Funding the pensions gap

As the author of the international best seller *How to Retire Happy, Wild and Free* once said: 'Retirement is the beginning of life, not the end'. Retirement age norms differ around the world and needless to say, not everyone wishes to retire at the same age.

From a country perspective, at the upper and lower ends of the scale are Mexico and France with Mexicans retiring on average at 73 and the French much earlier at 58.7.

For many clients however, their retirement date will be somewhere between these two figures.

"The question isn't at what age I want to retire, it's at what income."
– George Foreman.

Unfortunately the ability to retire early is not always a matter of choice and will very much depend upon the robustness of the client's retirement provision.

For many individuals who plan to retire early, their potential income streams in retirement will inevitably come from either having acquired a large pension fund or from plans to sell a successful business. They may also have personal investments/savings or be able to generate rental income from a property or indeed a number of properties.

Other individuals may simply be looking towards receiving income from a combination of savings, the state pension or income from a defined benefit and/or personal pension plan. For the latter category of client, this begs the question of how reliable these potential sources of income will be in the future and whether or not they will be sufficient to fund retirement at all – let alone early retirement.

Many of the world's retirement systems are now under significant stress

The Melbourne Mercer Global Pension Index looks at the public and privately funded components of the retirement systems of 16 countries. It also covers personal assets and savings outside of the pension system. Each of the chosen countries was given a score of between zero and 100 and the overall index value represents the weighted average of the 3 sub-indices – adequacy, sustainability and integrity.

Rank	Country	Overall index	Grade
1	Netherlands	77.9	B+
2	Australia	75.0	B+
3	Switzerland	72.7	B
4	Sweden	72.6	B
5	Canada	69.1	B
6	UK	66.0	B
7	Chile	64.9	C+
	Average	60.5	

Rank	Country	Overall index	Grade
8	Poland	58.6	C
9	Brazil	58.4	C+
10	USA	58.1	C+
11	Singapore	56.7	C+
12	France	54.4	C+
13	Germany	54.2	C+
14	India	45.4	D
15	Japan	43.9	D
16	China	42.5	D

Data: Melbourne Mercer Global Pension Index
NB. As regards the grading system, 'A' indicates a first class and robust retirement income system that delivers good benefits. It is also deemed sustainable with a high level of integrity. 'E' represents a poor system that may be in the early stages of development or even a non-existent system.

At the top of the scale, the Netherlands' retirement income system comprises a flat-rate public pension and a quasi-mandatory earnings-related occupational pension linked to industrial agreements.

Most employees belong to these occupational schemes which are industry-wide defined benefit plans with the earnings measure based on lifetime average earnings.

You can count on us

Ranking at number 10, the United States suffered an adverse impact on the sustainability sub-index due to a fall in asset values and a rise in government debt which stood at over $16 trillion as of 5 February 2013 at 9.30pm GMT.

The lowest position on the index went to China. The one-child policy in China has drastically reduced the number of young people born, skewing the age demographics of the country toward older adults.

In China, the birth rate has fallen from 5.5 children per female in 1960 to just 1.8 today. At the same time life expectancy has risen by an astonishing 28 years.

Experts fear that government-provided pension plans will not be able to support the impending tide of retirees, especially with many young people moving away to seek out opportunities abroad.

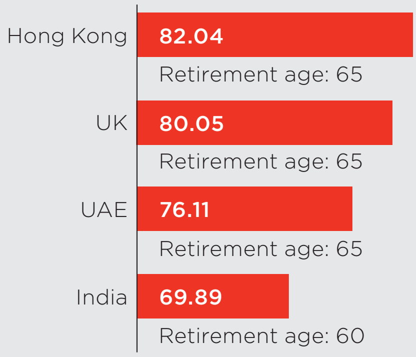
How sustainable is our future state pension?

The pressure on global state pensions will naturally increase as birth rates drop and average life expectancy continues to show an upward trend.

Consequently, the number of elderly in society is growing while the number of younger people is shrinking.

Countries such as France, Sweden and the USA are aging somewhat slower but at an appreciable rate. In Asia the two countries most affected are Japan and South Korea. Japan is already the oldest society in the world, while South Korea is undergoing rapid aging.

Sample average life expectancies



(Source of sample average life expectancies: CIA World Fact Book)

In the UK in 1955 there were 4 people of working age (age 20 to state pension age) for every 1 person of state pension age. There are now around 3 people of working age to every person of state pension age, and this ratio is expected to decline. Consequently, each working-age person will be paying proportionately more towards the state pensions of older people in the coming years.

Pensions experts warn that in the UK the state pension age could reach 68 for people born in or after 1964.

