Gateways – Routes to Financial Services

Edited by Mohibur Rahman

CONTENTS

Page

new policy institute

Acknowledgements

The New Policy Institute would like to thank the contributors to this report for all their generous help.

We would also like to thank all the participants at our initial seminar including the speakers: Adrian Boulding, Legal and General; Tania Burchardt, LSE; and George Yarrow, Regulatory Policy Institute.

Particular thanks are due to Dr Michael Taylor at the IMF, and to Mike Smith at Legal and General. We are particularly grateful to Legal and General for supporting this project.

Responsibility for content and any errors, of course, remains with the authors alone.

Published by the New Policy Institute

First published October 1999

New Policy Institute
109 Coppergate House
16 Brune Street
London E1 7NJ
www.npi.org.uk

Tel: 0171-721 8421
Fax: 0171-721 8422
Email: info@npi.org.uk

ISBN 1-902080-09-2

INTRODUCTION

Guy Palmer

What is a gateway organisation?

This pamphlet discusses the potential role of 'gateway organisations' in the provision of financial services and welfare. It sets out some of the theoretical arguments for such organisations, describes some practical examples, and identifies some of the issues in making such developments a practical success.

In this pamphlet, the term 'gateway organisations' or 'gateways' is used to describe intermediary organisations which operate on behalf of their members to help them obtain services from providers of financial and other services. Obvious examples are trade unions (e.g. with respect to pension provision for their members) and housing associations (e.g. with respect to household insurance for their tenants). Mutuality is an important aspect of this definition: in contrast to private sector intermediaries, such as independent financial advisors and supermarkets, the objectives of a gateway organisation simply reflect the interests of their members, rather than of others such as shareholders.

There is no single definition of the scope of the gateway's role. At its most limited, it liases with providers and consolidates large numbers of small accounts in a way that reduces administrative costs and maximises benefits. It might also take on a proactive role, advising its members of the need for pension provision, insurance, etc. And it might also take on and administrative role, for example organising the collection of payments. The paper by Barry Dixon and Adrian Boulding discusses such roles with respect to the specific example of the Printing Industry Pension Scheme. The paper by James McCormick discusses such roles with respect to household insurance for those in social housing.

More ambitiously, gateway organisations could potentially be the centres for access and delivery of a wide range of products and services. This is the subject of George Yarrow's paper, where he sets out the arguments for the emergence of 'Approved Welfare Providers' as the basis for fundamental welfare reform.

What are the arguments for gateways?

Nick Donovan's paper discusses some of the theoretical arguments. These can be divided into four broad headings:

1. To reduce risks and costs.
2. In reaction to greater discrimination by providers.
3. To ensure adequate provision for more vulnerable groups in society.
4. In reaction to the 'privatisation' of welfare provision.

Reducing risks and costs

As the number of financial products in the marketplace grows, choosing between them becomes more difficult, and consumers become more dependent on third party advice, for example from independent financial advisors. But, as the recent history of the pensions industry demonstrates, such an environment requires extensive, and expensive, regulation and, even then, risks remain. Perhaps more fundamentally, but certainly less explored, the combination of financial advisors and regulation results in an environment which relies heavily on the individual's initiative and judgement to ensure adequate provision.

One reaction to this situation is simplification and standardisation. This is one of the major themes of the government's approach, for example in the area of stakeholder pensions, and is a subject upon which the New Policy Institute has previously written.[1] But a recurring theme of all the papers is that sole reliance on such an approach stifles initiative by providers and results in products which are insufficiently tailored to individual circumstances. Gateways may offer an environment in which products can be more varied without risk and cost to the consumer becoming unacceptable.

[1] Guy Palmer (ed) *Quality Assurance or Benchmarking? Presenting Information About Pensions* (London: New Policy Institute, 1998).

In reaction to greater discrimination by providers

A clear trend in the insurance industry over recent years has been a growing divergence in premiums depending on the individual's circumstances, as technology allows providers to pinpoint risks ever more closely. If you live in one postcode, your household insurance may be orders of magnitude greater than if you live in another. As McCormick discusses, one consequence of such developments is that those most in need of insurance are the least likely to have it. This is clearly a matter of political concern, as it penalises the most vulnerable. Gateways can resist this trend by pooling risks across their membership, ensuring equal treatment for all members.

To ensure adequate provision for more vulnerable groups

Related to the above, private sector providers naturally focus on the less vulnerable and more affluent, actively competing for such business but with little or no interest in providing for more vulnerable groups. The demutualisation of financial services providers over the last few years cannot have helped this trend. Gateways offer a potential vehicle for governmental or other initiatives specifically aimed at the more vulnerable.

In reaction to the 'privatisation' of welfare provision

Whereas the three reasons discussed above all relate to trends in the marketplace, this final reason relates more to the governmental approach, both of this government and the last, to the provision of welfare provision. This is best demonstrated in the area of pensions, where provision of second pensions, organised by the individual and provided by the private sector, is a clear government policy. As Dixon and Boulding discuss, the government is asking the private sector to increase its sales of pension provision by 50%, whilst also wanting costs cut and risks minimised.

As Yarrow discusses, however, relying solely on commercial organisations to take on such challenges is problematic, with inevitable conflicts of interest between customers and shareholders. Instead, he proposes that they play a role in providing a range of sub-contracted services that lie within their area of expertise. The role of managing the contracts, and that of overseeing the new pension schemes generally, would fall on new types of intermediary organisations called Approved Welfare Providers.

What is required to make gateways a success?

This issues under this heading can be divided into two broad categories:

1. How to ensure takeup by the members of the Gateway?
2. How to ensure organisations set themselves up as Gateway organisations?

How to ensure takeup by the members of the Gateway?

This subject is discussed by Dixon and Boulding, and by McCormick. The first theme emerging is that of communication/promotion: awareness has to be raised throughout the membership and that promotion must be active. The communication must also not be distant and remote: local relationships with one-to-one, face-to-face communication are important, and site visits and roadshows have a role to play.

The second theme emerging is that of branding: the gateway organisation must have standing with its membership and the products must demonstrate value for money. Co-branding is an important aspect of this; for example, in the area of pensions, the employer must be fully on board and engaged in the process, with a close partnership between trade union and employer. Similarly, active involvement by the relevant services companies brings reassurance. Industry-wide schemes can provide further reassurance in the case of small employers.

The third theme relates to financial contributions by third parties, for example, employer contributions to conventional company pension schemes. These contributions are clearly an incentive for individuals to participate. The key question, as yet unanswered by the relatively small number of gateway developments thus far, is whether third party contributions are a prerequisite to the development of Gateways on a widespread scale.

How to ensure organisations set themselves up as Gateways

McCormick summarises some research by the Joseph Rowntree Foundation, which asked social housing providers why they did not offer a tenants' gateway scheme. The key finding was that most of the concerns were of a practical nature, rather than any opposition in principle. McCormick concludes that the financial services providers can and must address this concern.

Whilst the need for practical help and advice is clearly necessary, the question is also whether it is sufficient. There is a worrying analogy with the development of Credit Unions in the UK: there is no shortage of advocates for Credit Unions, the need is clear, and political profile and interest is high, but thus far they have simply not developed on the scale required to address the mainstream issues of financial exclusion. Furthermore, thus far they have had a natural tendency to gravitate towards the less vulnerable.[2]

More generally, the more pervasive and wide ranging developments envisaged by Yarrow will clearly not happen without active government leadership.

Conclusion

The aim of this pamphlet is to stimulate the debate about Gateway organisations, both theoretically and at the more practical level. As the various papers demonstrate, there are strong arguments for their development and clear examples of success. But individual successes do not make for widespread development with financial contribution and the role of government remaining the two key areas of concern.

