

THE CREDIT CRISIS: THE IMPACT ON PENSIONS

DR ROS ALTMANN



Credit crisis and pensions

The credit crisis has damaged private pensions. Defined contribution schemes have been hit by falling markets. Rate cuts have worsened annuity rates. Insurance companies are struggling with their annuity books, as backing assets (eg corporate bonds) have declined. Defined benefit schemes' assets have plummeted, while exceptionally low long gilt yields have increased liabilities. Most employers will struggle to fund their deficits. Trustees cannot find assets that properly match their liabilities. There are also no limited price inflation or longevity/mortality gilts. The Government should take advantage of exceptionally low yields to issue more paper before the gilt 'bubble' bursts. As the credit crisis increases Government borrowing, why not tap into the large domestic source of potential funding?

POLICY RECOMMENDATION: ISSUE PENSION AND ANNUITY GILTS

Credit crisis and pensioners

The credit crunch has hit pensioners hard. Equity or 'with-profits' investments have fallen, but even risk-averse pensioners who just left money in the bank for their retirement, have suffered. For pensioners with £15,000 savings, cutting interest rates from 5½ per cent to 1½ per cent is like cutting state pensions by £12 a week. The UK's 12million pensioners have low debts and a high marginal propensity to consume. Cutting rates is like a tax increase that will reduce their spending.

Even more worryingly, for the poorest pensioners, pension credit still assumes they earn ten per cent (yes, ten per cent!) interest on their savings. But they don't have that income, and are therefore at greater risk of poverty.

POLICY RECOMMENDATION: NO MORE RATE CUTS. CHANGE TEN PER CENT INTEREST ASSUMPTION FOR PENSION CREDIT

DR ROS ALTMANN is an independent expert on pensions policy, investment banking, savings and retirement. She is an economist by training and an investment banker by profession, having extensive experience of all areas of pensions, from state pension policy to investment management of pension funds. She was a consultant to the UK Treasury on the Myners Review of Institutional Investment and has worked on pensions policy issues with the Number 10 Policy Unit. She is also a Non-Executive Member of the Court Funds Office Management Board and Trustee of large UK pension schemes.

Key Points for Policymakers

1. Credit crisis has hurt private pensions and employers are struggling to fund contributions.
2. Dramatic, sharp rate cuts have damaged confidence, reduced pensioner incomes and worsened annuity rates – don't ignore this collateral damage.
3. Pension credit means-test still assumes pensioners get ten per cent (yes, ten per cent!) interest on their savings, therefore leaving many in poverty.
4. As the population ages, we need more savings for older people to live on but savings incentives have been reduced – bank accounts are now far safer than pensions, with pensions having maximum 90 per cent protection, while deposits (even in an Icelandic bank) were protected 100 per cent.
5. Pensions tax relief costs £30billion a year, half goes to top rate taxpayers. Contracting out costs £10billion a year, but private alternatives have not produced good pensions.
6. Demographic picture very worrying – we face a pensioners crisis. Baby boomers reaching age 65 in the next three years – what will they live on?

Demographics, pensions and retirement

The credit crisis is undermining an already weak savings culture. This is a demographic disaster. Economists have ignored demographics when forecasting future growth but the chart shows the stark reality. Since the 1960s, demographics could hardly have been more favourable for economic activity, with the baby-boom generation providing many more workers, far fewer children to support and a stable pensioner population. Growth was also artificially boosted in recent years by massive increases in both private sector and public sector debt – effectively ‘borrowing’ growth from the future. However, the demographics mean there will not be enough workers to repeat past growth and pay back these debts.

In the next few years, retiring baby-boomers will try to live on our state pension (the lowest of almost any developed country) and any private pension or savings they have accrued. But the credit crunch has severely reduced private pensions, thereby significantly worsening the pensions crisis. This will lead inexorably to a ‘pensioners’ crisis, unless we make radical changes to pensions – and retirement.

Let’s unravel some muddled thinking. The word ‘pension’ actually means two different things, which have the same name. The original idea was social insurance, preventing poverty for older people, unable to earn. This is really a state role, although 20th Century employers stepped in to provide social welfare via final salary schemes. The word ‘pension’ also refers to something very different – long-term savings. This is normally a private responsibility, but again employers stepped in to help organise pension schemes.

