International retirement challenges & approaches – lessons for the US market

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Overview

- Developed countries populations ageing – lessons to learn
- Retirement planning varies enormously – case study
- Unpopular policy decisions always delayed
- Pensions are long-term, politics are short-term
- Lack of financial education and awareness
- Opportunities and challenges for financial industry in retirement savings and income

UK and international trends

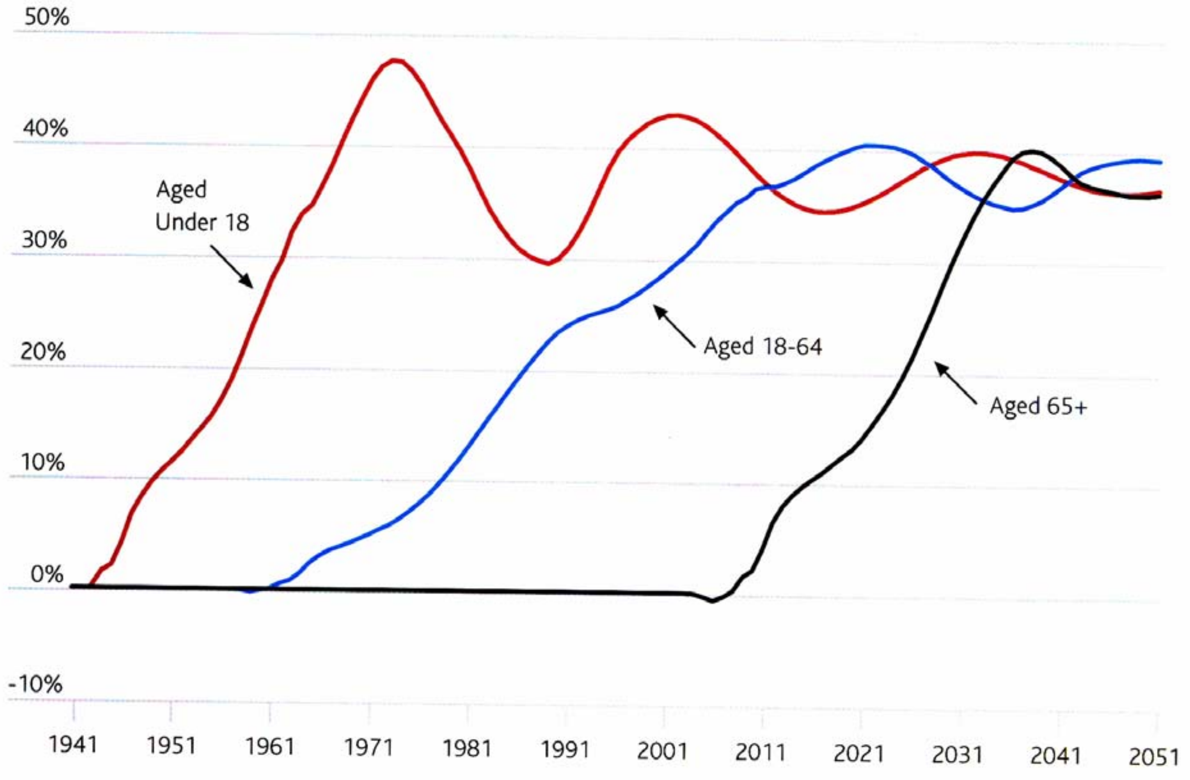
- Governments want to cut unsustainably generous social security pensions, raise retirement age, encourage saving
- Pension reforms in last few years gathering pace
- Collectivism vs. individualism
- Many different reform models
  - Compulsory national savings, tax deferral, employer
- UK used to be considered a model for other countries
- Government thought it had everything under control for ageing population

20th Century historical perspective

- Most developed countries encouraged early retirement
- Reaction to baby boom and industrial restructuring
- Expectations based on old demographics
- Impossible to continue as lifespan extends
- A smaller working population can’t support so many pensioners
- Urgent need to rethink retirement

Demography: sharp rise in over-65's

% change in UK population size



Source: Pensions Commission analysis based on a synthetic model of the England and Wales population

Why worry about retirement policy?