[2] Nick Donovan and Guy Palmer *Meaningful Choices. The Policy Options for Financial Exclusion* (London: New Policy Institute, 1999).

THE GATEWAY ROUTE TO PENSION PROVISION

Adrian Boulding and Barry Dixon

New routes to pension provision

Hooray for medical science and dietary improvements - the two key drivers behind our rapidly increasing longevity. The increase is in fact spectacular: as the Actuarial Profession revealed earlier this year, we are now living five years longer than was the case only fifteen years ago. A man aged 35 today can expect to live to 85, and a woman a further three years beyond that. The only problem, if you want to call it a problem, is that this creates a lot of years of retirement to be paid for.

The Government's response to the increasing cost of pensions is clear. They will target help at those who need it most - workers on low incomes and those not in paid work through disability or through adopting a non-remunerative role such as caring for others. This is to be achieved by the Minimum Income Guarantee of £75 per week for a single pensioner and through the changes to the State Second Pension which boost benefit levels for low earners.

But for the population at large, the Government's response is more along the lines of 'over to you folks'. Indeed the Government has set a target to increase the ratio of private to public pensions from 40:60 as it stands at present, to 60:40 over 50 years, with intermediate targets on route.

This is effectively asking the private sector to increase sales by 50%, and the conventional response to such a demand in a free market economy would be to increase marketing expenditure accordingly. But herein lies an apparent paradox: not only does the Government want the pension industry to dramatically increase private pension provision, they also want the industry to cut costs. And to make sure that lower prices are passed through to consumers, the Government will regulate the charges that Stakeholder Pension schemes can make.

It is this challenge that makes Stakeholder Pensions such an interesting proposition, and is one of the main reasons why some people do not believe that they will work, at least not without compulsion. But perhaps the sceptics are still seeing pensions the way they have been for the last couple of decades, instead of seeing them differently. To that extent we agree with them - if privately funded pensions remain as complicated vehicles that have to be sold to individuals by visiting them in their homes one at a time, we will not meet the Government's targets for increased provision.

Changes in the pension industry

However, there are major changes afoot on both the demand and the supply side for pensions. On the demand side, there is a growing realisation, particularly amongst young people, that the State will not be able to provide them with an adequate pension in the future. Whilst this has dawned on some more than others, the promised Combined Benefit Statement will act as a wake up call for the laggards. It is proposed that every citizen will receive a single statement once a year, containing details of their state pension entitlement and all their private pensions, on one piece of paper. And to make their future crystal clear rather than crystal ball gazing, it will be expressed in current prices. The simple message will be "if you carry on as you are, then you are heading for a pension of £ xx per week; now compare that with your current income and think about whether it will be enough for you".

On the supply side, a new Stakeholder Pension is being proposed. Designed to be a simple product, it aims to reduce the confusion and complexities normally associated with pensions to an absolute minimum. Furthermore, in order to both to protect employees' money and to provide reassurance, the Stakeholder Pension will carry an imprimatur from the Government that it meets stringent minimum standards. To ensure access to all those who need it, the Stakeholder Pension will be available in every place of work in the United Kingdom, unless good pensions are already provided there.

Role of gateways in pension provision

In its Green Paper *Partnership in Pensions* issued in December 1998, the Government flagged up the importance of affinity group gateways in the development of Stakeholder Pension schemes.

It is anticipated that schemes offered via affinity groups will have many advantages for stakeholder delivery. There will be a large membership base to build on, an obvious source of member representatives for scheme governance, and (most importantly) a confidence and trust that should flow from collective membership.

Members, whether employers or employees, make a voluntary decision to subscribe to an affinity group, such as their trade associations, because they value the expertise supplied and identify with the aims of the associations. When affinity groups develop pension arrangements, they will need to fulfil a number of requirements. These include an adequate representation of the members, accountability of those responsible, and regular and clear lines of communication. If these requirements are implemented then the members' allegiance and trust should be enhanced and the affinity scheme should go from strength to strength.

The Printing Industry Pension Scheme (PIPS) is a good example of what can be achieved in an industry of approximately 350,000 employees. The trade union - the Graphical Paper and Media Union (GPMU) - and employer's federation - the British Printing Industries Federation (BPIF) - agreed that, as well as negotiating the annual industrial agreement, it made sense to develop a pension scheme suitable for all those workers not able to join a good occupational scheme. The two organisations appointed independent financial advisers and adopted a low cost and flexible Group Personal Pensions scheme that would be suitable for any employer/employee. The trade associations sponsor the scheme and promote it within the structure of both organisations, effectively acting as a gateway catalyst enabling their members to access a good value and secure arrangement. The scheme is overseen by a joint management committee which meets quarterly. Minutes of meetings are considered by the elected GPMU Executive Council which ensures complete transparency and accountability.

This raises the question of whether all affinity groups are appropriate vehicles for pension provision. One can easily see the suitability of trade groupings where members trust their chosen organisation, but it would not necessarily follow that groups like supermarkets and sports clubs would be suitable. Their affinity would simply be a badge which fronts a product, and would lack the necessary discipline and accountability.

As stated above, good communications are essential as a service to members and are part of the confidence building process necessary for affinity pension provision. The Printing Industry plan has a freephone helpline (which quickly resolves most queries), issues an annual newsletter and accompanies the annual statement with a personal visit to each company by the advisers. The GPMU has also appointed a scheme Consultant/Ombudsman to promote the scheme and help members with any problems. This ombudsman service is purely advisory and does not conflict with formal regulation.

It is easy to see how the PIPS gateway is viewed as user friendly and there is no reason why other groups could not construct a similar gateway scheme which their members can use. What the Government has done (to its credit) is focus on the importance of strength in numbers and responsible governance. This has been lacking in recent years when individuals have suffered by buying pensions with high charges and poor administration.

Clearly appropriate affinity gateways, set up as transparent structures that give credibility can, with the employers' help, effectively deliver Stakeholder Pensions for those in the target group. The Government has done well to grasp the nettle of discredited pension provision by attempting to put in place something that the members will be comfortable with and that will be good value, secure and properly looked after.

A pension management committee in practice

The Government's Green Paper rightly states that Stakeholder Pension schemes need to be run in the interests of members and be capable of acting on their behalf. It is suggested that an ideal basis would be a board of trustees, responsible for the governance of such schemes.

However, the Green Paper also raises the possibility of alternative governance and it is clearly possible for a management committee to fulfil the same role as a board of trustees. A convenient way of examining the suitability of this alternative structure is to look at the management committee of the PIPS scheme as this has been running for some years, which essentially simulates a board of trustees and watches over every aspect of the pension plan.

It comprises eight members (four from the GPMU and four from the BPIF). The committee meets quarterly, with the chair alternating between the two bodies. There is secretarial support and minutes are issued to the respective organisations. The GPMU members include a National Officer, GPMU Consultant and two elected members of the Executive Council. At its meetings, the committee co-opts representatives from the providers and the appointed independent pensions advisers. Thus it is possible to deal, without delay, with any matter arising as all parties are present. The committee is independent and closely monitors all aspects of the scheme, particularly the contribution schedules. The committee has specific terms of reference which define its responsibilities and functions.

The advisers play a crucial role as they provide expert advice on the promotion of the scheme, how to identify the best value plan and what can be done to refine and improve the scheme.

