



# thinkpiece

Promoting debate and fresh thinking in the financial services industry

## Personal capability: the alternative to nationalising risk

*Elizabeth Truss and Professor Nick Bosanquet*

### Summary

- The global financial crisis has exposed the UK's level of risk and the fact that much risk has effectively been transferred to a local and personal level.
- Although personal risk is relatively low compared to the past, climate change and terrorism have increased global risk while increased life expectancy impacts lifestyle risk. People are exposed much more directly than ever before to financial risk.
- Despite this, the public's attitudes towards financial risk, and its ability to assess it, has become eroded as the government has sought to shroud consumers from risk through higher levels of financial regulation.
- There is a danger that this has made people less financially capable and more dependent on the state.
- There is an opportunity for the industry to develop and help people build the capability and receive the information that they need to properly manage the risks they face. The development of the internet provides an ideal and easily exploitable method for the industry to provide this information to consumers.

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# REFORM

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***CII Introduction: a consumer's ability to understand, assess and form a personal attitude towards financial risk is a key component in building confidence in choosing and using financial products. From choosing what pension funds to invest in to deciding whether or not to take out protection insurance or even whether to take advantage of that high-interest offshore cash savings account, households face almost daily critical decisions on financial risk in a way previous generations never had to consider. In this latest CII thinkpiece, Elizabeth Truss and Nick Bosanquet from the think tank Reform take a timely look at factors shaping the public's ability to take financial risk decisions, and in so doing argue that the very government regulation that is supposed to protect consumers might actually be quietly harming their ability to assess risk.***

The global financial crisis has exposed our level of risk and our fear of it. The whole purpose of the financial derivatives market was to spread risk, but it has become evident that this risk was simply being shifted to those who understood it less. This has led to the erosion of any sense of responsibility as knowledge and a sense of ownership were reduced each time the assets were transferred. The transaction created a sense that somebody up there must have known what they were doing. Instead of individual judgement there was a hierarchy of acceptance.

The cataclysm in the global financial markets is reflected by a shift in attitude to risk at a local and personal level. A safer and wealthier personal world has led to a desire to eliminate all risk and to pass it into the hands of the authorities. Risk is perceived mainly as a threat rather than an opportunity.

In this paper we argue that risk creates a vital incentive. We argue that further regulation will actually damage people's ability to assimilate risk and is in danger of creating incapable and dependent people. We argue that individuals need to gain confidence and capability in managing risk in order to take full advantage of opportunities and avoid the greater threats that are posed by global change.

## **The changing nature of risk**

In this paper we examine different types of risk and how their levels have changed over the past decades. The four areas of risk relevant here are:

- Personal risk in the local environment;
- Risk from global trends such as global warming or terrorism;
- Risk arising from changes in life expectancy; and

- Risks to financial institutions for variable return poor performance or ultimate collapse

### **Personal risk is low**

Personal risks in the local environment have fallen greatly in the last six decades. Road travel is much safer.<sup>1</sup> The risks from fire, domestic or industrial accidents are much lower.<sup>2</sup> Britain has a particularly strong record in reducing these personal risks through preventive action such as the wearing of seatbelts or the installation of smoke alarms.

### **Global risks are increasing**

Global trends are now seen as the main types of risk facing individuals. Yet these risks from global warming and global terrorism are infinitesimal for any one person even as they are seen as vitally important for the collective. Media coverage of collective risks is intense and may well act to block out more personal perceptions of risk. The idea of risk as a kind of doom that the individual can do nothing about has grown strongly.

### **Greater life expectancy has increased lifestyle risk**

The gains from longer life expectancy are obvious; less often cited are the risks (see chart next page). The risks of early mortality have fallen but economic and health risks have increased. The main economic risk is that of inadequate income in retirement and the main health risk is that of greater disability which also requires income support for carers. Public sector pensions improve security for the minority but their costs may lead to a weakening of pension schemes in other areas.

