An age-old problem

developing solutions for funding retirement

CII

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foreword

An age-old problem: developing solutions for funding retirement

Raising the level of long-term savings for retirement is a tough and complex task, with no easy solutions and no foolproof method to test new ideas. It is also something that policymakers and the industry have been wrestling with for years – attempting to develop lasting solutions in the face of a constantly changing economic and regulatory environment, as well as increasing longevity. Perpetual reform brings its own problems as each round leaves consumers and savers not just baffled, but also less willing to want to engage in a system that is subject to constant tinkering.

This report captures the current debate, and provides suggestions about how we can tackle this important public policy issue. It addresses pensions and long-term care as part of the same problem: the public must save significantly more for retirement.

Our report begins with an overview of the scale of the retirement problem. We demonstrate, with a simple theoretical model, the potential costs facing the average person about to enter retirement once long-term care and debt have been added to the equation. We then use this as a basis for calculating what the total size of the pensions gap might look like for all those retiring over the next forty years. In turn we summarise the current state of the Government's reforms and ask whether this will increase the level of savings sufficiently.

This is followed by contributions from a range of experts in the pensions debate, including the Minister for Pensions, Steve Webb, MP. The experts provide their considered views on the challenges we face, as well what possible solutions could look like. We are very grateful to each of them for their contributions, which provide different and original insights into this important issue.

Finally, we conclude by emphasising three areas that the CII believes are particularly important in the battle to increase long-term savings: education about saving for the future, trust in financial products and advice, and the stability of the future savings landscape.

Over the next few years, these age-old issues will be revisited as evidence about what works and what doesn't filters through. The key however is to ensure that this current round of reforms give consumers and savers the confidence they need to engage, and ultimately, to save for retirement.

David Thomson
Director of Policy & Public Affairs

The Chartered Insurance Institute
5 May 2011

Summary

- Increasing longevity poses the dual challenge of ensuring that individuals have enough income for a comfortable life during retirement and sufficient funds to cover the costs of long-term care.
- Increasing longevity also poses a risk to those providers (state and private sector alike) that guarantee the pensions of final salary scheme members. In response, savers are likely to discover that pension benefits will become far less generous over the next twenty years.
- As people face the prospect of reduced retirement income it is very likely that they will be tempted to rely on the state to cover the shortfall. This is a big gamble: in many cases we can be reasonably sure that state benefits will not provide a comfortable lifestyle in retirement, nor cover the costs of long-term care.
- As things currently stand, those entering retirement have not anticipated or planned for the costs of living that they are about to face. Currently many pre-retirees have little savings and carry the burden of significant debts just at a time when their incomes are about to fall.
- Our simple illustrative model suggests that, using the current replacement rate of roughly 30%, the average pensioner would fall short when trying to secure an enough income to adequately cope with day to day living expenses and provide for the costs of long-term care. Assets, including property, may have to be used in order to bridge the gap, and even then the state may eventually have to get involved.
- Saving more, paying down debts and above all else planning for the costs of retirement will be crucial if people want to be sure to avoid having to sell off a large proportion of their accumulated wealth during retirement in the future. It will also help to ease the burden on the taxpayer of paying for our elderly as this proportion of the population increases.
- In the UK there are however, significant barriers to long-term saving including complexity surrounding the UK's tax system, trust issues due to mis-selling scandals and uncertainties about the future, and a low level awareness about the scale of the challenge that will face individuals entering retirement. Reforms to pensions and long-term care must tackle each of these in turn.
- In response, the Government is introducing a wide range of measures which are likely to change the pensions landscape over the next twenty years and a review of long-term care is also underway. More debate and evidence is needed in order to understand the likelihood of success and identify what else must be done to improve the retirement incomes of the UK's elderly.

Longevity

Increasing longevity is likely to lead to an increasing proportion of the population demanding income during retirement for longer and requiring long-term care at some point during their lifetime.

Continuing improvements to healthcare and changes to peoples' working lives are ensuring that an increasing number and proportion of the UK population lives well beyond retirement age. According to the Office of National Statistics (ONS), in 1981 life expectancy for women was 76.7, by 2004-2006 it had increased to 81.3.[1] Over the next twenty years it is estimated that this demographic trend is set to continue – the result being to increase the percentage of the UK's population that are 65 or over from 16% to 23%.[2]

As longevity increases, the proportion of people who are very old will grow the fastest – with the number of people over 90 expected to nearly treble over the next twenty years. As a result of this trend, it is expected that older peoples' demand for care and support will increase by around two-thirds over the next two decades, assuming that disability rates by age will remain constant.[3]

On average, around one in three women and one in five men aged 65 are expected to enter a care home with the risk of entering residential care increasing with age. Currently the average care home costs £26,000 per year and the average stay is two years – though a significant proportion stay for more than four.[4]

[1] ONS statistics quoted in Swiss Re (Dec 2009), *The Insurance Report: The Cost of Doing Nothing*, p. 10

[2] Ibid

[3] The Commission on Funding of Care and Support (Dec 2010), *Call for evidence on the future funding of Care and Support*, p.8

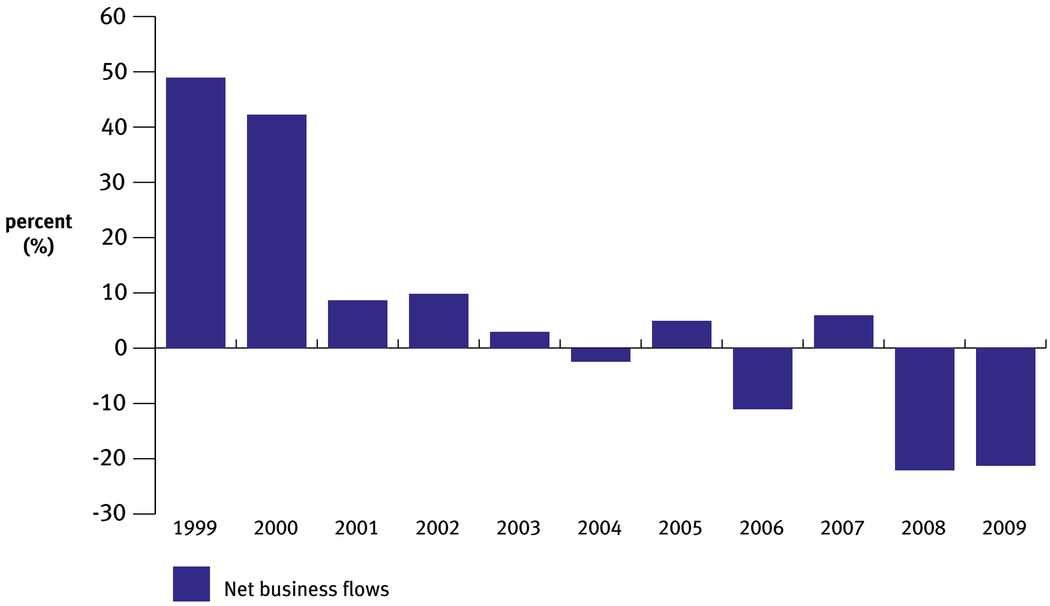
[4] Ibid p.14

Life insurance

With increasing longevity pensions will become less attractive as private pension schemes look to control the rising costs of provision.

Those providing pension products, particularly life insurance companies have been affected by increasing longevity. Over the last decade there has been limited demand for life insurance business with premium inflows remaining static. At the same time, many pension schemes have had to pay out greater amounts as people have made claims for longer. The overall effect has been a net outflow of business as total claims incurred has become greater than total premium inflows.

Figure 1: UK Life Sector Net Business Flows



Source: Financial Services Authority (FSA) Retail Conduct Risk Outlook, February 2011, p.38.

Note: New business flows are the excess of premium inflows over claims incurred as a percentage of claims incurred.

In response to this sustainability challenge, many employers within the private sector are in the process of replacing defined benefit schemes, which guarantee a specific income stream during retirement, with defined contribution schemes which provide a retirement income dependent on the level of contributions made. In 2008, of those private sector employees that were covered by a pension, 34% were covered by a defined benefit scheme – down from 55% a decade earlier.[5] The trend therefore is for less generous offerings for those who wish to contribute to a private sector pension.

Changes are also occurring with regards to public sector pensions. The Hutton Commission recently recommended that public sector pensions move from final salary schemes to career average schemes and that the retirement age of most public sector staff should increase in line with the State Pension Age.[6]

[5] David Pitt-Watson (Dec 2010), *Tomorrow's Investor: Building the Consensus for a People's Pension in Britain*, Royal Society of Arts Projects, p.11

[6] Independent Public Service Pensions Commission (March 2011), *Final Report*

The State

The taxpayer will only foot part of the bill – achieving an adequate pension and paying for long-term care will often be down to the individual.

The overall consequence of improved longevity is that paying for retirement will become more expensive for the individual, increasing the temptation to rely on the state for support during retirement. However, relying on the State may not provide an individual with an adequate retirement income stream, nor will it necessarily protect an individual in the event of ill health or disability.

The Organisation for Economic Cooperation and Development (OECD) defines an adequate retirement income as equating to 70% of pre-retirement income. However, after taking account of all retirement income streams **including State Pension and any additional benefits**, the average replacement rate in the UK for low earners (those with preretirement incomes of £15,750) is currently 51% providing a retirement income of just £7,875 per annum (after income tax and social security) and for average earners 30.8% providing just £9,702 per annum.[7]

In response to this low replacement rate the Government's pension's reforms (discussed in detail below) are focused more on incentivising increased long-term savings rather than providing more State support – though it should be noted that the State pension is likely to rise in time but not enough to meet the 70% replacement rate. In this environment, people will generally need to save more to generate an 'adequate' source of income during retirement.

Many individuals will also not be able to rely on the State to fund most of the costs attached to long-term care. The current rule is that anyone with assets worth £23,250 or above will be expected to pay for their care needs and in most cases, the value of any property owned will be included. There are important exceptions to this rule such as if there is a surviving spouse living in the house or if the home owners alter the terms of ownership of the property.[8] There is also state support which can amount to a maximum of £71.40 per week [9] in Attendance Allowance and a Registered Nursing Care Contribution of £108.70 [10] per week to help cover nursing home fees. Nevertheless, even with these additional forms of State support a large proportion of the population would be expected to cover a substantial chunk of the costs of long-term care.

