

CAN'T SAVE, WON'T SAVE:

Workers face up to 50% income drop

THIS VIEWPOINT IN BRIEF:

- Average income will drop by more than half on retirement to less than minimum wage, Fidelity research shows
- Retirement preparedness worse than in US and Germany
- Increased leisure time increases expenditure in retirement
- Move from generous defined benefit pensions mean many will struggle to save enough for comfortable retirement
- Little evidence of individuals taking responsibility for their retirement provision
- Savings rate at lowest level since 1950s



Simon Fraser

President, Fidelity Retirement Institute

This is the third year that Fidelity has carried out a study on Britain's retirement prospects. Through a mix of proprietary research and quantitative modelling, we have created a snapshot of how well prepared the UK is for retirement and can track this against the results in the previous two years. For the first time we also have figures for Germany, USA and Japan.

As in previous years, the results continue to cause concern. Despite an increasing focus on retirement, there is little evidence that people have taken heed of the warnings.

The typical household will face a significant drop in income at retirement to a level that is well below people's expectations of what they believe they need to enjoy a comfortable retirement.

The paper also explores the extent to which expenditure increases or decreases during retirement and, therefore, the practical implications of surviving on a radically reduced income.

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"Money talks...but all mine ever says is good-bye."

Anonymous

People, on average, will retire on just 47% of their pre-retirement income (Figure 1). To put this into perspective, someone retiring on 47% of national average earnings would be over £5 a week worse off than someone on the minimum wage working a 40 hour week.

What is more, the problem is deeper than the headline numbers might at first suggest: Figure 2 highlights how the move from defined benefit (DB) to defined contribution (DC) is creating a new underclass of 'have-nots'.

These are the growing numbers of people who will not benefit from a DB pension scheme. There is nothing fundamentally wrong with DC schemes. Indeed, with greater labour mobility and a decrease in the numbers of people spending all or most of their working career with a single employer, DC is arguably a better construct to meet the needs of today's workforce. The issue is rather that the move from DB to DC is often accompanied by a review of contribution levels, usually to the detriment of the workforce.

As Figure 2 shows, there is a yawning gap between what people in DC schemes are likely to receive compared with what they believe they need for a comfortable retirement.

The move away from generous DB schemes, coupled with the gradual erosion of state benefits over many years, means that there is an increased onus on individuals to take greater responsibility for their retirement provision.

There is little evidence that this is happening. Some people cannot afford to save more, but this should not mask the growing numbers of people who could save more but choose not to.

Figure 3 demonstrates how little we are saving compared to previous generations¹. At no point since 1959 have savings rates been so low².

Note: For a full explanation of each index, please refer to the definitions on page 6.

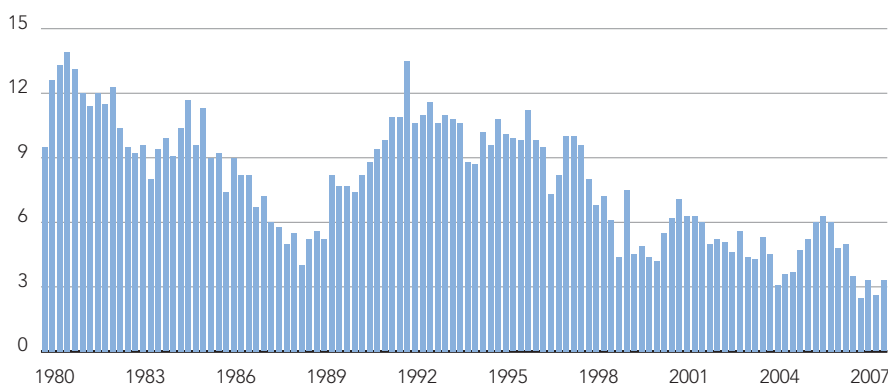
FIGURE 1: PEOPLE CONTINUE TO REFUSE TO TAKE RESPONSIBILITY FOR SAVING FOR RETIREMENT

| | FIDELITY RETIREMENT INDEX | FIDELITY RETIREMENT SATISFACTION INDEX | FIDELITY RETIREMENT EXPECTATION INDEX |
|------|---------------------------|--|---------------------------------------|
| 2008 | 47% | 68% | 68% |
| 2007 | 50% | 59% | 76% |
| 2006 | 42% | 53% | 66% |

