have used the results to justify its provision without charge to the users (see, HMT, 2008).

An improved state of financial health, like an improved state of physical and mental health, is a 'public good'. Public goods can be provided only through some form of collective organisation. By definition, there are few incentives for markets by themselves to provide them. However, particularly at present, it is unlikely that the government will be willing to raise additional taxes or to divert revenues from other priorities to provide this public good. Currently, some part of financial regulation is paid for by a levy on the financial services sector, and some part of that levy has also been used to finance educational and literacy building. The new Consumer Financial Education Body, which has taken over many of the latter functions from the FSA, will also be financed by a levy – although with a wider contribution base that includes include consumer credit firms as well as banks and insurance companies, advisors, brokers and investment firms. On the other hand, given the responsibility that a full financial health advisory service would have, it not clear that the scale of finance currently generated would be sufficient to pay for the sort of 'financial health care service' that is probably necessary. If the analogy with a conventional health service is sustainable, the implication is that resource needs would be considerable. Figure 4.2 above indicates the extent of the need and the items that might need to be publically provided and publically financed.

Section V: Governance, complexity and administrative costs

Introduction

One of the major problems confronting the reform of the pension system in the UK derives from the legacy of past regimes which have created complex and multi-tiered administrative structures, as each regime is set in its own regulatory framework. This was the main problem identified by Adair Turner's Pensions Commission and a focal point for its recommendations. Recent pension reforms claim to be based on the Turner recommendations: to date, however, they have only succeeded in adding yet another layer of complexity to that which already exists. These processes have made the overall system incomprehensible to all but a small number of technical specialists, with varying expertise derived from experience in financial services, public administration or public accounting.

Such expertise is evidently vital for the smooth running of the UK's highly complex pension system. Yet, complexity makes pensions hard to understand. It makes the exercise of rational choice between different savings products problematic. It also makes it very difficult to widen debate or to engage a broader public whose trust in the financial services industry is currently not strong (see Section IV). If savings rates are to be improved then public trust must be regained. Trust is based on understanding, so agents can anticipate the consequences of their chosen actions. While financial education and advice offer one route towards this goal, rendering pension schemes and different types of pension saving both more visible and more publically accountable is also essential to this process. In this section we address pensions as a public good (as opposed to an individual one) by examining a different dimension on the issue.

Problems of uncertainty

Current UK pension policy is steeped in the orthodoxies of rational choice. Under this approach, we assume that each individual is best informed about his or her needs and objectives and that therefore he or she is in the best position to determine how these might be met. Market provision offers choice and competition between providers generates high quality products at optimal prices. When we look at pension markets, three issues arise. First, the virtues of competition have not driven down administrative costs. In the UK as well as in many other countries it has proved necessary to introduce caps on management costs to keep them within respectable bounds. Market forces do not appear to drive down these costs as might be expected. Second, to make an informed choice in a complex market such as this one, financial education and advice is required. This has been covered in Section IV of our report.

Finally, there are issues of confidence and trust which are undermined by uncertainty. Here we must distinguish between uncertainty and risk: risk is both foreseeable and measurable; with the aid of extra insurance, I can cover myself against the possibility of its occurrence. Uncertainty is something quite different: it means I have no knowledge of the consequences of my actions (if any). I am unlikely to take action in the absence of knowledge concerning outcomes. High levels of uncertainty, therefore, foster non-participation in collective endeavours – whereas the presence of risk may not necessarily do so. It is therefore a public good to reduce uncertainty and to develop strategies of risk containment to promote participation.