- Social reasons, political reasons, economic reasons
- Social: alleviate poverty - support people too old to work
- Political: avoid social unrest, votes of ‘greying population’
- Economic: help older people maintain income and spending power to support growth in ageing society
- How much from social security, how much private funds?
  - Individual vs. employer, compulsion, products
  - Demographic reality scary

UK savings market

- Retirement planning: employer or private pension plans
  - Top tax relief – about 40% coverage
- Individual Savings Accounts – ISAs
  - Tax exempt roll-up and withdrawal, $14,000 pa limit
- Venture Capital Trusts: generous tax allowances too
- Child Trust Fund: tax free accrual
  - Each new baby gets $500 and parents invest to age 18

Reforms in UK

- 1960’s – privatisation of social security
- 1970’s – introduced national earnings-related pensions
- 1980’s – new ‘personal pensions’, cut national pension
- 1990’s – increased regulation after mis-selling scandals
- Considered best model – relied on employer and stocks
- All fallen apart since 2000

Current attitudes in UK – case study

- Pensions confidence destroyed
- Young enter labour force in debt, need to buy home
- Pensions are a ‘locked box’ – can’t get money back
- Employers dramatically cutting pension provision
- Policy changes improved position of wealthy but much worse for mass market
- Not enough incentives: just tax relief, benefits better off
- Too many disincentives
  - Social security means-test, over-regulation, complexity

UK very different from most of EU

- UK has more private pensions than rest of EU total
- UK relied on investing in stock market to deliver growth
  - EU investors very risk-averse, prefer bonds not stocks
- UK social security pension too low, too complex
  - Private pensions expected to support retirees
- Employer role was crucial in UK with final salary plans
  - Now in terminal decline
- Rest of EU has much higher social security pension and relied much less on private provision

UK social security pension so low, EU much higher

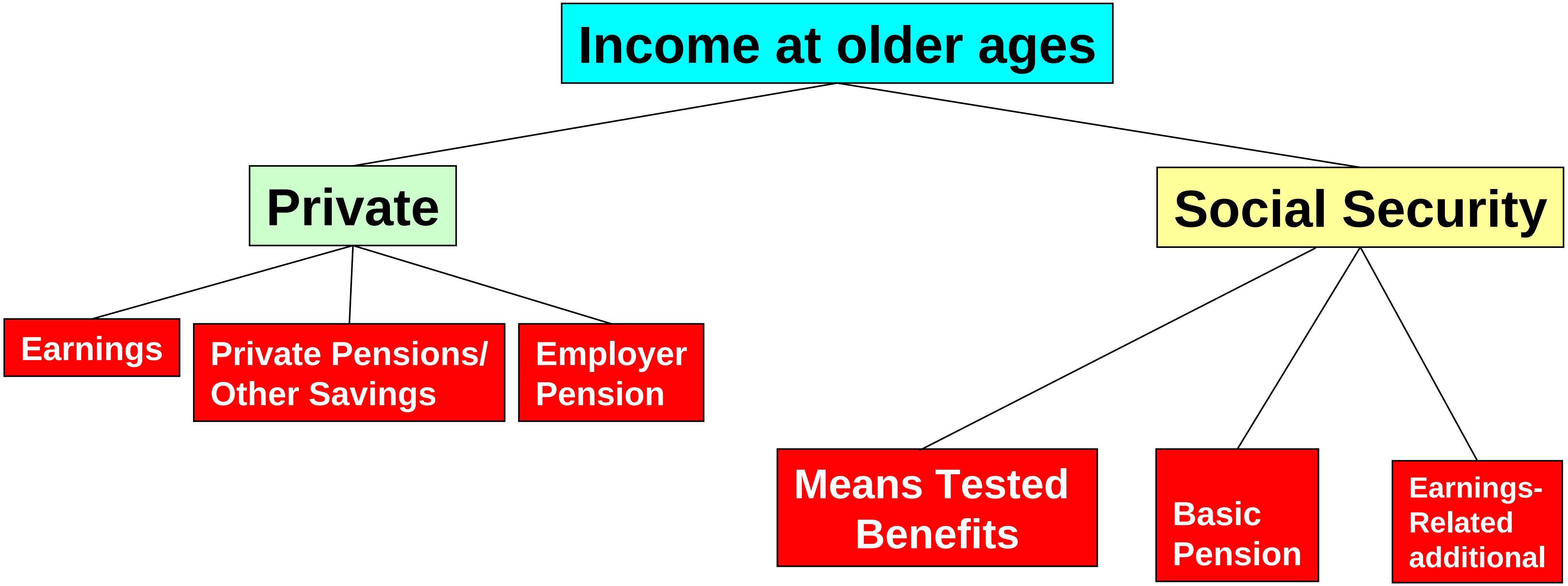
Country	approx. % of final pay (for someone retiring on average earnings)
UK	30
US	40
Germany	40
France	50
Italy	80
Spain	90

