

In an age of increased longevity, Stewart Ritchie, President of the Faculty of Actuaries, considers what is being done to plan for the rising cost of pensions...

A healthy future?

The subject of pensions affects everyone who hopes to retire, but we all know there are problems. The UK Actuarial Profession has thousands of its members working at different parts of the pensions industry coalface, so is well positioned to comment on some of the big issues that the country has to address in this area.

Over the last few years, it has become clear that the biggest single issue for pensions is increased longevity, ie. people are living longer. In round terms, the recent rate of improvement in longevity has been two to three years every decade. This is great news – people retiring now at 60 can reasonably hope to live another 25 or 30 years, almost half as much again as their parents could have hoped for at the same age. But it does make pensions a lot more expensive. Before moving on to look at the consequences of this increased cost of pensions, it is worth pausing to make a few more observations about longevity.

Actuaries who specialise in studying longevity now say that smoking is more important than sex. I don't think they are giving away their personal secrets when they say this! Rather they are noting that life expectancy now depends more on whether or not you smoke than on whether you are male or female. We are also seeing large differences in longevity due to other factors, including regional differences, and differences dependent on social class.

Another interesting issue is whether these extra years of life will be enjoyed in good health or endured in sickness and disability. Recent research based on data from NHS Scotland suggests that, on average, some but not all of these extra years will be spent in good health. In other words, we are able to keep people alive longer even when we can't make them fit and well again. This has obvious implications for the health and care budgeting for our ageing population.

A further point about longevity is that it is uncertain how rapidly it may improve in future. Are we reaching the end of a golden era for longevity, with obesity and other lifestyle problems about to curtail further improvements? Are we on the threshold of a quantum

leap in longevity as a result of medical advances in areas like cancer and heart disease? We cannot be sure, but the answer will have an impact on the future cost of pensions.

Given the increased costs that we already know about, there are basically three ways of dealing with them – save more money for pensions through larger contributions, reduce the size of pensions being paid out, or pay pensions from a later age. This applies equally to state pensions, public sector pensions (funded or unfunded) or private sector pensions. But there are further complications. At the start of this decade, investment returns collapsed as a result of stock market falls between 2000 and 2003. Markets have only now recovered to earlier levels.

We now look back at the previous three decades as being a golden era for the investment returns of funded pensions and we do not assume that those days will return to bail out rising pension costs. Another complication is that funded private pensions are increasingly becoming money purchase (or defined contribution), as opposed to final salary (or defined benefit). This means that much more of the pension risk will be borne by individuals, rather than their employers. Such risks could show up in poor investment returns or worsening annuity rates. There is also evidence that when an employer switches from defined benefit to defined contribution, the employer's contribution tends to go down at the same time. If you put less money in, it is pretty likely that you will get less pension out. There is no evidence that this slack is being taken up by increased employee contributions – in fact quite the reverse. Employee contributions are going down too.

So far, the changes in public sector pensions have not been as drastic as in private sector pensions. The Actuarial Profession does not take sides on this, but some observations may usefully be made. It is often suggested that public sector workers get paid less, on average, than private sector workers doing an equivalent job, and that needs to be remembered when looking at pensions. In other words, look at the total employment package, not just the pension element of



it. If we do look at whole packages, we are likely to conclude that, on average, the balance has swung in favour of public sector workers over the last six years or so, because that is the timescale over which private sector pensions have become markedly less generous. Another observation is that large numbers of public sector workers are women on low wages. It is not really about fat cats on either side of the public/private fence, even if reading the newspapers might suggest otherwise. And it remains to be seen whether private sector taxpayers will be willing, indefinitely, to underwrite public sector pensions of a type and scale that are increasingly unavailable to them.

The Government has embarked on two major packages of change, for state pensions and private pensions respectively. It plans to gradually increase State Pension Age to 68 for both sexes, starting after male and female State Pension Ages become fully equal at 65 in 2020. Given the rises in longevity, this was perhaps inevitable. It plans to make other changes to state pensions, such as re-linking the Basic State Pension to earnings rather than prices, which should have the effect of reducing the role of means-testing in old age. However, there will still be a very significant proportion of the retired population eligible for means-tested benefit after the state pension reforms mature, and this is unfortunate for the Government's private pension reforms. Here, the Government plans to use inertia to work in favour of private pension provision. If an employee cannot or does not join a decent

employer scheme, he or she will be automatically enrolled into a Personal Account, with total contributions of 8% of earnings in excess of £5,000 a year, split 3% employer, 4% employee and 1% tax relief.

In order for Personal Accounts to be cheap, no allowance will be made for the provision of individual financial advice to people being auto-enrolled into them. Instead there is likely to be some sort of generalised information to help people decide for themselves whether they should opt out of Personal Accounts, or perhaps to help them decide whether they should be saving more to fund their retirement. But the risk remains that many of those at whom Personal Accounts are aimed may find that their Personal Accounts will reduce their eligibility for means-tested benefits in old age. It will be interesting to see what steps the Government can take to reduce concerns in this area between now and the planned introduction of Personal Accounts in 2012.

Actuaries cannot predict the future but they are expert at measuring and managing long-term financial risk, which is what pensions are all about. Actuaries help employers, pension scheme trustees, individuals, and the Government, to decide what they want to achieve with a pension and how to achieve it. This involves not only putting an expected value on pensions but also reviewing progress as conditions change, including investment aspects. Actuaries are ready, willing and able to help address the challenges presented by the increasing longevity of the UK population.

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The Actuarial Profession
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