PENSIONS POLICY INSTITUTE
PPI

Response to the Thoresen Review of Generic Finacial Advice

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Summary

I. PPI research has identified some lessons from the New Zealand Retirement Commission's experience in encouraging greater financial awareness and providing generic financial advice.
   - The guidance should come from a body that can be seen to be independent of Government and the financial services industry. This is essential if the advice is to be credible and trusted by consumers;
   - A website is an obvious first step and New Zealand's website, ***Sorted*** may provide a useful template[1]. Other delivery channels, such as telephone or face-to-face, should also be considered and piloted.
   - Generic advice should cover a wide range of personal finance issues not just retirement planning;
   - Any other roles of the independent body should be complementary of the specific remit chosen.

II. The PPI has published a number of research reports on aspects of the design and implications of the proposed new system of Personal Accounts.

III. PPI analysis has shown that Personal Accounts may not be suitable for all employees due to their interaction with taxes and means-tested benefits.

IV. People in their twenties in 2012 who remain opted-in may be at low risk of Personal Accounts being unsuitable. However, there are some groups of individuals who may be at risk of Personal Accounts being unsuitable because they may lose entitlement to means-tested benefits as a consequence of saving in a Personal Account. In particular:
   - Single people who rent in retirement are likely to be at high risk of Personal Accounts being unsuitable;
   - Some low-earning individuals in their forties and fifties in 2012 with no additional savings are at medium risk of Personal Accounts being unsuitable.
   - Although they will not be auto-enrolled, some self-employed people, who do not benefit from an employer contribution and are not eligible for state second pension, may be at risk of Personal Accounts being unsuitable.

[1] See www.sorted.org.nz

V. There are other reasons why individuals may want to opt-out of Personal Accounts. For example, individuals with high levels of debt or who feel that their individual contributions are unaffordable or who have a preference to spend rather than save may decide to opt-out.

VI. The fact that Personal Accounts are not suitable for all does not necessarily mean that people should not be auto-enrolled. This is not a compulsory system. People do have the right to opt-out of the system. But given the complexity of some of the decisions that some individuals will face, it does imply that people will need very clear information and generic advice to help them make informed decisions about whether they should stay in or opt out of Personal Accounts.

VII. It also suggests that any system of generic advice will need to be able to cope with providing advice to a wide range of individuals with different characteristics and financial circumstances.

VIII. An important test of the Personal Accounts policy will be whether it is possible to design information and generic advice in a simple and easy to understand way to help people decide whether they should opt-out of Personal Accounts.

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Introduction

The role of the Pensions Policy Institute

1. The Pensions Policy Institute (PPI) promotes the study of pensions and other provision for retirement and old age. The PPI is unique in the study of pensions, as it is independent (no political bias or vested interest); focused and expert in the field; and takes a long-term perspective across all elements of the pension system. The PPI does not make policy recommendations, or support any one reform solution, but exists to contribute facts and analysis to help all commentators and policy decision-makers.

Lessons from the New Zealand Retirement Commission

2. New Zealand appears to have a very successful approach to providing financial education and generic advice, through the independent Retirement Commission. Although it is not possible to say definitively that an identical approach would work in the UK (for example there are different cultures, regulatory systems and savings products), PPI research[2] has identified some lessons for UK policy from the New Zealand Retirement Commission's experience.

3. The Retirement Commission's education programme largely works through the Sorted website. This is an established part of the New Zealand financial scene, with high awareness and usage.

4. Reasons for the Retirement Commission's success include:
    a. The Commission is independent of Government and the industry. As a Crown entity, the Commission reports to a Minister but its day-to- day operations are autonomous. Full funding by Government seems to be the current consensus, with both major parties expressing support.
    b. The Retirement Commission provides guidance to help people make financial decisions, but does not give 'advice'. People still have to make their own decisions, but the Commission aims to equip them to do so better, by promoting the consumer's responsibility to make well-informed choices. By stopping short of advice the Commission maintains its impartiality.
    c. The Retirement Commission's other roles are complementary, including research and advising Government on the effectiveness of retirement income policy. It does not have any role that could compromise its independence from the Government or the financial services industry. For example, it is not a regulator.

[2] PPI (2006) ***Lessons from New Zealand's Retirement Commission for UK policy on financial awareness and advice*** A report for The Resolution Foundation

d. Sorted is about lifetime financial planning – not product specific and not just about retirement. Sorted covers a range of personal financial issues from debt management to saving. The primary aim is to promote saving for income in retirement, but retirement is not the starting point of the conversation.
e. Sorted is user-friendly and trusted. Despite packing in a lot of information, informal language means Sorted is easy to read. The brand is advertised heavily (which takes 75% of the budget) and this seems to have achieved the desired awareness of the service as trustworthy, credible and impartial.
f. Sorted personalises its guidance. Games and calculators are used heavily. The user can enter their own data, make some what if? scenarios and then save in a secure My Plan site. Information is therefore cost-effectively turned into education and a call to individual action.
g. The Commission is developing ways to reach people in different ways beyond Sorted. Partnerships have been developed with organisations developing financial education in schools. A telephone based information service was trialled but did not work. Links with professional advisers are being developed. As part of the KiwiSaver Government initiative, new funding has just been obtained for seminars and 'champions' in the workplace for personal financial education.