Source: OECD 2007

EU social security and private plans

- Most EU countries social security contributions > 25%
- Would need to double in next 30 years, unsustainable
- Voluntary private pension covers < 50% in all OECD
- Need to increase private retirement plan coverage
  - US,UK, Ireland: >40% of employees have occ. plan
  - France, Italy, Spain: <10% of employees covered
  - Compulsion in Sweden, Australia: very high coverage
  - ‘Soft compulsion’ in New Zealand

Model of UK retirement income



UK distribution model - workplace

- Final salary giving way to defined contribution
  - Trust-based schemes declining as regulation rising
- Stakeholder experiment failed in workplace
- Insurance companies dominate pension market
  - Institutional investors still mainly use retail products
- Group personal pension schemes sold by advisers
  - Pensions like grapes, best sold in bunches
- Advisers doing well
  - GPP, SSAS, SIPP, EPP – complex arrangements

UK distribution model - individuals

- Personal pensions – stakeholder model falling out of favour
  - Cheap, not flexible, mainly for grandchildren!
- Self-invested personal pensions – SIPPs – huge growth
  - Flexibility, investment, transfers, tax breaks for wealthy
- Pension market developing after radical tax rule changes
- Pensions can now wait until later in life
- No more ‘use it or lose it’ annual allowance
- Top earners and their advisers taking advantage
  - Creating new products

UK problems to sort out

- UK social security pension too low, too complex, too means-tested
  - Means-testing half pensioners undermines private plans
- Trend from collectivism to individualism not well managed
- Too many reviews, policy changes, tinkering -> confusion
- Mass market in trouble
  - Employers cut back, scandals, must restore confidence
- Risk/difficulty of saving exceeds risk/difficult of not saving
- Savings rate has collapsed, just when needs to be rising

Retirement provision – new developments

- Group Self-Invested Personal Pensions - SIPP
- Small Self Administered Schemes – SSAS
- Flexible Invested Personal Pensions – FIPP
- Executive Pension Plans – EPP
- Unsecured Pension – USP
- Alternatively Secured Pension - ASP

UK policy mistakes

- Cut social security pension, increasing means-testing
- Short-sighted policies promoted unsustainable growth
  - Public sector employee pensions unaffordable
- Asymmetrical regulation: too hard to save, easy to borrow
  - Killing golden goose
- Complacency: pensions not in crisis now, only in future
- Wrong: pensions in crisis now, **pensioners** will be in crisis soon -> social unrest, economic decline
- Ensuring contributions go in is important to politicians now, but getting pensions out is vital to public years later!

