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Managing Retirement Risk in an Ageing World: The Global Picture

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In a rapidly ageing world, how old is "old"? The third annual report of the HSBC-commissioned Future of Retirement study, *The New Old Age* -- released in May 2007-- declares that "70 is becoming the new 50 in terms of active healthy ageing." The report concludes that "Far from being a time of misery, penury and frailty, life for most people in their 60s and 70s is characterized by good health, independence, control and a good quality of life."

This study, involving 21,000 people between the ages of 40 and 79 in 21 countries, for the first time compares the expectations of people near retirement with the experiences of those already retired. It reports that, even as their numbers rise, most retirees continue to be highly productive, contributing billions of dollars worth of work and volunteer time to their families and societies. A surprise finding, however, is the lack of concern amongst pre-retirees, ranging from a third to half of those surveyed, as to how they will cope financially after retirement. At the same time, the majority of pre-retirees do not expect their standard of living to fall after they stop working. Is this optimistic outlook justified, or cause for alarm?

Population projections show that, by 2050, there will be four times as many people age 65+ compared to people under 65, and in some countries such as Japan, the numbers will be significantly higher -- with just under half its population entering the 65+ age group by mid-century. Singapore is the world's second most rapidly ageing society, followed by western European countries such as Italy, Germany and Spain where generous pensions and early retirement incentives have been available for many years. Baby Boomers -- individuals born between 1946 and 1964 -- represent the bulk of the group gradually moving into retirement age in the coming decades. Not only are they numerous, but they will also spend a long time in the retirement phase. Over one-third of this group is expected to live well into their 80s or beyond (especially women and the more educated).

Olivia Mitchell, Wharton professor of insurance and risk management, and chaired professor at Singapore Management University, sounds a cautious note: "Global ageing makes for a much riskier world, inasmuch as people tend to retire too young, save and diversify too little, and outlive their assets." Mitchell is also executive director of Wharton's Pension Research Council . "My research shows that many workers are underestimating retirement challenges including the risk of outliving their assets, the future cost of healthcare and the erosive power of inflation in retirement," she says. "As a result, I worry that Boomers live with a false sense of security, and they may face a rude awakening when it's too late to do much about it."

Retirement Assets

What types of assets do people usually depend on in their retirement? "Across the spectrum of nations, we see that households tend to have different mixes of housing assets, financial assets and pension wealth, as well as government pensions," says Mitchell. In the U.S., for example, the median household on the verge of retirement holds about one-fifth of its assets in net housing equity, a fifth in pensions, a fifth in net financial wealth (cash, stocks and bonds) and 40% in state social security. Least well-off households are almost entirely dependent on state benefits and also tend to be heavily indebted.

Precisely comparable data are unavailable for other countries, but Mitchell reports that the average New Zealander is far more dependent on state insurance (49%) and property (30%); few Kiwis have financial wealth and virtually no one has a pension. Looking at Singaporeans, the data show that, on average, they hold nearly 40% of their total portfolios in net property, over 30% in net financial wealth, and 18% in pension wealth. Net housing wealth in Singapore is far more important to the average household than in Japan or Europe. "Over-reliance on a single undiversified property can be risky, as property prices can fluctuate significantly," warns Mitchell.

Individual Retirement Risk

To better manage the challenges of retirement, key sources of risk need to be identified at the individual, pension system, national and global levels. At the individual level, Mitchell highlights two worrying gaps among U.S. Baby Boomers -- financial illiteracy and lack of retirement planning. In a recent survey conducted with Dartmouth College professor of economics Annamaria Lusardi, the authors find that most boomers, including the college-educated, cannot correctly calculate compound interest over a two-year period. More worrying, only one in five has ever tried and succeeded in carrying out a retirement savings plan. "While it is a very difficult exercise to figure out how much you need to save for retirement many years down the road, the payoff is much greater for those who do," Mitchell says, citing research which shows that the net worth of people who plan their retirement is more than double that of people who barely even try to plan.

"We need a fundamental shift in outlook and behaviours if retirees are to avoid outliving their assets," says Mitchell.

