



OECD PROJECT ON RETIREMENT SAVINGS ADEQUACY: SAVING FOR RETIREMENT AND THE ROLE OF PRIVATE PENSIONS IN RETIREMENT READINESS

Background and motivation

The aim of this project is to provide a more comprehensive picture of the role of private and funded pensions for individuals in different countries and to assess their readiness to finance their future retirement.

Some of the key questions that would be addressed by this new, pilot project would be following:

- *Are people saving enough for retirement? Are private pensions fulfilling their complementary role in providing for retirement?*
- *Should policy makers introduce measures to increase retirement savings or to postpone retirement? Should these measures be targeted to specific population subgroups?*

These are key policy questions that require urgent answers to make sure that adequate policies are implemented to improve future retirees' savings and thus their retirement well-being. This project ultimately aims at providing such responses. In order to answer these questions, the study will assess – in a first phase - how much individuals have to finance retirement, focusing on the role of private savings. In a later phase of the project, it will compare retirement income with a suitable reference point.

This will help determine whether different individuals (broken down by age cohort, socioeconomic group and gender) are sufficiently prepared to finance their retirement and if not, how much their retirement savings (or retirement age) would have to increase in order to reach their retirement income target.¹ This exercise would ultimately lead to policy recommendations on how to improve retirement savings adequacy for population subgroups that are at greatest risk of not reaching their target income.

In this context, the project will look at actual individuals and assess, not only how much current pensioners have to finance their retirement (actual replacement rates) but how different cohorts, those close to retirement (i.e., aged 55 to 64) or younger cohorts (i.e., aged 35 to 54) fare in terms of rights and assets accumulated to finance their future retirement, underlining the role of private retirement savings.

This project was launched initially with a few countries, and over time new countries have been and will be added.

¹ There are already a few exercises assessing the retirement readiness of current workers: the Employment Benefit Research Institute (http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=4593), and the Center for Retirement Research (http://crr.bc.edu/special_projects/national_retirement_risk_index.html) for the US; and Moore et al. (2011): “Canada Looming Retirement Challenge” Howe Institute Working Paper Series on Pensions

Programme goals and objectives

Goal

To determine whether people are saving enough for retirement and examine the role that private pensions play and could play in the retirement readiness of the working age population. That is, to examine how much individuals have to finance retirement by combining all possible sources of retirement income and savings (i.e., public pensions, occupational, private pensions, and other savings such as private savings and housing).

Main objectives

- Provide a picture of the amount of financial resources people may have to finance retirement, including public, private and funded pensions, and other sources such as savings and housing. This includes having a good understanding on how the different sources of retirement income, in particular those stemming from private pension plans, combined across countries;
- Construct indicators of retirement savings adequacy to highlight the role that private pensions play in financing future retirement;
- Identify groups in the population of each country, according to various socio-economic factors, that may have insufficient retirement savings to finance retirement;
- Draw policy recommendations on how to improve the adequacy of retirement savings of different population groups in each country by, for example, promoting higher saving rates in private pension plans or increasing the contribution period by postponing retirement age.

Detailed description of the project

The project will calculate and estimate the amount of money that current workers have or may have to finance their retirement. It will consider and add up all the different sources of income that people may use to finance their retirement. In this context, the project will focus on the role of retirement savings from funded pension arrangements in contributing to finance retirement. Moreover, in order to determine whether individuals may be prepared for retirement and whether retirement savings may need to be increased, the total amount of income individuals have to finance their retirement needs to be compared against a reference or target income.

Retirement income sources

The different sources of income that will be considered in evaluating the retirement readiness of different population subgroups include:²

1. Pension rights accumulated in Social security or state pensions (PAYG funded pensions)
2. Pension benefit rights accumulated in occupational defined benefit pension plans
3. Assets accumulated in occupational defined contribution pension plans
4. Assets accumulated in personal defined contribution pension plans

² Where possible, the information will be combined with information collected by the OECD Directorate for Employment, Labour and Social Affairs, in particular on public pensions.

5. Other assets available to finance retirement:
 - a. Other savings (e.g. life insurance)
 - b. Housing

Reference or target income

The project will aggregate retirement income sources to get a single measure of expected old-age income for the different population subgroups. In addition, the project will address the question of adequacy by comparing the estimated income with a suitable reference or target income. Such a reference level can be defined in different ways.³

On the other hand, if one wanted to assess whether pension systems achieve the other key goal of preventing poverty in old age, one could compare the estimated retirement income of current workers against the relative poverty threshold (60% of equivalised median income).

One could also compare the estimated retirement income of current workers against the amount of income received by people already retired (e.g. those aged 65+). The amount of money retired people have to finance their retirement is easily determined as they are already receiving pensions. However, they may not have enough to finance retirement.

Consequently, another reference income to determine retirement readiness could come from an assessment of expenditure or consumption patterns of different cohorts given in current expenditures surveys. Using these surveys, a reference income could be calculated by comparing the expenditure or consumption patterns of those already retired with that of those in working age.

