Institute and Faculty of Actuaries

# Building a robust understanding of the problem of fairness between the generations

IFoA response to Intergenerational Committee

16 December 2016

**About the Institute and Faculty of Actuaries**

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

Intergenerational Commission
Resolution Foundation
2 Queen Anne's Gate
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16 December 2016

Dear Intergenerational Commission

**IFoA response to The Intergenerational Commission's first call for evidence**

The Institute and Faculty of Actuaries (IFoA) welcomes the creation of the Intergenerational Commission. We congratulate the Commission on its report '*Stagnation Generation'* and the insight it gives into the tensions between generations due to differing living standards. We believe consideration of intergenerational fairness (IF) should be a standard feature of policymaking across all government departments. The impact of any policy development should be assessed across current generations and where appropriate for future generations.

In the UK, the number of people over the age of 85 is expected to double over the next 20 years. Whilst this is a success and should be celebrated, it is not without its challenges. Society must rise to this challenge to ensure that it can meet the needs of our ageing population, without unfairly disadvantaging younger generations. We support the Commission's focus on differences in living standards and hope that we can help the Commission to develop its evidence-base and when appropriate to recommend potential solutions, particularly on the topics of pensions and social care.

We note the Commission has specifically stated it is not intending to include climate change within the scope of its work. We ask the Commission to reconsider whether it will include climate change, as the effects of climate risk could lead to differences in 'material wellbeing' between generations. Failure to implement early remedial action could lead to larger, more costly and more disruptive remedies at a later date, imposing greater costs on future generations. In addition, failure by the financial system to fully account for climate risk could affect investment performance, including that of pensions. Therefore, in addition to research on pensions and social care we have included further information on climate change in our response.

Over 2017 we will publish a number of bulletins on IF. Our aim is to provide a platform for thought leadership on three separate policy areas where IF is of particular importance. We hope our work will be useful to the Commission and we would be delighted to share these bulletins with the Commission as they develop.

We would be pleased to meet with the Commission to discuss any of the points raised in this response. Should you wish to discuss any of the points raised in further detail please contact Rebecca Deegan, Policy Manager (rebecca.deegan@actuaries.org.uk / 0207 632 2125).

Yours sincerely,

Colin Wilson
**President, Institute and Faculty of Actuaries**

**Pensions and social care**

We support the Commission's inclusion of both pensions and social care in its scope. The overall cost to the taxpayer of age-related benefits for those aged over 65 is increasing. Whilst this is somewhat inevitable as we have an increasing proportion of the population over the age of 65, it is important that any increases in benefits to this age group do not result in a system that is unsustainable in the long-term. If the benefits for one generation are too generous it will have a detrimental impact on the welfare of future generations, because in a Pay As You Go system there will be a perception that they will have funded the benefits of earlier generations, but will not then receive those same benefits themselves.

It is important that changes in both life expectancy and healthy life expectancy are embedded into Government policy decisions as they can have a significant impact on the sustainability of government spending. Here we provide further analysis that illustrates the effects of:

- improvements in life expectancy has had for pensions; and
- the effects on social care if these are not matched with the same level of improvement in healthy life expectancy.

Data on life expectancy and healthy life expectancy are produced by the ONS, and used by the OBR in its analysis of government policy, meaning the necessary information for analysis and action is already available.

*Pensions*
It is important that State, occupational and private pensions are all considered in the context of IF.

- State Pension
  There are apparent inconsistencies across government policy in its consideration of IF regarding the State Pension. The new State Pension came into effect from April this year and one of its aims is to create a state pension system that is affordable and sustainable in the long-term so that it provides a foundation for saving for future generations.[1] In addition, the interim report of the independent review of the State Pension age that is currently underway states:

  *"The system has been regulated over time to ensure that each generation of workers can afford to support each generation of pensioners. Pressures like longer durations of entitlement because of increased Life Expectancy have been met in the past by reducing the value of the basic State Pension. This in turn led to an increase in the number of people who slipped into poverty, became entitled to means-tested benefits and were comparatively*

[1] Department for Work and Pensions (2013) *Impact Assessment: The single-tier pension: a simple foundation for saving*

*penalised financially for any private saving, eroding further the perceived rewards of private saving for retirement."*[2]

However, in isolation, the amount of the State Pension increasing through the triple-lock year on year appears to be at odds with the government's commitment to IF in setting the new State Pension and reviewing State Pension age. Many, including the Work and Pensions Select Committee, have identified the triple-lock as unaffordable. We support the Select Committee in urging the Government to review the triple-lock to ensure that the State Pension is affordable and sustainable in light of increasing life expectancy. If the level of the new State Pension has been set at an appropriate level relative to earnings, it should mean that the triple-lock is no longer needed and maintaining it would only mean that State Pension income increases relative to the earnings of the working age population.

