Summary

- The UK's workforce is grossly undersaving for retirement, contributing on average 3.3 per cent to their pensions, when 12 to 15 per cent is required.
- Experts say that many will be disappointed when they realise they won't be able to retire when they want to due to lack of funds.
- Further increases to the automatic enrolment contribution rate and improving member communications are needed to help boost savers' pension pots..

A widening chasm

As the amount between how much people should save for retirement and how much they are actually saving widens, Sara Benwell considers why this is occurring and what can be done to mend the gap

It's no secret that the UK's workforce is not saving enough for retirement. Conservative estimates suggest that most people will need to save between 12 and 15 per cent of their salary to have enough to live on, but the Office for National Statistics has calculated that on average people are contributing just 3.3 per cent into DC pots.

Thus far the impacts of such low savings levels have been cushioned as many people who have retired in the past 10 years have still had some defined benefit retirement income.

But soon, as the first tranche of people who only have auto-enrolment pots begin to retire, we will start to see the scale of the savings shortfall laid bare.

The scale of the problem

It is hard to pinpoint exactly how big the problem is, particularly given that most people have several smaller pots, meaning it's tricky to understand an individual's pensions position.

But if we examine someone who enters the workforce now, with a salary of £25,000, we can start to see how big the gap could be.

Let's assume that they start saving the 5 per cent auto-enrolment minimum and stay opted in, with contributions rising to 8 per cent in 2019 as planned.

Assuming a generous return of 4 per cent per annum over inflation and a fee of 0.50 per cent p.a., they will see their pot growing to approximately £155,000 in today's terms, according to JLT calculations.

Someone who is 22 can reasonably expect to live for at least 20 more years after they retire. This means that a £155,000 pot would yield around £8,000 per annum, or £153 a week. Even assuming someone has the full state pension, this takes the average weekly income to less than £320 a week.

And this assumes someone saves consistently through their working life with no breaks, enjoys good investment returns and low costs and qualifies for the full state pension.

Of course, for many older people the situation is far graver. JLT estimates that someone who did not start saving until 32 would need to put away 18.8 per cent of their salary to make up the shortfall. Yet as we know, there are plenty of people in their 30s who are saving for the very first time at auto-enrolment minimums.

Experts may squabble about the precise amounts that need to be saved, but what is clear is that even with rising auto-enrolment contributions, we are still falling worryingly short of the mark.

Cardano head of defined contribution Ralph Frank says: "A pot of £100,000, which is well above what most DC retirees have currently been able to save by the time they retire, would buy a lifetime inflation-linked income of around £80 per week (in today's money) for an individual retiring today at age 70. This income falls to around £65 per week if the retiree is 65."

Expectations versus reality

The problem is exacerbated by two behavioural issues. The first is that many people assume that because auto-enrolment levels are government mandated they are therefore sufficient. The second is that few people believe they can live on significantly less than their working life salary.

On the latter assumption, most people are probably right. But unless people start saving more and quickly, many retirees are in for a nasty shock.

