

## Balancing Risk and Return: Encouraging Savings and Learning to Live with Financial Risk

*Barry O'Dwyer*

### Summary

- The article looks at how well the UK savings and investment regime services the different and generic needs of consumers, whether the various reforms under way right now will make things better, and what more needs to be done.
- Most consumers have very little long-term savings beyond property and their pension. Wealth in the former is merely a by-product of fulfilling the need for somewhere to live, and the latter from the never-to-be-repeated move to get their employers to shoulder their retirement costs through defined-benefit pension schemes.
- Pensions assets are fundamental to the investment sector, but unless it finds more cost-effective ways of encouraging more saving, regrettably the sector cannot economically serve a large proportion of the population. With declining public trust and confidence, so too has the sector's tacit role of helping people to save: for the public to do what it knew was necessary but was tempted to avoid.
- Despite the lack of confidence and understanding of the investment market, there are parts of the current savings framework that work well. One example is the *use it or lose it* nature of the cash ISA regime, which plays a part in getting almost one in three of those eligible to save.
- Short of the less efficient option of getting people to save in Cash Pensions, the best approach is encouraging people to save in products that invest in real assets. But key to this is getting people to understand that investment risk is a necessary part of the deal. A marketing message such as *for every £1 saved in a safe cash ISA, another £10 should be saved in a risky product* might be needed.
- There will be some hurdles to this, but amassing capital to give some economic power through old age is in everyone's interests. The Coalition reforms are a step in the right direction, but tweaks are necessary, such as to the NEST regime. But more needs to be done by the private sector, including some simple and powerful messages to engage people as they did with ISAs might be the answer.

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**CII Introduction: it may be one challenge getting consumers to save safely and sustainably, but helping them to understand and more importantly live with the concept of financial risk is especially challenging given the setbacks in recent years in the financial markets. In this latest in our series of Thinkpieces on pension saving and financial capability, Barry O'Dwyer from the Prudential gives his personal view of some of these challenges. Whereas in a previous article, Nick Hurman looked at the prevalence of property,<sup>1</sup> and the last article Liz Coyle looked at the importance of educating consumers on financial risk, Barry looks at understanding why risk is a difficult concept and suggests some solutions.**

Faced by an ageing population, the UK's public policy on pensions and encouraging savings has also started to mature. Policymakers are contemplating and, more importantly, *implementing* measures that even ten years ago would have seemed fanciful.

Perhaps the trick was to understand how much of the necessary changes could be implemented without younger generations feeling the pinch immediately. In very recent times, the pace of change needed to rein in government spending has made this more difficult – increases in the state pension age and the proposed changes to public sector pension schemes have attracted a lot of attention.

The government clearly has an interest in seeing the private sector shouldering more retirement costs and part of the public policy response has been a series of reforms aiming to promote more long-term saving. In this *Thinkpiece*, I want to look at how well our savings and investment regime serves the different generic needs of consumers; whether the various reforms underway at the moment will make things significantly better; and ask what more we might do.

### The prevalence of property wealth

When the marketing brains of our industry talk about consumer segmentation, they are almost always talking about segmenting within the wealthiest 10% of the population. This is because the depressing truth is that most consumers have very little long-term savings beyond their workplace pension. The ONS Wealth and Assets Survey shows how little wealth is held by UK households outside of their pension and home.

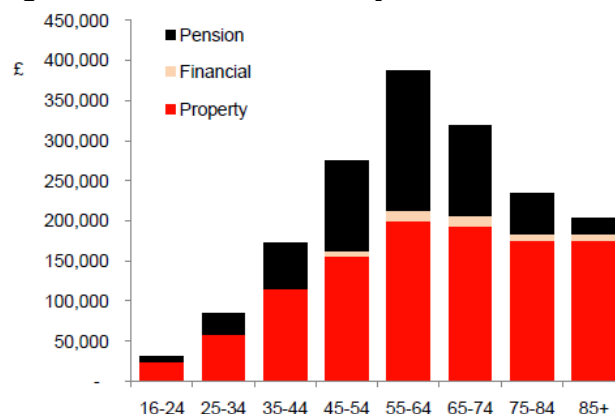
***In a deft move destined never to be repeated, many managed to get someone else (their employer) to shoulder the vast majority of the cost of generous defined-benefit pensions.***

