official pensions and investment provider

The Scottish Widows UK Pensions Report

A major assessment of pensions savings behaviour

June 2008

Foreword

In the twelve months since our last report the UK has experienced difficult financial conditions and, despite industry and Government efforts to maintain consumer confidence, this has inevitably increased uncertainty about the future in many people's minds. The question then arises: what has been the effect on savings habits and our financial preparation for retirement?

The Scottish Widows UK Pensions Report is now one of the most authoritative surveys of consumers' preparations for retirement, tracking consumer attitudes and behaviour over time, and reveals much about current consumer attitudes.

This year's survey reveals an overall improvement in the level of savings with our key measures (The Scottish Widows Pensions Index and the Scottish Widows Average Savings Ratio) showing an improvement compared with 2007, which was itself up on 2006. Fewer people are saving nothing and those already saving are tending to increase rather than reduce the amounts they put aside each month.

While this is welcome news, there is certainly no room for complacency. Individuals are saving more but when finances become difficult many are inclined to withdraw some of these savings. Despite the improvements, half of those who could and should be saving for retirement are still not doing enough.

Scottish Widows believes that "Preparation is Everything" – a simple truth now symbolised in our involvement as official pensions and investment provider for the London 2012 Olympics.

As pensions reform also progresses towards 2012, this fourth annual report allows us to track the nation's preparedness for retirement and identify specific challenges which need to be addressed now – such as those facing women and carers, young adults and the self-employed.

Finally, the UK Pensions Report series also provides Scottish Widows, policy-makers and consumers with a solid foundation on which to consider what more must be done to help all consumers prepare for their future.

We hope you find this edition of the Scottish Widows UK Pensions Report both interesting and informative and that it continues to influence the debate on the importance of pensions and long term savings.

Archie Kane
Chief Executive
Scottish Widows

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Executive Summary

The fourth annual Scottish Widows UK Pensions Report reveals a slight improvement in savings behaviour despite the credit crunch. Both our main measures of savings adequacy – the Pensions Index and the Average Savings Ratio – are slightly above their 2007 levels, which were themselves higher than in 2006. However, nearly half of those who could and should be making financial provision for their retirement are not doing enough, and it appears that many are drawing on non-pension savings that may previously have been earmarked for retirement to help tide them through hard times.

There remain substantial variations between different groups. Women still lag significantly behind men, although the gap has narrowed. Younger people, despite good intentions, are saving less than those closer to retirement. And defined-benefit (final salary) schemes, which remain the most secure way to build up an adequate pension, are heavily concentrated in the public sector.

One positive sign is some restoration in confidence in the security of pension arrangements, which is in contrast to a reduction in confidence in other investments such as property and ISAs. There are also clear indications that employer pension arrangements are an important incentive for staff recruitment and retention, which may encourage companies to retain good quality existing provision instead of levelling down to the Personal Accounts minimum level in 2012.

The research was carried out online by YouGov who interviewed a total of 6,381 adults over the age of 18 between 6 and12 March 2008.

The Scottish Widows Pensions Index

The Pensions Index focuses on those who can reasonably be expected to save for the long term – those aged between 30 and state pension age and earning £10,000 or more a year. It targets an income in retirement which people might consider adequate relative to earnings while working, but which would involve a reduction in living standard.

- The Scottish Widows Pensions Index for 2008 is 51%, made up of 33% who expect their main source of retirement income to be a defined-benefit scheme and 18% who are relying mainly on defined-contribution provision. The Index is up from 49% last year.
- If those relying mainly on a defined-benefit scheme are excluded, only 27% of the remainder are saving adequately for their retirement, again an improvement on 25% last year.
- 55% of men and 46% of women are saving adequately, up from 54% and 41% in 2007. The ‘gender gap’ is therefore narrowing, having widened last year.

The Scottish Widows Average Savings Ratio

This measures average savings as a percentage of earnings for those who are not relying mainly on a defined-benefit pension. Those with a ratio of 12% or more are treated as saving adequately.

- The average savings ratio has increased from 7.9% to 8.7%. It includes employer and individual contributions to pension schemes and also non-pension savings that are earmarked for retirement. It does not include investment in property.
- The key driver of the improvement was a significant increase in payments into non-pension investments, with pension contributions remaining fairly stable. However, the total amount held in non-pension savings did not increase, suggesting that many people are withdrawing savings previously intended for retirement when times are hard.
- Fewer people are doing nothing to prepare for retirement, with non-savers reducing from 24% to 18% over the year.
- Fear of not having enough in retirement is the single biggest factor in encouraging people to save, with 37% identifying this as their motivation.

Other key findings…

Attitudes towards retirement

- Most people still aspire to retire before state pension age. On average, they would like to retire at age 61, feel that may be able to afford to retire at 64 and would be angry if they had to work beyond 66.
- Retiring in stages is attractive, but mainly as a means of easing into retirement from an earlier age, rather than as a way of continuing to be economically active at older ages.
- The majority, including among those with substantial savings, are looking for a secure pension income as soon as they retire. This suggests that annuities will remain the key vehicle for those not in defined-benefit schemes, although a third would value flexibility to defer annuity purchase beyond age 75.
- Only 49% of married people believe it is very important to provide a pension for their spouse if they die first, and only 42% overall believe inflation-proofing their pension is very important. However, 70% see the value of shopping round for the best annuity rate.

Personal Accounts and Money Guidance

- 33% of respondents expected to contribute towards personal accounts when they are introduced in 2012, compared with 22% last year. Women and younger people are more likely to join than men and older people, largely because they are less likely to have alternative pension provision.
- Means-testing is not yet an issue that most people are familiar with, with only 27% saying that it had affected family and friends. While many said that means-testing could put them off saving, a significant minority felt it would encourage them to save to pull themselves clear of means testing in retirement.
- 61% of those earning between £10,000 and £30,000 say they do not have spare money to save in a pension, which could affect the opt-out rate for personal accounts.
- Independent financial advisers remain the most trusted source of advice, although young people are more likely to ask friends and family.
- Only 35% thought they would use the new money guidance service. Higher earners were more likely to prefer to access it by phone or internet, while lower earners preferred face-to-face or through the post.

Policy implications

1. Encouraging greater personal provision

Improvements in the Index and Ratio have been driven by increased savings by individuals rather than greater employer provision. Responsibility is shifting from institutions to individuals, and consumers need to be properly prepared and educated to take on this responsibility.

With the increase in non-pension savings apparently being offset by people withdrawing these savings when times are hard, more education is needed on striking the right balance between short-term and long-term savings, and particularly on the benefits of using pension, which removes the temptation to cash in retirement savings.

2. Encouraging longer working and good decisions at retirement

As a nation, we have still not got the message that we will need to work longer than we may have assumed previously. The Government needs to raise awareness of the planned increases to state pension age, and that this should be accompanied by longer working lifetimes.

Employers also need to consider whether they offer enough help to those who wish to work longer, for example by allowing flexibility in working hours and ensuring that pension schemes do not disadvantage those who may wish to reduce their hours or salary in later life.

The pensions industry needs to develop innovative flexible retirement products for those who value them, but also recognise that the majority will wish to secure their income when they retire.

Expert advice at retirement will become increasingly important for those with substantial pension provision, while those with smaller funds need to be helped to make appropriate decisions. It is important that initiatives like The Pensions Advisory Service's online pensions planner and the proposed Money Guidance service are well used by retirees.

3. Targeting personal accounts

Personal accounts must be well targeted to meet the needs of those with no current pension provision, while not eroding the benefits of good existing pension provision.

