

Resolution Foundation: Pensions White Paper Response

1. Introduction

The Resolution Foundation welcomes the chance to respond to the Government's proposals to reform pension provision in the UK. This is a vital area of policy and we applaud the thrust of the proposals to make access to retirement saving easier for people on low incomes.

Established in October 2005, the Foundation is a charity which carries out original research and develops policy proposals to influence government, industry and other stakeholders in its areas of interest. It is a separate organisation to Resolution PLC.

The Foundation is currently focusing on how people on low incomes access and use the financial services system. Our main project is to investigate the potential for establishing a national financial advice resource to provide impartial financial advice to people on low to moderate incomes (people who earn less than median income but are above benefit levels).

There is a common focus on the lower income demographic between the Resolution Foundation and the Pensions White Paper proposals.

While the White Paper stresses the importance of enabling people to make informed decisions about their pensions, it is unclear about how this will be achieved. This response argues that the proposals must be underpinned by a national advice resource providing generic financial advice targeted at people in this income group if the White Paper is to achieve its policy aims. The Foundation is supported in this view by both the Treasury and the Work and Pensions select committees in their recent reports on the NPSS proposals and wider pensions reform.

The Foundation has conducted research into the financial well-being of this group and their use of financial products. We have also proposed, with support from McKinsey & Co, delivery models to address the advice gap identified by the research. This work has been published in our 'Closing the Gap' report, on which we are consulting and have so far received nearly 40 responses. The Foundation also held a seminar on generic advice and pension reform, with experts from government, industry and the voluntary sector. Further research is now being completed, including detailed modelling by Deloitte & Touch LLP, on the benefits to individuals, the State and the financial services industry of providing a national financial advice resource.

Our response draws on this research and consultation work.

2. Key messages

The Foundation believes that the reform process offers an opportunity to address the advice needs of people on lower incomes and to help them secure adequate income in retirement, particularly in relation to the proposed Personal Accounts.

Pensions decisions are among the most complex and vital financial choices people make during their lifetime. Understanding of the pensions system is low and the Pensions Commission's evidence suggests that many people are currently failing to plan adequately for their retirement.

In many respects, people on lower incomes have the most to gain from the proposed reforms. Forthcoming research, based on modelling commissioned from Deloitte & Touche LLP, will show that people in this income group can significantly increase their retirement income if advice is provided and acted on. It will also help to lift them off Pension Credit, reinforcing personal responsibility.

The Government has made clear that the first test of pension reform is the promotion of a culture of personal responsibility for retirement saving. The content of the reforms, for both state and private pensions, aim to provide an environment in which the citizen is better able to take on this responsibility.

The Foundation supports this aim. However, for individual citizens to take responsibility, they must first make choices. Unless they choose a course of action, they will not put themselves in a position of responsibility. Generic advice can help people to understand and make such choices.

In private pensions, the introduction of universal auto-enrolment promises radical change by harnessing the power of inertia. Auto-enrolment is a valid and powerful aid to promoting effective access to pensions but, we believe, should operate within a wider environment of active choice, enabled via generic advice.

The choices for people on low incomes are also more complex due to their limited resources and the potential interaction of income with means-tested benefits. The choices are yet more complex for two key groups who are over-represented in this demographic: women and the self-employed. Women have far greater risk of being defaulted into sub-optimal strategies due to the likelihood that they have more time out of the labour market, the impact of unforeseen life changes (such as disability or divorce) and their greater expected longevity. Auto-enrolment and the S2P reforms effectively bypass the self-employed.

The provision of generic advice is key to promoting active choice and enabling all citizens to take personal responsibility for their retirement. It will also help to ensure that employees will be active, as part of a package of measures, in ensuring that employers comply with their responsibilities to auto-enrol and contribute.

The Foundation believes that the provision of generic advice is a key omission from the White Paper proposals. We are supported in our view by many of the responses to our own recent consultation and from the comments made at the seminar we held. We recommend that this should be addressed, possibly with suitable enabling provisions, in the first Pensions Reform bill. A national financial advice resource

could both enable pension reform and be the capstone of the Government's emerging 10 year strategy on financial capability.

It would also provide the most positive and consensual response to the recent reports of the Treasury and Work & Pensions select committees which both recommended the provision of generic advice as key part of the pension reforms.

3. Detailed Discussion

What advice is needed?

Advice is needed at all stages of the retirement savings cycle.

