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EVIDENCE FROM THE ASSOCIATION OF BRITISH INSURERS
Written evidence to the Work and Pensions Select Committee
Self-Employment and the Gig Economy

Executive summary

The ABI welcomes the opportunity to respond to the Work and Pensions Select Committee's inquiry into how self-employed and gig economy workers interact with the UK welfare system.

This submission is split into two parts focusing on our recommendations for improving pension saving for the self-employed; and addressing the disincentive that exists within the Universal Credit framework for individuals looking to protect their incomes by purchasing an Individual Income Protection (IIP) product.

It is widely acknowledged that the concept of automatic enrolment (AE) can and should be adapted to benefit the self-employed, and the ABI was pleased to note that this will be considered as part of the Government's 2017 Automatic Enrolment Review. However more research needs to be undertaken to better understand gig economy workers, who they are, and what specific challenges they face in interacting with the welfare system and saving for retirement.

Our proposals are outlined below:

Saving for retirement: the self-employed

The government should consider how the concept and framework of AE could be adapted to benefit the self-employed via an equivalent opt-out system of pension saving.

This opt-out system could be based on an adaptation of a model put forward by Royal London, where the self-employed are automatically opted-in to a scheme based on Class IV National Insurance Contributions, which are usually paid through self-assessment returns. This seems the most obvious system to deliver an AE-like 'nudge'.

However, it's important to recognise that if such a system were to be established that timing could be a potential problem as the self-assessed often save enough money to pay tax but may not have the additional funds to contribute towards a pension.

The Government will need to communicate any roll-out of a pension policy for the self-employed with a national awareness-raising campaign aimed at individuals submitting self-assessment returns, with frequent signposting to tailored information and guidance from the government's new financial guidance body.

Universal Credit and individual income protection insurance

Individual Income Protection (IIP) insurance could play a strong role in improving the financial resilience of the self-employed, by providing them with a secure alternative income if they find themselves unable to work for medical reasons. However, under the current system of Universal Credit (UC), individuals are disincentivised from purchasing IIP because it is treated as 'unearned income.'

In order to address this disincentive, the Government should consider a combination of two measures to ensure the fairer treatment of IIP under UC.

1. IIP to be treated consistently with Mortgage Payment Protection Insurance (MPPI) – a full disregard for mortgage loan and home rental payment elements of IIP claims;
2. IIP to be treated consistently with Group Income Protection – with any remaining IIP benefit withdrawn at a rate of 65p for every £1 received.

Rather than adding additional complexity to UC, these measures represent different uses of disregards already in place in the UC system. Taken together, these two measures represent short-term action to prevent significant disincentives to purchasing IIP, a subsequent shrinking of the IIP market and an increase in the government's overall welfare spend.

In the longer term, we believe IIP can play a greater role in achieving Government objectives such as reducing welfare spending and supporting people into and within the workplace. We were pleased to see recognition of the role that income protection insurance can play within the Government's Green Paper on Work, Health and Disability, and are working in close collaboration with the Work and Health Unit to explore its potential further.

Supporting the self-employed in saving for their retirement

The problem of under-saving

1. Automatic Enrolment (AE) is transforming the savings landscape for employees and the ABI commends the efforts of the Department of Work and Pensions (DWP) and the Pensions Regulator (tPR) in supporting businesses throughout the ongoing roll-out process.

2. Since AE was first introduced in 2012, over 250,000 employers have successfully implemented the system and more than six million new savers are now contributing to a workplace pension[1]. However, the 4.6 million self-employed individuals in the UK, who account for 15 per cent of the overall workforce, are not currently benefitting from this success.

3. Research shows that just 30 per cent of the self-employed are saving into a pension. Citizen's Advice and the Resolution Foundation have both identified a number of possible reasons for this including:

    - Contributing to a pension may be unviable for many self-employed individuals – the median self-employed person earns 40 per cent less than the median employed person;
    - A lack of awareness or understanding of the benefits of pensions, including tax relief - currently 69 per cent of the self-employed do not understand the tax breaks provided by a pension;
    - A lack of awareness of how to set up a pension;
    - A lack of accessible information about pensions, including the availability of affordable advice.[2] [3]

4. There are also a number of practical barriers specific to self-employed individuals. For example, the impetus is on the individual to proactively set up and contribute to their pension rather than this being set up and managed by an employer. In addition, without the employer contribution self-employed individuals are not incentivised to save into a pension in the same way as those in employment. Even among those with household incomes of over £1,000 per week, only 24 per cent of the self-employed are paying into a pension.

