For schemes sponsors, trustees, their advisers and consultants only

Can your employees afford to retire comfortably?

Planning for retirement

Fidelity INTERNATIONAL

Introduction

Dan Smith
Head of Distribution,
Workplace Investing,
Fidelity International

Since the introduction of auto-enrolment in 2012, employers in the UK must provide and contribute towards a workplace pensions scheme for their employees. Government statistics show that workplace pensions participation rates increased between 2012 and 2021, up from less than half to 79% of UK employees, before stabilising in recent years. Total annual contributions into workplace pensions were £115.9 billion in 2022[1].

At Fidelity, we have seen growing appetite from employers to support their employees both during their working lives and to also better prepare them for a life after work. 'Can your employees afford to retire comfortably?' shines a light on the costs of a comfortable retirement and offers practical solutions to help your employees remedy any shortfall in their retirement planning and secure their financial security in retirement.

A survey of more than 2,000 people across Britain, revealed that 94% say their most important dream is to feel financially secure for the rest of their life[2]. Increasingly, employees are looking to their employers to help them achieve this goal[3]. Our Workplace Workout programme aims to motivate your employees to engage with their pension plan, improve their financial confidence and make sure they're retirement ready.

1. Source: Department for Work and Pensions, November 2023 – Workplace pension participation and savings trends of eligible employees: 2009 to 2022.
2. Source: Legal & General, July 2023 – new research reveals financial stability is the UK's ultimate retirement dream, survey on 2,004 individuals aged 50+ between 14-19 April 2023.
3. Source: My Pension Expert, February 2024, Workers aren't engaging with their pension. Here's why it matters.

Retirement worries often top the list of employee concerns. Research undertaken in 2022 showed that more than half of UK adults aged over 40 are anxious about retiring. Indeed, planning for retirement is now regarded as a 'stressful life event', ranked more stressful than divorce by the 40-44 age group. The research also revealed that nearly one in 10 people have sought medical help for their retirement worries, while 16% said that feeling anxious about retirement has kept them up at night[4].

These concerns appear to be anchored in a lack of confidence about their retirement prospects: have they saved enough for a comfortable retirement and will their retirement savings last a lifetime? A 2022 Department for Work and Pensions (DWP) report revealed that roughly only 1 in 4 people have an idea of how much they need in retirement[5]. A further study among larger employers with over 10,000 employees showed that 44% of employees don't know how much they need to save to live the lifestyle they want in retirement[6].

Companies might feel that providing a generous pension scheme is the most effective way to meet their obligation to look after employees in later life. A good pension scheme is a tangible measure of a company's commitment to their workforce. Yet employees may still feel ill prepared.

Concerns about retirement readiness can have a tangible impact on productivity. It has been estimated that absenteeism and presenteeism (lost productivity that occurs when employees are not fully functioning in the workplace) caused by a lack of financial wellbeing costs private-sector business £6.2 billion each year[7].

So how can you help your employees get in shape for their retirement? The key questions they need to address are:

- How much income do I need for a comfortable retirement?
- What size of pension pot will deliver that income?
- What can I do if there's a shortfall?

A 2022 Department for Work and Pensions report revealed that roughly only 1 in 4 people have an idea of how much they need in retirement

