Institute
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Assessing adequacy of retirement income: a bottom-up approach

Key findings

Individuals will have many and varied ideas of what an adequate income looks like for them based on both their current lifestyle and the lifestyle they might aspire to. We therefore consider that a bottom-up approach, based on an individual's retirement income goals, as opposed to for example a proportion of their working life earnings, could help to encourage engagement.

A bottom-up approach could help to engage individuals and develop their financial capability by shifting the focus from inputs to outcomes. Creating a Bronze, Silver and Gold rating system could help individuals to break down their retirement income needs into smaller, more tangible goals. It could also help individuals to consider a range of potential retirement income options that could best help them to turn their savings into an adequate income.

If such an approach were implemented its success would be reliant on the availability of communications and tools that help individuals to set goals, monitor their progress towards them and understand what actions they could take to have the best chance of achieving them. We recommend that Government, regulators and the pensions and advice industries work collectively on a communication strategy. This should not be based on a 'one-size-fits-all' approach, but effectively targeted and aimed at improving financial capability.

July 2016

Ageing population

Contents

Executive summary 2
Background: Why adequacy and why now? 3
A bottom-up approach 5
How can individuals, industry and Government apply a bottom-up approach? 6
Focus on outcomes 7
Collective communication strategy 7
Segmentation 8
Tiered 8
Tools for assessing adequacy of savings and plan for retirement 9
Develop retirement income options 9
Conclusions and recommendations 10
References 11

Executive summary

Whether or not current and future retirees are likely to have an adequate income during their retirement is an ongoing policy debate. In our 2015 paper 'Saving for Retirement', we recommended that a bottom-up approach to assessing adequacy of retirement income, based on pensioners' outgoings, may help to foster engagement and encourage greater levels of saving. The purpose of this paper is to build on our earlier recommendation and demonstrate why a bottom-up approach is appropriate.

To do this we have set out:

- what is meant by a bottom-up approach; and
- how this approach might be applied by individuals, industry and Government.

We have drawn on a range of robust analysis in developing the IFoA's position and we hope that our conclusions and recommendations help to further this debate. Our aim is to help raise awareness to ensure that adequacy of retirement income remains a priority for individuals, industry and Government.

To embed this approach successfully we recommend that individuals, Government, regulators and the industry should:

- Change the policy narrative to focus on outcomes based goals (i.e. the amount of retirement income needed to achieve a specific goal) as opposed to attaining a specific level of input (i.e. the amount an individual should save from their income each month).
- Implement a collective communication strategy for guidance and advice. This should aim to build financial capability over time and be targeted based on individual circumstance, to increase the likelihood of the communications being effective.
- Make tools freely available that:
  - help people to set retirement goals, initially ensuring they meet the Minimum Income Standard (set by the Joseph Rowntree Foundation), before setting goals for financial resilience and improved quality of life. These could be framed in a simple manner by using a Bronze, Silver and Gold rating for people to assess their readiness for retirement;
  - enable individuals to assess the adequacy of their retirement income, for example by delivering the pensions dashboard. To allow individuals to assess their financial situation holistically, we recommend implementing this alongside tools that enable individuals to incorporate other types of wealth, in particular the value of housing assets;
  - link level of savings, in all vehicles, to likelihood of achieving retirement goals in a way that alerts people to how likely they are to reach each of their goals; and
  - help individuals to use a range of retirement income options, including pension products, as well as products that help a person to use their housing equity and other savings, to secure as far as possible an adequate income in retirement.
- Develop default solutions for retirement that offer a degree of flexibility combined with an element of guarantee.

Background:
Why adequacy and why now?

