Oxera

Agenda

Advancing economics in business

Keeping customers: the importance of persistency for savings

Patterns in consumer saving habits suggest that, over the long term, persistency rates (or the proportion of customers who keep saving in a given product) are falling. While part of this can be explained by customer switching, there is evidence that a significant proportion is the result of lapsing. In 2012 the government plans to introduce a new form of pension, Personal Accounts, and a key assumption in pricing these will be their persistency rate. Dr Rebecca Driver, Director of Research and Chief Economist of the Association of British Insurers, considers the issues

Switching is an important part of an efficient market. The ease with which customers can switch, particularly for long-term contracts, is one of the key factors that drives competition. Switching rates vary dramatically across industries. For example, Oxera (2006) shows that the extent of switching ranges from 21% for electricity to 1.4% for personal banking.[1]

For many financial services products it can be difficult to measure how much switching occurs. For example, a customer may simply take out a new credit card, but not cancel the old one, even if it is no longer used. The same is true for savings products, where it can be difficult to distinguish the extent to which a customer has switched to another product or provider (leaving existing savings where they are) from when they have stopped saving altogether. As it is not possible to know when a customer has switched, in many cases measured switching rates are lower for financial services products than utilities, for example.

Trends in persistency

In recent years there has been concern about the number of consumers who fail to keep saving in pension and investment products. Although there has recently been a slight improvement in short-term persistency (or the proportion of consumers who keep saving in a given product), statistics show that persistency over longer time horizons has been falling. For example, figures published by the Financial Services Authority (FSA) show that, in 2002, 53% of personal pensions sold four years earlier through company representatives, and 51% of those sold through independent financial advisers (IFAs), were still active (ie, regular payments were still being made).[2] By 2005, the proportion of personal pensions still active four years after they had been sold had fallen to 45% for those sold through company representatives, and to 42% for those sold through IFAs.

Declining persistency levels are influenced by various factors, some of which are good for consumers. The introduction of increased product flexibility, such as ‘payment holidays’, the move towards flat-charging structures, and reductions in exit penalties on many products, mean that the return on switching (to cheaper or better-performing products) can be higher.

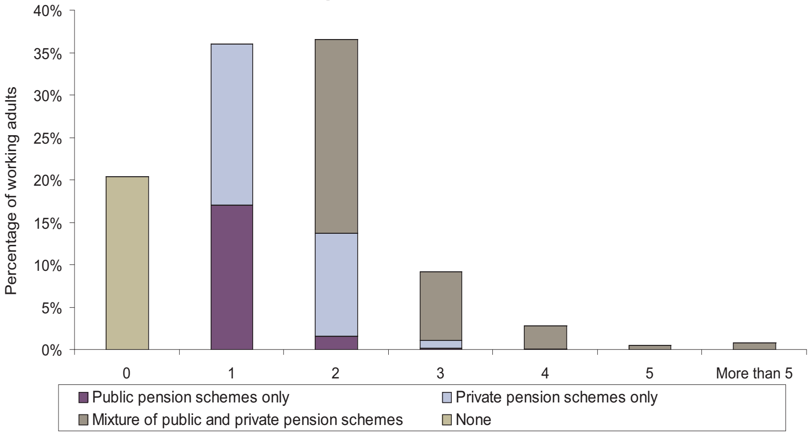
However, not all the reasons for lapses are positive ones, and they are often linked to worsening financial circumstances. When a customer decides to stop paying into a regular premium product, or to give up their single premium product, they can do so in two main ways: switching, when a customer moves their money to another savings product or provider; and surrenders, which occurs when a customer stops saving in the policy and withdraws the money, or leaves the policy paid up.[3] Research has found the following.[4]

– For regular premium policies, most lapses (around 90%) are people stopping saving (at least temporarily). The other 10% of lapses are people switching products.

– In a high proportion of cases (40% or more), income and affordability issues are the single most important reason for surrendering.

– Lower-income consumers, and those in lower social grades, are much more likely to surrender.