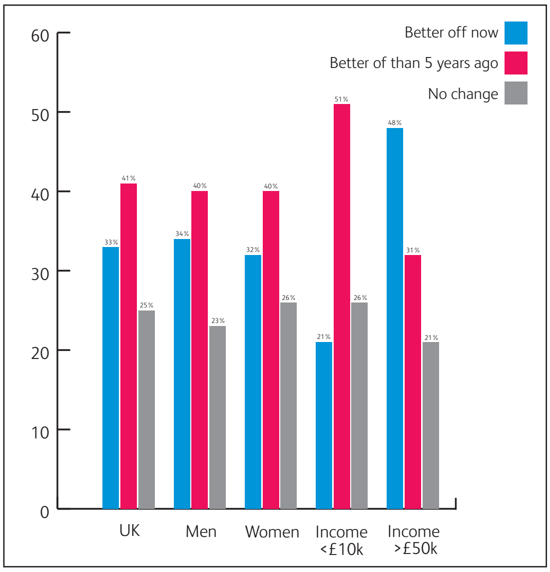
With affordability being the key reason why people do not currently save, the contingent employer contribution in personal accounts is an important part of making saving more affordable. Automatic enrolment will also help overcome inertia. However, the question of affordability and its effect on take-up rates needs to be investigated further.

Consumers must have confidence that it pays to save, and there are concerns that the possibility of means-testing may discourage many, including younger savers. The Government needs to demonstrate clearly that the benefits system does not undermine the incentive to save.

Introduction

The Scottish Widows UK Pensions Report 2008 marks our fourth annual snapshot of the UK's pension savings. This year's report, quite unlike previous years, has been overshadowed by the onset of the credit crunch and growing concerns of an economic downturn.

Chart 1: Do Britons feel better or worse off than they did 5 years ago?



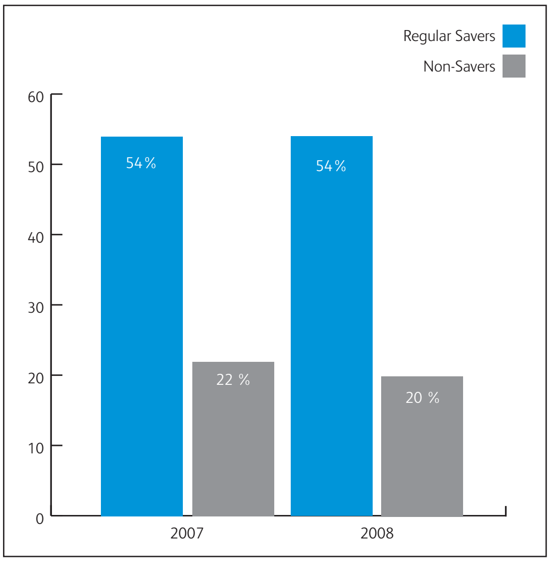
Our findings revealed that to date the credit crunch has had seemingly little impact on whether or not people feel optimistic about the short-term outlook.

- People are no more optimistic or pessimistic about their short- or long-term finances than they were a year ago.
- Equally, people are as secure in their jobs.
- Reflecting the overall improvement in our Pensions Index, which shows more people now saving adequately in their pension, optimism about retirement prospects has actually improved, up from 32% last year to 35% this year.

Whilst the overall picture has been relatively static, there are major differences in outlook between different groups. Men and women are broadly in line with the overall UK trend, people on low incomes (household income under £10,000 a year) are overwhelmingly more likely to feel worse off while those on high incomes (household income above £50,000 a year) feel generally better off.

People of working age are also generally less upbeat than those approaching retirement. Only **31%** of those aged 45-49 are optimistic or very optimistic about the short-term finances, which increased to **48%** of those in the 'at retirement' age 60-64. This perhaps reflects the fact that fluctuations in living costs and income are greater in the working age population while older people are less encumbered with concerns about job security or increases in mortgage repayments.

Chart 2: The impact of savings on levels of optimism



Our research was conducted during March before the credit crunch started to hit the retail mortgage market. Many thousands of people on short-term fixed rate mortgages are looking to remortgage during 2008. The Financial Services Authority (FSA) estimates that 1.4 million short-term fixed-rate mortgages are due to mature in the next 12 months and that mortgage payments could typically rise by £210 per month.[i] The FSA has raised concerns that "a **significant minority of consumers could experience financial problems because of their high levels of borrowing**".[ii] Therefore, we can expect to see some shift in consumer sentiment, particularly if the recent falls in the value of house prices continues to gather pace.

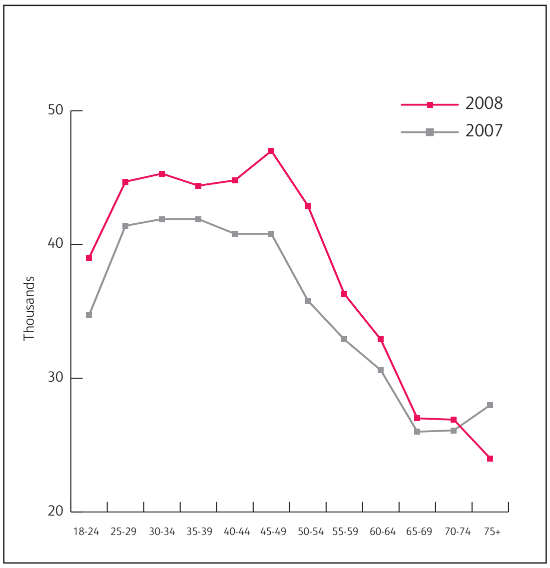
The Scottish Widows Average Savings Ratio has increased during 2008 whilst the increase in the levels of consumer debt has tailed off. We see a picture emerging in which households are becoming thriftier as they look to tighten their belts, reduce their spending and borrowing as the cost of borrowing becomes more expensive, and increase how much they put away for a rainy day. Our findings show that this emphasis on savings is geared towards easy-access short-term savings, which has implications for people's retirement savings.

Furthermore, as we all brace ourselves for the possibility of leaner times ahead, it is not clear that Britons have felt the benefits of the good times.

Despite all those years of continuous economic growth it is clear that large numbers of people do not any feel better off. Only **one-third** of Britons (33 %) feel better off now when compared with five years ago, while 41 % feel worse off. Furthermore, the 'feel-good' benefits of economic growth have been concentrated amongst those on higher incomes. Just 31 % of those earning over £50,000 feel worse than they did five years ago which increases to over half of people (51 %) earning less than £10,000 per year.

One possible explanation for this is the view that disposable incomes have failed to keep up with the cost of living. When we asked people how much household income they thought was necessary to feel comfortable the average figure in 2008 was **£40,000 per year**. This has risen over 11 % since 2007 when the figure was just **£36,000 per annum**. Average actual household income meanwhile has risen from £33,000 to £34,500. Looking at age-related income needs (Chart 3) we can see that the rate of increase is sharpest amongst those in their late-forties and early-fifties, possibly those who are most exposed to recent increases in mortgage interest costs.

Chart 3: Changes in age-related income needs between 2007 and 2008



More generally, this 11% increase in income needs compares with an official inflation rate of around 2.5%[iii] during that period. Many of the core household spending items which are used to calculate the Consumer Price Inflation (CPI) Index are rising much quicker than the headline figure suggests (Table 1).

Table 1: Price increases on selected items of household expenditures[iv]

CPI, April 2008	
Overall CPI	**3.0%**
Food	7.2%
Household energy	8.3%
Transport fuel	18.7%

Sharply rising food bills and mortgage costs, alongside steep increases in utility bills and fuel costs, all mean that Britons are already feeling the pinch. The cost of essential items is rising much more quickly than inflation figures would suggest, leaving many people feeling less comfortable.

Against this backdrop the combination of economic uncertainty and rising living costs 'making ends meet' rather than preparing for retirement seems to be the more pressing financial priority for households in 2008.

