Financial Capability Strategy for the UK

Preparing for later life

Summary

Whilst a large number of working age adults make ends meet day-to-day, very few people plan and prepare adequately for a financially secure retirement; this puts them at risk of financial detriment in later life.[a]

The transition into retirement can be a complex journey, with several stages, and some irreversible decisions. People aged 55 and over face big decisions about how to use their savings and assets to provide an income in later life. To make these decisions, people have to consider a number of factors that will influence their financial needs in later life. These will include when and how they want to retire, what income and standard of living they aspire to, how long they might live, and potentially declining health.

The retirement landscape is currently adjusting to the most significant set of reforms in a generation. Automatic enrolment, guaranteed guidance, and single tier pensions should contribute significantly to delivering better outcomes and increased financial security in later life. Alongside these reforms, more can be done to improve individual financial capability, so people can prepare more actively and adequately for later life. That is the focus of the recommendations in this Strategy.

The Strategy's overall aim in this area is to improve people's financial capability, so that everyone reaching retirement is at least able to make ends meet, and more achieve higher levels of financial resilience and security.

a. Income adequacy can be defined in a number of ways. When referring to the proportion of people who are on track for adequate incomes in retirement, the 'replacement rate' model is used. This assumes that people will need a proportion of their working age income in later life, and the proportion scales with income level.

This is your opportunity to shape the Financial Capability Strategy for the UK's approach to helping people prepare for later life:

Consultation question 9: How far do you support the Strategy's aim in respect of preparing for later life?

Consultation Question 10: What is your view of the recommendations for action relating to preparing for later life? How could they be improved?

See the complete list of consultation questions for the Financial Capability Strategy for the UK at **fincap.org.uk**

The recommendations for action are to

- Build on the success of automatic enrolment through:
  - Advice organisations, Government and product providers undertaking co-ordinated research about the most effective ways to **overcome attitudinal and motivational barriers** to long term planning and saving and committing to act on the results.
  - Increasing take-up of financial capability support that focuses on **budgeting and general money management skills** to enable and encourage people to save more for later life.
  - Joint action with the broader pensions industry to develop messaging to **support and then supplement the 'we're all in' campaign for automatic enrolment** from 2018.
- Build on landscape changes announced in the Budget 2014:
  - In relation to retirement income products and services, product providers will need to **develop their proposition to meet evolving customer needs**.
  - **Support people approaching and transitioning into retirement** so that they can make informed financial choices about their later life, including through the Guidance Guarantee.

Context

Financial capability is not just about managing well today – it is about planning and being prepared for the future. Planning and preparing for later life is complex and demanding; often it competes with more immediate financial priorities and pressures. As a result, very few people plan sufficiently far ahead, or provide adequately for the financially secure retirement that they want. On top of these challenges, the retirement landscape is currently in transition, with industry and advice providers adapting to comprehensive reforms to state and private pensions.

There is a major opportunity with the roll-out of automatic enrolment. Once complete, there are expected to be between six and nine million people newly participating or saving more into a workplace pensions.[1] Reforms announced in the Budget 2014 will create more freedom and choice for people nearing retirement about how they use their pension savings.[2]

However, despite these wide-ranging reforms, there are still financial capability challenges for individuals. An estimated 12.2 million people will face inadequate incomes in retirement.[3] New research by the Government suggests that 92% of these people would only need to make small changes to their current savings behaviours, to ensure they are on track for a financially secure future.[4] Greater freedom and choice at retirement will mean that individuals will need support to make key decisions, both through the Guidance Guarantee and different sources of advice, throughout their transition into retirement and after.

The challenge is to help people balance immediate financial pressures associated with managing day to day during their working life - such as paying off debt, moving to a new home or starting a family - with the need to prepare for retirement.

Against this backdrop, the Strategy's aim in this area is to:

