Association of British Insurers

Time to Act: Tackling our Savings Problem and Building our Future

June 2012

“You can be young without money but you can’t be old without it.”

Tennessee Williams

Executive Summary

The long-term savings industry fulfils a vital role for society. It helps people build up savings during their working life, and turn them into an income in retirement. It is there to meet the needs of millions of people, currently paying out £32.8 million every day to 5.6 million pensioners, and helping millions more to build up savings.

The industry has come through the challenge of the last decade well. It is a key part of the economy, a major source of capital for companies, and an important employer. The defined contribution pension schemes the industry provides reflect the needs of modern employees who change employment many times during their working life and need the ability to maximise employer contributions and tax benefits.

Long-term saving is now more important than ever as life expectancy continues to rise, but half of the working population does not make enough provision for their retirement. We know behavioural reasons play a huge part in people's disengagement from long-term savings. Automatic enrolment into workplace pension savings is therefore the right policy – saving must become the default mode for society.

However, we are faced with tremendous challenges. We are dealing with a global financial crisis on a par with the Great Depression of the 1930s. We want people to save more and lock their money away at a time of significant austerity which could last a decade or more, with low interest rates and depressed equity markets. At the same time, as individuals and governments need to pay down significant amounts of debt, there is huge uncertainty about the long-term welfare framework, and the pensions world is still struggling with the legacy of past mis-selling scandals, and the collapse of many defined benefit schemes.

Into this mix are coming the most significant reforms to pension saving for a generation. This is therefore a time of major challenge, of change and of self-reflection for pension providers, employers, regulators and stakeholders alike. The purpose of this paper is to set out the industry's position on the key issues, and to outline the path ahead.

In this testing time, we believe it is more important than ever that the industry confronts the challenges with a more united front. Internal debates, about the merits of different governance models for example, run the risk of fiddling while Rome burns. The country needs all its savings providers to speak more coherently and persuasively if we are to lift our savings rate.

Our most critical task now is to make automatic enrolment a success. To do this, we must focus the debate on what matters most for a good consumer outcome. Starting saving early, and saving more make by far the biggest difference. For example, contributing 12% of salary rather than 8%, the minimum under automatic enrolment, increases a person's eventual pension pot by half.

Investment performance is also important. Pension fund performance has held up reasonably well in spite of the difficult market environment. A saver putting £200 a month into an average pension scheme from end 2000 to end 2010 would have achieved a nominal return of 6.5% per year after all charges. It is important to remember that all saving – whether in a bank deposit account, defined benefit scheme, equity ISA or defined contribution scheme – carries an element of risk. No pension scheme, whether defined contribution or defined benefit, can be insulated from a wider downturn in the global economy.

Charges also influence people's retirement outcomes. However, they are much less significant than contributions and are continuing to fall – in newly set up automatic enrolment schemes, the average annual management charge of our members is 0.52%, and for many other existing schemes, both large and small, charges can be lower than 0.3%. We still have work to do on how best to explain charges and their impact on employees to employers choosing a pension scheme, especially those new to pensions. This is the subject of an ongoing consultation by the NAPF which we commend and support.

We acknowledge that there are still many criticisms levelled against the industry – some justifiable, others less so. But this is not an industry that is complacent about criticism – it has been evolving and reforming constantly over the last 20 years and will continue to do so. Like every other customer-focused industry, our industry must continually strive to raise its standards at every point to serve our customers better, and consider it natural to do so. This will contribute to making automatic enrolment a success.

One important part of this is helping people merge their small pension pots. We know that automatic enrolment will bring up to seven million new savers into pension saving, many of whom will change jobs very often. This is estimated to create 370,000 pension pots of less than £2,000 over the next 5 years, and with it the risks that people lose track of their money as they move jobs, and potentially fail to benefit from more competitive annuity rates. The ABI fully supports the Government's intention to address this problem. We believe we must find a solution which allows people to take their small pension pots with them as they move from employer to employer – our consumer research tells us that this is what people want. This will allow them to consolidate their savings which will also bring about more engagement with the process of building up their assets for later life.

We must also protect people from making pension choices contrary to their long-term interests. Where employees are offered to transfer out of their defined benefit scheme, the offer must be transparent, without cash incentives likely to skew people's choices. We therefore strongly support and endorse the Industry Working Group's Code of Good Practice on Incentive Exercises, which we helped draw up together with other stakeholders. This Code will substantially improve the protection of pension scheme members taking part in these transfer exercises.

People also have to take a hugely important decision at retirement about how they take their retirement income. Choosing the right shape of annuity and shopping around are vital. We believe our industry has a duty to help its customers understand and consider their options, and make it much easier to shop around for retirement income. To achieve this, we introduced our compulsory Code of Conduct on Retirement Choices, and we are now working with our members and other stakeholders to ensure it has maximum impact.

More broadly, effective stewardship promotes the long-term success of companies to the benefit of pension savers and society as a whole. The ABI believes that adherence to the UK Stewardship Code is best practice for asset owners and asset managers, and our members will engage positively with the Financial Reporting Council in its current review of the Code.

Looking ahead, we believe our industry needs to focus on three key themes, which will be the focus of our work going forward:

- First and foremost, we need to successfully implement automatic enrolment, continuing our support for employers in complying with their new and complex duties under the legislation.
- We need to make the most of the workplace to get people into the savings habit, for example through using corporate ISAs as part of flexible benefits, but also by exploring behavioural solutions, such as "save more tomorrow" mechanisms which use inertia to get individuals to increase their pension contributions over time.
- Finally, we need to take a holistic view of financial needs in later life, considering not only savings for a retirement income, but also for long-term care needs. The need for broad provision is only going to grow. Our industry must continue to work with Government to help meet that need and to serve our customers well.

We must all work together to tackle our savings problem and focus on the things that are most important to build our future: it is time to act.

Introduction

The pension and long-term savings industry exists to help people build up long-term savings and turn them into income in retirement. Long-term savings are central to social policy; they help ensure people have an adequate income throughout retirement, in addition to the state pension.

The ABI's members are well placed to support individuals in this important responsibility. Our members look after investments of £1.7 trillion, controlling 13.4% of investments in the London Stock Market. The pension industry currently pays out £32.8 million each day to 5.6 million pensioners, creating peace of mind through a guaranteed regular flow of income for life in retirement.

The industry has come through the economic challenges of the last decade well. It is a key part of the economy, a major source of capital for companies, and an important employer. The defined contribution pension schemes the industry provides reflect the needs of modern employees who change employment many times during their working life and need the ability to maximise employer contributions and tax benefits.

Long-term saving is now more important than ever as life expectancy continues to rise, and the current financial and economic crisis mean the responsibility for providing for their retirement falls more and more on individuals – a fact that is not lost on people. In recent industry research, 73% of people agreed that individuals in the UK will be required to take more personal responsibility for their financial security in retirement.[1]

However, we are faced with tremendous challenges. We are dealing with a global financial crisis on a par with the Great Depression of the 1930s. We want people to save more and lock their money away at a time of significant austerity which could last a decade or more, with low interest rates and depressed equity markets. At the same time, people and Governments need to pay down significant amounts of debt, there is huge uncertainty about the long-term welfare framework, and the pensions world is still struggling with the legacy of past mis-selling scandals, and the collapse of many defined benefit schemes.

Into this mix are coming the most significant reforms to pension saving for a generation, as automatic enrolment will bring millions of people into pension saving for the first time. Now is therefore a time of major challenge, of change and of self-reflection for pension providers, employers, regulators and stakeholders alike. The purpose of this paper is to set out the industry's position on the key issues, and to outline out the path ahead.

