

Falling into a retirement adequacy crisis

The word 'pension' is a widely known and understood term in the UK. The vast majority of the UK population will rely on a pension, in some form, to provide for their retirement. The three pillars of retirement provision – state, employer, individual – all help form what retirement might look like for an individual. It might seem hard to believe, that a universal state pension in the UK is less than 100 years old.

They say pensions are for the long term, but they themselves haven't been around for too long.

Following the launch of the UK's universal state pension in 1948, many employers looked to make pensions a key part of their remuneration package. Understanding of pensions was new, as were the rules and regulations that we are accustomed to today. Being 'defined benefit' (DB) in form, the long-term costs were broadly unknown and, through both increasing longevity and legislative requirements on DB pensions, they slowly faded out of prominence from the 1980s onwards.

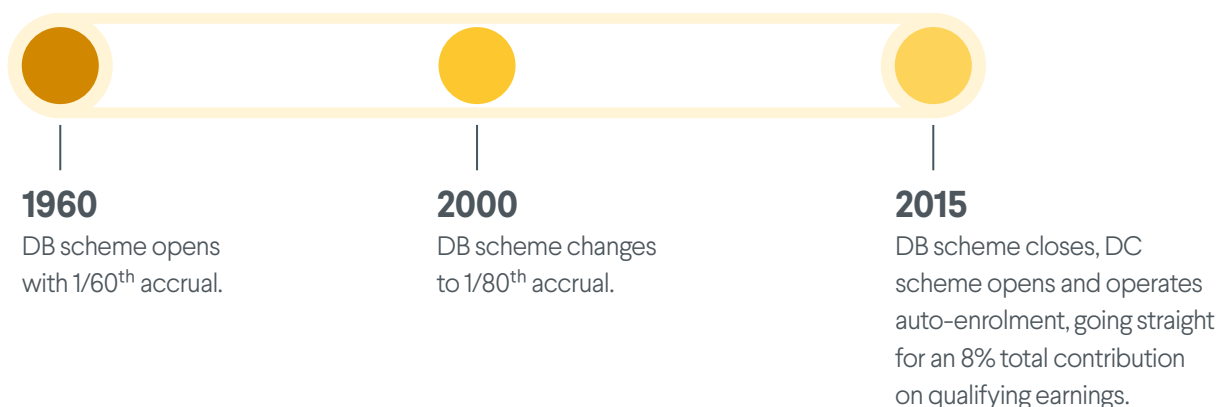
With most private sector DB schemes first closing to new members, and then to accrual, we gradually saw a rise in defined contribution (DC) schemes in their place. Again, a new concept. The running of a DC scheme also evolved over time. Throughout the 2010s, we've seen auto-enrolment increase

pension coverage throughout the UK, with new ways to invest, different strategies being designed to try and optimise member outcomes and technology being embraced to provide a better member experience.