5. This problem is compounded by evidence that the self-employed are not substantially investing in cash savings as an alternative to a pension - cash savings for the employed and self-employed are broadly similar.[4] Whilst any policy mechanism that encourages people to save is welcome, this could suggest that availability of pensions and other savings products is not the problem, and new savings products may not necessarily be the answer to the problem of under-saving of the self-employed.

[1] Aviva (2016) Auto Enrolment Pre-Review
[2] Resolution Foundation (2014) Just the job – or a working compromise? The changing nature of self-employment in the UK
[3] Citizens Advice (2016) Shy of retiring: addressing under-saving amongst self-employed people
[4] Citizens Advice (2016) Shy of retiring: addressing under-saving amongst self-employed people

6. For example, it has been suggested that the new Lifetime ISA (LISA), whilst not a replacement for a workplace pension, may provide an alternative to pension saving for the self-employed. However, the LISA will only be available to those aged between 18 and 40. With 42 per cent of the self-employed in the UK aged over 55,[5] the LISA on its own will not solve the problem of under-saving.

An AE-equivalent for the self-employed

7. Automatic enrolment has been exceptionally successful to date, with a 37 percentage point increase in participation in workplace pensions from 2012 to April 2015.[6] The success of AE comes in large part from the fact that, through the scheme, employers address most of the common barriers to pension saving outlined above by providing:

   - An incentivising matching contribution;
   - A convenient way of setting up and maintaining a pension and;
   - A source of information and advice.

8. The AE process also creates an optimal default position where employees proactively have to opt out once they are automatically enrolled into a pension, in contrast to a self-employed individual who has to actively opt in. This is about making saving simple, not just harnessing inertia – consumer research with non-savers indicates that many do want to save into a pension, and that non-saving is often a behavioural factor rather than a conscious decision.

9. We believe creating an AE-equivalent system for the self-employed would help to encourage saving for retirement. Both Royal London and Citizens Advice have put forward models for self-employed pension saving that recognise the elements of AE that underpin its success, and consider how these elements might be used in the context of the self-employed.

The Royal London model

10. Royal London has suggested a system in which the self-employed save for retirement through National Insurance Contributions (NIC).[7] They propose increasing the main rate of National Insurance Contributions paid by the self-employed (Class IV) from 9 per cent to 12 percent.

11. Self-employed people would be able to elect to have those additional contributions diverted into a pension, provided that they also contributed into the pension at a specified level. Royal London suggest individual contributions of 5 per cent (including tax relief) which, taken together with the redirection of the 3 per cent NIC increase, would imitate the 8 per cent AE target rate.

12. A disadvantage of this model is that Class IV contributions do not apply under a threshold of profits, currently £8,060 a year. As Royal London point out, for this group

[5] Resolution Foundation (2014) Just the job – or a working compromise? The changing nature of self-employment in the UK
[6] Institute for Fiscal Studies (2016) What happens when employers are obliged to nudge? Automatic enrolment and pension saving in the UK
[7]Royal London (2016) Britain's "Forgotten Army": The collapse in pension membership among the self-employed – and what to do about it

the State Pension may be an adequate replacement, but it would miss out some self-employed individuals.

The Citizens Advice Model

13. Citizens Advice recommend an opt-in pensions system for the self-employed based on self-assessment returns. They suggest that an equivalent of the employers' contribution provided under the current AE system is provided by Government up to a level of 1 per cent of gross income. This would be administered by NEST or a similar scheme.[8]

14. The reference in the Citizens Advice proposal to 'gross income' is potentially confusing. It may be simply referring to income before tax. However, in the context of self-employment, 'gross income' may be understood to mean total business income or turnover and this would be an inappropriate measure as it can often bear little relation to 'net profit' – which is the nearest equivalent to the earnings before tax of an employee.

15. If the matching contribution was set at 1 per cent, this would likely mean that people would limit their contributions to that amount – they will contribute up to a level which attracts the Government bonus, but would have little incentive to save more. For many this will be far too little to provide a suitable income in retirement.