Part 1: 2008 Pensions Index and Savings Ratio: Key Findings

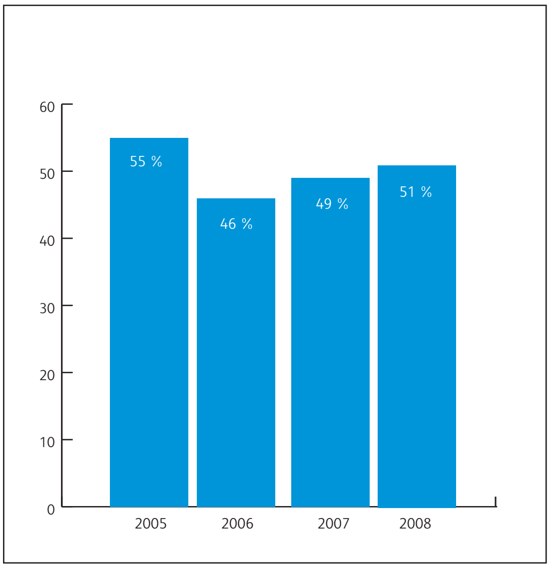
Continuing the trend in 2007, our key finding reveals that more Britons are now on track for an acceptable living standard in retirement than at any point since our first survey in 2005.

The Scottish Widows Pensions Index

The Pensions Index focuses only on those who can reasonably be expected to save for the long-term. We define those as being people aged between 30 and the state pension age (SPA) and earning more than £10,000 per year. For each income group we estimated how much they will need in retirement income as a percentage of their current working age income, and concluded that for all earnings levels a contribution of 12% of earnings should be sufficient. The Scottish Widows Pension Index tracks the percentage of those who 'could and should' be saving for retirement who are either putting aside at least 12% of earnings each year or expecting to get most retirement income from a defined-benefit pension scheme. Appendix 1 provides more detail on the methods and assumptions we have used.

- **The Scottish Widows Pensions Index stands at 51% this year. This calculation – which includes those people who have access to a defined-benefit scheme – represents the percentage of our target savers who currently appear to be on course for a comfortable retirement.** The index figure compares favourably with the **49%** figure we reported in 2007 and 46% in 2006, and is now getting back towards the levels witnessed in 2005.

Chart 4: 4-year Pensions Index trend

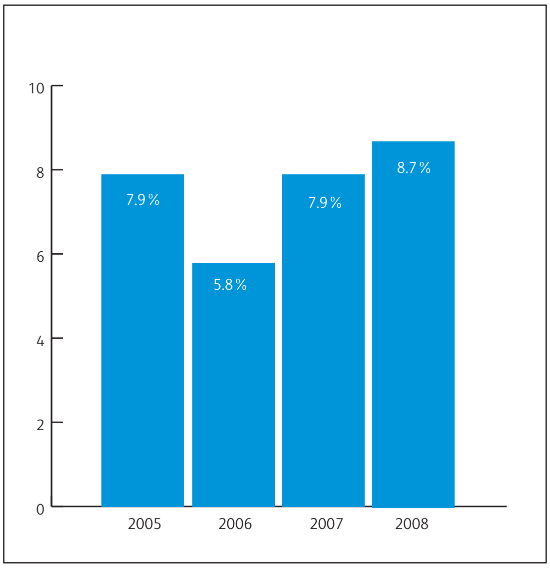


The Scottish Widows Average Savings Ratio

The Scottish Widows Average Savings Ratio tracks the average savings level of those not relying on a defined-benefit pension scheme, to measure how this compares with the 12% benchmark.

- **The baseline Scottish Widows Average Savings Ratio stands at 8.7% this year.** That compares with 7.9% on 2007, and is the highest level recorded since we started our yearly survey in 2005.

Chart 5: 4-year Savings Ratio trend



% of annual income saved (excluding final salary pensions)

Key drivers of improvement

The overall improvement in the Index and Ratio this year is driven by a number of significant factors:

- **There has been a narrowing of the gender gap.** After widening to 13% in 2007, it has now shrunk back to 9% in 2008. Women are therefore starting to close the long-standing shortfall between female and male retirement savings. This follows several years in which Scottish Widows has campaigned to encourage women to build up private pensions in their own right rather than relying on their spouse.
- **Confidence in defined-benefit schemes may be returning.** This is particularly the case among women, where the percentage of the Pensions Index group expecting a defined-benefit pension to provide most retirement income rose from 24% in 2007 to 29% in 2008, having been 28% in 2006. For men the percentage has remained almost constant over the three years, and is currently 36%. Other survey findings are consistent with the expected slow decline in active membership of defined-benefit pension provision, so the improvement suggests that many women are more confident this year than last year in the security of their defined-benefit pension arrangements, possibly influenced by improvement to the Financial Assistance Scheme (FAS). Almost two-thirds (64%) of respondents knew about Government efforts to compensate those in failing schemes.
- **Consumers are earmarking more non-pension savings for retirement.** The improvement in this year's Average Savings Ratio has come mainly from an increase in non-pension savings that individuals are making with the intention of boosting retirement income. However, the position is not as rosy as it first appears. Among the Savings Ratio group the total of all non-pension savings held has not risen. While more money is being placed into non-pension savings, the gain is being cancelled out by people subsequently making withdrawals from them. The Lipper FERI Fund Sales Report [v] confirms that in the first three months of 2008 net retail sales (contributions minus withdrawals) for ISAs were at an all-time low. Consumers have good intentions when it comes to non-pension savings, but the bucket is leaky. And the only investments that are secure for retirement are those in pensions.

- **Fewer people are sticking their heads in the sand.** Non-savers have reduced from almost one in four (24 %) of the index group to fewer than one in five (18 %).
- **The 'fear factor' is driving households to save more.** People are scared that they will not have enough to live on in retirement! (Chart 6). This upswing in fear has been accompanied with – and potentially driven by – a major drop in confidence in the state pension and in occupational pension schemes to provide a reasonable standard of living (Chart 7).

Chart 6: Fear of a pension shortfall is now the major motivation to save long-term

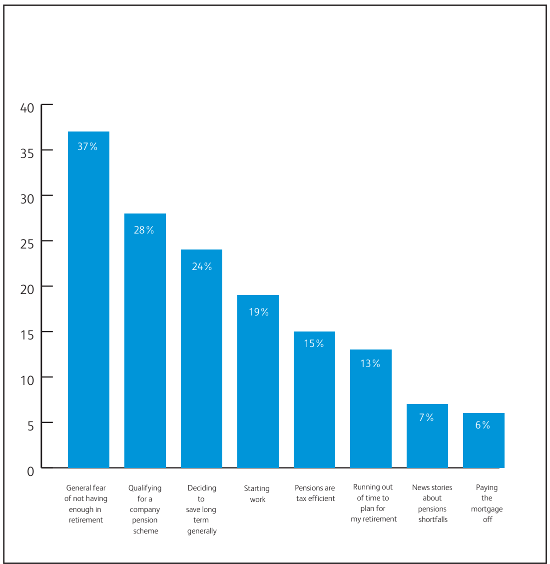
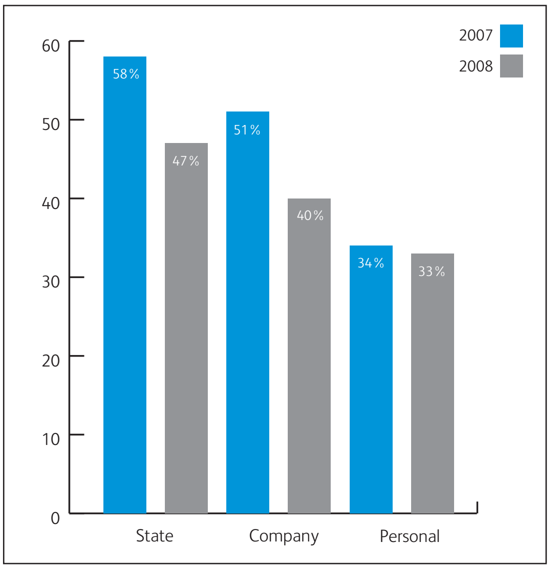


Chart 7: Which pension types are people confident will provide a decent retirement?



