Institute and Faculty of Actuaries

Saving for retirement

Policy Briefing

Key findings

There are four key priorities that policymakers need to consider to encourage and enable individuals to save for their retirement within an economically viable system.

Priority 1: The pensions framework must be sustainable for the State, savers and employers in the long-term. Building a sustainable pensions framework will ensure affordability of pension promises made by the State and support individuals to save for an adequate income in retirement.

Priority 2: There must be clarity on the role of the State. We would welcome the opportunity to work with Government to consider whether the new State Pension and the tax relief given to pension savings achieve the policy intent, and if not, how this might be better achieved.

Priority 3: Individuals need to understand how long they might live in retirement. If an individual underestimates their expected life span, and plans retirement income accordingly, they are likely to run out of savings before they die. Running out of funds in later life could be a significant challenge, particularly if the individual also has care needs.

Priority 4: Individuals need to understand what level of savings they will need to meet their retirement income needs and be encouraged to save to meet them. This change in emphasis will not be easy to achieve and we suggest a Government-led initiative, such as with auto-enrolment, with support from employers, pension trustees and providers is needed to raise awareness of the level of savings required to have adequacy of income in retirement.

The IFoA will continue to work alongside other stakeholders to help overcome barriers to saving for retirement by developing an evidence-base that will help to inform potential policy and pension industry responses.

September 2015

Ageing population

Contents

"Government, employers and the pensions industry need to take an active role in developing strategies that encourage a greater level of pension saving."

Gareth Connolly, Chair of IFoA Pensions Board

Introduction

The population over the age of 65 is increasing in the UK, with the number of people over 65 now reaching 11 million and the number of people over 85 projected to double in the next 20 years.[i, ii] More people living longer is a success story and should be celebrated. However, there is a need for governments and individuals to understand the challenges arising from an increase in the number of people living longer in retirement. State expenditure on age-related benefits for those aged over 65 is increasing, accounting for 65% of DWP benefit expenditure.[iii] It is therefore important the Government implements policy responses that are sustainable in the long-term.

In the UK, it is estimated that of the 38 million people of working age, around 11 million are not saving enough for their retirement. This will have significant implications for their quality of life in retirement.[iv]

For individuals it is important that they understand their retirement income needs and take action, such as saving accordingly, or being prepared to defer their retirement. Whilst auto-enrolment is an important step towards getting more people to save, there is more to be done if they are to be able to save enough to meet their retirement income needs.

We suggest current barriers to sufficient saving include:

- **Retirement seems too far away to begin planning for unless the benefits of saving are tangible;**
- **A lack of understanding around the amounts that people will need to save in order to have adequacy of income throughout retirement;**
- **Whilst acknowledging the forthcoming simplification of the State Pension, the pensions framework remains complex;**
- **The tax framework for pensions has changed frequently in the past, and these changes have not always been easy to understand, and therefore, may not have been fully appreciated ; and**
- **Owing to the tax privileges afforded to pension savings, there is a perhaps inevitable restriction on when people can access their savings, meaning that pensions are relatively inflexible compared to savings vehicles such as ISAs.**

To overcome these barriers we believe there are four key priorities that policymakers need to consider further to encourage and enable individuals to save for their retirement within an economically viable system:

Priority 1: **The pensions framework must be sustainable for the State, savers and employers in the long-term**

Priority 2: **There must be clarity on the role of the State**

Priority 3: **Individuals need to understand how long they might live in retirement**

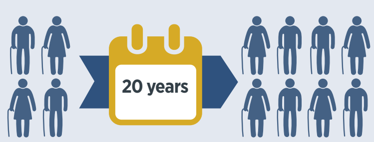
Priority 4: **Individuals need to understand what level of savings they will need to meet their retirement income needs and be encouraged to save to meet them**

Ageing population

11 million

Number of people over the age of 65 now reaching 11 million

Double



Number of people over 85 projected to double in next 20 years

65%

65% of DWP benefit expenditure going to over 65s[iii]

Priority 1:

The pensions framework must be sustainable for the State, savers and employers in the long-term

Building a sustainable pensions framework will ensure affordability of pension promises made by the State and support individuals to save for an adequate income in retirement.

The average age of the population is projected to continue to increase and this is driving up Government expenditure on pensions and the saving requirements for individuals. In anticipation of these demographic shifts, the Government has introduced a series of new measures.