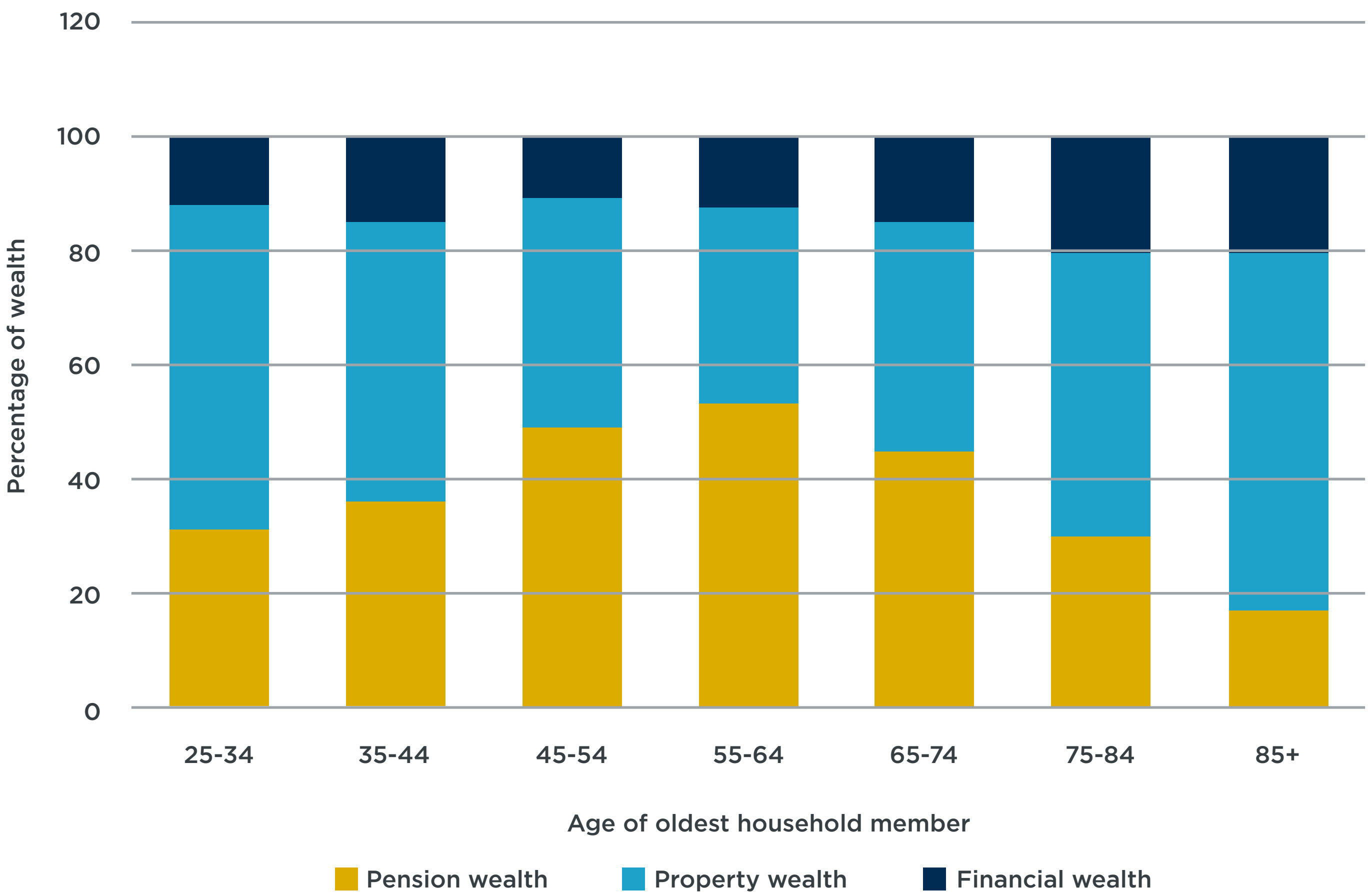
In the UK, the Department for Work and Pensions (2012) estimates that of the 38 million people of working age, around 11 million are not saving enough for their retirement. This could have significant implications for their quality of life in retirement. It is important that individuals understand their retirement income needs and take action, such as saving accordingly, or being prepared to defer their retirement.