[1] The Scottish Widows UK Pensions Report, May 2012, p. 15.

What is the pension problem we are seeking to address?

The ageing population is one of the biggest challenges facing mature Western economies.[2] As we are living longer, most of us will need more money to pay for our retirement. In addition, our longer life expectancy will increase the number of people with conditions such as Alzheimer's disease, which require costly care.[3] The ONS project the number of people aged over 85 to double by 2030 and the Office for Budget Responsibility expect UK public spending on long-term care as a proportion of GDP to increase 40% by 2030.[4] In addition, the proportion of retirees to workers is rising significantly. Those aged over 65 are set to rise from 22% to 28% of the adult population between 2010 and 2030, leading to the Government and many individuals moving away from a rigid notion of retirement and towards longer working lives.[5]

However, at the moment, only 46% of people are making enough provision for their retirement (down from 51% in 2011)[6] which means the majority of people are not saving enough for the kind of retirement they want.

Economic conditions, quantitative easing and increasing longevity have all put downward pressure on annuity rates. MGM Advantage estimate that on average annuity rates have fallen 11% since 2009.[7] The typical sum that men and women expect to retire on in 2012 has reached a five-year low of £15,500 annually, compared with £16,600 in 2011, according to the most recent study by Prudential, released in June 2012. Similarly, the maximum income available for drawdown has fallen and has been unstable in recent years for the same reasons. The EU's Solvency II directive and gender-neutral rates introduced as a result of the 2011 ECJ ruling may have a further effect on rates.

UK households are also borrowing more. In 2012, personal debt in Britain amounted to more than £1.4 trillion. Almost one-sixth of that total was unsecured lending,[8] with the typical UK family currently owing £9,134.[9] The Office for Budget Responsibility expects total household debt to increase still further, from 160% of disposable income to 175% to 2015, reflecting their expectation that consumption and investment will rise more quickly than income.[10]

In addition, employers are contributing much less to pensions than they used to: only 16% of defined benefit schemes are open to new members, down from 36% in 2007.[11] Where employers have made a switch to defined contribution schemes, they have tended to cut back on pension contributions. The ONS has found "a marked difference between employer contribution rates in DB and DC pension schemes".

[2] See, An Agenda for Adequate, Safe and Sustainable Pensions, EU Pensions White Paper, 2012, p.2.
[3] Figures from the Office for Budget Responsibility show that UK public spending on long-term care is expected to increase from 1.2% (2009/10) to 1.7% (2029/30) as a percentage of total GDP. This is growth of 40% – faster than any other area of age-related public spending.
[4] Quoted in Fairer Care Funding, Report by the Dilnot Commission, 2011.
[5] ONS sub-national population projections, 2010.
[6] The Scottish Widows UK Pensions Report, May 2012.
[7] MGM Advantage Annuity Index, April 2012.
[8] Bank of England Bankstats, Table A5.2, May 2012.
[9] The Aviva Family Finances Report, May 2012.
[10] Economic and Fiscal Outlook, Office for Budget Responsibility, March 2011.
[11] Purple Book 2011, Pension Protection Fund, p.32.

In 2009, the average employer contribution rate for private sector DB occupational pension schemes was 16.5% of salary compared to 6.4% for DC schemes.[12] This needs to be recognised as one of the most important reasons – arguably the most important reason – for the retirement savings gap.

So it is clear that people need to save more for their retirement. And people do want to save more – our recent consumer research shows that 81% of people want to save more.[13] This is true also for the younger generation – 91% of people between 18 and 24 want to save more;[14] and the IPPR found that 86% of 18 – 29-year-olds "would like to save for the longer term".[15] So why does this not happen in reality? The ABI's consumer research routinely asks this question. By far the most common answer from respondents is that they have no spare money, with 67% of our respondents selecting this as a key factor to help them save more. Similarly, in a report by Aviva, of those employees who are offered a pension scheme and actively decide not to contribute, the largest proportion (55%) say that they simply don't have the additional cash to put into a pension at this time.[16]

So it would appear that this is partly also a question of people's spending priorities – in other words, people on a very modest income may indeed struggle to make ends meet and have no money to provide for the future. People higher up the income scale may feel that they have no spare money, but that may also be because they have chosen to spend their disposable income elsewhere, rather than on saving for retirement. Ultimately, saving requires sacrificing consumption. People saying that they want to save more does not necessarily mean they want to consume less.

Behavioural economists – and cognitive scientists – have long identified the reasons for this: people have a strong focus on the short term and find it more difficult to engage with the long term.[17] People also have an optimism bias. Research shows that most people are confident overall that their future lives will be better than those of their parents.[18] Seeing their parents enjoy a higher standard of living in retirement than their grandparents, younger people today will find it difficult to engage with the thought that their retirement is likely going to be less affluent than that of previous generations, unless they make more provision for it.

[12] ONS Pension Trends, September 2011, Chapter 8, p.8.
[13] ABI Quarterly Consumer Survey 2011 Q4.
[14] Ibid.
[15] Young People and Savings, Institute for Public Policy Research, February 2012.
[16] Working Lives: A research report into employer and employee attitudes to saving in the workplace, Edition 1. Aviva. April 2012, p.4.
[17] See, Nicholas Barr presentation, April 2011, http://www.ebrd.com/downloads/research/news/Barr_EBRD_110401.pdf.
[18] The Optimism Bias – A Tour of the Irrationally Positive Brain, Tali Sharot, New York 2011.

We know that cognitive biases such as present bias, optimism bias and inertia prevent people from taking decisions about retirement savings. It is therefore absolutely right to set pension saving as the default, and the ABI strongly supports automatic enrolment into workplace pension savings. Employers' contributions can make a real difference to people's savings habits – our research shows that 50% of people will stay opted in so as not to miss out on money from their employer.[19]

Coupled with the single-tier state pension, which we support, automatic enrolment will make a difference to the retirement of millions. It is now almost upon us – a social revolution for retirement savings, the importance of which is hard to overestimate.

What will make most difference to the long-term savings challenge we are faced with?

In this crucial period for the development of retirement savings, it is vital that all parts of the pension industry work together to make automatic enrolment a success. This means focusing the debate on the issues that matter most for a good outcome.

What makes most difference to people's retirement income is how much they save, and how long for. People instinctively know that they need to save more – our latest research shows that many people are not confident they will have enough income in retirement, because they know not enough money is being put in. Just over half of respondents felt that insufficient personal contributions were a large contributing factor to their lack of confidence in having a sufficient retirement income.[20]

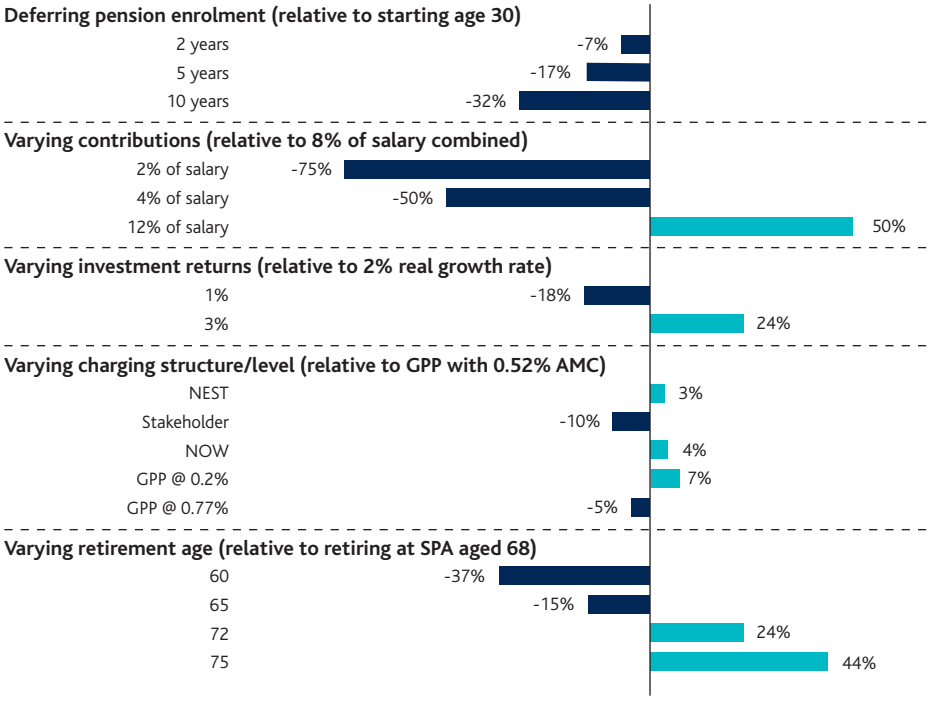
What is the impact of contributions?