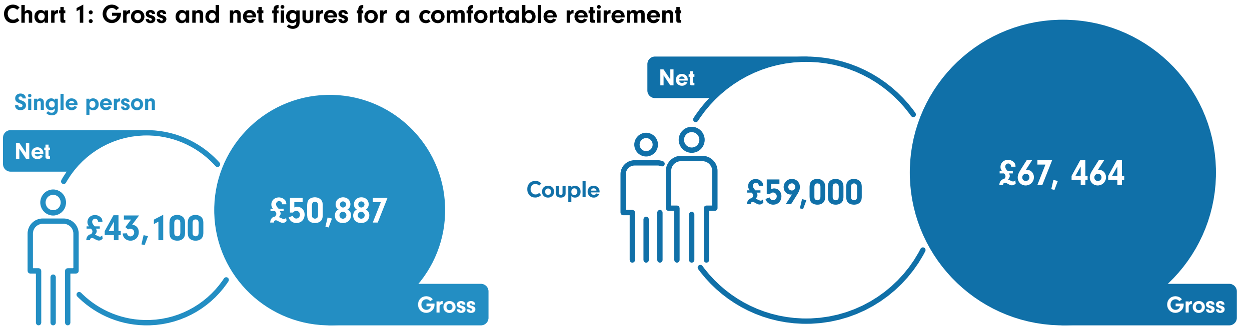
4. Source: Abrdn, August 2022 – Retirement anxiety is a growing trend.
5. Source: DWP, June 2022 – Planning and Preparing for Later Life.
6. Source: Aviva, October 2022 – Mastering the age of ambiguity.
7. Source: Cebr report – Aegon, 2021 – Financial wellbeing and productivity in the workplace.

If you don't know where you're going, any road will get you there

Our starting point is to understand what constitutes a 'comfortable retirement'? This in itself is hard to define and open to debate. What defines 'comfortable' for one person may be quite different for someone else. Nevertheless, there are a number of inputs we can consider:

- Final salary pensions, also known as defined benefits, have long been the 'gold standard' in pension planning. These schemes usually pay a maximum of two thirds (66%) of final salary. With the State Pension, this could provide between 75% to 100% of pre-retirement salary.
- DWP research suggested there should be a range for the replacement rate from 50% to 80% of pre-retirement earnings depending on income[8]. For high earners, fixed expenses are a smaller percentage of their earnings, so they have more wriggle room to cut back. That means a replacement rate of 50% could be enough. In contrast, people on low incomes may need a much higher proportion of their pre-retirement earnings to maintain a reasonable standard of living.
- More recently, the Pension and Lifetime Savings Association developed the Retirement Living Standards. The Retirement Living Standards study calculates how much is needed at retirement[9]. The study estimates the annual income required at different levels of comfort for a single person and a couple. They define three categories of expenditure 'minimum', 'moderate' and 'comfortable'. The amount required for each category is reviewed each year. The figures for a comfortable retirement are as follows:

Chart 1: Gross and net figures for a comfortable retirement



Source: Retirement Living Standards, Pensions and Lifetime Savings Association, 2023.
The net figures are the income required after tax is payable. For a couple, the figures assume that both have equal pensions.
NI contributions are excluded as these are usually no longer payable from State Pension age.

8. Source: Department of Work and Pensions, December 2017 Automatic Enrolment Review 2017.
9. Source: Retirement Living Standards, Pension and Lifetime Savings Association, 2023.

These figures are higher for anyone living in London (£45,000 net for a single person and £61,200 net for a couple)[10]. What's more, it is assumed that any mortgage has been paid off and rent isn't payable. The net figures are the income required after tax is payable. For a couple, the study assumes that both have equal pensions. Furthermore, the analysis excludes NI contributions which are usually no longer payable from State Pension age. In terms of defining 'comfortable', it's worth noting that this isn't living extravagantly. The Retirement Living Standards analysis for a comfortable retirement assumes Sainsbury's for the weekly shop, holidaying in the Mediterranean for two weeks each year (supplemented by three weekend city breaks) and driving a three year old Ford Fiesta replaced every five years[11].