Recent pension reforms, such as automatic enrolment (AE) and the pension freedoms signal a fundamental change in policy and provide an opportunity to consider how we can best ensure people have an adequate retirement income. AE has increased the number of people saving into an occupational pension (Department for Work and Pensions, 2015) and the freedoms give individuals greater flexibility to manage their pension savings to fit their personal circumstance, this however is not without risk.

The type of pensions that people hold has also changed. Previously, people had Defined Benefit (DB) pension arrangements, these guarantee, providing employer solvency, an employee a pre-agreed income in retirement for the rest of their lives. Whereas, many of todays and future retirees have an increasing proportion of their pension in Defined Contribution (DC) arrangements. This has transferred inflation, investment and longevity risk away from the employer to the individual.

Pensions are not the only consideration when assessing a person's ability to meet their retirement income needs. Figure 1 demonstrates that pensions and property are the two main components of wealth throughout a person's lifetime.

Figure 1: Composition of Wealth by Age (Institute of Fiscal Studies, 2015)

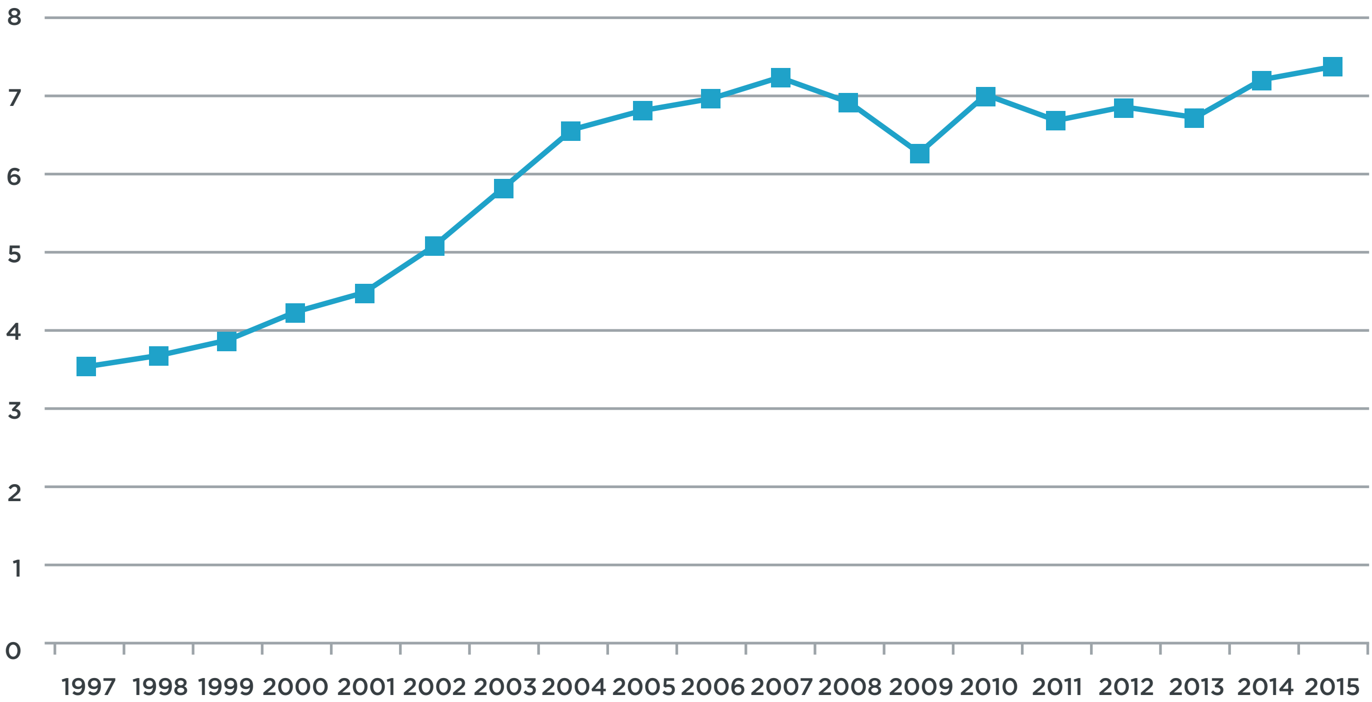


Recent trends in house prices could also affect the likelihood of future retirees saving enough, and the likelihood of current retirees using what savings they do have, to secure an adequate income for the duration of their retirement. Figure 2 illustrates the continuing rise of housing prices as a ratio of earnings. The rise in house prices to median earnings is making it harder for people to buy their own home. The Building Society Association (2015) found that the average first time buyer is now 36 years old, this compares to 23 years old in the 1960s (Post Office Mortgages, 2011).

It is important that we understand the impact of these changes on whether individuals will have an adequate income throughout the duration of their lifetime. Whilst our primary focus is on pensions as that is where our expertise lies, we have been mindful of the importance of housing wealth in our analysis.

We believe applying a bottom-up approach to adequacy will enable people to take account of all of their sources of wealth and any debts they might have when assessing the adequacy of their retirement income.

Figure 2: Ratio of median average house price in England to earnings (Department for Communities and Local Government, 2015)



A bottom-up approach

What one person might consider an adequate retirement income might not be adequate for another. A bottom-up approach would start with the individual thinking about the type of retirement they aspire to and the specific needs that they might want to meet. This is in contrast to an individual being led by the overall amount they would need to save.

Taking a bottom up approach would entail individuals thinking about all of their retirement income needs to create a holistic view of what their retirement might look like dependent on how much income they will have. This approach could be beneficial in engaging individuals if it is coupled with tools and communications as it could help to engage people, in the first instance, on their saving requirements, and then once they are in retirement, to think about how they turn their savings into a retirement income.