The issue of uncertainty is particularly important when prolonged periods of time elapse between paying for a product and the receipt of its benefits, as is the case with a pension. We know from earlier innovations in forms of payment and delivery of services or products that confidence and trust are vital for a system to function. If I pay for a product in advance (on the internet for example) can I be assured of its receipt? Where can I turn for redress if my purchase turns out to be a scam and my expectations are not fulfilled? In the absence of satisfactory answers to these questions, I will not act as the uncertainty is too strong. In a pension context, therefore, if I contribute towards a future pension, what do I know now about the level of pension I will receive? What will happen to my occupational pension if I change jobs or work overseas (within or outside the EU) for a number of years? Labour market change means it is increasingly unlikely that people will work for the same employer in the same location for the whole of their working lives. The shift to more individual pension accounts was justified by arguments of greater portability – but the reality of portability appears to be fast receding. At best it promises to be heavily clouded by complex regulations that are obscure to a private person trying to act responsibly to protect their income in old age.

Too many areas of uncertainty foster non-participation. Currently, around 47 per cent of the working population is saving either nothing or too little for a future pension (ABI survey, July 2010). What is needed is greater transparency and co-ordination. No-one expects the purchaser of a new car to be an expert in internal combustion engines: technical standards that guarantee performance and safety are developed elsewhere. Supermarkets and the food industry hallmark products to raise customer awareness about excessive consumption of salt, sugar and unsaturated fats and the damage this can cause to long-term health. To follow the medical analogy, general medical practitioners may and can offer advice and guidance on individual diet, but this is a relatively expensive way of safeguarding health when generic guidance can be provided by other means. Reliance on markets requires collectively recognised and respected public evaluations and signals to safeguard the public good. How these might be developed is outlined at the end of this section.

Conditions of complexity

In its First Report (2004), Adair Turner's Pensions Commission stressed the complexity of the British pension system, the costs it generates and the damage done to public trust by the constant additions and alterations introduced by various governments over the years. The main thrust of the Commission's recommendations aimed to secure simplification and greater clarity, to restore public confidence and foster participation by securing a trajectory towards a pension system that would, in time, be comparatively transparent and easily understood. Echoing the remarks made by William Beveridge in his famous report of 1942, Turner argued that greater certainty about public provision would encourage personal saving for a pension. Even as the Pension Commission was taking evidence and publishing its first report, however, collapsing company pension schemes attracted attention in the media and pushed New Labour to scrap one regulatory authority (OPRA) to create another (Pensions Regulator), together with a new agency (Pension Protection Fund) to guarantee that future bankruptcies did not deprive company pensioners of their incomes. While this may be a praiseworthy development, it added another pension institution to the heap that already exist and hardly clarified the pension situation for the public.

This example points up a general tendency. Governments are the agents that promote reforms – but the long-term interests of pension providers and their customers are not necessarily at the forefront of the politician's mind. Reform feeds reputation of minister and government, to promote a positive profile at the next general election. The time horizon here is five years, or possibly ten; yet it takes around 40 years to accrue rights to a pension. Moreover, tax changes, prevailing interest rates and fluctuations on global financial markets also affect pension saving outcomes. Hence temporal discrepancies emerge between the aims of government (which are necessarily short-term) and those of pensions, which take far longer to accumulate – and longer still when the paying out phase is added in.

The result of constant state interventions, as Turner among others acknowledged, is an administrative mess – and a very expensive administrative mess. The present approach has created an alphabet soup of pensions and pension products as well as non departmental agencies and associated bodies that carry responsibility for some aspect of administration. The separate administrative lineages and regulatory agencies of personal pensions (as individual financial products) and of occupational or company pension schemes may make some sense to those within the industry. They make little or no sense to a general public who are not represented on these bodies and who do not know the different official remits of the Pensions Regulator and the FSA, (to take but two examples, the latter soon to change). Some consequences of administrative complexity – already covered by Turner – need reemphasis.