FIGURE 2: THE MOVE FROM DB TO DC WILL EXACERBATE THE SAVINGS CRISIS

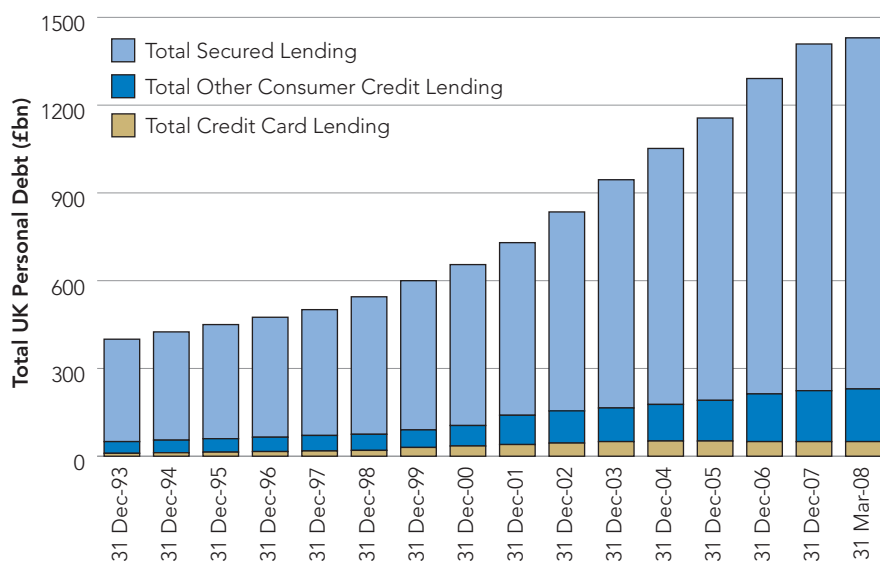
| | FIDELITY RETIREMENT INDEX | FIDELITY RETIREMENT SATISFACTION INDEX | FIDELITY RETIREMENT EXPECTATION INDEX |
|------------|---------------------------|--|---------------------------------------|
| OVERALL | 47% | 68% | 68% |
| DB MEMBERS | 66% | 106% | 63% |
| DC MEMBERS | 38% | 54% | 71% |

FIGURE 3: UK HOUSEHOLD SAVINGS RATIO



Source: Office of National Statistics (2008)

FIGURE 4: WHILE SAVINGS ARE FALLING, DEBT IS RISING



Source: Creditaction (2008)

In contrast, Figure 4 highlights our increased propensity to spend³. Admittedly, much of the increase is attributable to increased house prices and the desperate measures people will take to get a foot on the ladder. Even ignoring this, however, personal debt expressed as a percentage of GDP is higher than in other developed European economies⁴.

So how does the retirement index compare with other countries? Figure 5 compares the UK with Germany, USA and Japan. Using similar methodology, Fidelity has calculated the retirement index in each of these countries. Japan aside, the data would suggest we are worse off than our US and German counterparts.

What is more, while the movement of DB to DC scheme structures isn't a uniquely British phenomenon, the maturity and significance of occupational pensions in the UK means that this trend may be more pronounced. Therefore the 'real' difference could be much greater for future generations of UK retirees than the headline figure might suggest at first glance.

So will tomorrow's retirees have enough to live on in retirement? To answer this question we need to answer another question: how much do people need in retirement to live comfortably?

FIGURE 5: COMPARISON WITH OTHER COUNTRIES

| | FIDELITY RETIREMENT INDEX |
|---------|---------------------------|
| UK | 47% |
| GERMANY | 56% |
| USA | 58% |
| JAPAN | 47% |

Note: The calculation date for each index is different. All indices are correct as of 30.4.08

The two-thirds limit imposed on occupational final salary schemes has largely shaped our perceptions of how much we need to enjoy a comfortable retirement, but how relevant is this figure to today's retirees? The nature of retirement is becoming increasingly diverse and personal which makes it difficult to generalise. Might the figure be significantly more or less than this number?

Research conducted for the Pension Commission in 2004⁵, for instance, found that 50% was the 'minimum' replacement rate that median income households felt that they would be able to live on. This fell some way short of the 72% that they felt would be 'comfortable'.