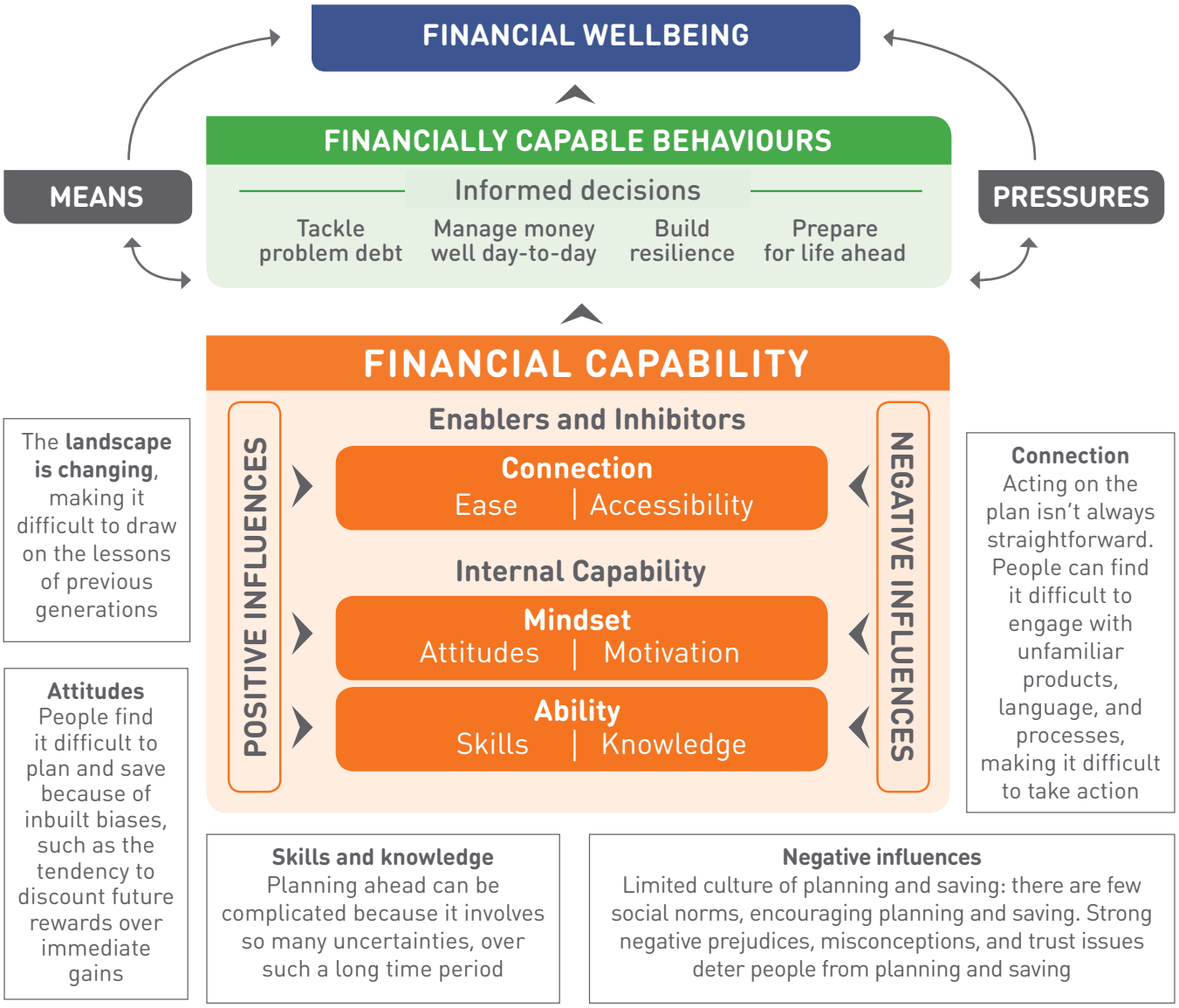
- support people to make adequate plans and prepare for their later life
- maximise people's financial wellbeing in later life by supporting them to make key financial decisions in the run up to retirement

Key facts

- There are around 30 million working age people in the UK.
- It is estimated that 12.2 million will face inadequate incomes in retirement.

Financial capability: insights and analysis

A range of factors influence an individual's ability to plan and save for later life. The Financial Capability Framework diagram (below) can be used to highlight a number of the common barriers.



Key insight 1: People do not have the right mindset to plan and save

Even where people have the requisite skills and knowledge, attitudinal and motivational biases prevent people from taking action. Behavioural economists have identified a number of different internal obstacles to action, including:

- **Inertia:** people tend to take the path of least resistance; rather than engaging with a complex problem and making big financial decisions, it is easier to do nothing.
- **Short-termism:** people tend to discount the value of future gains, preferring immediate rewards. This difficulty of deferring gratification means people will often choose to allocate money more to current priorities, rather than longer-term needs.
- **Optimism:** people tend to assume that they will be fine in the future, and that something will come along to help them – an inheritance, or windfall – making them less likely to plan and save to mitigate negative consequences.[5]

"The future is not relevant - it is today that I have to think about"

