Association of British Insurers

Identifying the Challenges of a CHANGING WORLD

THE TRENDS FACING INSURERS TOWARDS THE 2020s

CHAPTER SIX

Insurers and Paying for Life after Work

In the 70 years since the full establishment of state-provided welfare, the question of how to pay for life after work has been relatively simple to answer with a combination of occupational pension and state-provided support ensuring a respectable standard of life for employees, and the self-employed relying largely on a private pension. Within this framework, the state, the pensions industry, employers and individuals broadly knew their respective roles and accepted them, even as specific aspects of the regime changed.

It has been apparent for some time that this settlement is patently unfit for the next 70 years not least because of the terminal decline of Defined Benefit (DB) occupational pensions, rendered unaffordable by spiralling life expectancy, unfavourable tax treatments, declining(or negative) investment returns and the burden on employers of such generous benefits. A combination of Defined Contribution (DC) pension provision supplementing DB benefits and increasingly generous state provision of pensioner tax credits, benefits, winter fuel payments and free bus travel have kept the current framework staggering on, but few would pretend it is built to last.

Trends shaping future life after work provision are:

i) The need to save more

In the UK, we have long stopped saving enough as a working population to provide the level of retirement most of us wish to enjoy; some rates of saving into DC pensions are half of those normal in DB pension schemes. Just rehearsing some of the barriers to saving - behavioural economics (especially 'present bias'), lower employer contributions, too much personal debt, relatively poor industry reputation after mis-selling scandals, lack of understanding of the product, limited access to products – is enough to demonstrate that no magic bullet can fix the future. Auto-enrolment is an excellent and vital reform to ensure there is a foundation of workplace-based saving on which to build, but not even its most enthusiastic advocates would pretend it could provide an entire solution for the future and it faces its own challenges to ensure persistency, maximum employer and employee contributions, employee confidence in charging and ensuring optimal fund management performance.

ii) Changed economic circumstances

Our economic circumstances have changed for the worse. The foreseeable future will be one in which our economy continues to adjust to the post-crisis 'new normal,' as QE is unwound alongside higher taxes, less government spending and less disposable income for average households. This means more pressure on investment performance, continued stress on savings rates and ongoing uncertainty about the affordability and distributional benefits of the current tax incentivisation system for pension saving. Even when the UK successfully closes the output gap, its wealth relative to the other global powers will continue to decline, albeit to an uncertain extent and with it still remaining one of the wealthiest countries in the world.

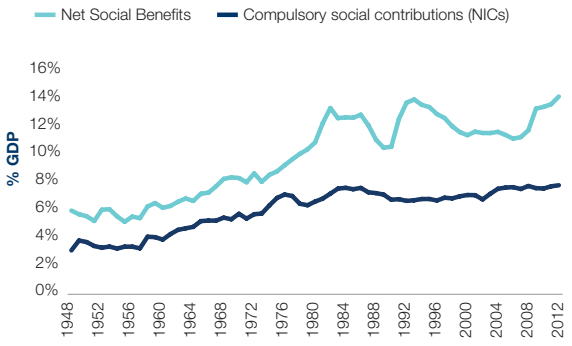
iii) An ageing society

Along with much of Western Europe and even some parts of Asia, our population is ageing and our ratio of workers to retirees is falling, making our current pensions system increasingly unaffordable. But ageing also brings with it other challenges for which our society is financially unprepared; the impact of dementia on our health system, the household economics of living for 30 years post-retirement and the need to fund later life care either at home or in residential and nursing facilities.

iv) A welfare state requiring radical reform

The Beveridge reforms of 70 years ago envisioned a basic safety net for all with additional benefits for those who contributed to them during their lifetime. Yet the contributory element has diminished over time while the level of overall state support has increased, resulting in the incentives for people to provide for their future being reduced and misaligned in an overly complex system (see Figure 21). While the proposed single state pension is a step back in the right direction, it is only the first step required.