Our own modelling shows the dramatic positive impact of starting to save earlier, and of making higher contributions.

The diagram overleaf is based on an AMC of 0.52% (the average AMC for newly set up schemes), and demonstrates the dramatic impact of deferring saving, and reducing contributions relative to paying higher charges.

[19] ABI Quarterly Consumer Survey 2012 Q2, to be published late June.
[20] ABI Quarterly Consumer Survey 2012 Q2, to be published late June.

Figure 1 – Variations in at-retirement pension pot value with multiple factors



Source: ABI Calculations

Key assumptions used in calculations:

- Inflation = 2%
- Earnings growth (real) = 0%
- Investment returns (real) = 2%*
- Annual gross salary at age 30 = £28,240
- Age at initial contribution = 30*
- Age at retirement = 68*
- Contributions taken from band earnings (between £5564 and £42,475)
- Combined contribution (own, employer and tax relief) = 8% of gross salary* (i.e. auto-enrolment phase-in is assumed to be complete)
- Annual management charge = 0.52%

** Unless an alternate value is specified for the scenario in question*

The GPP charging levels are derived from our survey of members' scheme charges, see below.

The dramatic impact of starting to save earlier and increasing contributions is also backed up by research by the Pensions Policy Institute.[21]

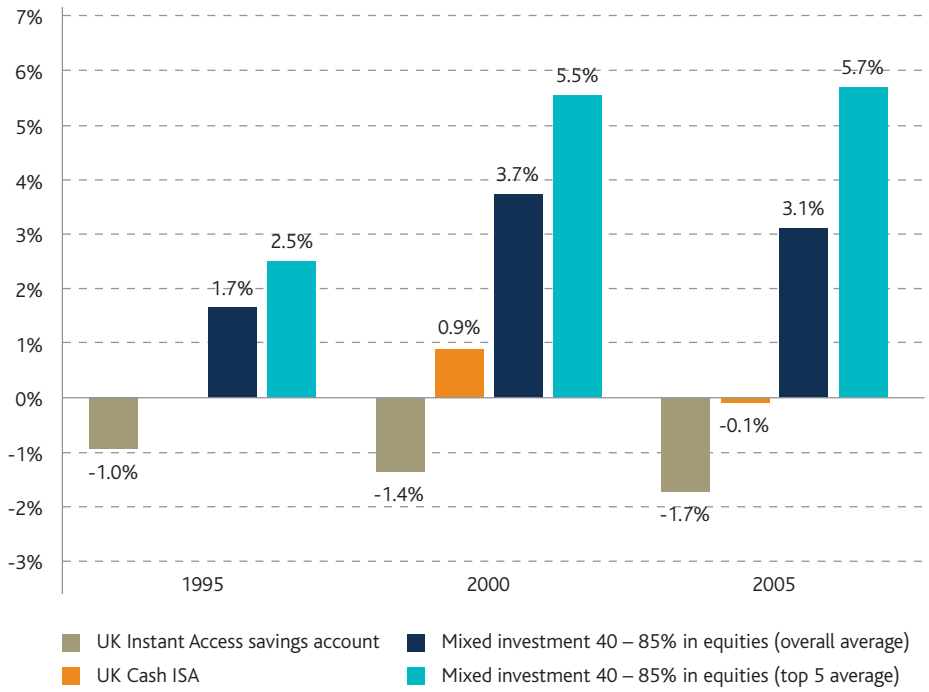
[21] Closing the gap: the choices and factors that can affect private pension income in retirement, Pension Policy Institute, February 2012, p.3.

What has investment performance in pensions been like?

After saving for longer, and increasing contributions, investment performance is the third most important factor for retirement outcomes. The most recent data from Money Management (March 2012) shows that pensions have performed well, even in tough economic conditions and the article concluded that "a personal pension can be an affordable flexible option that produces attractive investment returns in the long term".[22]

To illustrate this, saving £160 per month in an average personal pension, or £200 with tax relief added, over the last 15 years to end 2010 would have provided a saver with a pot of £50,650, after all charges. This represents an annualised real (above inflation) return of 1.7%, ultimately providing a retirement income of over £250 a month, before tax.[23]

Figure 2 – Annualised real return of average pensions (after all charges) from £200 a month gross saved over 5, 10 and 15 years and maturing at the end of 2010, compared to UK instant access savings accounts and UK Cash ISAs



Source: Money Management pensions survey, 2011; Bank of England Monetary & Financial statistics table G 1.3, ABI calculations; ONS Inflation statistics.

Figure 2 shows that a saver putting £200 a month into an average pension scheme from end 2000 to end 2010 would have achieved a 3.7% annualised return above inflation and after all charges, or 6.5% nominal. The top 5 pension funds in mixed investments (40-85% equities) performed significantly better. All these figures show the benefit of saving for retirement in a pension.[24]

[22] Money Management special report on pensions, March 2012.
[23] Money Management special report on pensions, March 2011. Annuity rates from Money Advice Service comparison tables, www.moneyadviceservice.org.uk/tables.
[24] Source: Money Management special report on pensions, March 2012 and October 2011.

How high are pension charges now?

It is sometimes suggested that pension charges are still very high and complex, making a huge dent in the savings pot that people accumulate. This does not hold true for modern pension schemes, as our recent survey results show. Pension charges have changed hugely over the last 15 years. In the 1990s, there were many and varied charges on contract-based DC schemes, with high up-front fees, due to commission. The totality of these charges could be significant, especially for people who stopped paying in after only a short period of time.

However, the advent of stakeholder legislation, with its price cap and requirement to eliminate all other charges, and IT improvements leading to cost reduction, led to much simpler charging structures in the insurance industry, and the predominant form of charging is now through an annual management charge (AMC).

In April and May 2012, we surveyed 95% of the contract-based market, including the eight largest providers, for their default fund pension charges for different sizes of pension schemes. This covers approximately 3.5 million active pension customers in over 103,000 pension schemes. It showed that:

- For schemes newly set up for automatic enrolment, the average customer experience across all sizes of scheme is an AMC of 0.52%. This covers over 50,000 people.
- While the average AMC at a scheme level across pre-existing GPPs is 0.91%, the average customer experience is a charge of 0.77%, reflecting the fact that larger schemes benefit from lower charges.
- However, approximately 800,000 customers in pre-existing schemes are already paying less than 0.5% AMC.
- There are also 1,700 schemes with charges set below 0.3%. Of these, 95% have fewer than 500 members, and 62% have fewer than 50 members.
- The highest charges reported to us were 2.11%. However, this applied to only six out of the over 103,000 pension schemes we surveyed, representing no more than 0.16% of active pension customers, and these legacy schemes are currently being renegotiated in the light of auto-enrolment.

