Savings goals for retirement series

Paper 1: Risks to staying on track

In 2019, the Institute and Faculty of Actuaries (IFoA) launched its ‘Savings goals for retirement’, a set of ‘rules of thumb’ intended to indicate how much people might need to save over a full working life in order to achieve a certain standard of living in retirement[1]. This was based on the Pensions and Lifetime Savings Association (PLSA)’s retirement living standards, which set out the expenditure needed to achieve a ‘Minimum’, ‘Moderate’, or ‘Comfortable’ lifestyle in retirement[2].

The Savings Goals

1. Coupled with the State Pension, **saving at the current 8% minimum Automatic Enrolment contribution level** should be broadly enough to provide a **‘Minimum’** level of retirement income.

2. For an individual to be likely to achieve a **‘Moderate’** level of retirement income, their total savings need to be **around one quarter (26%)** of average full-time earnings.

3. If an individual or couple is aiming to achieve a **‘Comfortable’** level of retirement income, they need to save **more than double** what they’d need to save if aiming for ‘moderate’.

The IFoA considers that rules of thumb can be useful tools for savers, to help them understand how likely they are to reach their goals when they reach retirement. We have therefore developed further rules of thumb, the first of which - ‘risk of staying on track’ – is presented in this paper.

Risk and uncertainty

The Savings Goals are aimed at young people who will rely heavily on defined contribution (DC) pensions for their retirement. Unlike previous generations who were more likely to have one or more defined benefit (DB) pension arrangements that provide predictable retirement incomes, young savers with DC pensions face significant risks to their ability to stay on track to achieve their desired standard of living in retirement.

Saving for retirement using only DC pension arrangements means that people now face a number of risks, as well as a huge range of uncertainties about how their finances will fare over a long period of time. This situation requires a much more active role for the individual in terms of risk management.

1. **Adequacy**

Pensions are expensive, as illustrated by the cost of achieving a ‘Moderate’ standard of living in retirement, which we calculate is 26% of average full-time earnings, currently £799 per month. This is far more than the minimum contributions required under Automatic Enrolment, implying the need for substantial additional voluntary savings. Employers can play an important role here, e.g. by offering to match employee contributions up to a limit, but **there is a clear risk that people will be unable to afford an adequate retirement income**.

Low interest rates are a major reason for the current high cost of pensions; a modest rise would substantially reduce the cost. More cost-effective solutions for securing an income on reaching retirement would also help.

[1] Institute and Faculty of Actuaries, Savings goals for retirement, October 2019 https://www.actuaries.org.uk/news-and-insights/public-affairs-and-policy/ageing-population/adequacy /savings-goals-retirement
[2] Pensions and Lifetime Savings Association, Retirement Living Standards https://www.retirementlivingstandards.org.uk/

2. **Investment risk**

The extent to which DC contributions will grow over the period to retirement is uncertain, as future investment returns are unknown. In addition, investments can be volatile in the short term - well illustrated by market reaction to COVID-19. These uncertainties present significant challenges to individuals when planning for their retirement.

By way of illustration, consider the cost of providing a 'Moderate' standard of living in retirement. **Our Savings Goal suggests 26% of average full-time earnings (AFTE), but owing to the uncertainty of investment returns prior to retirement, this is only the average contribution required; the actual contribution needed could be anywhere between 13% and 45% of AFTE,** depending on market conditions[3]. This makes it very hard for an individual to plan for a given retirement income.

The above example assumes that a fund of £473,000 is needed at age 68 to provide a 'Moderate' retirement income, when combined with the State Pension. In practice, the required fund is uncertain, partly due to longevity risk (see section 3 below) but also further investment risk:

- If the individual wishes to purchase an annuity at retirement, the cost of doing so could vary significantly from what we have assumed, since annuity prices can vary over time;
- If an annuity is not purchased, then under drawdown there is uncertainty over future investment returns. By way of illustration, after 30 years in retirement drawing a 'Moderate' income, we estimate that there is a 25% chance that the initial fund of £473,000 might still be worth £225,000 or more (adjusted for inflation since retirement), but also a 12% chance that the fund will have run out before then.

3. **Longevity risk**

Avoiding running out of money in retirement (i.e. longevity risk) is a further challenge for DC savers. Purchasing an annuity is the only way to insure against such risk but, as noted above, the cost of doing so can vary over time which makes it hard to plan with any certainty.

For savers who take the retirement income by drawdown, there is a risk that they will outlive their savings. Notwithstanding the current health crisis, we estimate that a quarter of young people entering the workforce now will live for 30 years or more after retiring at age 68. Coupled with the fluctuations in fund value, for the above example our calculations indicate **a 7% (roughly 1 in 14) chance that the fund will be exhausted during retirement**.

[3] We estimate there is a 90% chance the required contribution could fall within the range 13-45% of average full-time earnings.

Staying on track

It is clear that people need to review their retirement planning on a regular basis, in order to stay on track. To assist in this process, the Savings Goals can be coupled with a rule of thumb that indicates whether someone is on track and, if not, to understand the extent of the gap so that remedial action can be taken.

The IFoA's Saving for Retirement Working Party discussed how this could work in their 2019 paper Rules of Thumb[4]. This work suggested that members under the age of 40 could use a 'rule of thumb' to work out the size of pot they should have accumulated to date in order to be on track to achieve their desired retirement living standard:

Age - 22 × Savings Goal × 12 = Target Fund [5]

For example, someone aged 35 who is aiming to reach the 'Moderate' retirement income, could work out that the size of fund they should have saved in order to be in track is **£124,644**, as illustrated below.

35 - 22 × £799 × 12 = £124,644

The target fund is a simple guide, indicating if an individual's retirement plans are on track. If remedial action is indicated, then one of the many available bespoke tools will be needed to evaluate their options, which can include one or more of the following:

- Vary the amount of contributions
- Adjust expectations about retirement income
- Anticipate retiring later or earlier than previously planned
- Consider alternative sources of retirement income
- None of the above, and review the position again at a later date

The earlier an individual starts planning for their retirement, the greater the range of options available. On nearing retirement, the options available and appropriate actions will depend heavily on an individual's particular circumstances at that time. In future papers, we will explore further rules of thumb to help evaluate the impact on Savings Goals of varying both the target retirement income and retirement age.

[4] IFoA Saving for Retirement Working Party, Saving for Retirement: Rules of Thumb, May 2019
https://www.actuaries.org.uk/system/files/field/document/Saving%20for%20Retirement%20-%20Rules%20of%20Thumb%20-%20May%202019.pdf

[5] For those aged over 40 the formula changes slightly, with 22 becoming 20 (for ages 41-50) and then becoming 18 (for ages above 50).

Institute and Faculty of Actuaries

Beijing
14F China World Office 1 · 1 Jianwai Avenue · Beijing · China 100004
Tel: +86 (10) 6535 0248

Edinburgh
Level 2 · Exchange Crescent · 7 Conference Square · Edinburgh · EH3 8RA
Tel: +44 (0) 131 240 1300 · Fax: +44 (0) 131 240 1313

Hong Kong
1803 Tower One · Lippo Centre · 89 Queensway · Hong Kong
Tel: +852 2147 9418

London (registered office)
7th Floor · Holborn Gate · 326-330 High Holborn · London · WC1V 7PP
Tel: +44 (0) 20 7632 2100 · Fax: +44 (0) 20 7632 2111

Oxford
1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD
Tel: +44 (0) 1865 268 200 · Fax: +44 (0) 1865 268 211

Singapore
163 Tras Street · #07-05 Lian Huat Building · Singapore 079024
Tel: +65 6906 0889

www.actuaries.org.uk