Figure 21: Net social benefits and compulsory social contributions as a percentage of GDP, 1948 - 2012



Sources: ONS "Quarterly National Accounts Dataset", ONS "Public Sector Finances Dataset"

v) The very significant changes within the traditional life and savings industry
The provider base of the long-term savings market is changing fast too, with traditional life insurers, ranging across a spectrum including platform-based providers, specialist protection and annuity companies, pension buyout specialists and closed book companies. With a mix of ownership models underpinning this wide span of providers, the sophistication of the market poses a challenge for those looking to work with 'the industry' to construct a new framework for future provision.

Key Issues for insurers to address are:

i. How to develop a new framework for accumulation

ii. How to adjust to semi-retirement

iii. How to protect ourselves and pay for care

iv. How to reform our welfare framework

v. How to achieve the political and regulatory consensus necessary for insurers to deliver

How to develop a new framework for accumulation

Auto-enrolment has to remain the foundation for increasing savings between now and 2030. Built with cross-party support after a detailed independent review and EU state aid approval for NEST, auto-enrolment is the most ambitious state-sponsored intervention in retirement provision since Beveridge. If implementation continues to proceed smoothly between now and 2018, meeting the next set of challenges it will face are critical to it making a long-term difference. Firstly, people have to stay enrolled; high persistency levels are vital if the social outcomes are to be reached and for the economics of the low charge to work. This will be made more likely if employee and employer contribution levels continue to rise above the statutory minima, requiring an ongoing political and social pressure to do so. **Auto-enrolment must not turn into a 'done and move on' project for the political classes but instead represent a key part of the future welfare framework** particularly if auto-escalation schemes can become the norm. Behavioural economics has a role here too, particularly in ensuring the right conversation with workplace savers if they are considering dropping out. Studies in the US have demonstrated that conversations focused on eventual retirement income are far more effective in maintaining persistency than dialogue centred on contribution levels or fund management performance, so the more the auto-enrolment offer evolves with higher employer contributions and other benefits such as life assurance, the easier it will be to meet this challenge.

Resolving the future level of **tax relief incentivisation** of saving will also be important to setting pension saving levels over the next 20 years. While the principle of tax incentivising the deferral of income for retirement will remain important in overcoming an employee's natural bias to present day consumption, and in rewarding people for 'doing the right thing'. The likely future cost and distribution of an unchanged framework could be increasingly hard to justify for politicians in the 2020s, providing the industry with a challenge to suggest a more sustainable model that distributes tax relief more evenly and at lower cost to the Exchequer. Such a model could aim to be simpler for savers to understand and could potentially also incentivise insurance for other long-term needs such as later-life protection cover although employers would almost certainly need incentives of their own such as NICS rebate to offer such cover in a widespread way.

For such incentives to be effective, future dialogue with customers will need to focus increasingly on **desired outcomes**, not just contribution levels, especially in a DC environment, where savers need to focus on what they want their saving to achieve rather than view it through a retail saving mindset where short-term performance is important. This can help overcome the instinctive tendency towards present bias and inertia which can impair customer judgement. In particular employees need to focus on the income in retirement that their savings will generate which is often the best and only way to persuade people to save more. The online access to an holistic view of savings that platforms offer should help here and be an increasingly important part of the future.

Some politicians believe that an outcomes focus could be delivered through the increased provision of **targeted-outcome pension products**, such as the UK Government's 'Defined Ambition' suggestion which would seek to offer targeted outcomes in return for specified and persistent contribution levels from an employee and their employer. While such products have the benefit of apparent simplicity to the employee, they also face formidable obstacles. If the intention is to reassure an employee that year-on-year contribution levels will always increase the fund in its early years, it will dictate an investment strategy that will probably be too risk averse to achieve the desired end result. Even without this pressure, delivering a guaranteed product is always more expensive, raising the issue of whether customers are prepared to pay the premium required. Even if they are, such products face significant regulatory headwinds as conduct regulators focus intensely on the avoidance of policyholder detriment as a guiding principle of post-crisis insurance regulation and as prudential regulators worry about the solvency strains in parts of the continental European market created by guaranteed products operating in low interest rate environments. In the UK, the scepticism demonstrated towards 'With Profits' structures from both the new regulators is a reminder of the regulatory unease about savings frameworks where customers have limited power or access to the fund management techniques and structures being employed on their behalf.