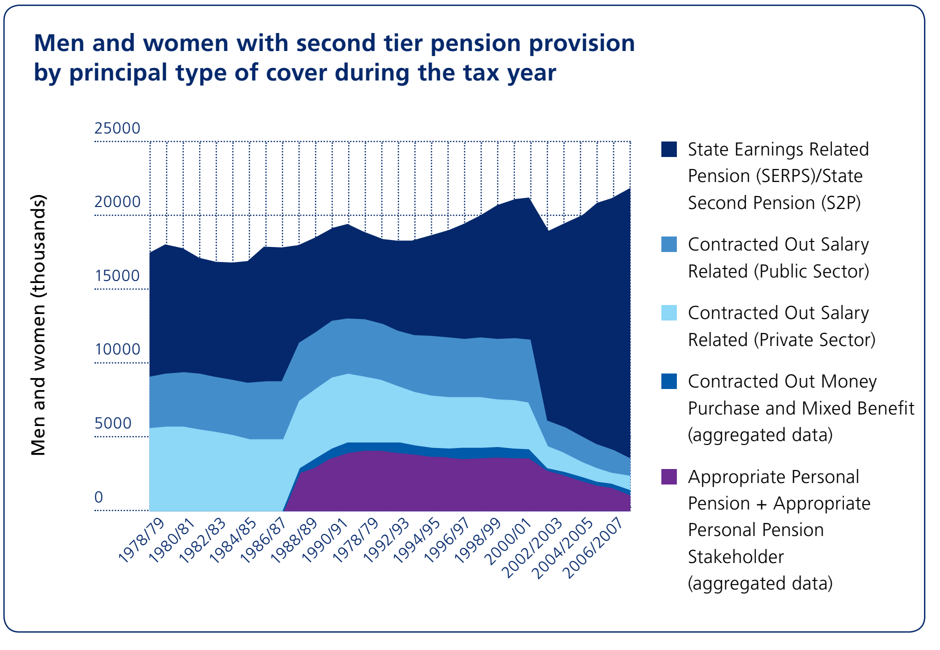
First, pension markets are highly regulated and regulation, of itself, distorts the signals of quality and price that are supposed to act as the hallmark of market systems. As regulation accrues steadily over time, the rational choice of savings product at time point X may not be the rational choice of savings product at time point X + 40. Constantly changing savings vehicles in order to sustain rationality drives up administrative costs and is unlikely to benefit the consumer in a world where early exit commonly carries financial penalties.

Second, thanks to the complexity of pension products and to the constantly modified tax and other regulatory changes, the issue of pensions and pension reform has become confined to a closed world of professional experts. This oligopolistic form of governance fosters suspicion, mistrust and generates assumptions (which are not necessarily correct) that policy develops to serve specific interests. In nearly all EU member states representatives of current and future pensioners are present on governing bodies. Such representation increases transparency and facilitates two-way communication and dialogue: consumers become aware of constraints and policymakers more aware of problems at the coal face.