State Pension Age

In the UK, State Pension Age (SPA) is currently 65 for men and will reach 65 for women by 2018. Figure 1 illustrates that the number of people aged 65 and over is increasing and is projected to continue to increase faster than the number of people under 65. The change in demographic caused by a growing proportion of people above SPA could have a number of effects:

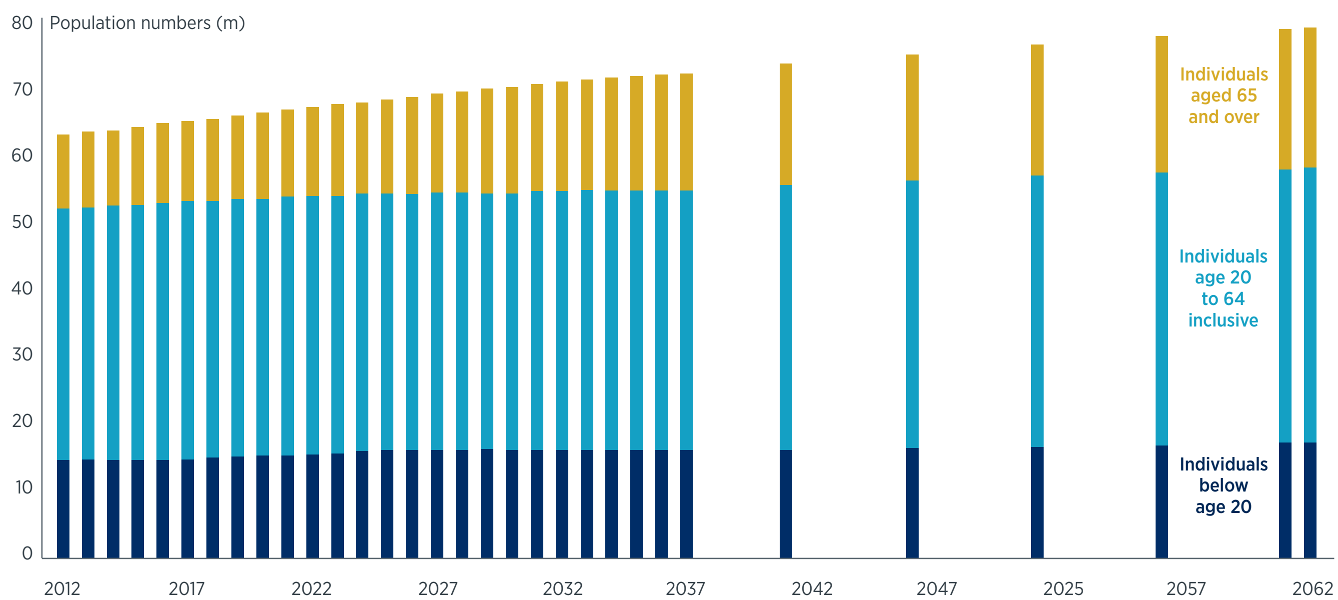
- If there are increasingly more people over SPA, there will be a greater demand on government spending to meet the costs of paying for the State Pension and other age-related benefits.
- If there are fewer people of working age, there are fewer people paying National Insurance. This means the working age population will have to pay more National Insurance per person, or Government expenditure on age-related benefits will have to reduce if monies are not allocated from elsewhere.

The Pay As You Go system in the UK means the payments to current pensioners are met from contributions by current workers. The rising proportion of the population over age 65 will increase costs to the current, and future, generations of workers for contributing to the benefits of older generations. To achieve intergenerational fairness it seems reasonable to find some way of ensuring that those who benefit from a longer life expectancy contribute to the increasing costs. Increasing SPA is one way to achieve this – delaying the point at which an individual begins drawing a State Pension. Linking SPA to life expectancy could help balance the proportion of people below and above SPA.[vi]

Triple-lock guarantee on basic State Pension uprating

The current Government has also pledged to maintain the 'triple lock' on the current basic and the new single-tier State Pension to ensure it rises with inflation, earnings or 2.5% per

Figure 1: Projected UK population split between below age 20, 20-24 and 65+ year olds [vi]



annum – whichever is highest. Recent estimates by the Office for Budget Responsibility (OBR) have revised the cost of the triple-lock to £2.9 billion in 2014-15; this is £2.4 billion higher than the original estimate in June 2010. The OBR's analysis suggests this reflects a combination of sustained shortfalls in productivity and real earnings, and high inflation.[vii] Based on current economic trends the triple lock will increase State expenditure on pension benefits as a share of GDP over the long term.[viii]

Automatic enrolment (AE)

To date AE has been successful in increasing the number of people saving. To build on this momentum, immediate focuses for the Government should be:

- monitoring the successful staging of AE to small and medium enterprises (SMEs);
- introducing auto-escalation; and
- investigating the saving levels for those currently excluded from AE.