In the UK the annual state pension is £5,727.80 for a single person and £9,159.80 for a married couple/civil partnership (tax year 2013/2014). This amounts to a paltry sum of £110.15 per week for a single person. Indeed, many expatriates will receive even less than this amount unless they have taken steps to make voluntarily contributions to their own home country's tax system whilst working abroad.

Annual UK state pension

£5,727.80

(tax year 2013/2014)

Weekly UK pension

£110.15

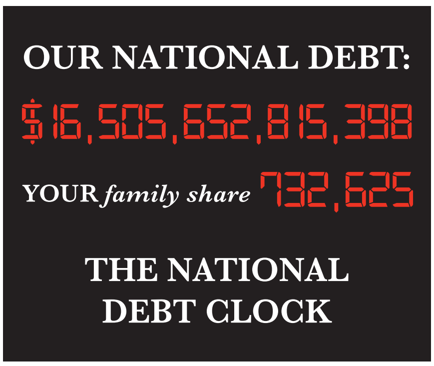
(tax year 2013/2014)

Average British Gas annual dual fuel bill for gas and electricity in 2012 was

£1,260

(or £24.23 a week)

US national debt:



as at 5 February 2013 at 9.30pm GMT

Furthermore, many UK expatriates will not receive index-linked increases to their state pension unless they retire in a country which belongs to the European Economic Area, Switzerland or one that has a specific agreement with the UK. Hence, in real terms, these pensions will lose value year on year. Looking ahead, however, will UK expatriates receive index-linked benefits to their pensions in the future? Is it sustainable to continue doing so?

Eligibility

In the United Arab Emirates, only nationals are eligible for state benefits and these do not stretch to foreigners who make up 88.5% of the combined population.

Funding deficits of defined benefit schemes

Among the challenges that many country's retirement systems face, is the decline in the percentage of employees covered by Defined Benefit (DB) schemes. Since these schemes have traditionally provided the most security for their members, this is a worrying fact. However, even for those clients who are members of a defined benefit scheme, there is still no room for complacency.

On 5 January 2012, Royal Dutch Shell became the last constituent company of the FTSE 100 to close its final salary scheme to new members.

In the UK it was recently reported that British businesses could face a corporate pensions deficit of as much as £295bn. Given that according to the Office for National Statistics there were 27.2 million members of defined benefit schemes in 2010, this represents a deficit of £10,846 per person. The impact of this could be potential cuts in pension promises and the ultimate cessation of indexed benefit payments or at least partial indexation of payments to members.

£27bn added to pension deficits this week as eurozone crisis continues

It was reported in November 2011 that FTSE 100 companies' pension deficits had grown by £27 billion since the end of the previous week.

Many pension schemes have more weightings in fixed income bonds than they do in equities in order that they are able to match future liabilities. How much money a company or insurer needs to put aside today to cover a pension payment due in 20 years' time depends on how much interest it will earn on that money in the meantime.

Interest rates on UK government bonds are now negative after allowing for inflation. A hike in liabilities has sent many pension funds deeper into the red. Gilts are important in the financing of pension funds but the yields they offer are damaged by the euro zone crisis and quantitative easing. The latest round of £75bn will only have made things worse.

In America the funding deficit of S&P 1500 company defined benefit schemes reached a post-World War II high in September 2011.

Potential corporate pensions deficit of:

£295bn

faced by British businesses

On the other side of the globe in America the funding deficit of S&P 1500 company defined benefit schemes reached a post-World War II high in September 2011. Unfortunately, many more of these company's schemes may face future difficulties if market conditions do not improve.

Never before has there been a more important time for clients to start saving to ensure that their hard earned money not only funds their existing expatriate lifestyle but also that it allows them the choice to retire early in the future, whether this be a matter of choice or necessitated through ill health.

Example

Let's look at a 45 year old male earning a tax free salary of £70,000 per annum who wishes to retire at the age of 65 on two thirds of his then salary. If his salary had reached £100,000 at the point before retirement, he would expect to retire on an annual income of approximately £66,666.

According to one financial adviser's website, in order to achieve a retirement income of £66,664.97 per annum, the client would need a retirement pot of £1,161,033.42. The client would need to have saved £2,583 every month for the first year and increase this premium by 2.5% for each of the subsequent 19 years.

The effects of putting off this pension provision year after year are devastating as the table below shows.

Effects of delaying saving by

Number of years	Resulting pension income (GBP)
1	61,333.22
2	56,272.52
3	51,470.89
4	46,916.84
5	42,599.38
6	38,507.95
7	34,632.46
8	30,963.21
9	27,490.92
10	24,206.71

The pension results are calculated using a compound annual growth rate before fund charges of 5% and assume an annual management charge of 1% which is deducted from the growth rate.

The calculation is based on 'today's terms' where inflation is assumed at 2.5% compound.

Contributions are assumed to be paid monthly and are applied monthly in advance.

Important notes

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