

MEMORANDUM TO THE WORK AND PENSIONS SELECT COMMITTEE INQUIRY INTO PENSION REFORM

1. The Resolution Foundation welcomes the Committee's inquiry into pensions reform.

Summary

2. The Foundation has not commented on the merits of the Pensions Commission's proposals. However, we believe that the reform process offers an opportunity to address the potential advice needs of people on medium to low incomes, particularly in relation to the proposed NPSS. This submission therefore focuses on the following key points:
 - Pensions decisions are among the most complex and vital financial choices people make during their lifetime. Understanding of the pensions system remains low and evidence suggests that many people are currently failing to plan adequately for their retirement.
 - The Foundation believes that generic, non-regulated advice¹ has a critical role to play in helping people make the right decisions in planning and saving for their retirement. The auto-enrolment model proposed for the NPSS would still leave people with important decisions to make about saving for retirement.
 - The pensions reform process provides an opportunity to ensure that advice needs are addressed. However, access to advice is an area the Pensions Commission neglected. This should be addressed in the Government's forthcoming White Paper on pensions reform.
 - In many respects, people on medium to low incomes have most to gain from the proposed reforms. Under the current system, they are saving less and are less likely to be a member of an available pension scheme than those on higher incomes. However, the 12 million people in this group currently have little or no access to financial advice.
 - It is essential that this 'advice gap' is filled if pensions reform is to meet its objectives and enable people in this income group to understand their options under the proposed NPSS and make informed decisions across their pensions lifecycle about, for example, their projected pensions benefits and the affordability of their contributions, and how best to maximise their pensions assets when they reach retirement.
 - The Foundation believes that generic, non-regulated advice on pensions should be made available as part of a broader national financial advice resource. We are currently researching cost effective

¹ Generic advice is information, advice and guidance that does not involve recommending a course of action in relation to a specific provider's product. It is defined by the FSA as 'Services and tools that use information about individuals' circumstances to help them to identify and understand their financial needs and to plan their finances. Generic advice helps consumers to identify: (a) choice and possible priorities for action which are appropriate to their needs; (b) how to take the next steps in addressing their priorities; and (c) how to access other relevant sources of information and advice.' [*Building financial capability in the UK: the role of advice*, FSA, July 2004].

options for providing such a service, which could be delivered through a public-private partnership

About the Resolution Foundation

3. The Resolution Foundation is a recently established research and policy organisation which aims to provide new thinking on how people can access and use the financial services system. The Foundation is not-for-profit and impartial, committed to producing high quality socio-economic research, and to producing practical proposals for action which are capable of being implemented by government and industry.
4. The Foundation is currently focusing on the 12 million people in the UK on medium to low incomes who are largely independent of state support but who currently receive little or no financial advice. The income levels of this group mean that they are considered unprofitable by the financial services industry and they therefore do not receive advice bundled with financial products in the same way as people on higher incomes. As they are not reliant on state benefits, they are also unlikely to be served by services aimed at the poorest and most vulnerable in society.
5. The Foundation believes that the lack of advice for this group results in poor financial decision-making, often at significant cost to the individual and the State. We are therefore committed to researching a new national service, which could be delivered through a public-private partnership, to provide generic financial advice targeted on this group.

Pensions and the need for advice

6. It is widely accepted that people in the UK today are faced with making increasingly complex financial choices. At the same time, the emphasis on them to take personal responsibility for their financial affairs is increasing. Pensions decisions are among the most complex and vital of those choices and reform, although much needed, has the potential to add a further layer of complexity.
7. The evidence from the Financial Service Authority's 'baseline' survey into financial capability² suggests that the vast majority of people in the UK are capable of exercising the basic financial skills needed to make ends meet and keep track of their money. However, the survey also shows that significant numbers of people are unable to plan their finances effectively or, critically, choose the right products.
8. The survey found that many people are failing to make adequate provision for retirement. Among those who had not yet retired, it found that 81 per cent of people did not think that the State would provide them with an adequate income in retirement. However, of those, 37 per cent did not have any additional pension provision. Overall, only 42 per cent of people surveyed were paying into a current personal or occupational pension.
9. In terms of choosing financial products (not just pensions products), the survey found that nearly half (46 per cent) did not collect any information to help inform their decision. The vast majority of those surveyed relied simply