Fidelity recently carried out qualitative research into this subject to better understand the key issues⁶. The research identified areas of pre-retirement expenditure that are eliminated or reduced after retirement and explored other expenses that may reduce or disappear after retirement. Of course, this is only one half of the story. Without work, we have to fill each day with something else and, in so doing, potentially incur new expenditure. The research explored the nature of increased expenditure in retirement.

All of these issues were investigated across different socio-economic groups. The results are summarised in Figure 6.

In the discussion on pre-retirement expenditure, all of the groups mentioned their mortgage. For most, this was the single largest item of expenditure that would reduce their retirement income needs. Almost everyone had paid off their mortgage by the time they retired. Some had used the tax-free lump sum to clear any outstanding mortgage debt at the point of retirement. Tax on income was also quoted on the basis that less income means less tax. Other costs associated with work were identified: work clothes, costs of commuting and buying expensive ready-made sandwiches were all mentioned.

There were some interesting variations between the groups: ABs recognised that more time had allowed them to strike better deals in a variety of areas like insurance, broadband supplier and, in particular, the provider of utilities like gas and electricity. Other groups were also aware that they could make savings by researching better deals but were often mistrustful of newer, less well-known, providers so they were inclined to stay with their existing, albeit more expensive, supplier.

The C1/C2 category identified a number of areas of discretionary spend where savings could be made. These ranged from taking less expensive holidays and selling the second car through to undertaking any necessary home improvements before retirement and reducing contributions to charity. They also mentioned the availability of free travel as a significant contributor to lower expenditure in retirement.

Those people in socio-economic group D mentioned most of the above but were also inclined to reduce expenditure on entertainment and socialising.

“Enough is as good as a feast”

John Heywood

FIGURE 6: CHANGES IN EXPENDITURE IN RETIREMENT

| SOCIO-ECONOMIC GROUP | EXPENDITURE ELIMINATED/REDUCED | EXPENDITURE INCREASED |
|----------------------|---|--|
| AB | <ul style="list-style-type: none"> • Mortgage • Tax on income • Commuting costs • Pre-made sandwiches • Work clothes • Utility bills | <ul style="list-style-type: none"> • Tax on living expenses • Hobbies • Dependent children/grandchildren • Healthcare and operations • Car insurance • Expensive holidays • Home improvements |
| C1/C2 | <ul style="list-style-type: none"> • Mortgage • Tax on income • Commuting costs • Pre-made sandwiches • Work clothes • Expensive holidays • Running a second car • Home improvements • Non work-related travel costs • Donations to charity | <ul style="list-style-type: none"> • Tax on living expenses • Hobbies • Dependent children/grandchildren • Healthcare and operations • Car insurance • Social expenses • Utilities |
| D | <ul style="list-style-type: none"> • Mortgage • Tax on income • Commuting costs • Pre-made sandwiches • Work clothes • Expensive holidays • Home improvements • Non work-related travel costs • Socialising • Entertainment | <ul style="list-style-type: none"> • Tax on living expenses • Hobbies • Dependent children/grandchildren • Healthcare and operations • Car insurance • Utilities |

Source: Fidelity research (2008)

"I have enough money to last me the rest of my life - unless I have to buy something"

Jackie Mason

Other items were mentioned individually such as off-peak gym membership, lower dry-cleaning bills for suits and a reduced need to save.

So how much impact do these savings in costs have? There wasn't a great deal of variation between the different socio-economic groups. Overall the reduction in retirement expenses is estimated at 60%.

So far, so good. This suggests that a replacement ratio of around 40% may be adequate for most people.

But, of course, our retirees now have eight hours each day to fill that were previously spent in the workplace. Invariably, this increases expenditure as can be seen from Figure 6.

Again there was a degree of commonality across the different socio-economic groups: developing hobbies and interests, spending more time with grandchildren, car insurance and healthcare were all areas where expenditure increased across all of the groups. Although not a direct consequence of retirement, the groups also remarked on increases in tax, particularly council tax and duty on items like petrol, cigarettes and alcohol. All of these were felt to be rising much faster than inflation.

Again, there were differences between the groups. ABs were inclined to take more expensive holidays and embark on home-improvement programmes whereas C1/C2s cited the increased costs of socialising more with friends and family and higher utility bills.

