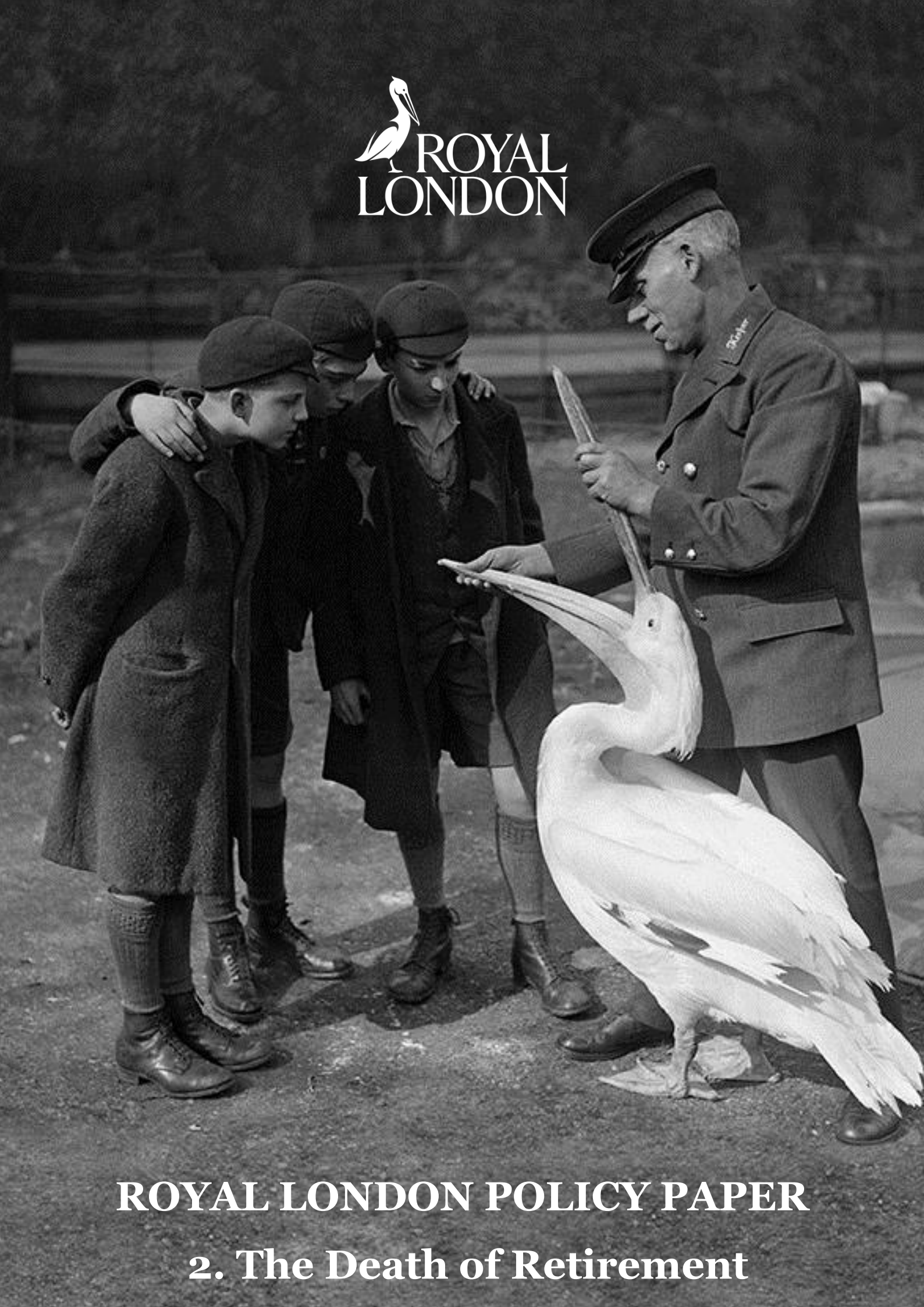

ROYAL LONDON POLICY PAPER

2. The Death of Retirement

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The Royal London Policy Paper series was established in 2016 to provide commentary, analysis and thought-leadership in areas relevant to Royal London Group and its customers. As the UK's largest mutual provider of life, pensions and protection our aim is to serve our members and promote consumer-focused policy. Through these policy papers we aim to cover a range of topics and hope that they will stimulate debate and help to improve the process of policy formation and regulation. We would welcome feedback on the contents of this report which can be sent to Steve Webb, Director of Policy at Royal London at steve.webb@royallondon.com

