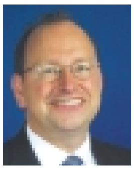
OLDIES GET ON THEIR BIKES



WE ALL DREAM OF A COMFORTABLE RETIREMENT, BUT THE PENSIONS CRISIS MEANS WE ARE HAVING TO WORK TO A MUCH OLDER AGE, SAYS **STEVEN BELL** OF DEUTSCHE ASSET MANAGEMENT.

The pensions crisis in the western world has been well-documented. Most discussion has focused on what governments and pension providers can do in response to ageing, falling returns and underfunding. The answer in many cases is often very little. Yet there is another, more effective response to declining actual and prospective pensions that is much healthier for the economy.

People in middle or old age, who find that pensions are less than they had hoped for, are postponing retirement. This phenomenon is already evident in the UK and the US, where state pension provision is limited, labour markets are flexible and company pension schemes are being cut. It may be that declining interest rates initiated this phenomenon even before stock markets started tumbling. In both the UK and the US, the retired or nearly-retired population are major holders of interest-bearing assets. For the population as a whole, net monetary assets roughly offset net monetary liabilities, but the young have nearly all the debt. Lower interest rates, therefore, involve a transfer from the old to the young and while the overall effect is probably to stimulate the economy, the old clearly lose out. They have responded by working harder and longer.

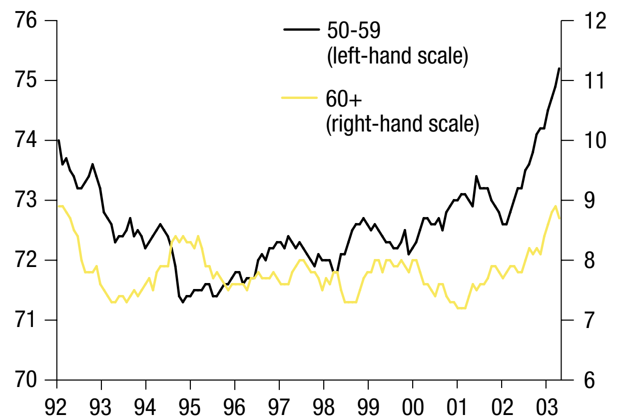
INFLUENCING RETIREMENT. There have been many studies of the economic forces that influence retirement. The general conclusion is that people retire if and when their incomes allow them to. The long downward trend in the average retirement age in developed economies in the 20th century did not reflect the changing nature of work or healthcare. This would have suggested later retirement, as a healthier workforce is less focused on heavy manual work. Indeed, before the first world war, 75% of men over 75 were in employment. The reason was simple: either you worked or you starved.

Rising living standards, the introduction of state pension provision and occupational pensions led to a massive improvement in retirement income in the 1980s and early 1990s in most countries. In the UK, the sector with the fastest growth of income during the Thatcher years was the retired population, despite her decision to switch the linking of the state pension away from earnings to the less generous RPI. Rising incomes of retired people reflected a number of factors.

First, interest rates were very high in both nominal and real terms during that period. Annuity rates were correspondingly high. Second, occupational pension schemes were beginning to bear fruit, with more people retiring with bigger pensions. Third, the enormous bull market in equities and to a lesser extent in bonds meant that those who retired on savings had a unexpectedly large nest egg. The strong performance of the stock market also allowed over-funded schemes to use their discretion to enhance pension payments. Given the problems which many companies had in getting hold of their pension fund surplus, they often used it as an alternative to redundancy payments to encourage older staff to retire early as part of a cost-cutting exercise.

WORTH LESS PENSIONS. These influences have now gone into reverse. Few pension schemes are over-funded, interest rates have tumbled and many pensions have unexpectedly been worth less. As a result, many older workers are simply postponing retirement (see *Figure 1*). The macroeconomic implications of such a move in an economy with flexible markets are extraordinarily positive. Simply shifting the average age of retirement by one or two years can weaken or even defuse the 'demographic time bomb'.

▪ Figure 1
Percentage of men in employment in the UK



Source: Datastream & DeAM

There are key benefits to the fiscal position. Instead of retiring, 'dis-saving' and reducing their contributions to tax revenues, those who work longer save more and pay more taxes. Encouraging people to work longer was one of the key objectives of the government's recent Green Paper on pension reform[1].

However, some of its policies have had the opposite effect. In its first term, the Labour government introduced the Minimum Income Guarantee, which radically reduced the incentive for low-income workers to save for retirement or to work once they had retired. The proposal to cap an individual's pension fund at £1.4m could have equally damaging effects at the opposite end of the income scale.

With a reasonable tax system, retiring later can transform an individual's pension position. By continuing to work and save you can build up a bigger nest egg. You also get a better annuity rate as you get older. The effect on living standards in retirement can be dramatic. *Figure* 2 illustrates this with a stylised example. Those of us still in work may often dream of a happy and comfortable retirement. It may take a little longer to turn that dream into reality.

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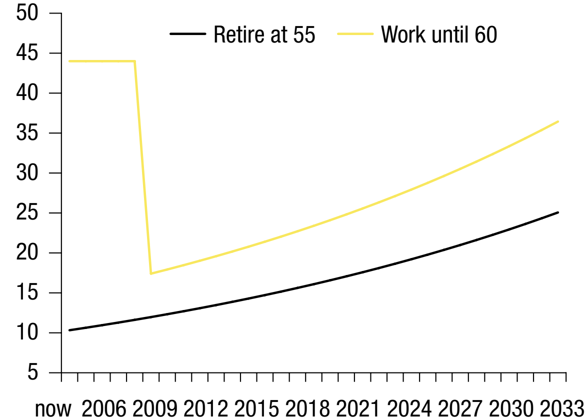
Note

1 *Simplicity, Security and Choice: Working and Saving for Retirement*, Page 8; Cm 5677, December 2002; www.dwp.gov.uk/consultations/consult/2002/pensions/gp.pdf

See also *The Treasurer's* interview with Alan Pickering on p29.

▪ Figure 2
The effect of postponing retirement on income



This is based on a stylised example of a male aged 55 who currently has a defined contribution pension pot of £250,000. The lower line is his income if he retires and buys a 3% escalating annuity today. The upper line assumes he works five more years earning £44,000 a year (twice average earnings) and saves 15% as a pension before buying a 3% annuity. The state pension is ignored.

Source: DeAM