Whilst some affinities may prefer the trust form of governance, it is difficult to see how a board of trustees could oversee a scheme any better than an efficient management committee. As Stakeholder Pensions will be tightly regulated, with many Pensions Act provisions included in product design, alternative governance could be just as effective. It could be argued that the lack of a board of trustees, with legal sanctions for malpractice would weaken scheme governance. But given that the Occupational Pensions Regulatory Authority (the body responsible for overseeing occupational pensions) will closely monitor stakeholder supervision, and that volunteers will be needed to exercise governance in a range of new stakeholder plans, it would seem unnecessary to rule out good committee governance from the stakeholder registration criteria.

Strength through numbers - promoting a gateway pension scheme

Like any product, gateway pension schemes will have to be effectively promoted. Awareness needs to be raised throughout the target group so that all employers and employees can give proper consideration to the merits of their gateway scheme.

The actual promotion consists of many facets and will evolve with experience. With PIPS a main priority is to reach employers, as this will facilitate the favoured group installation using payroll deductions. The BPIF mailshots its members as well as arranging for PIPS to be promoted regionally. With Stakeholder Pensions effectively being accessed via the workplace, it will be important to reach all employers, during the year 2000, so that they can anticipate and prepare for stakeholder implementation. New technology has an increasingly important role to play and PIPS is launching an internet website so that employers can easily access full information.

With awareness being both a bottom-up as well as top-down process, every effort is made by the GPMU, through journals and circulars, to inform members about the availability of PIPS. The caveat is always stated that members should join a good occupational scheme (if available) as it is important that PIPS, like the future Stakeholder plans does not undermine good existing company schemes.

It is important that individual members are aware of PIPS so that they can raise the question with their employer. There will also be self employed members who might join, as well as individual members working in a company which chooses not to identify PIPS, who might wish to join on a direct debit basis.

The role of independent financial advice is vital as the scheme sponsors are anxious that all potential members receive proper information and guidance. Clearly, as with Stakeholder Pensions, the low cost regime will only allow for basic advice to be given, but along with the sponsors promotion and the Government's education campaign, employees can make an informed decision, as they do when joining a similar (basic advice) occupational scheme. When an individual has a complex background of former schemes, then time spent on detailed advice would trigger an appropriate fee, to be paid by either the employer or employee.

Co-branding: the attraction of gateway provision to consumers

Successful partnership gateways will want to utilise the brands of all providers whenever they display their wares to potential consumers. With the partners well chosen, the brands will complement each other, with the result that the whole will be stronger than the sum of the parts.

The trade union badge brings the member the knowledge and the reassurance that someone is looking after their interests. This will be an especially welcome development for the many who do not understand everything about often complex pension plans. Furthermore, in recent years, trade unions have been at the forefront of exposing and sorting out pensions mis-selling. This will give them an opportunity to be involved at the start before any selling takes place.

The employer's badge brings confirmation that the employer is fully on board and engaged in the process. This is vitally important as the employer is being trusted with collecting contributions from the payroll and passing information to and from.

Furthermore, belonging to an industry-wide scheme brings an added degree of reassurance in the case of small employers. Whilst the staff will respect the employer's detailed knowledge of his own line of business, they recognise that on pensions matters the employer may be something of a novice, but has the strength of the industry wide scheme behind him.

Financial services companies' brands will bring two things. First, they will bring a sense of security, giving conviction that the money is being well invested and long term confidence that the money will still be there in forty or so years time when the pension is being drawn.

The second important contribution from a financial services brand will be value for money. This is not a universal brand value in financial services, but it will be amongst the successful providers of Stakeholder Pensions - those that are able to survive in what is known in the industry as the '1% world' (whereby charges are limited to 1% per annum).

Just how important these collective brands are is illustrated in a recent survey conducted by Legal & General amongst members of the Musicians Union. Like many specialist trade unions, the Musicians Union was wondering whether Stakeholder Pensions was an area that their membership would welcome them getting involved with. The results (see the box below) showed a clear majority favouring a trade union based gateway provision of pensions - a preference which topped the list over various alternatives:

"If you were starting a pension plan, in which of the following ways would you be happy to arrange it"

Trade union	55%
Financial adviser	52%
Insurance company	32%
Employer	27%
Local authority	5%
Supermarket	2%
Sports/ leisure/ football club	0%
Don't know/ none of the above	5%

Source : Legal & General survey of Musicians Union members, June 1999

Conclusion

For Stakeholder Pensions to succeed, the issue of pension provision will have to be looked at afresh. One of the new ideas that has much to offer is gateway provision, with a triumvirate of trade union, employer and insurer pooling their strengths to offer secure, flexible and value for money pensions.

Of course there are concerns about getting involved in pension provision. Members are worried about whether they will be doing the right thing, and employers are worried by the Government's proposal that they will have to nominate a Stakeholder Pension scheme.

These concerns are precisely the reason why collective bodies such as trade unions and employer trade federations should be getting involved in gateway pension provision. Collectives are ideally suited to take time to examine various concerns and worries, to seek out independent financial advice where help is needed and to produce a package that will reassure members, offering them a safe route through to providing for retirement.

INTERMEDIATE INSURANCE: A GUIDE FOR THE GATEKEEPERS

James McCormick

Introduction: addressing financial exclusion

With the Treasury-led Policy Action Team on Access to Financial Services and the Scottish Executive's Action Team on Local Anti-Poverty initiatives both due to report by the end of 1999, the Government has at last signalled its desire to understand the nature of financial exclusion in a country with a highly competitive financial services market. More importantly, this work is focused on finding practical solutions. Parallel work on credit unions and access to small firm finance suggests a properly holistic response to financial exclusion can be achieved.

The analysis of financial exclusion has become more sophisticated in recent years. The traditionally polarised debate - between critics arguing for an end to the geographical discrimination of 'red-lining' in insurance cover and mortgage lending and an industry unwilling to concede the scale of exclusion - has been challenged by the evidence. Exclusion from financial services is neither a simple story of households being refused access, nor a straightforward process of self-exclusion from products that are widely available to all. The classic model of supply and demand is inadequate to explain patterns of use in banking, insurance and credit facilities.

The problem of financial exclusion has deepened rather than widened in recent years. Thus, fewer households are now without any financial products than in the past. Exclusion is not so much a reflection of outright refusal to provide as the relative lack of appropriate and flexible products, inaccurate information and conditions that mean having such products in areas of high-risk and low-income is not worthwhile.

There is little evidence of systematic exclusion North-American style because there is little need for the insurance industry to refuse cover outright. Exclusion occurs in other ways instead, through cost-reflective pricing and steeper 'entry' requirements (such as stricter home security standards). As one insurer stated in a recent study of the home insurance market *'there is no such thing as an uninsurable risk, only an unpayable premium'*[1]

If these problems are to be addressed in a sustainable manner, the agenda for change must focus both on product design, better tailored to the needs of financially less secure households, and on distribution channels, using intermediaries which are equipped to meet the needs of excluded and poorly served customers. In this paper, examples of home contents insurance in low-income communities are used to explore the role of social housing providers in designing secure routes to financial inclusion in partnership with the insurance industry. The paper concludes that there is significant scope to create new market opportunities without the need, yet, for tighter government regulation or provision of a 'last resort' product for poor households. Similar conclusions can be drawn for access to banking and credit facilities, although the precise balance between designing new products and working with alternative providers will differ.

Households without insurance

Despite increasing levels of insurance coverage in Britain, around five million households are still without insurance against the risks of burglary, fire and flood damage. Two-thirds of them rent from a local authority or housing association, and two-thirds are headed by someone who is not in paid work. They are unlikely to be targeted by the mainstream insurance providers for mail-shots, or to shop around by telephone to find the best quote for their circumstances.

