The issues that hinder the improvement of the employee benefits system

Longevity: Why 75 should be the new 65

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Average defined contribution (DC) fund members are on track to replace just 39% of their income when they retire, based on their current accumulated retirement savings and contribution rates. While this ignores any other savings members may have, members under the age of 30 are likely to be in their first job, not have any additional savings and have particularly poor retirement prospects. About 95% of members under 40 can expect to replace less than 75% of their income when they retire[1].

There are a number of reasons for these startling statistics. Firstly, many people are entering the workplace later due to longer training periods and, potentially, difficulty finding permanent full-time employment. This means they are starting to save later in life.

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Secondly, the general economic gloom means that investment returns are likely to be lower in the future than they were when many funds were designed. Shorter careers, higher salary expectations due to qualification levels and lower investment returns mean that savings at retirement are simply less than they used to be relative to salaries at retirement. Annuity (pension) prices, on the other hand, are higher, so retirement savings do not stretch as far as they used to when retirees buy life annuities. These changes can occur relatively quickly. For example, on 1 January 2002, a 40-year old who was on track to receive a pension of 75% of his salary when he retired at 65 could expect to replace only 40.5% of his income in retirement by the end of September 2012[2] aged 50. This deterioration was driven mainly by declining forecasts of investment returns and rising projected annuity costs.

A contributing factor to poor projected replacement ratios is improving life expectancy, which has led to questions being asked as to whether retirement ages between 60 and 65 are still appropriate. Men and women retiring at 65 can expect to live another 16 and 20 years respectively, of which 7 to 9 years will be spent in relatively good health. Extending the retirement age seems an obvious and powerful way to boost retirement benefits: retiring at 67 instead of 65 could add 15%–30%[3] to a member's savings in retirement. Retiring even later could boost benefits further.

Retirement, incapacity and productivity

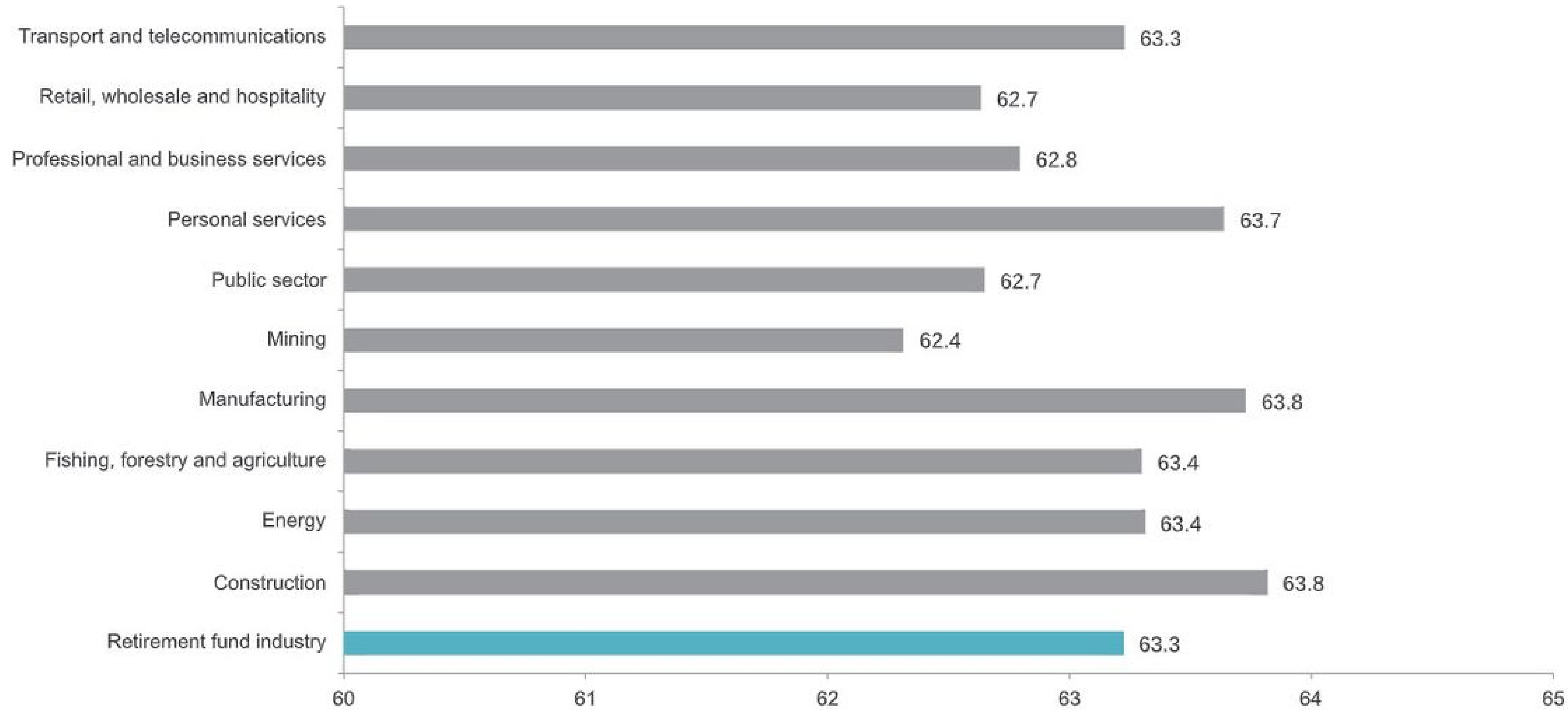
Retirement ages exist because old age will eventually render workers unproductive and unable to perform their work. This deterioration impacts on profitability for the employer, as well as health and safety in the workplace. Economists would argue that retirement ages are necessary given our high wage inflation rates, which make older workers expensive relative to younger workers who may be more productive[4].