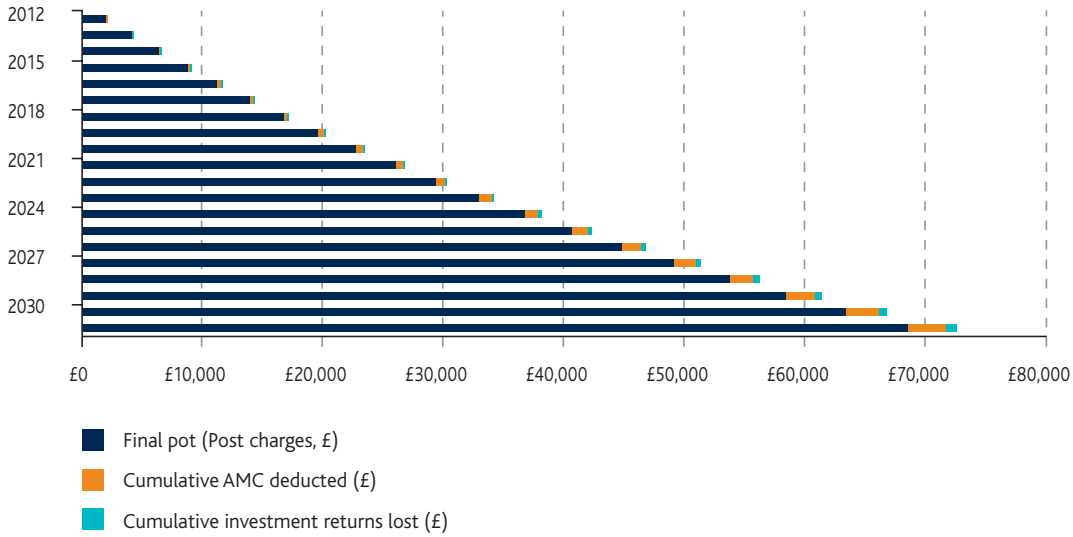
Half the companies surveyed (accounting for 63% of market share) offer active member discounts due to demand from clients. However, all but one company reported a very low take-up of this option among their schemes. The largest differential reported for any one scheme was 0.8%, but the typical differential between the costs paid by an active and a paid-up member is in the range of 0.2% to 0.5%.

Most companies reported charges decreasing over the past three years, mainly due to the competitive nature of the market. Others reported no change. No company reported increasing its charges on individual or workplace pension schemes.

What is the impact of different charges on a saver's pension pot?

The impact of a 0.5% AMC over 20 years is shown in the diagram below. It essentially shows that an individual's final pot is 5.4% smaller than a "nil-charges" pot, both through cumulative charges deducted and the lost investment returns from these charges.

Figure 3 – Breakdown of savings pot composition over 20-year period



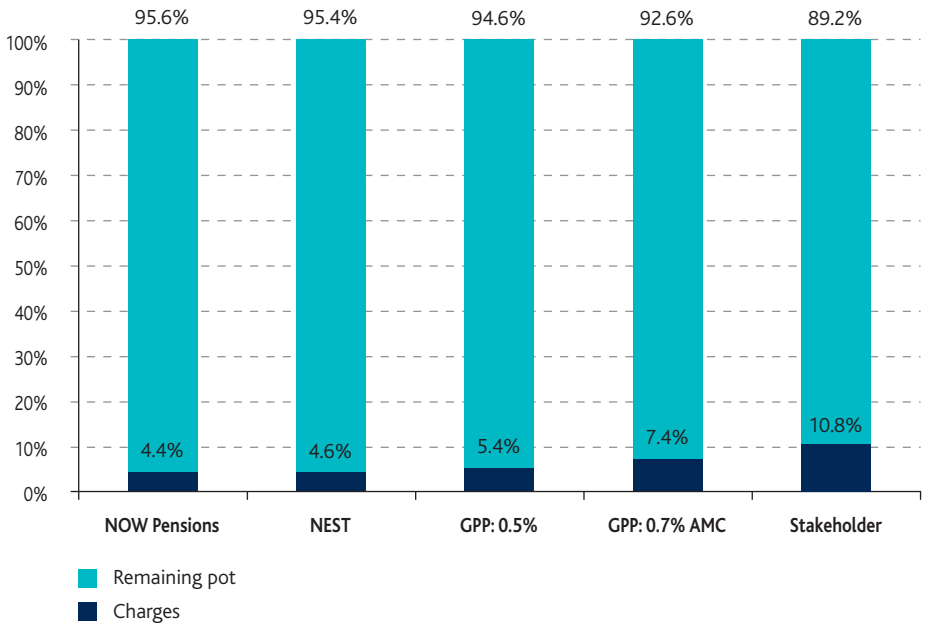
Source: ABI calculations

Key assumptions:

- Initial salary = £25,000;
- Investment returns (real) = 2%;
- Inflation = 2%;
- Annual management charge = 0.5%;
- Combined contributions = 8% gross salary

This compares well to charges and charging structures used in other parts of the market, such as the National Employment Savings Trust (NEST) and NOW: Pensions. The graph below shows that there is no dramatic difference between different structures for a saver on average earnings and saving for 25 years, with stakeholder charges diminishing the pot the most.

Figure 4 – Impact of different charges on the final pension pot (median wage, full contributions)



Assumptions:

- Inflation, asset growth & real earnings growth are all 0%.
- All contributions based on band earnings (i.e. those over £5,715).
- Contributions start in October 2012, and reflect legislative minimums as they are phased in.
- All contributions receive full tax relief.
- Proportions are relative to a 'no charges' scenario.

However, different charging structures can have a significant impact depending upon the time period one is assessing, people's level of earnings, and their persistency of saving, as shown in the Annex.

What about other costs to the pension?

FSA rules require all providers of contract-based pensions (including GPPs) to give their customers a key features document and a key features illustration which include "appropriate charges information", describing the nature and amount of charges.[25] These charges are not defined, but will typically include the Annual Management Charge, but not dealing costs. The same FSA rulebook says that projections must not include the dealing costs incurred by the fund on the underlying portfolio.[26]

Dealing costs incurred by the fund are also excluded from the EU rules for retail investment funds and from the definition of charges for Stakeholder pensions. The ABI's good practice guide for unit-linked funds, which covers the vast majority of employer-sponsored contract-based pensions, states that if dealing costs are charged to the fund, this fact should be clearly disclosed to policyholders, although it does not say that the amount should be disclosed.

[25] FSA Handbook, COBS 13 Annex 3 – Charges.
[26] FSA Handbook, COBS 13 Annex 2 – Projections.

These costs are sometimes referred to as "hidden charges" because their disclosure is not required. However, they are overheads, such as stamp duty, brokerage costs, and the costs of accessing markets, that are incurred as a necessary part of buying and selling the fund's underlying investments in order to achieve the investment objective.

The reason that disclosure of the amount of dealing costs is not required in customer information is the difficulty in producing a meaningful and accurate figure for an individual customer. This is because dealing costs comprise explicit costs, such as dealer commission and stamp duty; and implicit costs, particularly the bid-offer spread on share prices. We agree it is desirable that these are made more transparent overall, but note the difficulty of presenting these costs as a cost to an individual customer in a meaningful way.

Our research also shows us most people do not think that charges play a particularly large role in the value of their pension savings – our most recent consumer research found that this was the factor of *least* concern for respondents, with contributions and investment returns ranking higher in importance.[27] As shown in Figure 1 above, this is borne out by the numbers. Still, the industry recognises it is important that charges are transparent, so that customers are made aware of the existence and effect of charges and costs, can make comparisons, and are able to scrutinise them if they wish to.