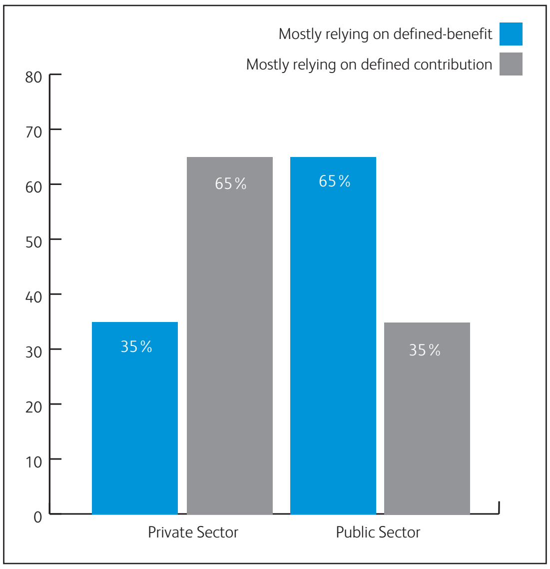
The importance of workplace pension provision

Workplace pension provision is still valued notwithstanding the falling reliance on employers.

- **The role of employers seems to be in decline.** Among the index group, only 48 % of respondents this year felt that their company pension would help ensure a reasonable standard of living in retirement, compared with 60 % in 2007. The move away from defined-benefit provision and the possibility of 'levelling down' appear to be impacting on people's perceptions about how committed their employer is to maintaining a workplace pension.
- **However, there is more confidence in the security of pension.** 57 % believe pensions are "very safe" or "quite safe", compared with 44 % last year. This is against a background of falling confidence in ISAs and property investment.

- **Employer pension schemes are still an important incentive for staff recruitment and retention.** 53% of employees said that their employer's pension scheme was an incentive to stay in their current job, while only 16% said it provided no incentive at all.
- **Yet again there is a major split between the public and private sector in terms of types of pension scheme being offered.** Defined-benefit schemes are heavily concentrated in the public sector (Chart 8).

Chart 8: Pension expected to provide most income, by employer



- **Defined-benefit pensions are very much seen as the gold standard in offering a much more valuable incentive.** 62% of those whose employer is contributing into a defined-benefit scheme on their behalf said it was a 'major incentive' for them to stay where they are. This fell sharply to just 32% of those whose employer is paying into a defined-contribution scheme.
- The employer contribution is therefore vital in determining whether employees place any value on the company pension scheme. **64%** would be less likely to look for a job elsewhere if their employer 'increased' or 'started to make' contributions.

The ‘Aspiration ‘ Gap

Simply having access to a pension is a major spur to saving. People are more likely to say they plan to save more for the retirement where they already have access to a pension scheme – 36% compared with the overall average of 31% – and this figure increases further still where they are already making contributions into a pension (Table 2).

Table 2: Intentions to save more in 2008 by those with a pension

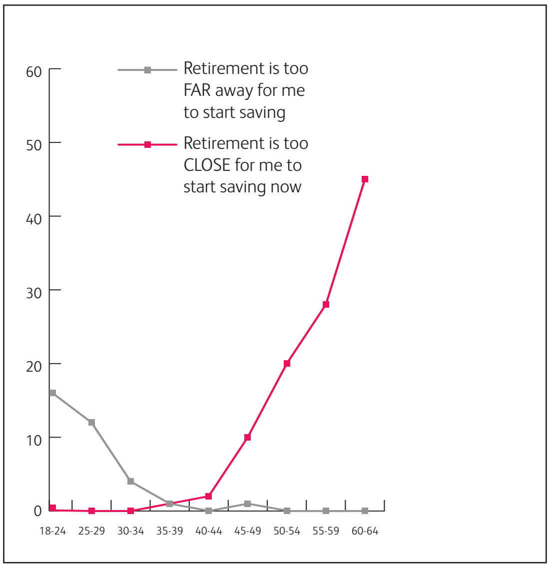
Intend to save more	
Overall	31%
Not currently making contributions	25%
Already contributing to a stakeholder	47%
Already contributing to a individual personal pension	45%
Already contributing to a defined-benefit scheme	41%

- **Looking back at our 2007 responses, half of young people aspired to save more, but only one-third actually did.** In 2008, again the age group most likely to say they will save more in the coming year is those aged 18-29 (48%), which increases to over half of those aged 18-24 saying they are likely to save more.
- **This reflects the fact that 42% of these people are confident that they can increase their earnings in the coming 12 months** – though this is down sharply from 53% in 2007, this age group is still most likely to feel able to save more in the coming year.
- **However, of those who said they would like to save more, 40% are focussing on the rainy day.** The types of savings likely to be amassed can, of course, be accessed well before retirement should a short-term financial need crop up.

Savings priorities of older people

- **Only 21% of those aged 60-64 felt that they would increase savings in the coming year.** Over half (53%) of the remainder said that they could not afford to save more.
- **32% thought that they were already too old** for additional savings to make a difference to their standard of living in retirement. In some cases ‘old age’ starts to become an obstacle to save for people who may be 15-20 years away from retirement (Chart 9).
- Generally speaking, age is less of an obstacle to saving during people’s thirties and early forties. However, as we know, this period also coincides with major life stages – all of which may act as alternative obstacles to long-term savings – such as getting married, buying a home and starting a family.

Chart 9: Age as an obstacle to save



Differing savings goals between men and women

- Of those likely to save more in the coming 12 months there is a clear gender gap in people's savings priorities. Women outpace men on short-term savings, while the trend reverses for long-term savings (Table 3).
- While men are more likely to cite additional earnings as a spur to save more (32% versus 25% for women) women are more likely to cite paying down debt as a spur (28% versus 23% for men).

Yet again this demonstrates that even where key groups of 'under-savers' are making some provision for their long-term, they are saving in ways which might not withstand short-term financial pressures leaving them exposed to the risk that they will be poorly prepared for their retirement.

Table 3: The gender gap on savings priorities

	Saving for a rainy day	Saving for retirement
Women	39%	28%
Men	33%	34%

Part 2: Easing into retirement: what will a flexible retirement mean in reality?

An area of increasing importance to industry, consumers and public policymakers, is creating a more flexible approach to retirement. Flexibility will come in various guises. But with flexibility comes choices – important choices which could make a huge difference to their wealth in retirement. All of which raises key issues for industry and public policy: how well do the consumers understand the choices facing them? And how can they be better prepared for them?

When and how to retire?

The Government is keen to foster a movement away from what has been called the 'cliff-edge' of retirement with a standard retirement age at 65, towards a more fluid transition into retirement in which people are selective in when and how they stop working.

- That will require some changes in employment practices, particularly with our findings revealing that **more people would like to consider part-time working as a stepping stone** from full-time employment to full-time retirement.
- Crucially, there has been **no major shift in people's willingness to work longer**. In fact, while phased retirement is very popular this is very much seen as an affordable alternative to early retirement. One-third of young people claim that they would like to enter semi-retirement at 50.

To better understand what is likely to happen to retirement age, we ask people to think about three different retirement ages: the age at which they would *like* to retire, the age at which they think they will be able to *afford* to retire, and the *maximum* retirement age beyond which they would not be willing to work.

1. Preferred age of retirement

The age at which people envisage retiring is **61** years. There are some clear discrepancies between what people envisage will happen and the extent to which they are planning for that outcome. For example, those with employers paying into a defined-benefit scheme expect to retire earlier at 60. This compares with just 62 amongst those with no savings. Given the very different degrees of pensions adequacy between these two groups it is safe to assume that the latter group of non-savers are likely to experience much more difficult choices at retirement involving the need either to keep on working beyond 62 or to accept a much lower replacement income in retirement than they had hoped for.