There is a clear disconnect between the reality of income needs over the much longer term and the actual provisions made by individuals. In surveys many individuals agree that they have made inadequate provision for retirement yet they continue to do little about it.

### **Financial risk**

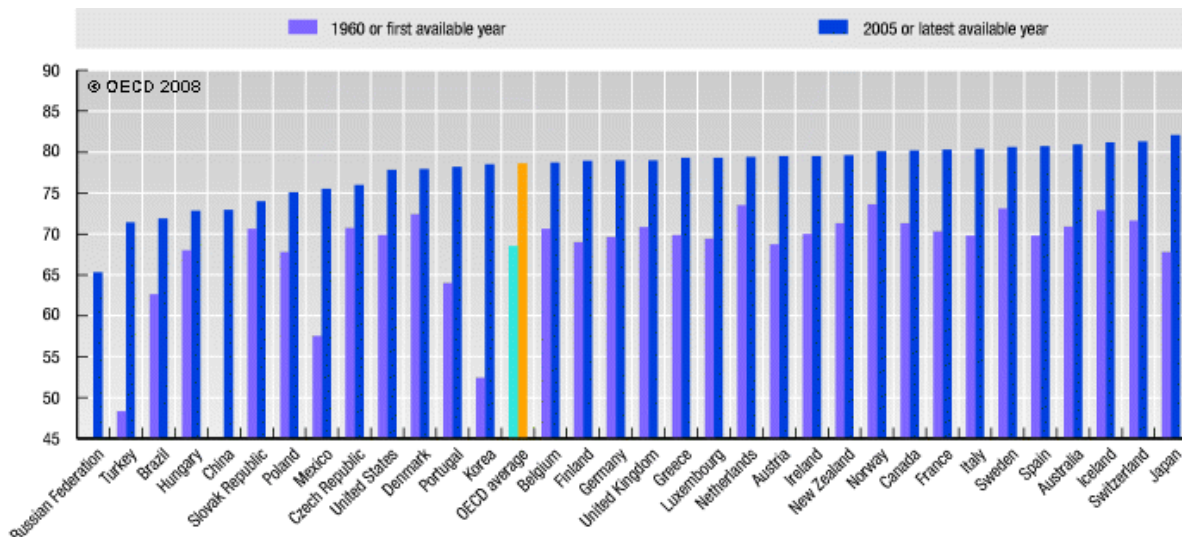
Globalisation and a hierarchy of information have conspired to create a diffusion of responsibility. This may be partly the result of perceptions the fourth

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<sup>1</sup> Department for Transport (2008), Road Casualties Great Britain: 2007 Annual Report. In 1930 with 2 million vehicles there were 7,305 fatalities and in 2007 with 34 million vehicles, there were 2,946 fatalities.

<sup>2</sup> Hansard (2008), Col. 474, 4 July: industrial accidents in the work place have plummeted, the number of fatal injuries to employees fell by 73 per cent, the rate of fatal injury fell by 76 per cent and the number of reported non-fatal injuries fell by 70 per cent; Department for Communities and Local Government (2008), *Fire Statistics Monitor*, 21 November: there were 450 fire deaths from 2006-07, the lowest figure since before 1950.

Life expectancy increase (Organisation for Economic Co-operation and Development, 2008)



type of risk: those affecting the returns from financial institutions. The low take up of stakeholder pensions has been a surprise but it should not have been given the continuing publicity about the falling returns to annuities, and the closure of final salary pension schemes. The lack of indexation of tax brackets has meant that an increasing number of more affluent pensioners will pay higher rate tax even allowing for the higher level of allowance. Thus the developments of the last ten years may well have created much greater pessimism about the rewards to longer term saving. The single exception has been the ISA which is simple, owned by the individual and tax free.

### The nationalisation of risk

Due to the changing nature of risk, calls for government intervention have grown and with it the desire on the part of authorities to protect people from risk. However, attempts to eliminate risk are a fool's game. Regulatory authorities and government have to be careful that in protecting people from one risk they are not inadvertently exposing them to other, even more serious risks.