THE DEATH OF RETIREMENT

Executive Summary

Changes in workplace pension provision mean that coming generations of retirees could have a radically different experience of retirement from their parents. Unless today's workers begin to save significantly more for their later life, many will find that the quality of later life enjoyed by their parents will be unattainable unless they work well beyond traditional retirement ages. For many people, continuing to work to these much higher ages may simply be beyond their physical capability. Without significantly higher levels of engagement in pensions, we may be witnessing the 'death of retirement'.[1]

In this paper we look at the workplace pensions into which millions of people are currently being enrolled. Whilst the average contribution rate into an old-style final salary pension was around 20% of total wages, the statutory minimum for a new automatic enrolment scheme is barely one third of this level. Previous pension levels will be unattainable at these contribution levels, so this paper asks what individuals would need to do in terms of longer working lives in order to address this shortfall.

Our key findings are:

- Someone on average earnings targeting the 'gold standard' of a total pension of two thirds of their pre-retirement income, and securing inflation protection and provision for a widow/widower would need to work to 77 if they only contribute at the statutory minimum level; for an index-linked pension with no survivor benefits they would need to work to 76, and for a level pension they would need to work to 73;

- Someone targeting the 'silver standard' of half their pre-retirement income would need to work just over 71 (index-linking, survivor benefits), just under 71 (index-linking only) or 67 (level pension);

We also consider what would happen to someone who doesn't start contributing at the statutory minimum level until later in life – for example, someone whose first pension is an automatic enrolment pension at age 35 or 45.

[1] There are interesting parallels here with the situation in the US where few workers have ever had access to guaranteed salary-related pensions. A 2013 survey found that 1 in 3 'middle class' Americans were planning to work into their eighties because they could not afford to retire, whilst a similar number thought they might never retire. See: http://money.cnn.com/2013/10/23/retirement/middle-class-retirement

We find:

- For those who start saving at 35, they need to work to 79 for a gold standard pension with index-linking and survivor benefits, to 78 for just an index-linked pension and 76 for a level pension;

- For those who start saving at 45, they need to work to nearly 81 for a gold standard pension with index-linking and survivor benefits, to 80 for just an index-linked pension and 78 for a level pension;

We also consider the position of people on higher incomes, such as those on double the national average income.

Our key findings are:

- The goal of 67% of pre-retirement income is effectively unattainable for those who contribute only at the statutory minimum level; such a person would need to work into their mid 80s to reach such an income with index linking, and to their early eighties for a flat pension with no inflation protection;

- The goal of 50% (which the Turner Commission recommended for higher earners) is attainable by working to around eighty for an index-linked pension and to the mid 70s for a flat pension with no inflation protection.

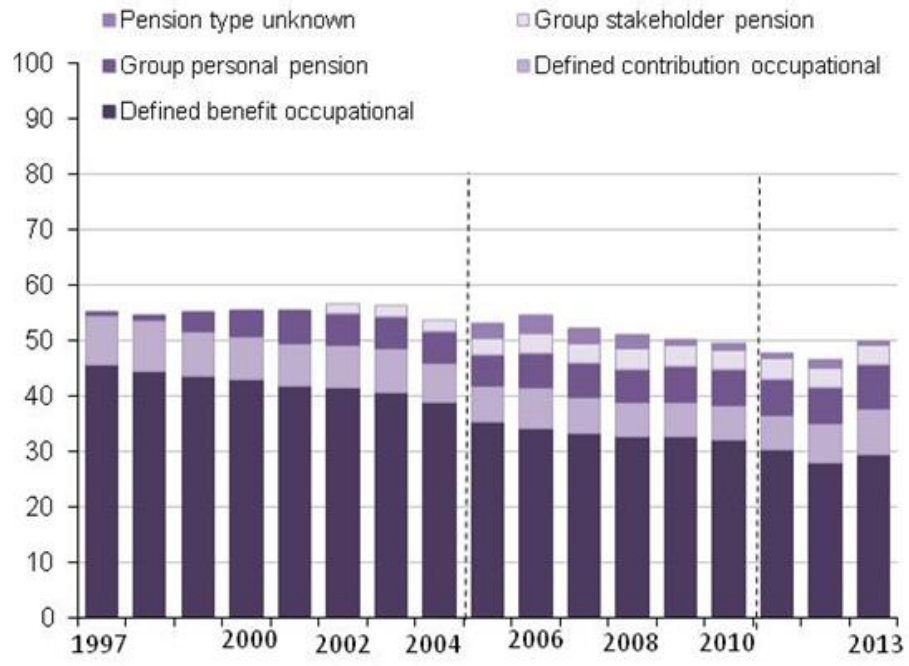
The key message of this paper is that whilst automatic enrolment is a vital initiative in getting people to start pension saving, there is clearly much more to be done to get people saving at a level that will give them the quality of life in retirement that they may expect or may hope to achieve. With even the statutory minimum contributions of 8% not in force until 2019, and with the Government signalling it has no plans to require higher contributions, much more needs to be done to ensure that individuals do not reach later life only to discover that the sort of retirement that they want has become unattainable.

