Financing Retirement - History and Policy Changes
Transcript

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Financing Retirement:

History and the Policy Agenda

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The title of the talk tonight is "Financing Retirement: History and the Policy Agenda", and what you see is not necessarily what you get, so we will be cantering through a few areas which are not necessarily all about financing retirement. I will be talking principally from a UK perspective, but thinking very much also about what is happening internationally, and in particular the places that have been successes in terms of tackling the retirement-funding conundrum, perhaps actually rather better than we in the UK are doing right now or look set to do in the future unless we change.

The things that we will look at in this talk are: where we are today; a short history of retirement – how we got to where we are in terms of thinking about retirement; a look around internationally and see what is going on. We will be paying a great deal of attention to life expectancy and healthy aging because this is the elephant in the room when we think about retirement; some of the implications of that, policy responses, and some sort of appreciation of really what we have got to expect, as a nation, as a people and as individuals, going forward into retirement.

Steam Engines and a Wristwatch

But first, let me begin with a story about steam engines and the watch that I am currently wearing on my wrist. The steam engines we are concerned with are those of the Somerset & Dorset Joint Railway. The line of that railway goes past my house not far from the Watery Bottom Viaduct near Bath. There is a picture taken in the 1960's of two un-rebuilt Southern Railway steam locomotives, built in the 1940s, passing over this part of the line: a West Country class Pacific called Bude, and a 642 Squadron, an un-rebuilt Battle of Britain class Pacific. The details of this picture are important because it was taken on the 5th of March 1966, the day before the line shut forever. The link to my watch is the fact that on the back of the body there are inscribed the following words:

> "British Railways, London Midland Region, J Johnson, in appreciation of 45 years' service"

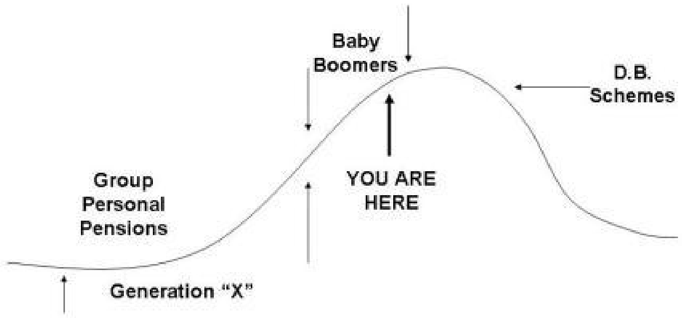
It was given to one James Johnson in 1961, who was a banking engine driver at Bath Green Park Shed, the home shed for the Somerset & Dorset Joint Railway. Banking engines pushed goods trains up steep inclines, and so the chances are that James Johnson, wearing this watch maybe, drove his engine past where I now live, between 1961 and 1966, up the steep 1/50 incline of this part of the track. But in 1966, the day after this line shut, he is listed as retiring – 7th March 1966, James Johnson retired, after a fifty year period of service on the railways. He joined the Midland Railway, with which this line was associated, at Carlisle Canal Shed in 1916.

Why do I cite all this? The first thing is to point out the change in working patterns. Back then, you would expect to work for an employer either for your entire working life or for a large part of it. James Johnson would have joined the railways, and he would have been very pleased to join the railways, partly because it was a reserved occupation and he did not have to go to the trenches, but he would have been delighted to join the railways for two reasons: firstly, it was very secure employment, and it had always been regarded as such – there were layoffs in the 1920s, but not too many; and the second reason he would have been delighted to join the railways was that they were early adopters of pensions. The railway companies were the first to begin providing pensions for the bulk of their employees, and a pension, in 1916, would have been something to treasure, because, if you did not have a pension from your employer, then you were looking at a means-tested retirement pension, payable from 70, and the means-testing was severe. It was not a joke; they would send people round, and if they went into your house and thought you had a dining room that was too posh for the house, you had to sell it. It was just dreadful! So, a job that had security and a pension was something to treasure.

Even within my working lifetime, I can remember jobs like that. When I joined the financial services industry in 1980, I was taken to one side by the Branch Secretary of Norwich Union's Newcastle Branch, and I was told that I was a very lucky young man: if I worked hard and kept my nose clean and did what I was told, I would have a job for life, the Society would look after me, my family, and my children, into retirement and beyond. It was a patrician deal. But today that patrician deal has gone, and we have got some problems.