Figure 1 Distribution of number of schemes under which individuals have some accrued pension entitlement



Note: Sample = 3,158.
Source: ABI YouGov Survey 2007/08; Driver, R., Gunawardena, D. and Hillman, N. (2007), 'Retirement Savings in the UK: The State of the Nation's Savings 2007/2008', ABI Insurance Market Study No. 4.

– Unemployment significantly increases the probability of surrendering.

– Similarly, reduction in income, paying off debt and change in personal circumstances are key reasons why people stop saving completely.

For pensions in particular, labour mobility also has a significant impact on persistency, because of the importance of employer attitudes to pension savings. As workers move between jobs, whether they save for retirement will be heavily influenced by the existence or otherwise of an employer scheme. With each job move they are either likely to accrue entitlement under more than one pension scheme, or to stop saving if there is no employer provision. Figure 1 shows the number of different pension schemes that people have. There are more people with rights under two or more schemes, than have rights under only one scheme. Of those who have rights under more than one scheme, the majority have rights under a mixture of private and public sector schemes. Given the importance of employer contributions, if a new employer does not provide a pension scheme, individuals may choose to stop accruing pension rights, rather than take out a personal pension.

Labour mobility also helps to explain the difference between the 32% of working age adults who are not currently contributing to a pension, and the 17% who do not expect to have any pension income outside the state pension. Worryingly, a recent YouGov survey for the ABI shows that a significant fraction of these lapsers (over 35%) are over 55 years of age (see Figure 2).[5]

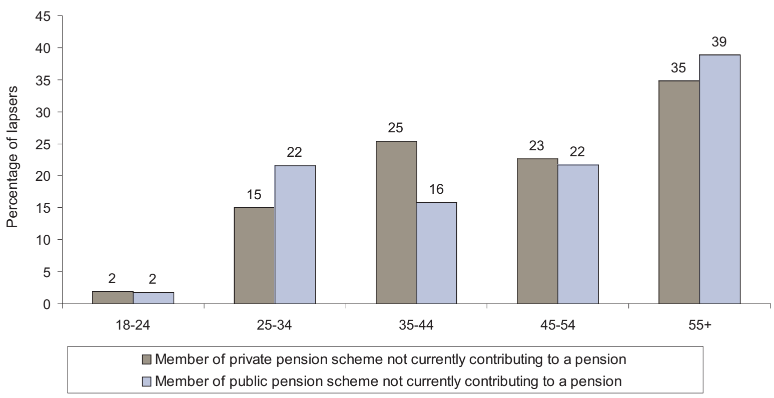
Lapsers are those who are entitled to some non-state pension, but who are not currently contributing to it, either personally or through their employer's benefits package. For those aged 55 and above, there is a significant risk that they may not have provided adequately for their retirement, and they are also unlikely to benefit from planned pension reform. One of the reasons for this under-provision may be that they have overestimated the generosity of state pension provision. It is noticeable that it is the older age group that is more likely to overestimate average state pensions, with one in four 50–70-year-olds expecting higher provision than is available. This group, which makes up around 7% of the working population, may risk having accrued insufficient pension rights when they enter retirement.

Personal Account pensions

The fact that a significant proportion of the generation of workers coming up to retirement will face inadequate pension provision is not the only issue linking the persistency of pension savings and public policy. In 2012, the UK government will introduce a new form of pension—Personal Accounts. Personal Accounts are primarily targeted at employees on median to low incomes, whose employers do not currently provide them with an adequate pension. The aim is to encourage more people to save for retirement, and part of the inducement to do so will be a mandatory employer contribution of 3% of banded earnings.[6]

Responsibility for the successful introduction of Personal Accounts rests with the Personal Accounts Delivery Authority. As with any long-term savings product, a key

Figure 2 Age profile of lapsers



Note: Base = 1,022 (all those not currently contributing to a pension).
Source: ABI YouGov Survey 2007/08; Driver, Gunawardena and Hillman (2007), op. cit.

element of its success will be the extent to which those who open a Personal Account keep saving—in other words, once started, how persistent the savings flows are. Large numbers of dormant Personal Accounts, containing small amounts of money, will be costly to administer and will push up the costs for the system as a whole.

