think piece
Promoting debate and fresh thinking in the financial services industry

Increasing longevity: blessing or a curse for financial services?

Mick McAteer

Summary

- Consumers are facing increasingly difficult choices regarding their long-term financial futures. Rising living standards and improved medical science mean that people are living longer and with this comes increased costs of pensions, health and social care.
- Unfortunately, the three areas that typically gave support—the state, family, and employers—are all weakening, while more emphasis has been placed on personal provision. This presents a challenge for the industry and the public. Consumers are not future proofed, whether because the state is unable to protect them or they are underinsured.
- A new retail distribution system must be implemented: one based on consumer needs and greater professionalism; better and more efficient business regulations must be introduced; better self-governance must be adopted by all firms; and consumer advocates should be working with the industry to make it better ('co-production'). This would meet the needs of most retail consumers.
- For those consumers who are not economically viable for mainstream retail providers, a partnership between industry and third sector providers (such as charities and NGOs) provides the best way of improving access. Such quasi-market solutions offer the best chance to tackle financial exclusion.
- So the need for some sort of "insurance" has never been greater. The industry must face up to the short-termism and conflicts of interest embedded in the sector through the current distribution system. A more long-term approach to consumer treatment can create a more sustainable situation that will have huge commercial rewards.

Number 3 (June 2008)

*The Chartered Insurance Institute is the world's largest professional body for insurance and financial services and is the leader in awarding qualifications to industry practitioners. Our **think**pieces are a key part of our ongoing commitment to promoting innovative thinking and debate within the insurance and financial sectors.*

The views expressed within the article are those of the author and should not be interpreted as those of the Chartered Insurance Institute and its members. *The author has asserted his right under the Copyright, Designs and Patents Act 1988 to be identified as the author and copyright owner of the text of this work, and has granted the CII worldwide perpetual licence to reproduce and distribute it in whole and in part. We welcome suggestions from potential contributors, but we are also seeking feedback from our readers. We urge you to get involved—especially as we intend some of our articles to be open to rebuttals for publication.*

CII Group | PFS | CII

CII Introduction: People are living longer and with this come increased costs of pensions, health and social care. Is the financial services industry as it is currently configured capable of supporting consumers in this difficult environment? How will it meet the needs of those who are often excluded? In this third article in the CII's new Thinkpiece series, well known financial services consumer advocate Mick McAteer provides a unique consumerist insight on these issues. He challenges the industry to realise its significant potential to help consumers, and offers some radical proposals for this to happen, identifying the commercial benefits to the industry for doing so.

Major demographic and socio-economic trends are radically reshaping the financial services landscape and mean that consumers face more uncertain and unpredictable futures. Rising living standards and vastly improved health care mean that UK citizens are on average living longer – which is good news but comes at an obvious cost in the form of a rising bill for decent pensions, health and social care.

However, the four pillars which consumers used to rely on for protection and support - the state, family networks, paternalistic employers; and personal provision - seem to be crumbling. The UK needs a new, radical vision of how to fund a dignified and secure old age for all its citizens.

The role of the state

The ageing population and rising consumer expectations puts increasing pressure on the public purse. However, the fall in the birth rate undermines support ratios so that comparatively fewer people are working and paying taxes to support citizens who are not economically active.

Overall, the gap between the funding needed to meet consumers' retirement and healthcare needs and the actual level of funding the state can realistically provide is growing. It may seem like stating the obvious but pensions and health and social care are not a 'free good' - they have to be paid for. The UK is partly funding costly retirement by raising the state pension age. But even these reforms leave a significant shortfall to be funded.

At the risk of oversimplifying there are really only two ways of funding pension and health care costs: (i) by the state on a pay as you go basis – from the current tax base; or (ii) "pre-funding" through the accumulation of assets or by insuring those needs. Costs can be pre-funded through individual private insurance, employer provision or alternative quasi-market mechanisms.[1]

The state will always play a major role in people's lives through the provision of a safety net. But it seems sensible to assume that there is a natural limit on the proportion of future welfare costs that can be met through taxation given political constraints. We think the state will focus its role on meeting the needs of the most vulnerable consumers and providing a foundation level of pension and long term care for other consumers. Any additional needs over and above this core level of provision must be pre-funded through asset accumulation and insurance.