Employers have an increasingly important role, especially as more small and medium-sized employers with no experience of pensions need to fulfil their new auto-enrolment obligation. There are currently no requirements for charges to be disclosed to members for trust-based schemes at the outset. We are working with the National Association of Pension Funds and others on a common way to tell employers about the effect of charges on their members, and are also exploring ways to disclose dealing costs.

What difference do governance structures make?

There has been much discussion lately about the difference between trust-based and contract-based defined contribution pension schemes. Sometimes it is claimed that one legal form is better for customers than the other.

We believe the different legal form is much less relevant than what happens on the ground. For example, the fitness and propriety of key decision-makers in providers offering contract-based schemes is checked by the FSA before they can take office – trustees do not have to undergo similar checks.

[27] ABI Quarterly Consumer Survey 2012 Q4, to be published late June 2012.

Although legislation does require trustees to have appropriate knowledge and understanding of the law relating to pensions and trusts, only 52% of schemes have documented or formally assessed the learning needs of their trustees[28] and only 45% of schemes report that all or most of their trustees have made use of The Pensions Regulator's Trustee Toolkit.[29] Indeed, one-in-five trustee boards in small DC schemes meet less often than annually or not at all.[30]

Contract-based providers must demonstrate to the FSA that they consistently deliver fair outcomes to customers and that senior management take responsibility for ensuring this happens. Other Treating Customers Fairly outcomes require firms to ensure that:

- customers are sold products designed to meet their needs;
- products perform as customers have been led to expect;
- customers get the right information; and
- the fair treatment of customers is central to the providers' corporate culture.

We believe that the FSA's TCF requirements are virtually equivalent to the Pension Regulator's six principles for good DC outcomes, and we are looking forward to our continued engagement with tPR on this.

Trustees on the other hand have a fiduciary duty to place the interests of the members of their pension scheme first. However, the nature and content of fiduciary duties need to be clarified, with some commentators concluding that the understanding of the fiduciary duty has lost its way.[31] Others state that the "generality and vagueness of fiduciary duties" and their organic nature mean that the legal application, interpretation and development of the list of core and ancillary duties may never be regarded as finally complete.[32]

Ultimately, we believe all pension schemes need to be judged on the customer outcomes they deliver. There is no evidence that one governance structure necessarily delivers better results than another – charges in trust-based schemes are not lower than in contract-based schemes[33] and neither is performance better. Indeed, charges in the Australian superannuation schemes (which are trust arrangements) are higher than in the UK, at AUS$ 1.50 per week (£49 annually), plus 0.59% a year of the account balance. The average investment return of supers over the last ten years was 3.8%.[34]

The pensions industry therefore needs to put these internal debates aside and tackle the challenges with a more united front.

[28] *Occupational pension scheme governance – A report on the 2012 (6th) scheme governance survey*, The Pensions Regulator, May 2012.
[29] *Occupational pension scheme governance – A report on the 2012 (6th) scheme governance survey*, The Pensions Regulator, May 2012.
[30] Ibid.
[31] *Protecting Our Best Interests – Rediscovering the Fiduciary Obligation*, Fair Pensions, March 2011.
[32] *Good Governance for Pension Schemes*, Paul Thornton and Donald Fleming, 2011, p.52.
[33] Charging levels and structures in money-purchase pension schemes: report of a quantitative survey, DWP research report No. 630.
[34] APRA, Annual Superannuation Bulletin, June 2011.

Don't people prefer to save in ISAs?

The IoD recently associated the increase in amounts paid into ISAs from £35.7 billion in 2007 to £53.8bn in 2010/11, and the fall in employee and individual pension contributions from £25.6 billion in 2007 to £22.9 billion in 2009, with "dwindling faith in pensions".[35]

The success of ISAs in encouraging savings is welcome but it does not follow that it is because of a crisis in confidence in pensions. The increase in ISA contributions can be partly attributed to tax changes in those years: the annual limit for ISAs has gone up from £3,600 to £5,340 while the annual allowance for pensions has been cut from £255,000 to £50,000. Unemployment has also increased from 5% to 8%, which has a direct impact on pension contributions.

Other recent figures show that, as one might expect, people also regularly take money out of ISAs. Net sales of ISAs – new sales minus encashments – halved in the tax year 2011/12 to £2.1bn, from £4bn in the previous two years. The five years before that, from 2004/5 to 2008/9, saw negative net sales.[36]

Meanwhile, other forms of short-term saving have also increased: credit union deposits rose 19% from 2008 to 2009 alone;[37] and peer-to-peer lending has grown exponentially. Balances on credit cards have continued to fall since 2008.[38] It is difficult to read anything conclusive into this saving behaviour or to compare it to pension contributions.

Another report found that people with more liquid savings were more likely to save into a pension.[39] The reality is that 30% of employed people have no liquid savings at all and another 33% have less than £2,500.[40] We know that 81% of people want to save more,[41] and more recent research shows that individuals would like to save in a variety of sources. When presented with the option to save in an ISA, a pension, a savings account or property, 23% said they would like to save in all four; a further 24% selected pensions individually or with one of the other options.[42]

All forms of saving are complementary, and getting people into the savings habit is much more important than the vehicle used. ISAs and pensions serve a different purpose – ISAs are medium-term savings vehicles, whereas pensions are intended for retirement. We believe it is not instructive or helpful to state that savings vehicles are in competition or that people prefer one or the other. Auto-enrolment will change the savings landscape and should result in more people with lower incomes saving into a pension; anyone should be encouraged to save for both the short term and the long term.

[35] Roadmap for Retirement Reform 2012.
[36] Investment Management Association monthly retail statistics, April 2012.
[37] FSA annual Credit Union statistics, 2009.
[38] Credit Card Market Statistics, British Bankers' Association, September 2011.
[39] Who saves for retirement? Strategic Society Centre, Institute for Social and Economic Research and Prudential, using Wealth and Assets Survey data, December 2011.
[40] Ibid.
[41] ABI Quarterly Consumer Survey 2011 Q4.
[42] ABI Quarterly Consumer Survey 2012 Q2, to be published late June.

Should people be able to access their pension savings early?

Early access to pension saving could conceivably encourage more pension saving, or provide flexibility for individuals facing financial hardship, or provide more flexibility during the accumulation of pension savings, for example, by promoting intergenerational wealth distribution.

However, we believe that the case for introducing early access to pension saving is not supported by the available evidence, regardless as to which of these objectives early access is intended to achieve. There is a rich evidence base examining early access, and some international practical experience of the concept. But this evidence is extremely mixed as to whether the benefits would outweigh the risks for individuals and society. For example, whilst there is some evidence that early access could incentivise under-saving groups to save, such as people in low income groups, women and younger people, it also exposes these savers to having less income than expected to live on in retirement. This is a serious risk given rapidly rising longevity.

Furthermore, many people see having savings locked away as a positive aspect of a pension: our consumer survey found that 45% of people rejected all options for early access and would prefer to only have access to their pension savings at retirement.[43]

We therefore agree with the Government's conclusions[44] that early access to pension savings should not be considered at the present time in view of the limited evidence that it would have a positive impact on pension saving, and the extensive pension reforms already in progress. Once automatic enrolment has been fully phased in, research should be undertaken into the reasons why some people may decide to opt out. If evidence shows that early access is a significant factor, early access could be revisited.

Do people trust the pension industry?

