Group Economics

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Today's cost of saving crisis…tomorrow's cost of living crisis

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In economics, we've become well accustomed to the word crisis over the past 10 years. We've had the banking crisis and the government debt crisis, to name a couple. Two years ago, we also became familiar with the oft-quoted 'cost of living crisis', when food and other prices were rising and wages were stagnant. Today, it could be said that we are in the era of the pension crisis, with the topic of provisioning for retirement very much to the fore. Indeed, earlier this month Baroness Altmann, the former UK pensions minister, said that pension funding had reached "crisis point" and blamed the Bank of England's quantitative easing policy of buying bonds.

Earlier this year, the threat to some company pension schemes – including Tata Steel and BHS – hit the headlines. In recent weeks, particularly post the EU Referendum result, this issue has moved from being firm-specific to being something of an existential crisis for the pensions industry as a whole. Even firms otherwise in rude health are facing huge pension challenges.

Changing demographics, such as the fact that we are living longer, have affected pension affordability as income must fund longer retirements. Simultaneously, funding pensions is becoming both more difficult and expensive. Bond yields have fallen globally since the UK voted to leave the EU in June – some people have been celebrating lower mortgage rates with the Bank of England cut to base rate, however this move with additional quantitative easing has hit the cost of pension provision. For example, the interest rate or return on purchasing risk free 20-year UK government gilt has fallen from 2.1% to 1.14% over this period. Back in 2010, the yield on a 20-yr UK gilt hit 4.6%. Gilt yields are central to funding pensions. In order to make up for lower interest payments, a pension fund must purchase more bonds to get the same return promised to pensioners.

This explains why pension deficits have been widening, as liabilities are increasing at a faster rate than the underlying asset base used to fund them. This is calling into question the sustainability and affordability of both public and private sector pensions.

Along with the State Pension from the government there are two main types of pension. Firstly, defined contribution (DC) – based on how much money has been paid into your pension pot. These were traditionally used to purchase an annuity, or annual income, at or after retirement. Defined contributions are more common place in the private sector.

The other is defined benefit, or DB, which are the most attractive and expensive to fund. These are based on your salary (final salary or career average) and how long you have worked with an employer.

DB plans face the greatest problem. Members of these schemes are guaranteed an income on retirement for life. The risk of providing this income rests solely with the employer. Almost one third of employees in Northern Ireland are members of such a scheme. Some 78% are employed in the public sector – 11 times the figure in the private sector.

So how bad is the problem? Turning to the private sector first, the latest calculations by Hymans Robertson, a pension consultancy firm, put the UK DB deficit at £1 trillion. That is, the value of liabilities exceeds assets by £1,000billion or £1trillion. Firms will have to fill this hole. Not surprisingly, an increasing number of schemes are closing to new entrants. A trend that has been underway for several years and which is set to accelerate with the cost of providing a DB pension having now risen to 50% of pay.

Hymans Robertson highlights the problems facing DC schemes too. Before the EU referendum, they calculated that 65% of DC pension savers in the UK were not on track to receive adequate income in retirement. Plummeting UK gilt yields and annuity rates since the Referendum have seen those figures jump to 75%. According to some commentators, this is the worst time ever to retire as annuity rates, whereby pensioners purchase an income for life scheme with their pension pot have plummeted. A decade ago, a 65 year old with a £100,000 pension pot could have secured £7,092 p.a. with an annuity. Today, the same £100k would purchase £4,462 p.a. If pensioners want to inflation-proof this income, each £100k would purchase an annual income of just £2,256 p.a. or just over £6 per day. Less than the price of a fish supper!

So that's the private sector; what about the public sector? Outside of the state pension, which all UK citizens are entitled to, the UK government is responsible for over 100 separate pension schemes. In 2014/15, total public sector pension payments amounted to £127bn. 70% of this was state pension expenditure with the remaining 30% pension payments to public sector workers.

The UK's public sector pension promises will largely be paid for from future public expenditure. There isn't a big public sector pension pot set aside for this. According to the National Audit Office, after member contributions have been taken into account, the UK's net public sector pension liability stood at a whopping £1.49 trillion in 2014/15. This figure has risen by almost one-third since 2009/10.

Putting this figure into context, the total public sector pension liability is over one-quarter larger than the UK's national public sector debt for the corresponding year. Alternatively, it equates to £55,000 per household or 81% of UK GDP. After member contributions, the annual public sector pension payments were equivalent to 1.6% of GDP or around £1,000 per UK household.

Looking ahead, these public sector pension liabilities, like their private sector equivalents are set to soar. This will mean an increasing proportion of public expenditure will be required to meet pension demands rather than being spent on public services. The National Audit Office estimates that 8% of GDP is projected to be spent by the government on state and unfunded public sector pensions, net of member contributions to unfunded schemes in 50 years' time. This is a five-fold increase from current level.

Funding this will require a combination of reducing spending elsewhere, increased taxation or additional borrowing. In recent years we have already seen a series of reforms to state funded pensions. These have included increasing the pension age *(e.g. to 68 by 2046)* and aligning the public sector retirement age with it. Most public sector pensions have moved towards career averages rather than final salary schemes and member contributions have increased. These have slowed the rate of growth in public sector pension liabilities. However, more action will be required in the years ahead. The phrase 'pension levy' may be something we hear more about in the not too distant future alongside taxing retirement lump sums.

In Northern Ireland, the pension crisis poses a threat to efforts to rebalance the economy. We hear a lot about whether public sector workers get paid more on average than private sector workers, but

the differential between pensions in the public sector and the private sector is actually a much bigger issue and only likely to get wider. However, conversely, there will probably be more pressure in the public sector to outsource work to the private sector to help limit the government's pension liabilities.

Rebalancing the economy though is about more than rebalancing between the public and private sectors. One of the biggest issues is the inter-generational divide, whereby the older generations are enjoying pension benefits that young people today will only be able to dream about. As a result, we should expect to see a rebalancing of policy in the years to come to help the younger generations, at the expense of older people. Overall, the term saving / pension crisis is set to become a much more prominent theme for the foreseeable future.

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