[7] OECD (2009), *United Kingdom: Highlights from OECD Pensions at a Glance*

[8] Emma Simon (July 2009), *Long-term Care: How to Beat the Meanest of Means Tests*, Telegraph

[9] Figures obtainable from DirectGov website:
http://www.direct.gov.uk/en/MoneyTaxAndBenefits/BenefitsTaxCreditsAndOtherSupport/Disabledpeople/DG_10018710

[10] Brownlow Wealth Management Ltd (April 2010), *Factsheet: Registered Nursing Care Contribution*

The general public: high in debt, low in savings

With paying for retirement being increasingly the responsibility of the individual, it is vital that people start saving more now and pay off their debts before they reach retirement age. Evidence suggests, however, that people are failing to act in this regard.

From 1995 to early 2008 the savings ratio in the UK, a measure of the amount of disposable income that is saved by households, fell from just over 10% to just under zero. Over the same time period household debt as a proportion of income rose from just under 100% to 150%.[11] As a consequence of this relatively low savings and high debt environment roughly half of British households have net financial wealth (all household assets including pensions less liabilities) of £5,000 or less and a quarter of the population have net financial wealth that is 'negligible or negative'.[12]

Whilst it must be noted that the distribution of net financial wealth does increase with working age, peaking just before retirement, there are still 25% of households in the pre-retirement age bracket (55 to 64) who have net wealth of around just £900 and 50% who have net wealth of around just £18,000.[13]

For its 2011 report on retirement, Aviva surveyed more than 5,700 consumers aged over 55 in order to better understand the spending and saving trends of the UK's over 55s. One in five of this group said that they still needed to repay their mortgage and owed an average of £65,107. Over half of the pre-retirees (aged 55-64) did not believe that they would be debt free before their 65th birthday and 16% did not feel they would be debt free by 70.[14]

With regards to savings, Aviva found that one in five of the over 55s had virtually no savings at all. Aviva also found that those aged 55-64 are more likely to have no savings than those who are retiring (65-74) and the long-term retired (75 years or over) suggesting that 'the next generation to retire is likely to find it considerably tougher financially than the older generation.'[15]

Theoretical case study: our illustration of the potential costs when entering retirement

These trends have left the average person entering retirement facing a potential shortfall. Even after taking into account capital held in assets that has been accumulated over the course of a lifetime, factoring in all the trends described above, an average pensioner may not be able to live comfortably and afford the costs of long-term care.

Consider the average person just entering retirement. Their life expectancy at 65 is 17.6 years requiring a retirement income for the entire period of £388,000 to meet the replacement rate of 70%.[16] If the statistics about personal debt in retirement described above are taken into account, these pensioners may also be paying down mortgage debt of around £50,000 over the period and, if they are unlucky enough to get ill may have to pay long-term care fees for four years, which would result in an outlay of roughly £104,000. **The sum of all these outgoings is about £542,000.**

[11] Financial Services Authority (February 2011) *Retail Conduct Risk Outlook*, p.21

[12] Ibid p.44

[13] ONS (2009), *Wealth in Great Britain: Main Results from the Wealth and Assets Survey 2006/2008*, pp.33–34

[14] Aviva (March 2011) *The Aviva Real Retirement Report: Issue 5*, p.4

[15] Ibid p.10

[16] Our model makes the assumption that this income stream is needed to cover all costs other than long-term care and mortgage debt.

Currently, an average pensioner gets a retirement income of £9,702 per annum which would equate to £171,000 over a 17.6 year period. Excluding pensions, those just entering retirement have income in other assets worth on average £338,000[17] of which the majority is tied up in property. And, assuming the pensioner requires long-term care during retirement, they may be able to receive an additional £37,460 in State support over the four-year period. **The sum of all this potential income is £546,000**, which just matches what that pensioner requires for an adequate income and to meet long-term care for four years.

The reality is that many pensioners do not live adequately during retirement. Their pension income is insufficient and some are put in the position where they have to use the capital tied up in other assets, including property, to meet the additional costs of long-term care. The State has to intervene once a pensioner's assets fall below £23,250, and research from the Local Government Intelligence Unit suggests that currently 25% of self-funders run out of money and ultimately fall back on the state safety net.[18]

Saving more and paying down all debts are ways in which an average pensioner can mitigate against the risk of losing their assets. In the above scenario for example, if the pensioner successfully achieves a retirement income with a replacement rate of 70% and pays off all debts early, then this would ensure that they are left with assets worth £270,000.[19]

What this means for the overall pensions gap

In September 2010, Aviva published research predicting that the UK will have an annual pensions gap of £10,300 per person for all those retiring over the next forty years, and £317.5bn overall per annum.[20] This calculation looked at the discrepancy between what income people will need to live adequately during retirement and what they can expect from their pension. It did not factor in the need for long-term care or paying down debt.

To fill this gap in the debate we kept many of the above assumptions about the average person entering retirement and applied these to the total population expected to retire over the next forty years.[21] We further assumed, in line with the Dilnot Commission, that a quarter of those entering retirement would require long-term care for four years, and that a quarter would also be paying down debts of £50,000. In this scenario, the average annual pensions gap per person is significantly higher than predicted by Aviva – £14,500 per person per annum and £451bn overall per annum. According to this methodology, the total size of the pensions gap would equate to £8trillion over this period – nearly six times UK GDP in 2010.

17 ONS (2009) *Assets and Wealth Survey*, p.12

18 J. Carr-West and L. Thraves (March 2011), *Independent Aging: Council Support for Care Self-Funders, Local Government Intelligence Unit*, pp.7–8

19 Assumes that assets and Government contributions stay the same

20 Aviva (Sept 2010), *Mind the Gap: Quantifying the Pensions Gap in the UK*

21 Aviva (Sept 2010) predicts that 31 million people will retire in the UK over the next forty years.

Barriers to long-term savings

If we are to tackle the current low savings environment we must understand what conditions exist to put people off saving for retirement. Complexity, awareness and trust are three of the key factors that have been identified by experts.

Complexity

Michael Johnson from the Centre of Policy Studies has argued that complexity is the main barrier to saving in the UK – particularly the complexity of the tax system. In response, his paper argues that the Government should bring Individual Savings Accounts (ISAs) and all pension savings closer together to combine 'the instant access of ISAs with the tax advantages of conventional pension savings'.[22]

Aegon also came to the conclusion that the current pension system of tax and other incentives to save is 'very complex, not understood, and difficult to describe to people.' Indeed AEGON noted that 'it's hard to overstate the time and effort researchers put into explaining – even in simplified form – the high level essential elements of the system' when running focus groups looking into incentives for long-term saving.[23]

Awareness

Associated with the problems of complexity are low levels of awareness about long-term savings. When reflecting on its focus group sessions, Aegon noted that tax advantages of saving through a pension were not mentioned by participants at all and the tax benefits of ISAs were only mentioned once.

Similarly, in recent survey undertaken by Aviva it was noted that half of all respondents thought that 50% or less of preretirement income would be sufficient during retirement[24] – significantly less than the ratios suggested by the OECD and the Turner Report.[25]

Low levels of awareness also persist regarding the care system. According to the Dilnot Commission's Call for Evidence many people do not understand how the system currently works including that they may need to pay for their own care (under the means-tested system). There is also confusion over the role of different parts of state support – 'for example why the NHS is free, disability benefits are universal, but social care is means-tested.' There are also complicated and multiple assessment processes and different parts of the care and support system do not always work very together.[26]

Trust

Low levels of awareness, stemming in part from the complexity of the system are compounded by low levels of trust following mis-selling scandals, the apparent high cost of pensions, and a continual 'moving of the goalposts' by Government.

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[22] M. Johnson (June 2010), *Simplification is the Key: Stimulating and Unlocking Long-term Saving*, Centre for Policy Studies, p.VIII

[23] AEGON (January 2011), *Towards More Effective Saving Incentives: AEGON' s Conclusions from Independent Research*, p.7

[24] Aviva (September 2010), *Mind the Gap: Quantifying Europe' s Pension Gap*, p.12

[25] Lord Turner's Commission suggested a net retirement income of 67% of pre-retirement net income for a median earner, 70% for a low earner, and 50% for a higher earner

[26] The Commission on Funding of Care and Support (December 2010), p.17

Mis-selling

Michael Johnson argues that there has been 'a near fatal erosion of trust, fuelled by mis-selling scandals, excessive costs and a long period of poor investment returns.' As a consequence the pensions industry faces a regulatory backlash. The industry must therefore embrace the round of reforms stemming from the Financial Services Authority (FSA)'s recent review of retail investment distribution, including raising the professional standards of retail investment advisers. This will help to rebuild public trust and enable the industry to engage with the regulator in a 'credible manner'.[27]

This decline in trust was well documented in a survey undertaken by the CII in late 2009 which found that one in five respondents will never trust financial services again and 72% of people have not very much or not trust at all in financial advisers and life insurance providers.[28]

In their recent Retail Conduct Risk Outlook the FSA also noted that part of the reason for limited demand for life insurance products over the last decade has been the knock on effect of 'pension and endowment mis-selling, as well as the issues surrounding Equitable Life'.[29]

Costs of pensions

The Royal Society of Arts also proposes that trust is at the heart of an effective pension system. 'Savers need to trust that, even when there are unforeseen circumstances, the pension fund will be run in their interests.'[30] Levels of trust are, however, likely to be negatively affected by the fact that pensions are far more costly in the UK than abroad. The author writes 'the fees charged on pensions (in the UK) are very large, and of huge significance in determining the size of the pension.'[31] They note that a 1.5% charge per annum translates into 37.5% over the lifetime of the pensions. And what is true for cost is also true for returns – a 1% lower return will give a 25% lower pension.[32]

In response to the challenge of creating a cheaper pension with better investment returns the authors look to the Netherlands which operates Collective Defined Contribution schemes. These schemes are effective, the authors argue, because the risks lie with the collective not the individual, this allows for investment in assets yielding higher returns, and that the members of the collective 'do not need to pay an agent entirely to mitigate this risk, as happens with the purchase of annuities'.[33]

Moving the goalposts

AEGON also noted that there is a general recognition that the pension system is changed on a regular basis, and is unreliable – indeed there is a 'strong sense of cynicism about the sustainability of policy.'[34] People cannot be expected to effectively plan for the future without a stable environment in which to operate, particularly when there are so many other variables, such as the macroeconomic environment, which will remain uncertain.