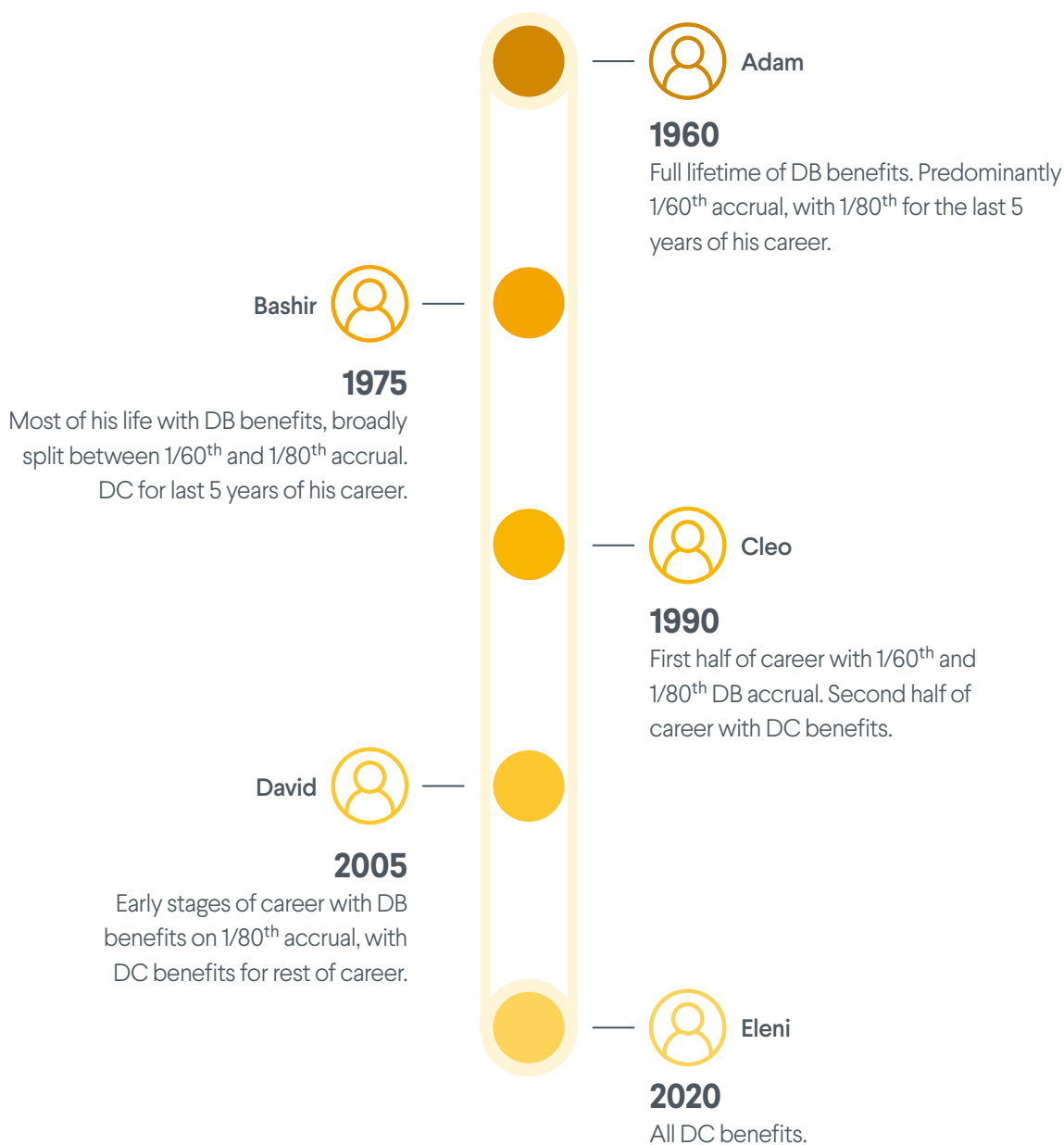
Comparing today to how the pensions market looked 50 years ago, there is a drastic difference in the landscape. But fundamentally the role of a pension is to provide a sufficient income in retirement; that has remained constant. With this continued evolution of pensions in the UK, have we lost track of what matters most to members – an adequate income in retirement? Are the latest generations significantly worse off at retirement than their predecessors? And, if so, how have we gotten here?

THE TYPICAL EVOLUTION OF A UK PENSION SCHEME

To help us compare and contrast the (short) history of occupational pensions in the UK, we have designed what a typical pension scheme's journey may have looked like. This sees the evolution of a UK pension scheme, starting with a DB scheme with a typical 1/60th accrual rate, which is reduced to 1/80th as the scheme matures and eventually closes and converts to a DC scheme in its place. For simplicity, our scheme ignores some of the complexities that many DB schemes experienced in the 1970s, 1980s and 1990s (ie GMP benefits and equalisation).



Next we need our members, who are at the heart of the story. Here, we've used 'personas' to help bring some of the members to life and who have joined the scheme at different points in its evolution. Member details, such as salary and Normal Retirement Age, are kept consistent, as are the assumptions. Please see the appendix for more details.



The personas represent different generations of UK society. They may represent you or members of your family, parents or children, partners or siblings. They are more than just personas; they represent real individuals. While everyone's specifics differ, they broadly summarise each generation's journey to retirement.

HOW OUR PERSONAS COMPARE

Both DB and DC schemes give a different output for retirement; a DB scheme will naturally provide an annual pension entitlement whereas a DC scheme will give a pension pot at retirement. This means that Adam will just have his annual pension entitlement, Eleni will just have her pension pot and the other personas in between will have a mixture of both.

