PPI Policy seminar: What level of pension contribution is needed to obtain an adequate retirement income?

The Pensions Policy Institute (PPI) held a policy seminar on 22 October 2013 to launch its latest report *What level of pension contribution is needed to obtain an adequate retirement income?* The research was funded by the Association of British Insurers (ABI) and the Defined Contribution Investment Forum (DCIF), and the analysis is based on a model developed by the Department of Mathematics, King's College London. This report is one in a series of reports on automatic enrolment, which is also sponsored by B&CE, DWP, Institute and Faculty of Actuaries, Legal & General and Prudential.

The report analysed the effect that contribution rates to workplace pensions could have on overall levels of retirement income. The report also analysed the contribution rate needed to have a "good chance" of achieving an adequate income.

Michael Pomery, PPI Chairman, chaired the seminar.

Chris Curry, PPI Director, presented the main findings of the report. These included:

- Adequacy can be defined as to what extent individuals have a retirement income that allows them to fulfil their basic income needs or replicate their pre-retirement living standards. Replacement rates are a useful measure if the second definition of adequacy is preferred.
- Retirement income from private state and private pensions is uncertain. For example, a median earner that saves only at the minimum contribution rate of 8% of a band of earnings throughout their working life, will have a less than fifty-fifty chance of achieving an adequate retirement income.
- The probability of achieving an adequate income varies by earnings level. However, adequacy of retirement income is harder to achieve if the single-tier state pension is uprated in line with changes in average earnings instead of the triple lock of changes in the Consumer Prices Index (CPI), average earnings or 2.5%.
- Different factors such as the annual management charge (AMC) paid by scheme members, the investment approach followed and the different indexation mechanisms for the state pension all affect the minimum contribution rate required to have an adequate retirement income. For example, the total contribution required for a median

earner to reach a two-thirds chance of achieving the target replacement income ranges from 10% in a low charging scheme following an investment approach that aims to reduce volatility but not at the expense of potential returns and where the state pension is uprated be the triple lock to 17% in a higher charging scheme following an alternative investment approach that reduces volatility in early years at the expense of potential returns and where the state pension is uprated by changes in average earnings.

- Whether people take career breaks, start to save later in life or decide to retire some years after their SPA affects the contribution rates needed to have a good chance of reaching an adequate retirement income. But this also depends on the indexation mechanism used to uprate the single-tier state pension.
- Many individuals will need to save more than the legal minimum to have a good chance of achieving an adequate retirement income. There are different strategies that the Government could consider to ensure that automatically enrolled members save more into workplace pensions. These range from incentives and advice to inertia based mechanisms such as auto-escalation where members commit to increase contribution rates as their wages increase.

Steve Webb, MP – Minister of State for Pensions gave a government view on the main findings of the report. He remarked on the contribution of the report to illustrate how different factors may affect the adequacy of retirement income. He also highlighted the importance of the triple lock indexation for the single-tier state pension. He noted that initiatives such as the Government's agenda on Defined Ambition could improve retirement income adequacy by providing more certainty to sponsors and members of Defined Benefit schemes and improving outcomes for members of Defined Contribution schemes.

On the different factors that may affect adequacy, the Minister remarked on the importance of avoiding individuals exiting the labour market early. On the different strategies to increase pension saving, he remarked that policies such as inertia based mechanisms could be discussed once automatic enrolment is fully rolled out.

Simon Chinnery, Chair of the Defined Contribution Investment Forum gave an asset management industry view. He remarked on the importance of the industry in being able to provide good DC options for members. He also highlighted that one of the main messages of the report was the importance of diversification in the default fund to reduce volatility and the dispersion of outcomes.

Finally, Simon argued that charges alone should not be the only factor behind pension saving decisions. In this sense, he highlighted the importance of looking at other factors such as the investment approach.

Steve Gay, Director of Life Savings and Protection, Association of British Insurers, gave an insurance industry view. He welcomed the findings of the report and noted the importance of consistent contributions to ensure scheme members achieve an adequate retirement income. He also highlighted the finding that for many individuals saving at the legal minimum may not be enough, although he agreed that the first priority should be to ensure that automatic enrolment is fully rolled out, particularly among smaller companies. He noted that improving trust in pensions is key to ensure members remain engaged with saving through, for example, more transparency on charges.

Finally, Steve noted the importance of incentives to push the UK pension saving agenda. In this sense, he argued that future policies aiming to incentivise people to save more into their pensions should be easy to understand and implement, be cost neutral to Government and should have broad partisan support.

Discussion
The following points were raised during the questions and discussion section. They do not necessarily reflect the views of the PPI or the PPI seminar speakers.

- There was discussion around some of the assumptions of the report such as that individuals take the 25% lump sum at retirement and that they buy a level annuity with the remainder of their pot. The analysis was based on assumptions that are representative of the most prominent behaviour at retirement.

- Some discussion followed on whether the UK pension system is capable of delivering consistent outcomes for different individuals, as some policy developments appear to be inconsistent. For example, this research highlights that higher earners need higher contributions to achieve an adequate retirement income, but tax relief for higher earners is being limited through the reduction in the Annual Allowance and the Lifetime Allowance. This is an area that the PPI would like to explore further in 2014.

- It was also highlighted that the analysis in the report assumes that a higher earner earns at the 70th percentile of age-specific economy-wide earnings. So the reduction in the Liftetime Allowance is unlikely to have an effect on the contribution rate necessary to achieve an adequate retirement income.

- There was a discussion about the possibility of considering other investment strategies than the ones analysed in the report. It was agreed that the main goal of the report was to generate discussion and thinking considering the whole range of factors that may affect retirement income adequacy, rather than focussing only on investment approaches.

- Charges are one of the factors that affect adequacy together with others. However it was felt that the industry could do more to ensure charges are properly explained and disclosed.

- There was some discussion about future mechanisms to increase the State Pension Age. A range of options could be considered to link future SPA changes to life expectancy, but taking into account regional differences.

- Default funds play an important role in automatic enrolment as many members may stay in default funds. It was felt that default funds should provide good value for many for members.

- Policies such as auto-escalation, which is used in the US, can help to increase member savings. However, it was highlighted that is often difficult to transfer solutions from other countries and that it is important to consider the specific characteristics of the UK pension system.

- Automatic enrolment may have an impact on older workers. The value of being automatically enrolled for an older worker will depend on a number of factors such as, for example, their ability to use the trivial commutation and previous savings. Older workers will be the topic of the next PPI report in the automatic enrolment series.

- There is an apparent paradox between society's focus on consumption and the need for people to save. Some discussion followed on the importance of considering other types of assets to increase pension saving, such as housing.