In complementing its safety net role, the state must also ensure that financial markets are "fit for purpose". It would be churlish to deny the very real progress that has been made within the insurance sector over the past five years led by the CII and other far-sighted industry representatives. However, more effective interventions are needed to create efficient markets that operate to high ethical standards, and provide access to products that consumers need.

Changing role of the family

The extended family and carers have traditionally been an invaluable source of support for vulnerable consumers. Yet the fall in the birth rate, and the rise in single person households means that this support mechanism will disappear for many in society. For example, the number of one person households in the age 75 and over group will increase to 2,372,000 by 2026,[2] while the number of childless pensioners will double from 10% to 20% in the next 20 years.[3]

Employers

The other main source of support for many consumers used to be employers who provided final salary pension schemes and/or valuable health schemes. However, this paternalistic role is also changing with employers closing down final salary schemes and transferring risk to consumers. Meanwhile a more fragmented labour market means that the old "job for life" is disappearing for many to be replaced by more self-employment and portfolio careers.

---

[1] Note that the state can also pre-fund liabilities for example through state-run funded pension schemes. Some of the so-called sovereign funds fulfil this role e.g. Norway. Moreover, the new system of Personal Accounts are a quasi-market version.

[2] Department of Communities and Local Government, "New Projections of Households for England and the regions to 2029", Table B: http://www.communities.gov.uk/ news/ corporate/new-projection-households

[3] Turner Commission, First Report, Chapter 5, p.194.

Personal provision

Personal provision is also changing its role. The last several years of the welfare state has been characterised by an attempt to transfer risk and responsibility from the state to individual consumers who are expected to use financial services to meet their core financial needs. This may stem at least partially from the political reality faced by politicians who are reluctant to increase taxation or put more responsibility on employers.

However, for a number of reasons this transfer of risk is not working. Serious levels of financial exclusion and underprovision in the UK mean that unless we can reverse trends, millions face bleak financial futures – futures that because of increasing longevity may be prolonged.

Around half the population are under-providing for retirement. Around 60% have no medium-long term investments to speak of;[4] and only around 12% have income protection insurance.[5] This level of underprovision led us to set up the Financial Inclusion Centre (FIC).

In summary, the lack of personal provision and constraints preventing politicians increasing taxes to fund costs on a pay-as-you-go basis means that the UK faces a significant shortfall in resources at an individual and societal level to meet future needs. Something has to give unless we do something about it.

Societal tensions

Increasing longevity may introduce social stresses as well as financial stresses. Older citizens will become more politically influential. The median voting age at the last general election was 58. As the population ages overall, this is likely to rise. There is potential for intergenerational strife with age based politics increasingly replacing traditional class based politics as different groups in society compete for limited resources.

Opportunities for the insurance industry

The seismic changes in society surely point to a huge opportunity for the insurance industry to help consumers build on the core level of state provision. After all, the essence of insurance is about helping consumers protect themselves against risk. Indeed, despite the litany of mis-selling scandals over the past two decades which have left a legacy of mistrust and the doom-mongering about the future of the insurance industry, it is hard to think of a UK consumer sector (other than the healthcare and pharmaceutical sectors) with so much potential.

If the industry has a collective soul it really ought to be searching for it at the moment. It must face up to the short-termism and conflicts of interest embedded in the sector through the current distribution system. Unfortunately, its reluctance to do this has conspired to almost blow the opportunity to benefit from the massive long-term dividend that is surely in store.