1. Pension provision of the present generation of retirees

For many years, the dominant form of workplace pension provision has been 'Defined Benefit' (DB) where individuals are promised a set level of pension at a pre-determined age, based only on their years of scheme membership and on their salary, either at retirement or averaged over a longer period. Such provision was, of course, by no means universal, and was particularly concentrated in the public sector and amongst higher earning employees in the private sector.

As Figure 1 shows however, such provision has been in long-term decline.

Figure 1. Employee membership of a workplace pension by pension type: 1997-2013

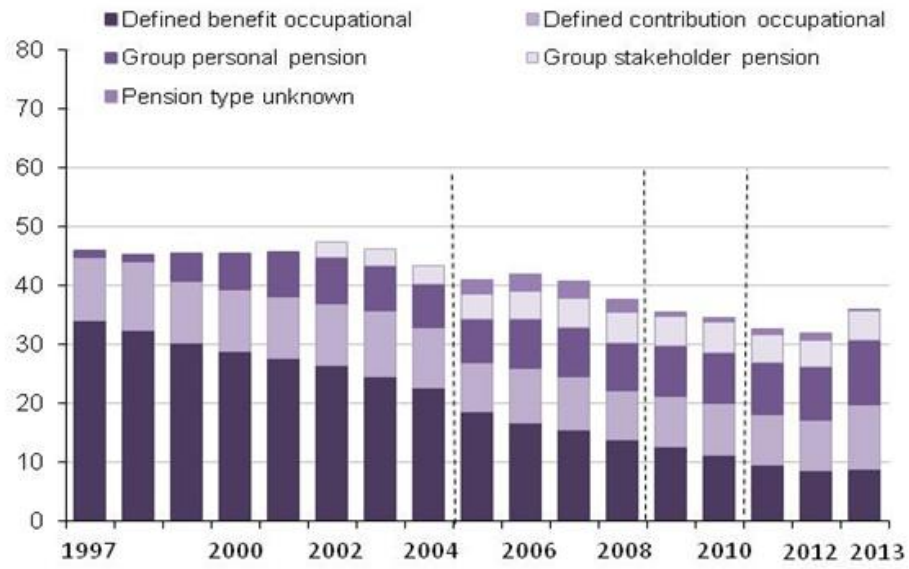


Source: Office for National Statistics, Pension Trends 2014

The reasons for the decline in DB pension provision have been widely discussed, but include growing costs as longevity has increased, increased regulatory burdens (including mandatory indexation of post-1997 service) and reduced investment returns.

As a result, employers have progressively closed their DB schemes and looked for cheaper and more predictable alternatives. Figure 2 shows the same data as Figure 1 but just for the private sector. As will be immediately apparent, the level of coverage is much lower in the private sector and has declined much more rapidly over time.

Figure 2. Employee membership of a workplace pension by pension type, private sector: 1997-2013



Source: Office for National Statistics, Pension Trends 2014

Although coverage very slightly improved in 2013 because of the start of automatic enrolment, coverage of open DB schemes in the private sector is set to decline further, not least because of the ending of the National Insurance rebates paid to such schemes in 2016. As a result, some have forecast that there will be no open DB schemes in the UK's largest 250 companies by the end of this year[2].