In the impact assessment accompanying the 2007 Pension Bill, the government indicated that it anticipated that Personal Accounts would have persistency rates of 75%.[7] Given the target market, how realistic is this?

There are two parts to the answer to this question. The first is the extent to which the use of auto-enrolment helps, and the second is the extent to which the target market is likely to suffer from inherently worse persistency than the UK working population as a whole.

Auto-enrolment

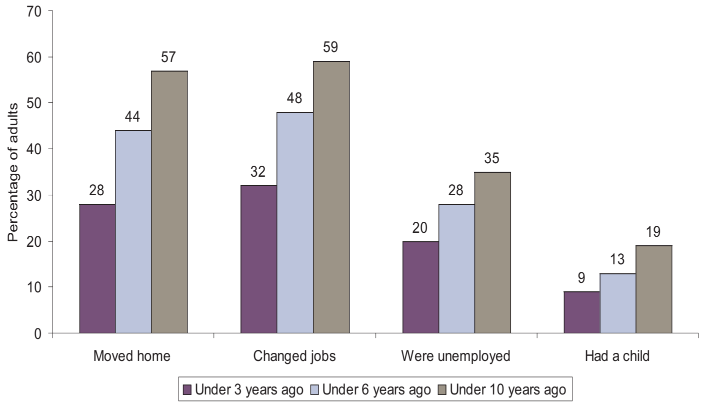
One of the key elements in the success of Personal Accounts rests on an insight from the behavioural economics literature—namely the importance of default options. In this case, the government is hoping to harness the power of auto-enrolment. When workers join firms they will be automatically signed up to the pension scheme and will need to make an active choice not to be part of the scheme. Evidence from the USA suggests that auto-enrolment is a powerful tool in increasing the proportion of workers who save within a pension. For example, Choi et al. (2006) documents the fact that auto-enrolment increases pension scheme participation for almost all demographic groups, but particularly among the young, low-paid, Blacks and Hispanics.[8] They also show that, although the proportion of workers who drop out after 12 months is higher under auto-enrolment, the increase is only 0.3 to 0.6 percentage points. However, this evidence is based on a case study approach, looking at four companies that actively chose to introduce auto-enrolment in order to increase scheme participation. With Personal Accounts, the degree of employer engagement and enthusiasm will not always be that high. The question is, therefore, will auto-enrolment by itself be enough?

Likelihood of shocks

The second important factor in driving persistency for Personal Accounts will be the extent to which the target market is more likely to be hit by adverse shocks and hence has to drop out. In October 2006, the ABI commissioned a YouGov survey to help understand the causes of switching and persistency. One of the questions asked was when was the last time various life events had occurred. The results show that, in the three years preceding the survey (2003–06), 32% had changed jobs, 20% had experienced unemployment, and 9% had had a child (see Figure 3). Life changes such as these can impact incomes and/or expenditures, and this may affect the ability and willingness to save.

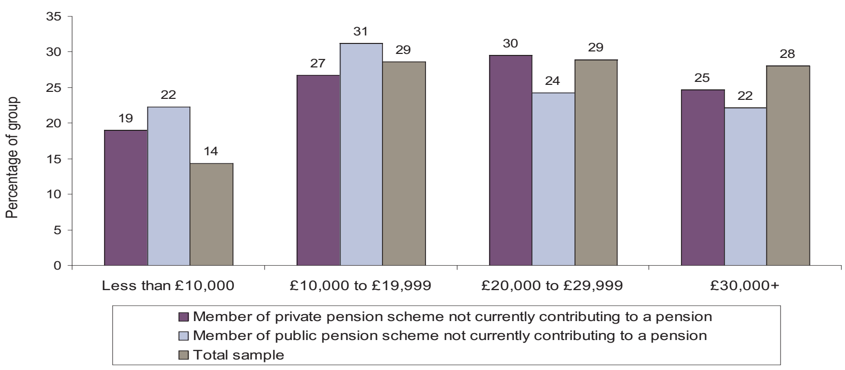
Those who are better off tend to face a more stable economic environment. For those on incomes of more than £30,000, only 6% had been unemployed in the past three years. In contrast, 25% of those earning less than £20,000 had been unemployed in the previous three years, rising to 29% for those earning less than £10,000. This is suggestive of the fact that the target population for Personal Accounts is likely to suffer from worse persistency rates than for the population as a whole because they are more likely to suffer shocks.