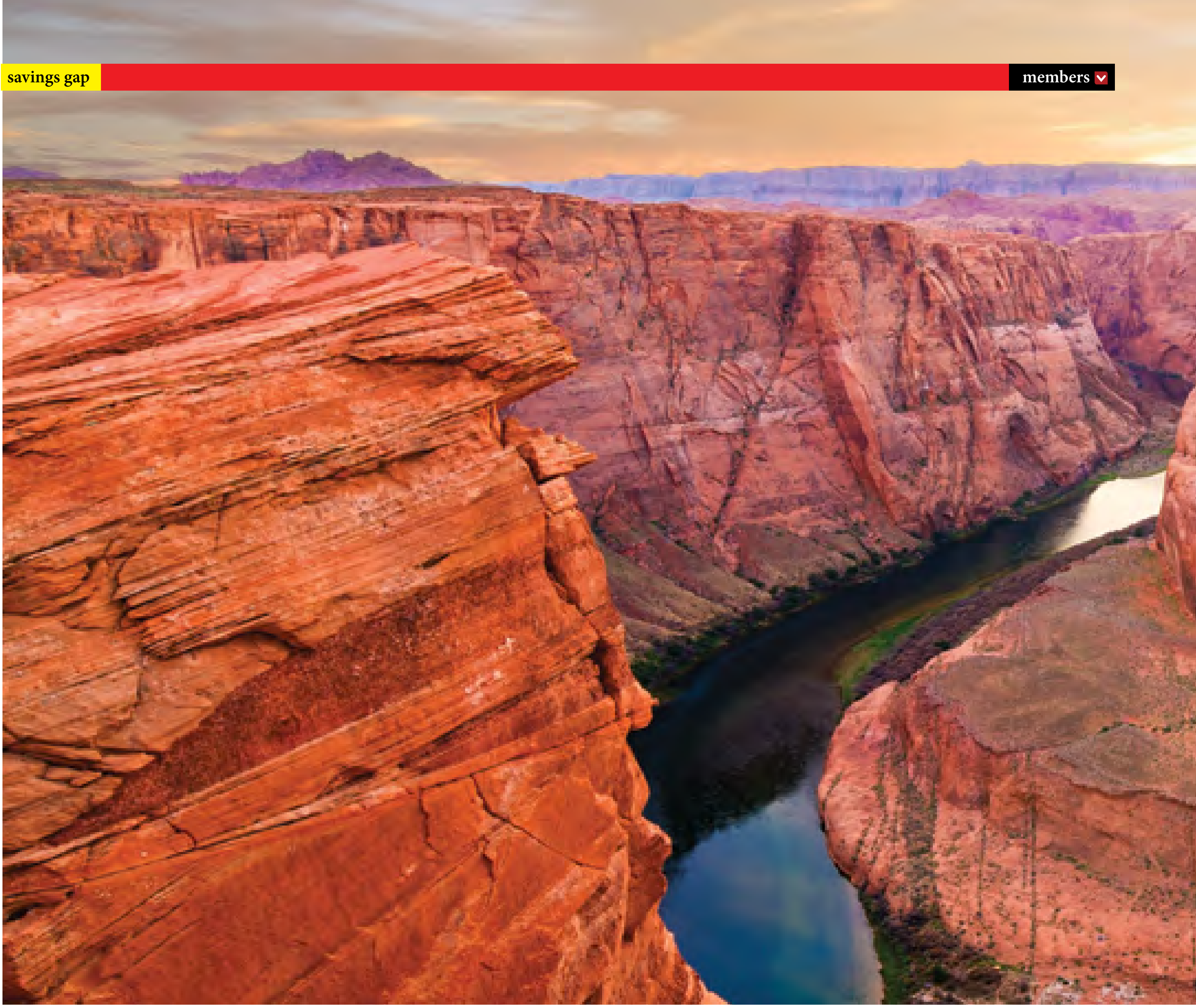
JLT Employee Benefits head of technical John Wilson says: "Six in 10 expect to require an annual income of 50 to 100 per cent, or above, of their current income. Yet the current pension replacement rate in the UK is just 29 per cent.

"Low earners (earning £10,000-£15,000) can't envisage living on much less than they do now, so more of them are targeting 100 per cent of their current income levels than people in other income brackets; of course, it is this group that is least able to afford to contribute to a pension."

A culture of mistrust

Disappointment is just the tip of the iceberg when it comes to the consequences of inadequate saving for retirees, society, the pensions industry and the government.

One natural result is that people are likely to have to retire later than they



had expected. Many thinking that they can stop working when they reach state pension age will be sorely disappointed.

Frank explains: "Many savers are likely to find themselves facing a bleak existence in retirement.

"Those who are not able to continue working will need to settle for a lower standard of living in retirement and/or place more demands on family and the state/other taxpayers for support."

These changes in working patterns are likely to have consequences for younger workers too. For starters, with slower career progression as bottlenecks develop among senior management.

There is also likely to be a set of people who retire assuming they can afford to do so, only to find they cannot. These people may struggle to re-enter the workforce. At this point we can only assume they will either be left unable to make ends meet or searching for new kinds of employment.

There may also be people who simply cannot continue in their existing jobs. It is hard to imagine a painter and decorator still going strong at 80. Indeed, many manual workers may struggle to continue into very old age.

This is likely to place an ever-bigger burden on the state. Particularly if increasing house prices lead to more people entering retirement without owning their own homes outright.