Housing wealth is obviously very important. People need somewhere to live and many enjoy considerable wealth that is merely the by-product of fulfilling that need. In most cases, we know that this was not a

<sup>1</sup> See the list of previous Thinkpieces at the end of this article.

deliberate retirement strategy, not least because there is still considerable resistance to the idea that this asset should be monetised to pay for needs in retirement including long-term care.

**Figure 1: Household Assets by Class**



Source: ONS Wealth & Assets Survey

We also know that for many people, pension wealth has been built up in a relatively painless way. In a deft move destined never to be repeated, many baby boomers managed to get someone else (their employer) to shoulder the vast majority of the cost of what have turned out to be relatively generous defined-benefit pensions.

***We should treat property wealth with caution. If any generation invested in any scarce and necessary asset with a long-term buy-and-hold strategy valuations would increase almost relentlessly.***

So, as a country, we are fortunate to have £8 trillion of household wealth, about three-quarters of which is owned by people over 45 years of age. But let's not lose sight of the fact that this has largely happened because:

- a whole generation of people invested in an asset class (UK residential property) that has performed well for reasons linked to demographic changes; and
- many of the same generation got lucky and found someone who was prepared to underwrite their longevity and long-term investment risk.

We're in a good starting position but we should treat property wealth with caution. I would contend that if any generation invested in any scarce and necessary asset with a long-term buy-and-hold strategy, valuations in that market would increase almost relentlessly. If the next generation has more people than the last, it is almost inevitable. In fact, valuations will only start to fall over a sustained period if the number of sellers increases markedly. So, whilst decrying the reluctance of people to monetise their property wealth earlier, I am also acutely aware that much of the property wealth is very dependent on the fact that many people refuse to monetise it until death.

## Encouraging savings

Three-quarters of people in the UK have less than £16,000 in financial wealth, a fact that is profoundly important when considering what the financial services industry can and can't do. It shows how fundamental pension assets are to the sector, and naturally therefore where much of our efforts are concentrated. And it illustrates that unless we find more cost-effective ways of encouraging more saving, regrettably the savings industry really can't economically serve a large proportion of the population. I say regrettably not to curry favour with policymakers, who naturally have a focus on how to help this population, but because I genuinely think it is an unfortunate position we have got ourselves into. There are some things about the door-to-door direct sales-force days that we wouldn't want back, but it is lamentable that progress in cleaning up the industry's act has come at the cost of what was a really valuable function in society – making sure people did what deep down they knew they should, but were all too tempted to avoid.

The importance of this – encouraging people to do what they should – is brought out by the table below. For most of the population financial services is plain boring but something they know is important and therefore it gets put off until another day. It cannot be dismissed because it's important, but can't be tackled either because it's difficult.

***It strikes me that one of the reasons that we have built up £8 trillion of wealth was because the people who built this wealth had absolutely no idea of the risks they were taking.***

The statistic that stands out is that 43% of people who hold equity-based products think they have a zero capacity for risk. It suggests that any mechanisms designed to compensate and address low level of financial capability through, for example, the provision of financial education have their work cut out for them.

### Figure 2: Consumer Perceptions of Asset Risk

Level of risk the respondent is willing to take when investing by current holdings of risk investment products

Asset Class	Risk Level			Don't Know
	None	Low-Med	Higher	
Equity ISA	20	74	6	1
PEP	16	77	7	1
Unit trust, investment trust, OEIC	16	77	7	0
Investment bond	24	72	4	0
Stocks & shares	24	71	6	0
Endowment policy	30	66	3	1
<b>All</b>	<b>43</b>	<b>53</b>	<b>3</b>	<b>1</b>

Source: FSA Financial Capability Baseline Survey, 2007

It might sound a bit mischievous or even cynical to suggest this, but it strikes me that one of the reasons that we have built up £8 trillion of wealth was because

the people who built this wealth had absolutely no idea of the risks they were taking. I am certain that this is true of pensions wealth because as soon as employers understood the risks they were taking with defined benefit schemes, the vast majority closed their schemes as quickly as they could.

