ROYAL LONDON

ROYAL LONDON POLICY PAPER 11

The 'Mirage' of Flexible Retirement

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THE 'MIRAGE' OF FLEXIBLE RETIREMENT

Executive Summary

Automatic enrolment into workplace pensions has been one of the biggest good news stories in pensions for many years. As at 31st December 2016, nearly 7.2 million workers[1] had been automatically enrolled into a workplace pension, with more than four in five choosing to remain in a pension rather than exercising their right to opt out. This is a hugely encouraging reversal of the long-term decline in pension scheme membership in the private sector.

However, whilst pension scheme membership has risen, average contribution rates have fallen. At time of writing, mandatory contribution rates under automatic enrolment are just 1% of a band of 'qualifying earnings' for employees and 1% for employers. Even when the scheme is fully implemented in April 2019, the combined contribution will be just 8% of qualifying earnings.

As we showed in our previous report, 'The Death of Retirement' published in February 2016[2], these contribution rates are less than half of those which have been going in to older 'Defined Benefit' pensions. As that report showed, there is a real danger that such low contribution rates will leave millions of people simply unable to afford to stop working if they want to achieve a decent standard of living in retirement.

This report updates that analysis in two important ways:

- First, we take account of the fall in annuity rates since our last report; this change alone adds around ten months to the length of time for which someone has to work to achieve a decent standard of living in retirement;

- Second, we vary the assumption that we made about the choices which people will make about work in later life; in our first report we assumed that individuals would continue to work full-time up to, and beyond, state pension age until they had built a pension pot large enough to enable them to retire; in this report we examine an alternative – and perhaps more realistic assumption – that individuals instead draw a state pension as soon as they can and then cut down to part-time work until their pension pot has reached the desired level.

[1] Source: The Pensions Regulator, monthly automatic enrolment compliance report to December 2016: http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-declaration-of-compliance-monthly-report.pdf
[2] Royal London Policy Paper 2: "The Death of Retirement" which can be downloaded at www.royallondon.com/policy-papers

The new assumption that people do not defer their state pension but instead take a pension as soon as they can and reduce their working hours – so-called 'flexible retirement' - has a profound and shocking impact on the results of our analysis.

We find:

- For those who are targeting a 'gold standard' retirement (replacing two thirds of their pre-retirement income) they will have to work on for <u>an additional five to seven years</u> compared with a person who keeps going full time and defers taking a state pension; specifically, someone who wants a gold standard retirement with a pension protected against inflation and provision for a widow or widower will need to work until they are 85; this compares with a retirement age of 78 for someone who is willing and able to continue working full-time and deferring their state pension through and beyond pension age;

- For those targeting a 'silver standard' retirement (replacing half of their pre-retirement income), switching to part-time work at state pension age means working life is also extended by between five and six years for those who want to be able to afford a pension which is protected against inflation; only the most basic silver standard pension, with no inflation protection and nothing for a widow or widower remains available at a more realistic age.

The 'antidote' to having to work to these extreme ages is, of course, to put more in to the pension in the first place. And here our report offers a glimmer of hope. Compared with the person who only contributes at the legal minimum of 8% of qualifying earnings, we find:

- Someone who contributes 10% of qualifying earnings can retire around three years earlier, whilst someone who contributes 12% of qualifying earnings can retire up to six years earlier; <u>as a rough rule of thumb, each extra 1% on the contribution rate enables you to retire at least one year earlier</u>;

- Even for those who do not begin pension saving until somewhat later in life, an increase in contributions still makes a big difference; for those who do not being saving until they are aged 35, we still find that there is long enough before retirement for each additional 1% on the contribution rate to allow for a working life at least one year shorter than would otherwise be the case;

Our report reveals the stark choices which we face as individuals and as a society. If we only set money aside at minimum levels through our working life and seek to cut our working hours as soon as a state pension becomes available we will face an unappealing choice between working on well into our seventies or seeing our living standard drop markedly as we move from work to retirement. But our report also shows that a modest increase in saving levels can make a big difference to this trade-off. We must therefore ensure that we do not regard automatic enrolment as a 'job done' when contribution levels reach 8% in April 2019.