16. Citizens Advice also recommended that providers increase information and advice to self-employed people about their pension options and work together to create and expand dashboards for self-employed people to see the value and trajectory of their pension. The ABI produced a guide, Retirement Choices Made Clear, to simplify and standardise the language used to describe retirement options.[9] We are also leading the Pensions Dashboard prototype project reporting to HM Treasury with input from 17 pension firms.

ABI proposal

17. The ABI believe that more research needs to be undertaken to better understand gig economy workers, who they are, and what challenges they may face in saving for retirement.

18. The ABI advocates an AE equivalent opt-out system of pension saving for the self-employed as the most effective way of helping self-employed individuals save for their retirement.

19. This opt-out system could be based on the Royal London model, in that basing such a system for the self-employed around National Insurance Contributions paid through the self-assessment system is the obvious system to deliver an AE like nudge.

20. However, it's important to recognise that if such a system were to be established that timing could be a potential problem as the self-assessed often save enough money to pay tax but may not have the additional funds to contribute towards a pension.

[8] Citizens Advice (2016) Shy of retiring: addressing under-saving amongst self-employed people
[9] ABI (2016) Making retirement choices clear: a guide to simplifying language on retirement options

21. Any roll-out of a pension policy for the self-employed would have to be heavily signposted through self-assessment communication and awareness campaigns with accessible guidance and advice services available to help overcome current knowledge barriers.

Universal Credit – the interaction with Individual Income Protection Insurance

22. The self-employed are particularly vulnerable to the financial impact of being unable to work due to health reasons as, unlike those that who work for a business, they do not have access to Statutory Sick Pay or other kinds of Occupational Sick Pay. They are also currently excluded from the Government's Fit for Work service.

23. Individual Income Protection (IIP) could play a strong role in improving the safety net for both employees and the self-employed. IIP is a product purchased by an individual to insure their income against the risk of being unable to work due to illness or injury. If a policyholder is unable to work, IIP will pay a proportion (usually between 50-85 per cent) of their income until they are able to return to work, or for period of time specified in the policy (usually 2, 3, 5 years, or until retirement). IIP also offers vocational rehabilitation services in order to help someone to return to work more quickly. For the self-employed, particularly those who work from home, an additional benefit of IIP is that it can protect both their home and business headquarters if used for mortgage or rent payments.

24. The most common reasons for a claim on an IIP policy are mental health problems, cancers and musculoskeletal conditions. IIP is almost always purchased through an Independent Financial Adviser (IFA).

25. A significant percentage of self-employed individuals have already purchased IIP. A survey by the Federation of Small Businesses found that around 9 per cent of self-employed individuals currently have an IIP policy in place. This contrasts with around 3 per cent of the employed population.[10]

26. Anything that disincentivises this form of self-provision will likely serve to increase levels of financial vulnerability, particularly among the self-employed.

IIP and Universal Credit

27. Universal Credit (UC) replaces six current welfare benefits. It will be means-tested based on a range of factors, including household earnings, family composition, housing tenure, savings and whether claimants have children.

28. Under UC, IIP benefits will be treated as 'unearned income'. This will result in a £1 reduction in entitlement to UC for every £1 of IIP benefit received. This leaves individuals with IIP significantly disadvantaged compared to the current scenario.

29. Assessing the impact of UC is complex and can only be predicted based on a series of assumptions. The process for the self-employed is particularly complex, given the

[10] FSB (2016) Going it alone, moving on up: Supporting self-employment in the UK

real time assessment of earned and unearned income. The Centre for Economic and Social Inclusion (CESI) analysed the impact of UC in their 'Getting the balance right; social security and income protection' report to the ABI (published in July 2014).[11] They concluded:

> *"Overall, our analysis suggests that more households will face higher Marginal Deduction Rates (MDRs) as a result of UC, and substantially fewer will see a very strong benefit. Most worryingly, MDRs will increase most substantially for middle-earning households – who should arguably be a key priority group for encouraging self-provision."*

30. A high Marginal Deduction Rate, or effective tax rate, indicates consumers are voluntarily paying for cover that provides only marginal net benefit when the interaction of that cover with UC is modelled.

31. As it stands, the transition to Universal Credit will trigger a sequence of events for individuals with IIP:

    - Providers will likely write to many customers to advise them to review their policy requirements;
    - Returning customers will approach advisers with very complex advice needs;
    - Rational consumer behaviour in many circumstances will be to stop paying for their policy (lapsing).