In what way can the industry meet the needs of consumers and wider society? We want to work with the retail and institutional industry on meeting two major challenges:

- How do we promote efficient, competitive retail insurance markets that consumers have confidence in? Millions of consumers who represent a viable commercial proposition for retail insurers are not insuring themselves against risk or accumulating assets - even though rationally they ought to be; and
- How do we work with the industry to develop alternative, radical solutions to meet the needs of huge numbers of consumers who also need to be insured against longevity risks but are not commercially viable for mainstream retail insurers?

Promoting fairer, more efficient and sustainable retail insurance markets

A new blueprint for reform is needed to promote consumer confidence, make markets more efficient and sustainable so it can serve the needs of more consumers cost-effectively, and encourage new product development to meet the changing needs of consumers.

Our reform programme consists of the following core elements:

- reforming, and realigning, the retail distribution system incorporating a new clear advice model created around consumer needs, and greater professionalism in the sector building on the work done by the CII and others. The Retail Distribution Review (RDR) must get this right;
- more effective, targeted, and balanced prudential and conduct of business regulation;
- better self-governance within the industry; and
- 'co-production' – consumer advocates working with industry to build a better financial system.

Effective regulation

Effective, not more, regulation is paramount. Good regulation promotes consumer confidence and efficient markets. Ineffective regulation fails to protect consumers and undermines confidence, increases distribution costs and distorts competition.

To be fair to insurers, part of the blame for short-termism must be laid at the door of the regulators and the financial system itself. Regulators have

[4] Which? briefing on National Pensions Savings Scheme, Jan 2006.

[5] FSA *Baseline Study* March 2006, Table 6.2.

tinkered with the retail distribution system and until now have been afraid to directly address the conflicts of interest caused by commission bias and aggressive remuneration.

Moreover, the financial system at the moment does not sufficiently reward firms that try to offer long term added value. The blame here lies with institutional shareholders, fund managers, and investment analysts who display an amazing lack of insight into how retail financial markets work. These powerful agents have not undertaken due diligence in the past to understand the reputational damage caused by misselling. What they have failed to understand is that the current commission-based system is undermining the industry's long-term financial viability: it results in churning rather than real growth in new business. This behaviour of analysts and investors means that most insurers have not been able to move away from the self-defeating distribution models that still prevail today.

One should be pessimistic about the likelihood of the market 'self-correcting'. Further interventions, not just by regulators, are needed to create the necessary conditions that reward consumer focused behaviour and penalise detrimental behaviour.

In terms of regulation, the FSA, therefore, needs to focus its efforts on two key objectives:

- changing the market dynamics along the entire supply chain, not just at the point of sale, to promote effective competition; and
- regulating more effectively the way the industry conducts business and the all important relationships and conflicts of interest between providers, distributors, and end-users. Critically, the FSA has to become a more effective enforcer of regulation.

We have developed a blueprint for better regulation consisting of: a small number of core, high level principles and targeted rules that set minimum standards and focus on the root causes of consumer detriment; tougher, more transparent regulatory enforcement; and a major streamlining of the regulatory rule book. We are confident that this would to more efficient regulatory regime, more competitive markets and better consumer protection standards.

Better self-governance and risk management within industry

However, the industry itself can do so much more to improve consumer governance and ensure that the consumer interest is properly represented within corporate structures. Very few major insurance companies in the UK (there are some notable exceptions to be fair) have independent mechanisms for representing the consumer interest at board level, or checks and balances in place to identify and manage risks, or systems to stress test new products.

Co-production

Consumer advocates have a duty to expose corporate malpractice and unfair treatment of consumers. However, given the sheer scale of the challenges facing the UK, we also have a duty to promote confidence and trust, efficient, competitive markets and encourage greater financial provision. In practice this means:

- working in partnership with consumer-focused firms to 'co-produce' consumer friendly and innovative financial products and services; and
- helping firms implement consumer representation mechanisms, design and stress-test products and services to minimise risk of consumer detriment.

We have a mutual interest in making markets work. The Soil Association and the Fair Trade Foundation in the food sector have shown how using market levers can be used to achieve campaign objectives and help markets evolve.