1. Introduction

In 2016 we published an analysis of how long people will need to work if they want a decent retirement. This was based on the assumption that someone builds up a full state pension and complements this with a workplace pension, saving from age 22 with statutory minimum levels of employee and employer contributions of 8% of 'qualifying earnings'[3].

We set two benchmarks – a 'gold standard' where income in retirement (including state pension) is two thirds of pre-retirement earnings, and a 'silver standard' where the target is replacing half of pre-retirement earnings. In each case we looked at securing an income on three bases:

- An income just for the individual employee, with no provision for a spouse or partner and no inflation protection;
- An income just for the individual, but rising in line with inflation through retirement;
- An income with a survivor's pension, rising in line with inflation through retirement; this is a proxy for the kind of retirement benefits that someone in a Defined Benefit pension scheme might expect to enjoy;

Our central assumption was that the individual would work continuously up to and beyond state pension age until they had built up a pension pot which, combined with their state pension, would give them the target standard of living. We assumed full-time work right up until the date of actual retirement, and that the individual deferred taking their state pension, thereby enjoying an enhanced state pension when they did eventually stop work.

Table 1 is drawn from our original report and summarises our key findings for someone on average earnings.

[3] Mandatory contributions at 8% do not come in until April 2019. The mandatory minimum contribution rate is currently just 2% of earnings - 1% from the firm and 1% from the worker. The DWP's 2016 Automatic Enrolment Evaluation published in December 2016 shows that from the start of automatic enrolment in 2012 up to 2015 there has been a surge of around 3 million in the number of private sector workers contributing less than 2% into a pension; this suggests that large numbers of private sector workers are indeed contributing just at the statutory minimum rate.

Table 1: Estimated retirement ages for an average earner to receive target levels and types of pension provision[4]

	"Gold Standard" (67% of pre-retirement income)	"Silver Standard" (50% of pre-retirement income)
Index-linked, with survivor benefits	77	71
Index-linked, no survivor benefits	76	71
Level pension	73	67

If we assume that achieving a post-retirement income of around two thirds of pre-retirement income means that living standards do not fall significantly on retirement, then Table 1 makes it clear that those who are only contributing at the statutory minimum level to their pension will have to work well into their seventies to avoid a drop in living standards.

In this report we update this analysis in two important ways:

- First, we take account of the changes in annuity rates since our last report;
- Second, we vary the assumption that individuals work full-time and defer taking their state pension until the day on which they stop work completely; we look at what happens to those who draw a state pension as soon as they can but who use this occasion to drop down to part-time work; we then ask the same question as before – how long would you have to work to achieve a gold or silver standard of living in retirement?

[4] Note that in this table and succeeding tables all retirement ages have been rounded to the nearest year; this explains why in some cases slightly better pension provision can apparently be achieved by working to the 'same' age;

2. Updated assumptions on annuity rates

The baseline for our analysis assumes that individuals take their accumulated pension pot and use it to buy an annuity – a guaranteed income for life. Whilst in a world of pension freedoms people now have a much wider range of choices as to what to do with their pension pot, the use of an annuity remains a helpful benchmark to assess the adequacy of pension savings, especially for those who want a guaranteed level of income through retirement. This is the sort of provision which would have been enjoyed by those who benefited from Defined Benefit pensions in the past.

Since we undertook our last analysis annuity rates have fallen and so the first thing that we need to do is update our analysis. We do this in Table 2 which repeats our analysis from last year but simply applies the latest annuity rates. The numbers in brackets show the change compared with our 2016 results. As noted above, all of these estimates are rounded to the nearest complete year.

Table 2: Estimated retirement ages for an average earner to receive target levels and types of pension provision – based on 2017 assumptions and with change on 2016 in brackets

	"Gold Standard" (67% of pre-retirement income)	"Silver Standard" (50% of pre-retirement income)
Index-linked, with survivor benefits	78 (+1)	72 (+1)
Index-linked, no survivor benefits	77 (+1)	71 (-)
Level pension	74 (+1)	68 (+1)

Table 2 suggests that simply taking account of economic and other changes in the last twelve months, people will now have to work for an extra year. Looking at the unrounded data, it would probably be more accurate to say that the fall in annuity rates has added around ten months to the necessary length of someone's working life. But it is clear that if you are planning to use your pension pot to secure an income for life at retirement, recent falls in annuity rates do mean that you will have to work longer to achieve your target retirement income.