"

A comfortable retirement assumes Sainsbury's for the weekly shop, holidaying in the Mediterranean for two weeks each year (supplemented by three weekend city breaks) and driving a three year old Ford Fiesta replaced every five years

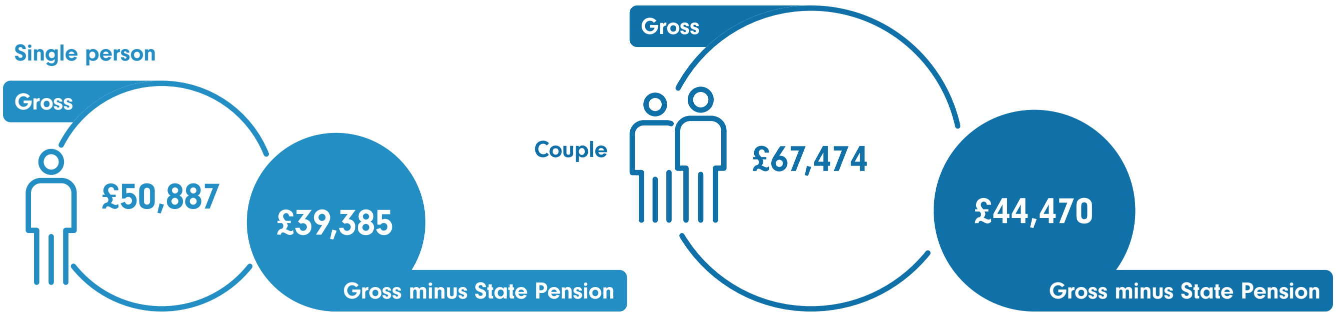
10. Source: Retirement Living Standards, Pension and Lifetime Savings Association, 2023.
11. Source: Retirement Living Standards, Pension and Lifetime Savings Association, 2023.

What size pension pot will provide that level of income?

If we use the Retirement Living Standards figures to answer the first question 'How much do I need for a comfortable retirement?', then we can move on to address the second question 'What size of pension pot will provide that level of income throughout retirement?'

This will depend on a number of variables. Is there any income from defined benefit schemes to take into account? What about the State Pension? Fewer people will retire in the future with benefits from defined benefit schemes, but most people should be entitled to a State Pension. If we assume the maximum State Pension is payable of £11,502 (and that both parties in a couple have a full National Insurance record), then the income levels required for a comfortable retirement would reduce:

Chart 2: Gross amount required after allowing for full State Pension



Source: Retirement Living Standards, Pensions and Lifetime Savings Association, 2023.
The gross figures are before deduction of tax or any National Insurance contributions. For a couple, the figures assume that both have equal pensions. National Insurance contributions are usually only payable before State Pension age.

At retirement, people can use their pot to provide an income for life using an annuity or choose drawdown to provide income, where the pot remains invested and so it is subject to investment risk. Most people are choosing drawdown to manage their retirement income. Drawdown sales are around three times the volume of annuity sales[12]. The latest report from Morningstar, an investment research company, suggests that a safe inflation linked withdrawal rate with a 90% probability of money lasting for 30 years is 4% assuming a 40% equity weighting[13] (see chart 3 for calculation assumptions). This means a single person with a full State Pension would need a pension pot of nearly £1 million. A couple would require a combined total pension pot of a little over £1.1 million.

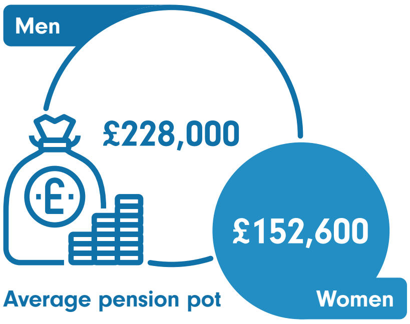
12. Source: FCA, April 2024 – Retirement income market data 2022/23.

13. Source: Morningstar, November 2023 – The State of Retirement Income.

An alternative approach would be to buy a lifetime annuity, which provides a guaranteed income for life. A level lifetime annuity for a 65 year old would provide an income of £7,104 for a purchase price of £100,000[14]. This would reduce the pension pot required to a little under £550,000 for a single person with a full State Pension or around £685,000 for a couple both aged 65.