Market innovations

The blueprint we have set out above we believe would promote a fairer, more efficient and sustainable retail market. However, we also think that consumer advocates could work with the industry to develop radical and innovative solutions to deal with longevity and other socio-economic risks.

Personal Accounts will complement retail products and make a significant contribution to building up pre-retirement funds. But much more needs to be done. For example, we want to explore:

- a working age, personal lifecare fund designed to meet the social insurance needs of consumers such as income, health insurance, and to fund costs of long-term care; and
- a post retirement fund, to combine annuities and other assets to maximise income in retirement or to pay the costs of long-term care. Equity release has failed to take off as expected and we need to deal with the problem of small annuity pots which don't offer economies of scale.

These safe haven products need careful research and development and there are major issues re: minimum standards, distribution, the role of incentives, and importantly how these funds would interact with the social welfare framework and state benefits. FIC would welcome the opportunity to work with the industry to develop products that meet consumer needs.

But it's not just on the retail side where innovation is needed. Retirement liabilities can be pre-funded in one of two basic ways – either sufficient assets are built up which are then decumulated over time or unknown increases in longevity can be insured against. Some of the recent developments in the field of longevity bonds look promising and could provide at least a partial solution to the pressures facing employers/ trustees of final salary schemes and annuity providers.

However, there will still be large numbers of consumers who will not have access to decent pensions and insurance through the market and/or employers either because they do not represent a commercially viable proposition for insurers or represent too great a risk. There is a real need for alternative, innovative quasi-market solutions. We believe that a partnership model between the insurance industry and third-sector providers (charities and other not-for-profit organisations, NGOs, trade unions, and local authorities) offers the best way of changing the economics of access. The third sector already has the infrastructure in place and knows vulnerable consumers but lacks the funding and capacity to develop the products and services people need. The industry has the resources and access to the markets and, crucially, a vast store of knowledge that we need to exploit if we are to mount a sustained challenge on financial exclusion.

Summary and conclusions

So, increasing longevity brings with it a positive future for many of our citizens but clearly brings additional risks and costs in the form of higher retirement and healthcare costs. There is a very real fear that the UK has not faced up to challenge of meeting these costs.

We do need a more radical vision of how to meet these challenges. We already face major problems with financial exclusion and under-provision, coupled with longevity and other major environmental challenges such as increased single households and falling birth rates. Our fear is that consumers are not future-proofed to meet them: whether because the state is unable to protect them or they are underinsured. The need for ‘insurance’ has arguably never been greater in modern times. If the industry can persuade consumers that it has the products and services they need and can be trusted then the rewards for the industry will be great.

If you have any questions or comments about this publication, please contact the CII Policy & Public Affairs team on:

☎ **020 7417 4782**

💻 **seamus.heffernan@cii.co.uk**

Mick McAteer is a leading financial services consumer advocate in the UK as well as Europe. He is founder and Director of the Financial Inclusion Centre, founding director of Hackney Credit Union, and non-executive director of The Pensions Advisory Service. At the European level, he sits on the consultative panel of the Committee of European Insurance and Occupational Pensions Supervisors and the Financial Services User’s Panel (FINUSE). He previously worked at Which? (formerly the Consumers’ Association) for 13 years from 1994 to 2006 where, among other things, he formulated that organisation’s financial services policy.

The **Financial Inclusion Centre** is an independent, not-for-profit think tank set up to combat financial exclusion and under-provision in the UK. It does this by undertaking research into the causes of financial exclusion and developing innovative solutions to protect consumers and promote access to fair and affordable financial services. ***www.inclusioncentre.org.uk***

The **Chartered Insurance Institute** is the world’s leading professional organisation for insurance and financial services with 92,000 members in 150 countries. Our mission is to protect the interests of the public through guiding the profession. This is achieved through maintaining the professional, ethical and technical standards of those working in insurance and financial services.

*For more in the **think**piece series, please visit **www.cii.co.uk/thinkpiece***