The Current Retirement Landscape in the UK

Let us take a look at the current pension landscape in the UK, which can be seen on this graph.



We have just seen a bow-wave go through of people who have retired on very good, defined benefit pensions. That is where a promise is made that you get a fixed percentage of (usually) your final salary as a guaranteed income when you retire. In contrast to this, I have got a defined contribution pension whereby a certain amount of money is paid into the pension fund each year. Therefore, the fund grows up in accordance with whatever investment return we can get, and then I have to buy an annuity to turn it into pension income. The outcomes from those schemes, it has to be said, are not as good as the defined benefit pensions, but I am lucky compared with what is coming behind me.

In the graph, I have got group personal pension plans there for generation X. They are like individual pension pots that your employer happens to pay into, but they are owned by you, and they are basically the architecture that we are seeing out there in occupational pensions today. The problem is that nowhere near enough people are paying into a pension, and nowhere near enough people are paying enough into a pension, and so we have got this huge pension gap looming, where people will retire on incomes that are totally inadequate. Or maybe they will not retire, and this is something that we will consider as we go down the track. Either way, the forward outlook for generations X and Y is not good. I have a pension fund which is probably 10 times the average pension fund in the UK. The average pension pot last year was somewhere around £27,500, which will buy you about £1,800 a year of income – this is pitifully poor. But even on the pension I have got, I will not generate enough income to retire on that pension fund alone. My options are limited.

A Short History of Retirement

It will be useful now to take a step back to have a short history of retirement. First of all, we have got to remember that the idea of retirement is relatively recent. It could be argued that, given what I said earlier about an age seventy retirement age, that actually the idea of a a number of years' comfortable retirement is a post-War idea. It was an idea that only really took root with the end of the Second World War, and it is really the second half of the twentieth century that it became something that people culturally looked forward to. This was really delivered through the Beveridge Report, which set out the welfare state idea for after the War. This is at a time when Britain and Europe were industrial powerhouses: they made steel, they mined coal, they built ships – they did all sorts of things that we do not seem to do today. So, we had the economic base to make a range of promises about pensions, about the welfare state, that maybe, going forward today, we are going to find very hard to sustain.

Some International Perspectives

When we look around the world, at the developed world, we typically see a two or three tier pension system. That will typically be:

1) The state: a central core pension provision, maybe not very generous, but something of a staple;
2) A supplementary state scheme, or compulsory private saving;
3) Voluntary private saving.

So, as we look around the developed world, we typically see these sorts of things in terms of retirement-funding architectures.

State systems in Europe are typically social insurance, which differs subtly from notionally contributory-based system that we have got in the UK, but in fact, both are, to some extent at least, pay-as-you-go. In other words, the contributions made today go to pay the pensions of the people who are retired right now. We call those pay-as-you-go or pay-go systems. The question emerging, as the developed world ceases to be the economic powerhouse it once is: are these sustainable? On this, I think the jury is, at least, still out on whether that is possible or not.

If we look around the world, state retirement benefit systems are under pressure, where they exist at all. If we think about India or about China as an economic powerhouses, they have basically taken a look at the Western model of pay-as-you-go pensions and walked rapidly in the other direction. India, for example, has a state pension, but it is so pitiful that it is economically impossible to even think about living on it. It is absolutely miniscule! They are quite clear that they are going to do no more than that. They are also reasonably clear that they are going to provide some kind of architecture which people can put into nationally, but they are currently working on that. So we see state retirement benefit systems are under pressure. What do we mean by that?

In the UK, we spend 5.1% of GDP on all state retirement benefits. That makes us the cheapest in the EU 25. France spends 12.5% of GDP on state retirement benefits. Germany spends 16.5% of GDP. This is not sustainable. It is arguable that it is sustainable at 5.1%, but there are at least some global commentators, such as the IMF, who would argue that the pension and healthcare promises made forward by the UK Government to its population effectively make the UK bankrupt today. Now, I do not know whether they are right – I think they probably are, and certainly, there are arguments both ways, but, either way, this is a very big problem.

When Beveridge reported in 1942, he was reporting against a background of means-tested age pension, which was largely considered to be undignified, and so he put in place a pension as of entitlement, that you had paid for with contributions, National Insurance contributions. Ironic then that, in the late-1990s, we moved away from that welfare state principle of entitlement back towards means-tested benefits, such as pension credit and guaranteed credit.