5. Some lessons for the UK from the Commission's success might be:
a. There is no obvious reason why the UK should not have a source of independent, generic guidance on personal financial planning; in fact one seems more necessary especially if the UK follows New Zealand with a national auto-enrolment savings scheme like KiwiSaver.
b. The guidance should come from a body that can be seen to be independent of Government and the industry. This means funded by Government and either by all industry providers or none.
c. A website is the obvious first step, and Sorted is an excellent template to follow.
d. There are choices on how to move beyond the website, for example to face-to-face provision. The workplace may be a good place to start.
e. However the conversation with potential users starts, it has to cover all lifetime financial issues. As the Retirement Commission chose to take the emphasis off the "R" word (retirement), should the emphasis in the UK be taken off the "P" word (pensions)?
f. Any other roles of the independent body should be complementary to the specific remit chosen. This will probably mean a role in carrying out consumer research and advising

Government on personal finance policy issues. It could extend to being a formal reviewer of personal finance policy on behalf of Government.

6. For further details on each of these points see the PPI's report Lessons from New Zealand's Retirement Commission for UK policy on financial awareness and advice.

Personal Accounts

7. The Government proposed that a new system of Personal Accounts be introduced from 2012. Although many details are yet to be finalised, the basic framework would be:
   - Auto-enrolment for all employees aged over 22 and earning more than £5,035 a year into a Personal Account (or an equivalent), with the opportunity to opt out.
   - A minimum contribution of 4% from the individual on band earnings between £5,035 and £33,540 a year. This would be matched by a minimum[3] 1% contribution of band earnings from the Government and a compulsory[4] 3% contribution of band earnings from the individual's employer.
   - Low charges, aiming for an annual charge of 0.3% of assets under management.

8. The Government's stated objective for Personal Accounts is to "***radically improve access to affordable, low-cost pension saving for many on moderate to low incomes who do not currently save in a private pension***."[5] Personal Accounts will offer many people in the target market (those on low to median earnings) access to a low cost, portable pension with an employer contribution for the first time.

9. The Government estimates that between 6 and 10 million people could eventually save in Personal Accounts. The actual participation rate will depend on a number of factors including how employers and individuals react to the proposals, which are difficult to foresee in advance.

10. The PPI has conducted a significant programme of work on a number of different aspects of the design of Personal Accounts including the suitability of Personal Accounts and their interaction with means-tested benefits, an analysis of the implications of alternative charging structures and a discussion of the possible governance structures of the Personal Accounts Board and Delivery Authority.

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[3] As this is provided through the current system of pension tax relief, the Government contribution would be higher for individuals who pay higher rate tax

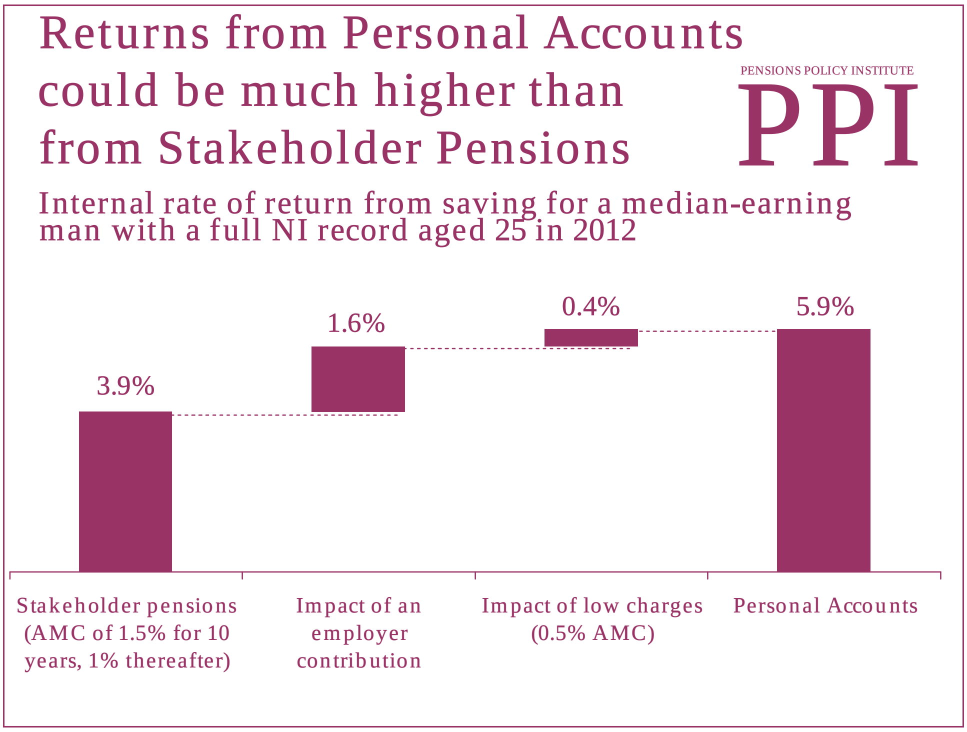
[4] For employees who do not opt out of Personal Accounts