However, income from a level annuity does not increase with inflation. Even low levels of inflation can have a significant impact on the real value of money. A man who lives to 85, the average life expectancy for 65-year old men, would see the value of their income reduce by around a third at just 2% annual inflation[15]. For women the impact is greater because life expectancy is longer. If an inflation linked annuity is used, the rates would be similar to the drawdown 'safe withdrawal rate' of 4%. However, it may not be necessary to fully inflation link income as we explore later.

These figures, ignoring any defined benefits that may be payable, suggest many people could fall short of the amount required for a comfortable retirement. A 2022 ONS report on pension wealth suggests that the average pension pot for men in their 60s is £228,200 and for women in their 60s is £152,600[16].



A 2022 ONS report on pension wealth suggests that the average pension pot for men in their 60s is £228,200 and for women in their 60s is £152,600

14. Source: Hargreaves Lansdown, September 2024 (based on a single life, level annuity rate of £71.40 per £1,000 with a 5 year guarantee on death).
15. Source: Fidelity international, 2024 – The impact of inflation on retirement planning.
16. Source: Charles Stanley, July 2024 – What is the average pension pot by age in the UK?

Squaring the circle

So what can your employees do if the data suggests they're not on course for a comfortable retirement? Here are some actions that can help:

Pay more into their pension pot

At some point, perhaps in their late 40s or early 50s, people can find that day to day financial worries recede. The mortgage may be paid off, children could be less financially dependant and they might be more established in their career. At this point, retirement is no longer a distant vista, but a looming reality. A greater focus on life after work, coupled with the means to act, can catalyse an increase in retirement savings. This can make a significant difference. A 55 year old, planning to retire at 67 (the State Pension age from 2028), who increases their savings by £150 a month could increase their pension pot by £30,000. If they're in a scheme where the employer matches the employee contribution, this could add around £60,000 to their pension pot. These figures assume average annual investment growth at 5% (though bear in mind the value of investments can fall as well as rise).

> **A 55 year old, planning to retire at 67, who increases their savings by £150 a month could increase their pension pot by £30,000**

Delay retirement

Delaying retirement has several benefits, for example:

- More time for pension pots to grow (though again the value of investments can fall as well as rise).
- More time to make pension contributions.
- A higher State Pension (if retirement is delayed beyond State Pension age and the State Pension is deferred).
- Better annuity rates or higher income withdrawals possible under drawdown.

A 67 year old with a £300,000 pension pot who delays retirement for three years, and makes additional pension contributions of £300 per month (including employer contributions), could see their fund increase from £300,000 to nearly £370,000 (assuming annual 5% compound investment growth, which is not guaranteed). What's more, the State Pension is increased by 1% for every 9 weeks of deferral. Deferring three years would increase the current maximum State Pension from £11,502 to around £13,500. There are other benefits too: annuity rates increase with age and more income could be taken from drawdown as funds don't need to last so long.

> **The State Pension is increased by 1% for every 9 weeks of deferral. Deferring three years would increase the current State Pension from £11,502 to around £13,500**

Take more income

The conventional wisdom is that a 4% inflation linked income each year is likely to last for at least 30 years in most instances. The analysis that underpins this assumption was developed by US financial adviser, William P Bengen. Interestingly, separate US analysis shows that over a 140 year period, US retirees withdrawing at the rate of 4% each year, would only have a 10% likelihood of ending up with less than their initial capital after 30 years and a 10% chance they would have 6 times their original capital[17].