At enrolment, the saver has to:

- *Understand* the state and private pensions systems and the options available to them
- Assess the *affordability* of contributions to pensions and other savings vehicles in the context of other financial commitments and levels of debt
- Decide what, if any, pension saving is *suitable* for their circumstances
- Choose an *appropriate* investment strategy to optimise risks and reward to their circumstances and preferences
- Potentially, *select* a provider, under the branded provider model, for personal accounts

During the accumulation phase, the saver must:

- *Regularly re-assess* the enrolment decisions in the light of changing personal and financial circumstances
- *Persist* in contributing and *adjust* contributions, where possible, to make them adequate for their projected needs
- Review options to *diversify* their savings to reduce risk or to *consolidate* to reduce costs and/increase flexibility
- Monitor and evaluate *changes in the pensions system* and adjust their savings to respond

At retirement, the saver is then faced with choices over:

- Timing and phasing of the *vesting* of pension rights
- Whether and to what level to *commute* potential income for cash
- The method, options and provider with which to *annuitise*
- What allowance to make for future *long term care* needs and potential release of any *housing equity*.

All of these flow as a natural consequence of giving universal access to private pensions via auto-enrolment and a system of personal accounts. For many of these decisions, the economics of personal accounts will not enable the financial services industry to provide regulated advice except on a fee-paying basis. For most, if not all, of the target population, this will not be affordable.

To be successful, the private pensions regime must be built on the firm foundation of state provision. The White Paper proposes a number of reforms that are designed to simplify and increase the sustainability of the state pensions regime. However, as commentators such as the Pensions Policy Institute have observed, the measures

would create a long period of transition. Considerable uncertainty will remain about what people will receive from the State and whether additional private provision will impact on their state benefits through the operation of means testing.

Why is generic advice needed as a central plank of the reforms?

The first test of pension reform set by the Government is that it should promote personal responsibility. To achieve this, the reforms must engage the individual in the process of saving. This is achieved by making an active choice to save. The mechanisms proposed in the private pension reforms will have the effect of defaulting people into saving through auto-enrolment. There is a potential mis-match here between the goal of personal responsibility and harnessing of inertia.

Analysis for the Foundation suggests that there are two functions performed by the advice process. The first is as a 'trusted sense maker', helping to develop understanding of the nature of the choices and their consequences. This engages the consumer in active consideration of the choices available to him/her. The second is as a 'persuader' which coaches them to reach a decision and act on it.

Auto-enrolment is potentially a very powerful tool for public policy. It helps to address the issue of persuasion by using inertia to enact decisions. Its correct operation relies on the citizen opting out where this is appropriate. Generic advice can provide a safety net to ensure that this will happen in more cases. It is worth noting that generic advice is present in other pensions models where auto-enrolment has been implemented successfully, such as the United States.

So the Foundation believes that access to generic advice to enable an active and informed choice is an essential, yet missing, plank of the proposed reforms. It is an essential precursor to effective and persistent auto-enrolment and the key to the issue of communication with the target market.

Advice is the key policy tool to promote personal responsibility as it enables choice among those with limited financial confidence and capability and is the best mitigation against the risk of auto-enrolling those for whom it does not pay to save.

But beyond this, generic advice is a potentially powerful tool in itself. Modelling work for the Foundation by Deloitte will indicate that generic advice, if acted on by younger generations of low income people, could significantly increase net assets, primarily in the form of retirement saving.

This is achieved by helping people optimise their debt and spending, and by communicating the benefits of and ways to make retirement saving. This combination has the potential to take saving beyond the default threshold to levels that are much nearer to adequacy. This is because it looks beyond how much is being saved to the wider issue of how best to structure overall finances, tackling financial health issues in a holistic way.

This addresses one of the key questions left open in the White Paper on how best to communicate with the target market.

This is further supported by the experience of the New Zealand Retirement Commission. The Commission found that it needed to address questions about lifetime financial planning, not product specific issues and not just retirement itself. Thus, whilst the primary aim of the Commission is to promote savings for income in retirement, this is not the starting point of the conversation with consumers. It could

be argued that this need is greater in the UK, where state pensions, even after reform, will still be far more complex and unpredictable in their impact when compared to the regime in New Zealand.

Who has greatest need?

Generic advice is especially relevant for the Foundation's target group of those who are earning less than median income but are not dependent on means-tested benefits. Financial choices are all more crucial for this income group as they have limited resources of income and capital to recover from financial errors or to withstand unexpected changes in financial circumstances.