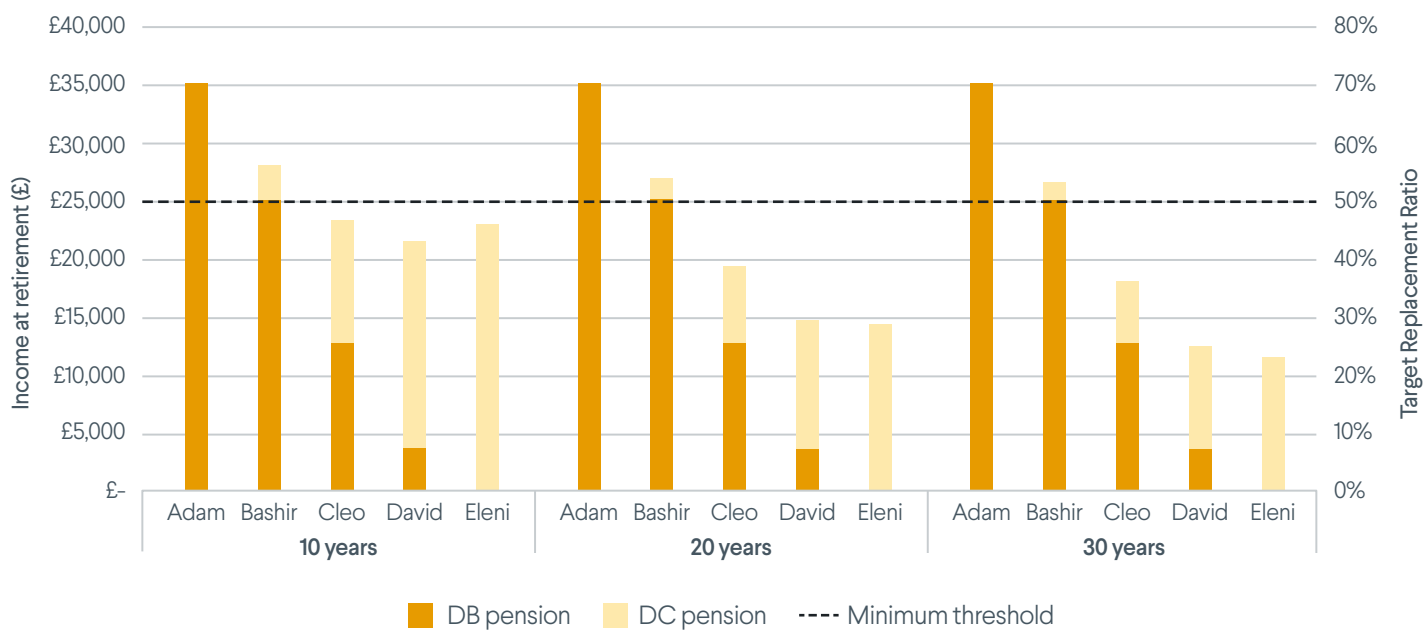
There are different ways to access a DC pension pot. However, for our modelling we want to compare like-for-like, and so assume that members draw their DC pot as an annual pension through income drawdown.

On this basis, there are three clear conclusions to draw from our modelling and comparisons, and we explore these in turn.

THE IMPACT OF LONGEVITY

The length of a DB pension is relatively uncertain, being directly linked to the longevity of the member. However, the member has the security and backing of a guaranteed pension, regardless of how long they live. This isn't the case for a DC pension pot, where a member has to predict their longevity and ensure they have enough in their pension pot to last the rest of their life. Purchasing an annuity provides this guarantee, but the member is paying an insurance premium for this.

Under income drawdown, the member is faced with a challenge: “how much money can I draw to last the rest of my life?” In managing this uncertainty, a member might expect for their income to last 10, 20 or 30 years in retirement. The below chart models what an annual income might look like for our personas under this basis, with modelling being shown on either an income £ pa basis, or a Target Replacement Ratio basis (income at retirement as a proportion of salary before retirement). For illustration, we’ve considered a 50% Target Replacement Ratio as the minimum threshold for what an adequate retirement income may look like.