Here is the paradox: although financial service markets in Britain are highly competitive, the bulk of competition is heavily geared towards lower-risk/higher-income households. Most insurers want to attract the already-insured, who are often prepared to shop around on price to get a better deal. There is much less interest in designing more appropriate products for the uninsured, it often being assumed that this end of the spectrum is too risky and would require cross-subsidies which are simply untenable in today's market place.

---

[1] Claire Whyley, James McCormick and Elaine Kempson *Paying for Peace of Mind: Access to Home Contents Insurance for Low-income Households* (London: PSI/IPPR, 1998). A summary of Findings is available free of charge from the Joseph Rowntree Foundation: www.jrf.org.uk.

This seemingly inexorable trend is being challenged by the growth of *intermediate insurance markets*, bringing home insurance within reach and within the budgets of many low-income tenants. Research findings from an eighteen-month study funded by the Joseph Rowntree Foundation (JRF)[2], highlighted the strategic role to be played by local authorities and housing associations in reducing financial exclusion. As gatekeepers positioned between private insurers and largely 'inert' markets of low-income consumers, they have greater powers to strike an affordable deal for tenants than many have realised in the past. Many have used these powers to deliver comprehensive 'new for old' policies at a lower cost than many of their tenants could otherwise access.

Types of intermediate insurance schemes

The most common intermediate model is 'Insure with Rent', where tenants pay for their insurance cover along with their rent. These schemes offer the option of paying premiums in cash on a weekly basis, thus allowing unbanked households to gain access to affordable cover which mainstream policies generally do not. Just under half of all local authorities in the study offered an Insure with Rent scheme. Since those councils with the largest stock are more likely to offer an insurance scheme, around 60 per cent of council tenants across Britain have access to an 'Insure with Rent' policy. One in seven of them are actually insured in this way, rising to one in three in some of the longer-established and most actively-managed schemes.

The second arrangement is the 'Arms Length' approach, where the housing provider negotiates a branded policy for their tenants, but where the tenants are then unable to pay for their insurance with the rent. Payment by cheque through the post or over the counter at post offices are the main alternatives. While a much smaller proportion of housing associations than councils offered any kind of tenants' insurance (around one in five), half of these schemes were of the 'Arms Length' variety. Around one in ten of these households have actually insured through the association.

A fledgling intermediate insurance system is therefore available, using social housing providers as the key 'gateway' institutions. But it has not yet managed to reach all of those uninsured households who would like to be covered. This is a timely reminder, also relevant to the wider welfare reform debate, that it is not enough to design products and distribution routes which are better tailored to the

[2] Whyley *et al*, 1998

needs of excluded households. An active promotion strategy is also required. What practical steps should government and the insurance industry take in order to nurture a more effective intermediate sector?

What more can be done?

More Insure with Rent schemes are needed to close the remaining gaps in geographical coverage. As part of the JRF study, social housing providers were asked why they did not offer a tenants' scheme. The striking finding was that most of the concerns expressed by landlords were of a *practical* nature rather than reflecting any opposition to being involved in principle. Instead there was understandable concern about the potential costs, liabilities and administrative effort falling upon the landlord in the early years of establishing a scheme, and in the event of it being less than successful.

Most of these concerns can now be addressed by the leading insurers and brokers in this part of the market. Following the unfortunate experience of a number of failed schemes in the 1980s (run by one 'niche' company which has since withdrawn from the market), a small number of mainstream insurers have built up considerable expertise in managing Insure with Rent schemes, even in low income/high risk urban communities which might otherwise be priced out of the market. They have developed IT systems which are compatible with different rent accounting systems and housing providers collecting premiums are able to earn commission which should pay for a dedicated post to manage the scheme, in return for which the insurer deals with all claims.

There is no longer any reason why any council or housing association should be left to pick up the tab if tenants run into arrears. Packages should be available which suit the needs of even the rural council with a small stock or a relatively new housing association.

These insurers have recognised the bargaining power of landlords as the gatekeepers to large numbers of potential customers which their competitors have largely failed to serve.

The JRF study suggested - contrary to first impressions - that there is considerable scope for growing viable insurance schemes even in the least likely parts of Britain. At the time of the fieldwork, one quarter of councils and one in seven associations without a scheme were actively considering how to establish one or were about to establish one. These partnerships between social housing providers and mainstream insurers should be pursued further before tighter regulation of the insurance industry, or new responsibilities upon housing providers, need to be considered. There is, however, one exception concerning the flow of accurate information: there should be a binding duty on *all* public and private landlords to explain in plain language that tenants are not automatically insured by paying the rent, with further information about insurance options for council and housing association tenants if a scheme does exist.

Providing choice

The goal is not necessarily to persuade all housing providers to establish their own branded insurance scheme. It is more important that all tenants have access to affordable and appropriate insurance options. Whereas local authority tenants have to rely upon their council to run a scheme if they wish to combine insurance with the rent, the same is not always true for housing association tenants. For example, the Scottish Federation of Housing Associations (SFHA) runs a block scheme which tenants of any association may join on an ‘Arms Length’ basis. While many Scottish associations do run their own scheme, tenants of other associations are still able to benefit from the deal negotiated by SFHA. They do not need to rely on their own association. In the North-West of England, a number of associations reported that they already steer their tenants towards ‘the very competitive scheme run by the local authority.’ Although only a handful of councils open their schemes to other tenants at present, this blurring of the boundaries ought to become more common in the future.

The recipe for success

The most successful insurance schemes have a number of features in common. Perhaps the most important aims are to achieve a threshold level of take-up and a healthy ratio between premium income and claims made over the course of the ‘insurance cycle.’ The proportion of tenants insured through their landlord is strongly related to how long the scheme has been established, but it is also related to the type of scheme. Where the housing provider plays an active role in collecting premiums - the Insure with Rent model - the take-up rate tends to be higher.

Where housing associations are reluctant to collect premiums along with the rent, the most common option is to pay in cash each week over the counter at post offices. Those tenants who prefer or need to pay this way (including those with no choice because they have no bank account) end up paying more than council tenants because of the additional transaction charge. Tenants of housing associations operating the Arms Length model may end up being charged 30 per cent to 80 per cent more for the same policy if they pay at post offices.

There are strong grounds for the Post Office network to play an enhanced role in future as a gateway to various financial services. Its geographical reach remains more extensive than the branch banking infrastructure, it is a trusted and familiar point of access for excluded households (as well as the population as whole), and it already serves as a distribution point for banking and insurance products written by mainstream providers[3]. However, while the use of the Post Office makes insurance policies more *accessible* to low-income households, the cost advantage resulting from block purchase deals with insurance companies may be significantly diminished. These policies would also be more *affordable* if a greater proportion of housing associations chose the Insure with Rent model. The issue of transaction charges on basic insurance policies and money transmission bank accounts delivered through post offices must be addressed, not least if the proposed shift to electronic delivery of all social security benefits is not to disadvantage low-income households.

Another challenge is to improve the viability of intermediate schemes by cutting the need to make a claim in the first place. While there are fewer conditions attached than on policies available through the mainstream market - minimum home security standards are typically not required - there is no long-term advantage in insuring homes which are poorly secured. One-third of households in social groups D and E have no window locks, over half are without properly secured doors and only one in ten have a burglar alarm.

Some local authorities invest the money that they earn on their insurance account to improve the physical security or energy efficiency of the stock. But much more needs to be done. A share of the revenues generated by Insurance Premium Tax (IPT) could be ear-marked for a Neighbourhood Risk Reduction Fund, targeting new resources on upgrading the least secure homes in areas of continuing housing demand. This would help cut the risk of burglary and increase the long-term insurability of high-risk neighbourhoods. At the very least, Insure with Rent policies should be exempt from IPT. The New Deal for Communities provides an ideal testing ground for such ideas.