[5] DWP (2006) ***Personal Accounts: a new way to save***, p5

11. The most relevant of these to the work of the review is the work that the PPI has undertaken on the suitability of Personal Accounts and incentives to save. Suitability and incentives to save

12. Personal Accounts could give as many as 10 million people access to a low-cost pension savings product with an employer contribution for the first time.[6] As a result of the low charges and employer contribution, incomes from saving in Personal Accounts are likely to be higher than incomes from saving in Stakeholder Pensions for many people. (Chart 1)

Chart 1[7]



13. However, auto-enrolment inevitably raises questions about the suitability of Personal Accounts for the employees who are auto-enrolled. The value of an individual's Personal Account depends on the complex interaction of a number of factors and will vary depending on an individual's particular circumstances.

14. The employer's contribution, tax relief and investment returns all increase the value of an individual's Personal Account but

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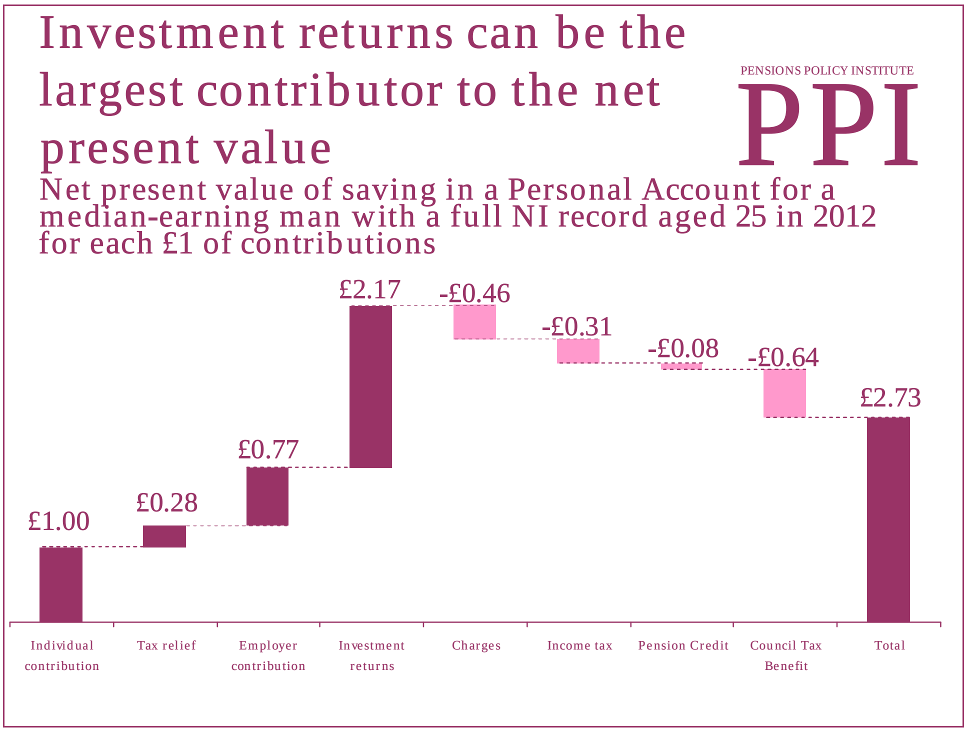
[6] DWP (2006) ***Security in retirement: towards a new pension system***, Fig 1.xi.

[7] PPI (2006) ***Are Personal Accounts suitable for all?*** p. 18. Assumes Stakeholder contributions are equivalent to the minimum employee contribution to Personal Accounts, with no employer contribution. The 'internal rate of return' is the nominal interest rate that the individual receives on his or her individual contributions to Personal Accounts, after allowing for the effects of tax relief, employer contributions, investment returns, charges, income tax and means-tested benefits. It is the same as the 'effective rate of return' used by the Pensions Commission and should not be compared with investment returns on other forms of saving.

charges, income tax and any eligibility to means-tested benefits that an individual may forego as a consequence of saving in the Personal Account will reduce the total value. How these combined factors interact will depend on an individual's particular circumstances. (Chart 2)

Chart 2[8]



15. In the PPI's analysis, Personal Accounts are defined as being 'suitable' if individuals do not lose out as a result of their saving. This is a less stringent definition than ensuring that saving in Personal Accounts is the right thing for all consumers, which would be more consistent with the FSA's definition of 'suitability'.