However, one could argue that current retirees' expenditures are constrained by the income at their disposal and therefore, their income determined from their expenditure fails to indicate their real needs in retirement.

Additionally, one could use the life-cycle theoretical approach to calculate retirement needs of different population subgroups as the reference or target income to assess current cohorts' retirement readiness.

Finally, the evaluation of retirement readiness of different cohorts can be evaluated at retirement or at their current age. For people close to retirement (e.g. aged 55 to 64) or younger cohorts (e.g. those aged 35 to 54), one can determine what assets and pension rights they may have accumulated up to now by looking at their work histories. However, one cannot know what will happen between now and the time they retire. Consequently, one needs to make assumptions about their future. Alternatively, one could calculate what current retirees had in their past at different ages and compare, or what the life-cycle approach would suggest that people should have at different ages and compare with what they currently have.

Therefore, based on the different assumptions and their complexity as regards the target or reference retirement income, and of the different income sources considered to assess the overall income available to finance retirement, the project comprises four main phases:

³ It would be important to keep in mind the need for a replacement income. Therefore, reference incomes such as earnings in the years preceding retirement (at the individual level) and average earnings (at macro level) could be used, in line with the works of the EU Open Method of Coordination and *Pensions at a Glance*.

Project implementation

Phase 1

In this phase, the project will only consider state pensions, occupational pensions, as well as personal pensions, as the main source of income to finance retirement. This phase will look sequentially at (i) current pensioners, (ii) cohorts that are close to retirement (people aged 55 to 64), and (iii) the cohorts of prime age workers (those aged 35 to 54). Cohorts close to retirement have already build up most of their pension rights and assets accumulated and very little needs to be assumed about what will happen between now and retirement. In general, it may be safe to assume that current trends may continue. For the younger cohorts (prime age workers), assumptions about what will happen between today and the time they retire become trickier. Different alternatives would have to be evaluated. The (actual or projected) retirement income for all these cohorts would also be compared with that of new workers entering the workforce, as calculated in the OECD publication *Pensions at a Glance*.

Phase 2

In phase 2, the project will extend the sources available to finance retirement by incorporating other savings and the main asset that people have, such as housing. An imputed rent for homeowners will be calculated (which can be used when comparing estimated income against the reference level in Phase 3). In addition, a simulation will be carried out to evaluate the potential contribution that housing could make to retirement income by converting housing assets into a retirement income (for example, one could assume that workers buy a reverse annuity mortgage at retirement). It will be done first for cohorts close to retirement and then for younger cohorts. Simulations will also be made to calculate the additional retirement income that could be obtained from other non-pension savings (e.g. savings in life insurance contracts, bank deposits and mutual funds). The report will also discuss the extent to which housing and other non-pension savings are currently being used to generate additional income streams after retirement.

Phase 3

Finally, in phase 3, the project will attempt to develop a suitable reference measure of retirement income for each cohort and socioeconomic group. It will therefore calculate a reference or target retirement income based either on expenditures surveys or on the life cycle approach, either evaluated at retirement or at their current age.

Each phase will include an analysis of how sensitive the results are to the underlying assumptions, for example, to the retirement age, saving rates, portfolio compositions, returns on investments, inflation, annuity rates (which includes the effects of interest rates and life expectancy), wage profiles, and the probability of remaining in employment.

Country coverage

Calculations of retirement saving adequacy have begun for four countries (Chile, Germany, the Netherlands and the United States). The calculations for Germany are under discussion with the country authorities. Agreements have been established to begin calculations for France, Italy, Iceland, Norway and the United Kingdom.

Concrete steps

1. Assessment of data needs.

- The countries assessed need to have *survey and/or administrative data on private pensions at the individual level*
 - Data needs to be publicly available. However, agreements with relevant institutions in the different countries could be established for accessing non-publicly available data sets and/or helping in carrying out the calculations following a common framework.
 - There is a need to calculate *labour histories* in order to determine pension rights and approximate pension assets (when necessary) up to the actual date of the survey.
2. Calculations of retirement savings adequacy could be presented according to different income groups (minimum three: low, medium, high), which will require detailed information on distribution of income, savings and contribution behaviour by age and income.
 3. Calculations will be done for two working age subgroups, those close to retirement (aged 55 to 64) and prime age workers (those aged 35 to 54). The project will not assess the retirement savings of young workers (those aged 16 to 24 and 25 to 34) as they may not have much labour histories and calculations require strong assumptions about future work histories.
 4. The following assumptions will be used as baseline:
 - Assume future accruals in DB plans (both state and occupational private plans) in line with the past experience of the specific income group (e.g. wage profiles and the incidence of and spells of unemployment and their impact on retirement benefits would have to be modelled).
 - Contribution rates in DC plans, based on past ones, will be kept fixed in the baseline case.
 - Market return, inflation and longevity assumptions (as reflected in annuity rates): use prudent, long-term values.
 5. A sensitivity analysis would be performed around those baseline assumptions.