2. Affordable age of retirement

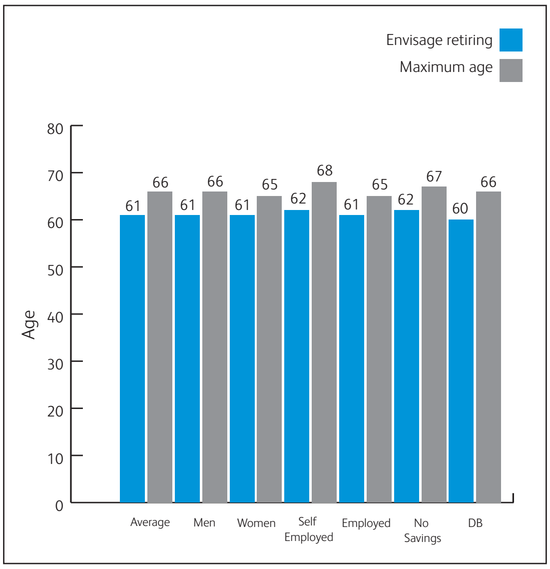
Most people think that they will be able to afford to retire at age **64**. Again, some groups are more realistic than others, with those aged 18-24 believing that 63 would be affordable, through to a more realistic assessment of 66 years for those aged 60-64. Yet again, there is no difference in expectations on what constitutes an 'affordable' retirement age between full-time and part-time workers, even though part-time workers build up smaller pensions pots and may well find that they don't have enough saved up to retire when they had envisaged.

However, there is a major difference between those with savings and those with none. People with over £50,000 in savings and investments think they'll be able to afford to retire at 62 years, which increases to 66 years for those with no savings at all. This four-year gap demonstrates that the non-savers are mentally striking a trade-off between saving less now, and working for longer in later life.

3. Maximum age of retirement

The maximum age beyond which people would be unwilling to work longer is **66** years. Self-employed (68 years) and older people nearing retirement (again 68 years) would be the only groups prepared to work until the Government's proposed state pensions age.

Chart 10: Envisaged age of retirement across different groups



Phasing retirement

69% would prefer to stage their retirement – moving from full-time to part-time employment rather than moving straight from working full-time to full retirement. It is a more popular option amongst those in the professions (**72%** of ABC1s) who may find the option of 'keeping their hand in' more attractive and more practical, than manual workers (**65%** of C2DEs) who may well have a less sanguine view of working into retirement in any shape or form. This is reflected when we looked at income levels with only **55%** of those with household income of up to £10k per year supporting the idea, compared with 75% of those with household income over £30k per year.

The notion of flexible retirement is also more popular with regular savers (**73%**) when compared with non-savers (**64%**). This rises to **76%** of regular savers earning £10-30k per year and falls to only **53%** of non-savers who earn £10-30k per year. Support is highest at **75%** amongst those who are actually saving in an individual personal pension or other defined contribution arrangement suggesting that there will be evermore demand for more flexible products at retirement.

- The age at which people would like to move into part-time work has fallen slightly since 2007 to 57% The age at which people would then like to stop working altogether is 63.
- Young people would like to move into part-time work aged 54 with nearly one-third (29%) of people aged 18-24 picking 50 as the age at which they would like to slow down.
- The ages at which people would like to move into part-time work and eventually full retirement are almost identical between savers and non-savers. Those making no provision whatsoever would like to semi-retire at 57 and enter full retirement at 63. Somehow, without the benefit of pensions savings, these people have the same expectations as those who are making some provision for their retirement (they would choose to semi-retire at 56 and enter full retirement at 63).

When and how to secure retirement income?

Currently, the UK requires all those with personal pensions to buy an annuity no later than age 75. The UK annuity market has tripled in size in the last 15 years with over 400,000 contracts purchased in 2007.[vi] The combination of an aging society with more people living into their retirement, and reforms such as personal accounts, which will see between 4 and 7 million additional people in the UK saving in a workplace pension,[vii] this market can only grow as the defined-contribution pensions market itself grows and matures.

However, to ensure consumer demand is maximised, it will also require a greater degree of product innovation offering people greater choice in how and when they turn their long-term savings into retirement income. But which product features will people want, and which ones will they need?

Annuities: Age 75 rule

In spite of calls for reform, there was limited appetite for introducing greater flexibility as to when people buy their annuity.

- **34% of our sample said that they would like the flexibility to delay buying their annuity beyond their 75th birthday.**
- There is no major shift in opinions when we looked specifically at those with defined contribution schemes (i.e. those who will actually be forced to buy an annuity at some point in the future).
- For most people it was considered more important to buy their annuity as soon as they retire so that they could benefit from a secure income stream straight away. This view was supported by 60% of people.
- Interestingly, this view was MORE popular lamongst those with large amounts of savings and investments (56% of those with over £50,000 already saved) than those people who have no other savings to fall back on (54% of those with no other savings and investments).

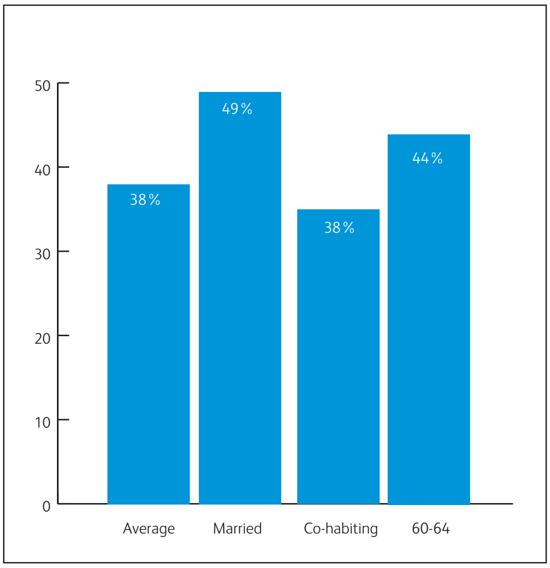
There is a high value placed on the need to secure their retirement income. In spite of increasing life expectancy there is relatively little demand to delay the purchase of an annuity. However, it is arguable that increasing the minimum age for starting pension to 55 (from April 2010) without any corresponding increase to the maximum age sends out the wrong signals about the need for many to work beyond 'normal' retirement ages. Current rules also restrict innovations that many people might find attractive in practice.

Providing for your spouse

Given that many women remain reliant on their husbands for their retirement income, and that women are likely to outlive their spouses, it might be expected that buying a joint life annuity would be seen as essential to people planning for their retirement. That is not the case.

- Overall, only 38% thought it was 'very important' that their pension pay out survivor benefits.
- Only **half (49%) of married people** thought that it was 'very important' that their pension continued to pay out benefits to their spouse in the event that they died first. Interestingly, this becomes even **less of a priority for co-habiting people (38%).**
- And it does not become that much more significant for those nearing retirement who are actually more likely to be thinking about which annuity to purchase. Only 44% of those aged 60-64 said survivors' benefits were 'very important'.
- **Nearly 1-in-5 married people (19%) either thought it was not important or that it didn't apply to them or they simply didn't know!**

Chart 11: Should one's annuity provide for their spouse



Combating inflation

Given the increasing length of time people spend in retirement it may be important to protect income against increasing prices. Pensioner households can feel the impact of inflation more than others as more of their income is likely to be fixed over time.

- Yet only 42% said that inflation proofing was 'very important'
- This fell to just over one-third (36%) of those on the lowest incomes (up to £10k pa) who are least capable of withstanding periods of larger increases in the cost of living.

Again, the need to protect one's retirement income against inflation can be addressed through annuity purchase. With industry figures suggesting that 87% of people currently purchase a level annuity [viii] – which does not increase in value with prices over time – many people could be seeing their incomes eroded by inflation in retirement.