² *Financial capability in the UK: establishing a baseline*; FSA, March 2006

on promotional literature and other product information to make their choice; only 21 per cent enlisted independent advice in doing so. And, in making their decision, 45 per cent said they considered neither the product features nor its price. The survey concluded that 'people were generally poor at choosing products, they renewed existing products without considering alternatives, and even when they did look to purchase something new they did not necessarily shop around.'³

10. The Foundation strongly supports efforts to improve financial capability by improving financial education and information. However, these outcomes, and the gulf shown by the FSA's findings between people's competence in basic financial matters and their ability to plan ahead and choose products, suggest that improving basic financial skills by providing education and information will not, on its own, be enough to help people make the right decisions. This is supported by academic research on behavioural economics which shows that people typically do not engage with long term financial planning or the risks associated with choosing financial products without an external stimulus. In planning for retirement therefore, as well as in making other important financial choices, we believe that people also need advice, accompanied by appropriate external prompts, to help them make these decisions.

The Foundation's research

11. The Foundation has commissioned a comprehensive programme of research to understand the composition, characteristics and needs of the 12 million people who currently lack access to financial advice. This shows that, although very aware of the challenges posed by the lack of pensions provision, this group currently save less and are much less likely to be a member of an available pension scheme than those on higher incomes.
 - This group is more concerned about pensions provision than the general population. For example, among middle-aged workers in the group, 60 per cent say that they worry a lot about their income in retirement compared to 33 per cent of people over 40 years of age among the population as a whole.
 - Overall, people in this group save less than the average at equivalent life stages. The most significant differential is among families and middle-aged people. For example, middle-aged workers save around two-thirds as much as the average; £124 a month compared to the average of £179. Savings are also much more likely to be for short term expenditure (on holidays or a car, for example) rather than for the long term.
 - The proportion of the group who are members of an available employer's pension scheme is consistently lower than higher income 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.
12. This group therefore has a great deal to gain from pensions reform. Indeed, the Commission asserts that 'the NPSS will provide to low and middle earners the opportunity to save at the low costs currently only available to those with higher incomes or working for large private companies or the public sector.'

³ *Levels of financial capability in the UK: results of a baseline survey*; FSA, March 2006

The NPSS and advice

13. The Pensions Commission estimated that some 12 million people who are earning and have the resources to save for retirement are not doing so adequately. Many of them are in the medium to low income group the Foundation has identified.
14. The proposed NPSS aims to significantly increase pensions coverage among people on low incomes. This is predicated on using auto-enrolment to overcome the inertia associated with saving, improving incentives by cutting back the scope of means-testing projected under current state pension indexation policies and reducing costs, including those associated with providing regulated advice.
15. However, the model proposed for the NPSS would still leave people with complex and important decisions to make about their pensions. As set out above, the group of people on whom these reforms are targeted currently have little or no access to the financial advice they need to make the right choices in planning and saving for their retirement. The Foundation therefore believes that it is essential that generic, non-regulated advice is made available to assist this group in making decisions at key points during their pensions lifecycle:
 - When they first come into contact with the pensions system, need to understand it and are first required to make decisions about their options.
 - At key points during their pensions lifecycle, for example if their personal circumstances change, they reconsider their retirement aspirations or the system itself changes.
 - When they reach retirement age and need to make decisions about realising their pension assets, alongside other issues such as considering their long term care.
16. In addition, a number of specific triggers for advice can be identified if the NPSS is adopted:

Suitability of the NPSS

17. Under the model proposed for the NPSS, it would pay the vast majority of people to stay within the scheme. However, although the emphasis is on achieving high levels of take up through auto-enrolment, the Pensions Commission recognised that there would still be some people at the lower end of the income scale for whom means-testing would act as a disincentive and who may therefore wish to opt out of the scheme. Information and advice would be needed to assist people in making the right decision in these circumstances. The need for this would increase further if the Commission's recommendations on containing the spread of means-testing are not implemented.