There are a number of factors an individual should take into consideration when planning for their retirement, including:

- ✔ State Pension entitlements
- ✔ current age
- ✔ the age at which they start to save for their retirement
- ✔ the actual age the individual plans to retire and whether they plan to phase their retirement
- ✔ assumptions on life expectancy
- ✔ whether they are single or have a partner
- ✔ number of dependents and the ages of those dependents
- ✔ health status

If we were able to create an approach to retirement planning that engaged individuals with these factors it would help them to make informed decisions, both whilst saving towards and when using their pension savings.

There are a number of ways a bottom up approach could work. One way that we suggest is to have a Bronze, Silver and Gold rating to help provide a framework for people to assess their readiness for retirement. Items would be fluid between the three dependent on the individual's views but could be framed as:

- **to achieve Bronze the individual would need to be able to meet all of their necessary outgoings.**
- **to achieve Silver and Gold could be where a person has sufficient savings to be able to afford additional non-essential items, or have enough savings to protect them against an unforeseen cost, such as if they experience ill health.**

The Bronze level could be linked to the work that the Joseph Rowntree Foundation has done on its Minimum Income Standard. This is a benchmark of income adequacy based on its analysis of what the public consider necessary for a minimum acceptable living standard and is calculated by specifying baskets of goods and services required by different types of households in order to meet these needs and to participate in society. It covers more than basic survival, but does only cover necessities and not luxuries (Joseph Rowntree Foundation, 2015).

In the rest of this paper, we set out how we consider that individuals, industry and the Government could apply this approach to helping people assess the adequacy of their retirement income. The success of automatic enrolment is in large part due to inertia, yet at retirement individuals are faced with making complex decisions. Whilst we are mindful that this alone will not get people to engage, we hope that reframing how we think about adequacy could help individuals to transition from being savers due to inertia, to becoming informed and actively engaging with retirement planning.

How can individuals, industry and Government apply a bottom-up approach?

Applying a bottom-up approach to assessing adequacy of retirement income can help to inform individual behaviour, industry initiatives, regulatory change and policy reform. We consider that it could help to ensure that individuals save enough and that in retirement they are able to manage their savings effectively, to as far as possible, secure an adequate income that lasts the duration of their retirement.