Inheritance

Differing levels of importance are placed on being able to pass on wealth to one's children.

- In all half (49%) said that it was fairly or very important to them to pass on wealth to their children.
- However, the bequest motive becomes less important as people get older – probably as they realise that they might need any assets to fund their retirement – only 46% of those over 50 said it was important to them to pass on wealth which increased to 56% of those under 30.

There is limited consumer demand for pension products which enable greater inter-generational transfers of wealth. While there clearly is a desire amongst some people to leave a nest egg to their children, this desire falls amongst those people who are nearing retirement. In any event, most people simply will not enter retirement with large amounts to bequeath to the next generation.

Exercising the 'Open Market Option' – shopping for the best annuity deals

The 'open market option' allows consumers to shop around the market for the best annuity deals. Most people – **70%** – said that it was "fairly" or "very important" that they would be able to take advice and shop around for the best annuity rather than just stick with their current pension provider.

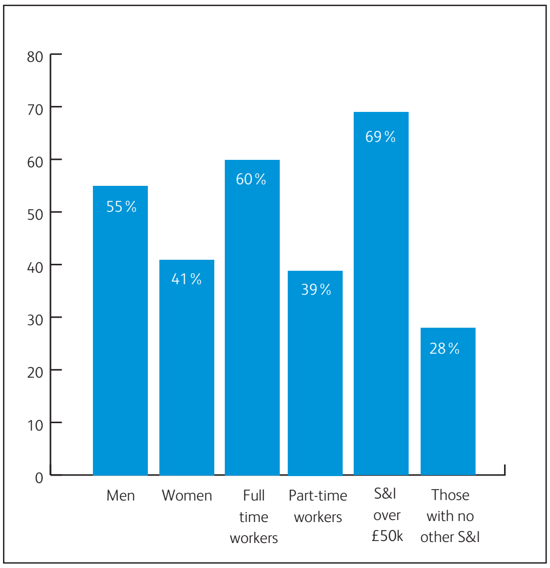
Since 2002 the Financial Services Authority (FSA) has required pensions providers to inform customers of their right to shop around. However, with industry figures suggesting that two-thirds of people choose the 'internal' annuity option, i.e. they stay with their existing provider, there is clearly some way to go in promoting greater competition. Of course, staying with one's current provider may well be in the consumer's best interest: half of those who stay put did in fact shop around. As a recent ABI report claims "the figures for those buying internally (from their existing provider) should not be interpreted as those who could have obtained a better rate using OMO. They also include those with funds which are too small to exercise OMO, and those who obtained a rate internally that is either the same as or above the highest OMO rate" [ix] Nonetheless, more support and information for consumers in this area would prove helpful.

Taking a tax-free cash lump sum

There is demand for greater product flexibility in retirement products, but it is concentrated amongst those who think they will be able to afford it. Flexibility only applies where you have the money to make those choices. The need to generate income may be a greater financial priority for low-income households than simply taking the cash. Where low-income households would take a cash lump-sum it is quite telling what they would use it for: paying down debt.

- Awareness of the tax-free lump sum available at retirement is limited. Only 61% of those with private pension arrangements expected to receive a lump sum, while 29% did not and 10% did not know. In practice a large majority of those retiring take the lump sum.
- Amongst those approaching their retirement the need for flexibility is considered even more important.

Chart 12: Those who aspire to take tax-free lump sums from their pension pots



The most common reasons for tapping into the pension pot demonstrate a wide range of motives.

- 36% would re-invest the cash somewhere else.
- 37% would use it to increase retirement income.
- 17% would pay off the mortgage.
- 19% would pay off other debts.

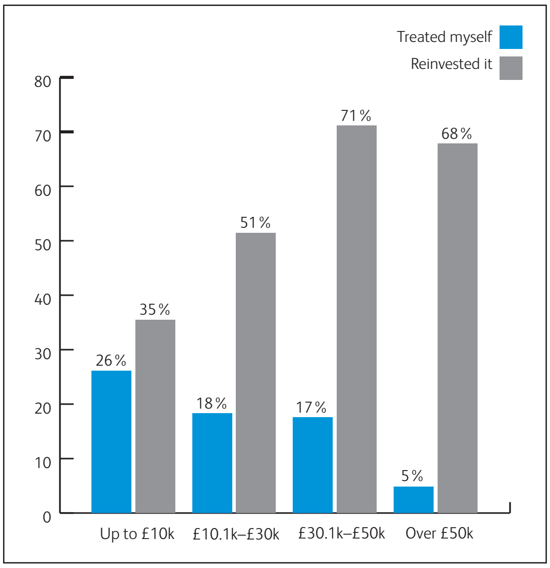
People with other savings and investments are likely to have long-term motives.

- **56% of those with over £50,000 of other savings would re-invest any tax-free lump sums.**

People with no other savings and investments are drawn to short-term objectives.

- **52% of those with no other savings and investments would spend any cash lump sums on paying down debt.**

Chart 13: How did you use your tax-free cash lump sum



Taking tax-free cash is clearly popular. However, the motives for taking the money change greatly depending on the individual. Reinvesting the money, whilst being the prudent option, appears to be a luxury for the well-off. There is strong evidence to suggest that for people with low-incomes or no other savings and investments it is being used as a means of paying off debts built up during their working lives, rather than helping to generate income in retirement.

Supporting people to exercise personal responsibility?

What the previous findings illustrate clearly is that the individual is faced with stark choices. As the UK undergoes a massive 'risk transfer' from the state and employers onto the individual, it will be increasingly left to the individual not only to make greater provision for themselves – in the form of greater levels of personal savings – but also to make decisions for themselves about how best to use those savings to meet their financial objectives. Picking the right products at the right times are complicated decisions requiring some degree of guidance and advice.

There is currently an 'advice gap' across all ages, including those making decisions in later adult life. Reforms to promote new forms of guidance – such as the proposed national Money Guidance scheme (discussed in Part 5) – will provide a useful first-stop shop. However, regulated forms of financial advice will need to pay greater attention to the needs of the increasing market of retired investors and of the products best suited to meet their needs – whether it be in the form of annuities, income drawdown products or equity release. This will ultimately lead to more suitable product choices being made, enabling consumers to boost retirement incomes and benefit from wider access to new and innovative retirement products.

Part 3: Personal accounts – will they hit the target?

With the Government steering important pension reforms through Parliament, in the current Pensions Bill, the major aspect of those reforms will be the introduction of the new personal accounts from 2012. Since we last reported in 2007, the Government has now created the Personal Accounts Delivery Authority, or PADA, to ensure that the new schemes are designed in such a way as to increase the overall level of pensions savings in the UK, and that those schemes should be specifically targeted at those people who do not currently enjoy access to pensions savings.

Overcoming inertia

With the benefit of auto-enrolling all workers over the age of 22 into the new scheme, the personal accounts could well play an important role in breaking the cycle of inertia. The second most common reason for not saving in a private pension, cited by 15% or our respondents, was "I have never thought about it seriously".

Furthermore, we found that the average non-saver does not expect to start saving within the next five years. Indeed, 44% of those not currently saving in a pension said that they expect they will never start saving. There is strong evidence to suggest that it is much more difficult to change the behaviour of a non-saver the closer they get to retirement.

The decision to delay pensions savings by twenty or thirty years hardens the individual's resolve to ever start saving. In other words, non-saving is habit forming, which vindicates the government's decision to break that habit by targeting personal accounts on younger workers, with auto-enrolment kicking in at age 22.