Staging for SMEs is underway and is unlikely to be straightforward. The Pensions Regulator (tPR) is responsible for ensuring employers comply with AE. It is also raising awareness of employers' duties and has produced detailed guides and interactive tools that take employers through the AE process step by step. However, SMEs tend to have less awareness of AE since many will not have previously offered any kind of pension scheme. Additionally, there is no guarantee that the first pension provider they approach will necessarily take them on.[ix] Close monitoring of the AE process will help to ensure SMEs successfully enrol their employees.

The total minimum contribution level by 1 October 2018 will be 8% on qualifying earnings. However, the band of earnings used to calculate contributions for AE means that for low earners the headline 8% contribution becomes just 3.4% and the maximum any saver can receive is 6.9%.

Table 1: The effect of band of earnings on AE contributions based on 8% total contribution[x]

Annual salary	AE contribution, taking into account the impact of band of earnings
£10,000	3.4%
£15,000	4.9%
£20,000	5.7%
£27,000	6.3%
£40,000	6.9%
£50,000	5.8%
£60,000	4.8%

This level of contribution, by itself, is unlikely to be sufficient to provide an adequate level of retirement income. One suggestion to increase contribution levels is auto-escalation. As suggested by the former Pensions Minister Steve Webb, auto-escalation would seek to capitalise on inertia in the same way as AE and automatically increase the contribution rate when a person's salary increases.[xi] For example, an individual currently contributing 4% of their salary may agree that, should they be promoted and their salary increase, they will increase their contribution level to 5% of their new salary. This will increase the overall contribution from 8% to 9% as the employer will contribute 3% and the State a further 1% by 2018. With the roll out of AE to be completed in 2018 it would be timely for Government to be thinking about strategies that build on this momentum to encourage a greater level of saving, whether that be increasing minimum contribution levels, making changes to the band of earnings, or encouraging auto-escalation.

In addition, AE does not capture all of the working population, for example, low-paid workers, including those with multiple low-paid jobs and the self-employed. Under the current system these groups will not be able to benefit from AE. Additional research would be helpful in understanding what this means for these groups' income in retirement.

>5 million

Over 5 million workers are automatically enrolled into a workplace pension

≈ 1 in 10

Around 1 in 10 people have opted-out

Priority 2:

There must be clarity on the role of the State

For individuals to grasp their saving needs it is important there is clarity on State provision, including State Pension, tax relief and other age-related benefits.

Individuals should have clarity on what they will receive from the State and what they will have to self-fund.

State Pension

The objective of State Pension provision has changed over time and is currently going through a period of further change. In its 2013 Impact Assessment for the single-tier State Pension the Government set out its policy objectives as:

"To deliver a simpler and fairer state pension that provides a better foundation for saving and is sustainable for future generations. The intended effects of state pension reform are:

- *individuals have a better understanding of the state pension system, including how much they can expect to receive and therefore engage more actively with planning for retirement;*
- *inequalities of state pension outcomes within the current system are reduced;*
- *individuals have reduced interaction with means-tested benefits in retirement; and*
- *the state pension system is more affordable and sustainable in the long-term."*[xii]

There will be some complicated changeover arrangements as the Government transitions from the current basic State Pension to the new State Pension and it is important individuals are appropriately supported in understanding what they will receive from the State under the current system, during the transition period and under the new system.

From April 2016, the full new State Pension will be at least £151.25 per week for men born on or after 6 April 1951 and women born on or after 6 April 1953.[xiii] If people expect their outgoings during retirement to be above this amount, they will need adequate savings to support this additional expenditure.

In addition to the State Pension other age-related benefits include:

- Attendance allowance - to help with care needs due to illness or disability
- Winter fuel payment
- Housing benefit
- Council tax support
- TV license concessions

The result is that 65% of DWP benefit expenditure goes to those over age 65.

Tax relief

The Chancellor set out in the 2015 Summer Budget that Government will be reviewing pensions tax relief. In its paper 'Strengthening the incentive to save' the Government has set out its aim as:

"With increased longevity and the changing nature of pension provision, the government needs to make sure that the system incentivises more people to take responsibility for their pension saving so that they are able to meet their aspirations in retirement."