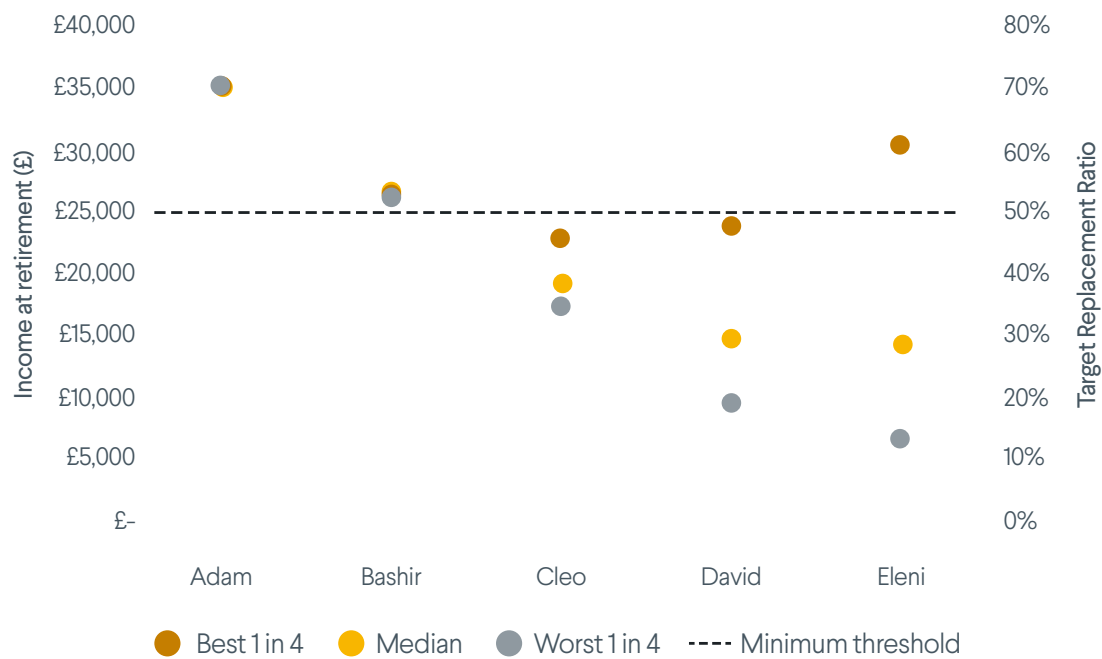


Even for a short period of time, the sole DC outcome for Eleni is notably worse compared to the sole DB outcome for Adam. If Eleni wanted to achieve Adam's income, her pension pot would only expect to last her seven years, then she would run out of money. The picture is bleaker for DC as longevity increases, and this picture is blended for the personas in between.

In most cases members cannot accurately predict their longevity; not only do DB members benefit from a greater retirement income, they also benefit from downside risk protection of their own longevity. DC members do not have this luxury, nor can they predict how much income they should take to ensure their DC pension pot lasts for their life. The irony is that, as longevity has increased, the pensions industry has evolved to make members carry that risk.

THE VARIABILITY OF PENSION OUTCOMES

The above modelling illustrates the median outcomes for DC pension pots, but the median is just what a typical member can expect in their retirement. Unlike DB pensions, it's in no way a guarantee for DC pension pots and members incur all of the investment risks of their pension, both upside and downside. And when using income drawdown as the way to take a DC pension pot, members also bear this investment risk throughout retirement as well. To illustrate what this risk looks like, the chart below showcases a median outcome and a best and worst 1 in 4 outcome for our personas, assuming the income is required for a 20-year period.



The range of outcomes becomes more varied as members have increasing reliance on their DC pension pot for their retirement. Adam, for example, has a guaranteed income under a DB pension, and therefore has no volatility at all. Eleni, on the other hand, has a very wide range of outcomes, with even her best 1 in 4 not surpassing Adam's income. The downside risk is also alarming; with a 1 in 4 chance of having a pension worth less than £7k pa (or less than a 15% Target Replacement Ratio). This level of risk is significant and blends through the personas, and generations, of those who rely on DC for their retirement outcome. Eleni won't be able to determine her expected retirement outcome until later in her retirement journey, which is arguably at a time when it's difficult to make any meaningful changes to that outcome.