The main replacement for DB schemes has been 'Defined Contribution' (DC) provision where the only thing specified in advance is the amount going in to the pension pot. Where the pot is used at retirement to buy an annuity, or income for life, the real value of the pension will depend on a range of factors including:

- The amount contributed into the scheme;
- The investment performance of the scheme;
- The amount taken out in charges for running the scheme and managing the investments;
- The age at which the pension is drawn;
- Annuity rates at the time of retirement;

[2] See for example: "Death of a decent pension": http://www.express.co.uk/news/uk/635906/gold-plated-final-salary-pension-funds

As Figures 3 and 4 show, the amount of money going in to typical DC pensions has, for many years, been substantially less than the amount going in to DB pensions[3].

Figure 3: Average employer and employee contributions into DB workplace pensions (% of total salary)

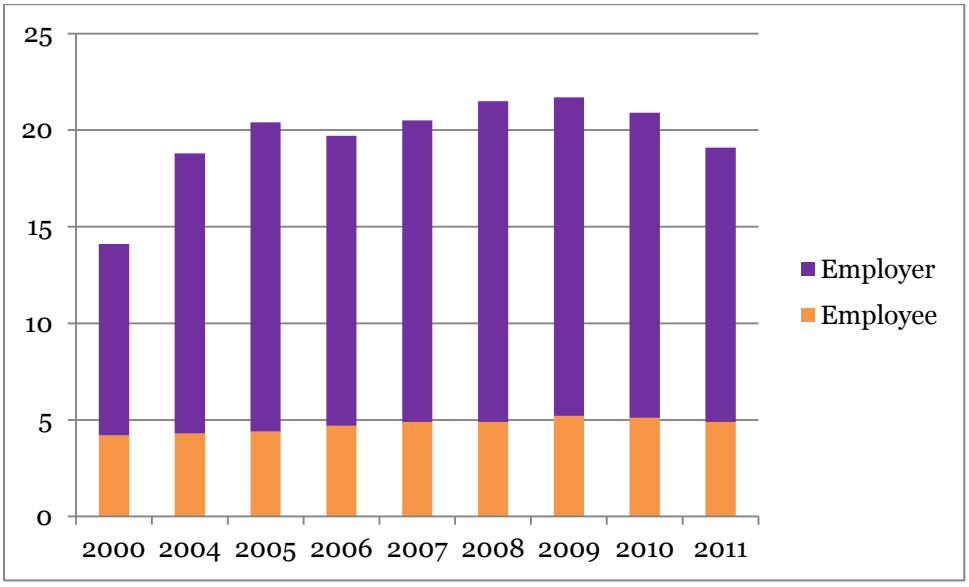
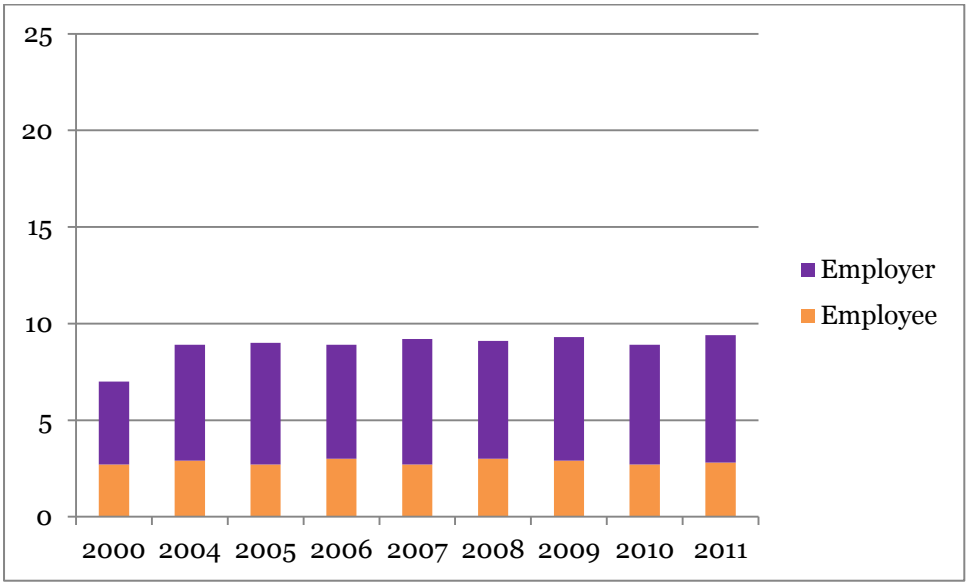


Figure 4: Average employer and employee contributions into DC workplace pensions (% of total salary)



[3] Note that both charts have the same scale on the vertical axis.