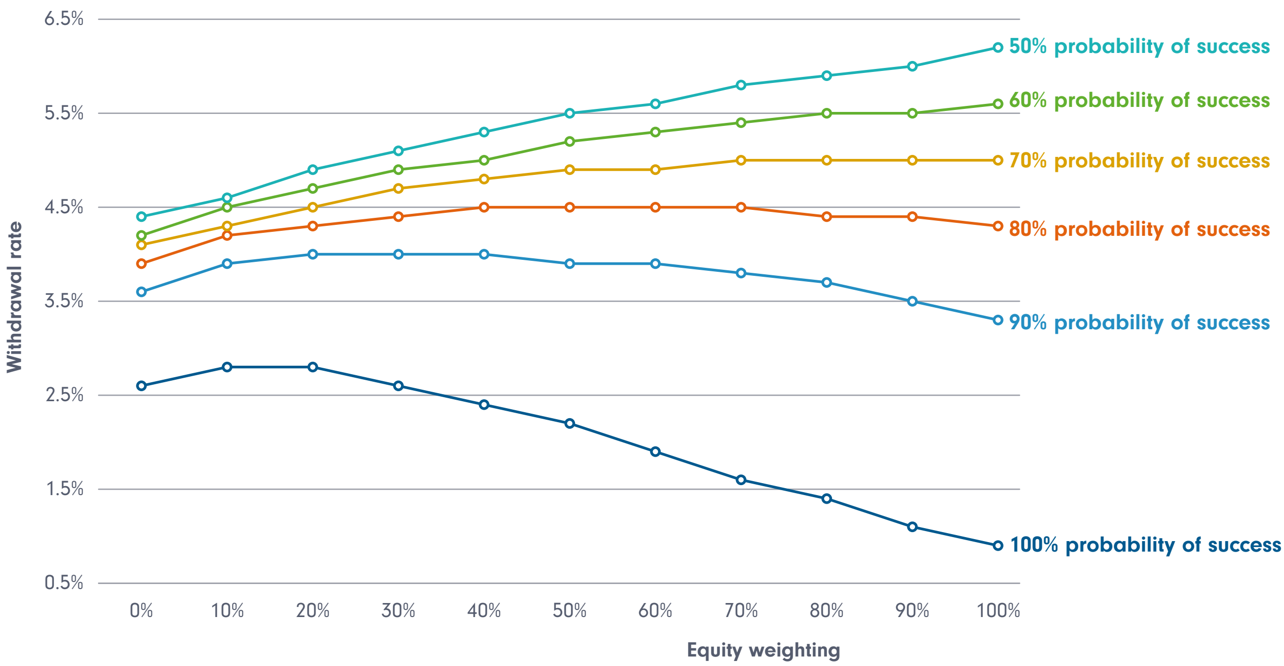
Consequently, 4% may be overly conservative. However, there are risks in taking more income than this, but there may be ways to mitigate these risks:

> **The conventional wisdom is that a 4% inflation linked income each year is likely to last for at least 30 years in most instances**

Accept a lower probability of success

A 90% probability of success underpins the calculation of 4% as a safe withdrawal rate. If the probability of success is reduced the income could increase (see chart below). This could be suitable where there is a backstop that could be used if funds did run out. This might be property equity (downsizing or equity release) or perhaps the likelihood of a significant inheritance. A 70% probability of success could push the withdrawal rate from 4% to 5%.

Chart 3: Withdrawal rates by probability of success and equity weighting



Source: Morningstar. Data as at September 2023.

Note: The analysis assumes anticipated 30-year gross returns from equities of 9.41%. Estimated fixed-income gross returns (including cash) are 4.81%. The inflation forecast over this period is 2.42%.