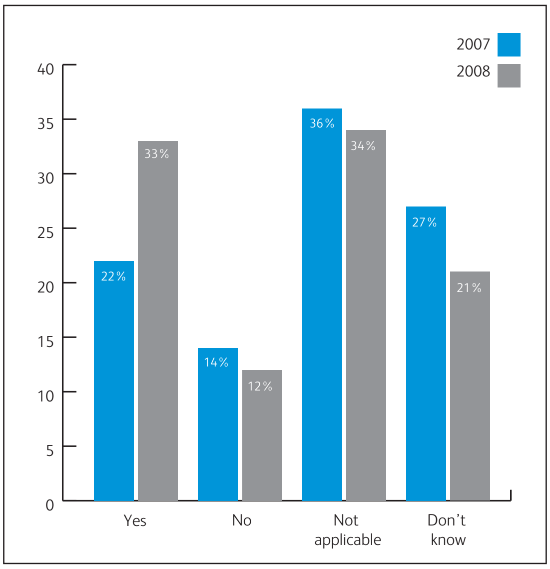
Table 4: When will non-savers start to save in a pension?

Non-Savers: When will you start saving?	Never
18 – 29 year olds	9%
30 – 50 year olds	40%
Over 50 year olds	83%

Encouraging new savers?

The last 12 months has seen a large shift in the number of people who think they will save in personal accounts post-2012 with 33% saying that they would remain opted-in. This is up from 22% in 2007. This shift has been driven in large part by a reduction in the number of 'don't knows' with more people being unsure in 2007.

Chart 14: Likely take up rates under personal accounts



Women are slightly more likely to stay in the scheme (35%) So too are younger workers, with nearly half (45%) of those under the age of 30 saying they would choose to have a personal account. Take up will also be slightly higher amongst part-time workers (36%) and those with young families (41%). 33% of self-employed people said they would opt-in. Whereas in 2007, 36% of women under 30 said they would remain opted-in to the scheme, today that figure stands at 46%.

Preventing negative contagion: Hitting the target?

The primary objective of personal accounts will be to get Britons saving more, i.e. through encouraging non-savers to 'level up' to the proposed minimum total contribution of 8% of annual salary.

There is also an important secondary objective of not disturbing existing pension provision, with considerable efforts being made to identify and limit possible negative impacts, i.e. preventing existing savers from "levelling down" where people are already saving more than 8% of their annual salary.

Preventing 'levelling down' of existing pensions savings

Measures to prevent negative contagion effects

- Bans on transfers in or out of the new personal accounts for at least 5 years;
- Limiting the amount of qualifying earnings and placing an annual cap on contributions into the scheme set at £3,600 in 2005 earnings terms; and,
- Exempting employers offering good quality workplace pensions which at least match personal account contribution rates from having to offer workers the new scheme.

While take up will be much higher amongst those with no pension (45%) and those who are not currently contributing into their pension (41%) our findings show that there remains some cause for concern as to whether personal accounts will hit their target market, and whether they will generate new savings:

- A large minority – nearly **one-third** of those currently contributing into stakeholder scheme and 28% of those saving in an individual personal pension – believe that they will remain in personal accounts;
- **32%** of regular savers said that they would save into a personal account. This is equal to the **33%** of non-savers who said that they would remain opted-in;
- Meanwhile, nearly **one-in-five** people who currently classify themselves as non-savers believe that they will opt-out of the new scheme when it arrives; and,
- The groups most likely not to join include the self-employed (18%) and those on low incomes (17% of those earning less than £10,000 per year).

Part 4: Addressing the barriers to save

Ultimately, the success of personal accounts will come down to how, or whether, they are able to overcome persistent barriers to save in reaching those key groups of non-savers.

In previous years, the Scottish Widows Pensions Report has highlighted how certain groups within the target market for personal accounts could fall outside those who ‘could and should’ be saving. This included, most notably;

- those in early adult years that might fall into the ‘could not’ group, given the likely problems they might face with affordability to save;
- women over the age of 50 with no existing savings, who, in many cases may be unlikely to save enough in their personal account to pull themselves clear of means-testing.

Pays-to-save and the impact of means tests

Given the possibility of people on low-incomes being auto-enrolled into personal accounts and subsequently caught by the means test trap, the pays-to-save debate has risen up the political agenda. What perceptions do people currently have about means tests and whether they present an obstacle to long-term savings?

- Only **27%** said that they or friends and family had been affected by means tests;
- Amongst those in retirement this rose to 46% and peaked at **53%** of those aged 65-69;
- The age group most likely to be put off saving as a result of means testing was those aged 40-49 of whom 39% thought means tests were a potential disincentive to save.
- **One third (34%)** of those with no savings and investments said that means tests had an impact on their non-saving status.

Perceptions of means testing as a widespread obstacle to save were not borne out by our findings with only 13% of those aged 18-29 being aware of people they knew receiving means tests. Yet means testing could have a big impact on the way people save for retirement.

A majority of young people – **60%** – said that the potential for means testing would change the way they saved for retirement. However, young people are split on how they should respond:

- **1-in-4 people** (21%) said that they would ‘definitely’ or ‘probably’ save **LESS** for their retirement. A further 15% thought it a possibility.
- Meanwhile, more than **1-in-6 people** (18%) aged under 30 thought it likely that they would end up saving **MORE** in order to pull themselves clear of means testing in retirement.

Affordability as an obstacle amongst personal accounts target savers.

Overall, **54%** said they do have any spare money to save for retirement. The figure jumps to **61%** for those with children; which compared with **50%** of those with no children. As for the likely success of the new personal accounts, people in this target market – those earning less than £30,000 per year – are also likely to struggle, with **61%** of those earning between £10,000-30,000 saying they don’t have spare money to save in a pension. Income is the major factor in determining affordability, and has become more of an issue for those on middle incomes during 2007.

Table 5: Impact of affordability by income group

	Household	Personal
Up to £10k	81% (-5% on 2007)	78% (-2%)
£10 – 30k	70% (-1%)	66% (+1%)
£30 – 50k	60% (+6%)	47% (+6%)
£50k+	46% (+4%)	29% (+1%)

- Affordability has receded as an obstacle for lower income earners (compared with 2007) while it has become a more important concern for those on higher incomes.
- Amongst those with high incomes the most common reason for not saving more is that they already save enough (41%).

Problems with affordability may well help to explain the low levels of envisaged contribution rates. People envisage that their average contributions will be as low as £33 per month. This is almost unchanged on the 2007 figure of £32 per month. As we reported then, this falls well short of the 4% of annual salary that people would be required to save as a minimum under the personal accounts. This equates to around £70 per month for a worker earning the national average income,[x] twice the £33 per month envisaged. When people come to realise how large the shortfall is it may result in some people choosing to opt-out and save nothing at all.

Furthermore, the amounts people intend to save in personal accounts reveals that those groups who are already more likely to be saving in a pension will stand to benefit most.

- Men would want to save much more than women, £42 per month compared with £26 per month;
- This gender gap increases amongst young savers with men under 30 planning to save £41 per month and women under 30 planning to save just £24 per month.
- Those with children and part-time workers will also be financially stretched by personal accounts.

Table 6: Impact of children

	Personal Account Contribution
People with no children	£36 per month
People with children over 18	£36 per month
People with children aged 5-18	£31 per month
People with children aged 0-5	£24 per month

Table 7: Impact of working status

	Personal Account Contribution
People in full-time work	£41 per month
People in part-time work	£20 per month

Phasing it in: concerns about affordability are not limited to employers

Given the concerns about affordability, the Government's decision to phase-in the introduction of personal accounts has been broadly welcomed, particularly by employers groups concerned about the cost implications of moving immediately to an 8% minimum contribution. Under the government's revised plans employers and employees will now only contribute 1% each in the first year.

Phasing in personal accounts contributions

Those who prefer to **build up to 4% over three years**

- **42%** of our respondents shared the concerns of employers in thinking that phasing the scheme would be positive in helping to spread the cost of making additional pension contributions.
- Personal accounts target savers are more likely to support phasing in with support increasing to **47%** of non-savers and **55%** of those on low incomes (those with household incomes up to £10k per year).