---

[3] Nick Donovan and Guy Palmer *Meaningful Choices. The Policy Options for Financial Exclusion* (London: New Policy Institute, 1999).

Conclusion

There has been a marked growth of intermediate insurance markets in recent years. Some of the most competitive insurance companies in Britain now consider this end of the market to offer sustainable business opportunities: the returns are lower than those earned from pursuing higher-income customers, but intermediate markets are profitable nonetheless if policies are sold on a high-volume basis through established gateway partners. In some cases, customer loyalty may also be greater.

Social housing providers now have more choice over what kind of package to offer their tenants. Compared with a decade ago, improvements in risk management and the stronger commitment of housing departments has resulted in schemes being much less prone to failure. Housing associations in particular could do more to establish insurance schemes, signpost their tenants towards successful council-run schemes, or collaborate with each other in setting up city-wide/regional pools.

Most of the practical barriers can be addressed. If they are, the result should be more low-income tenants gaining access to affordable insurance.

NEW ARRANGEMENTS FOR WELFARE DELIVERY

George Yarrow

Introduction: alternative forms of welfare provision

One of the effects of the development of the welfare state during the twentieth century has been that it has displaced alternative forms of welfare provision. Individual saving and insurance has been 'crowded out' by compulsory national insurance, as have been a whole range of social institutions whose scope and activities could have been substantially greater had public policy followed a different course. This crowding out effect has affected people in lower income groups most, since their demand for incremental social security, over that provided by the state, is relatively limited or non-existent.

The displacement of non-state forms of welfare organisation has, of course, been far from total. Many institutions have survived - some have even prospered - and new organisations have developed to deal with needs that have not been well met by public provision, which tends to be relatively inflexible and bureaucratic. Indeed, the very complexity of current arrangements gives rise to a particular demand for 'gateway' organisations that can lower the costs of access to the products and services that are already available. Furthermore, as the value of welfare payments which are linked to inflation continues to fall relative to the growth in average earnings (earnings grow faster than inflation), and as other benefits are withdrawn altogether, it might be expected that this will stimulate the growth and development of non-state welfare institutions in the future.

Current problems and issues

Despite many recent successes in the development of new welfare organisations, there are nevertheless some deep-seated problems that need to be addressed if non-state institutions are to play a more substantial role. For example, at modest incomes, non-state provision of welfare is still very much a small-scale 'add-on' to the welfare state. This means that the 'transaction costs' involved tend to be high in relation to the value of the services provided and that the overall level of activity is heavily driven by decisions about state provision. Yet the welfare state continues to evolve with relatively little regard for the possible role of non-state institutions. More specifically, policy strategies do not appear to be based upon any fundamental analysis of how responsibilities for the various welfare-related activities might be best allocated among different institutions. One way of doing this could be according to their relative specialisms in respect of each activity for example.

Another very basic problem arises from the continuing trend towards greater means-testing of state benefits. Notwithstanding the statement in *A New Contract for Welfare*[1] that the Government does not want to see the welfare state "becoming a residual safety net for the poorest and most marginalised", the logic of current policies is that this is very much the direction in which public policy is still heading.

It is well understood that high withdrawal rates of benefit at modest incomes imply high disincentives for self-help (in particular when benefit is reduced once the claimant's earnings reach certain thresholds, thus potentially resulting in a net loss of *overall* income). One response to this incentives problem has been a trend towards greater conditionality in the state system (together with attempts to reduce the very highest withdrawal rates).

Much less well understood is that high withdrawal rates establish equally severe disincentives for the development of non-state forms of social organisation that cater for the welfare of their members. Unfortunately, greater conditionality in the state system does little or nothing to alleviate this effect. Thus the benefits provided to its members by a voluntary welfare organisation will be substantially eroded if it results in a lowering of state benefits entitlement for its members. And if the benefits of particular types of social organisation are perceived to be low, the supply of such organisations will likewise tend to be low.

Since it is the more vulnerable in society who typically rely most on collective action for their security, and since the disincentive effects of means-testing bear most heavily on lower-income groups, the effects of means testing on social organisation are, over the long term, particularly pernicious. Those with higher incomes will be much less affected: they have both the resources and, more crucially, the incentives to make provision for their own futures (the combined marginal rate of taxation and benefit withdrawal is very high at low income, but it falls steeply higher up the income scale).

[1] (Cm 3805, March 1998).

Factors influencing the development of the welfare state

Three key factors can be used to explain the actual development of the welfare state over the past century, including the current trend towards providing minimum income guarantees (e.g. income support, a minimum pension guarantee) with their associated, high withdrawal rates. They are:

1. *Democratic politics*, which give rise to pressures for governments to redistribute economic resources in their search for votes and other forms of support.

2. *A perception that explicit or implicit means-testing implies lower demands on the public finances than does, say, universal national insurance*.

3. *Concern to provide a universal safety net*, since perhaps the most important, single failure of social security arrangements before the welfare state was the lack of universal coverage - a significant fraction of the population made neither individual nor collective savings and insurance.

The first of these factors can, for present purposes, be taken as given.

The second factor, which has been very influential over the past forty years, is arguably a false perception. Account needs to be taken, at least in the longer term, of behavioural responses to means testing - including dependency, passivity and/or fraud. Over time, these responses tend to give rise to greater spending demands. The issue will, however, not be considered in detail here.

Rather, the focus of this paper is on the third factor, the desirability of a universal safety net, and in particular on the question of whether there might be better ways of combining universal coverage with effective welfare provision than is possible with current policies. Before the question can be answered, however, it is necessary to consider, in a little detail, precisely what activities are encompassed by the term 'welfare'.

The components of welfare

The term welfare can be applied to a potentially wide range of different products and services. Perhaps the single most important set of elements comprises various forms of income replacement and income support, which occur when an individual or household faces a fall in income. This is usually due to defined contingencies like sickness, unemployment, disability and old age, but welfare payments can also be triggered when income falls below certain minimum benchmarks, as is the case with income support, housing benefit and council tax benefit.

The provision of welfare involves much more than just income replacement and financial support, however. It also includes a wide range of direct services, such as medical and nursing care, education, accommodation, various in-home services, advice and information, organisation of access to products and services, sympathy and emotional support, and so on. Furthermore, the needs of individuals are varied and idiosyncratic, being highly contingent on particular circumstances. Efficient delivery of aid requires mechanisms that are sensitive to needs in specific circumstances and are capable of organising similarly varied and idiosyncratic packages or bundles of resources (advice and assistance, comfort and sympathy, care, facilities, cash, and so on) in response.

The contractual basis of any delivery system will, therefore, necessarily be incomplete: it is not possible fully to specify obligations and entitlements in all possible contingencies. This conclusion becomes particularly obvious once it is recognised that a contingency is defined not only by an actual physical reality but also by how that reality is perceived. Individual A might be entitled to benefit B in the event that C happens, but the assessment of whether C has or has not occurred may be a difficult and controversial exercise.

Being able to deal with such difficulties and 'grey areas' is one of the most fundamental issues of welfare organisation. As the parable of the Good Samaritan spells out: in uncertain circumstances people in need cannot necessarily rely on those from whom they may be due formal obligations, particularly where conflicting agendas are involved.