Low charges for workplace savings schemes will also be important in an economic environment expected to be characterised by low interest rates, challenging investment

returns and suppressed wage growth. Both the level and construction of fees and charges will become increasingly transparent as long-term savings providers implement the ABI's Agreement on Fees and Charges and as platforms and comparator style websites emerge to compare charges and break down their component parts. Transparency will also shine a spotlight on the levels of cross subsidy which exist in DC schemes between those with low accumulated pots and those with large pot sizes. It is likely that new pricing frameworks will emerge which more accurately reflect administration and investment costs of individual pots differentiating between the fixed costs, which are incurred for every individual, and the variable costs this will reflect the wide range of customers the industry is serving.

The extent to which employers and individuals make **increased use of platforms** may be key to whether the 2020s see people saving more or just saving differently. If platforms can fulfil their potential to attract a wide base of customers to online consolidated saving practices, they could stimulate greater saving and help bridge the uncertainties surrounding moving from accumulation to decumulation which can deter people from pension saving in the first place.

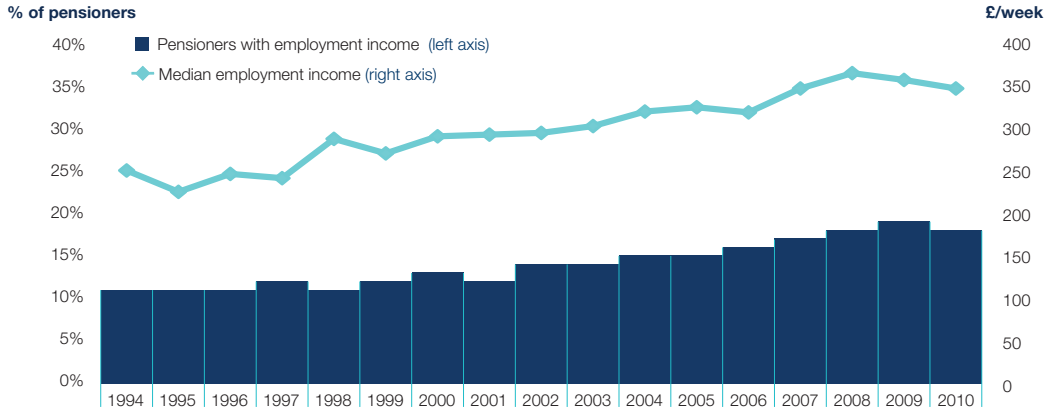
Finally, customers' future needs will also require **simple mass market savings and protection products** that can facilitate short-term saving and basic protection needs for those lacking either the capability or appetite to seek out more complex products. The groundwork for this has been laid with the Government's recent Simple Products taskforce. While such products would attract low initial deposit and premium levels for providers, they could encourage good habits, build and protect assets and underline the wider importance of insurance to a healthy society. In a future where advice may be only the preserve of the upper end of the mass affluent group and above, simple products will also be a necessity, although to be fully successful they may require a degree of regulatory approval that will be difficult to secure in the initial phases of the new conduct regulatory regime. Whether the Simple Products initiative delivers a new suite of products or not, it seems likely that in a world characterised by information overload and complexity, there will be a market for starter products on a mass market non-advised basis.

How to adjust to 'semi-retirement'

As a society we are still just about clinging on to the concept of a fixed universal retirement age acting as the gateway to a life of non-work, it will seem increasingly meaningless in the 2020s.