Male, late-20s, no pension

"Regarding pensions, it's hard to save for one. I was told I'd have to save £260 a month for about 30 years, but it's too much ... so hopefully I'll win the lottery"

Male, late 30s, no pension[6]
Source: DWP 2012

Key insight 2: Planning ahead can be complicated because it involves so many uncertainties over such a long time period

Effective planning for later life has to take account of short- and medium- term financial priorities and offset those against future needs. When planning over decades, there are huge uncertainties. Even people approaching retirement have to plan for the next 20 years or more, factoring in issues such as changes to health and the possible need for long-term care.[b]

> **"I'm worried about care. Friends of mine have gone through that recently and the prices have gone through the roof - it's unbelievable. To be honest, I've not thought how I would deal with it if it happened to me. I haven't thought that far ahead"**
>
> Male, aged 56 – 65
> Source: Ignition House, 2014[7]

Few people think about or understand the financial realities of later life, such as how much income they might need, and how much they need to save to achieve this. Nearly two-thirds (64%) of people paying into a pension said they had little or only a vague idea of what income they would need in retirement, rising to 87% amongst people who were not saving into a pension.[8] This lack of basic knowledge makes it difficult to make realistic plans for later life and set savings goals.

> **"I don't understand my pension at all. I got a statement in, and I just looked at it and then I put it away. Then I went into work and they were all like, 'we've lost money on it', and I was like, 'have we?!' I don't know - it comes out of my wages every month, and hopefully I'll get something at the end of it."**
>
> Female, 30, Glasgow
> Source: Money Advice Service, 2014[9]

b. Financial Resilience in Later Life, Age UK 2014, which refers to the U-shaped spending curve in retirement, i.e. spending more during early, active years of retirement, lessening spending during mid-retirement, then an increase in spending in late retirement alongside increased medical and care expenses.

Key insight 3: There is a limited culture of planning and saving

Social norms are an important driver of behaviour. People learn to do many things by following the examples of others, and are encouraged to continue these behaviours when they feel they are approved by others.[10] Automatic enrolment will help to build a culture of saving, making it normal for people to set aside a proportion of their income to prepare for later life. Encouragingly, three-fifths of workers now see themselves as mainly responsible for preparing for and financing their retirements.[11]

However, as a society we are still at a very early stage in this process, and planning and saving for retirement are not yet social norms in the UK. Looking at what makes people feel more satisfied with their financial situations, there is evidence that saving for retirement does not achieve this. By comparison, being able to pay bills on time has a huge impact on satisfaction, and having a small 'rainy day' savings pot makes a positive difference to the way people feel. Yet, in the longer term, almost all pensioners who have saved even a little for later life say that it makes a difference to their quality of life.[12] Without this wider culture, it is difficult to create the feelings of affirmation and reward which incentivise people to plan and prepare for the future.

Case study: Planning for Later Life (Age UK)

"When my husband took his private pension out, he was told we would get a pension of £100 a week but when he retired we were shocked to be told that after taking out a lump sum to pay for a new roof and boiler, we'd only be getting £65 a month because we hadn't increased our original monthly payments.... This was nearly 8 years ago when we didn't really know how pension pots worked. Now we have more information, we're left feeling rather foolish, especially as the payments have dropped to £49 a month and my husband's asbestos health issues were never discussed."

Source: Financial Services Commission[14]

Key insight 4: Acting on a plan is not always easy, as people can find it difficult to engage with unfamiliar products, language and processes

There are challenges in the complexity or unfamiliarity of language, products, and processes which make it difficult for people to act on their plans. Automatic enrolment means that many people will start saving without having to understand their workplace pension in the same way they may have done before, or make an active choice. However, to consider whether to save more or how to consolidate savings, people need to engage with a topic that many will find unfamiliar. This may be felt even more acutely when people have to make choices about how to take their pension as retirement income.

Even financially knowledgeable and motivated people can struggle to understand the benefits and risks of different product choices and to make informed decisions about retirement saving. Prior to the changes announced in Budget 2014, the FCA estimated that customers lose out on around £115 – 230 million a year by not making the best choices about how to turn retirement savings into income.[13]

Key insight 5: The landscape is changing, making it difficult to draw on the lessons of previous generations.

Each generation will have a slightly different experience of retirement and later life. Changing macro-economic, legislative and social conditions mean that different age cohorts will face different challenges and will have different requirements for later life.[15] This makes it difficult to draw and build upon learning from previous generations, as the assumptions for one generation will often be different for the next.