We have identified four policy and industry responses where adopting a bottom-up approach could be complementary in achieving adequacy of retirement income:

- Shift the focus to outcomes and income needs as opposed to saving requirements.
- Develop an effective communication strategy across regulators, Government and industry.
- Create and maintain tools that help people to assess the adequacy of their savings and plan for their retirement.
- Create in-retirement default vehicles.

Focus on outcomes

Our research suggests that getting people to focus on outcome based goals (i.e. the amount of retirement income needed to achieve a specific goal), as opposed to attaining a specific level of input (i.e. the amount an individual should save from their income each month), means they are better able to set goals and understand the impact on their quality of life of not achieving them (IFoA, 2014). For example, being able to ascertain that you could need approximately £20,000 p.a. to achieve the goals you had set for your retirement will better enable you to understand the value of your current savings than knowing you have, say, £200,000 of savings with no clarity over what income this could provide for you to live on. If an individual is aware that their current level of saving will only provide £10,000 p.a. this will let them know that they need to take action. This could include saving more, planning to work for longer, taking a more realistic view of what they might be able to afford in retirement, or considering how they might use other sources of wealth such as their house to meet their goals.

Our research also found that where individuals believed their efforts to be worthwhile i.e. where the potential reward outweighs the effort, focusing on outcomes improves engagement in financial decision-making (IFoA, 2014). We therefore suggest that breaking down goals for retirement income into, say, Bronze, Silver and Gold categories will help individuals to set a series of smaller, more tangible retirement income goals, as the pay-off between the effort and reward will be more obvious.

To achieve this we need tools that in the first instance help people to build a picture of what their retirement goals might be. This could be an interactive tool that first captures an individual's personal circumstance in sufficient detail to work out their Minimum Income Standard (household, composition, sex, employment status, urban or rural location, health status etc.) to achieve a Bronze status, and then helps them to set out what other goals they might have to achieve Silver and Gold.

For example:

- ✔ Household maintenance (e.g. roof repair)
- ✔ Maintain mode of transport (e.g. in rural places it may be critical to be able to travel to the nearest town, which may be some distance away)
- ✔ Meeting potential care costs if experience ill health
- ✔ Home improvements
- ✔ Travel (e.g. either long distance holidays or shorter distances to visit family)
- ✔ Treats (e.g. weekly meal out or non-essential clothes)
- ✔ Hobbies (e.g. gym / club membership)
- ✔ Home help (e.g. weekly cleaner especially if mobility is reduced)

Work could be done to provide a guideline of the amount needed to achieve each of these goals to allow individuals to build up a picture of their overall income need and to test the effect of aiming for different goals. Individuals should also be encouraged to review their goals regularly in case their circumstances change.

Shifting the focus from inputs to outcomes and getting people to assess the adequacy of their savings will not be easy. It is important that the pensions and advice industries work with Government and employers towards a collective communication strategy if we are to get people to engage.

Collective communication strategy

There are a number of Government, regulatory and industry programmes underway to improve the communication of retirement income needs and options:

- the Government's initiative to provide a free 30 minute guidance session via Pension Wise and the ongoing evolution of Pension Wise post-2016 Budget
- HM Treasury's review of public financial guidance
- the Financial Conduct Authority's (FCA) Retail Distribution Review and Financial Advice Market Review
- at the European level, the European Insurance and Occupational Pensions Authority recently consulted on good practices for communication tools and channels for communicating to occupational pension scheme members across Europe
- Association of British Insurers Pensions Language Steering Group

We support these initiatives and it is encouraging that Government, regulators and industry are involved in each of them. These initiatives offer an opportunity for sharing best practice and developing common approaches to help individuals to understand their retirement income needs and options.

The evolution of Pension Wise creates an opportunity to develop a 'one-stop-shop' for tools and communications that help people to set retirement income goals and assess their progress towards them.

The current review of Pension Wise provides an opportunity to use the cost saving from streamlining the Money Advice Service, Pension Wise in its current form and The Pensions Advisory Service to invest in developing a suite of tools to help people. It will be necessary to maintain these tools if they are to remain useful and the ongoing maintenance of the tools could then be met by the levy.