***The ISA regime has a lot going for it. The “use it or lose it” nature of the allowance is an effective call to action which dominates the personal finance media for the ISA session.***

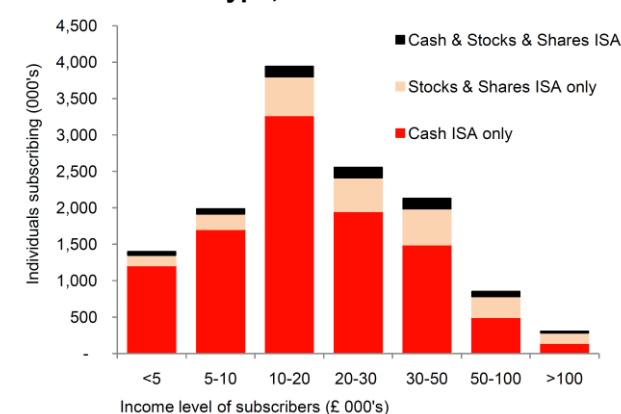
And if you cast your mind back to the last widely-held mass-market equity-based product, it was the With Profits savings endowment. Up until the invention of mortgage endowments, the humble With-Profits savings endowment may have delivered successfully for generations of savers, partly because it got people to invest in equities without necessarily understanding all of the risks. The reason that this sounds alien and unacceptable now is part of the reason this kind of widespread ownership of equity-based products will be difficult or impossible to replicate.

### But people can save if they want to

But it's not all doom and gloom. There are parts of the current framework regime that work very well. One such part is the Individual Savings Account (ISA) regime. This regime has a lot going for it. Its *use it or lose it* nature of the allowance is an effective call to action which dominates the personal finance media for the ISA season. It undoubtedly helps that the Cash ISA proposition is a no-brainer for anyone who is going to save anyway.

No surprise then that total take-up is impressive. Each year about 14 million people subscribe to an ISA, almost one in three of those eligible. And Cash ISAs in particular have been extraordinarily successful, accounting for about 10.5 million of that total, including with younger age groups and low to moderate earners as Figures 3 and 4 show.

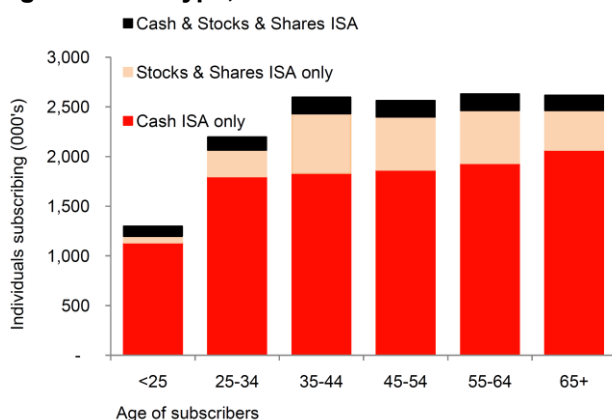
### Figure 3: Individuals Subscribing to ISAs by Income and ISA type, 2007–2008



Source: HMRC

***We can't force people to love taking risk, but we can convince them that they need to take it from time to time.***

**Figure 4: Individuals Subscribing to ISAs by Age and ISA Type, 2007–2008**



Source: HMRC

The fact that the vast majority of ISAs are cash ISAs is an issue, however. It seems to me that we face a choice:

#### **Choice A: 'The Cash Pension'**

We can design and market products like Cash ISAs that invest in safe assets that people understand. We could extend this thinking to pensions and have a Cash Pension.