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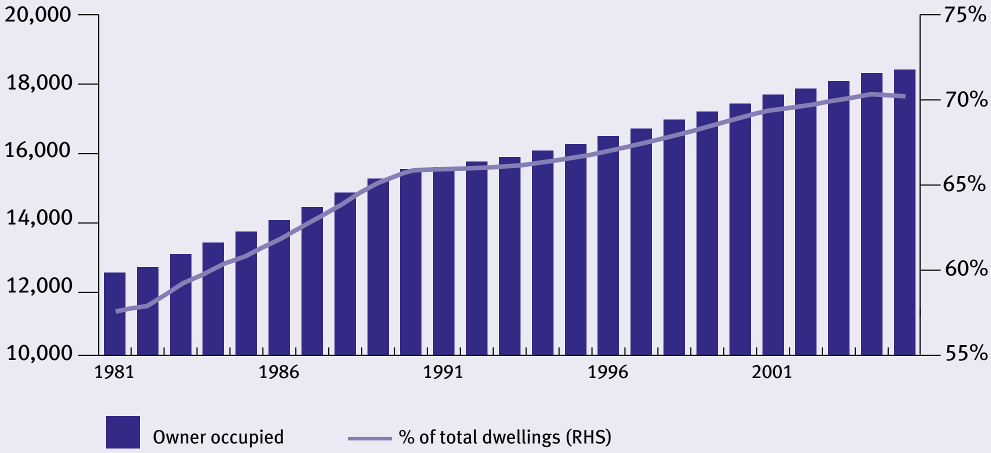
27 M. Johnson (June 2010)
28 CII (February 2010), *What we talk about when we talk about trust*, p.12
29 FSA (February 2011), see note 11 above, p.39
30 D. Pitt-Watson (December 2010), see note 5 above, p.19
31 Ibid, p.18
32 Ibid, pp.17–18
33 Ibid, p.21
34 AEGON (January 2011), see note 22 above, p.7

The attraction of property

The relatively low demand for investing in pension funds is in stark contrast to the demand for property. From the 1980s to the mid 2000s home ownership increased substantially from an already high level of around 60% to 70% by 2005.

Figure 2. Home Ownership in the UK 1981–2005



Source: CML Housing Finance Issue 02 2007, p.3

AEGON's consumer research suggests key attractions of property include 'transparency, ease of understanding and herd behaviour/peer effect' – none of which are generally associated with investing in pensions. Worryingly though, the decision of investors to favour property may be storing up issues for the future including:

- 'A concentration of demand for retail assets in residential property, further fuelling an asset price bubble – which will ultimately correct at what price for savers?
- Concentration of risk for savers – in just one or two assets, not even one or two asset classes;
- Further leveraging of that risk – through the use of mortgage debt to acquire those assets; and
- A lack of solutions to decumulate property wealth – without risk of outliving their assets'[35]

[35] N.Hurman (March 2011) *What Motivates Us to Save? Creating Effective Incentives for Public Engagement in Pensions*, CII Thinkpiece no.52, pp.2–3 (**www.cii.co.uk/thinkpiece**)

Long-term care insurance

Another barrier to long-term savings is the potential costs of long-term care which reduces incentives to accumulate assets worth over £23,250. A means tested system where some pensioners must pay 'catastrophic costs' for care, 'does much to undermine pension saving'.[36]

In response to the potentially massive costs of long-term care, insurance can provide people with protection in case of ill health and disability. However, take up of pre funded long-term care insurance is typically low right across the world with France seeing the highest rates of around just 15%.

James Lloyd of the Strategic Society Centre argues that the reasons for low take up are mainly linked to demand side barriers including the cost of the products, uncertainty over the availability of care, ignorance of the risk of needing care, inertia, and the complexity of products. He reiterates the view posed by others that prefunded long-term care insurance is 'never likely to prove an adequate response to the problems posed by the long-term care funding system'.[37]

The system therefore needs radical reform and Lloyd presses for a state-sponsored public private partnership insurance scheme rather than a re-born pre funded long-term care insurance market. He argues that 'rather than tens of thousands' such a partnership 'would result in participation levels measurable in the tens of millions'.[38]

The Commission on Funding of Care and Support was set up by Government as an independent body to make recommendations on 'how we can achieve an affordable and sustainable funding system for care and support, for all adults in England, both in the home and other settings'. It will lay out its final recommendations in July later this year.

[36] James Lloyd (February 2011), *Gone for Good? Pre-funded Insurance for Long-term Care*, The Strategic Society Centre, p.48
[37] Ibid p.6
[38] Ibid p.7

The Government's response: changing the retirement landscape

The Government's reforms are aimed at breaking down the barriers to saving whilst minimising the cost to the taxpayer. Whether or not in they succeed in this regard they nevertheless represent a radical reshaping of the environment for retirement over the next two to three decades. Below is a brief recap of what has been decided so far.

Changes to Basic State Pension

What's changing?

- The Government has committed itself to **restoring the earnings link to the Basic State Pension** which is likely to cause the state pension to rise more quickly.
- The Government has introduced a **triple guarantee**, whereby pensions are raised by the highest of earnings, inflation or 2.5%.
- The Government has also **increased the standard minimum guarantee** so that most Pension Credit recipients see the full cash rise in Basic State Pension.
- The Government wants to introduce a **'flat-rate' Basic State Pension for all**, possibly worth about £140 per week.

Implications for pensioners

- These changes will ensure that recipients receive greater retirement income from their State pension and a move to a 'flat-rate' should help to simplify the system by removing the Second State Pension.

Age-related rule changes

What's changing?

- The Coalition Government plans to bring forward by six years Labour's proposals for increasing the State Pension Age to 66.
- The aim is now to **increase the State Pension Age to 66 by 2020**. The age increase from 65 to 66 will be **phased in from 2018–2020**.
- The Government will **abolish the default retirement age** which allows companies to force out staff once they reach 65.

Implications for pensioners

- People will have to wait for longer before they can receive their Basic State Pension and so may have to work for longer. Abolishing default retirement age should make it easier for people to be able to do this.

Automatic enrolment of employees into occupational pension schemes

What's changing?

- The Government has implemented a Bill to make it law that all employers must automatically enroll their staff into pension schemes regardless of the size of their organisation.
- A new, Government-backed workplace pension scheme known as the National Employment Savings Trust (NEST) will be established to support successful implementation of auto-enrolment.
- The earnings threshold at which employees are automatically enrolled will be aligned with the personal allowance for income tax (Note: from 2011–12 tax year, it has been confirmed that the basic personal allowance for individuals under 65 will be raised by £1,000, from £6,475 to £7,475)

Implications for pensioners

- Automatic enrolment should help to increase the number of people who save for retirement by ensuring that, by default, they are entered into a pension scheme.

Changing pension indexation from RPI to CPI

What's changing?

- The Government has decided to switch the inflationary link from the retail price index (RPI) to the consumer price index (CPI). This is likely to mean that the **value of occupational pensions will rise more slowly** than previously.

Implications

- The DWP estimates that the change will reduce pension liabilities by **£65.8bn**.
- The affect of the change will however, be limited by the 70% to 80% of private occupational schemes with legally binding rules that specifically link pension uplifts to the RPI. In its consultation paper, the Government announced that it would not force these schemes to switch to the CPI.

Reforming public service pension provision

What's changing?

- The Hutton Commission has conducted an independent review of the long-term sustainability and affordability of public service pension provision in the UK.
- The Commission's Interim Report suggested that members of public service pension schemes should have to increase the amount of contributions they make.
- The final report recommended that public sector retirement age moves in line with the Basic State Pension Age and that public pension schemes should change from final salary to career average schemes.

Implications

- These reforms will reduce the final pension pots of public sector staff assuming that they contribute the same amount of their income as before. However, it has been suggested that public sector pensions will still be more generous than their private sector equivalents after the changes have come in to affect.

Changes to rules on annuities

What's changing?

- The Government is changing the rules on annuities so that savers will be able to leave their pension funds untouched past 75, and those that live on will not have to take their benefits in the form of an income at all.

Implications

- The Government argues that the proposals make private pension saving more attractive by giving individuals greater choice over how they can provide a retirement income for themselves and use the contributions that they have made.

Changes to tax rules

What's changing?

- The Government has decided that **from April 2011**, the total amount that people can contribute to their pension pot with tax relief will be cut from £255,000 to £50,000.
- The Government has however, decided that **tax relief should be maintained at the full marginal rate** rather than introducing restrictions on higher rate relief as many thought would be the case.
- The **lifetime allowance from tax** will also be reduced to £1.5m so that anyone contributing more than this will be taxed.

Implications

- The Government has attempted to strike a compromise between trying to increase tax revenues by targeting the largest contributors to pensions without deterring too much saving for the future.

Reforms to the provision of long-term care

- The Commission on Funding of Care and Support was set up by Government as an independent body to make recommendations on 'how we can achieve an affordable and sustainable funding system for care and support, for all adults in England, both in the home and other settings'.
- The Commission will also be looking at funding in the context of broader support for older people and other users of care services. The Commission will publish its final report by the end of July 2011.

Will these reforms be enough?

The proposed changes are widespread – with numerous measures being implemented to tackle different public policy issues at the same time. The sheer number of reforms makes it hard to predict whether the Government will be able to achieve a successful balancing act between improving long-term savings whilst reducing the costs of State provision.

Research from AEGON in collaboration with the Pensions Policy Institute (PPI)[39] suggests that the current set of reforms should lead to an increase in the number of savers, but will not necessarily lead to increases in the overall stock of pension saving. This is because of the assumption in the PPI's modeling that the proportion of employees who are active members of private sector defined benefit pension schemes falls by 80% between 2006 and 2035.[40]

AEGON's and the PPI's research suggests that the Government's reforms in general may not be a 'game changer' in terms of increasing the savings ratio to a level closer to the 70% replacement rate recommended by the OECD. There is a big caveat here though – the results and modelling were based on a focus group of 25 people, which means that the results are not representative of the population at large.

The scale of the challenge to increase savings is massive, and the evidence that the current set of reforms will successfully break down barriers to saving is mixed. More debate and evidence is needed in order to understand the likelihood of success and identify what else must be done to improve the retirement incomes of the UK's elderly.

On long-term care, the future is unknown as the Dilnot Commission is yet to set out its final recommendations. Now is an opportune moment to consider this additional problem as part of a debate about saving and preparing for retirement.

[39] The results of the modelling can be found in: Pensions Policy Institute (Jan 2011), Towards more effective savings incentives: a report of PPI modelling for AEGON.