The key point here is not that DB pensions are inherently superior to DC pensions, but that the switch to DC involves moving to a model where the total amount being contributed is substantially lower than in the past. It would be reasonable to assume that this will in due course result in much lower pensions.

One response to this would be for individuals to work longer. This will improve their pension provision in three ways:

a) By working for longer, more money will go into the pension and earlier investments will have more time to benefit from compound growth;

b) By buying an annuity later, a better rate should be achievable, other things being equal;

c) By deferring taking their state pension, they receive an increment of around 5.8% for each year of deferral;

The question we seek to answer in this paper is just how much longer would individuals have to work to achieve the sorts of pension provision that many achieved in the past.

We begin in Section 2 by setting out some benchmarks for how much might be regarded as 'enough' income in retirement. We then describe in Section 3 the contribution levels implied by the new rules over automatic enrolment. In Section 4 we set out our estimates for how long individuals at different income levels would need to work to achieve different target incomes in retirement, depending on when they start saving. Section 5 looks instead at the levels of contributions that would be needed to avoid having to work for so long past state pension age. The final section draws some policy conclusions.

2. How much is enough?

If the purpose of saving for retirement is to enable someone to maintain their quality of life when they are no longer earning a wage, then an intuitive way to measure 'adequacy' of pension provision would be relative to pre-retirement income.

In 2004, the much-respected Turner Commission set some income-replacement benchmarks for groups at different income levels. For an average earner, they assumed that an income of around two thirds of pre-retirement gross earnings would be an appropriate target in terms of preserving pre-retirement living standards.

It should be noted that it is not necessary to achieve one hundred per cent replacement of pre-retirement gross earnings because:

- Those above state pension age no longer have National Insurance Contributions applied to their earnings;

- Those who are no longer working will save on work-related costs, including travel-to-work expenses;

- Many people in retirement will own their home outright so will no longer have to find mortgage interest costs;

- Whilst those in work will generally need to put aside some of their income in savings for later life, those in retirement do not generally need to do so;

An income of two thirds of pre-retirement gross income is readily obtainable for those who had reasonably long-service in a salary related pension scheme. For example, with a current basic state pension of just under 22% of average earnings, someone with 28 years' service in a pension providing 1/60th of final salary for each year of membership would attain the two thirds target by the age of 65.

Two additional features of DB pension provision which are valuable and which also need to be considered in any comparison with DC outcomes are:

- Most DB pensions made provision for a surviving husband or wife in the event of the death of the scheme member, generally paying a survivor's pension of at least 50%;

- Public service pensions generally provided full protection against inflation in retirement, whilst private sector schemes had to provide limited inflation protection in respect of service from 1997 onwards; with retirements typically lasting two decades or more, this protection has become increasingly important.

For our analysis in section 4 we therefore consider each at-retirement benchmark on three bases:

- A pension at retirement which is fully index-linked and provides survivor benefits;
- A pension at retirement which is fully index-linked and provides no survivor benefits;
- A level pension at retirement with no survivor benefits.

Whilst a target of two thirds of pre-retirement gross income might be regarded as a 'gold standard', it is clear that such a goal is unattainable for many, including for higher earners. We therefore also consider a 'silver standard' of a replacement rate of fifty per cent of pre-retirement gross income. The Turner Commission took the view that this would be the right sort of target for those on higher incomes.

3. Pension contributions under automatic enrolment

In the previous section we noted that the combined rate of employer and employee contributions to a typical DB scheme has averaged around 20% of wages in recent years, whilst the equivalent figure for a typical DC scheme has hovered at just under 10%. However, the statutory minimum contribution under the new automatic enrolment scheme is lower still.