Given these arguments, it makes sense to set the retirement age relative to the capacity and capabilities of older workers. This was the approach taken to setting the retirement age at 65 in the late 1800s. Back then, 65 was the age at which most workers were considered incapable of safely performing their work. However, by 1997, UK men and women retiring at the age of 65 could expect seven and nine years of healthy living in retirement before becoming incapacitated[5]. So it might be time to reconsider the average retirement age of individuals.

It is difficult to make definitive statements about the productivity of older workers. Some studies show that productivity declines with age, others show that older workers tend to be better at accuracy and output consistency. Others show almost no relationship between age and productivity once factors such as job fit and experience are taken into account. The demands of different jobs vary greatly. For example, physically demanding work lends itself to earlier retirement, while jobs involving people skills or intellectual effort lend themselves to later retirement. This suggests that different retirement ages are required for different jobs[6]. The graph below reveals surprisingly little variation in normal retirement ages despite variation in occupations. This suggests that further refinement of retirement ages should be possible.

The key lies in refining the retirement age to make it appropriate for the category of worker and not simply extending the retirement age for everyone. This is important to safeguard employee welfare and to prevent an increase in unemployment at younger ages.

Normal retirement age: Average per sector



Source: Member WatchTM 2012 data set

A global comparison of retirement ages and youth unemployment rates shows that there is no relationship between the two.

Later retirement and employee welfare

Evidence suggests that people who work later are least likely to die early[7]. People who retire earlier often report that they feel in poorer health and view the loss of their job in a similar way to people who have been retrenched. However, continuing to work can severely harm the health of those in physically demanding jobs[7]. This reinforces the point that certain jobs do not lend themselves to later retirement. In these cases, employers will need to consider alternatives to improve retirement benefits for these workers, as extending retirement age is not a viable option.

Later retirement and unemployment

Just over half of economically active South Africans between the ages of 15 and 24 are unemployed[8]. But a global comparison of retirement ages and youth unemployment rates shows that there is no relationship between the two. Economists agree this is due to economies slowly adjusting to gradual changes in the size of the working population. Employers bringing in new retirement ages independently will slowly change the size of the working population, which is unlikely to have a significant negative effect on the economy.

Practical suggestions

One suggestion is that determining the retirement age should be up to the employer and not the retirement fund. Even if funds could extend the retirement age, members would continue to retire earlier if their employment contract suggested so[9]. The employment contract and fund retirement age together play a very big role in determining when employees retire and would need to be reviewed simultaneously.

When the employer is considering the retirement age, different retirement ages could be considered for different categories of workers. Other elements of the benefits package would also need to be amended to make sure that each group gets a fair deal. For example, workers with earlier retirement ages will need higher contribution rates towards their retirement savings to reach a reasonable benefit target. This may require another part of the benefit package to change to ensure sufficient take-home pay during employment.

Employers would need to use their judgement in deciding how far to extend the retirement age, given their workforce. Most international experts believe that 75 is a reasonable maximum retirement age at the moment, although this may rise with medical advances. Given the entrenched nature of the 60, 63 or 65 retirement age, employers may wish to consider a more modest and gradual extension.

Any change would need to be carefully communicated. In a defined contribution (DC) fund, extending the retirement age would not remove the right to retire early but would give members the option to work later. DC funds would also not penalise members choosing to leave before the normal retirement age. What this doesn't address is that individuals who do not fully understand their retirement needs are most likely to retire early without adequate savings.

Implications

Employers need to consider the characteristics of their workforce to assess whether workers might benefit from older retirement ages both financially and in terms of increased longevity, without harming profitability. If it is appropriate to increase the retirement age, employers can introduce gradual increases, such as a two-year extension or the opportunity for a worker to phase out from working and phase into retirement over a five-year period. Workers would still be able to retire at the current lower retirement age without penalty.

References

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