Most people trust the pensions industry to look after their money; only 12% were worried that their pension provider would go bust.[45]

This is also backed up by complaints data from the Financial Ombudsman Service (FOS), which shows that complaints on pensions are low relative to other products:

- There are five times as many FOS complaints about credit cards, and four times as many about current accounts as there are about pensions;[46]
- In each of the last 6 years, under 5% of FOS complaints have been about pensions, and it is now only 1.5%; and
- Only around half of the complaints about pensions are about providers. The majority of complaints are about sales and advice.[47]

[43] ABI Quarterly Consumer Survey 2012 Q2, to be published in late June.
[44] See, http://www.hm-treasury.gov.uk/consult_early_access_pension_savings.htm.
[45] ABI Quarterly Consumer Survey 2012 Q2, to be published in late June.
[46] Financial Ombudsman Service annual review, 2011/12.
[47] Ibid.

However, we acknowledge that there are still many criticisms levelled against the industry – some justifiable, others less so. But this is not an industry that is complacent about criticism – it has been evolving and reforming constantly over the last 20 years and will continue to do so.

So how can we make pension reform a success?

We believe it is a natural process for every customer-focused industry to constantly strive to improve its offering to customers. This is equally true for the pension industry. We are working to raise our standards at every point in the pension life cycle – helping employers with their new legal duties under automatic enrolment as they set up or extend their pension scheme, working with Government on a solution to help people merge their small pension pots, supporting customers in making the right long-term decisions, and looking after our customers' interests through effective stewardship.

How does the pension industry help employers with their auto-enrolment duties?

The ABI's members are supporting individual employers with their new duties under auto-enrolment. The legislative framework surrounding automatic enrolment is complex, and brings about considerable implementation challenges. Employers must decide which qualifying scheme to use, follow complex criteria determining which employees to automatically enrol, ensure that the right communications are sent to employees at the right time, manage opt-outs, and ensure the right contributions are made.

We have worked hard with Government to ensure that the employer duty regulations are not overly burdensome for employers. Our members are now supporting employers with their new duties, for example through providing web-based tools helping employers establish the eligibility of workers for automatic enrolment. This can take the form of a solution that allows the employer to simply upload their HR information onto the provider's systems, which will then classify the employees into eligible employees, non-eligible employees, and those who have other entitlements.[48]

How should the pension industry address the issue of small pension pots?

It is also critical that we help people merge their small pension pots. We know that automatic enrolment will bring up to seven million new savers into pension saving, many of whom will change jobs very often. By 2017 this is estimated to create around 370,000 pension pots of less than £2,000 a year.

[48] For only one example, see Standard Life's "Lifelens", http://www.workbenefitszone.com/html/Corporate/offering/LifeLensAutoEnrolmentDEMOTranscript.html.

The ABI strongly supports the Government's intention to address this problem. We believe savers, and society as a whole, would benefit from a mechanism which encourages people to merge the small pension pots they acquire during their working life. The number of lost or stranded pots could be reduced, and people would benefit from greater choice when buying a retirement income due to a larger pot. Helping people merge their small pension pots and reducing the number of pots could also help them engage with their pension saving, particularly new savers who have never saved into a pension before.

Our consumer research also tells us emphatically that this is what people want – 58% of respondents want their pot to move automatically with them as they move employment, compared to 17% who prefer a solution where they can see all their pension entitlements in one central place, 15% who would like their pot to stay where it is, and 10% who would like their pot to automatically move to a central scheme, with a new pot started by the new employer.[49]

This is why we believe we must find a solution which allows people to take their small pension pots with them as they move from employment to employment. We will continue to engage with the Government and other stakeholders on how to best to make this happen.

What is the pension industry doing to ensure people do not inappropriately give up rights from defined benefits pensions?

We must also protect people from making pension choices contrary to their long-term interests. Where employees are offered to transfer out of their defined benefit scheme, they should receive a balanced presentation of the facts, be supported by advice, and not be encouraged by cash incentives to give up valuable defined benefit rights. We therefore endorse and strongly support the Industry Working Group's Code of Good Practice on Incentive Exercises, which we helped draw up together with other stakeholders. This Code will benefit consumers by substantially improving the protection of pension scheme members taking part in these transfer exercises.

The ABI expects all its pension provider members to comply with all principles in the Code that are relevant to their business, and to only transact transfer business undertaken in compliance with the Code of Good Practice.

The ABI will continue to work with members and the Industry Working Group to support the development of the ownership, maintenance and monitoring of the Code to ensure it delivers positive outcomes for consumers.

[49] ABI Quarterly Consumer Research 2012 Q2, to be published in late June.

How is the industry supporting people making better retirement choices?

People also have to take a hugely important decision at retirement about how they take their retirement income. They must balance a variety of risks at retirement; uncertainty about the future, and the downward pressure on annuity rates, mean it is all the more important for each individual to select a retirement income product that suits their needs, and to shop around for the best deal. The retirement income market is diverse and competitive and constantly evolving to meet these needs. But there is an enduring challenge in engaging the whole range of customers and ensuring they can find the right product.

We believe our industry has a duty to help its customers understand and consider their options, and make it much easier to shop around for retirement income. To achieve this, we introduced our compulsory Code of Conduct, and we are now working with our members and other stakeholders to ensure it has maximum impact.

Implementing the Code comes with challenges for us and our members. Our members have different ways of working and will need to make changes to the literature they send, the data they collect and the questions they ask of customers. We are working hard to deliver it, especially focusing on how best to achieve our commitment to transparency on rates, in a way that is realistic and useful for customers; and a fair reflection of what each of our members is offering.

We are also working with intermediaries who specialise in retirement income, to understand how the market works from their perspective and how we can make shopping around the norm to improve customer outcomes. In particular, we are looking at how a directory of at-retirement specialists can be delivered. Working with others will also help us evaluate success of the Code. Raising standards needs to be a continuous process and we will look closely at how effective the Code has been.

How do pension providers ensure members' money works in their long-term interest?

Finally, effective stewardship promotes the long-term success of companies to the benefit of pension savers and society as a whole. As such, the UK Stewardship Code – which sets out the principles of effective governance by institutional investors – is good for consumers and good for companies.

The ABI's members are active as institutional investors in two key ways. They are asset owners in their capacity as pension providers, because they hold the legal ownership of company shares invested on behalf of their pension customers. Where pension providers have an asset management arm, they also act as asset managers, managing investments on behalf of the pension provider.

Insurance companies are already implementing the Code through their investment management arms and are working hard to ensure that external fund managers and other firms adhere to the principles of the Code. For example, approximately 80% of pension assets held by ABI members are currently managed by their internal fund managers, and all ABI members' internal fund management arms are signatories to the UK Stewardship Code.

Likewise, approximately 20% of pension assets held by ABI members are managed by external fund managers, and over 90% of these external fund managers are signatories to the Code.

However, the ABI's members believe that adherence to the UK Stewardship Code is best practice. Pension providers with internal asset managers will therefore continue to hold them to account regarding how they discharge their responsibilities and also use their best endeavours to exert influence over external fund managers.

The ABI is committed to working with the Financial Reporting Council – which operates the Code – to help ensure the Code continues to foster long-term success for companies to the benefit of consumers and broader society.

Conclusions and future agenda

Looking forward, we believe our industry needs to focus on three key themes, which will be the focus of our work going forward:

- Help employers implement automatic enrolment;
- Make the most of the workplace to get people into the savings habit; and
- Start to take a holistic view of financial needs in retirement.

First and foremost, we need to implement automatic enrolment, continuing our support for employers to help them comply with their new duties and overcome the implementation challenges. This will involve delivering solutions such as providing hubs which can be used by employers to determine which employees they need to enrol, and education and communication materials that explain the employer's duties.

