Multidisciplinary expertise is required to develop a strong understanding of longevity risk. Economists, financial experts, actuaries, demographers, gerontologists, biomedical scientists and others all must play a part in addressing the conundrum presented by ageing populations across the world, according to David Blake of the UK's Pensions Institute who spoke at a recent Australian School of Business conference. At the heart of the issue is how long everyone will live, and then how to pay for their increasingly longer lifespans. Australia was ahead of the pack when it established auto-enrolment for superannuation in the early 1990s, but this is only half of the solution to paying for longer retirement periods. The UK now plans to emulate Australia with the introduction of auto-enrolment next year, but it's way ahead on annuities. Debt-ridden Europe, on the other hand, looks set to face a further economic debacle from longevity risk, Blake tells Julian Lorkin of Knowledge@Australian School of Business.

An edited transcript of the interview follows.

Knowledge@Australian School of Business: Is there an easy way to address longevity risk?

David Blake: No-one has been good at predicting the trend risk from longevity – that is, the improvement in life expectancy. Over the last 100 years, individual lifetimes have increased at the rate of two and a half years per decade – that means someone born 10 years after somebody else will be expected to live 12½ years longer. Governments and pension plans have underestimated the extent of this risk and individuals really don't understand it at all. What we're beginning to do now is actually measure and quantify this risk and try to develop models that improve our understanding of this trend and to predict it better. That requires involving different disciplines, such as biomedical scientists, and considering what's happening with cures for cancer and so on.

As our understanding increases, then perhaps we will be able to better predict how long people will live in future.

Knowledge@Australian School of Business: An issue that's come out at the conference is education or how to teach the individual about longevity risk.

David Blake: That's true. Individuals have a very poor understanding of their own longevity risk. You could have 10 individuals in a room aged 65 – one of those individuals will die at 66 and the last at 95 – and that's a huge range of outcomes. People have a very, very poor understanding of how long they might live after they retire and therefore what kind of pension savings that they should have accumulated during their working lives in order to prepare for retirement. Most people actually underestimate how long they're going to live. They start getting aches and pains and think, "I'm going to pop off quite soon," whereas the reality is they actually can live an extremely long time after retirement. That's the real risk that society faces, that individuals simply haven't made sufficient preparation for their retirement.

Knowledge@Australian School of Business: The bad news is that people haven't prepared for it, but the good news is that they're going to be living a lot longer. How do you get this information across to people?
David Blake: I think the most relevant time to do this is at school, possibly around the age of 14 or 15 when they should be getting a better education in finance and banking. Part of that education should be what's to be expected in the personal lifecycle: you expect to continue your education and start work, you're then going to want to have a house with a mortgage, children, school fees … But at that early age 14 year olds never think they're going to die, so they need educating to understand that they will end their work lives and go into a period of retirement – and they don't want to suffer an extreme drop in their standard of living. They will need adequate resources to fund retirement, even if it's only for a short period of time or for a very long period of time. There's an 8% chance of a 65 year old reaching 100. That is 35 years of retirement, and people have to prepare for that.

Knowledge@Australian School of Business: There's a huge gap because people have obviously looked at their parents who, because of poorer healthcare 30 or 40 years ago, may expect to live shorter lives. How can people understand that things have changed, even in the past decade?

David Blake: That's a very good point. People's estimation of their own life expectancy is closely linked to the age that their parents died, and therefore they don't build in that improvement in life expectancy. Of course, all the improvements in medical treatments and cures and treatments for cancer are the reason why people are underestimating how long they will live in retirement.

Knowledge@Australian School of Business: Another theme of the conference seems to be the gap between what academics are looking at and what the practitioners are proposing. How can you bring those two together?

David Blake: There's a potential conflict there because the targets that academics face are getting papers into good publications and high quality journals, and that does not necessarily involve solving realistic problems. I think that the longevity risk as a problem can give rise to sensible academic solutions that are of use to practitioners by working on these problems from a range of disciplines. This is a genuinely multidisciplinary area of research. You need economists, experts in finance, actuaries, demographers, gerontologists, biomedical scientists, people who understand diet and others. And we need to learn from all these different groups of people, because they all think in slightly different ways – they all have different terminologies – and you've got to break down those barriers. This is essential if we're going to understand longevity risk, quantify it, measure it and then provide solutions. Part of this conference is looking at what the capital markets can do to help provide the solutions which have traditionally been the role of insurance companies. It's been life insurance companies that over the last 200 or 300 years have provided solutions to people living too long, and the standard example of that is the life annuity; the lifetime annuity is the way that individuals hedge their own longevity risk, although they're not very popular.