[40] AEGON (January 2011), see note 22 above, p.5

Summary

In order to gain a better understanding of what else might need to be done to increase long-term savings we asked financial services experts to provide their views on the possible challenges and solutions to this issue. We received contributions from individuals representing 15 different organisations including:

- The Pensions Minister
- The Pensions Regulator
- The Association of British Insurers
- The British Chambers of Commerce
- The National Employment Savings Trust (NEST) Corporation
- Saga Group
- Insurance Firms: AEGON UK, AXA, Scottish Life, and Standard Life
- Three think tanks: The Pensions Policy Institute, the Institute of Economic Affairs, and Reform
- Two consumer educational bodies: the Personal Finance Education Group and the Money Advice Service

A snapshot of the arguments

- In his contribution, the Minister for Pensions argues that a flat-rate pension coupled with automatic enrolment will provide a 'pension system fit for the Twenty-First Century'.
- Automatic enrolment is also welcomed by many other contributors to this report including The Pensions Regulator and the ABI which argues that the reform will be a 'social revolution in retirement savings'. Many of the contributors also support the notion of a flat-rate State Pension with Saga Group arguing that it will help future generations 'understand that there is only a certain amount they will get from the State'.
- However, the think tank Reform is not so positive on the proposed changes to the state pension arguing that the flat-rate state pension in New Zealand is a 'major reason for the low household savings rates in that country'.
- Furthermore, whilst many contributors welcome the Government's proposals, a number believe that more must be done to ensure an adequate standard of living in retirement. The ABI, AEGON and AXA are particularly concerned that saving only 8% of one's salary will become the norm.
- In order to ensure that savings are above and beyond the statutory minimum, contributors press for a number of additional measures including:
    - Better education and information for people of all ages on the benefits of long-term savings. In this context some contributors stress the need for a mass communication campaign. The ABI add that it is ready to work with the DWP to 'seize this once in a generation opportunity'.
    - Improving understanding through further simplification of pensions. Scottish Life believes that implementation of a simplified advice regime could help in this regard.
    - Improving levels of trust by ensuring a more stable and predictable long-term savings environment.The ABI and Standard Life also believe that the Retail Distribution Review can help to improve consumer confidence.
    - Improving the flexibility of savings products. To meet this aim a number of respondents suggest designing products that bring ISAs and pensions closer together.
- The above summary represents only some of the themes covered by the contributors and does not do justice to the originality of many of the ideas and arguments expressed below. We would therefore encourage readers to the take time to consider each of the submissions in turn and to draw their own conclusions.

Steve Webb, MP
(Minister for Pensions)

The challenges we face in pensions are more stark today than ever.

When the earnings link was broken in 1980, the State Pension was 26% of average earnings. By 2009 it was 16%. Many are still missing out on a full Basic State Pension, particularly women, and look set to retire on a pittance. This is neither fair nor sustainable.

Piecemeal changes introduced over time, like the Graduated Retirement Benefit, SERPS and S2P, have made the current system so complicated and confusing that many have absolutely no idea what they can expect from the state when they retire. Many of our poorest pensioners faced with such a complex means-tested system, fail to claim the support they are entitled to. The outlook on private pensions is as bleak. Less than half of all workers today are saving in a pension and 7 million people are not saving enough for their retirement. The numbers of those in the private sector saving in a Defined Benefit scheme have been falling for decades to just one million today. If this continues, millions could face an impoverished retirement.

That is why we have acted urgently to avert a pensions crisis in the future. First, we have restored the earnings link and provided a triple guarantee that the State Pension will increase by whichever is higher: earnings, prices or 2.5%. This will mean that someone retiring today on a full Basic State Pension will receive £15,000 more over their retirement than they would have done under the old prices link.

Second, our Pensions Bill, currently going through Parliament, is the next step in helping millions save for their retirement in a workplace pension. It will ensure there is a balance between costs and benefits for individuals and a more proportionate impact on employers, and bringing forward the increase in State Pension age to 66 by 2020, among other measures. The state pension age plays an essential role in ensuring that the state pension remains sustainable and affordable for the future. People will have to work longer but they will get a simpler, better pension when they retire.

Third, our Green Paper, ***A State Pension for the 21st Century***, sets out options for a simple contributory flat-rate state pension, set above the current level of the means test, currently estimated at around £140 a week. We want to see a single, simple, decent state pension that protects people from poverty and encourages effective saving for retirement.

Our proposed reforms will end inequalities in the current system that penalises women, low earners and the self-employed. People will have clarity and certainty about what they will get from the state and see what other savings they might need. And they will know they will be better off in retirement if they save. We want to ensure people have the opportunity to save.

The next generation will face a different world, with increasing life expectancy, the decline in final salary schemes and lower annuity rates. They are going to have to take greater personal responsibility for saving for their retirement. Reforms to the state pension will make it fairer and simpler for future pensioners. And they underpin plans for automatic enrolment into workplace pensions to encourage further saving. This will be important for those low and middle income workers who previously have never had opportunity to save in a pension before. Automatic enrolment from 2012 will bring between 5-8 million into saving for the first time. It is only fair that generations who will benefit from increases in longevity share in the costs, and we will be looking at options to make the new system more automatic in ensuring further revisions in life expectancy to determine future increases in state pension age.

With a streamlined, flat-rate pension uprated by our triple guarantee, and millions more people saving for their retirement, we can make sure, at last, that we have a pension system fit for the Twenty-First Century.

Bill Galvin
(Chief Executive, The Pensions Regulator)

The ageing population presents policy-makers across the developed world with one of their biggest public policy challenges: how to require, incentivise or nudge people towards making adequate provision for their retirement.

The UK Government has opted for a package of reforms designed to overcome barriers to saving: including a state pension that's intended to be fairer, more generous, and better-suited to provide a retirement saving foundation, coupled with automatic enrolment into a qualifying workplace pension scheme, to provide a near universal second tier of provision.

The Pensions Regulator has been given a central role in making auto-enrolment a success by ensuring that employers comply with their new duties. Employers will need to automatically enrol staff, make contributions and register with us, as well as adhering to safeguards to prevent staff members being discouraged from saving.

The largest employers will be subject to the requirements from next year, as part of a 'staging' process that will eventually see the smallest employers automatically enrolling their staff in 2016.

The regulator has a big job in terms of educating employers of all sizes in their new duties, and helping them understand what they need to do and when. We intend to establish a culture of compliance amongst employers and so limit the amount of regulatory action we need to take.

But this is only part of our job in supporting the Government's drive to ensure that the second pillar of the pensions system is enabling better outcomes in retirement for more people.

In defined contribution (DC) schemes, members carry the majority of the risk, so it is particularly important that schemes are well-run and deliver good value. Automatic enrolment will result in a significant expansion of the numbers of people saving into DC pensions.

In light of this, we recently published a discussion document on DC schemes, looking at what constitutes good outcomes for members. We have set out six key areas which we believe are necessary for good outcomes:

- appropriate decisions with regards pension contributions;
- appropriate investment decisions;
- efficient and effective administration;
- protection of assets;
- value for money; and
- appropriate decisions on converting private pension savings into a retirement income.

It's important for effective DC provision that there is no ambiguity over who is acting in members' interests and how decisions that affect members are taken. This is not always the case, particularly in contract-based schemes. And it's also crucial that the structures that manage these retirement savings are competent, resilient and durable. This can be a challenge for trust-based schemes. The existence of many small schemes, the way in which deferred members are catered for, and how members' funds are treated at retirement are all challenges that the industry needs to address.

An increase in individual financial capability could have a big effect here, for those who can and want to take more control over provision for their retirement. This is a long-term project, and we welcome the presence of organisations such as the newly formed Money Advice Service.

However, in the short term, the challenges facing the industry can only be met with affordable pension provision that offers inbuilt consumer protection for those members who will be defaulted into, through and out of schemes. And that is what we're helping the industry to work toward.

The pensions landscape is changing and is set to look very different in the future. The challenge for us is to make sure that the collective decisions of employers, along with their advisers, trustees, and the industry as a whole, make the reform process a success and enable good outcomes for retirement savers.

Dr Yvonne Braun (Assistant Director, Savings & Retirement, Association of British Insurers)

The challenges to get people saving more

Why do people not save more for their retirement? The ABI's consumer research routinely asks this question. By far the most common answer from respondents is that they have no spare money.

When looking at the data behind this response, we find that this answer is given by an almost identical percentage of the non-savers across all income groups. So it would appear that this is 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.

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.[41] The older, mesolimbic part of the brain is responsible for decisions about the short term. The newer part of the brain, the prefrontal cortex, is responsible for decisions about the longer term. Saving for retirement requires a decision in the present about the future. But in the present, the short-term view is likely to win. Broadly speaking, people are therefore more likely to spend on their credit cards than they are to save for their retirement, in the same way that resolutions – for example, to start going to the gym next week – are very hard to keep when the next week actually arrives.

However, taking decisions about retirement savings is further complicated by the fact that many people are not aware of key developments affecting retirement. For example, people routinely underestimate their life expectancy by assuming they will live to the same age as their parents. There is also confusion about how much the state pension will provide – although the Government's decision to consult on a flat-rate single state pension will help in this respect.

The complexity of decision-making can also act as a deterrent – for example, people can end up not taking a decision when faced with many different funds to choose from in a pension. And past mis-selling scandals have undoubtedly undermined trust in the pension industry.

It has also not helped that for many years, defined benefit provision was the paradigm of pension provision in the workplace – and the numbers are still large: in 2009, 6 million people were in Defined Benefit pension schemes, both public and private. As a result, many people did not have to engage much with retirement planning. This has not contributed to a culture where people engage closely with providing financially for their retirement.

The possible solutions

We know that cognitive biases such as present bias and inertia prevent people from taking decisions about retirement savings. It is therefore right to set pension saving as the default, and the ABI is a strong supporter of automatic enrolment into workplace pension savings. Automatic enrolment will be a social revolution for retirement savings, the importance of which is hard to overestimate.

[41] see, Nicolas Barr presentation, April 2011, **http://www.ebrd.com/downloads/research/news/Barr_EBRD_110401.pdf**

Automatic enrolment will also tackle the complexity of decision-making. To qualify for automatic enrolment, pension schemes must offer a default investment fund. This will be the destination for people unwilling to engage with choosing a fund, or daunted by choice. The DWP's forthcoming guidance for default funds makes it clear that these default funds must involve a de-risking mechanism – typically, switching a member's investments from more volatile to less volatile assets as the member approaches retirement.

However, defaulting people into workplace pensions will not be enough – we must also turn the tide and help people engage with saving for their retirement. In this respect, the Government's recent commitment to a single, flat-rate pension will be very helpful. It will put paid to people's confusion about how much they can expect from the state, and will end the means-testing trap which undermines people's motivation to save for their retirement because they cannot be sure they will reap all of the rewards.

