The problems of retirement –
The decumulation crisis in the UK today

A Sapiens White Paper

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1 The problems of retirement

This paper is the first in a series of articles where Sapiens (www.sapiens.com) will look at the key problems faced by the UK retirement industry.

In this first paper, we look at the underlying issues facing the UK retirement industry, and how the Life Insurance software industry as well as other sectors are facing up to those challenges.

It’s not an industry secret that the UK (as with most of the world) is slowly facing up to the realisation that there are problems with the idea of retirement. Barely a week passes without a politician, a journalist or a media “Talking Head” reminding us that there is a ‘pensions time bomb’, a ‘pensions ‘crisis’ or even a ‘pensions disaster’.

The instant reactions are often simplified and reduced to sound-bites: make people retire later, enforce pension savings or simply make the government do something. The truth, as is acknowledged by much of our industry, is that the retirement ‘time-bomb’ is no longer a simple case of financial book balancing. Over the last twenty years there has been a fundamental shift in the understanding of just what is meant by retirement and the expectations of what kind of retirement can be achieved (or at least managed) by a majority of UK retirees.

Today’s retiring population has very different needs to previous generations of retirees and above all, their attitudes and behaviours are radically different, driving the need for a systemic shift in the Industry and Government approach to retirement provision.

The traditional retirement life stage where retirees hung up their tools and suits in favour of lounge slippers is no more. Today the same age cohort are more active, healthy and demanding (behaviours and attitudes) wanting a phased retirement option.

The first, and perhaps most talked about issue, is that of the ageing population. In simple terms we are living longer and healthier lives, but not retiring commensurately later. The facts are startling. In 2012 there was a population of 10 million over 65 year olds, an 80% increase since 1951. The average period expectation of life at age 65 was 11.5 years for men, 14 years for women. This is now 18 years for men and nearly 21 for women, as shown in the ONS graph below.

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1 Tom Rutherford (2012), Population Ageing: Statistics, available online at http://www.parliament.co.uk/

This is in itself is not a great cause for concern – the pre war growth of a relatively young population easily matched the growth of the pensionable population, and thus was able to fund retirement without too much concern. However, the reality of 2013 is that the working population is not growing at a sufficient rate to sustain the retirement needs of a faster growing retired population – the age dependency ratio for retired people to working age people in 1950 was 16. In 2010 it was 25. In 2050 it is estimated to be 40. This rate of growth is clearly putting an unsustainable burden on the working population.

2 Time for change

An ageing population in itself is not necessarily a crisis. Nations have managed population explosions in the past. However, there are a myriad of other factors that push this issue towards the point at which it becomes a problem.

For one, the political model which prevails in the UK has shown itself incapable of the agility or speed of decision required to offset such an issue. The change in life expectancy over the last 60 years has clearly outstripped any government attempts to match it with retirement age changes: an 8 year increase in life expectancy from 1950 to 2013 has been matched by a 2 year increase in state retirement age - not fully effective until 2028. And even this self-evident necessary change had to be dragged screaming and kicking through the political process. The political view is often the short term one, whereas the retirement business is perhaps the longest of terms when it comes to the financial world.

One of the oft suggested ways out of this impending crisis has been to enforce savings. Workplace pensions are a key part of this and the early success of Auto Enrolment has backed up this opinion. Department of Work and Pensions figures suggest an increase
in pension scheme participation from 61% to 83% post AE. In its stated objective of enabling ‘individuals to save towards achieving the lifestyle they aspire to in retirement’, Auto Enrolment has been a success.

However, Auto Enrolment is only providing a fraction of the pension provision that an average 1970s defined benefit pension would provide. It is unquestionable that the average working individual is worse off in pension provision terms today than their counterpart from 1970. An austere economic climate and the escalating costs of defined benefit schemes has meant that many organisations are operating with smaller margins, and as such have little capacity for generous pension investment.

Another key factor driving the pensions crisis is that your pension pound doesn’t go as far in 2013 as it did thirty years ago. Some recent research by AXA shows that the annuity rates available today are considerably less than they were 15 years earlier, and in a low interest economy they do not look like rising in the short term.