She advocates a two-pronged approach: mitigating risk by making positive lifestyle choices on the one hand ("keep fit, eat a healthy diet, marry right and have good kids!"); and financing risk through savings, investing and buying insurance on the other. Mitchell strongly supports staying in the workforce longer to allow people to earn and save more. Her work has shown that saving shortfalls can be cut in half if one merely defers retirement from age 62 to age 65. Indeed, she notes that "working to 70 implies more saving and less drawdown of one's retirement nest egg which can greatly enhance well-being at age 90 or beyond."

But simply building a retirement account is not enough; People also need to be protected against living too long. On the insurance front, Mitchell stresses the need for better financial market products that can help people manage longevity risk; otherwise, people may run out of money in the later years. These products include income or payout annuities (which provide a guaranteed income stream for life), long-term care insurance (covering elder-care), and reverse mortgages (where homes are sold in return for a monthly income for life). Having a steady stream of income is also likely to enhance the retirement experience: For instance, in the U.S. context, retirees having annuity payments were far more satisfied a decade into retirement, while only half those without annuity income said they were happy. Retirees with annuities were 30% less likely to have symptoms of depression.

One reason people tend not to save enough is that they underestimate retirement income needs. "Life expectancy is not the right metric for retirement planning; rather, we must help people project income drawdowns using more realistic survival tables," Mitchell states. In Europe, for instance, actuaries are now using maximum life spans of 120 years for retirement planning purposes.

Defined Benefits vs. Defined Contribution Pension Schemes

What about pension system risk? "Both public and private pensions are under siege today," says Mitchell. In particular, many developed nations have public or governmental schemes of the "Pay as You Go" variety which are unfunded, so that retirees are fully supported by taxes on younger workers. But global aging has made these plans increasingly expensive and many systems face financial crisis. An IMF study projected that public pension debt currently exceeds GDP in France, Germany and Japan (and this is an understatement, as it captures only the benefits payable to 2050). Such large pension costs are, in part, attributable to generous benefit levels and incentives designed to encourage early retirement. For example, in Germany, the Civil Service Pension Fund is a non-contributory scheme financed entirely through taxes; it provides beneficiaries up to a maximum of 72% of final salary after 40 years of service.

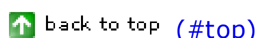
Mitchell cites the U.S. Social Security system as another example of an unsustainable structure. Established in 1935, it takes in US$600 billion from 161 million workers annually, making it the single largest U.S. government program. At current rates, annual benefits payments will exceed revenues within a decade, unless the system is significantly revamped. Mitchell notes that "the U.S. Social Security system is underfunded to the tune of about US$11 trillion in present value. This is approximately equal to the size of the U.S. GDP." In the developing world, public pension debt is also high, amounting to double or triple national GDP in some eastern European and Latin American countries.

Looking ahead, such systems face increased challenges. "When economic and population growth slows, younger generations will do less well than current retiree groups," says Mitchell. "Due to lower fertility rates and longer life spans, our children will be required to support more older people for longer periods than at any previous time in human history. The global aging challenge is not an issue for the future -- it is here and it is now."

There are two main types of pensions, defined benefit and defined contribution. In the former, the employer generally bears investment risk and responsibility; in the latter, employees are generally given some choice over where to invest their retirement plan assets but they also bear the uncertain investment outcomes. In the U.S. and Europe, defined benefit plans were long the norm, but of late have become underfunded due to poor risk management and badly priced insurance premiums. Many employers have therefore moved to either terminate their plans or freeze them to new entrants, due in part to their perceived high costs and volatility.

By contrast, defined contribution plans are growing in popularity around the world, because they often allow participants some control over investment decisions and also because they allow workers to take their savings with them when they change jobs. Some of the better known funded defined contribution plans include Australia's Superannuation accounts, Chile's APF system, and Singapore's Central Provident Fund. Employees in these plans make mandatory contributions with varying degrees of choice about how they invest the retirement assets. While the funded aspect makes such plans appealing, questions are now emerging about their efficacy in helping workers meet retirement objectives.

Part 2 of this article, to be published in the next issue of Knowledge@SMU, will examine Singapore's Central Provident (CPF) fund, one of the world's oldest and best known retirement schemes.



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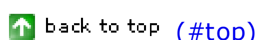

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