We also need to make sure people regain their trust in the pensions industry, which has suffered from mis-selling scandals. A vital reform here is the retail distribution review – it will end the untenable situation of advisers selling products to consumers on the basis of the level of commission they receive, rather than what is in consumers' interest. The ABI strongly supports these reforms.

However, as far as trust is concerned, we take issue with some commentators' statements about pension charges. They have described an annual management charge of 1.5% as representative of the industry's current practices. This has no basis in reality. Pension charges in the UK are highly competitive internationally, and the ABI's members are routinely pricing schemes at or below NEST's charges. It is time for the charges debate to return to the facts: If people start saving early, and remain persistent, their contribution, the employer contribution, and tax relief should, over time, allow them to accumulate a tidy retirement fund.

In this context, we must take care that 8% of salary does not become the new social norm for retirement savings. It would be dangerous if people are lulled into a false sense of security and believe they have "sorted out" their retirement needs by automatically enrolling into a pension scheme paying the minimum contribution. We believe it is important for Government to start considering now what behavioural devices are available to make people increase their contributions, such as "save more tomorrow".

This brings me to the final point. We need automatic enrolment to succeed if we really want to crack the problem of undersaving in the UK. The ABI believes that to achieve this, we need a concerted mass communication campaign by all stakeholders, including Government, the media, consumer bodies and the industry, to increase people's awareness that it is in their best interest to save given how long they will spend in retirement. We are ready to work with DWP to seize this once in a generation opportunity.

Dr Adam Marshall
(Director of Policy, British Chambers of Commerce)

An ageing population is not just a problem for the Government, but it is also one for business. An increasing number of people in retirement and a decreasing number in employment, coupled with low savings rates, will all change the shape of the labour market and consumer society in the UK. Retirement will become more a fluid concept and business will create flexible jobs to take advantage of this new pool of labour, that may not want to work full-time, but still may have a lot to contribute to the economy. The so-called 'grey pound' will become more influential, and the private sector should make the most of the opportunities it presents.

Business does have a role to play in encouraging saving. BCC supports the principle of the 2012 reforms, and accepts the 3% compulsory employer contribution for all qualifying employees. For the first time, the pensions industry will have a commercial incentive to create products for those previously outside the norm of private savings, such as agency workers, or others with atypical working patterns.

But these reforms come at a price. Ultimately, the direct cost (the contribution) will be accepted by employers as a 'business as usual' cost, like National Insurance Contributions or National Minimum Wage uplifts. However, the high indirect costs (the administration, the complexity of payroll, new starter procedures and external advice) will put a real burden on UK PLC, particularly small businesses, where the marginal cost per employee will be higher.

Successful regulation works because compliance is easy and the law is straight-forward. The 2012 reforms risk being so complex that a large number of businesses don't comply with the regulations, either in full or in part. This will damage the credibility of the reforms, and leave millions of individuals still without adequate pension savings. 93% of UK businesses have less than 20 staff. Their owner managers are not employment law or pensions experts and, for many, hiring and managing staff is a time-consuming but necessary task, not a business focus. For those employers, these reforms will be bewildering.

We still have a few years before these smaller firms are subject to their new duties. This gives time for the Act to be cleaned up and the smaller regulatory and administrative burdens removed or modified. Business can understand why they now need to pay a 3% pension contribution, but employers will not be so understanding when the cost of that contribution to the business is dwarfed by administrative costs.

Lawrence Churchill (Chairman, NEST Corporation)

For those of us in the pensions industry it's easy to make assumptions about the knowledge of typical defined contribution scheme members.

But behavioural research has demonstrated that some of these assumptions are open to question.

In 2006, a study of Wharton MBA and Harvard college students' decision making in mutual fund investing was conducted.

The authors presented their test subjects with four mutual funds that were all substantially similar: tracking the S & P 500. They were asked to choose a fund in which to invest $10,000, following receipt of standard investment information, for example, fund prospectuses. In the control group without fee information, 95% of test subjects failed to minimise fees when picking funds, fees were the only real differentiator between the funds. In the group with fee information, 85% did not minimise fees.

Bear in mind that this group were in the top 2% of student performers in the country and therefore much more capable than the population as a whole.

So even people with an elite business background many make elementary mistakes in investment fund selection. In fact, there is some evidence to suggest that lower income and lesser educated groups, while not necessarily investment savvy, are actually very competent at managing their money, in the form of daily and weekly budgets, purely and simply because they have to be. They literally can't afford not be on top of their costs.

Behavioural biases affect everyone to some extent. The economist Harry Markowitz once explained how he picked his USA university pension funds portfolio:

> “I should have computed the historical covariance and drawn an efficient frontier, instead I visualised my grief if the stock market went way up if I wasn't in it – or if it went way down and I was completely in it. My intention was to minimise my future regret, so split my [retirement pot] 50/50 between bonds and equities.”

Markowitz exhibits a couple of things to note:

- Naive diversification – asset allocation based on rules of thumb that leads to less than optimal results.
- Regret bias – taking a decision so as to avoid future regret.

The introduction of automatic enrolment means that there will be a large influx of new pension savers with different features to traditional investors.

The target group is strikingly different to the population currently saving into a pension. While median earnings in the target group are around £20,000 median earnings of those contributing to a pension are around £30,000.

This means National Employment Savings Trust (NEST) future members are likely to have less familiarity with financial products than existing savers. Those with pensions currently are more likely to have higher levels of savings and to work in managerial or professional jobs.

They are also likely to have a higher level of education. They are also likely to be older. As such, the average risk capacity of the target group is considerably lower than that of those currently saving into a pension.

Our research shows that on balance our target group is more risk averse than risk seeking with a large proportion (37%) of the target group favouring taking no risk whatsoever with retirement savings. Risk preferences also trend by income with those on lower incomes being more likely to be risk averse than those on higher incomes. Our research also showed that younger people have some of the strongest reactions to investment loss.

The research showed that the target group are likely to have negative and emotional responses to investment loss. The research observed: disappointment, anger, surprise and incredulity when research participants were confronted with hypothetical investment losses. Loss was also felt with a sense of immediacy and was not considered within the context of a long-term savings vehicle. Loss aversion was observed most strongly among the young (who were often the most risk seeking) and those on low incomes.

When we look at designing a default approach for our members, there are three areas of risk in tension with each other – the risks that people want to take (their risk appetite), the risks people can take (their risk capacity) and the risks people need to take to deliver a retirement income. The challenge for developing the investment approach has been to balance these three factors.

Our approach may look a bit different from that taken by many workplace schemes because the people that NEST is designed for are not the typical target market for pensions.

We need to manage our members' exposure to risk to encourage them to save regularly and build up retirement savings over their working life. The key aim is to get people saving and keep them saving – our approach is designed to encourage that.

You can read more about are existing research and how we developed our approach at **www.nestpensions.org.uk**

Steven Cameron
(Head of Regulatory Strategy, AEGON)

The challenges

To most people, deferring consumption doesn't come naturally, particularly when disposable income is being squeezed. This means right now, identifying and delivering effective incentives to save is particularly important. The Coalition Government has introduced a range of new policy initiatives in this field, as well as advancing many, such as pensions reform, put in train by the previous Government. But will these – either individually or collectively – deliver a breakthrough across the UK in saving for retirement?

To seek to address this question, AEGON recently commissioned independent research[42] into consumer attitudes to saving. Research in this field, particularly direct with customers regarding how they might behave, is surprisingly light. We wanted to assess if current incentives are working and to gain insight into how consumers might 'behave' faced with possible changes to savings incentives, including tax breaks, removal of compulsory annuitisation and higher state pensions.

We concluded that the current system of savings incentives has many positive basic design elements, and that it can influence behaviour. But at the same time, it's clear that the system suffers from several important limitations.

Many consumers just aren't aware of what's on offer. Few, for example, really understood the concept of 'tax relief' but were attracted to the concept of getting 'top-up' money from Government.

Lack of awareness is partly (but not entirely) fuelled by the sheer complexity of the current system, including the interaction between private pension saving and entitlement to state benefits. But despite what industry commentators often claim, we found the potential to lose out on means tested benefits wasn't disincentivising savings – because none of those we researched had any awareness of this. Similarly, while removing compulsory annuitisation was viewed positively by our consumers, most hadn't been aware of the compulsion in the first place.

There's also a major issue with lack of trust – not just with financial services providers but in Government to maintain current arrangements and incentives.

All these clearly hamper the effectiveness of the current system. Economic modelling the Pensions Policy Institute carried out for us demonstrated that even after auto-enrolment (which AEGON supports) and other current reforms, most individuals looks set to end up well below the retirement income levels put forward by Lord Turner and others as adequate.

A further issue is that individuals seem much more attracted to property (in addition to a first home) as a means of long-term savings.

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[42] Towards more effective savings incentives

The possible solutions

Based on our research, AEGON has identified a range of possible solutions to making savings incentives more effective.

One relatively simple solution is for our industry to change the way it describes pensions tax relief. Those we researched responded far more positively when this was presented as ‘matching’, or a free contribution from the Government to top-up their savings. This is one example of how clearer communication can pay dividends. Taking this wider, we believe there is huge scope to simplify the disclosure material currently prescribed within regulation to make it more empowering to customers.

Another key finding was the major influence employers have on employee savings behaviour. The availability of an employer contribution was cited as a common trigger to get people starting saving. Industry and Government should focus even more on encouraging employers to support pensions and maintain valuable employer contributions – particularly as we begin to phase in pensions reform. A good outcome would be a lower opt out rate once automatic enrolment commences. An even better one would be for contributions from employers and employees to remain above the statutory 8% minimum.

To improve awareness and understanding, we’d very much support a mass education and awareness campaign of the advantages (including tax incentives) of different savings products. The money advice service (formerly CFEB) could play a key role here.

Within this, we believe there needs to be a specific focus on the costs, benefits and risks of property as investment compared to other asset classes. This should also cover the benefits of diversification between asset classes and considerations around turning certain assets into an income stream in retirement.

While many of the new initiatives the Government is proposing have clear attractions, we have concerns that initiative overload can in itself, discourage engagement with savings. Frequent change makes it harder for consumers to build and maintain awareness and understanding. And it fuels mistrust when what people really want is to have trust in a stable, reliable savings environment.

Finally, we’d strongly encourage policymakers to invest time in researching likely consumer (and indeed employer) behaviour. We may well find that the key to encouraging greater savings isn’t introducing still more policy change – it might be helping consumer engage better with the current system.