Private saving varies widely across the planet. In France, until recently, private saving for a pension, certainly company employer-based saving for a pension, was a rare event, but reforms in 2003 have put in place architectures which mean that, increasingly, company and individual pension saving, and certainly employer-based pension saving, are taking off. And they need to take off, because you cannot carry on spending 12.5% of GDP in France on retirement benefits. They know that and they are trying to push the reforms through, but it is a bit like turkeys voting for Christmas.

Workplace pension schemes are on the march in Europe, but the irony is that they are in decline in the UK. In 1967 in the UK, we had 12 million people enrolled in mostly defined benefit benison schemes, out of a total workforce, at that point, of 16 million. In other words, three-quarters of the workforce were saving into a good pension or having a pension provided for them. That figure today is 45%. Through my advising of and work with the Institute of Directors, employers tell me that they no longer see it as their role to provide a pension because their employees no longer demand it. Ironic, is not it? Only ten years ago, we were the best pension nation on the planet. Now, the best pension nation, per capita, is Australia.

The UK Savings Landscape

Occupational schemes are shrinking: in 2004 there were 97,000 in the UK, but only two years later, in 2006 there had shrunk to 78,000. At this rate of decline, occupational pension schemes, as we currently understand them, will have ceased to exist in seven year's time. That is not going to happen, of course, as there will be a long tail. And by "occupational schemes", I mean trust-based pension schemes. There are other types of pension.

The most worrying thing is there are at least 4.7 million people who are eligible to join a pension scheme and receive an employer contribution who are not doing so, and 10 million at least are not saving into any kind of pension at all.

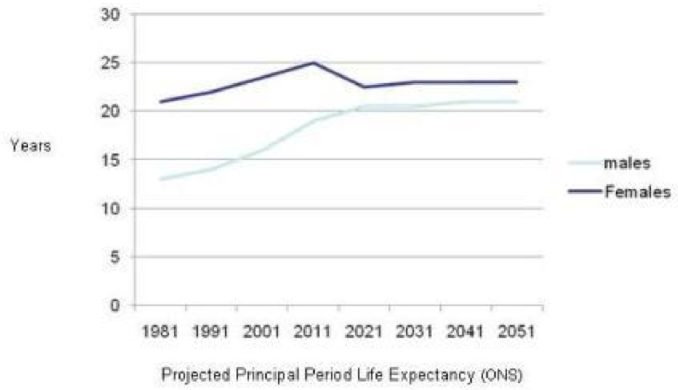
There has been a structural switch to group personal pension plans. They are contract-based plans. They require a lot less administration by the employer, and they have been a success story, with 6.7 billion per annum going into them. The other success story has been an architecture called Self-Invested Personal Pensions, where you control the investment content of your pension, and that has really taken off.

Interestingly, in individual savings accounts, which have been the savings success of the last twenty years, we now have 350 billion of assets in individual savings accounts, and this is saving for retirement. How do we know this? Because 80% of equity ISA money sticks for ten years or more, and 65%, believe it or not, of cash ISA money sticks for ten years or more. People are already using ISAs as retirement savings vehicles because they are simple and they understand them. Pensions are incredibly complex and people do not understand them. And it is going to overtake the 400 billion that there is in occupational defined contribution pension plans pretty soon. So the pensions market is moving; it is very much in flux.

Life Expectancy and Healthy Ageing

The second reason why pensions are important lies around longevity and healthy aging. This is because, if you have a pot of X amount of money, and you want to draw an income from that pot over Y years, clearly, the lower the number that Y is, the bigger annual income you can expect, and this may also contribute to some of the issues that you are likely to experience in later life. So I am going to spend some time now looking at longevity, because longevity and the increases therein are at the core of some of the issues that we are going to face in retirement.

This can be made a great deal clearer with a graph from the Office of National Statistics of the projected increase in life expectancy for males and females.



I am just going to come straight out and say that I think this projection is rubbish. If you look at where we are now, at 2011, particularly for males, we are seeing a really quite steep rate of increase, which ONS, for some reason, thinks is going to decrease and then level out. Why? This projection is not credible.

Every longevity projection there has been over the last twenty years has been beaten. All the actuaries who are responsible for calculating this stuff set out projections for life expectancy and they are continually beaten.