16. Individuals are categorised by being at low risk, medium risk or high risk of Personal Accounts being unsuitable for them depending on the effective level of return that they are likely to receive.

[8] PPI (2006) ***Are Personal Accounts suitable for all?*** p.12. In this example we assume the man remains opted in to Personal Accounts for his entire working life. The 'net present value' of an individual saving £1 in a Personal Account is the total amount received in pension income during retirement as a result of that saving in today's prices. This man loses entitlement to some Pension Credit and Council Tax Benefit as a consequence of saving in a Personal Account. He does not lose any entitlement to Housing Benefit because we assume that he owns his own home.

17. People at <u>low risk</u> of Personal Accounts being unsuitable for them are likely to receive back the value of their individual contributions to Personal Accounts, together with a full investment return on their contributions. Examples are:
    - Single people in their twenties in 2012 with full working histories.
    - Single men in their forties and fifties in 2012 who have a full working history and large additional savings.

18. People at <u>medium risk</u> of Personal Accounts being unsuitable for them would receive back the value of their individual contributions, protected for inflation, and some investment returns on their contributions, although they may not receive full credit for the investment returns. This group includes:
    - Single people in their twenties in 2012 with low earnings and broken working histories, whether because of caring breaks or unemployment.
    - Single people in their forties and fifties in 2012 with low earnings and full working histories.
    - Single people in their twenties in 2012 who stay opted in to Personal Accounts while employed, and then become self-employed at a later date.

19. People at <u>high risk</u> of Personal Accounts being unsuitable for them are likely to receive back less than the value of their contributions into Personal Accounts. This group includes:
    - Single people who are likely to rent in retirement and have no additional savings. These people are likely to qualify for less means-tested Housing Benefit as a consequence of saving in a Personal Account.
    - Although they would not be auto-enrolled, single people in their forties and fifties in 2012 on low to median incomes who are self-employed.

20. No single definition of 'suitability' is likely to be appropriate for the circumstances of every individual. For some people, it may be rational to save even if they have a low return on their saving, for example, if they have a strong preference to smooth consumption over their lifetime. On the other hand, some people may require a high return, for example, if they are very risk-averse or have high levels of debt. Returns from saving in a Personal Account could be higher for people who are married at some point in their retirement than for single people.

21. The Government's test is that individuals should get back at least the value of their own contributions (but not necessarily the value of their employer's contributions, real investment returns or the tax relief) protected for inflation.[9] This suggests that the Government would only be concerned about individuals in the PPI's high-risk group.

[9] DWP (2006) ***Financial incentives to save for retirement***, Paragraph 1.12

22. If Personal Accounts are not suitable for everybody then this does not necessarily mean that individuals should not be auto-enrolled. But it does have important implications for what information is needed to help people make informed decisions about whether they should opt out.

Generic advice

23. Some of the factors that affect the suitability of Personal Accounts could be more problematic than others to incorporate into a system of information and generic advice. Clearly, nobody can predict with certainty all of their future life circumstances when making a savings decision.

24. Some factors may be relatively straightforward to reflect in a system of generic advice, such as current age, earnings and level of debt. Others may be more difficult, such as the affordability of contributions and likely future housing or marital status.

25. These findings suggest that:
   - People will need very clear information to help them make informed decisions about whether they should stay in or opt out of Personal Accounts.
   - Any system of generic advice will need to be able to cope with providing advice to a wide range of individuals with different characteristics and financial circumstances.

26. Factors that have an impact on the likely return that an individual may receive from a Personal Account (and hence their decision to stay in or opt out) include their:
   - Age
   - Current and projected future earnings
   - Whether they have taken, or plan to take, time off work
   - Level of employer contribution (if not self-employed)
   - Investment returns
   - Tax treatment
   - Level of other savings and wealth (eg home ownership) that they have accrued
   - Eligibility for any means-tested state benefits in the future

27. Other factors which don't directly affect the likely return from the Personal Account but may need to be considered by individuals in their decision about whether or not to opt-out include the affordability of their contributions, their level of indebtedness and their preference to spend rather than save.

Further analysis

28. The PPI is planning to conduct further analysis to consider the impact of possible policy options that might improve the incentives to save for some of the individuals in the high and medium risk groups identified.

29. Policy options that may be analysed include how increases to the trivial commutation and capital disregard limits may affect incentives to save in Personal Accounts.