So how does this affect our calculations? In aggregate, the anticipated increase in costs after retirement was around 30% of pre-retirement costs. Therefore, about 70% of pre-retirement earnings is the figure most people would appear to need to ideally enjoy a comfortable retirement. This is consistent with both the Pension Commission research and the Fidelity Satisfaction Index.

However, this is a broad generalisation and most acknowledged that they could manage on 50% of their pre-retirement income. Again, this is consistent with the Pension Commission findings.

CONCLUSION

The message still isn't getting through. We need to save more to enjoy a comfortable retirement. What is more, the move from generous defined benefit provision means future generations really will struggle to save enough. Already the level of support from the state in retirement is among the lowest in Europe. Yet we continue to spend rather than save.

If there is a silver lining, it is that even those in our research groups who hadn't nearly as much as they felt they needed for their retirement were enjoying their freedom and independence from the workplace. For most, there was a period of adjustment to realign their expenses to their new income but, once this was achieved, retirement proved to be a rewarding experience.

As greater numbers of people face the challenge of generating an adequate income in retirement, contentment with one's lot may be more difficult to achieve.

Sources

1. Office of National Statistics, Household sector, Use of disposable income (2008)
2. UK household savings 'slump to 48-year low', Jon Land writing for 24dash.com (2008)
3. Creditaction.org.uk (2008)
4. Precious Plastic 2008, Consumer credit in the UK, PricewaterhouseCoopers (2008)
5. A New Pension Settlement for the Twenty First Century, Pensions Commission (2005)
6. Fidelity research undertaken by Bdifferent (2008)

DEFINITIONS

The Fidelity retirement index

Provides a snapshot of the typical household's retirement readiness. It shows how much people will receive in retirement, expressed as a percentage of the amount they are likely to be earning just before they retire.

A high figure illustrates a high degree of "replacement income" in retirement.

The Fidelity retirement satisfaction index

Provides a gauge of a household's retirement prospects against what they think they need to enjoy a comfortable retirement. People were asked to say how much they would need in retirement, as a proportion of the amount they are likely to be earning just before they retire. This number was then compared with what their savings are likely to produce.

A high percentage figure indicates a high likelihood that people will achieve a retirement income that is in line with their goals.

The Fidelity retirement expectation index

Measures a household's retirement prospects against what people expect their savings and benefit entitlements to generate. Respondents were asked to say how much income they expected to have in retirement, as a proportion of the amount they are likely to be earning just before they retire. This number was then compared with what their savings are likely to produce.

A high figure illustrates that people have a realistic expectation of their retirement income.

INDEX METHODOLOGY

The Fidelity Retirement Savings Survey was conducted on behalf of the Fidelity Retirement Institute by NOP. It included 1,001 people from all parts of the UK. The respondents are in work and are not yet retired. They are also the financial decision makers in their households. Statistics on employer contributions to defined contribution schemes depended on whether respondents were able to say whether their company was making payments into their pension schemes. Interviews were completed in January 2008.

The Fidelity Retirement Indices were calculated using a method, known as stochastic modelling, which examined hundreds of different investment scenarios for each of the people surveyed.

The Fidelity Readiness Index represents the median (or mid-point) of the results produced. The Fidelity Retirement Expectation Index and the Fidelity Retirement Satisfaction index represent the average of the results produced.

For the purposes of this paper, the following assumptions have been made:

- pre-retirement earnings will rise at the rate of 3.5% per annum
- the Basic State Pension will rise in line with increases in the Retail Price Index, which is assumed to increase at 2% per annum
- the State Pension Age is 65. In practice, women born before 5.4.1955 will be able to claim their State pension earlier than this
- retirement incomes include a full state pension, incorporating SERPS/S2P entitlement, based on a full history of National Insurance contributions. In other words, there were no periods of contracting out
- SERPS will accrue on the pre-2002 basis until 2002, at the flat rate of S2P basis from 2007 onwards and at the greater of the two for the period from 2002 to 2007. This ignores the transitional arrangements between 2002 and 2007 (the impact of which is small) and assumes that in the long term S2P will move to a flat-rate accrual
- there will be no entitlement to means-tested Pension Credit as other income is expected to lift total retirement income above the levels at which this would apply
- market variability and correlation of asset classes are based on historical market performance
- average returns of each asset class are based on Fidelity's forward looking assumptions and not on the market's performance



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