By 2010, 18% of people drawing a pension also had a paying job of some sort; a trend badged as **'semi-retirement'** by KPMG (see Figure 22). This makes economic sense for pensioners who may not have benefited from the generous occupational schemes otherwise typical of the working lives of their generation. But it also reflects the better health of these retirees in their early years and the growing belief that full sudden retirement can be bad for physical and mental well-being[14]. Over the next 20 years as the retirement demographic takes on those who typically had a mix of pension provision involving lower employer contributions, society will need to adjust more profoundly for this group of semi-retired people. The welfare system will need to encourage their continued working by avoiding benefits or tax traps that negate the value of post-retirement employment, while a labour market needs to continue to evolve that can utilise the potential supply. In an ageing society, we will all need to get more comfortable with the idea that certain types of work are done by the semi-retired, just as we now accept as commonplace how much of the civic volunteering fabric of our communities is provided by pensioners.
A similar shift in attitude may also be needed in our approach to **property equity**. Culturally, the British are more likely to trust the value of our bricks and mortar than

Figure 22: Percentage of pensioners with employment income, and their median employment income, 1994 - 2010



Source: DWP "The Pensioners' Income Series 2010-11".
Note: A pensioner is defined as an individual over state pension age, or a couple with one or more individuals over state pension age.

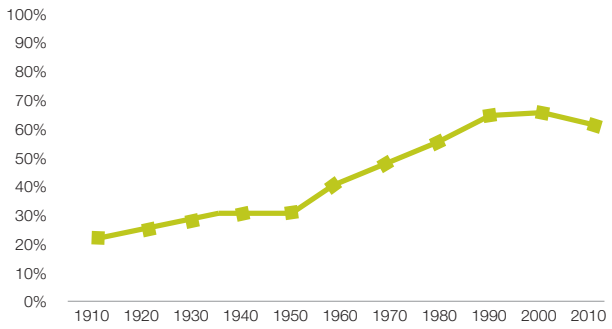
[14] 'Work Longer, Live Healthier' Report, Institute of Economic Affairs, 2013.

"We face significant challenges, not least an ageing population, the decline of Defined Benefit pensions, a reducing state pension and a low growth/low interest rate environment. The core social purpose of retirement and protection products will remain but we will have to adapt our product offering, investment strategies and standards of transparency if we are to deliver fully for customers and maximise returns."

Andy Briggs, Group CEO, Friends Life Group

we are to instinctively trust the assets invested with our banks, our governments or our pension providers. The home is often instinctively viewed as an illiquid asset, often maintained with a view to inheritance for the next generation rather than to be utilised for ourselves (see Figure 23). For many, this could be an unsustainable position in the decades ahead. If people are to continue to live longer but save less, they will need to adjust to a view of the home as a critical asset that may have to be partially realised at the appropriate time in our retirement to ensure the level of care (residential or otherwise) and income we would wish. For those who wish to avoid this route at all costs, it needs to be explicit that they must make greater savings provision before retiring, work during retirement or have the means to purchase at-need protection products to avoid a forced sale of their home when long-term care is required. Insurers will also have a key role to play in this, needing to produce products with the flexibility to offer people a range of options for realising value from their property assets and which are affordable and accessible to customers while not overly capital intensive. Regulatory attitudes will be critical. With property owner patterns also changing as high deposits and significant levels of student debt see increasing numbers of first time buyers in their mid-late 30s, this will remain a difficult, albeit necessary, area for the market to serve.

Figure 23: Percentage of owner-occupied households in England and Wales, 1910 - 2010



Source: ONS (2013) "A Century of Home Ownership and Renting in England and Wales"

The **annuity market** will also face challenges in a world with more 'semi-retirees' as the retirement trigger point and decision become more complex to judge. A more flexible decumulation regime seems inevitable, driven by customer demand and by the impact of platforms on behaviour. Meeting these challenges may be difficult as providers of enhanced, partial and deferred annuities are forced to regularly adjust their measurement of the norm in the face of increased demand, especially as public requirements of annuity options grow.

Outcomes-focused products, whether guaranteed or not, may also be a bigger part of the market as people without any component of DB pension seek to establish a degree of certainty in their retirement provision. With regulators sceptical, outcomes-focused products may come to encapsulate a new paradigm that having moved away from a world in which long-term savings products were designed around tax and IT systems, long-term savings products instead have to be built around conduct regulatory permissions.