To achieve this it has set out four principles:

- simple and transparent
- personal responsibility
- build on the early success of AE
- sustainable

We would welcome the opportunity to work with Government to consider whether the new State Pension and the tax relief given to pension savings achieve the policy intent, and if not, how this might be better achieved.

Priority 3:

Individuals need to understand how long they might live in retirement

The shift in the pensions environment

Traditional Defined Benefit (DB) plans are continuing to lose their dominance in occupational pensions owing to a shift towards Defined Contribution (DC) pension arrangements. In the UK, there are significantly more DC schemes than DB schemes and this trend is expected to continue as a significant proportion of DB schemes are closed to new customers, frozen to contributions from existing members or winding up.

This transition shifts inflation, market and longevity risk from employers to individuals, meaning retirement income may be subject to greater variability than before. In addition, the freedom and choice agenda has ended compulsory annuitisation. Irrespective of whether these products offer value for money, they offer an important lifetime guarantee, meaning that individuals would be protected against running out of income should they outlive their savings.

The guarantee offered in DB arrangements and by annuities meant that individuals did not have to make active decisions regarding making their savings last a lifetime. With the growth in DC, for many individuals this is no longer the case and so it is important that people understand how long, on average, they are likely to live for and the potential variance around that age.

This will be important both in terms of making retirement income decisions, but also in ensuring that an individual saves adequately throughout their working life to support their retirement income needs for the entirety of their retirement.

Understanding life expectancy

There is a lack of common understanding as to what an individual's life expectancy might be, how this might change over time and that an estimate of any one individual's life span is based on an average from a representative population. Understanding life expectancy and knowing how long one individual will live for is complex. Research has shown that individuals can underestimate how long they are going to live for and this could result in under saving.

A study by MGM Advantage found, on average, males aged 55-64 expect to live to 81, whilst females in the same age range believed, on average, they would live until they were 79. Both of these estimates were considerably below the national average life expectancies of 86 and 89 for men and women.[xv]

Whether a person's life span is longer or shorter than their estimated life expectancy is determined by a large number of factors including their health and socioeconomic status. This adds further complexity.

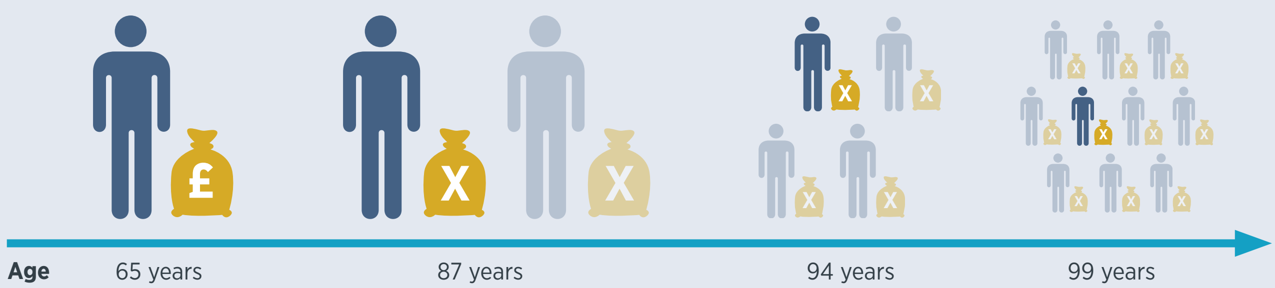
It is important that individuals understand the potential range of ages they might live to. Table 2 demonstrates the likely life expectancy of a male dependent on their current age.

Table 2: Results of ONS 'How long will my pension need to last?' tool for an adult man with 10 year age intervals [xvi]

Male				
Current age	Life expectancy from now	1 in 4 chance of reaching	1 in 10 chance of reaching	Chance of reaching 100
25	88	99	104	20.7%
35	87	97	103	17.0%
45	86	96	102	12.7%
55	86	95	100	10.9%
65	87	94	99	8.8%
75	88	94	99	7.4%
85	92	95	99	6.9%
95	98	100	102	20.5%
105	106	107	108	

If an individual underestimates their expected life span, and plans retirement income accordingly, they are likely to run out of savings before they die. Running out of funds in later life could be a significant challenge, particularly if the individual also has care needs.

For example



A male currently aged 65 has an average life expectancy of 87; however he has a one in four chance of living to 94 and a one in ten chance of living to 99. If individuals in this cohort had saved expecting to live until 87, a quarter will still be alive a further 7 years beyond this, potentially without an adequate income.