It is a sobering thought that for someone following this strategy, in the last 12 months they may have only got 2 months nearer to being able to afford to retire.

3. What if you draw your state pension as soon as possible?

In our initial report, we assumed that people take advantage of the option of deferring their state pension and instead keep working full time until they have a large enough private pension pot to retire. Under current rules, putting off taking your state pension results in an increased rate of state pension of 5.8% for each year of deferral.

However, in reality, relatively few people do defer their state pension. Indeed, there is a widespread assumption that we are moving to an era of flexible or phased retirement where people might combine a mix of pension income and paid work, but perhaps for fewer hours per day or days per week.

So what would happen if we were to relax the assumption that people defer taking their state pension until they stop work, and instead assume that they take a state pension as soon as they can and then work part-time until they can afford to retire? The dramatic answer is shown in Table 3.

Table 3: Estimated retirement ages for an average earner to receive target levels and types of pension provision assuming state pension drawn as soon as available and combined with part-time work thereafter – based on 2017 assumptions and with change on Table 2 in brackets

	"Gold Standard" (67% of pre-retirement income)	"Silver Standard" (50% of pre-retirement income)
Index-linked, with survivor benefits	85 (+7)	78 (+6)
Index-linked, no survivor benefits	83 (+6)	76 (+5)
Level pension	79 (+5)	69 (+1)

The combined impact of taking state pension as soon as possible and cutting back on working hours has a huge impact on the age at which anything but the most basic standard of living in retirement can be achieved.

For those targeting a 'gold standard' retirement, missing out on the benefits of an enhanced state pension through deferral and reducing ongoing contributions into a workplace pension can add between five and seven years to an already elongated working life. For those targeting a 'silver standard' retirement, the basic state pension is already contributing significantly towards the target living standard for an average wage earner, and so the target remains relatively attainable. But the total income achieved at age 69 would fall in real terms each year because of the purchase of a 'level' or un-indexed annuity. Those wanting to protect this modest starting income level against inflation would need to work on into their mid 70s or beyond.

Table 3 shows the combined impact of taking a state pension at the earliest possible date and cutting to part-time hours at the same point. Further analysis shows that it is the decision to claim a state pension as soon as possible which is doing most of the damage. By claiming a state pension at once you are foregoing a boost of 5.8% in your eventual state pension for each year that you defer. By contrast, although reducing hours means less money going in to the pension, those final years of contributions would have very little time to compound and most of the growth in the fund would come from the money which has already been invested in the preceding 45-50 years.

Whereas deferring your state pension has tended to be the exception in the past, even when the incentive to do so was far greater than under the current rules, this analysis suggests that individuals with small private pension pots may need to think very carefully about state pension deferral in future. If they do not, they may be condemning themselves to working on to ages well beyond those that most people would consider to be acceptable.

4. The antidote – saving more?

For those who do not want to be working well into their seventies and who want a good standard of living in retirement, the only other option is to build up a larger private pension pot. In the future, it is those who have large private pensions to complement state provision who will be the ones with choices in later life. In this section we examine the link between contribution rates and potential retirement ages.

The figures are all for an individual whose goal is a 'gold standard' income at retirement, but which does not then increase in line with inflation nor provide for a widow or widower. Table 3 shows that a lifetime of contributions at 8% of 'qualifying earnings' enables an individual to retire at 79, assuming that they draw a state pension as soon as they are able to do so and then work part-time.

Table 4 shows the corresponding retirement ages available to those who make higher levels of annual pension contributions throughout their working life. Results are shown where the contribution rate is a percentage of 'qualifying earnings' as in the earlier analysis and also where the contribution is a percentage of 'total earnings' from the first pound. This distinction is explained more fully in the box.

Box: "Qualifying Earnings" and "Total Earnings"

Under the legislation around automatic enrolment, the statutory minimum contribution rates apply only to 'qualifying earnings' and not to an individual's total earnings. Qualifying earnings are a band of earnings from a floor of £5,824 per year (in 2016/17) to a ceiling of £43,000 [check]. However, some pension schemes apply pension contributions to the whole of an individual's pensionable pay, starting from the first pound. The difference between these two can be significant, especially for someone on modest earnings.