However, Pension Wise alone will not be sufficient, even if we are able to improve the current low number of people using Pension Wise it will be important that the industry and consumer bodies also take an active role in helping individuals to assess their adequacy.

Our 'Transforming consumer information: a discussion paper' highlights two focuses for transforming current consumer information:

- segmentation, for effective targeting of information; and
- tiering, to build financial capability over time.

Segmentation

We believe that a traditional 'one-size-fits-all' approach is less effective than a targeted approach (IFoA, 2012). Our research found when consumer information targets specific cohorts, rather than trying to be applicable to everyone, that it is more likely to be beneficial. Segmentation of the market, which allows the targeting of consumers to deliver more focused information, has the potential to increase engagement levels by making information more relevant to consumers' objectives.

People can be segmented in a number of ways and we recommend the following:

Table 1: Segmentation for retirement income planning (IFoA, 2012)

FACTOR	IMPACT	EXAMPLE SEGMENTS
Financial wealth	Impacts the degree of choices available and the complexity of decisions to make	Constrained Mass market Affluent High net worth
Risk capacity	Impacts ability to bear different risk exposures	High Medium Low
Distribution channel	Impacts ability to engage, educate or advise	Guidance Simplified advice Full regulated financial advice
Financial capability	Impacts ability to understand financial concepts	Highly informed Fairly informed Uninformed

After defining the segments, the communications to each segment should be set in the context of the individual's current circumstance. For example, when considering the Minimum Income Standard, it would be helpful to frame communications from the vantage point of someone who has constrained financial wealth, has a low risk capacity, will need access to free guidance and is more likely to be less well informed on financial matters. Whereas, those able to begin thinking about maintaining a more affluent quality of life will likely have more wealth and perhaps a greater capacity for risk, could benefit from paying for regulated financial advice and have higher financial capability. Communications could usefully take account of these differences as our research found evidence of stronger engagement where these points were addressed (IFoA, 2012).

Tiered

These communications should aim to facilitate the evolving process of engagement towards increasingly higher quality financial decision making. Most people have insufficient knowledge to make optimal long-term financial decisions due to the complexity involved. People generally start with low levels of knowledge and engagement; however, this can steadily improve over time (IFoA, 2012). In the first instance, communications to individuals could focus on helping them to set goals and work out the income required to meet them. Once individuals have set their goals, communications could focus on helping them to understand the likelihood of them achieving their goals, educating them on key risk factors, and then finally, informing them of appropriate actions they might take if they are not on track to achieve their goals.

The complexity of working out how much retirement income an individual might need and gathering information on all of their assets and wealth at their disposal to meet them is a significant barrier. Many people are daunted by information that appears complex and may not have the confidence or patience to read and digest it. For example, annual statements for pensions contain more information than most people are capable of or willing to read. This is understandable given disclosure and compliance regulations, but these rules have shifted the focus onto what has to be communicated as opposed to what people need to know. This loses the focus on the bigger picture - of communicating to people how much they are actually going to need. Detailed information must remain available, as it is important that people are given information about their policy, realistic expectations of what they can expect to receive from their pension and the context for these expectations. However, the focus of communications must be what the consumer needs to know i.e. what income are they going to need, how close are they to achieving it, and what they need to do if they are not close to achieving it.

Tools for assessing adequacy of savings and plan for retirement

We support the FCA's recommendation of delivering a pensions dashboard by 2019 as recommended in its Financial Advice Market Review.

The proposal is for the dashboard to include State, defined contribution and defined benefit entitlements. This will allow individuals with several pension pots to have a clear understanding of their overall pension savings.

We suggest that a useful first stage could be for State Pension benefits to be available via the dashboard, followed by the big DC Master Trusts (e.g. NEST, The People's Pension, and Now Pensions). Once this is in place, we recommend Government and the regulators undertake a further cost-benefit analysis to determine the value of adding smaller schemes and DB pensions. It is important that the benefits outweigh the cost to consumers, as the cost of this tool will ultimately fall to them. A staging approach will allow lessons to be learnt along the way and will set realistic expectations of what can be achieved.