Interestingly, when I first came into financial services, one of my first jobs was writing out quotations for pension schemes. In those days we still used longevity tables, life expectancy tables, to do the calculations for these insured defined benefit schemes. I noticed, at the top, that it said something like LA10/49 – this was 1980. I went over to my supervisor and said, "These tables – are they from 1949?" "Yes, that is the last time we did these tables." Of course, it was absolutely crazy, and these people are supposed to be actuaries! In fact, things have got a lot better now in that they have a continuous mortality study, which is done on a rolling basis, and actually it seems to be at least keeping up with the pace. But I put in this ONS graph really just to show how questionable some of these predictions are which we meet in this area. One can easily see why such predictions are questionable simply by looking at the facts.

Average male life expectancy is now 82. In 1948, it was 66. In 1948, male retirement age was set at 65, when the state pension as we currently see it came in. That is a one-year differential. So right now, today, if we were to preserve that one-year differential between the state retirement age and average male life expectancy, then the state male retirement age right now today should be 81.

If you get to 65 today, you have at least 17 years life expectancy in front of you. If you are female, aged 65, you have 20 years of life expectancy in front of you. But, healthy life expectancy is just 13 years and 15 years respectively, and this points up the scale of the problem with long-term care that is coming towards us.

Life expectancy itself and healthy life expectancy are separate issues, but they are issues which are both associated with retirement and they both throw up their own funding conundrums.

Added into this picture, of course, must be the questions of social class and location, because life expectancy varies greatly according to these factors. For example, male life expectancy in some areas of inner city Glasgow is barely 65.

Where is it going? Male 65 cohort life expectancy is forecast to be 25 years by 2051. I think it will be more than that. My own father retired from the Civil Service age 63. He is 93, today, and is experiencing increasing health problems, such that he will probably shortly need residential support and care. But this figure is even higher for women, with female 65 cohort life expectancy is forecast to be 28 years by 2051.

The age 80 population will grow from 2.8 million in 2008 to 5.8 million in 2033, and 10.6 million in 2083. One in three girls born today can expect to live to over 100, and one in four boys.

Male and female life expectancy is converging. The thing which used to kill men in their fifties was arterial blockage, and what that is about is narrowing of the arteries, usually associated with cholesterol. So, as a man in my late-fifties, I would be pedalling down the street one day, and finally, that artery that had been thickening up would get a clot in it and I would topple over, and if I hit the floor hard, it might actually unblock it. So, if I survive, I would be carted to hospital, where I would be laid on a bed, and because they did not know the difference between different kinds of heart attacks, they did some fairly standard drips, which of course did nothing for an arterial blockage, and they really did not have the scanning equipment – and this is as recently as the early-1980s. So it was that nothing was done about the thickening of the arteries, and so, with all likelihood, I would have another blockage shortly afterwards and this time die. But since then, statins have revolutionised male life expectancy. They have changed the landscape completely. Now, you go and you get a cholesterol test as you get all the usual sort of tests, blood tests and whatever, and if you are at risk, you are just put on statins. These medical revolution, alone, is extending male life expectancy exponentially.

As a smoker, I have got a 20% greater chance right now, today, of getting lung cancer than a non-smoker. But for a non-smoker in my cohort, there is only about a 0.1% chance of getting lung cancer. Where it really kicks in as a killer for smokers is when one gets into their eighties, and it kicks in not only as a lung cancer but a range of other cancers. I will come back to why that might be quite important down the track. I suppose I am managing my own risk here, but the one thing I do not want to be is in a nursing home.

The number of people over state pension age will increase 32% by 2033, and yet the number of under 16s is only going to increase by 10%. Who is going to pay the pensions of these people, and who is going to pay for our long-term care? It is a pretty hefty equation.

Male life expectancy, according to a recently released report by the Department of Work & Pensions, who clearly do not talk to the Office of National Statistics, suggests that male life expectancy increased by 44 days, which is well over a month, in the last year alone. That is the pace of increase in longevity. Nearly a million people over state retirement age today will live to be 100. Currently, there are 12,400 centenarians. So these longevity figures will mean that we will go from 12,400 to nearly a million within the life expectancy of the current retiree cohort.