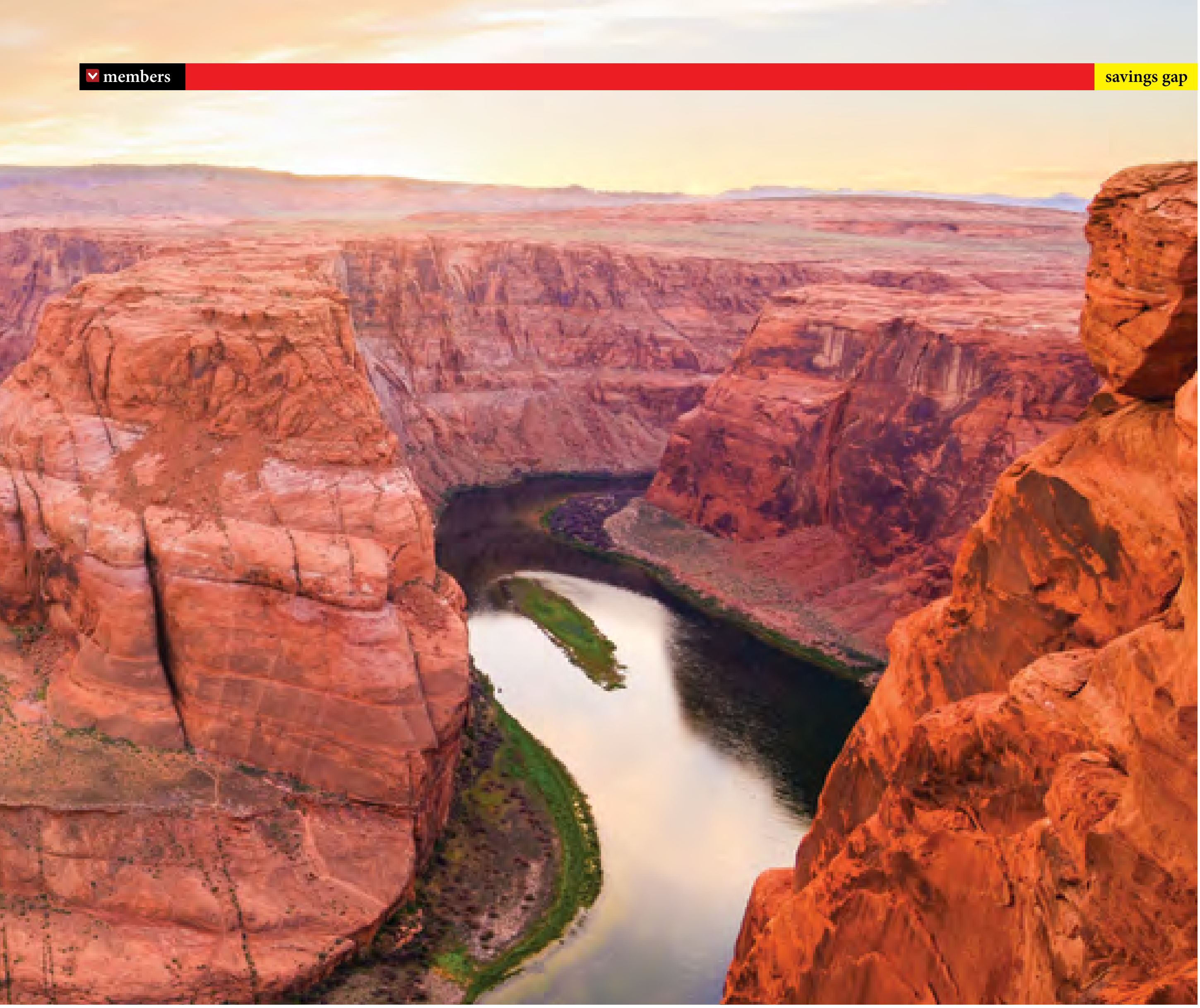
In 2017, pensions cost the government £111 billion, a whopping 42 per cent of the welfare bill. And it is hard to imagine any UK government finding an extra £100 billion down the back of the sofa.

Inevitably, public perceptions and trust in the pensions industry will worsen and the government is likely to face a backlash as people realise they face poverty in retirement.

What can be done?

For younger savers at the beginning of their savings journeys, we are not a million miles away from a savings rate that could ensure an adequate retirement.

JLT estimates that if auto-enrolment rules are changed to apply to every penny of earnings, not just those over the qualifying threshold, we will have gone a long way to bridging the gap.



Wilson says: "If AE contributions were increased to 10 per cent, with the employer paying 5 per cent matched by an employee contribution of 5 per cent and contributions were based on earnings from £1, as opposed to being based on the AE qualifying earnings band, then a two-thirds replacement rate for a median earner could be achieved."

That said, the government needs a clear strategy on how to increase minimum contributions something that was clearly lacking from the last auto-enrolment review.

Royal London pensions specialist Helen Morrissey says: "While auto-enrolment minimum contributions are due to increase to 8 per cent next year, this is still nowhere near enough and we need government to look at how minimum contribution rates can be increased to more sustainable levels."

Frank added: "Ultimately, government is best placed to allay the consequences by further increasing the minimum contribution rate."

It is also critical that we spell out the business consequences for employers who do not play their role in ensuring staff are saving enough. Good matching strategies can help increasingly squeezed employees put away what they need to.

Member communications have a role to play here too. Some experts, such as Selectapension director Peter Bradshaw think that savers need a wake-up call to the harsh realities that face them if they don't start saving.

He says: "*[We need to]* show people what a miserable life in retirement could be if they only had the state pension to live on, and encourage them to be more self-sufficient.

Others believe that a more aspirational approach leads to better engagement. Either way, communications need to be simplified and relevant, and look beyond just pension savings.

Eliminating debts and looking at employees' finances holistically can help ensure that people can actually afford to make the pensions contributions they sorely need.

Written by Sara Benwell, a freelance journalist