Priority 4:

Individuals need to understand what level of savings they will need to meet their retirement income needs and be encouraged to save to meet them

There are a number of considerations for individuals when they are making decisions about their retirement savings. These include basic living costs for the length of retirement, any hobbies or leisure activities and any potential care costs, particularly in later life. The accumulation of all of these costs will impact on how long an individual's savings last in their retirement.

Replacement ratio

Under saving may result in a person not being able to cover their current level of daily outgoings for the potential duration of their retirement and / or make provisions for any care needs they might have.

The 2004 Pension Commission Report recommended a set of replacement ratios based on income band as a bench-mark for assessing adeqacy of retirement income. This is the percentage of working income that an individual needs to maintain the same standard of living in retirement. These figures range between 50% for top earners, 67% for median earners and 80% for low earners.[xvii] The IFoA has carried out a series of calculations on the level of savings a person might aspire to save to meet their replacement ratio. One example looked at an individual earning a median salary of £21,000 over a possible 40 year working life, contributing 8% - the 2018 AE minimum contribution level – and with full entitlement to the current basic State Pension. For this individual, we found that the level of income in retirement would be approximately 70% of the recommended replacement ratio.[xviii] This means a typical individual under this scenario, who is saving the AE minimum contribution only, will still fall short of what is widely regarded as an acceptable level of income in retirement.

Retirement income from both a private and State Pension is uncertain, and saving the AE minimum contribution may not provide adequacy of income for all.[xix] The IFoA would welcome a review of current replacement ratios in light of recent changes to the pensions framework and whether a bottom-up approach based on pensioners' outgoings might be a more appropriate measure.

Focus on outcomes

IFoA research suggests that if a person focuses on outcomes (i.e. the level of income they are going to need in retirement) and understands the impact of under saving on their quality of life they will then be better able to focus on their target level of saving. This will mean they can monitor progress towards this target and, where possible, take action to achieve this during their working life.[xx] We also found that individuals would be more likely to engage in financial decision-making if they believed their efforts were likely to be worthwhile. One way of demonstrating potential risks and rewards of financial decisions would be to provide a projection of the individual's retirement income based on current assets and savings relative to their retirement income goals, for example a specified replacement ratio.[xxi]

The Government has made a significant first step to help people make financial decisions about their retirement income by setting up Pension Wise. However, individuals will have an important role to play with considerably more engagement required than we have seen to date, and than AE will bring. Greater engagement leads to individuals placing a higher importance on their pension, and therefore, the importance of saving to ensure their pension is adequate. We suggest as people gain a deeper understanding of their goals, they are more likely to strive to achieve them, and the savings gap should close and reliance on the State decrease.

This change in emphasis from financial targets to lifestyle targets will not be easy to achieve. A Government-led initiative, such as with AE, with support from employers, pension trustees and providers is needed to raise awareness of the level of savings required to have adequate level of income in retirement.

Pensions dashboard

The Financial Conduct Authority and Work and Pensions Select Committee have recommended that the Government prioritises the introduction of a pensions dashboard, to give people an overview of the key information on all of their pension funds.[xxii xxiii] The FCA has set out in the final report of its Retirement Income Market Study that it is working with Government to develop a pensions dashboard in the longer term. This tool should enable consumers to view all of their lifetime pension savings, including their DC, DB and State Pension entitlement in one place. As people are likely to have a number of employers throughout their working life, and therefore, potentially a number of pension pots, this will allow an individual with several pension pots to have a clear understanding of their pension savings. Whilst the benefits in such a tool are clear, the regulator and Government must consider the level of cost involved and whether this would fall to the customer, and if so, whether the benefits of having this tool would outweigh the cost to their savings.

Where next?

Overcoming the barriers we have set out in this paper will be reliant on individuals understanding the tangible benefit of saving for their retirement and ensuring the pension framework incentivises saving. Future changes in policy must aim to ensure that people have adequate retirement income to last for the duration of their retirement.

Increasing saving levels for retirement will require a fundamental shift in approaches to saving and will require action and alignment by Government, regulators, the pensions industry and individuals.

The IFoA is commited to undertaking research, working alongside other stakeholders, to develop an evidence-base that will further inform potential policy and pension industry responses to the challenge of saving for retirement.

We will continue to build on our analysis of:

- **State Pension Age;**
- **Auto-enrolment;**
- **Tax relief;**
- **Life expectancy; and**
- **Measures of adequacy.**

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