Privatised social security failed

- Governments tried to encourage people to leave national earnings-related pension
- Use social security contributions for private plans
  - Originally only final salary, then personal pensions too
- Rebate of contributions called ‘contracting out rebate’
  - Originally very attractive – Mrs. Thatcher’s bribe
- Then reduced rebates so now not actuarially fair
- Privatised pensions led to horrendous complexity and pensions lower than social security benefits given up!
- Policy now being withdrawn gradually

More reform initiatives: 1997-2006

- New Regulator (FSA) after ‘mis-selling scandal’
  - Too restrictive, 6-hour full fact find too expensive
- Simplicity, security and ‘informed choice’
  - Decision trees, websites, leaflets, pension forecasts
- Offer cheaper products, 1% charge cap, no advice
- Every employer required to offer stakeholder pensions
  - 82% empty, no advice, pensions are sold not bought
- Supply side reforms, ignored demand
  - Can’t distribute one by one, need economies of scale

Still more reforms: 2006-2008

- Radical shake-up of private pension contributions
- Fantastic for top earners, change nature of pensions
  - Put in 100% of salary up to $400,000pa, full tax relief
  - Lifetime limit of $3.6million
  - Investment flexibility – wide range of assets
  - Real estate, quoted/unquoted equity, business assets
  - Originally proposed residential property for pension – led to stampede, pensions became ‘sexy’, withdrawn!
  - Mandatory annuitisation for most, but more flexibility

And more to come: 2008-2012

- Further reforms of social security pension
- Personal accounts to encourage non-savers into pensions
  - National savings scheme for pensions
  - 3% minimum employer contribution if worker pays 4%
  - ‘soft compulsion’ - auto-enrolment
  - Workers allowed to opt out, but employers compelled
  - Generic advice only
  - Government body to design scheme + default options
  - Aim for 0.3% charges!

Personal accounts create near-term opportunities

- Financial companies could have huge assets to manage
- Take advantage of inertia to get more people contributing
- Government can claim lots more people are saving
- Government will save money on means-tested benefits
- Individuals will think they are doing what they need to do

But very dangerous longer-term

- Those currently in pension plan may end up worse off
  - Employers currently contribute well over 3%, will cut
- People won’t realise they are not contributing enough
- Many non-savers will opt out
- Many who stay in will be hit by penalties in social security
- Generic advice can’t cope with complexity of UK system
- Be careful about suitability, investment default, annuities