In 2081, according to the same estimates, there will be 22,000 adults aged 110 or over. Harry Patch, the last veteran of the trenches in the First World War, died aged 110. Imagine 22,000 Harry Patch's living up to 120. – And, as I said earlier, nearly 30% of today's children will live to be 100.

But it gets worse, because the work of a man called Aubrey de Grey. I have had him along to talk at one of the events I organised, and I remember the whole room falling silent as he walked in because, everybody in the room was dressed in chalk-stripes like any businessperson, and in walked Aubrey de Grey who was really like something out of the 1970s: loon pants, slouch bag, huge beard, very long hair. What he does is he runs a global research foundation called the Methuselah Foundation. He is based in Cambridge, but there is a global network of these people working towards the same goals, and they are doing research into the triggers of aging in cell biology. Now, I am not a scientist, so forgive me if I get this wrong, but they believe that there are elements of the DNA which are programmed within a cell to trigger aging. They think there are five of these triggers to aging in cell biology. They believe they know where all these five are. They have found and learned how to turn off three. They are very close to turning off the fourth, they think, and they are working on the fifth.

I get his newsletters, and recently featured in the newsletters was story of a colony of mice in Sacramento, California. They have injected these mice with their early formulations of what they think could turn off the triggers to aging in cell biology. These mice are five years old. Mice normally only live till two. So, there is this colony of five-year old mice in Sacramento. The reason that is interesting is because mice, in terms of cell biology, are apparently the closest thing to us. They are closer than chimpanzees, apparently. So, it is effectively the case that works for mice might well work for us.

So, let us assume he is not mad, even though a lot of people think he is. But let us assume that he is onto something, and let us assume that, as he once said, the first person to live to 1,000 is already alive. Who would want to take a bet on where longevity assumptions go now?

And who would want to take a bet on all those insurance companies who have made it their business, and quite rightly so, to provide annuities to many pensioners in the UK. I have always said that we have never seen an insurance company actually go down in the UK, although it is at least arguable that Critical Life effectively went down. But if we do see an insurance company go down, it will be an insurance company that provides annuities, and it will be because they have got their life expectancy assumptions wrong, because, basically, when you give them money, they are taking an estimate on how long you live, and if you live too long, they start losing serious amounts of money. But imagine Aubrey de Grey is even halfway right, and suddenly we go from a life expectancy of 90-ish today to a life expectancy of 150, 200, 300, 500, 1,000?

Now, the way his stuff would work, he proposes, is that I would get an injection, aged 56, of whatever it is he has, and my biological age would go back about twenty years, and as they get better at this, they will knock that back even further. So, I would physically look a bit younger than I do now, but internally, I would be thirty. And after the next twenty years, you would get another injection and then it goes back again, and you just keep doing that indefinitely. And this throws up all sorts of weird conundrums. For instance, what do we do with 1,000 year old people who are fit and active?! They would be out playing squash, or off to work riding motorbikes! Where would we need children in all this, or maybe we wouldn't need children even more.

But the whole point about this is that everything that we assume today could go seriously wrong, and it could go seriously wrong the other way too. We could get a catastrophic pandemic which radically shortens life expectancy, so do not think I am just saying it has got to be a one-way bet.

The Implications

As we all live longer, we are running into a problem, and that problem is long-term care. One in two men and two in three women, according to recent estimates, will need some kind of form of high-dependency care before they die. So, long-term care, for me, is the elephant in the room. It is right here and now with me, right as we speak. My mother is in hospital suffering with N-stage pancreatic cancer, and my father is going to need care very soon. That will need to be paid for. It will need to be paid for either from their estate, which is pretty much where it is going to have to come from, or it is going to be paid for by taxes.

It is difficult to get an estimate, but the central case for the long-term care bill from the Exchequer last year was about 16.5 billion. That was a 20% increase on the year before. It is increasing by 20% per annum, compound.

It used to be the case that smokers paid for the long-term care bill. The smoking tax bill last year was, I believe, 9.5 billion, decreasing by 5% per annum, compound, as smokers either died or gave up.

The thing is, from a logical point of view, if you visit to a care home, what you will find mostly in there right now today are women non-smokers. So, right now, today, what the Government should be doing, from a logical perspective, is encouraging everybody to smoke, and especially women!

I probably will not make become incredibly old. My central case, based on analysis of my genealogy, my internal structure, knowing what I know of my parents and so on, I think I am probably going to live to 87 and then probably die of something or other then. The issue for me is that I should not spend time in care.