When workers are first automatically enrolled, the statutory minimum contribution by employee and employer together is just 2% of a band of earnings starting from £5,824 per year. This statutory minimum is phased up to a combined 5% from April 2018 and 8% from April 2019. For a worker on the national average wage of £27,600, this works out at a minimum contribution of £1,742 per year. However, the percentage rate only applies to a band of 'qualifying earnings' and not to the whole wage. Expressing the figure of £1,742 as a percentage of £27,600 gives a contribution rate of just 6.3%.

In summary therefore, whereas around 20% of salary was going in to provide DB pensions, and just under 10% of salary was going in to average DC pensions, the new automatic enrolment minimum equates to just 6.3% of total wages for an average earner. If contributions remain at the statutory minimum level, there will be a substantial reduction in the amount of money going in to pensions compared with the DB world and even compared with contribution levels into established DC schemes.

4. When can you afford to retire?

If individuals are passive in their pension planning, simply acquiescing to being automatically enrolled into a workplace pension at the age of 22, and doing no more than contributing the statutory minimum, what sort of retirement can they expect? Or, to phrase the question in a different way, if they want to have the sort of income in retirement that the best pension provision has provided in the past, for how long would they need to work to achieve this goal?

For each of our case studies we look at two possible benchmarks – a 'gold standard', where total income from state and workplace pensions at retirement replaces two thirds of pre-retirement gross income, and a 'silver standard' where the target is an income at retirement of half of pre-retirement gross income. For each benchmark we look at a pension which rises through retirement in line with inflation and provides for survivors, one which rises with inflation but provides no survivor benefits and a simple 'level' pension which remains unchanged through retirement.

We begin with a worker at the national average wage of £27,600 per year who is automatically enrolled at the age of 22 and does no more than contribute the statutory minimum contribution into a DC workplace pension with charge levels set at the current charge cap of 0.75% per year[4]. Table 1 shows the age at which this person could retire depending on the level and type of pension provision which he/she was seeking to obtain:

Table 1. Estimated retirement ages for an average earner to receive target levels and types of pension provision[5]

	"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

Even for those starting work today, whose state pension age is already 68 and may well rise further, the figures in the first column of Table 1 make shocking reading. To fully replicate the kind of pension which would have been enjoyed by someone with decent service in a final salary scheme, today's new worker

[4] Full details of the assumptions which underlie these projections are set out in the Appendix
[5] 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;

would need to work until they were 77 based on contributions at the statutory minimum. Even disregarding the valuable benefits of inflation-protection and provision for spouses, the worker would need to work until 73.

The goal of a 50% replacement rate looks somewhat more attainable, but again only if things like inflation protection and provision for survivors are regarded as an optional extra. In short, contributions at the statutory minimum level will simply not be enough to attain the equivalent of the best pensions of previous generations at retirement ages to which we have become accustomed.

Table 2 repeats the analysis for someone on twice the national average wage.

Table 2. Estimated retirement dates for an earner on double the average wage to receive target levels and types of pension provision

	"Gold Standard" (67% of pre-retirement income)	"Silver Standard" (50% of pre-retirement income)
Index-linked, with survivor benefits	85	80
Index-linked, no survivor benefits	84	79
Level pension	81	75

As Table 2 shows, attaining two thirds of pre-retirement income is a pretty much unattainable goal for those on higher earnings who wish to contribute only the statutory minimum of 8% of band earnings. Even a more realistic target of 50% of pre-retirement earnings (something which the Turner Commission thought was a reasonable target for higher earners) looks beyond the reach of most people without a significant increase in contribution rates.

Whilst these results are alarming enough, they do make the assumption that someone is automatically enrolled at the age of 22 and contributes every year of their working life up to retirement. Whereas a start date of 22 for pension saving will become the norm for future generations, many in the existing workforce did not start saving until much later in their working life, and gaps in contributions due to periods of unemployment, sickness or family responsibilities are not uncommon.

We have therefore repeated the analysis in Table 1 for those who do not start pension saving until a) their mid 30s and b) their mid 40s. Given that only one worker in three in the private sector had any pension provision at all when automatic enrolment began in 2012, this will be a more realistic scenario for many of

today's workers who are already some distance into their working life. The results are shown in Tables 3 and 4.