Phil Hickley
(Senior Public Affairs Manager, AXA UK)

The big challenges

A number of factors are in place that stop people saving adequate sums for their retirement – many of them interact to provide a complex set of circumstances that hold people back. Among the most important will include: affordability, and the ability of today's workforce to set aside a meaningful contribution from their earnings to provide an income in retirement. In the coalition Government's attempts to deal with the fiscal debt the majority of people now have a lower disposable income than they did a few years ago and further squeezes are on the way – for example many people won't feel the impact of higher national insurance contributions or the changes to taxation and tax credits for a little while yet and some are still coming to terms with recent wage freezes. Higher inflation, and the impact this has on living standards, alongside the need for an increasing number of our younger population to service student debt also play their part.

Inclination to save encapsulates all the other pressures that people often feel under. Even when they have the available funds with which to make provision for their old age, the benefits of instant gratification versus comfort in old age will often mean that many folk will happily trade up to the next electronic gadget rather than squirrel money away for the future. From some earlier research we have undertaken we know that there are many people on average and above average earnings that can't bring themselves to join a decent employer's pension scheme because they'll be giving away some of their hard-earned wages now.

Another feature that currently deters would-be contributors from either starting or increasing their pension contributions to a more meaningful level is the ***complexity*** of the current system and how state provision interacts with personal provision. While clearly successful in bringing a number of pensioners out of poverty, means tested benefits have a lot to answer for in preventing a number of lower to average earners being given sufficient encouragement to make a start in saving for a pension. Indeed, any reader who happens to peruse the personal finance pages in any number of newspapers and magazines just to look for clarity and guidance about their own position could be forgiven by being completely baffled by what they read.

Finally, the prospect of a ***rapidly changing environment*** for jobs, lifestyles, leisure time, family structure (with more and more people facing the prospect of helping to look after not just themselves but their parents and children too) will all contribute to peoples' uncertainty around the need to contribute to a pension. Many people will continue to chance their arm believing that their inherited wealth – mostly in the form of property ownership – coupled with continual Government tinkering with the system will be enough to 'get them by'.

Clearly for most this will be a misguided approach.

The possible solutions

Knowledge that the savings gap has been in place for many years will lead to a conclusion that any number of attempts to close it and encourage greater saving for a comfortable retirement have already been tried; most have failed. The 'reward' structure in the form of tax relief is in place and while we might debate complexity and simplicity, few can argue that tax relief in itself is of insufficient value to encourage people from making provision if they have the inclination to do so.

Over many years traditional occupational pensions in the form of final salary or defined benefit schemes have been in decline for any number of reasons. Throughout this decline, however, we have retained and developed options allowing more modern company schemes – set up on a money purchase basis – through to group personal schemes, SIPPs and right down to individual personal pensions. Alongside numerous investment possibilities the infrastructure is in place to able to support growth in pension provision, yet in the main it is not happening so what more can be done?

The coalition Government has made a useful start in ratifying earlier attempts to get people into workplace schemes from 2012 with the launch of NEST and auto enrolment is certainly the right policy approach to getting the savings habit kick-started. What we'll need to avoid though is the idea that a combined 8% contribution on a segment of earnings will provide anything like the level needed to secure a comprehensive pension in retirement to match most peoples' aspirations.

Education must feature strongly in how we might close the savings gap. Right now our young people are not sufficiently prepared on leaving the education system to be able to understand and manage their financial affairs effectively or with any confidence. Long before they contemplate starting a pension they're likely to need to make fundamental decisions around some of the basics like contributing to a family budget, paying off a student debt, housing costs and saving for necessities well before they consider saving for some luxuries and they are simply not equipped to be able to do so. Better financial education must be the way forward from the classroom through further education and into the workplace.

While it has been many years in the making we are starting to build the fabric of a financial education service for our adult population although I don't propose in this short article to debate its merits and how it might be improved further to secure better financial prospects for people at large.

Where we are missing a trick is by largely ignoring the education system and the role it can have in equipping the future generation with the basic tools that will enable them to make informed judgements about their finances that will lead to a closing of the savings gap more naturally and without further tinkering between carrot and stick.

Dr Ros Altmann (Director General, Saga Group)

The challenges

The inadequacies of UK retirement savings have been well-documented. Estimates of the 'Savings Gap' run into many billions of pounds. It is clear that people have generally lost confidence in pensions and, in many cases, they simply do not want to engage. Even when there is an employer contribution on offer, workers often still decline the chance to join company pension schemes.

This leaves millions of people at risk of an impoverished old age, trying to survive on just a state pension and perhaps means-tested top-ups in later life. In order to overcome the challenges of pensions inadequacy, it is important to recognise what the barriers to pension saving really are.

Firstly, the state pension system itself undermines private pension saving. As nearly half of pensioners end up entitled to means-tested Pension Credit when they retire, pensions could be an unsuitable investment for significant numbers of workers, especially those on moderate incomes who cannot be sure they will not be means-tested in retirement. Pension Credit will take away much or all of any private pension income, so many people will be better off saving in an ISA, rather than a pension.

Secondly, many people have so much debt, or such inadequate incomes relative to the lifestyle they want to achieve now, that they feel they just cannot afford to put money into a pension.

Thirdly, incentives for pension saving, other than for top-rate taxpayers, do not seem that attractive. Many younger people, who may end up on higher rate tax in future, particularly those in debt, who do not already own a home, could find that they will be better off not contributing to a pension at the moment. Better and clearer incentives are needed.

Fourthly, the level of house prices has been a problem for pension saving, with many younger people finding housing so expensive and having to take on so much mortgage debt, that they cannot afford to put money into a pension as well.

Fifthly, the nature of the pensions vehicle itself is a problem. Pensions are- a 'locked box' – this is both a strength and a weakness. Of course, the fact that people cannot access their money until later life has the advantage that they cannot spend it before retirement and it should be there in future to help support their old age. However, the disadvantage is that for many young people contributing to a pension feels like having their hard-earned money 'confiscated' from them and put into an investment which charges fees each year, may or may not do well and even if they desperately need the money, they cannot get it back. This puts them off contributing in the first place.

Finally, with such high levels of debt among all age groups, it is not clear that pension saving should be their first priority, but if they do not start saving early and getting into that habit, there is a risk they never will. All these factors, along with successive scandals over the years and the complexity of the whole system, have led to inadequate retirement savings in the UK.

The possible solutions

Rename private pensions: Pensions really need an 'image makeover', in order to help people feel more positive towards the idea. The word 'pension' often has negative connotations nowadays. It conjures up the image of being old, which many people resist and my first suggested solution is to rename private pensions. We should abolish the word 'pension' for anything other than what the state pays people in their old age.

Radically redesign state pensions: As the Government is proposing to radically reform the state pension, paying a decent flat-rate minimum of £140 a week in today's money, future generations will eventually be able to understand that there is only a certain amount they will get from the state. The rest is up to them and if they want more, they will have to do some saving. We can then come up with more creative savings vehicles that will be called something other than 'pensions'.

Design more flexible products – for lifetime savings: The industry could design more flexible products, for 'lifetime savings' which will help people save for their old age but have some access to their money if they really need it. This would help people contribute or put in more in the first place.

Lottery: I would like to see a lottery attached to these long-term savings too, so that anyone putting money in would be entered for a prize of, say, £1million, each month. That taps into the psyche of many people who probably want to feel that there may be something in it for them today, not just in some very distant future.

More use of insurance: There is clearly insufficient attention being paid to the need to insure against very bad outcomes in later life. Whether it is insurance against illnesses that curtail earnings or insurance against the need for expensive long-term care, it would make sense to tie in pension provision with an insurance overlay.

In conclusion, there is an urgent need to rethink pensions and both Government and the financial industry have crucial roles to play in helping individuals prepare for a better retirement. Pensions alone, however, will not solve all the problems faced by our ageing population and it will be essential to help people plan to work longer – preferably part-time for a number of years – as well.

Ronnie Morgan ACII, DipPFS and Robin Nimmo (Strategic Insight Managers, Scottish Life)

The challenges

Much has been written on the subject of the savings gap and many reasons for it have been put forward:

- Poor perception of pensions and of the savings industry
- Complex products
- Longevity improvements, leading to reduced annuity rates
- Interaction of savings and means-tested benefits
- Fear of locking money away for the long-term
- Tax incentives being skewed towards the wealthy

While each of these plays a part, the crux of the matter could be simpler: as a nation, we don't want to, or feel we have to, save for our retirement. Or at least we don't want to save at the level required.

What reasons are there for this?

- A generation in which many believe the state will provide; that it's their right under the Welfare State. People were led to believe that the state would look after them from "cradle to grave". With this mindset, how likely would they be to teach their children about the necessity to save for retirement?
- A view that your employer would look after you, particularly if you worked in the public sector.
- A generation of consumers – savings rates have fallen and levels of personal debt have risen. It could become more socially desirable to spend than to save, fuelled by skilled product marketing and easy availability of credit.

Due to a number of factors – principally changing demographics, longevity and changing employer/employee relations – neither the state nor employers will be providing as much toward retirement as was previously the case. This means everyone will have to either work longer, or save more while working, or a combination of these.

The government has already decided that the age from which the state pension is paid will be increased. But the other part of the equation is down to individuals and employers. People must save for their retirement at an appropriate level.

To help make this happen there are a few key components:

1. Get crystal clear about the reality of the situation. If we don't save for retirement, life may be very hard.
2. Show clearly how much should be saved to get a reasonable outcome.
3. Reinvigorate the savings culture; make people feel good about saving for their retirement and show that excessive spending and debt are unacceptable.

Financial education must be at the heart of this.

We need to make sure future generations have a good grasp of financial matters. This can be achieved through the national curriculum and also by means of voluntary groups. Financial businesses have an important role in this, to help ensure a savings culture takes hold.

For those who are heading towards retirement, we must also make financial education and assistance available, otherwise we may have a lost generation; people who believed they did not need to save for retirement, but were sadly mistaken.

As for generation X, can we make an i-SA as desirable as an i-Pod?

The possible solutions

The UK has an estimated savings gap of £27bn according to the Association of British Insurers. But what are the possible solutions for reducing this gap? Put bluntly, if Individuals want to avoid a low income in retirement, they will need to save more or work longer.

Most individuals are not aware of how much they need to save, or they think the State will look after them in their retirement. Such perceptions need to change. Individuals need to be informed, in clear and simple terms, what they are likely to get from the State. And they need to be educated on the need to save, how to save and where they can get help or advice on saving for retirement. Such messages could be delivered through the workplace as part of automatic enrolment.