But we must accept that this would be a radical departure from the way previous generations saved for the long term. Improvements in longevity have already made funding for retirement an expensive business. Asking savers to fund it with deposit products will make it hugely more so.

***The question is how we educate consumers not only to understand the risks they are running but crucially to accept risk as being a necessary part of the deal.***

#### **Choice B: Offer Real Investment Products**

We can continue to design and market products that invest in real assets. This is undoubtedly the most efficient way to fund for retirement but we need to accept that there are many people for whom these products could work very well but the system currently conspires to ensure only the wealthy (or very determined) have access to them.

I think most of us want to make Choice B work better and for more people. The question is how we educate the average consumer not only to understand the risks they are running but crucially to accept risk as being a necessary part of the deal. We can't force people to love taking risk but we can convince them that they need to take risk.

I wonder whether it might be possible to market a message that said something like *for every £1 saved in a safe cash ISA, save £10 in a risky product* (or whatever the appropriate ratio would be). We would then need to be explicit that everything except cash deposits is a risky product. What we need is to get a lot of people to understand first and foremost that they are taking risk. We then need to portray the idea that risky investment as a positive part of an individual's financial plan: taking risk is the way you will have a chance of affording the retirement you want.

Not all risk can be portrayed positively though. Even if we get customers to a point where they understand that investing in a pension will involve taking investment risk, the problem is that it also involves taking political risk and it is often the political risk that makes negative headlines for pensions.

#### **The importance of retirement saving**

Asking people to lock their money up for 30 or 40 years and to trust future politicians not to change the rules is a difficult sell. Saving for retirement doesn't come naturally. In fact, saving for retirement is a deeply *unnatural* thing to do. First of all, the concept of a long retirement is an entirely modern phenomenon. But even in the era when retirement occurred very shortly before death, saving for this period was unusual and the more traditional approach was to have children and hope that at least one of them looked after you in your old age.

***The government should reward handsomely those citizens who voluntarily defer their consumption in order to be able to pay their taxes in old age rather than rely on state hand-outs.***

It is, however, in everyone's interests that people amass capital that gives them some economic power in old age. Thus saving in a pension ought to be the most highly incentivised form of saving: the state should reward handsomely those citizens who voluntarily defer their consumption in order to be able to pay their taxes in old age rather than rely on safety net hand-outs. The fact that some respected industry commentators query whether it might be better for some customer segments to save for retirement via a product that wasn't designed for that purpose means that we haven't got the balance right.

Pension savers also need stable and predictable treatment from the legislature. The recent reforms by the Coalition are a much better direction in which to head than the planned reforms of the previous Government. That said, the justification for both sets of reforms arose out of a feeling that the tax treatment of pensions was too generous and should be 'on the table' in an age of austerity. This worries me and makes it very much harder to convince consumers to take the political risk that governments won't renege on the pensions tax deal.

## The current pension reforms

I'd like now to turn to some of the reforms underway to try and address the issue of under-saving among mass market consumers.

The first is compulsory auto-enrolment and the National Employment Savings Trust (NEST). I am supportive of these reforms: they are grounded in a realistic view of consumer behaviour and should help to start closing the savings gap.

Most of the concerns expressed about NEST and compulsory auto-enrolment fall into three categories:

- in relation to the impact on workplace pensions, the risk that employers level down to the baseline 3% contribution;
- the related point employees will regard the 8% total contribution as an acceptable target, enough to provide a good pension; and
- means-testing raises suitability concerns for low earners.

There is something in each of these concerns, though they are a bit overdone. We would be doing well even if we manage to get people saving 8%, most of whom weren't saving before. And we'll have an opportunity to persuade people to increase contributions over time.

My concern, in fact, is more that the structure of contributions itself, far from providing too little for those who stay in, will encourage a large number of members to opt-out as their 4% contribution is simply too much to forego from their take-home pay, even at the price of losing the matching contribution. We need to be realistic about the priorities of those on modest incomes and those aged under 40.