To give an example, if we assume that the full 8% mandatory contribution has come into force, an individual earning £20,000 per year would have to pay £1,134 in total contributions. This is 8% of the difference between £20,000 and £5,824. By contrast, an individual paying 8% from the first pound would pay £1,600. Until now we have presented results based on the assumption that individuals are saving at the statutory minimum, which is 8% of qualifying earnings. However in this section we also present results for those paying a set percentage of their total earnings from the first pound, as this is a more intuitive way to understand required contribution rates and is the definition actually used in many workplace pension schemes.

Table 4: Estimated retirement ages for an average earner to achieve 'gold standard' retirement with a level pension – impact of different contribution rates applied from age 22

	Retirement age (contribution rate based on qualifying earnings)	Retirement age (contribution rate based on total earnings)
8%	79	75
9%	77	73
10%	76	72
11%	74	70
12%	73	68

Table 4 shows the way in which even modest increases in the rate of pension contributions can 'buy' individuals extra years of retirement. For example, an increase of two percentage points in the contribution rate from 8% to 10% enables an individual to retire around three years earlier, whilst an increase of four percentage points brings forward retirement by between six and seven years. A more radical change of moving from the statutory minimum of 8% of qualifying earnings to 12% of total earnings delivers an extra decade or more of retirement.

In reality, of course, many people do not start saving at age 22 and many may only have benefited from the policy of automatic enrolment being introduced later in their working life. We therefore repeat the analysis in Table 4 but show in Table 5 the results for someone who starts pension saving at age 35 – perhaps because of the impact of automatic enrolment.

Table 5: Estimated retirement ages for an average earner to achieve 'gold standard' retirement with a level pension – impact of different contribution rates applied from age 35

	Retirement age (contribution rate based on qualifying earnings)	Retirement age (contribution rate based on total earnings)
8%	84	81
9%	82	79
10%	81	78
11%	80	76
12%	78	75

Not surprisingly, Table 5 shows that those who do not start pension saving until age 35 are faced with an extremely long working life if they simply stick to the minimum contribution rates under automatic enrolment. But Table 5 does also show that even those who start saving later can materially improve their prospects through increased contribution rates. As with those who start saving at 22, a two percentage point increase in contribution rates takes around three years off the required working life, whilst a four percentage point increase makes a difference of around six years. It is clear, then, that even those who missed out on the start of automatic enrolment and do not start thinking about pension saving until their mid 30s (perhaps after they have put down the deposit on a house) can still make a noticeable difference to their options in later life through increased rates of pension saving.

5. Conclusions

Our 2016 report showed very clearly that the current mandatory rate of pension contributions under automatic enrolment could leave people having to work well into their 70s or even beyond if they wanted to attain the kind of quality in life in retirement that has been enjoyed by many in previous generations. Economic developments since that report, and in particular the further fall in interest rates, have pushed attainable retirement dates even further into the distance.

In this report we show that the normal practice of drawing a state pension as soon as possible, perhaps combined with a reduction in hours to part-time work, means that attaining a high quality retirement at a realistic age becomes almost impossible. Even those who are not worried about protecting their income in retirement against inflation or providing for a widow or widower will not be able to reach a 'gold standard' retirement until the age of 79, if they do not take advantage of the option of deferring their state pension.

Our clear conclusion is that those who are only prepared to contribute into a private pension at the minimum legally required rate will need to put off taking their state pension and work on full time if they are to have a more realistic retirement age, albeit still one that is more like to start with a '7' than a '6'.

But we also find that there is a surprisingly effective 'antidote' to the prospect of working on long past traditional retirement ages. Even modest increases in pension contribution rates can have a significant impact on the age at which people can afford to retire. Each additional percentage point on the contribution rate can take a year or more off someone's working life, and a target contribution rate of 12% of total earnings would enable someone to retire at target living standard without working past state pension age.

With the rules around automatic enrolment under review in 2017, this report reinforces the critical importance of contribution rates. If we do not want to see a generation of workers who simply cannot afford to retire with a decent living standard at acceptable ages, the issue of boosting contribution rates beyond the minimum 8% level must be addressed as a matter of urgency.