Adequacy of savings

18. The Pensions Commission proposed that the NPSS should be based on an overall contribution rate of 8 per cent of salary.⁴ The Commission estimated that this would deliver a replacement ratio of 45 per cent for a median earner saving from the age of 25 until state retirement age, 30 per cent paid through the Basic State Pension and 15 per cent through the NPSS.⁵
19. This may be considered inadequate for some people. The Commission also estimated that a more desirable replacement ratio of, for example, 60-66 per cent could be achieved by doubling the total contribution level.⁶ Thus, for large numbers of people, the issue of the adequacy of their retirement income and how much they should contribute could therefore arise. Where this does arise, it would require people to consider their aspirations in retirement alongside their projected pension benefits and the affordability of their contributions.
20. Evidence of inertia under the current system suggests that people are very unlikely to engage in this process without a 'call to action' to act as a prompt. The DWP are developing pensions forecasts to provide this stimulus. However, the Foundation believes that there would also be a need to provide advice to enable people to discuss their options and engage meaningfully in making decisions about matching their retirement aspirations and their savings.

Advice at retirement

21. The Pensions Commission did not propose that an annuity should be built into the NPSS, although it did recommend that reserve powers should be taken to provide annuities should the market not be performing efficiently. This suggests that the intention will be to allow people to 'shop around' for their annuity. Research indicates that people are currently likely to achieve an increase in their income of 10 per cent or more by shopping around for the best annuity rate available on the open market, rather than taking the one offered by their pension provider (although only 40 per cent currently take up their option to move to another provider).⁷ In addition to the annuity rate, the individual will also need to consider the type of annuity they should purchase. This is therefore another clear trigger point for advice.
22. Specific groups are also likely to have particular advice needs under the proposed scheme:

The self-employed

23. The Pensions Commission suggested that the NPSS should be made available to the self-employed but did not set out how this might be achieved. Research shows that the self-employed often view their business as providing security for their retirement. However, for today's generation of self-employed people, many of whom are engaged in activities which will not deliver an asset on retirement, this is unlikely to be the case. As they do not have

⁴ Based on a contribution from the employee of 4 per cent, a 3 per cent employee contribution and a further 1 per cent in tax relief

⁵ The replacement ratio is the ratio of income in retirement to that immediately before.

⁶ This would require the individual to contribute 10 per cent of their salary

⁷ Annuities: bonus or burden; ABI, 2005

access to the State Second Pension, the self-employed face particular challenges and their advice and wider needs would need to be particularly carefully considered in developing the NPSS.

Small employers

24. Those working for small employers, especially those operating without formal structures and procedures, are another group who may require advice on their options. Again, although the thrust of the Pensions Commission's proposals is to keep opt out levels low, the employer and employee may prefer to reach an informal agreement by, for example, mutating the employer's contribution into a cash payment. Access to advice would be particularly important in these circumstances.

Conclusion

25. Despite welcome recent efforts by the Government to increase engagement in pensions through the Informed Choice agenda, people's understanding of the pensions system and their awareness of their options in planning for their retirement remain low. There is considerable evidence to suggest that, under the current pensions system, large numbers of people are failing to plan adequately for their retirement.

26. The reforms proposed by the Pensions Commission and the creation of a NPSS are aimed at significantly improving pensions coverage. However, as set out above, the auto-enrolment model proposed for the NPSS would still leave people with important choices to make about their pensions. The Resolution Foundation believes that there is therefore a critical role for generic, non-regulated advice in helping people to make these decisions.

27. In many respects, people on medium to low incomes have most to gain from the proposed reforms. Under the current system, they are saving less and are much less likely to be a member of an available pension scheme than those on higher incomes. However, they currently have little or no prospect of getting the financial advice they need to make the right decisions in planning for retirement. The pensions reform process provides an opportunity to ensure that their advice needs are addressed; this issue should be tackled in the Government's forthcoming White Paper.

28. The Foundation believes that advice on pensions should be delivered to people on medium to low incomes as part of a broader national service, providing generic financial advice to people on low incomes. We are currently developing cost effective options for providing such a service, which could be delivered through a public-private partnership, and will consult on these options shortly.