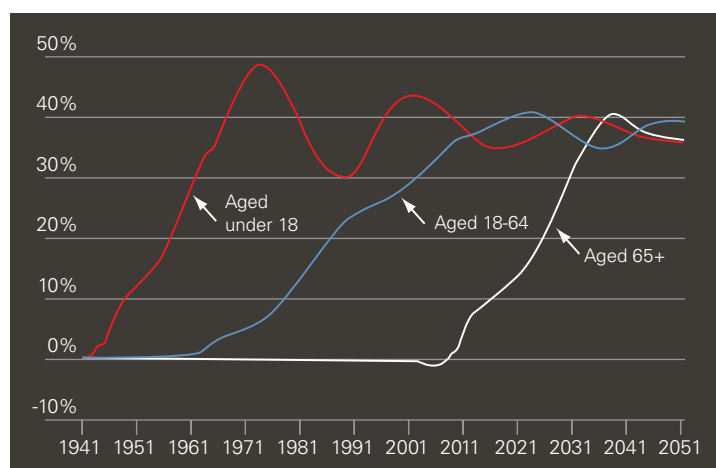
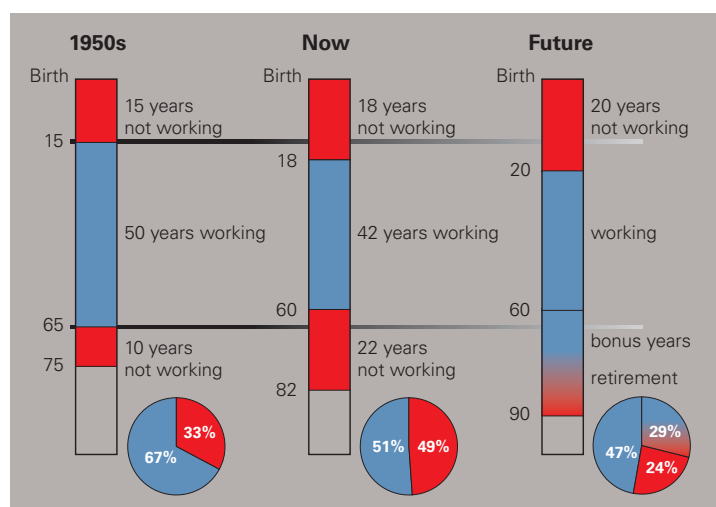


Chart 1 Annual growth rate of population by age group 1941-2051

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



Governments have overly-relied on employers and equity markets to provide good pensions, to supplement falling state pensions. But, with increasing longevity and unreliable equity returns, private pensions cannot provide enough income. The state then has to supplement pensioner income via means-testing nearly half of all pensioners, which unfortunately makes private pensions an unsuitable investment for the majority of the population. Incentives to encourage saving in a pension are in the form of tax relief, which costs £30 billion a year; half of which goes to top rate taxpayers. Is this the best way to spend such large sums? Paying £140 a week to all residents over age 75 would end savings disincentives, treat women fairly, abolish means-testing and poverty for almost all the elderly and cost around £2-3 billion a year.

POLICY RECOMMENDATION:
PAY ABOVE PENSION CREDIT (eg £140 pw) TO ALL RESIDENTS OVER 75

Pension credit penalises saving but also penalises earnings over £5 a week, while age discrimination protection stops at 65, thereby discouraging longer working lives and consigning people to retiring too early. What a waste of resources! There is a whole new phase of life waiting to be grasped, that previous generations could not have dreamed of. ‘Bonus years’ where people work part-time, (just as has been achieved for working mothers), gradually cutting down but still contributing to their own income and the economy. Policy could and should encourage older people to benefit from these ‘bonus years’. The diagram shows how this could change people’s lives.

POLICY RECOMMENDATION:
REMOVE PENSION CREDIT £5 EARNINGS DISREGARD, INCREASE JOB PROTECTION FOR OLDER WORKERS AND PROMOTE BONUS YEARS CONCEPT

Policy recommendations:

1. Issue specific pension and annuity gilts – long-dated/lpi/ longevity/mortality gilts.
2. Don’t keep cutting interest rates, cut income tax or national insurance instead, or maybe bring back 10p tax rate.
3. Adjust pension credit interest rate assumptions and end £5 per week earnings disregard.
4. Radical reform of both pensions and retirement – pay £140 a week to all residents over age 75 and encourage longer, but part-time, working lives.

The ESRC sponsors the Parliamentary All Party Group on Social Science and Policy and welcomes suggestions from Members on topics for discussion. Contact Lesley Lilley, Senior Policy Manager, lesley.lilley@esrc.ac.uk

Published by:
 Economic & Social Research Council
 Polaris House, North Star Avenue
 Swindon SN2 1UJ
 Telephone: 01793 413033
www.esrcsocietytoday.ac.uk