### The "risk free" culture

The search for a risk free culture has created a false sense of personal security. The governmental and business culture has encouraged risk taking, particularly in personal finance. Over the past 10 years we have seen a huge increase in debt and an apparent belief in "consequence free" increases in wealth and lifestyle. Total household debt outstanding has more than doubled in real terms over the past decade to £1.5 trillion – more than UK GDP<sup>3</sup> and more than three times the level of 12 years ago.<sup>3</sup>

<sup>3</sup> Bassett, D. et al. (2008), *The hole we are in and how to get out of it, Reform*.

### The nationalisation of risk

The converse of this appears to be a "nationalising" of risk and a cracking down on risky behaviour from a high level. Two examples are the recent steps to limit the risk reward structures in the finance industry, and the move by the US government to nationalise "poor quality debt". It may be that some of these moves are necessary in the short term.

### The alternative approach: individuals gain capability to manage risk

However, this is the wrong approach for the long term. Instead, individuals need to understand the risk present in their products and dealings so that they can develop effective strategies for managing risk.

In the UK where levels of wealth and information are growing, we might expect that people have the capability to deal with these increased risks. However there are two key points that need to be addressed to make this happen:

- There is a vast "capability gap" in being able to understand and deal with these risks across the population and the professions.
- The information required to manage risk is not necessarily available to the individual.

The financial services industry has a critical role to play in addressing these points. In some cases this has hitherto been lacking, for example in providing full information on risk. There is an opportunity for the industry to develop and help people build the capability and receive the information that they need to properly manage the risks they face. The development of the internet provides an ideal and easily exploitable method for the industry to provide this information to consumers.

## The politics of risk

In 2005, immediately after winning his third General Election, Tony Blair sought to change the terms of the political debate on risk. In a set piece speech, he tried to explain why politicians were losing the battle against regulation. The public over-estimated levels of risk; regulators wanted to increase their own influence; politicians gave the false impression that life could be certain and predictable. As a result, policy makers were under pressure “to act to eliminate risk in a way that is out of all proportion to the potential damage”.<sup>4</sup>

His call for a new national debate on risk fell on deaf ears, perhaps because he did not follow through the logic of his own arguments. He argued for greater deregulation in the business sector, both in the UK and in Europe. But he said that the government should continue to bear the risk for welfare services.<sup>5</sup> It is difficult to argue for greater personal responsibility in one part of the economy but government responsibility in the rest.

A similar speech made now would be more successful. Risk-sharing policy in public services has radically changed. Tuition fees are accepted across the political spectrum, and the cap on fees will probably rise in next year’s government review. The Turner commission on pensions accepted that government alone can no longer provide an adequate income in retirement. Most importantly, the Department of Health has announced that individuals can contribute their own funds to NHS treatment.

There are various reasons for this radical change. The public finances will not allow governments to increase public spending much above inflation in the foreseeable future. A more informed and more prosperous electorate can take on greater

responsibility. Regardless of the current slowdown, fifteen years of steady economic growth combined with a revolution in information technology have transformed the potential of UK economy and society.

Hindsight is a wonderful thing. Tony Blair could not have known that social networking via the Internet would provide a powerful form of self-regulation. The ability of consumers to rate each other publicly has enabled the creation of new business models, such as eBay. It might represent the beginning of a new national debate about risk for which the former Prime Minister called.

The debate on choice in public services – which began at the start of this decade – hinted at a new balance between government and individual. Greater prosperity and connectivity have accelerated the process. The next generation of politicians will find it easier than Tony Blair to redraw the debate on risk; they can hope that greater individual capability will help both economic recovery and social progress.

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<sup>4</sup> Blair, T. (2005), Speech to the Institute of Public Policy Research, 26 May (<http://www.number10.gov.uk/Page7562>).

<sup>5</sup> Ibid. “The pooling of such risks is still the fundamental basis of our case for publicly funded public services.”

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