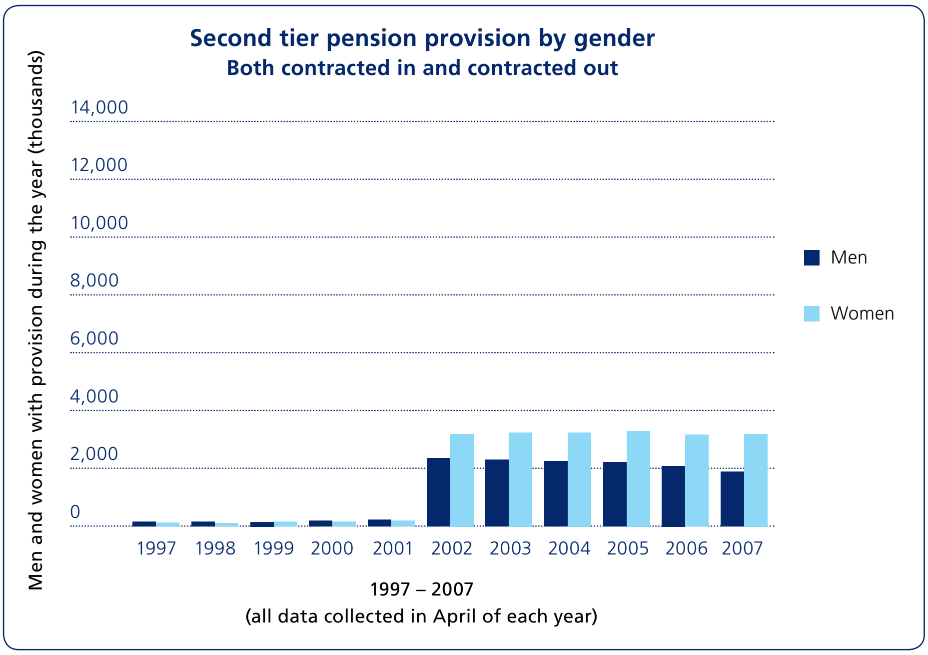
Third, current state regulatory structures reflect internal divisions in the pensions industry itself. Consumer / customer protection is tacked on almost as an afterthought. It is by no means unusual for someone to move around various jobs in the public or private sector – or even to be employed overseas, inside or outside the EU – in the course of a working life. The generic advice on the pension implications of these job changes remain scattered across a range of official and non-governmental agencies and their websites, leaving the consumer to piece together his or her retirement rights – leading to errors and misapprehensions. For example: a person is covered by a DB scheme offering 1/80th of final salary for every year completed with the firm. (S)he leaves after 15 years employment. 25 years later, on retirement, this 'final salary' deferred pension component represents a far smaller proportion of real final salary (even if indexed at CPI) than it would if the worker had stayed put. In pension terms, (s)he loses out, because the situation has only become visible with hindsight.

Finally, current British pension provision leans too heavily on employers and employers' previous choices. There are around 5,800 separate company-based pension schemes in existence in the UK at present: a slight fall since the days of Anthony Crossland (in the late 1960s when there were nearly 7,000), but not by much. With the demise of contracting out, the complexities resulting from relations between these employer schemes and the state second pension appear to be in decline:

Figure 5.1 Second tier pension cover and contracting out



However, there remain sizeable number of pensioners who have, as a result of these changes, acquired mixed public and private rights to a second pension that will bedevil administrators for several years yet.



Company pensions expanded in an era when most employees expected to spend their entire careers with one employer and, thanks to a tighter labour market, were encouraged to do so. Public sector professional schemes aside, this approach is outdated. Company pensions foster labour market rigidities, penalising mobility among older workers. Temporary or part-time staff, given the option of membership, may or may not be covered (their coverage is currently one of many pre-occupations of NEST). Elsewhere in Europe, small schemes were largely amalgamated and rationalised decades ago. Their continued protection in the UK prevents any real development of the 'portable pension': the original idea behind personal pensions that has yet to be realised.

For these reasons we advocate the promotion of personal pension saving along simplified lines to increase transparency and foster trust among the many small savers with little experience or knowledge of financial services but who would be willing to save if the whole system became more transparent. As argued above, mistrust and uncertainty over the long-term future of pensions fosters non-participation. It also helps to divert potential savings into other products, most evidently property (see Pensions Commission First Report 2004 ch. 5). This has created problems for younger generations seeking accommodation while property 'bubbles' divert potential investment towards other goals that neither create jobs nor raise gross national product. In seeking to create more pension saving, the damage done to public trust by current mechanisms through which policy is generated has to be ameliorated. Government may be moving to implement many of the Pension Commission's recommendations. However, this transition necessarily takes decades and, in the interim, we urgently need mechanisms to improve public accountability and promote transparency.

Recommendations: revive a Pensions Commission (Office of Pensions Review)

The Pension Commission's Second Report (2005, ch. 7, Fig. 18) recommended the creation of a permanent Pensions Commission to provide Parliament with up-to-date information concerning life expectancy, trends in private pension provision, in retirement rates and employment rates among the elderly. This recommendation was not adopted by the previous New Labour administration. We wish to revive the idea of a permanent Pensions Commission and to redefine its remit.