Wanted: new forms of welfare delivery

Once it is understood that, in the final analysis, welfare provision needs to be a tailored service, it becomes clear why neither the state nor for-profit, commercial organisations are likely to be effective welfare providers. Public bureaucracies are not renowned for their efficiency as providers of individualised services, since, among other things, they find it difficult to combine the necessary discretion with the rules-based approaches required for monitoring and control purposes. They also encounter problems connected with the weakness of bureaucratic incentives and with the intrusion of other agendas (e.g. control of public expenditure).

Similarly, when there is uncertainty about precisely what is and what is not required to be done in particular circumstances in order to discharge obligations set by strict contract, commercial organisations face conflicts of interest between customers and shareholders that can lead to inefficient outcomes. There are also problems of simply writing contracts that are both enforceable and capable of covering the wide range of contingencies that are encompassed by the notion of social welfare, which, as already stressed, includes advice, assistance and care, as well as financial transfers. Even where the range of contingencies can be narrowed, and where mechanisms can be established to adjudicate on compliance disputes, the resulting transactions costs may be very high (as illustrated, for example, by some of the problems in developing the market for long-term care insurance). In any event, claimants in distressed circumstances may be little comforted by the possibility of obtaining performance compliance via arbitration or litigation, both of which will tend to impose additional burdens at a time when they might be most difficult to bear.

What we currently lack, then, are organisations whose perspectives are more aligned with the interests of those likely to have most at stake in the effective provision of social welfare. It is clearly impossible to legislate for Good Samaritan behaviour, and impossible to avoid all conflicts of interest (if resources are transferred *to* someone in need, they will, explicitly or implicitly, simultaneously be transferred *from* someone else). Nevertheless, it should be possible to create welfare institutions that are a better approximation to the ideal than is either the state or a for-profit commercial organisation. One way of doing this, for example, is by stipulating that the final delivery of welfare services should be allocated to organisations whose ownership and control lies ultimately with their members. Central to the achievement of this outcome is the establishment of a broader incentive structure that does not deprive people of the benefits that membership of such institutions can bring. In practice, this implies a radical reduction in the use of means testing in the provision of state benefits.

Such organisations exist today, and in the past have existed on a much larger scale in, for example, the form of Friendly Societies. Their most important characteristic is that the organisation exists, first and foremost, to promote the interests of its members in respect of the provision of welfare services. Neither the state nor commercial organisations, each of which has other interests and agendas, can make a similar claim.

New welfare providers in a system of universal provision

As noted earlier, the chief weakness of the social security arrangements in the periods before the advent of the welfare state was the lack of universal coverage. The achievement of universal coverage, which has been a major policy advance of the twentieth century, does not, however, require universal state provision. The alternative strategy is to legislate for universal coverage, but to assign the responsibilities for the organisation and delivery of services (of all types and including advice and assistance) to non-state welfare providers.

A historical precedent for this approach exists in the role played by the Approved Societies, a form of mutual organisation, in the administration of National Insurance during the period between the social security reforms of Lloyd George and Beveridge. Like the National Insurance scheme of the time, however, the activities of the Approved Societies were relatively limited in scope compared with the range of activities that is nowadays covered by the welfare state. Nevertheless, the principles embodied in the earlier arrangements could be applied in current circumstances simply by assigning a wider set of responsibilities to institutions that, like the Approved Societies, satisfied a set of prescribed conditions as to their activities, organisation, and governance.

Under such arrangements, the state would continue to have two roles: First, it would re-distribute economic resources via the tax system (quite apart from any considerations of ethics, democratic politics can be expected to continue to give rise to demands for substantial re-distribution). One possibility here is a universal system of tax credits, whose values vary with contingencies such as age and disability, such that credits can either be set off against tax liabilities or, for those without a sufficiently high tax liability, be wholly or partly redeemed for cash with 'Approved Welfare Providers' (AWPs) who could then reclaim from government. Such credits could replace a whole set of existing allowances and benefits (personal income tax allowances, child benefit, the basic state pension, income support, and so on) and their payment could be made contingent on individuals being willing to enter into arrangements for the supply of some prescribed, minimum welfare package with an AWP.

Second, the state would set the parameters of the basic welfare package (e.g. minimum levels of insurance and saving for retirement), grant licences to welfare providers that satisfied specified conditions and regulate compliance with those licences. As in the privatised utility industries, there would be penalties for breach of licence including, in the limit, withdrawal of a licence (i.e. withdrawal of approved status).

The role of the private sector would be to supply a whole range of sub-contracted products and services to the new welfare providers. These would include financial services products (e.g. insurance, re-insurance, pension products, fund management) and some forms of care services (e.g. residential homes, nursing care).

Such an arrangement recognises the comparative advantage of private sector organisations in the effective supply of easy-to-define products and services. Crucially, however, the contracts for such products and services would be struck and supervised by the new AWPs, acting on behalf of their members. In this way, private sector suppliers would be competing for the accounts of large, well informed buyers, rather than for the accounts of the small, often poorly informed buyers who are to be found on the fragmented demand sides of equivalent markets today.

The central role in all of this is clearly played by the AWPs. Their responsibilities would include: supply of the basic welfare package, administration of tax credits, contracting for products and services, assessment, advice, organisation of delivery, and direct assistance. It is to be expected that the vast majority of the population would choose to join an AWP, since the allocation of tax credits would be contingent on such an action. All AWPs would offer the same basic welfare package, but would differentiate themselves by offering extra products and services in addition to the required minimum, thereby introducing elements of choice and competition into the provision of services to their members. The ultimate shapes and sizes of the institutions that emerge would be determined by this process of choice and competition.

Since AWPs would also provide the route by which tax credits could be redeemed for cash (by those lacking sufficient tax liabilities against which to offset the credits), they would constitute a single first port-of-call on a wide range of welfare matters, including those relating to the redistribution of income through general taxation. This is desirable not only because it reduces transactions costs, which are of particular significance when the value of resources transferred in each transaction is relatively small, but also because it means that the relevant institution will be much better placed to deal with the situation faced by a particular individual in its idiosyncratic entirety.

Conclusions: gateways versus hubs

At its most limited, the notion of a gateway institution might be used to refer to an organisation that serves an aggregation function, consolidating large numbers of small accounts in a way that reduces transactions costs of provision. The AWPs described above would certainly perform such a function, but they would do much more than that. A better metaphor to apply to them might be that of 'welfare hubs'. They could be centres for access to and delivery of a wide range of products and services, from state entitlements to contracted financial and care services to 'beyond contract', Good Samaritan assistance. Universality would be achieved by ensuring that everyone was a member of one or other of the potentially many hubs that would be available, and amongst which individuals could choose.

GATEWAYS – SOME OF THE THEORETICAL ARGUMENTS

Nick Donovan

At their simplest, gateway organisations can act as intermediaries between their members, and financial services providers. They can purchase financial services on behalf of their members, searching for the most appropriate provider and product, negotiating the terms of the contract, ensuring that neither the individual nor the provider behave inappropriately, and perhaps also playing an administrative role in the collection of payments and the distribution of benefits.[1]

Other, more ambitious, visions of how gateways organisations could operate have also been put forward: namely that these organisations - sometimes termed Approved Welfare Providers or AWPs - could form the basis of a new welfare state.[2] The adoption of some of these ideas was even floated by Government as a possible route for its welfare reform programme.[3]

Whichever vision is considered, it is important to understand some of the theoretical arguments supporting Gateways – many of which are based upon an understanding of the problems of imperfect information in the market for financial services.

---

1 See Claire Whyley, James McCormick, and Elaine Kempson *Paying For Peace of Mind, Access to Home Contents Insurance for Low Income Households* (London: Policy Studies Institute/IPPR, 1998) and Nick Donovan and Guy Palmer *Meaningful Choices. The Policy Options For Financial Exclusion* (London: New Policy Institute, 1999).