Pension and annuitisation

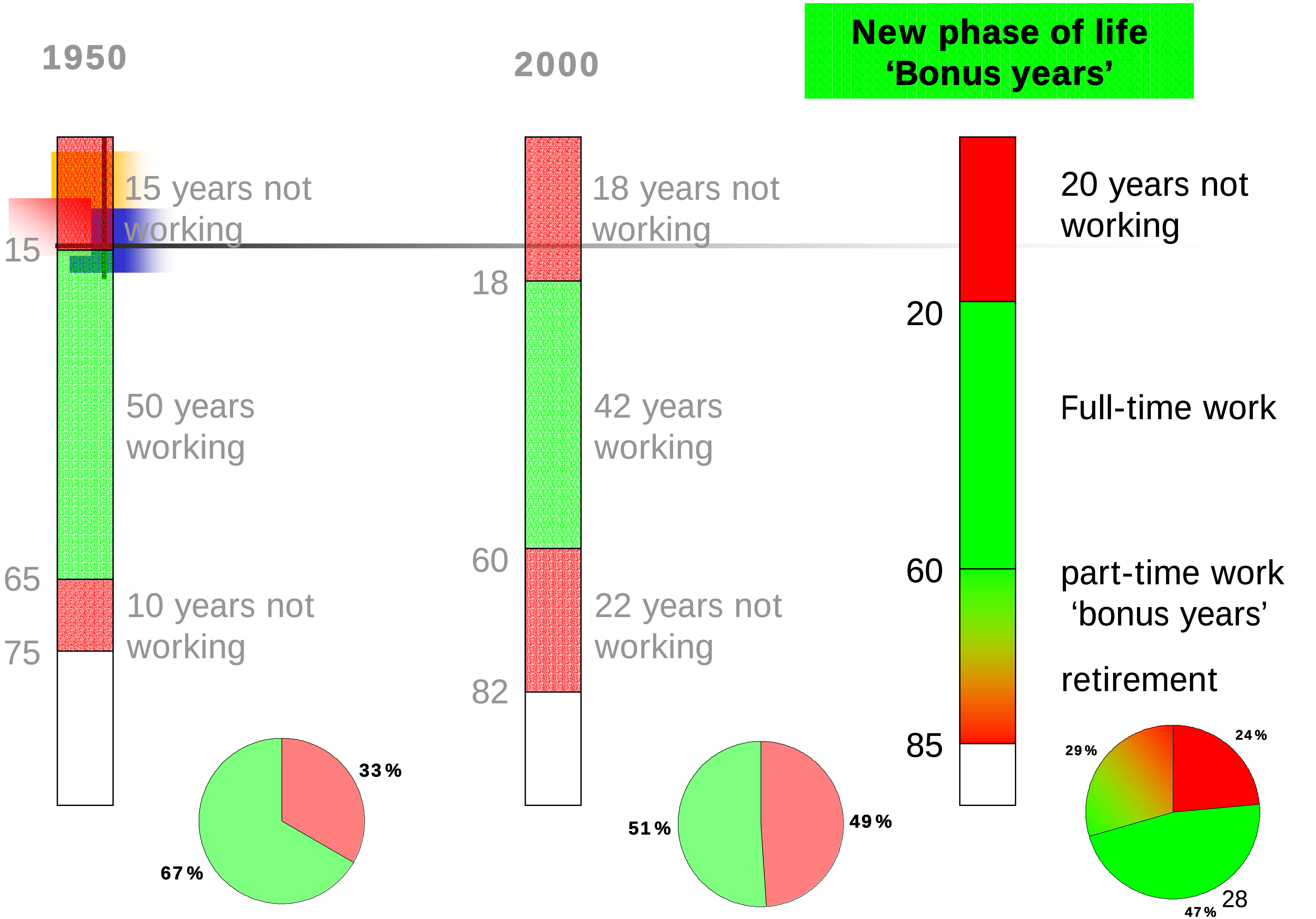
- UK annuities only post-retirement – bad press
- Mandatory annuitisation by age 75 unpopular
- UK has introduced lot more flexibility post-retirement
  - Open market option
  - Enhanced annuities
  - Income drawdown
  - Investment linked annuities
  - Limited period annuities
  - Lifetime money back guarantee?

Far more choices at retirement

- Buy an annuity – enhanced or other
- Pay an income from the fund ('unsecured income')
- Take no income, just tax free lump sum
- Take a partial pension leaving remaining funds invested
- Phase retirement
- Combine phased retirement and unsecured income
- Take income at age 75 – 'alternatively secured pension'

The future? Rethinking pensions

- Simple social security pension to provide basic minimum
  - Covers social welfare, fair to all, no mandatory annuity
- Clear message: without private income you get minimum
- If you save or keep working, you will have more
- Lottery attached to saving?
- BUT higher savings alone won’t solve **pensioners** crisis
- Must also rethink retirement
  - New phase of life ‘bonus years’
- Employer role – part-time work for older people


New phase of life
'Bonus years'
1950
2000
15 years not working
15
50 years working
65
10 years not working
75
33 %
67 %
18 years not working
18
42 years working
60
22 years not working
82
51 %
49 %
20 years not working
20
Full-time work
60
part-time work
'bonus years'
retirement
85
24 %
29 %
47 %
28

Lessons for US

- Social security should pay flat-rate, basic minimum
- Tax incentives less effective for most earners
- Some form of ‘soft compulsion’ will increase savings
- Greater investment flexibility can be very helpful
  - But too much choice leads to confusion
- ‘My house is my pension’ – equity withdrawal
- Annuities can play an important part
- Encourage more saving and also more working
  - Part-time work for older people, like for young mothers
- Role for advisers to help educate and plan

Thank you for listening

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