Secondly, we need to make the most of the workplace to get people into the savings habit, by providing help and guidance, extending the range of savings products that can be accessed through the workplace, and by exploring behavioural finance mechanisms such as "save more tomorrow" which have been shown to be effective in the US.

Research shows that the workplace is one of the most effective places to reach people with messages about their finances. For example, the Money Advice Service and its predecessors have reached 4 million people through 1,500 employers, with 8 out of 10 taking action following a seminar.[50] To leverage this, our members are offering employer intranet systems helping employees with budgeting software and pension planners. Scottish Widows' mymoneyworks is but one such example.[51]

[50] www.moneyadviceservice.org.uk/workingwithus/workplace.
[51] http://www.scottishwidows.co.uk/extranet/products/corporate-pensions/mymoneyworks.

There is also a growing and very positive trend of employers offering corporate ISAs to their employees which are provided by our members alongside pensions. Offering a corporate ISA can help drive engagement in savings, particularly for young people who traditionally do not save into a pension. The corporate ISA can be an "entry level" savings product and can be an effective way of kickstarting the savings habit.

To drive up contributions from the legislative minimum, we also believe that the industry and employers should explore additional behavioural techniques to help people reach their savings goals. For example, recent research shows that 28% of those enrolling with minimum contributions would be encouraged to save more if they could see the progress towards their pension goal shown on their payslip.[52]

In addition, we should explore models of auto-escalation of contributions for employees alongside automatic enrolment, such as Save More Tomorrow™ (SMarT). SMarT is a mechanism where participants are invited to join a programme that commits them to increase their saving, beginning at some time in the future, for example next January. Work by Benartzi has shown that such programmes can be extremely effective in getting people to save more, by making it easier to gradually increase their savings rate over a period of years. In the US, it quadrupled retirement contributions among employees at a mid-sized manufacturing company in the first three and a half years of its implementation. The programme is now used by more than half of the large employers in the US.[53]

Auto-escalation would help ensure that savers do not default to saving the legislative minimum because of inertia. Instead, it would harness people's cognitive biases. It would commit them to saving more in the future, which people are very willing to do, because it makes a painful future action easier today. It would also harness inertia, because further increases would be automatic. In fact, inertia would keep people on a trajectory to adequate savings rather than preventing them from getting there.[54]

Finally, we need to start to take a holistic view of financial needs in later life, considering not only savings for a retirement income, but also for long-term care needs. The need for broad provision is only going to grow. Our industry must continue to work with Government to help meet that need and to serve our customers well.

We must all work together to tackle our savings problem and focus on the things that are most important to build our future: it is time to act.

[52] Keep on nudging: making the most of auto-enrolment, Standard Life, 2011, p.12.
[53] Shlomo Benartzi, Save More Tomorrow, New York, 2012, p.14.
[54] Ibid, p.105.

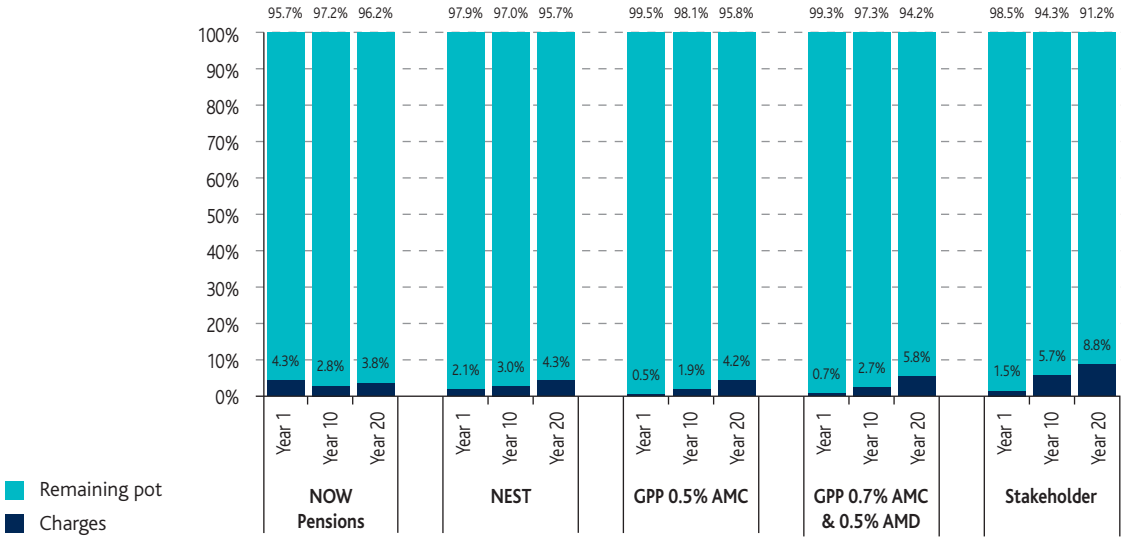
Annex – Impact of different charging structures on savers' pension pot

The graphs that follow demonstrate that charging structures have advantages and disadvantages for different saving patterns.

For example, for a saver on the median wage, the percentage lost to charges in NOW: Pensions is the lowest among all the schemes modelled after 25 years, and the highest after one year.

A saver on the minimum wage saving persistently for 20 years would lose 5.8% of their pot to charges in NOW, 4.3% in NEST, 4.2% in a GPP with an AMC of 0.5%, 5.8% in a GPP with an AMC with 0.7%, and 8.8% in a stakeholder scheme. However, if that saver stopped contributing after 5 years, after 10 years they would lose 6.0% of their pot in charges in NOW (update with new deferred member charges), 4.1% in NEST, 3.9% in a GPP with an AMC of 0.5%, 7.8% in a GPP with an AMC of 0.7% (going up to 1.2% for deferred members), and 11.4% in a stakeholder scheme.

Figure 5 – Charges: Median wage, full contributions



The assumptions applying to all scenarios are as follows:

- Inflation, asset growth & real earnings growth are all 0%.
- All contributions based on band earnings (i.e. those over £5,715).
- Contributions start in October 2012, and reflect legislative minimums as they are phased in.
- All contributions receive full tax relief.
- Proportions are relative to a 'no charges' scenario.

Scenario-specific assumptions:

- Median wage = £28,168 pa. [ONS median wage for 30-39 year old].
- Minimum wage = £12,160 pa. [250 business days * 8hrs * £6.08/hr].
- Full contributions = Start at age 30, contribute to and retire at 55.
- Partial contributions = Start at age 30, contribute until 35 (5 full years), retire at 55.