We suggest that the revival of a permanent Pensions Commission, with a duty to inspect and report on any government initiatives that affect pensions and savings, is vital to the renewal of public trust in saving for old age. This body should not only incorporate expert technical advice but should represent the industry, employers and scheme members. This recommendation is timely, as the Coalition Government has created an Office of Budget Review [OBR]: a revived and renamed Pension Commission could form part of this, or a similar but separate office. Following the imminent demise of the FSA, an Office of Pensions Review [OPR], analogous to the OBR, could absorb the Pensions Regulator and the Pensions Protection Fund alongside regulatory powers of the FSA relating to the various approved personal pension schemes. We would also suggest that this independent body should sustain other duties, as detailed below. The overall objective is to create an independent and representative organisation to oversee trends in pension development and safeguard the public good over the long term.

Office of Pensions Review:

1. **Provision of public education on pensions.** This would cover generic information concerning the structure of pension provision in the UK, the interrelationship between public and private pensions and which agencies regulate which type of pension provision, etc. In the likely event of contributors accumulating more than one pension savings 'pot' this would help provide customer information about tracing previous savings and calculating likely pension income on retirement.

2. **Provision of independent consumer advice.** Review and publication of the implications of market developments and changes in government policy for the long term development of pensions: review of provider performance etc. To include co-ordination of consumer redress currently divided between different agencies.

3. **Provision of independent advice to industry and government** on pension development (to include the statistical and technical data detailed by Turner but also, for example, the identification of default contribution rates for employers and employed, of default life cycle investment funds for those unwilling to manage their own investments and of means to make personal pension savings more truly portable).

Ideally the OPR would incorporate representatives of all stakeholders, including employers, trade unions and consumer associations as well as the industry and professional organisations. Hence representation would be invited from, for example, the ABI, NAPF, TUC, Pensions' Regulator, Consumers' Association, IFA Network, fund trustees, fund managers, actuaries, accountants and so on. DWP and Treasury observers could be invited to attend meetings, but the object, as with the OBR, would be to guarantee the independence of the new agency. Self evidently not all associations and representatives would have active interests in every field: one might assume that the OPR would operate through a series of sub-committees formed to address specific issues.

Funding such an initiative, particularly in the current climate, would be challenging. Suggestions might include a levy on all commercial stakeholders, supplemented by the willingness to accept in-kind contributions from the rest (i.e. seconding staff at the expense of their employer). The objective is to extend the powers of this permanent body beyond those envisaged by Turner. Were this to happen, most of the stakeholders listed above would wish to secure the representation of their views. In which case, financing activities might not prove so problematic.

The objectives in creating a new central agency are to correct the problems identified in this report – to create more transparency in pension policy development and delivery: to protect against short-term exigencies creating longer term complexity and to facilitate co-ordination of both strategy and method between the multiple interests and agencies currently active in the field. In particular, the OPR could offer advice on knotty problems that still bedevil pension and saving development: how to foster pension portability and labour mobility – particularly for migrant workers (UK workers temporarily going overseas as well as the other way round); how to secure greater gender equality; how to protect the very old. Implicit in all of this is the need for policy makers and the industry to appreciate that competition and choice can only deliver advantages and benefits if market rules are both explicit and clearly understood by all actors. The principle objective of our proposed new agency is to work to secure this end. All political parties promise a simplification in pensions over the very long run. However, this will not happen for decades yet and, in the interim, pensioners and workers need more help now.

Finally, as a postscript, we would advocate the introduction of a benefit 'passport', attached to Pension Credit, which would enable those too old to earn a living to receive associated means-tested benefits (housing, council tax etc.) automatically. Multiple means testing is pointless, demeaning and wasteful of public resources: in this electronic age, we should work to abolish it.

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