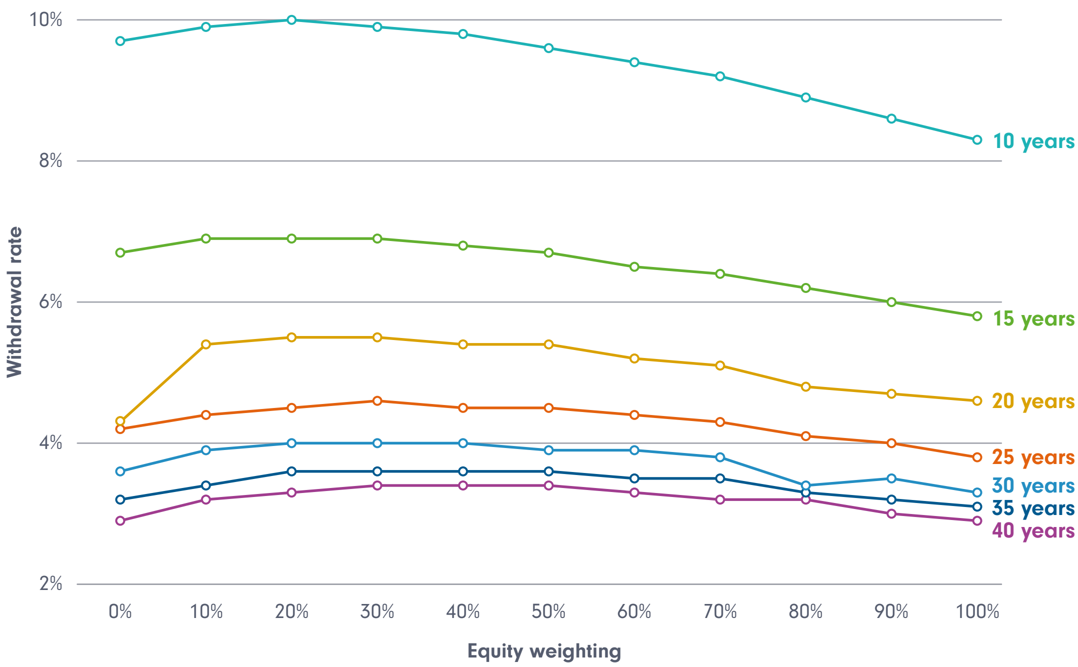
17. Source: Ben Henry-Moreland, Kitces.com, January 2022 – Why High Equity Valuations And Low Bond Yields Won't (Necessarily) Break The 4% Rule.

Choose a shorter term

Many people will die within 30 years of retiring. The average life expectancy for a 65 year old is 20 years for a man and 22 years for a women[18]. Someone whose life expectancy is likely to be reduced by poor health or lifestyle factors could consider a shorter term (though the prognosis for many illnesses can vary widely). For example, if a 20 year term is chosen, up to 5.5% could be withdrawn with a 90% probability of success.

The average life expectancy for a 65 year old is 20 years for a man and 22 years for a women

Chart 4: Safe withdrawal rates based on term and equity weighting (90% probability of success)



Source: Morningstar. Data as of September 2023.

Note: The analysis assumes anticipated 30-year gross returns from equities of 9.41%. Estimated fixed-income gross returns (including cash) are 4.81%. The inflation forecast over this period is 2.42%.

Don't fully inflation link income

Expenditure is often considered highest in the early years of retirement, then reduces as poor health restricts activities. Expenditure may increase again if there are significant care needs towards the end of life, but only 1 in 4 men and 1 in 3 women over 65 will have 'substantial care needs during retirement'[19]. This means it may not be necessary to fully inflation link income each year. In its 2022 report, Morningstar modelled partial inflation-linking, assuming income was inflation linked by 1% less than the actual rate of inflation. This increased the initial 'safe withdrawal rate' by 0.5%[20]. In 2023, Morningstar refined this further by adjusting for actual spending patterns in the US, which raised the starting 'safe withdrawal rate' by 1%[21].

18. Source: ONS Life Expectancy Calculator, September 2024.
19. Source: Institute and Faculty of Actuaries, 2015 – Pensions and the funding of long-term care.
20. Source: Morningstar, December 2022 – The State of Retirement Income: 2022.
21. Source: Morningstar, November 2023 – The State of Retirement Income, 2023.

Work during retirement

Around 1 million people, or roughly 1 in 10, over the age of 65 are still working[22]. As well as the additional income working after retirement provides, it can offer opportunities to socialise and combat loneliness. Increasingly, it's a bridge between work and retirement with the transition to outright retirement occurring after several years. In these instances, income may be lower if employment is part time or in a less senior role. That means income might need to be topped up from retirement savings or other sources.