Figure 6 – Charges: Median wage, partial contributions

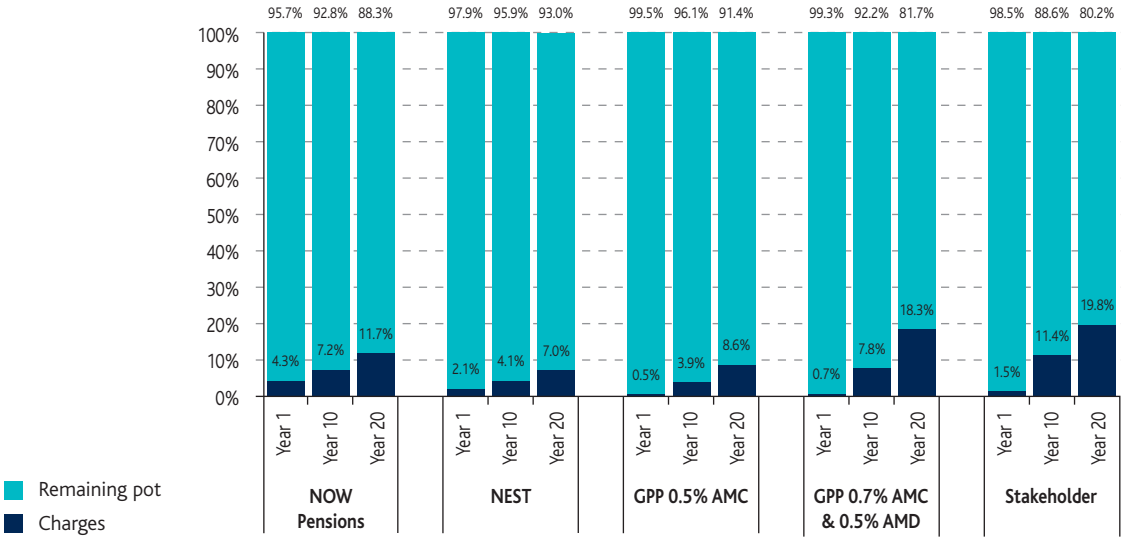


Figure 7 – Charges: Minimum wage, full contributions

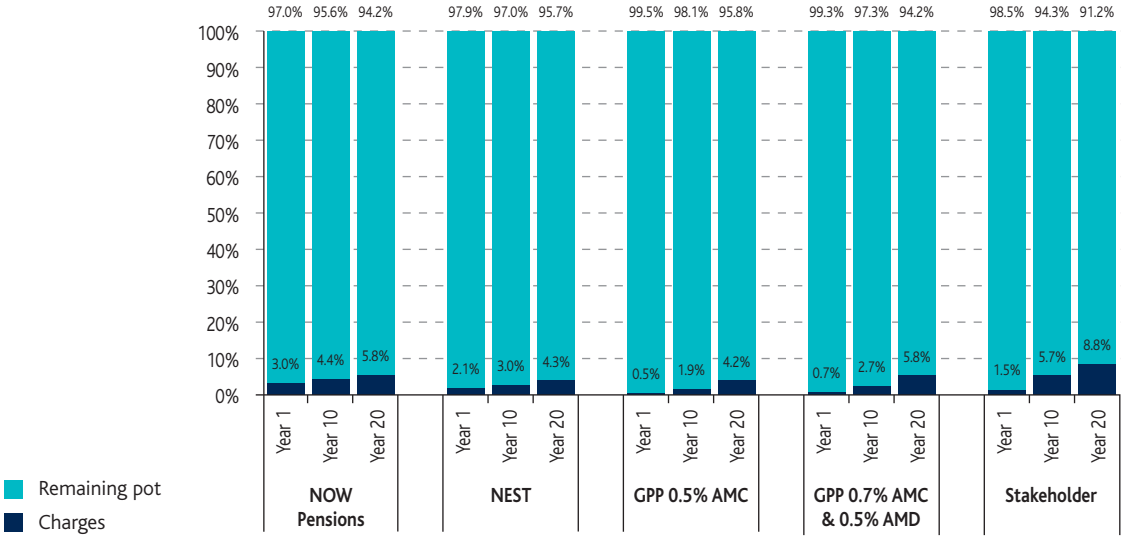
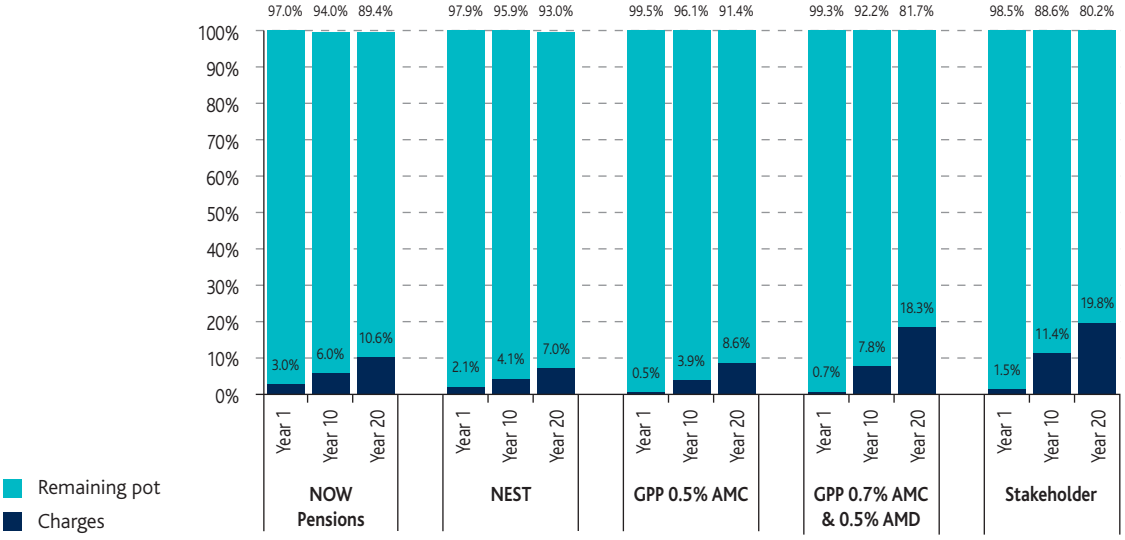


Figure 8: Charges: Minimum wage, partial contributions



The examples show that all charging structures have advantages and disadvantages, and involve an element of cross-subsidy between different categories or cohorts of members.

For example, NEST's contribution charge is likely to be removed once it has repaid its Government loan. It could therefore be argued that scheme members joining NEST in the early years will subsidise cohorts joining in 20 years' time. Similarly, two policyholders invested in the same default fund with an insurer, one with a very large, one with a very small pot, will receive the same service yet pay different amounts by virtue of the AMC being a percentage of fund value. The saver with the large pot is arguably paying disproportionately more compared to the saver with the small pot.

Similar issues arise with a flat administration charge regardless of the size of the pot – this is attractive for those with very large pots, but could dramatically erode the value of deferred members with small pots.

This ultimately raises the question whether there should be cross-subsidies between members, or whether charges should match the costs of services used by the member. Cross-subsidies make it possible for lower paid workers to save in a pension scheme without losing a large part of their first year's contributions in charges, which could be a huge disincentive to save.

It would also be extremely difficult to make everybody pay for precisely the services they use as many services are pooled. However, cross-subsidies bring their own trade-offs, and as the Pensions Policy Institute said in its examination of charging structures for what is now NEST: "Each charge structure has advantages and disadvantages and there are trade-offs that have to be made."[55]

[55] PPI, Charging structures for Personal Accounts, precise reference to follow.

The UK Insurance Industry

The UK insurance industry is the third largest in the world and the largest in Europe. It is a vital part of the UK economy, managing investments amounting to 26% of the UK's total net worth and contributing £10.4 billion in taxes to the Government. Employing over 290,000 people in the UK alone, the insurance industry is also one of this country's major exporters, with 28% of its net premium income coming from overseas business.

Insurance helps individuals and businesses protect themselves against the everyday risks they face, enabling people to own homes, travel overseas, provide for a financially secure future and run businesses. Insurance underpins a healthy and prosperous society, enabling businesses and individuals to thrive, safe in the knowledge that problems can be handled and risks carefully managed. Every day, our members pay out £147 million in benefits to pensioners and long-term savers as well as £60 million in general insurance claims.

The ABI

The ABI is the voice of insurance, representing the general insurance, protection, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

The ABI's role is to:

- Be the voice of the UK insurance industry, leading debate and speaking up for insurers.
- Represent the UK insurance industry to government, regulators and policy makers in the UK, EU and internationally, driving effective public policy and regulation.
- Advocate high standards of customer service within the industry and provide useful information to the public about insurance.
- Promote the benefits of insurance to the government, regulators, policy makers and the public.

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