2 George Yarrow 'On Welfare Reform' *Essays in Regulation* no. 8, (Oxford: Regulatory Policy Institute, 1997).

3 Frank Field 'Mutuality's Role in the Millennium'. Speech given at the Building Societies Association AGM, Thursday 28 May 1998, and published in *Reflections on Welfare Reform* (London: Social Market Foundation, 1998).

The cost of searching for financial products

'The things we buy can be divided into three categories: 'search goods', which are easily compared before we buy them; 'experience goods', which are harder to compare before they have been bought but which you can learn about when you have them, and 'credence goods' which are extremely difficult to compare, even when you have been buying them for quite a time.'[4]

Bank accounts can be seen as search goods: its quite easy to compare them thanks to the introduction of Annual Percentage Rates (APR). However, many types of financial products are either experience or credence goods and hence have high information costs attached to them. Pensions, long term care insurance, PEPs and life insurance, could be defined as credence goods. The quality of these goods is not revealed until many years after it is purchased. Mortgage protection policies, most forms of private medical insurance, home contents insurance, and legal expenses insurance are more like experience goods.

While individuals open bank accounts themselves (perhaps comparing the APRs and terms and conditions of different accounts beforehand) they generally need financial advice before buying credence goods. At present, this advice is provided by financial advisers – who are governed by conduct-of-business regulations.

Regulation

Opportunities rarely exist for repeat purchases of financial products like pensions, thus preventing the consumer from learning from experience. Some products represent a very high proportion of the individual's assets. The long term nature of some products means that their quality can be hard to judge. Moreover, they are often extremely complex. In short, *caveat emptor* (buyer beware) does not apply.

These issues have led to a situation in which the average investor requires financial advice. But the interests of financial advisers do not always coincide with those of the consumer. They may, for example, feel an overriding duty to maximise shareholder value, or to maximise their commission-based profits,

[4] 'Defusing the pension timebomb' *Economics in Action* (London: London Economics) Issue 1, 1998.

rather than represent the consumer. This can lead to a propensity to oversell or mis-sell particular financial products.

Tough 'conduct-of-business' regulation is therefore deemed necessary. Such regulation is designed to protect individual retail consumers from unscrupulous, fraudulent or incompetent financial service salespeople and advisers. Examples of this type of regulation include rules governing the marketing of financial products, and training and competence exams for individual salespeople. In particular, when financial advisers give financial advice they first have to run a 'know your customer' fact find in order to provide suitable advice (the 'best advice' environment).

Regulation is, however, a costly exercise. The present system of conduct-of-business regulation, where advisers are obliged to offer best advice after a lengthy 'know your customer' fact find is expensive – estimated at around £600.[5] These costs, when passed on to a consumer, can lead to high charges which often price the product out of the range of those on low incomes – undermining the government's aim of encouraging self-reliance through the purchase of more long term savings products such as Stakeholder Pensions and Individual Savings Accounts (ISAs).

Is the answer to simplify products or rely on gateways?

The Government's Welfare Reform Green Paper stated that by 2020 much of the social insurance and pensions currently provided by the state would be delivered by the private and mutual sectors. If this objective remains true, then this will involve moving certain products (e.g. social security benefits) from a Henry Ford ("any colour as long as it's black") social security system to a private sector which could potentially provide much more choice and flexibility in the variety of welfare insurance and savings products which it offers. This could be beneficial, in that consumers might receive welfare products which are more closely tailored to their needs. However, it comes at a price: the increased cost to the consumer of gathering information about available products and choosing between them.[6]

---

[5] Adrian Boulding 'Quality Assurance: Stakeholder Pensions' in Guy Palmer (ed), *Quality Assurance or Benchmarking? Presenting Information about Pensions* (London: New Policy Institute, 1998), p. 6.

[6] Tania Burchardt and John Hills *Private Welfare Insurance and Social Security. Pushing the Boundaries* (York: Joseph Rowntree Foundation, 1997), p. 9.

This problem can be addressed through two broad approaches. One is to re-design, by statute, financial products into simple, bland but relatively safe, products – which in fact may not be dissimilar, in terms of the choice and variety on offer, to what the social security system had provided. These products are then given a quality assurance stamp to prove that they all share minimum characteristics. This is the approach being taken with Stakeholder Pensions and ISAs.

However, a second option might be to aim to retain the variety and flexibility which the private sector can offer and place a heavier responsibility on the shoulders of an intermediate gateway institution: by creating a consumer-purchaser split.

The rationale for the regulation of financial products to the consumer is that individuals possess insufficient information to make informed decisions, and that the interests of those who offer financial advice are not completely aligned with the consumer. A system in which financial services were bought by gateways on behalf of their members (a consumer-purchaser split) could potentially remove the need for costly conduct of business regulations. In such a scenario, the gateway would take over the role of the financial adviser – pooling the costs of gathering and analysing information about complex financial products. The information asymmetry would therefore be re-balanced. Moreover, the potential conflict of interest that arises today when profit making firms give financial advice, is not present as the customer's and gateway institution's interests are better aligned.

Can gateways help with moral hazard and adverse selection?

Many of those discussing reform of the welfare state, often but not exclusively on the Right, profess some regret that the private and mutual sectors lost their major role in the provision of social insurance with the birth of the modern welfare state.[7] Often this has led to a reluctance to recognise the intractable problems which would be faced in transferring most social insurance from the state to either the private or mutual sectors. Two of these problems are 'moral hazard' and 'adverse selection'.

[7] For a good example of this literature see Arthur Seldon (ed.), *Re-Privatising Welfare: After the Lost Century* (London: IEA, 1996).

Moral hazard

"Moral hazard problems arise when there is imperfect information concerning the actions of those who purchase insurance, because these actions cannot be perfectly monitored and insurance contract cannot specify all of the actions which the insuree is to undertake…This then is the fundamental conflict: the more and better insurance that is provided against some contingency, the less incentive individuals have to avoid the insured event, because the less they bear the full consequences of their actions."[8] For instance, it is argued that the existence of unemployment benefit makes the unemployed more reluctant to take another job. Furthermore, as the insured event is more likely to occur than if insurance is not available, because of the higher claims rate, premiums will eventually rise.

Moral hazard problems have traditionally been dealt with, in both the private and state sectors, by co-insurance: the insured individual is required to meet part of the cost of the insured event. In car insurance, for example, the driver is usually required to pay an 'excess' charge. Likewise, statutory sick pay does not commence until after three days of illness - requiring the worker to meet some of the costs of their loss of income (although the employer usually steps in here).

Being smaller in size and closer to the consumer than a private corporation or the state, a gateway or AWP may have an advantage in the monitoring needed to minimise the problems of moral hazard. Indeed some have gone further and speculated that they could assist in verifying claims – reducing fraud in the process. "*AWPs based on shared values, characteristics or interests, or on a particular locality can be expected to be more effective in detecting and deterring fraudulent claims than either large 'for-profit' institutions or the state.*"[9]

---

[8] J. Stiglitz 'Risk, Incentives and Insurance: The Pure Theory of Moral Hazard' *Geneva Papers On Risk and Insurance* (Geneva: Association for the Study of Insurance Economics) 8 No 26, January 1983. pp. 5-6.