In addition, we recommend that alongside implementation of a pensions dashboard, Government, regulators and industry work together to implement and maintain tools that enable individuals to incorporate other assets as well as debts, such as housing to gain an overall picture of their wealth.

A further development could be to link the dashboard to tools that enable individuals to work out how close they are to achieving their retirement income goals based on their current level of savings. This could be staggered with individuals checking off Bronze, before working to achieve a Silver or Gold rating. The Joseph Rowntree Foundation already has an online tool for working out your minimum income standard (http://www.minimumincome.org.uk/).

Develop retirement income options

So far, we have mainly covered how the bottom-up approach could apply to saving, however, a bottom-up approach could also apply when an individual turns their savings into a retirement income. The collective communication strategy as outlined above should continue during retirement and if anything is even more important as the individual comes to make decisions about how they turn their savings into an adequate income.

Here the use of the Bronze, Silver and Gold ratings could be particularly useful in assisting individuals to determine how they can use their savings to meet their financial needs throughout their retirement.

There is a range of products that may be better suited to different aspects of an individuals retirement income needs. For example, if the Bronze rating were linked to achieving the minimum level of income needed to achieve a socially acceptable standard of living, then one option for ensuring this is secured for the duration of a person's lifetime is to purchase an annuity. Whereas, if someone needs to meet an unforeseen cost, or wishes to buy a new car for example then flexibility in accessing their savings may become more important and therefore a product such as income drawdown may be more appropriate for the more variable elements of their Silver and Gold retirement income goals.

For many individuals, expecting them to actively manage their pension savings to achieve an adequate income in retirement will be neither desirable nor in some cases possible. We suggest one industry development that might help people to manage their retirement income to achieve a Gold rating is default solutions that offer a degree of flexibility combined with an element of guarantee. NEST, for example, has set out a blueprint for a default pathway that it believes would cater for most of its scheme members in retirement (NEST, 2015). The development of appropriate default decumulation options should promote behaviours more likely to lead to good outcomes for retirement income. This could be useful for all scheme members, but in particular, where members are unable to, or do not engage and make an active decision about their retirement income.

Whilst we have spoken about pension products, individuals may wish to couple these with, or prefer to use, other products such as investment / financial products and equity release products to achieve an adequate retirement income.

Conclusions and recommendations

Individuals will have many and varied ideas of what an adequate income looks like for them based on both their current lifestyle and the lifestyle they might aspire to. We therefore consider that a bottom-up approach, based on an individual's retirement income goals, as opposed to for example a proportion of their working life earnings, could help to encourage engagement.

We consider that a bottom-up approach will help to engage individuals and develop their financial capability by shifting the focus from inputs to outcomes. Creating a Bronze, Silver and Gold rating system could help individuals to break down their retirement income needs into smaller, more tangible goals. It could also help individuals to consider a range of potential retirement income options that could best help them to turn their savings into an adequate income.

If such an approach were implemented its success would be reliant on the availability of communications and tools that help individuals to set goals, monitor their progress towards them and understand what actions they could take to have the best chance of achieving them. We recommend that Government, regulators and the pensions and advice industry work collectively on a communication strategy. This should not be based on a 'one-size-fits-all' approach, but effectively targeted and aimed at improving financial capability. The evolution of Pension Wise could be a useful hub for the implementation of this strategy and the housing of tools and information.

We are also supportive of the drive to implement a pensions dashboard, although we suggest this could usefully work alongside tools that enable individuals to consider all of their wealth and assets. The dashboard could also link to the individual's retirement income goals to help people understand whether they appear to be on track to achieve them.

We hope this paper supports efforts towards ensuring individuals achieve an adequate retirement income. We will be completing further work on this topic and would like to work in partnership with others to provide further analysis and practical solutions.

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