Table 3. Estimated retirement dates for an earner on the average wage to receive target levels and types of pension provision – STARTING AT AGE 35

	"Gold Standard" (67% of pre-retirement income)	"Silver Standard" (50% of pre-retirement income)
Index-linked, with survivor benefits	79	73
Index-linked, no survivor benefits	78	73
Level pension	76	70

Table 4. Estimated retirement dates for an earner on the average wage to receive target levels and types of pension provision – STARTING AT AGE 45

	"Gold Standard" (67% of pre-retirement income)	"Silver Standard" (50% of pre-retirement income)
Index-linked, with survivor benefits	81	75
Index-linked, no survivor benefits	80	74
Level pension	78	72

The stark message of Tables 3 and 4 is that those who start pension saving later in life will need to work well beyond traditional levels in order to attain even the modest 'silver standard' of pension provision.

Differences between men and women

By law, annuity rates have to be the same for men and women, so as long as someone earns the national average wage and uses the accumulated pension pot to buy an annuity, the figures in the tables above will apply equally to men and women.

However, in practice, the necessary retirement ages for women are likely to be higher than for men to achieve any given target pension. There are two main reasons for this.

The first is that we have assumed for all those who start work at 22 that they work continuously until they retire. This is quite an extreme assumption and is likely to be particularly unlikely for those women who take time out from paid work because of family responsibilities. Whilst the new state pension provides relatively good protection for gaps in paid work, someone not in paid work misses out on contributions into their workplace pension and so would have to work longer to make up the shortfall.

The second factor is that even when women do return to work after breaks, they will often to do so on lower wages than a male contemporary, for example because of the interruption to their career progression. This means that the amount going in to a pension is likely to be lower than it would have been and again means that the woman in question will end up working further beyond state pension age to achieve the sorts of pension targets that we have considered in this paper.

5. The 'antidote' to longer working – higher contributions

So far we have assumed that the problem of inadequate pension saving is 'solved' by longer working. As we have seen, even for those who start contributing at age 22 those who contribute only the statutory minimum amount into a workplace pension would have to work well beyond state pension age to achieve the kind of income in retirement that was the norm for many in previous generations.

On the assumption that working well into your seventies and beyond is likely to be unacceptable for most, we consider in this section the main alternative – putting more into the pension each year.

We have looked at the position of workers starting work today and have assumed that they would be looking to stop work at state pension age, which under current legislation would be 68. Table 5 shows what proportion of 'band earnings' someone on average earnings would need to contribute through their working life to reach the income thresholds and types of pension provision that we have been considering so far.

Table 5. Estimated contribution rates for an earner on the average wage to receive target levels and types of pension provision at age 68

(% of band earnings required)	"Gold Standard" (67% of pre-retirement income)	"Silver Standard" (50% of pre-retirement income)
Index-linked, with survivor benefits	25.1%	13.8%
Index-linked, no survivor benefits	22.4%	12.3%
Level pension	13.8%	7.6%

One of the interesting features of Table 5 is that the required contribution rate for a 'level' pension replacing half of pre-retirement levels is just under 8% which is in line with the statutory minimum level which will apply from 2019. In other words, we estimate that someone who does indeed start pension saving at 22 at the minimum level and continues for the next 46 years without interruption can expect this basic level of pension provision. But they will have no protection against inflation and have no provision for a surviving spouse.

Expressing contributions as a percentage of 'band earnings' allows us to compare these with the current automatic enrolment minimum of 8% of band earnings.

But in schemes which do more than the statutory minimum it would be quite normal for contributions to be expressed as a percentage of total pay. We have therefore presented in Table 6 the same analysis as in Table 5 in terms of contribution rates required as a percentage of gross pay.

Table 6. Estimated contribution rates for an earner on the average wage to receive target levels and types of pension provision

(% of gross pay required)	"Gold Standard" (67% of pre-retirement income)	"Silver Standard" (50% of pre-retirement income)
Index-linked, with survivor benefits	19.8%	10.9%
Index-linked, no survivor benefits	17.7%	9.8%
Level pension	10.9%	6.0%

Table 6 shows that a combined contribution rate of 11% of total pay throughout someone's working life would deliver a good level of pension at retirement, albeit one that did not keep pace with inflation. Given that average contributions to DC pensions before the start of automatic enrolment were around 9% of total pay, such a goal ought not to be unattainable, but it will not happen if large numbers of workers and their employers simply default onto the automatic enrolment minimum and if that minimum is not raised in some way.