[9] Field *op cit.*

However, these claims are worth investigating further. There is a tension between the intimacy needed so that effective monitoring can take place, and the size necessary to provide a viable risk pool and the economies of scale. For example, in discussing the minimum size for Friendly Societies after the 1911 National Insurance Act, one historian has written: *"In the end small societies were not altogether excluded from the scheme, but they had to be grouped in units of at least 5,000 members for the purposes of pooling surpluses and deficits. This preserved the best of both worlds, small units for close supervision but large units for the sharing of risks."*[10]

Adverse selection

"Voluntary schemes of unemployment insurance…have always failed because those men most likely to be unemployed resorted to them, and, consequently, there was a preponderance of bad risks…which must be fatal to the success of the scheme."[11]

What Winston Churchill had in mind when he stated this was what economists now term 'adverse selection'. Adverse selection arises when the customer knows more about her risk status than the insurer. For example, in the market for health insurance there are those with a high risk of illness and others with a low risk. Initially the insurer will offer premiums based upon the average risk. This will be more attractive to the high risk consumer, more of whom will buy insurance. The risk portfolio of the insurer will be skewed towards higher risks and eventually, due to a higher rate of claims, premiums will have to be raised. The market failure is that low risk consumers are not offered insurance at an appropriate price. So low risk customers suffer because of this information problem. So too, do low income consumers, as insurance becomes more expensive.

One way that the private sector has tried to minimise adverse selection is through the utilisation of information technology. Analysis of postcodes provides an approximate guide to the risk of burglary. Analysis of the age and gender of a driver, coupled with the type of car they own, provides an approximate guide to the risk of a car accident. And analysis of lifestyle

---

[10] Ernest Peter Hennock *British Social Reform and German Precedents: the case of social insurance 1880-1914* (Oxford: Clarendon, 1987), p. 264.

[11] Hansard 1911 vol. 26 col. 495, cited in A. B. Atkinson 'Social Insurance' LSE STICERD discussion paper WSP/65, (London, 1991), p. 7.

provides an approximate guide to the risk of illness and early death. Premiums and exclusions are adjusted accordingly. The state, however, through its ability to compel citizens to join insurance schemes, has an inherent advantage over the private sector in tackling adverse selection.

It is not clear whether gateways have any advantages in coping with the problem of adverse selection.

The mutualisation of risk

As discussed above, technological developments have allowed private providers to pinpoint risks ever more closely. For example, Geographical Information Systems allow insurers to map the risk of burglary to individual postcodes. Private agencies also collate information on individual's credit worthiness using database technology. The common theme is that both credit and insurance risk can be ever more closely pinpointed. Cross subsidies from low risk individuals to high-risk individuals are unravelling as products are increasingly matched to an individual's risk profile. Risk is being de-mutualised. For many individuals, this is very welcome: they face financial services closely tailored to their lifestyle. They have both choice and flexibility. The other side of the coin is, however, that high-risk individuals face higher insurance premiums and less chance of gaining credit. Choice and flexibility come together with exclusion and uninsured risk.[12]

But risks are not evenly distributed throughout our population. Those living in poverty, by and large, face greater and more numerous risks than other members of society. For instance, Gosling *et al* found that men in the bottom wage quartile were almost three times more likely to be out of work the following year as men in the top wage quartile.[13] Men in social class V are four times more likely to be die early because of a fatal accident than those in social class I.[14] Crime is higher in deprived areas. The consequence of all this is that those least able to pay often face the highest premiums.

---

[12] On this see A. B. Atkinson 'Private and Social Insurance, and the Contributory Principle' in (eds) N Barr and D Whynes *Current Issues In the Economics of Welfare* (Basingstoke: Macmillan, 1993) p. 35.

[13] Gosling et al *The Dynamics of Low Pay and Unemployment an Early 1990s Britain* (London: IFS, 1997) Table 2.14, p. 45.

[14] Drever and Whitehead *Health Inequalities* (London: ONS, 1997), p. 106

Gateways can potentially reverse the trend towards the ever-greater individualisation of risk. By acting as a gatekeeper to a large group of customers, the gateway can set the terms of any contract to include equal treatment of all its members. This already occurs in gateway schemes providing home contents insurance: '*within each local authority scheme, tenants pay the same level of cover regardless of their postcode. "One rate risk pools" are the key condition set by social landlords as gatekeepers if insurers wish to gain access to potentially large blocks of business.*'[15] The low-risk members of the scheme cross-subsidise those at high risk.

Administrative costs

As well as pooling risks, it is possible that gateways could also be used to reduce the administrative costs of providing financial services. There are three stages in administering an insurance policy or pension that are currently all carried out by private firms: the firms collect money from customers, manage the funds, and then distribute the benefits. There is no fundamental reason why it is only pension and insurance companies that should be responsible for the first and third stages of the operation. Where there are existing schemes that collect money from people, there might be scope for trade unions, housing associations and local authorities, to collect premiums and payments alongside the collection of union dues or rent.[16]

Flexibility about the range of payment options (in particular the ability to pay by cash) and about the frequency of payments, is crucial to the success of any attempt to target low-income households. Traditionally, private sector insurers have a poor record of targeting accessible schemes at low-income households. The overheads of actively selling savings schemes, insurance and pensions to low income households can be very high – involving door-to-door salespeople. Indeed, there is a trade off between a desire to minimise the 'reduction in yield' (the impact of charges on a policy) which can be very significant in low contribution policies and the selling methods used to reach these households.

---

[15] Whyley *et al*, p.20

[16] See John Plender *A Stake in the future: the stakeholding solution* (London: Sonoma, CA : Nicholas Brealey Pub., 1997).

In the various home contents insurance gateway schemes, reducing administrative costs is an important component of ensuring the profitability of such schemes. When payment of premiums is combined with an existing payment system (for example, rent collection or credit union deposits), then transaction costs may be significantly reduced.

Conclusions

This paper has argued that gateways may offer some significant advantages over a purely private and individualised financial services market.

Note, however, that this does not imply that it is possible to transfer large sections of welfare insurance, which at present are provided by the state, to a gateway-based system. This is simply because there are some risks, in particular unemployment and possibly long term care insurance, which are effectively uninsurable by any agency except the state.[17]

[17] The arguments supporting this statement have been extensively rehearsed elsewhere. In particular see Nicholas Barr *The Economics of the Welfare State* (London: Weidenfeld and Nicholson, 1987).

ABOUT THE AUTHORS

Adrian Boulding is Pensions Strategy Director at Legal and General. He is the author of 'Quality Assurance: Stakeholder Pensions' in *Quality Assurance or Benchmarking? Presenting Information About Pensions* (New Policy Institute, 1998).

Barry Dixon is the Graphical, Paper and Media Union's Consultant/Ombudsman on the Printing Industry Pension Scheme and is a former Chairman of its management committee.

Nick Donovan is Development Manager at the New Policy Institute. He is co-author of *Meaningful Choices: The Policy Options for Financial Exclusion* (New Policy Institute, 1999) and editor of *Second Chances: Exclusion from School and Equality of Opportunity* (New Policy Institute, 1998).

James McCormick is Research Director of the Scottish Council Foundation, Edinburgh and co-author of 'Paying for Peace of Mind' (PSI/IPPR, 1998).

Guy Palmer is Director of the New Policy Institute. He is co-author of *Meaningful Choices: The Policy Options for Financial Exclusion* (New Policy Institute, 1999) and editor of *Quality Assurance or Benchmarking? Presenting Information About Pensions* (New Policy Institute, 1998).

Professor George Yarrow is Director of the Regulatory Policy Institute and a Senior Research Fellow, Hertford College, Oxford. His recent publications on welfare reform include *Towards an Inclusive Society* (Natwest, 1997) and *On Welfare Reform* (Regulatory Policy Institute, 1997).