With annuities still providing the bulk of retirement provision in the UK, a flat lining annuity yield means that as an investment, the pension is not competitive. And yet despite this, for reasons both legislative (the removal of compulsory annuitisation is still in its infancy) and traditional (as Ros Altmann rightly points out ‘most people don’t realise

3 Available at www.axa.co.uk
they don’t have to buy an annuity\(^4\), the annuity remains king in the world of pension provision.

However, in our opinion, perhaps the biggest issue facing the retirement environment today is that the very idea of what retirement means has changed immensely over the last fifty years. As mentioned earlier, in 1960, a male retiree was expected to retire at 65, and live to 76. Retirement was a single transformative event, accompanied by a lifestyle downsizing. Any downstream care costs would be managed by a traditional family model that saw the frail and infirm cared for within the family unit.

This has changed fundamentally. There are now clearly three stages of retirements – the expensive bucket list phase (fuelled by baby boomer expectations, there is now a view that retirement is an opportunity to do all the things that have been put off), the traditional retirement phase and the care phase (it is no longer a given that elderly parents will be absorbed into the family unit and cared for accordingly). In addition, there are additional factors muddying the once clear transition from work to retirement: the desire to continue working into retirement, the need to pay for large non-state funded expenses (most likely medical in nature) and the desire to ‘leave something for the kids’.

AEGON have put together a succinct view of this changing retirement model.

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\(^4\) Ros Altmann (2013), [www.pensionsandsavings.co.uk](http://www.pensionsandsavings.co.uk)

\(^5\) Available at [www.aegon.co.uk](http://www.aegon.co.uk)
All this is well and good, and certainly cause for concern in itself, but the fundamental, oft-unspoken truth about this change in retirement expectation is that this retirement model has been developed without due consideration for underlying financial support. To sustain a pension equivalent to the minimum wage would require a pension pot of £220,000. That is a £250 monthly contribution, assuming a 46 year working life, a 2% growth rate and a 67 year old retirement age.

Such a pension would not support the bucket list and ‘leave something for the kids’ requirements, let alone the potentially most expansive retirement phase of all, the care phase. Partnership put the average cost of live in care at around £27,000 per year\(^6\). For four years care (the expected length of care for the average care home resident), that is nearly half of the minimum wage equivalent pension pot. It doesn’t leave a lot for the other stages of retirement.

It’s quite clear that most individuals cannot sustain a retirement model of the like described above and below:

3 The retirement reality and expectation gap

So, in many people’s eyes, these stages of retirement are prioritised. The bucket list and the traditional retirement phases are tacitly supported by the traditional (and for the most part most popular) retirement model; a 25% tax free cash sum to subsidise the bucket list with an annuity to support the traditional retirement need.

Most noticeably, care falls outside of this model. In many people’s eyes, the burden of care falls on the state. But this in itself shows up some shocking numbers. Spending on long-term care in 2061 could range from 1.5 per cent to 2.5 per cent of GDP compared with 1.1 per cent in 2016, increasing per capita spending by more than fivefold from

\(^6\) Available at [www.partnership.co.uk](http://www.partnership.co.uk)
£276 to £1,491 on the higher projection (Kings Fund). These are government funds that are directly competing with those needed to sustain pension payments.

Can this be managed? Recent reports of the possibility of NHS bankruptcy would suggest not. The Kings Fund certainly doesn’t believe that the NHS, at its current levels of funding, can support this level of care requirement. Even if the government can manage to support a pension and a care safety net for the retired population, there will surely be an impact on the non-core retirement benefits. Already there is talk about means testing winter fuel allowances. Will this extend to all the ‘perks’ of retirement: the free bus passes, the television license, the dental care. Whichever way you look at it, the overall government spend per individual on retirement benefits will shrink.

It all sounds like a daunting near-apocalyptic scenario, and it is true that the retirement issues facing the UK now are unprecedented. And yet, as with all challenges, there are solutions (even Fermat’s Last Theorem was eventually resolved!). As part of this series of discussion papers, Sapiens will address in detail many of those solutions; the pragmatic, the imaginative and the fantastic. But for now we will look at the challenges presented by the issues.