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***The NEST contribution structure could be tweaked so that the 3% employer contribution is paid to employees whether they opt in or out.***

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One way to resolve this would be to tweak the NEST contribution structure so that the 3% employer contribution is paid for employees whether they opt in or out. This would mean everyone was building up a pension at some level from day one. It would also simplify the system because there would be no working out who was in and who wasn't. It may not be

popular at this stage to be suggesting what could be regarded as a payroll tax but the only additional cost over the current proposal would be in respect of employees who opted out, which I am assuming everyone is hoping will be a small number in any event.

Of course the basic 3% level is nowhere near enough to provide a good retirement income, and it is there that the private sector could find a role encouraging people to contribute on top of the basic level

So to conclude, we need simple powerful messages to engage people and should learn from where they've been successful such as with ISAs where the tax deadline, the media and the industry all point in one direction and consumers respond to it.

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***We need simple powerful messages to engage people, as with ISAs, where the tax deadline, the media and the industry all point in one direction and the consumers respond to it.***

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We need to simplify our communications about risk so that consumers understand that taking risk is positive and necessary to meet their retirement goals.

We need consensus and stability around incentives to save, particularly in relation to pensions. There should be no ambiguity – voluntarily locking your savings away for your old age ought to be the most tax-effective way to save for retirement.

Our industry should embrace NEST. It is in everyone's interests to get the whole nation saving for retirement. And we should think carefully about how we could make it totally universal.

**This is an edited version of a presentation given at The Investment Network on 15 April 2011.**

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Managing post-conviction personal finances is the core to preventing resurgence into crime. Chris Bath of reformed offenders charity UNLOCK returns to our Thinkpiece series and shows that every stage in the criminal justice process contains personal finance elements that can potentially lurch people back into crime when they get out. He identifies specific steps that should be done by both the Government and the industry to stop this, thereby strengthening the pathways to rehabilitation and resettlement.

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The landscape for retirement is changing. The UK Government is in the process of implementing a number of reforms to pensions to try to incentivise long term savings. Changes are also afoot at the EU level and, on 1 March the European Court of Justice banned underwriting by gender. Trenner considers the potential impacts of this ruling on the UK annuities market and the consumer within the context of the other reforms that are taking place.

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The distribution of financial products has undergone significant changes in recent times as firms have begun to utilise new technologies to reach consumers. Lucian Camp notes the progress made by what he calls the "D-I-Y driven distribution revolution" but controversially asserts that financial planning is still failing to engage the mass market. Ultimately, he argues, the industry needs a Bill Gates like visionary.

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No 44: [A Passage to India: Towards Robust Economic Growth?](#) by Donald Hepburn, Associate Fellow in International Economics, Chatham House, [International series, no.11](#) (29 September)

Published in the backdrop of the Commonwealth Games, it unpicks some of the underlying economic trends with India's developing economy. The paper begins by identifying the reasons for India's relative success during the financial crisis, before outlining the future prospects for growth and the infrastructural and political barriers to prosperity.

No.43: [Time for collective action? Redressing the damaging effects of cartels on small businesses](#) by Ingrid Gubbay and Antony Maton, Hausfeld & Co LLP (10 September)

This paper, by the authors examine some of the harmful effects of cartels on small businesses and discusses reasons why firms remain reluctant to claim for damages. The paper then moves on to highlight the affordable options open to SMEs for redress, and the opportunities for insurance firms to become the underwriters of collective action.

No.42: [Speedy Recovery or Lingering Crisis in the Gulf Economies?](#) by Vanessa Rossi and William Jackson, Chatham House, [International Series no.10](#) (30 July)

Over a year after covering this region in an [earlier thinkpiece](#), the author returns to examine how the Gulf economies have fared especially following the Dubai property crisis last autumn. Despite the setback, Chatham House's forecasts nevertheless show much promise for significant growth in insurance and financial services over the next 5 to 10 years.

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