A simplified advice process is needed to increase take up rates for savings products. Some individuals are not willing to pay for advice, yet they need help in choosing suitable products. A method of streamlining the current advice process is needed, keeping costs to a minimum while still providing appropriate recommendations.

Many individuals do not want to save in pension products because they don't want to lock money away until their retirement. A product that combines the best elements of a pension with the accessibility of, say, an Individual Savings Account (ISA) could help reduce the savings gap. Individuals could then save for their retirement in confidence, knowing that they can access some of their savings in certain circumstances, for example to buy their first home or in case of financial hardship.

The Government provides generous tax concessions on pension and ISA products, yet these benefits are seldom fully understood or appreciated by individuals. How many people understand tax relief on pension contributions? A simpler method of incentivising individuals to save may have greater impact. A Government matched payment system could be one possible way. For each £1 an individual contributes to their pension plan, the Government could pay in £1 up to a certain overall limit. Such structures are simple for people to understand and many will already be familiar with them from their employer's pension scheme.

Automatic enrolment is being introduced from 2012. This will go some way towards helping to reduce the savings gap. But it's unlikely to provide individuals with an adequate income in retirement, especially if contributions are set at near to the minimum levels. Individuals will need to make additional savings through the scheme or by other means.

These suggestions could all help to reduce the savings gap; but compulsion may be the only way of eliminating it completely. Automatic enrolment is a good start. Individuals could be compelled to save through removal of the opt-out while minimum contribution levels could be increased from the current low levels over a period of time. The downside with compulsion is that it is likely to be viewed by many individuals and employers as an additional tax, something which is unlikely to be welcomed.

David Nish (Chief Executive, Standard Life)

The need to improve long-term savings in the UK is one of the most important issues facing society. One in five Britons living today can expect to see their 100th birthday and retirements now commonly extend across three to four decades. Whilst this is to be celebrated, it means people will need to save more if they are to enjoy financial security in later life.

At present, too many people are failing to save sufficiently or are not saving at all. Standard Life's latest research with the Life Academy charity shows that only 51% of adults are actively investing in their financial future.

Solving this problem will not be easy; there is no quick fix. A programme of sustainable change is required over the course of 10 to 20 years and the industry will need to work with policy makers and other stakeholders as never before to achieve the required outcome.

This partnership approach is already beginning to take shape. A welcome political consensus is emerging around the need to increase levels of long-term saving and the reforms necessary to deliver it. The proposed universal State pension will simplify saving and provide a strong foundation on which individuals can build private provision. Furthermore, the launch of automatic enrolment and NEST in 2012 will play a significant role. It will bring millions of individuals into long-term savings and form the basis of an inclusive and sustainable workplace pensions system.

So far, so good. But we need to go further to deliver the fundamental, long-term rebalancing of the economy towards saving that is so vital to the country's future well-being. In particular, we need to do three key things:

- Make saving more attractive and more engaging by focusing on customers' needs;
- Increase levels of financial capability and inclusion; and
- Increase consumers' trust in long-term saving and the financial sector.

As an industry, we need to design products to suit consumers. For example, working with policy makers, we should explore ways to bring ISAs – an extremely popular form of saving – and pensions closer together. This would help to create a simpler and more flexible approach to long-term savings.

But it is not enough simply to provide consumer-focused products. If people are to use these products we need to increase levels of financial engagement and inclusion. This will require a sustained investment in financial capability across society to equip people with the skills to make sound financial decisions.

Simplifying saving and improving financial capability should help to bolster consumer confidence in the industry. But to secure greater levels of trust, the industry must become more transparent and deliver better outcomes for customers. That's why Standard Life supports the Retail Distribution Review, which will provide individuals with greater clarity and control over the cost of advice.

By working closely with policy markers the industry has a unique opportunity to transform the savings landscape and deliver real benefits for society as a whole. For the sake of this and future generations we must seize it.

Professor Phillip Booth (Editorial and Programme Director, Institute of Economic Affairs)

The big challenges

The state has more or less taken over the role of providing income in old age for the majority of the population. Those in the bottom 60% of the income distribution receive most of their income in old age from the government in one form or another. Few of them have any incentive to supplement their income by saving.

We need clearer thinking about the relative advantages of state and private retirement provision. There are continual complaints that private saving can never be sufficient for retirement because annuity rates are so poor. Also, defined benefit schemes are closing down because the costs of funding decent provision are rising. Instead, people suggest, we should have more state provision – especially for people on low incomes.

Unfortunately, the risks do not go away when the state provides pensions – they are hidden and often become systemic. If we add pensions and health obligations to Britain's future national debt then the total debt burden we are passing to the next generation comes to about 500% of national income. This is a very real burden that arises from this generation making promises to itself without putting aside the means to meet those promises through saving.

The fact is that, if we wish to be retired for 20 years or more and work for only 40 years, we have to make big sacrifices during our working life to pay for our retirement. Low annuities from private saving are simply an indicator of the basic economic facts of life.

Of course, it is true that private saving for retirement leads to risks arising from low investment returns and increasing longevity. Those risks can be managed, however. If life expectancy at retirement increases and annuity prices rise, then individuals face exactly the right incentives to work for longer, work part-time past retirement age and save more in the years before retirement. This may not be ideal, but the situation is controllable and the incentives run in the right direction. On the other hand, when the state provides us with our retirement incomes risks can be systemic and self-reinforcing. For example, if longevity increases, there will be more pensioners and they may then use their voting power to increase, rather than decrease, pensions. The taxes that are necessary to finance the higher pension bill will discourage and not encourage the work and enterprise necessary to finance higher living standards in old age. Furthermore, state pension systems rely on the working population not shrinking relative to the retired population and yet there are absolutely no incentives within state pension systems to ensure the population stability that is needed.

So, in short, we need to return to the debate we were having two decades ago and move to more private pension provision. State provision does not reduce the costs or the risk – it merely brushes them under the carpet.

The possible solutions

In February the Institute of Economic Affairs published a paper which, amongst other things, made proposals for long-term reforms of the pension system[43]. Pensions Minister Stephen Webb is on public record as having described the short-term proposals in the paper as “loathsome”. Fortunately, the Treasury seems to have a more receptive view of the longer-term proposals discussed in that paper: indeed, three out of four of them were mentioned in the budget as providing the basis for reform.

The view expressed in that paper is that the state pension system should be reformed along the following lines:

- The Basic State Pension and the second state pension should be merged into one pension.
- The contributory principle should be maintained.
- Pension age should be changed so that life expectation at retirement remains constant and this process should be de-politicised.
- People should be able to contract out of this government scheme with an actuarially fair rebate to invest in a personal scheme.

The current arrangement with two separate state pensions with different uprating, qualification and indexing rules is bizarre and must be a disincentive to save due to the complexity and uncertainty the systems create. The contributory principle should be reinforced because it enables people to understand their state pension entitlement as it accrues – they can therefore make rational savings decisions. Fixing life expectation at retirement will considerably de-risk the state pension system and allow people to save in novel ways, with a greater degree of certainty. For example, they could save for a bridging income between their desired retirement age and state pension age.

If we take these three reforms together, costs would be reduced sufficiently to allow a state pension to be paid at a level at which means testing would be minimal. Incentives to save would therefore be restored right across the earnings spectrum. Of course, allowing people to contract out of the state system automatically provides a strong incentive to save.

Unfortunately, though the government has indicated that it will follow the first three principles of reform, it looks as if contracting out will be abolished and not extended. Instead of allowing people to contract out of part of the state pension the government will, instead, provide a higher state pension for everybody. The contracted-out rebates which are currently saved in private schemes will be spent by the government wiping out up to £8bn of saving at a stroke. This is not the way to go. Instead, the principle of contracting out of the state pension scheme should be extended to allow everybody to save privately for their future pension income.

[43] Booth P. M. (2010), *Sharing the Burden: how the older generation should suffer its share of the cuts*, Discussion Paper No. 34, Institute of Economic Affairs, London.

Chris Curry (Research Director, Pensions Policy Institute)

The landscape for retirement saving in the UK has been changing fast since the election of the Coalition Government in May 2010. And that provides perhaps the first big challenge in the coming years. Retirement savers are having to try and account for changes in the taxation of pensions, the options surrounding taking pension income, changes in the advice regime, changes in State Pension Ages, and changes in public sector pensions, not to mention possible further changes surrounding the whole structure of the state pension system and early access to private pension saving.

This state of flux in the policy environment will have real world impacts on savers, in some cases increasing options and flexibility, but also increasing the need for help and advice. Until the retirement savings framework reaches something approaching stability, it is going to be difficult for people to work out what they ought to be doing.

Of course, auto-enrolment will help to overcome some of the barriers to decision making, with inertia meaning that unless people actively choose not to, many of them will be pension saving by default. The Government estimates that this could increase the number of people saving in a pension by up to 8 million – a very welcome increase. But this gives rise to a second big challenge – ensuring that auto-enrolment works well given the economic environment in which it is being introduced. When the idea of auto-enrolment was first proposed in 2005, individuals may not have noticed or minded the reduction in take-home pay in the months after auto-enrolment. However, in the current economic background of stagnating pay, higher inflation and less job security, more people than previously expected could opt-out of pension saving as they work hard to manage their money, or might prefer to save for a rainy day in the near future rather than in retirement. It will be important to ensure that auto-enrolment works as well as it can, to avoid diluting the undoubted benefits.

Opt-out rates could be further increased if returns on pension saving funds in the first few years after auto-enrolment are not high, and people do not see gains in their embryonic pension funds. And this leads on to the next big challenge: the people most likely to need help understanding the benefits and values of long-term saving are not the sophisticated investors or high net worth individuals who traditionally have been served by advisors. They will be low to median earning individuals, who may be saving relatively small amounts in cash terms, but to whom pension savings could make a significant difference to the level of income they have to live on in their retirement. People who, having been auto-enrolled, will not have had to make any decisions about saving could suddenly have to make very important decisions about how to best turn their pension fund into an income. Finding a way to help these individuals through the increasingly complex and ever changing savings landscape is perhaps the biggest retirement saving challenge we currently face.

Dr Patrick Nolan (Chief Economist, Reform)

Time to grasp the nettle on the cost of an aging population

No one should be surprised by the fact that the population is getting older. For decades researchers have been studying these trends and investigating their implications for relatively generous welfare states, like that of the UK. Some countries have even undertaken major reform to manage these future costs. Yet relatively little has been done in the UK to face up to these demographic changes and recent policies will increase, not reduce, the longer term cost of entitlements. The reason for this is political – with governments being unwilling to risk a backlash among the large number of pensioners who vote.