The first challenge is to take an informed, considered view of the issues rather than to react in tabloid knee-jerk fashion. For one thing, an ageing population underfunded by its working population is nothing new – national insurance increases implemented in 1950 were documented as being ‘due almost entirely to the growth in the cost of retirement pensions’. And despite the gravity of the situation, the ageing population and dependency ratios will not continue to grow exponentially – Eurostat suggest that “for the majority of countries, the proportion of persons aged 65 and over is projected to attain the highest increase within two decades”. There is an event horizon, and if we can see that horizon, we can plan for it. It’s not a Sisyphean task – if the age ratio levels then we can price retirement with certainty.

Next is the issue of addressing just exactly what is meant by retirement. All of the issues discussed above are based on the traditional view of retirement – a cessation of paid work and the commencement of funded leisure as a single transformative event. The truth, as already mentioned above, is that the standard paradigm for retirement has changed.

Retirement is no longer a single, transformative event, whereby an earned income is replaced by an annuity with no prospect of change until death. It is now seen as a series of lifestyle changes/events, as we ease ourselves through the gears of retirement. We still want the same things from retirement - certainty of income, the opportunity to do other things, a provision for death and a protection against the unseen. Perhaps, there

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7 John Appleby (2013), Spending on health and social care over the next 50 years, the Kings Fund

is an argument that we want more than we can realistically have and there will have to be a recalibration of retirement expectations.

4 Managing the retirement reality and expectation gap

But once we manage to break the frankly damaging traditional view of retirement, perhaps we will find ourselves in a stronger position to manage not only our expectations, but also our retirement. A number of financial organisations in the UK are starting to provide imaginative solutions that think outside the traditional annuity for life solution, and these need to be embraced and encouraged. We will explore the response of providers to this particular challenge in our next paper.

The third challenge presented by the issues above is that of political inertia and short-termism. There have, it must be said, been some far-sighted and thoughtful changes to pensions legislation in the last few years, but as a whole, the last thirty years of political oversight has often acted as brake to innovation in retirement solutions rather than a spur. The long delay in abolishing compulsory annuitisation and the complexity of the Protected Rights model are but two examples. Ultimately, the challenge to pension legislators is to find a model of political engagement that supports the providers, the advisor and most of all, the retirees, and doesn't simply play to tabloid shock and horror.

The fourth challenge is understanding who exactly is responsible for ensuring a comfortable retirement. Is it the state, with the provision of a tax breaks, legislation such as Auto Enrolment and care guarantees. Or is it the employer, but in a defined contribution rather than defined benefit model. Or is it the individual, the only party truly able to match expectation and capability. The reality is that it is a mix of all of these, but perhaps there has to be a wider acceptance that whilst the state and the employer can help, ultimately the type of retirement an individual has must be governed by the informed and responsible individual.

Finally, and perhaps most important, is the bald economics of retirement. There is a challenge to be smarter, to be more imaginative in how our retirement is funded. This comes with two clear provisos. First is the message that you can't have what you can't pay for. If you’re not saving for a pension, you can’t expect a retirement villa in Majorca. And second, perhaps more positively, is the simple fact that the retirement options available to most retirees today are not providing the best financial outcome for the individual situation that they could attain. The dearth of advice at retirement is perhaps the primary reason for this – the low uptake of enhanced and impaired annuities (this is increasing as a consequence of the ABI OMO initiative and greater awareness – a definite success story for our industry) , the lack of awareness of reinvestment options, and no real understanding of the benefits of deferring annuity purchases are just some of the areas and options that need to be made clearer to the majority of the population.
So, to sum up, there are clearly some major issues facing the retirement industry today. And yet far from being a scenario of doom and gloom, these issues should be prompting the industry to reinvent itself, to become an industry that is fit for the 21st century. The challenges are clear, and over this series of papers, we will look at what insurance providers, legislator, advisors and pension software providers are doing to support this fundamental shift in the way retirement is understand and managed in the 21st century.
The problems of retirement

What is the decumulation crisis in the UK today

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