32. The supply side for IIP will also be affected as:

    - Lapsed policies may lead to advisers having to return commission payments on past sales (clawback), which may push some specialist providers and advisers into insolvency;
    - Advising on IIP in the context of UC becomes simply too complex and risk-laden to be worthwhile.

33. It is highly likely that this will lead to an increase in welfare dependency and, therefore, in welfare spend.

Wide-ranging and significant consequences of the current arrangement for UC

34. As well as the potential impact on individuals outlined above, wide-ranging and significant risks arise through the introduction of UC in its current form:

    - An unintended shift from self-provision and self-reliance to greater welfare dependency – Treatment of IIP under UC risks making self-provision against the most significant risk to financial wellbeing less valuable to individuals and, in some cases, completely worthless. This runs counter to the current Government's principle of encouraging personal responsibility and private provision.

[11] ABI (2014) Welfare reform for the 21st century: the role of income protection insurance

- A shrinking market, leading to higher welfare spending – In the future, there is a significant risk that the benefits and relevance of IIP could diminish, which would in turn diminish consumer appetite and demand for the product. This could significantly shrink the market ,The consequence of lower IIP coverage will be higher welfare spending and lower tax revenue for the government, making any expected fiscal savings from this change illusory.
- Advisers consider IIP as toxic and stop selling it – The vast majority of the 100,000 IIP sales each year are intermediated. As currently the treatment of IIP under UC is complex, unclear and potentially offers poor value, advisers may avoid recommending it.
- Conduct consideration and further erosion of consumer confidence – Providers and advisers will have to notify the one million existing IIP customers of the changes. Attempting to explain the complex considerations and decisions that customers will need to make regarding whether they continue their policy will confuse consumers and may cause many to cancel their policies, leading to more welfare spend.

ABI proposal for remedying the treatment of IIP under UC

35. The ABI advocates a combination of two measures to ensure the fairer treatment of IIP under UC. Both these measures are necessary to prevent the creation of significant disincentives to the purchase of IIP. Longer term, we would like to explore how IIP might play a greater role in achieving Government objectives, such as reducing welfare spending, reducing the employment disability gap, and promoting financial wellbeing:

    - IIP to be treated consistently with Mortgage Payment Protection Insurance (MPPI) under Universal Credit – a full disregard for mortgage loan and home rental payment elements of IIP claims; and
    - IIP to be treated consistently with Group Income Protection Insurance under Universal Credit – with any remaining IIP benefit withdrawn at a rate of 65p for every £1 received.

36. Taken together, these two measures represent short-term action to prevent significant disincentives to purchasing IIP, a subsequent shrinking of the market and an increase in welfare spend. We would be happy to provide the Committee with further information on how these two disregards operate in practice. What is important is that, rather than adding additional complexity to UC, they merely represent different uses of disregards that already exist.

Comparison of IIP treatment under three different models

37. The below sets out a comparison of how IIP is treated under three different models: the current benefits system, Universal Credit, and the ABI's proposal.

38. The consequence of means-testing is that the real value of IIP can be reduced because it may lead to a fall in income received through the benefits system. This is usually called a 'marginal deduction rate' (MDR) or 'effective tax rate'.

39. Under the ABI proposal, MDRs are higher than under the current system, but lower than under the UC system, particularly for households with a mortgage or paying rent.

Example

40. The example below is for a working couple with three children. They have incomes of £25,000 and £9,000, a £80 per week mortgage (or rent) payment and Individual Income Protection product that would pay £150 per week in the event of a claim.

41. Under the current UC arrangement, all their £150 IIP benefit is offset by a £1 for £1 reduction in UC. IIP has increased their household income by £0 – an MDR of 100% - and thus rendering their IIP effectively 'worthless'. Such a person would likely have decided to stop paying their IIP premium and rely on the welfare state.

42. Under the ABI proposal, £80 of IIP benefit is paid to the mortgage lender and disregarded for UC, with the remaining IP benefit reducing UC by 65p for every £1 benefit received. In effect, their IIP has increased household income by £98 per week. This is lower than the full £150 insured amount but sufficient to protect their lifestyle and give them genuine value and protection.

About the ABI

43. The Association of British Insurers is the leading trade association for insurers and providers of long term savings. Our 250 members include most household names and specialist providers who contribute £12billion in taxes and manage investments of £1.6 trillion.