We have completed a number of reports, and have a further report underway on State Pension age (Hammond, R. *et al.* (2015) *Sessional paper: Considerations on State Pension age in the UK*, IFoA (2016) Submission to State Pension Age Review and with a broader scope Armstrong, A. and van de Ven, J. (2016) *The impact of possible migration scenarios after Brexit on the State Pension system*). Again, should it be of assistance to the Commission we would welcome the opportunity to discuss these papers and our future research.

- Occupational and private pensions

There are a number of changes in the pensions environment that could affect IF. For example, the ongoing transition from defined benefit (DB) to defined contribution (DC) pensions, automatic enrolment, taxation of pensions and pension freedoms. Whilst automatic enrolment is reversing the decline in the number of people saving into a pension, contribution rates are significantly less generous for today's workforce who are enrolling into DC schemes, compared to the contributions being paid into DB schemes, many of which are now long-closed to new members. In 2015, the average total contribution rate for DB schemes was 21.2% of pensionable earnings (5.0% for members and 16.2% for employers) and the average total contribution rate for DC schemes was 4.0% of pensionable earnings (1.5% for members and 2.5% for employers).[3]

When considering the impact of pensions policy on IF, one area of focus is how we can help people to manage longevity risk. If people run out of money before they die, they will likely fall back on the state and this will have implications for the affordability of the welfare system. Based on your report we believe the Commission has a good understanding of the challenges and so we have not set out to repeat your analysis. We would like to draw your attention to a number of IFoA outputs that might be useful to the Commission as it develops your work in this area. If you have any comments or questions on any of these papers please do not hesitate to contact us.

  - Policy briefing: the challenge of longevity risk: making retirement income last a lifetime. This paper provides an overview of longevity risk in the UK, USA and Australia, considering the role of the State, private and occupational pension provision. We recommend five principles for managing longevity risk – adequacy, information, flexibility, equity and sustainability. In early 2017, we will be publishing a follow-up to this work looking at adequacy in further detail.

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[2] Cridland, J. (2016) *Interim report: Independent review of the State Pension age*
[3] ONS (2016) *Occupational Pension Schemes Survey, UK: 2015*

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- The IFoA's Taxation of Retirement Savings Working Party is currently undertaking research analysing both the macroeconomic implications and the affect for individuals of the existing tax regime, as well as proposed alternatives (including ISA-style pensions). As part of its analysis, the Working Party will consider IF. We expect to be able to share this analysis with the Commission in spring 2017.
- We are also in the process of producing a policy briefing on DB pensions and the potential responses needed to maintain an appropriate balance between current retirees and current employees. Again, we would envisage being able to share this with the Commission in spring 2017.

How pension funds invest is also a consideration for IF. For example, whether the investments are exposed to climate risk, whether the investments are contributing to economic growth, whether they will have a long-term benefit (e.g. infrastructure investment), or whether they are contributing to market behaviours that can have a damaging long-term effect on the economy. In April, we published a briefing on the need for greater investment in infrastructure. Infrastructure should be considered as an important long-term investment option for both the Government and the private sector (e.g. pension funds), in order to facilitate sustainability in areas such as energy, transport and housing. Although infrastructure projects help to generate economic growth, there is often a shortage of available capital to get them off the ground because that growth is only in the future. The World Economic Forum estimates that there is a need for $3.7tn of infrastructure investment annually, yet only $2.7tn is invested.[4] The UK has an investment gap and has had a flat investment share of GDP since the financial crisis in 2008. This means it is falling behind all other G7 members on built asset wealth per capita.[5]

This lack of investment is also of general concern to institutional investors in view of its impact on long term investment returns, productivity, growth and the sustainability of the UK economy. Inappropriate short-term management remuneration structures and a failure of governance is one aspect of investors' short-termism that needs consideration.

Encouraging a change in this mind-set, so that the rewards reaped by future generations are considered alongside short-term government spending / private sector investment performance, is an important step in ensuring that investment is used as a tool to improve IF. The inclusion of IF as a standard feature of policymaking and the impact of any policy development being assessed across current generations, and where appropriate future generations, could help to demonstrate the value of projects that will deliver rewards over the long-term. For further information, please see our policy briefing Infrastructure investment: mind the gap. Should the Commission decide to consider the investments of pension funds we would welcome the opportunity to discuss our briefing and recommendations.

*Social care*

Whilst life expectancy in the UK has been increasing at a relatively constant rate, trends in healthy life expectancy - how long a population might live without health needs - are much less consistent and the number of people with social care needs in later life is rising.[6] In our response to the House of Lords Committee inquiry into the sustainability of the NHS, we argued that social care funding must be a priority for creating a sustainable healthcare system for the future.[7] In order to achieve long-term sustainability of the NHS and ensure that the system is fair from an intergenerational perspective, those benefitting from longer lives and access to health and care services should contribute to the increased costs.