How to protect ourselves and pay for care

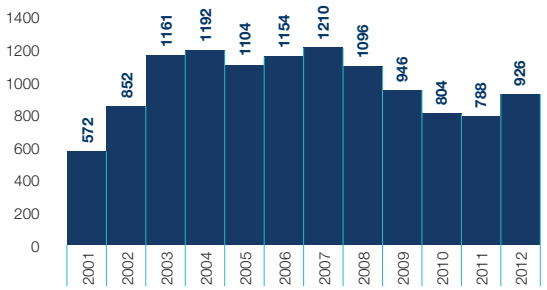
The change in attitudes needed towards budgeting for care is already underway as some of today's pensioners deal with the challenges of their own parents' ageing and as the NHS struggles to cope with the impact of dementia-related conditions on its primary care capacity. These pressures helped lead to the setting up of the Dilnot Commission on **Long Term Care** with the principal recommendation of a fixed cap on private provision for care costs (but not residential costs) accepted by the Government in February 2013. The Dilnot framework is potentially a promising one; accepting some (although not all) long-tail liability for the State and offering the industry the opportunity to develop products that can help customers meet their liabilities of paying up to the cap and accommodation costs. While a modestly sized immediate needs annuity market exists at the moment, the challenge here is to see if social attitudes can change enough to persuade people of the validity of paying for a protection product over a period of years that could offer them some financial cover should they end up needing residential care in later life. **This is a major**

challenge in a society as rooted in consumer spending as we are and where many people carry an exaggerated sense of what the State will provide for them in old age. On the other hand, people do buy such products to protect their income and living standards from critical illness which may never happen (albeit to potentially cover a present need such as a mortgage) and the more people become familiar with the care system through personal experiences with their older generations, the more possible it is that such products could connect with customers. For wider levels of self-provision to be developed in the 2020s, customer engagement with the trade-offs involved will need to become more profound; how far will people expect to be sure of receiving any benefit from a protection-based insurance policy and how far in advance will they consider purchasing one? What will be the trigger points in the life cycle that will act as 'prompts' for action and how can appropriate advice be given prior to purchase? How sufficient would their expected level of retirement income be to cope with care costs? These will be significant questions to answer, and they will increasingly overlap with the broader policy and public dialogue around savings.

Distribution will also be critical here. For some, protection benefits are already provided by the employer as part of **the employment package** and devising a more formalised system to bundle with auto-enrolment could well be the most successful way to build coverage to meet society's future liability. One way to promote and develop such products could be with a voluntary employer contribution and tax relief, like a pension scheme, so that employees had a clear incentive to prepare for the future. However funded, employers could be critical to any significant renewed provision of savings and protection products in the future for reasons of scale, trust levels and ability to provide basic advice.

Equity Release clearly has a role to play too, as noted earlier. The mis-selling and mispricing of the late 1980s market has long been replaced by a smaller, functioning and profitable market, successfully self-regulated with an ABI code (see Figure 24). However, it remains small and some social stigma remains to the concept of not passing on a home intact as an inheritance. Critical to the successful development of a future market would be the regulatory environment. If Solvency II is finalised in a way that proves difficult for annuity providers, it will potentially restrict capital availability for the market to develop or scale up Equity Release products. From a conduct perspective, the sales process for a significant mass market proposition would need to be clearly agreed and understood with regulators to avoid any increase in the market supply being met with a blizzard of avoidable concerns. Developing products with greater flexibility such as partial release will also be important.

Figure 24: Total value of advances in the UK equity release market, 2001 - 2012, £million



Source: Equity Release Council statistics

Developing product **understanding and performance** will also be vital to build a broader protection market. This means insurers would continue to standardise and self-regulate on issues such as non-disclosure and changed circumstances which have bedevilled the reputation of many protection products, fairly or unfairly for many years. With publication of pay-out data becoming the norm too, it should be easier for protection insurers to build greater confidence in the value of their product and better understanding about the range of circumstances covered, especially if in the context of a reformed welfare state.

How to reform our welfare framework

It is hard to look far into the future and see the current welfare framework surviving unchanged into the 2020s. Three aspects of a revised welfare framework seem likely.