Research by the Foundation shows that the proportion of this income group who are members of an available employer's pension scheme is consistently lower than that for higher earners. For example, young people in the group are half as likely as those on higher incomes to be members of an available pension scheme; 32 per cent compared to 63 per cent.

Lower earners are more likely to be working for small employers and hence are less likely to have access to an employer's scheme. Generic advice will be especially valuable for this group in ensuring that they can access the new Personal Accounts via their employers. By understanding the value of the employer contribution and their right to receive it, they can help to ensure their employer's compliance with the new regime.

Women form a higher proportion of this income group than among higher earners. Women face additional challenges in making provision for retirement. They are more likely to have career breaks to raise a family or care for a relative. Divorce will have a greater impact as they are less likely to have savings in their own name. They also continue to have significantly greater longevity. All these factors differentially impact women and make their choices more complex and the consequences of their decisions more significant.

Self-employed people are also over-represented in the group relative to higher income groups. The self-employed present additional challenges as the White Paper's policy prescription largely passes them by. Auto-enrolment will not work for them, and the S2P reforms likewise. The implications of this are particularly acute in the lower income group as many do not have business assets to fall back on. They may have a relationship with an accountant but will no longer receive personal finance advice from them as a result of the tightening regulation of investment and insurance which no longer allows accountants to give regulated advice, unless separately authorised to do so under the Financial Services and Markets Act.

How should it be provided?

The Foundation believes that generic advice must be free at the point of use. As the advice will provide a public good and also help to address market failure of demand among this income group, we believe that it is best financed via a private/public partnership between government and the financial services industry.

We are currently consulting on delivery proposals but expect that a telephone-based service will be at the core of the resource due to its broad coverage and ability to deliver personalised advice at relatively modest cost.

The Foundation's research suggests that a new body, independent of government and the industry, should be set up to oversee the establishment of the resource. Its governance arrangements should be closely linked to those for the proposed 10 year financial capability strategy announced recently by the Economic Secretary to the Treasury.

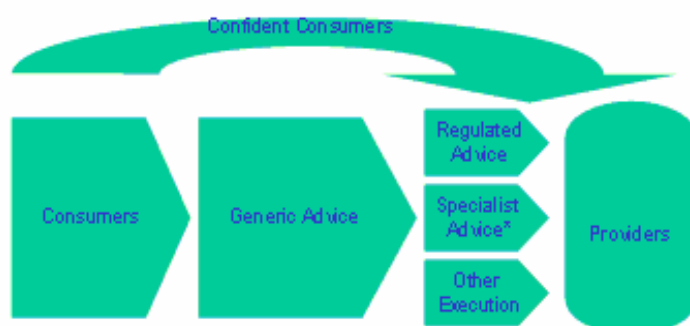
We see generic advice as both an enabler and precursor to the White Paper reforms. It provides a generic process to convert the financial needs of people on low incomes into demand for appropriate financial services. The following diagrams, from our recent pensions seminar, illustrate how we envisage generic advice plugging the advice gap more generally for unconfident consumers.

Current advice framework



- Costs to bridge gap make uneconomic for lower paid
- Regulated advice model complex and over-engineered for basic needs
- Independence/impartiality difficult to sustain
- Gap is growing wider as costs increase

New advice framework



- Generic advice model simpler and suited to lower income groups
- Converts many basic needs into demand industry can engage with
- Can connect to regulated advice and facilitate other execution
- More aligned with impartiality/independence

* e.g. NDL, TPAS

As it is proposed that Personal Accounts will not include a regulated advice regime, generic advice should fill the advice gap that will exist to assess whether saving is

worthwhile for an individual. For more technical questions, there may be a need for a more specialist resource. A potential model for this is the current pensions advisory service, TPAS.

When should it be provided?

We have argued that generic advice is an enabler for pensions reform. It follows from this that it needs to be provided first so that it is established as part of culture well before the White Paper reforms are implemented. In any case, the White Paper proposals will have an impact before they are implemented as employers and employees take action in anticipation of the changes.

In addition, an operational generic advice service will help our understanding of the environment the reforms will play into and the impact that targeted advice can have in kick-starting individuals' financial understanding and management.

We believe that the coming legislation should address the provision of generic advice as part of the reform package, possibly through appropriate enabling powers to create a suitable delivery authority. Generic advice should also be the capstone of the forthcoming 10 year financial capability strategy.

Our recommendation is that the Government should seek to introduce a national financial advice resource at the earliest opportunity, in partnership with the financial services industry, as the first enabling step to enabling the wider range of pensions reforms proposed within the White Paper.