Roughly 1 in 10 people over the age of 65 are still working

Leverage other assets (including property equity)

If other assets aren't notionally earmarked as a backstop to cover the possibility of requiring expensive care later in life or running out of money, they could be used to boost retirement income. ISAs and other savings and investments could fall into this category. One of the largest assets people may have is the equity in their home. Downsizing at retirement can often make sense and any excess equity, which is tax free if it's from the sale of the homeowners' primary residence, can be used to top up income. Alternatively, equity release can allow retirees to remain in their home, but still release equity without the need to make any repayments during their lifetime. Typically, at age 68 up to 40% of the equity in a home can be released[23].

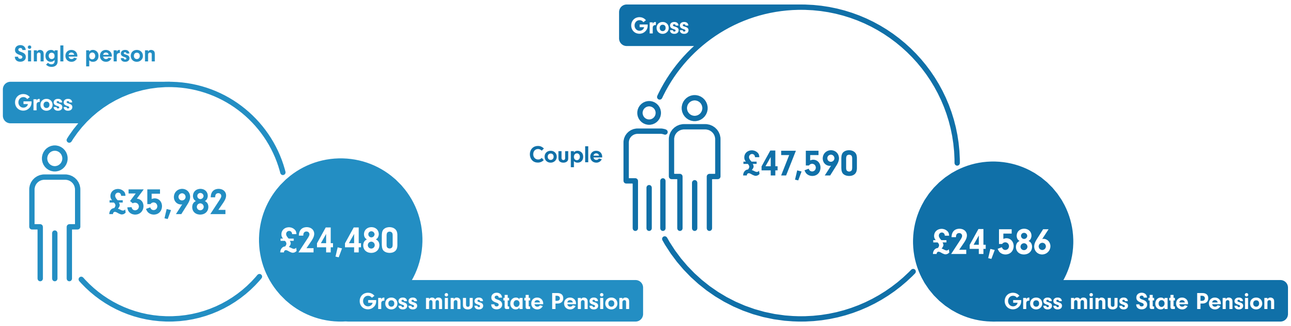
"Downsizing at retirement can often make sense and any excess equity, which is tax free if it's from the sale of the homeowners' primary residence, can be used to top up income

22. Source: Personnel Today, October 2023 – Over 65s boost workforce numbers by almost 1 million.
23. Source: Money Release, September 2024.

Accept a moderate level of comfort

The Retirement Living Standards not only estimate how much is required for a comfortable retirement, but also consider how much is needed for a moderate level of comfort in retirement. The figures are shown below after deduction of the full State pension.

Chart 5: Gross amount required for a 'moderate' retirement allowing for full State Pension



Source: Retirement Living Standards, Pensions and Lifetime Savings Association, 2023.
The gross figures are before deduction of tax or any National Insurance contributions. For a couple, the figures assume that both have equal pensions. National Insurance contributions are usually only payable before State Pension age.

This may be a more realistic ambition for many more people. A moderate standard of living, excluding mortgage or rent payments, would still include holidaying for 14 days in the Mediterranean at an all inclusive 3* hotel plus three weekend city breaks in B&B accommodation. It assumes a three year old Ford Fiesta, replaced every seven years.

The Retirement Living Standards also define a minimum standard for retirees, but for the purposes of this report it's assumed that most people will aspire to a comfortable retirement, perhaps defaulting to the moderate level if it's unavoidable.

Summary

A comfortable retirement may seem challenging, but there are a number of ways that people can boost the income they receive. The options range from continuing to work after retirement, retiring later, accelerating their retirement savings, taking more income – while mitigating the risks – and using all the assets available, including property equity. If there is still a shortfall, a moderate retirement may be a solution that still allows people to enjoy their life after work.

Fidelity INTERNATIONAL

WI10924/WF2076174/CSO/0925