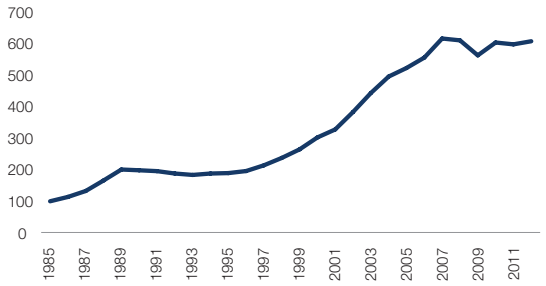
The first is an increased focus on the **poor and the vulnerable** which may be forced on society rather than chosen by it. In contrast to the cultural norms in many of the emerging economies, the British state and wider society has sought to provide some form of basic welfare safety net since the Elizabethan era. **If distribution of wealth in the UK continues to develop into an 'hourglass' shape, the scale of economic problems facing the bottom 20%** and their relative lack of opportunity to escape them will have its own momentum and require a significant focus of welfare provision to prevent social breakdown and destitution and uphold the standards of protection for children and vulnerable people we now expect as a society. These problems will continue to become more expensive for the state as the cumulative effects of multi-generational unemployment and social exclusion build further and the barriers to work and economic productivity therefore grow ever higher.

We are also likely to see a revival of the **contributory principle** as politicians are confronted with the rising cost of an unreformed welfare state and seek to minimise the other options of increasing general taxation or significant benefit cuts. The contributory principle was one of the

foundations of Beveridge's vision for the British welfare system, built on the concept that the state pays out most to those who pay in the most. For it to succeed in the future, it will need to regain the support of the middle classes by offering confidence and clarity to those contributing. In practice, this would mean no more blurry use of NICs to pay for services such as the NHS and the continuing removal of universalism, tackling non-means tested benefits such as the Winter Fuel Allowance and free bus passes for pensioners, which will be politically controversial.

The extent of **wealth transfer** within the current welfare framework will also come under scrutiny; our system now enshrines an unprecedented level of wealth transfer from the under-35 working population and the self-employed towards those in retirement, many of whom have already benefited from a significant uplift in their net wealth thanks to the relative rise in house prices over the 25 year period to 2008 (see Figure 25). While this transfer initially helped tackle the very real problem of pensioner poverty, it is hard to see how this is sustainable for the 2020s, especially if the burden on the working population is increased further by more increases in general taxation to fill the projected gap in public finances in the 2015-20 Parliament and with the added impact on the under-35s of saving for higher mortgage deposits and paying back higher education debt.

Figure 25: House price inflation 1985 - 2011 (1985 = 100)



Source: ONS House Price Index Table 33.

Welfare reform may come in small, grudging steps rather than through grand plans but change is inevitable. For as long as the old quip remains relevant that the British want Scandinavian standards of welfare provision with American levels of personal taxation, the challenge will be formidable to reform a welfare system that is increasingly strained by the tensions within it.

How to achieve the political and regulatory consensus necessary for insurers to deliver

For insurers to play a full part in meeting these social challenges, the gap between political appetites for solutions and what **regulators** are prepared to countenance will be increasingly important to bridge. Although they are reluctant at the moment, regulators will need to become increasingly involved in these debates about how products needed to equip future generations for life after work can be made to work, engaging with the trade-offs necessary to marry together political, social and regulatory imperatives.

No less challenging will be attaining a measure of **political stability and consensus** among political decision-makers and their opponents. Providers of long-term savings and protection products are natural partners of governments, but much greater cross-party consensus on the big issues of the future will be essential to achieve meaningful change, just as it was key to the establishment of auto-enrolment. This will require a more proactive industry which is bolder in its thinking, setting a compelling but politically neutral agenda which politicians can engage with and which feels inclusive of the needs of society as a whole. This will never be easy to accomplish but it is a vital task for the future to achieve reforms the industry can support and work with.

abi.org.uk/jointhedebate

How can we build on auto-enrolment so it becomes the foundation for healthier saving and protection levels?

What steps can insurers take to be ready to meet the needs of the semi-retired?

How can the industry build on the new Long Term Care framework to meet customer and political expectations?

What welfare reforms are most needed to ensure the best alignment with the provision available from the private sector?

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