Figure 3 When was the last time you did any of the following?



Note: sample = 5,329.
Source: ABI YouGov Survey 2007/08; YouGov ABI Survey 2006. Peppes, A., O'Neill, D., Gunawardena, D. and Driver, R. (2007), 'Understanding Switching: A Consumer Survey Based Approach to Switching and Persistency for Pensions and Investments', ABI Insurance Market Study No. 2.

Figure 4 Earnings profile of lapsers



Note: sample = 835 (excludes those individuals who did not state their gross personal income).
Source: ABI YouGov Survey 2007/08; YouGov ABI Survey 2006; Driver, Gunawardena and Hillman (2007), op. cit.

These risks are reinforced by the results from Driver, Gunawardena and Hillman (2007). Looking at the earnings profile of lapsers, 19% of lapsers with rights under a private pension scheme, and 22% of those who have been part of a public pension scheme, have earnings of less than £10,000 (see Figure 4). These proportions are much higher than the 14% share of those earning less than £10,000 within the total sample, indicating that individuals in this group are more likely to become lapsers than would be the case for the rest of the population.

Persistency and Personal Accounts

For any long-term product, particularly within the financial services sector, the extent to which customers switch has an important impact on how it is priced. The assumption for persistency within Personal Accounts will therefore have an important impact on charges within the system. If persistency is below assumed levels, charges will need to rise in order to cover costs within the system.

Personal Accounts will therefore be an interesting case study in persistency. They will start with the advantages of auto-enrolment, but will need to overcome the disadvantages of disengaged employers and a target market with lower incomes than is the case for many existing pension schemes. Low-income savers are more likely to be subject to economic shocks and are more prone to dropping out. Both of these factors suggest that persistency within Personal Accounts is likely to be lower than for pensions as a whole. Although auto-enrolment will help, the incentives for employers differ from those in the USA, for example, meaning that the impact is likely to be reduced, although not eradicated. The key question is, therefore, how realistic is the assumption of 75% persistency for Personal Accounts?

Rebecca Driver

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[1] Oxera (2006), 'How to Evaluate Alternative Proposals for Personal Account Pensions', ABI Research Paper 1, October.
[2] FSA (2007), '2007 Survey of the Persistency of Life and Pension Policies', November.
[3] When a customer surrenders a regular premium policy, they can either withdraw the money or leave the policy 'paid up', where the money is left in the policy, but no further saving is made. One example of why a policy might be paid up would be for a pension, where legal restrictions mean that it is not possible to access the money until they retire. Therefore, a policyholder who did not want to continue to save in their existing pension, but also did not want to transfer the money to a new pension policy, would have to leave the money where it was.
[4] FSA (2000), 'Persisting: Why Customers Stop Paying into Policies', Consumer Research Paper 6; FSA (2004), 'Stopping Short: Why Do Consumers Stop Contributing to Long-term Savings Policies?', Occasional Paper 21; Smith, S. (2006), 'Persistency of Pension Contributions in the UK: Evidence from Aggregate and Micro Data', The Centre for Market and Public Organisation, University of Bristol, Working Paper 06/139.
[5] Driver, R. Gunawardena, D. and Hillman, N. (2007), 'Retirement Savings in the UK: The State of the Nation's Savings 2007/2008', ABI Insurance Market Study No. 4.
[6] Employer's contributions will be limited to 3% of earnings between £5,035 and £33,540. This range represents the Primary Threshold and Upper Earnings Limit, respectively, for National Insurance Contributions in the year 2006/07, and will be updated annually in line with average earnings.
[7] Department for Work and Pensions (2007), 'Pensions Bill: Impact Assessment', December 5th.
[8] Choi, J., Laibson, D., Madrian, B. and Metrick, A. (2006), 'Saving for Retirement on the Path of Least Resistance', in E. McCaffrey and J. Slemrod (eds), *Behavioural Public Finance: Towards a New Agenda*, Russell Sage Foundation.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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