So, what we have got to recognise is that public and private pension systems, as we see them today, cannot support a thirty year retirement from an effective 35-year working life. And when I say “effective”, that is because you have got to pay off student loans, save for a car, save for a house, and so on. The systems we have today, whether public or private, were simply not designed to do this, so we need to rethink retirement.

Policy responses

We need to raise the state pension age, and, more than this, we need to raise it to 70, for a starter. It is not going to work is we simply raise the retirement to 66 years old in a few years time. I absolutely hear the complaints we are getting now about women’s pensions, but 66 in 2020 is not even nearly enough, and 68 in 2048, which is the current proposal, is just too little, too late.

Employer attitudes need to change. They need to think about how they support and engage with older employees. The biggest increase in any employee category last year was employees over state retirement age.

State retirement benefit systems need reform, and they are getting reformed; they are getting reformed to a decent flat-rate universal pension which provides a real incentive to save. But beyond that, you have to go and save, because if you want more than £140 a week, it is up to you. This is a real incentive to save.

People are going to use a mix of retirement funding solutions, from employer-based pensions, through housing equity, through continuing to work. There is going to be a mix, a blend of tools that people use to solve the retirement income conundrum.

The Government has set out that it is going to try and fill that retirement funding gap that we saw in the pension tsunami in the first slide by auto-enrolling employees into pension saving, and they are going to put in 8% of band earnings between about 7,500 and 33,500, at current values, a year. I do not think this is enough, and I think, because of the personal debt problems we have got in the UK, that there will be quite a high level of opt-out.

It is flat-rate for future state pensions, probably from 2020, but what about today’s pensioners? They are going to left on a mix of a pitiful state retirement pension and means-testing, which means that we carry on carting around in that old area.

And what can we do to make pension saving attractive again? I mentioned Equitable Life, then there was Maxwell Group, and the list seems to be just endless; the number of pension scandals we have had over the past ten years is phenomenal, and the whole pension brand has become tarnished. In fact, I am amazed that there are so many of you here to find out about pensions tonight, because if I go into a pub and say, “Hello, I work in pensions,” you can just see people switching off immediately!

And of course we have got abolition of the default retirement age, which means that people can carry on working into later life, and any argument against that is like Canute standing against the waves. It is inevitable and it will happen, whether we personally might like it or not.

Conclusions

Employers have been moving away from the provision of pensions recently. They will have to re-engage with pensions, in auto-enrolment, starting in 2012, as millions of people will get herded into pension saving for the first time. However, they are interested in other reward structures. I mentioned earlier on the success of individual savings accounts. Employers are now offering those as a core working benefit, into which they just pay your salary, automatically, so you do not see it – it just gets hived off. These are proving incredibly popular, and that is really good news.

Long-term care – how are we going to pay for this? We have got a third commission looking at this, the Dilnot Commission, which is due to report shortly, and I suspect that it will say, unfortunately, that we are going to have to carry on paying for this from residential housing equity and estates – we cannot expect the state to carry on making the huge contributions it already is.

I believe auto-enrolment to be a weak policy. Australia has done extremely well in pensions by compelling employers to make contributions on behalf of their employees. Next year, employers will be compelled to put 12% of total salary into their employees' superannuation plan, and employees are heavily incentivised to contribute on top of that. They will contribute an aggregate 16.5%, average, of salary next year, and this is making them the best pensioned nation on the planet per capita, by as long way. So I think auto-enrolment, this sort of semi-voluntarist approach really is not going to work. I think it will need to be made compulsory, and I would expect that to happen from 2017.

How much longer for tax relief on pensions? If you have got a decent flat-rate pension but nothing beyond that, that is a very clear incentive to save. If it is a very clear incentive to save, why are we giving all this money away to people who can already afford to save? It makes no sense to me.

However, it is not all doom and gloom. We are all living longer, healthier, more actives lives than ever before, so there are some good things in all of this, but we are going to have to work longer and we are certainly going to have to get over the idea that we can fund a thirty-year retirement out of a 35-year working life. We are going to have to raise state retirement age, so that we can pay some kind of suitable state pension to those who get there. And I would say we are also going to have to rethink how we do pensions today, because I think the brand has become so tarnished that people would rather walk on glass than save into a pension where they have a choice. We do need to rethink retirement.