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[4] World Economic Forum (2013) *Strategic Infrastructure: Steps to prepare and accelerate public-private partnerships.* May 2013. Geneva World Economic Forum

[5] Arcadis (2015) *Global Built Asset Wealth index 2015: Which nations are building the strongest foundations for economic success*

[6] IFoA (2014) *Longevity Bulletin 04 – Longer life in better health?*

[7] IFoA (2016) *Response to House of Lords Inquiry – Long-term sustainability of the NHS*

An alarming number of older people do not have a plan in place to deal with the potential costs of social care should they develop chronic health conditions. In an IFoA survey carried out earlier this year, when asked if they had considered long-term care costs only 4% of the respondents had made plans and 30% had not thought about it at all.[8]

As the population ages, and more elderly people develop complex care needs, this lack of financial planning will ultimately see individuals fall back on the state, with their care funded by the working population.

Once the Commission begins to think about solutions to this, we have three member-led research papers that may be useful. This is another key policy priority for the IFoA, and therefore an area where we plan to complete further analysis over the next 12 to 18 months that we will be able to share with the Commission.

- Elliot, S. *et al.* (2014) *Long-term care: A review of global funding models.* This paper looks at alternative long-term care (LTC) funding models and options. It analyses six models used in other countries and their potential application to the UK. The paper provides a demographic overview for each of the six countries to illustrate the increasing global demand for LTC and the funding need to meet this growing demand. It examines the approaches each country has taken to address the funding issue with varying degrees of public/private co-operation and partnerships. The authors hope that the lessons learned from these other markets will assist the UK as we try to come to grips with our growing social care funding issue.
- Kenny, T. *et al.* (2014) *How pensions can meet consumer needs under the new social care regime.* This paper analyses the potential cost of care for self-funders should the care cap and increased means-testing thresholds come into force. It discusses the potential role of financial products in helping people to manage their care costs.
- Kenny, T. *et al.* (2015) *How financial products can work alongside the Care Act (2014) to help people pay for care.* This paper takes into account the pension freedom reforms and completes more in-depth analysis into whether the current and proposed means-testing frameworks incentivise or penalise savers.

**Climate Change**

Climate change is one of the biggest threats that the planet faces. The effects of climate change are already apparent with increased volatility in weather patterns and a higher frequency of extreme weather events. The Intergovernmental Panel on Climate Change (IPCC) has stated, with a very high level of confidence, that impacts from recent climate-related extremes such as heat waves, droughts and floods reveal significant vulnerability of some ecosystems and many human systems to current climate variability.[9] Without action, climate change is likely to become more disruptive in the first half of this century and to become destructive and potentially catastrophic in the second half.

The precise impacts of these changes are far from predictable. Climate change will occur over a long time horizon and with a high level of uncertainty about the exact nature and timing of its impacts.

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[8] IFoA (2016) *Survey report – Public attitudes to freedom and choice one year on*
[9] IPCC (2014) *Climate Change 2014: Synthesis Report. Contribution of Working Groups I, II and III to the Fifth Assessment Report of the Intergovernmental Panel on Climate Change* [Core Writing Team, R.K. Pachauri and L.A. Meyer (eds.)]. IPCC, Geneva, Switzerland, 151 pp.

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- Early action on global greenhouse gas emissions reductions will increase future options for policymakers and business and provides several “option benefits”. It postpones “climate milestones”, the dates at which any particular concentration of $CO_2$ is attained. It also allows more time for more effective adaptation to the future adverse impacts of climate change.

- Failure to implement early remedial action toward a given target or acceptable limit for $CO_2$ concentration could lead to the need for larger, more costly and more disruptive remedies at a later date, as well as earlier and more severe climate impacts. For example, capital stock may need to be replaced over a compressed timescale, perhaps before the end of its useful life. By taking action earlier, governments could avoid building additional carbon-intensive capital stock and increasing further the replacement costs.[10]

With the Paris Agreement in place following COP21 and the inclusion of climate change in the UN’s Sustainable Development Goals (SDG) there is growing global consensus that we need to take action on climate change now. We believe the Commission could play an important role in encouraging the UK Government to strive towards meeting both the Paris and the SDG targets for climate change. There is a role for government and regulators in:

- implementing effective levels of carbon pricing;
- encouraging transition towards a low carbon economy;
- supporting innovation in low carbon technologies;
- encouraging adaptation to the effects of climate change; and
- requiring climate-related financial disclosures by businesses and investors.

These measures would help the UK reduce its greenhouse gas emissions and assist with future resilience to the effects of climate change. However, implementing this will not be without challenge, and that is why we are asking the Commission to consider including this within its scope, as the most severe impacts of climate change will be felt beyond the traditional time horizons of political, regulatory and business cycles.

There are also other intergenerational environmental concerns which could have major implications such as pollution, agricultural sustainability and the preservation of biodiversity, which all have health, financial and quality of life dimensions.

In 2015, we published a policy briefing which covered these issues in detail ‘*Climate change: Managing risk and uncertainty*’. As resource and environment issues are also one of our key policy priorities, we will be doing more analysis on climate change, and other resource and environment issues. This will include the implications of resource and environment risks for pension funds. We would welcome the opportunity to share this work with the Commission to support its efforts should it include climate change within its scope.

[10] IFoA (2015) *Policy briefing – Climate change: Managing risk and uncertainty*