An approach of denial and delay is no longer affordable. The biggest challenge in encouraging action on population ageing is that people think that dealing with the problem can be put off. Often it is seen as a problem for 2040 or 2050, which is well beyond the attention span of many policy makers and media commentators. But the effects of population ageing will be felt much earlier than that. The OECD has, for example, recently estimated that the working aged population will peak in 2015. Indeed, as the Pensions Policy Institute has shown, between 2009 and 2015 the number of people of state pension age or older is likely to grow by 457,000 and life expectancy at 65 will increase from 21.0 to 21.7 years. This means that from around the end of this Parliamentary term policy makers will no longer be able to rely on a growing working age population to help fund increasingly expensive entitlements. Programmes that are currently unaffordable are only going to become more so.

Yet the case for moving quickly is not just a fiscal one. People also need to be given time to prepare for changes in policy frameworks. For any change there will be a group of people who are relatively disadvantaged in the transition. This will include people who are below but close to retirement age and so will have relatively little time to change their plans. Given this it may be tempting to delay any changes to ensure that these people do not lose out, but this would increase future problems. Population ageing means that more people would be caught in the transition if the change is delayed and that the group of losers would be larger.

While there may be little case for delaying a change the fact that these losers are created means that the transition to any new policy framework will require careful consideration. This includes considering how to improve the labour market outcomes of the over 55s and whether to continue to apply (grandfather) existing entitlements. Yet there is little evidence that transitional issues have been given serious consideration in the UK. Instead the approach taken has involved shoring up support for change by making the system as a whole less, not more, affordable. This is an incoherent approach that will cost future generations dearly.

Some commentators may argue that the Coalition has grasped the nettle on these costs. It has, for example, shifted forward the increase in the retirement age and proposed reform of public sector pensions. Yet any savings from these changes will be swamped by promises made elsewhere. Shifting forward the increase in the retirement age will, for example, only save money until 2024, after which the age will be back on its earlier trajectory. In contrast, decisions such as indexing the state pension to wage growth not price growth will continue to grow in cost and will alone mean that the cost of pensions will be some £20 billion higher (in today's money) in 2050.

Likewise, proposals to introduce a universal state pension for new recipients also have the potential to significantly increase costs. There is a view that a universal pension could reduce the cost of pension benefits through avoiding the problems of means-testing discouraging savings and the potential loss of benefits from contributions to National Employment Savings Trust (NEST) pensions. While it is clear that people in the UK need to increase their savings, the experience with universal pensions in countries like New Zealand highlights that the introduction of this policy is unlikely to provide a silver bullet. The universal pension in New Zealand is a major reason for the low household savings rates in that country. Incentives to save are reduced when people know that they will receive a benefit even if they make no preparation for their own retirement.

The Coalition's plans will not put the system of retirement support onto a fiscally sustainable footing and will make the choices facing future generations even harder.

Wendy van den Hende (Chief Executive, Personal Finance Education Group)

PFEG (Personal Finance Education Group) is an independent charity helping schools to plan and teach personal finance relevant to students' lives and needs. Its mission is to ensure that all young people leaving school have the confidence, skills and knowledge in financial matters to participate fully in society.

This contribution will, therefore, focus on issues related to children and young people and their financial education.

The big challenges

Many children are growing up in families and communities that grapple with poor levels of financial awareness, lack of information about relevant products and services, under-developed financial skills, unstable personal financial circumstances and competing pressures on spending.

One challenge is a widespread lack of awareness of the need for financial education in addition to provision of financial advice. Financial education should be seen as an effective early intervention to prevent future problems with unmanaged personal debt and poor preparation for retirement.

There is a need to increase understanding that financial capability is a lifelong process – a continuum along which people move throughout life. Financial education is essential to help young children begin the journey along the continuum.

Children are interacting with money issues earlier and earlier. We know that they are engaged with financial services and products from a very young age – children have mobile phones from aged 8, they are purchasing items online from 10 – either using parents' cards, or increasingly, prepaid ones. They have to make complex decisions when they are young and inexperienced – about whether a university education will be a good investment, whether they will then earn enough to pay back the loan, whether or not to take out credit cards or store cards.

In schools competing pressures on curriculum time and accountability measures that encourage schools to focus on acquisition of large numbers of qualifications can squeeze the time for essential learning for life.

Where the need for financial education is recognised an additional challenge is to equip teachers with the confidence and competence to teach it.

Most of all there is a huge challenge in motivating school-aged children and young people to think about long-term planning. Retirement seems a very long way away when you have not yet embarked upon working life. Alongside this are the influences on spending experienced by younger age-groups – the pressures of consumer opportunity and choice compete with the need to plan ahead.

The possible solutions

Clearly the ultimate aim must be to develop a financially capable society. Financial education for children and young people is essential to this.

Education

The single most effective long-term solution is to develop in schools a systematic programme of financial education whose aim is to enable young people to develop:

- knowledge and understanding to inform judgments and decisions about managing money in their present and future lives
- appropriate attitudes that are reflected in taking personal responsibility for money management, questioning the claims of some financial products and evaluating available information before taking financial decisions
- financial skills that are demonstrated through day-to-day money management and planning for future financial needs, such as budgeting for weekly household items, monitoring bank accounts and credit cards and checking whether savings and investments are meeting financial goals.

Such education must start as soon as children begin school and continue until they leave full time education. Early learning provides a firm foundation on which to develop positive financial attitudes and build further knowledge and skills.

Financial education will enable them to thrive rather than merely survive as they move into independence.

Supporting saving

As well as learning why saving is important we must get children saving from an early age. Only by doing so, can we be sure that the saving habit is established and embedded as a way of life.

School banks are making a come-back but some schools have difficulty in finding a bank to support them. Support for school banks – preferably with young people helping to run them – would link financial education with financial action.

Outside school, now that the Child Trust Fund has been discontinued, we need to look again at incentives for younger children and their parents. Is there a role for the financial sector in promoting savings schemes for children as a corporate responsibility activity – not for profit schemes – rather than commercial ones?

Once they have saved as young children, incentives could be provided for teenagers to save for university education, for a car to travel to work or in anticipation of living independently. With saving for the future established it will be easier to encourage saving for retirement.

Jackie Spencer
(Later Life Policy Advisor, Money Advice Service)

The biggest challenge facing the UK in saving for retirement is many people are poorly equipped to plan ahead and make informed choices about financial products.

The FSA carried out a large-scale survey into the financial capability of the UK population which was published in 2006. Evidence from this survey shows that large numbers of people, from all sections of society, are not taking basic steps to plan ahead, such as saving sufficiently for their retirement or putting money aside for a rainy day.[44]

Respondents under state pension age were asked about the provision they had made personally for their retirement and also whether they would be able to make ends meet on the state pension alone.

- Over four in five (81%) said that government pension would not provide them with the standard of living that they would hope for in retirement.
- Despite this, only two in five respondents (42%) who were not yet retired had a current personal or occupational pension.
- The results indicated that over a third (37%) of those who felt that the government provision would be insufficient did not have any additional pension provision, indicating a relatively small degree of planning ahead in this context.
- Over two in five people (42%) put their current standard of living before their retirement planning, agreeing with the statement 'I would rather have a good standard of living today than plan for retirement'.

As many people have low financial capability, increasing savings for retirement will depend on providing good financial education and advice about money, to equip people to understand their financial choices. We believe that our provision of free, unbiased money advice through the Money Advice Service will be essential to help people manage their money better, and so improve the quality of their lives.

In July 2010, the Money Advice Service published Transforming Financial Behaviour research which is designed to learn how we can use the findings from psychology and sociology alongside more traditional policy interventions to foster behavioural change, and in particular, to find practical ways to create an environment that supports enduring financial capability.[45] The findings underline the need for financial education and advice (as well as information) to support people in making good money decisions. These learnings from behavioural science are incorporated into our new on-line tool, the Money Advice Service health check to be launched in mid 2011. This on-line health check will provide a personal action plan to help people identify and address their money priorities needs such as saving for retirement.

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44 http://www.fsa.gov.uk//pubs/other/fincap_baseline.pdf

45 http://www.moneyadviceservice.org.uk/_assets/downloads/pdfs/20100709_transforming_financial_behaviour_summary.pdf

Conclusion and CII view

From the research conducted and stakeholder contributions received it seems clear that, a prior and necessary condition for increased savings is for the general public to be convinced that saving more is in their long-term best interests, and further, that legislation will be enacted to ensure promises from suppliers are kept. From the CII's perspective there are three areas in particular where we think more effort must be made in order to meet this necessary condition for increased savings.

- The scale of the problem is massive – elderly people who have not saved and who cannot rely on the state face the possibility of having to use virtually all of their accumulated wealth if they wish to achieve an adequate income and pay for long-term care costs during retirement. This frightening message must be communicated to the general public by Government, industry and consumer bodies to let the consumer know just what is at stake if they choose to do nothing.
- Trust is a key issue and the industry must embrace reforms such as the Retail Distribution Review and the forthcoming simple products regime which are both aimed at improving levels of trust around financial services and products. On the flipside, the aims and successes of such reforms must be well publicised or they will have little effect in changing consumer attitudes and behaviours.
- The general public needs certainty about the future savings landscape. This is hard to achieve given the constantly changing macroeconomic and political environment in the UK and abroad. However, Government and Opposition must do their best to provide certainty about future rules – making cross-party support for the latest set of reforms important. With major reforms on the way political consensus must therefore not just be struck on the analysis of the problems but on the solutions as well. But more must be done to investigate how the Government can guarantee a secure and predictable long-term savings environment over the decades to come.

It is clear that we are at a crucial juncture for securing major reforms to provision for retirement. Future generations must be able to look back at this moment as a watershed when we made the necessary changes to fairly address the longevity 'timebombs' and not when the impetus for deep and meaningful reform was spurred.

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About the Chartered Insurance Institute (CII)

Professionalism in practice

The CII is the world's leading professional organisation for insurance and financial services, with almost 100,000 members in 150 countries.

We are committed to maintaining the highest standards of technical expertise and ethical conduct in the profession through research, education and accreditation.

Our Charter remit is to protect the public by guiding the profession. For more information on the CII and its policy and public affairs function, including examples of the range of issues in financial services and insurance that we cover, please see:

www.cii.co.uk/policy

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