THE INCREASING REQUIREMENTS ON MEMBERS

The gradual shift from DB to DC over time has placed much more onus on members to understand and position themselves for their retirement. Adam has the certainty that his DB pension will keep pace with his salary and provide him with an adequate and guaranteed level of pension at his retirement, that will last throughout his retirement. Eleni has a DC pension, but no certainty about what her retirement income may look like, or how long it will last. She's had no guidance on the level of income she'll need to sustain her retirement, and no assurance that her DC pension is designed to lead to an adequate outcome for her.

A benefit, and consequence, of the move towards a DC pensions landscape is the increase in member choice and flexibility. Adam's main decision throughout his retirement journey is when to retire. Eleni, however, needs to consider much more and at all stages of her retirement journey. How much should she contribute into her pension, knowing she must balance that against her wider lifestyle needs? Should she change her investment strategy? What about how and when to retire? What product should she go into? How much to draw out and when? These are questions the typical member isn't equipped to deal with. In DB, there is very little choice, you either stay in the scheme or transfer out. So, a member is very unlikely to make an incorrect decision. However, in DC, there are many ways to make an incorrect choice that negatively impacts retirement outcomes, and members may not know if they do make an incorrect decision.

THE PERSONAS IN BETWEEN

We've focused on Adam and Eleni, both showing the clear differences of DB and DC respectively and how retirement outcomes have worsened as DC has become more prominent in the UK. However, the personas in the middle will be where many generations lie, a combination of both DB and DC benefit to provide for retirement. These personas will not receive the full benefit of a DB pension whilst taking on all the risks and challenges of a DC pension. Take David for example, his outcomes are broadly comparable to that of Eleni, even with 10 years' of DB accrual. His DB pension only keeps up with inflation, and he has missed out on the crucial early years in DC that really make a difference. He is still exposed to both longevity and investment risk through his DC pension, and he still has the same complex decisions to make throughout his DC journey. These personas have even less time to make any required changes to better their retirement outcomes.

GOING BEYOND THE MODELLING...

Our initial thoughts and modelling have focused solely on the personas we've created, to showcase how a decline in retirement outcomes has resulted from the replacement of DB pension schemes with DC. Going beyond the modelling, however, shows an even bleaker picture for younger generations. In the real world, there are greater concerns to retirement adequacy that need to be addressed (which need separate publications to fully explore):

- **DC schemes still aren't providing a suitable outcome for retirement.** Members of DC schemes are on track for a significantly worse retirement outcome compared to those who are still active members of DB schemes.
- **Pensions coverage, even after auto-enrolment, is still behind.** Auto-enrolment gaps still leave many behind, including the part-time, self-employed, low-salaried and very young or elderly employees.
- **Pensions inequality remains a critical problem to address.** Equity in pensions is still poor, with both pension participation and retirement outcomes being significantly worse under gender, ethnicity, disability and socio-economic lenses* compared to the wider population.

**Non-exhaustive list*

A GRADUAL EROSION OF RETIREMENT OUTCOMES

As DB schemes mature and a DB pension starts to become a legacy (at least for the private sector), we trend towards a world with more DC reliance and, as a result, lower expected outcomes which are achieved with much greater volatility. This will mean a gradual trend towards poorer outcomes in retirement and will have negative societal consequences. And whilst 'retirement adequacy' as a term will mean different things for different people, no matter how you look at it, the conclusion is largely the same. Retirement standards have trended downwards, and continue to do so.

We're pleased that the Pensions Commission is being revived to try and reverse this downwards trend, and the pensions industry itself is continually looking for solutions to improve member outcomes. However, strong and impactful decisions are needed to avoid a future where retirement poverty is the norm.

This is the first in a series of publications exploring the finer details of retirement adequacy, which will culminate in actionable steps to reverse the current trend. In the meantime, if you have any thoughts to share or would like to discuss further, we'd love to **hear from you**.



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Appendix: Modelling notes

Starting salary of £25,000 pa. Assume salary increases of 4% pa and inflation of 2.5% pa. DC members are enrolled on an 8% total contribution rate and use qualifying earnings (with lower earnings limit increasing with inflation). Normal retirement age of 65. Assumes that members do not take any tax-free cash on retirement.

Investment strategy is a typical strategy for a DC Master Trust; full equity exposure up until 10 years, slow de-risking into a diversified strategy at the point of retirement, with this being maintained throughout retirement.