Industry, government, advice providers, and individuals are all adjusting to recent changes to the pensions landscape and the long-term, cumulative impact of these changes won't be clear for some time. In designing and developing solutions to support people to prepare for later life, it is essential to align with current reforms so that interventions complement and build upon each other.

Recommendations for priorities and actions

Priorities and actions have been developed based on the insights from the Financial Capability Framework and the Preparing for Later Life Working Group.

- **Priorities**: what the strategy will focus on
- **Actions:** how these priorities can be delivered

The consultation period will be used to gather views and build consensus on the way forward. The next step will then be to work with partner organisations to develop detailed action plans ready for publication in the final strategy.

Priorities

We propose five key priority areas for the working age population. These form the core objectives of the proposed preparing for later life strategy.

Key insights	Priorities
1. People don't have the right mindset to plan and save, because of inbuilt biases.	1. **Tackle attitudinal and motivational barriers** to long-term planning and saving.
2. Planning ahead can be complicated because it involves so many uncertainties over such a long time period.	2. Supporting people to understand **why and how to plan and prepare** for a financially secure future.
3. There is a limited culture of planning and saving.	3. Make planning and preparing for later life a more normal, talked about, **part of people's lifelong money journey.**
4. Acting on a plan is not always straightforward, as people can find it difficult to engage with unfamiliar products, language and processes.	4. **Help people to take action** with advice, guidance, and support from existing messengers
5. The landscape is changing, making it difficult to draw on the lessons of previous generations.	5. Work together to **build on landscape changes**: > product providers need to develop new retirement propositions to meet new and changing needs > use the Guidance Guarantee to support people approaching and transitioning into retirement

A fundamental step to achieving these ambitions is to boost day- to-day financial capability, particularly for those who are making ends meet, constantly struggling, or unable to keep up. Existing financial capability interventions, targeted at more immediate money management, are an essential first step to help these people save appropriately for later life.

The following section sets out recommendations for action. The recommendations reference some existing programmes of work and interventions aimed at supporting more people as they plan and prepare for later life. A key conclusion of the preparing for later life working group was that new initiatives should build on these existing initiatives and programmes.

Recommendations for action

Delivering against these priorities will require action from a wide range of organisations. In some areas the necessary steps are clear, but in others we need to work together to identify and agree the way forward. Drawing upon a wide range of expertise, the Money Advice Service has taken the lead and developed a set of proposed actions to deliver the strategy.

Priority 1. Tackle attitudinal and motivational barriers to long-term planning and saving

A number of different approaches have been tried in the past to encourage people to engage with longer-term financial planning but with little success - apart from automatic enrolment. Automatic enrolment bypasses the mindset barriers, using inertia to help people save. For a large proportion of the population, however, minimum savings levels through automatic enrolment will not be sufficient to provide for a financially secure future. We recommend that work should be developed to build on automatic enrolment when it finishes rolling out in 2018. In particular, this should include:

- Advice organisations and product providers researching, testing and agreeing ways of **addressing attitudinal and motivational barriers** to long term planning and saving.
- Advice organisations and product providers researching and testing messages to **encourage people to save more**, whether that be in a workplace pension or in another savings vehicle.

Priority 2. Supporting people to understand why and how to plan and prepare for a financially secure future

Work is already underway to help people understand what they might need for a financially secure future. Simple language guidance has been developed and tested in an attempt to overcome some of the barriers created by complex, regulatory language. The move to a single-tier state pension will mean that more people can understand the provision to which they may be entitled, so they can make plans to build enough savings for a supplementary income. Free tools and impartial information is available to help bridge the skills and knowledge gaps which people have in this area.

But more needs to be done to boost individual capability. The recommended actions are:

- Regulators and product providers work together to **embed clear and consistent language** into wider communications with customers.
- The Money Advice Service **piloting new tools** for both working-age and near-retired people to:
  - support people saving outside of workplace pension schemes
  - help people understand likely longevity
- **Helping people understand their wider financial picture** and use this to inform their preparations for later life. In practice, this will mean helping people understand their likely state pension provision and their existing assets (including their workplace pension, additional small pots, savings, or property). This would help people understand what they are on track to receive and whether they need to make any changes to their current plans or preparations.

The FCA, Money Advice Service, Government, advisers and financial services providers would need to pilot and evaluate the effectiveness of this approach, measuring whether this presentation of information leads to a positive change in customer behaviours.

- Product providers, the FCA, the Pensions Regulator, advisers **work together to improve the ease and accessibility of information** presented to customers.