6. Conclusions

We have seen that workers in Defined Benefit pension schemes have generally enjoyed employer and employee contributions into their pensions of around 20% of salary. This was enough to deliver for many an income at retirement of around two thirds of pre-retirement income, together with protection against inflation and provision for a surviving spouse. We have also seen that typical contributions into DC pensions were running at about half of this level before the introduction of automatic enrolment. Statutory minimum contributions into automatic enrolment schemes imply a further reduction in the amount per head going into pensions.

If the amount per head going into pensions is in some cases only one third of previous levels, something will have to give.

We have shown that today's workers who want to reach the income levels of the best of DB provision would need to work into their late seventies, even if they start saving at 22, if they only contribute at minimum levels. The figures are, not surprisingly, even worse for those who do not start contributing until their thirties or forties.

We find that a much lower quality of pension provision is attainable for those who contribute throughout their lives at the minimum level, but this only provides half of pre-retirement income and no protection against inflation in retirement. It would also be further undermined in the event of periods out of paid work due to unemployment, sickness or family responsibilities.

If individuals want a better retirement than this, and to have enough time after stopping work in order to enjoy that retirement, then the only answer is for more money to go in to pensions. Whilst inertia and automatic enrolment is a great start, this paper shows that it simply gets people to the starting line. Without action to get contribution rates up, too many people will find later in life that they simply cannot afford to retire.

Appendix 1: Assumptions behind the models

Projections of the sort contained in this paper are inevitably based on a large number of assumptions. Wherever possible we have chosen to use typical or average figures, and when projecting future investment returns we have used assumptions in line with those required in Statutory Money Purchase Illustrations (SMPIs).

The key assumptions we have made are:

- Average earnings and thresholds for automatic enrolment rise at 2.5% per year;
- State pension remains a constant share of the national average wage, in line with the current statutory rules; we assume that the person receives the full 'new state pension';
- Investments in the fund rise at 5% per year, and charges are capped at an Annual Management Charge of 0.75%;
- The individual uses their accumulated pension pot to buy an annuity; future annuity rates are in line with those used in Statutory Money Purchase Illustrations (SMPIs);
- That individuals immediately contribute at the full rate of 8% of band earnings from the start of their membership; we ignore the effects of the initial 'phasing' of contributions from an initial 2% to 5% in 2018 and 8% in 2019; this is because this is a transitional feature of the system and all new workers from 2019 onwards will start at 8%;

Appendix 2: National, Regional and Local Estimates

Throughout this report we have based our analysis on someone earning the national average wage. However, wage levels vary considerably from area to area. As the state pension is set at a constant level for the whole country, this means the number of years of work a given individual needs to do to attain a 'gold standard' or 'silver standard' pension will vary from area to area because of variations in local wage levels.

We have therefore produced estimates for each nation of the United Kingdom, each English region and each local authority to see how much the figures in the report vary across the country. Our method is as follows:

- We have used Office for National Statistics data on the median gross annual wage of full-time workers as at April 2015; the data refers to full-time workers who have been in post for one year or more; this is a consistent definition to the one used in the main report;
- Where national, regional and local wage data is available we have reworked our estimates to estimate the age at which a worker on the typical wage in that area could stop work having achieved a 'gold standard' (of two thirds of pre-retirement income) or a 'silver standard' (of half of pre-retirement income) of living in retirement;

A full spreadsheet with data for each nation, region and local authority is available from www.royallondon.com/policy-papers. The following table shows key results for illustrative local authorities:

Table: Age at which you can retire in selected areas to achieve target pension income

Description	Median annual wage	'Gold Standard'	'Silver Standard'
Copeland	£40,040	80	75
Tonbridge and Malling	£34,996	79	74
United Kingdom Average	£27,645	77	71
Sedgemoor	£25,000	76	70
Boston	£20,376	73	67

Whilst local estimates are subject to some sampling variation it is still clear that because of big variations in wage levels across the country, workers in some areas will need to work for far longer than others to maintain their standard of living into retirement. This is particularly because the state pension of around £8,000 per year provides a far higher proportionate level of income replacement in low age areas than in high wage areas.