Knowledge@Australian School of Business: Annuities are not popular and it seems to be only a few better-informed people go for them. Others tend to put off thinking about retirement until they reach the last decade of their working lives and suddenly have a big panic about how they are going to live.

David Blake: That's right.

Knowledge@Australian School of Business: In Australia, facing up to longevity risk to some extent has been taken away from the individual because people are forced to save something in their superannuation pot. Can the UK and other parts of the world learn something from the pension situation in Australia?

David Blake: I think Australia's got it half right and half wrong, and I'll tell you what I mean by that.

In 1992 auto enrolment came in requiring all workers to contribute to a pension plan (superannuation). As a result, huge sums of money have been built up. The problem is there's no requirement in Australia to buy an annuity when you retire; there's no requirement to hedge your longevity risk. Yet a pension plan's only purpose is to hedge your longevity risk to provide you with a standard of living in retirement relatively similar to the one enjoyed just prior to retirement, and that should be for however long you live, whether you only live a couple of years after you retire or whether you will live well beyond 100.

The good part (of Australia's approach to superannuation) was the effective auto enrolment into the plans; the weak point was then not having the requirement to buy an annuity, and we know that in Australia only 29 people in 2009 bought lifetime annuities.
I come from the UK where there's a mandatory requirement to buy annuities, and half a million people a year retire and have to buy annuities. We have the world's biggest annuity market and sell more than half the world's life annuities. So Australia can learn something from us in decumulation – how you draw down assets and hedge your longevity risk. On the other hand, we can learn a lot from Australia about the success of auto enrolment, and we have, because in 2012 a pension scheme based on auto enrolment called NEST, the National Employment Savings Trust, is going to start. It has auto enrolment as the underlying principle. Seven million workers in the UK who don't have pension plans beyond the state pension plan will be auto enrolled on to this NEST plan, and we are building on the experience of the success of auto enrolments in Australia.

**Knowledge@Australian School of Business:** So there are these two approaches, but in other parts of the world they don't seem to be on the radar. In a recent interview I think you said that Europe was living in "fantasy land", what did you mean by that?

**David Blake:** Europe is living in "fantasy land" because it has an ageing population and the state pensions are far too generous. In countries like Greece, you can retire in your early 50s and then the government pays a pension to you at the same level as your pre-retirement income for the rest of your life. Greece has built up a national debt many times its income, it is insolvent and Germany has had to bail out Greece to stop it becoming insolvent. All the other countries in Europe have far too generous state pension systems; the retirement age has not been indexed to increases in life expectancy. With the declining fertility in Europe, the dependency ratio is rising. In other words, the proportion of retired people drawing a pension to the number of people working and paying the taxes to pay those pensions is rising very rapidly. It's simply not going to be feasible to set the tax rates so high on young workers to pay for these generous state pensions. Young workers will simply emigrate and thereby compound the problem.

**Knowledge@Australian School of Business:** We're aware of these problems but nobody's come up with a solution. Is there a solution, maybe everybody's just got to muddle through? After all, this isn't a terminal problem. There won't suddenly be a huge implosion. It just means people end up a bit poorer.

**David Blake:** I think people are going to end up a lot poorer. The muddling through model is the typical national model that we use in Britain, but it's going to result in not slightly lower living standards in retirement, but substantially lower living standards in retirement. When you look at the political side of this, the older generation is in the majority and they will be voting for governments that provide resources to them, and expecting the young generation to pay. So we have the young generation going "Grrr" and taking off to somewhere else where tax rates are lower. This increases the relative weight in the voting results of older people and they'll be continually voting for more and more resources devoted to them. But there will be nobody there to pay the taxes.

**Knowledge@Australian School of Business:** Hopefully it won't come to that. David, thank you very much.