Priority 3. Make planning and preparing for later life a more normal, talked about, part of people's lifelong money journeys

Automatic enrolment is helping people become accustomed to longer-term saving. Over time, its introduction will hopefully support the development of a stronger culture of long-term planning and saving, so that planning and preparing for retirement are a more normal part of people's lifelong money journey, rather than something to put off or only consider in the approach to later life.

- **Build a more active culture of planning and saving:** support people to understand and proactively prepare for later life as part of their lifelong money journey. To do this, further work is needed to identify opportunities to mainstream consideration of retirement saving into key financial planning touch-points, for example when people are experiencing major life events and may be prompted to reassess their financial position and plans.
- Joint action with the broader pensions industry to develop messaging to **support and then supplement the 'we're all in' campaign for automatic enrolment** from 2018.

Priority 4. Help people to take action with advice, guidance, and support from existing messengers

The retirement savings and income landscapes involve unfamiliar products and potentially complex financial decisions with different risks and benefits. Individuals will need support to navigate these choices throughout their lives. The guidance guarantee meets some of this need, giving people near retirement support to understand their options. However, more can be done to help people throughout their working lives and during the transition into retirement, to ensure they are on track for a financially secure future:

- **Support people approaching and transitioning into retirement** so that they can make informed financial choices about their later life, including through the Guidance Guarantee.
- **Use the points and opportunities when people engage with their money** to prompt them to think more about later life and begin to save more. For example, employers and HMRC regularly communicate with people about their income, workplace pension savings, tax and benefits.
- Product providers, regulators, and advice organisations developing and **embedding clear and consistent messages across all channels**.

Priority 5. Cross sectoral work to build on landscape changes

To make the most of current reforms to the pensions landscape, there is an ongoing need to develop understanding of customer needs and responses, and to agree and implement consistent and effective approaches to helping people plan and prepare for later life. The recommended actions are to:

- In relation to retirement income products and services, product providers and other organisations will need to **develop their proposition to meet evolving customer needs**.
- Use the **Guidance Guarantee to support people approaching and transitioning into retirement**. The Money Advice Service and the Pensions Advisory Service will have key roles to play, alongside the other organisations involved in the delivery of the Guidance Guarantee.

The Preparing for Later Life Working Group

The Financial Capability Strategy for the UK has drawn on the expertise of a wide range of organisations. A working group of experts drawn from the private, public and charity sector developed the analysis and recommendations for this section of the strategy. Ted Hart, Head of Public Policy at Legal & General chaired the group, with the Money Advice Service providing the secretariat.

Represented on the group were:

- Association of British Insurers
- Age UK
- British Bankers' Association
- Building Societies Association
- Citizens Advice
- Consumer Finance Association
- Council of Mortgage Lenders
- Department for Work and Pensions
- HM Treasury
- Investment Management Association
- Money Advice Service
- National Association of Pension Funds
- National Employment Savings Trust
- The Pensions Advisory Service

The group met four times between March and July 2014 to assess the evidence base and help develop the analysis and recommendations for the Preparing for Later Life workstream.

Consultation questions:

Consultation question 9: How far do you support the Strategy's aim in respect of preparing for later life?

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1. Framework for the Analysis of Future Pension Incomes, Department for Work and Pensions 2013

2. Freedom and Choice in Pensions, HM Treasury 2014

3. Framework for the Analysis of Future Pension Incomes, Department for Work and Pensions, 2013

4. Scenario Analysis of Future Pension Incomes, DWP 2014

5. See, for example: Nudge, Improving Decisions about Health, Wealth, and Happiness, Cass and Sunstein 2008; Financial Capability: A Behavioural Economics Perspective, de Meza, Irlenbusch, Reyniers 2008

6. Money Lives, Money Advice Service 2014

7. Ignition House Research commissioned by AXA Life Invest, Friends Life, LV= and NEST conducted in May 2014

8. Attitudes towards Pensions: the 2012 Survey, DWP 2012

9. Money Lives, Money Advice Service 2014

10. Behavioural Economics: Seven Principles for policy-makers, New Economics Foundation 2005

11. Attitudes towards Pensions: the 2012 Survey, DWP 2012

12. Price of a comfortable retirement, NEST 2014

13. Freedom and Choice in Pensions, HM Treasury 2014

14. Financial Resilience in Later Life, Age UK Financial Services Commission 2014

15. The Economic Circumstances of Cohorts Born between the 1940s and the 1970s, IFS 2013

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