Retirement / The "Third Phase" And The Possible Impact of Covid-19

Introduction

What does retirement mean to people today? A 65 year old person today (ignoring Covid-19 for the moment) can expect to live another 20 years on average. The questions arise as to whether people want to stop working for such a long part of their lives and more importantly can they afford to retire for 20 years?

Most early pension schemes were Defined Benefit Schemes, which means that the benefits on retirement were specified and guaranteed for life.

The first Defined Contribution Schemes did not come into existence until the 1970's. In Defined Contribution schemes nothing is specified or guaranteed.

In a Defined Benefit the company carries all the risk and in a Defined Contribution (DC) scheme the individual members carry all the risk. Defined Benefit (DB) schemes are becoming rare and so this paper will focus on DC schemes.

Retirement – Financial and Legal Considerations

For many retirement is seen as the "Third Phase" where people want to have more choice over what they do and when they do it. The ability to have this choice is usually dependent on having an acceptable level of financial security.

Employment legislation has also had an important impact on retirement. Attempting to force an employee to retire simply on the attainment of a certain age is in breach of the equality legislation. Generally, to force an employee to retire, it must be specified in the contract of employment and also be justifiable on substantial grounds other than age.

The State Pension (contributory) in Ireland is currently payable from age 66. This raises to 67 in 2021 and then to 68 in 2028.

The Potential Pension Time Bomb

The recessions of 2008 and the current one we are entering have had significant impact on investments and confidence. For DB schemes it has resulted in organisations putting additional monies into their schemes to ensure they are funded and for DC schemes it means the value of the investment is lower.

There are two critical factors when it comes to assessing your pension, the annual income you can expect to get from the scheme and the number of years that you are likely to require it.

For DB schemes the benefit is known and the number of years you will have to draw down on it does not matter. For a DC scheme the number of years has a very significant impact on the monies that can be taken annually.

A prudent person may expect to generate an investment pot of €150,000 over their lifetime. At today's rates this will buy a pension annuity of approximately €9,000 and they would have to wait an additional two years to receive the State benefit of €13,000 (if they qualified) giving a total of €22,000.

Impact of Covid-19

The financial impact that the current Covid-19 pandemic will be significant and ongoing. This will impact on funding requirements within DB schemes and the value of investments generated by DC schemes. In addition, Covid-19 may impact on life expectancies as older people tend to suffer more.

Another factor, unquantifiable, is the impact that this will have on peoples willingness to invest in their retirement schemes. For the most part DC schemes allow individuals to decide to invest, or not, as they choose. When people are out of work contributions usually cease and it can be a challenge to get people to invest in pensions after a period of unemployment.

The very nature of work may change. Working from home and the extension of lessons from the "gig" or "platform" economies may become more mainstream. This could bring more choice as people approach the "third phase".

Governments around the world are spending unimaginable sums to support the economy and people in need. The cost of doing so will place many governments in very high levels of debt, which impact all economies. Ireland, before this crisis began, had unacceptably high levels of national debt.

Auto Enrolment

The last government planned the introduction of auto-enrolment pensions from 2022 on a phased basis. The scheme would apply to everyone over 20 and under 60 earning more than €20,000 p.a. who is not already in a pension scheme. The individual would contribute 1.5% of salary rising to 6% after ten years. These contributions would be matched by the employer.

While the concept has merit, the levels of contributions are very low and the pension provided by this level of investment (similar to the illustration above) will not be sufficient to allow people to retire at age 65 or within a short period thereafter.

The Public Sector

An analysis by the Department of Public Expenditure has found that the cost of Public Sector Pensions will rise from €3.4 billion to €5.3 billion by 2025 and €7.3 billion by 2040. Contributions paid by a public servant will not change at all over this period. Public sector pensions are financed out of current spending. It is also significant that contributions from current staff are less than 50% of monies paid out to pensioners.

A public servant with full service will receive a pension worth 50% of their final salary plus a lump sum of 150% of final salary. Is this affordable and sustainable?

Future Expectations

The "third phase" is about people having more choice when it comes to what they do and how much. It is a question of combining personal interests and competencies together with financial needs to maintain desired living standards. The investment pot is the security blanket.

Others may remain with their current employers longer in existing roles. Alternatives also include moving to fixed term contracts or becoming part time. They may also move to different roles to allow them to extend their careers.

With the changing concept of employment and how work is carried out new opportunities may become more common to allow a more flexible approach to work and for older individuals who choose to continue to work longer to do so in a manner that suits them personally. To move to more working from home could also be significant.

Other Considerations

Every employer needs to take time out to understand the impact this crisis is having on their pension schemes. It's essential to determine if any decisions need to be made now, and to identify what potential financial and legal obligations become relevant.

Given the number of people who are not currently working, and the uncertainty as to how long this will last, consideration needs to be given as to how pension contributions will be handled during lay-offs, or periods of short time working. In addition, if rates of pay are reduced, as was the case post 2008, how will this impact pensions?

Organisations, in general, need to continually review their business continuity plans in the context of the impact of Covid-19 on their markets and the implications this has on the type of organisation they need to be to successfully compete in the future.

Responsibility of Organisations and Trustees

During the COVID-19 pandemic, and the economic slowdown that has only begun, it is imperative that trustees communicate regularly with one another, the sponsoring employer, the scheme actuary, scheme administrators and professional advisors. All financial and legal implications need to be identified and evaluated. Employees and pensioners need to be kept informed.

Conclusion

When thinking about and reviewing pension schemes it's important to consider these key questions:

- Why should people retire and when should it happen?
- What should retirement be based on?
- Should it be voluntary or imposed?

Retirement is the longest term planning that any of us are likely to ever undertake personally. The younger people are when they start planning the easier it will be to put in place an appropriate investment plan. It takes a very significant investment pot to generate sufficient funds to retire for 26 years.

Employers and employees together with the government all have a responsibility in this area.

If any business has questions, or need further guidance or support on the issues discussed in this article, please do get in touch with me at brendan.mccarthy@stratis.ie.

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