Those who prefer to **pay 4% from day one**

- **Over one-third (35%)** said that they would rather pay the full amount from day one.
- This option was more popular amongst regular savers and those on higher incomes.

Those who prefer to pay in **more than 4% from day one**

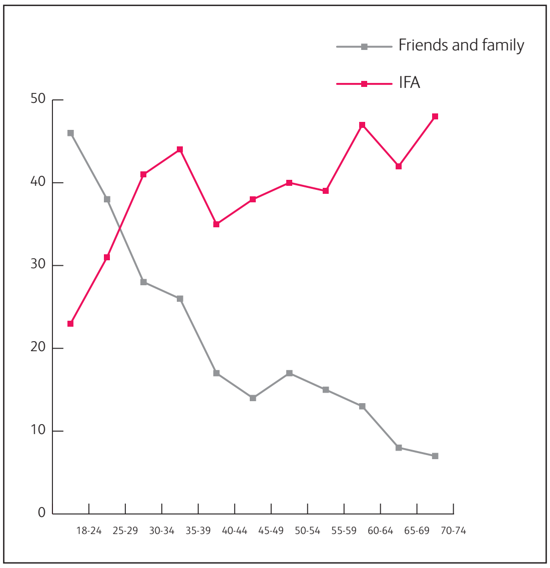
- A small minority (14%) said that they would rather pay more from day one.
- Again, this is more popular with those who are already saving (16% compared to 11% of non-savers); and those on middle to higher incomes (18%).

Part 5: Money Guidance: filling the gap in the advice market

Personal accounts will shine the spotlight on the need for greater access to retirement planning tools and advice. The government has signalled the creation of a new Money Guidance service to help people plan ahead. But where do people go for trusted pensions advice and how will Money Guidance fit into existing advice services?

At present, Independent Financial Advisers (IFAs) remain the single most trusted source of pension advice for 37%. Notably, IFAs are preferred more by older savers, while friends and family are a preferred source of information for young people.

Chart 15: Trusted source of pensions advice by age group



It could be that as people get older, they learn to trust the professionals more. Or simply, that they acquire the financial means to afford professional advice. Either way, it seems that as people get older, they also rely on their families less.

Only **16%** saw their employer as a source of pensions guidance. However, this doubled to **33%** where the employer is making contributions into a defined-benefit pension scheme. Compared to employers and friends and family, the pensions industry itself came out favourably with one-quarter of respondents **(25%)** seeing pension providers as a trusted source of advice. This is up on 2007. Meanwhile, trust in the Government is relatively low at **9%** and has fallen since 2007.

While many people clearly do trust some sources of advice, it is clear that **a large minority do not know who to trust or where to go for guidance**. When we asked where people where they go to get information and guidance about pensions, there was a definite gap in the market. **The pensions 'advice gap' is greatest in those households with lowest incomes, which illustrates the need for a 'Money Guidance' service.**

Table 8: The pensions advice 'gap' by income groups

Don't know where to go (by income levels)	
Up to £10k per year	22%
£10k – £30k per year	13%
£30 – £50k per year	8%

Money Guidance

Only 34% thought that it was likely or very likely that they would use the new service. However, even with the scheme at a very early stage, and general awareness levels very low, it was promising that the popularity of the service (and therefore likely levels of demand) rises amongst some key elements of the target audience.

- 50% of those aged under 30 said it was likely that they would use the scheme. This rises further still amongst young women at 52%.
- Those with families are also more likely to use the service. 38% of those with children thought that they would use money guidance, compared with 32% of those without children. Those with young children are even more likely to use it at 45% of those with children under 5.
- Those on lower incomes seem more sceptical with only 35% of those in households with income between £10,000-30,000 likely to use the scheme. This rose to 43% amongst those with household income between £30,000-50,000.
- Equally, the service seems to be more popular amongst regular savers of which 39% said that they would use the service, compared to 27% of non-savers.

Accessing the new scheme

- **Online access:** Far and away the most popular channel with 88% saying that they would be happy to access Money Guidance online. This increased to 92% of those under the age of 30. Surprisingly this channel remains very popular amongst older people too – the so-called 'silver surfer' generation – with 82% of those over 50 preferring online access.
- **Access from home:** Channels which can be accessed from the home are more popular amongst those with children – for example, 33% those with two children said they preferred to use the telephone while 91% would use the Internet. 31% of those on long-term sick leave would also prefer the telephone.
- **Access from work:** Interest amongst employees was low with only a limited role seen for employers. Only **12%** say they would prefer access through a workplace seminar.

Funding the new scheme

When asked who should pay for the service, **74%** said it was for the Government to fund. The second most popular option was the financial services industry on **36%**. 1-in-5 thought employers should pay for it while 1-in-10 thought it should be funded by the end-user.

Table 9: Money Guidance: preferred delivery channels

Income groups	Preferred channel
High-income households (earning over £50,000 pa)	**More likely to favour…** • **The Internet (95%)** • **Telephone (38%)**
Low-income households (earning up to £10,000 pa)	**More likely to favour…** • **The post (39%)** • **Face-to-face (44%)**

Part 6: Conclusions and recommendations

Pensions Index

Preparing for greater personal responsibility

With 49% of Britons still experiencing a shortfall in their retirement planning it is critical that people heed the message to save more for their retirement. The concept of locking away your savings for the long-term is clearly still popular. Indeed, following the increase in pensions adequacy in the last two years, it seems the age of voluntary pensions savings is far from being in terminal decline. It is perhaps more accurate to state a view in which responsibility is being shifted from institutions to individuals and that individuals need to be properly prepared to make the most of that new-found responsibility.

Encouraging a long-term view

Clearly, post-credit crunch there is a danger that people choose to over-rely on 'leaky' short-term savings. Using short-term savings products to meet retirement needs may also see consumers lose out over the long-term on the generous of tax relief on pensions products. People still need to be educated on striking the right balance on short-term and long-term savings.

Encouraging flexible retirement and the need to retire later

Educate people on the need to work longer

'Phased retirement' seems to be the new 'early retirement'. Today, the fastest growing group in the UK labour market is men and women working past their traditional retirement age, with close to 9% increase in "older workers" between 2007 and 2008. But despite the growth in people working into their late years, there remains a mismatch. Rather than giving up work in their late 50s, as was the trend in the 1980s and 1990s, today people expect to give up working full time during their 50s. Here there is a disparity between what kind of retirement people want and what kind of retirement the Government thinks is affordable.

The Government will therefore need to raise awareness of how retirement ages are set to **increase** and what that will mean for people's expectations of retirement and their overall retirement planning needs.

Flexibility in the workplace

Flexibility in choosing when to enter retirement will require some changes in employment practices. Wider access to flexible working hours for those nearing retirement will be critical. Some occupational schemes still apply an upper age limit at which the individual must retire. There may also be more subtle obstacles arising from the type of occupational pension provision in place. For those in defined-benefit schemes where the level of their pension is related to their final salary or calculated on a career average the employee is motivated to maximise their income towards the end of their career. The prospect of changing one's hours or working conditions, or taking a pay cut, may impact negatively on the level of pension benefits they ultimately receive. People may also require new skills in order to achieve their aspiration to extend their working lives at a time when, in spite of the Government's Lifelong Learning agenda, access to vocational training for those over the age of 50 is still highly limited.

Flexible retirement products

There is a clear need for more market-led innovations to create flexible financial products to help people with retirement planning, and enjoy greater flexibility over how people make use of their retirement funds. The ability to take up to 25% of one's pension fund in the form of a tax-free cash lump sum has proved highly popular. Products such as income drawdown and equity release will also become a more common feature of the retirement planning market. Obstacles to consumer take up – such as lack of awareness about products – need to be addressed by the industry.

Greater access to at-retirement planning and guidance

Our findings showed that large numbers of married people are buying an annuity based on providing for one, rather than two. Faced with greater personal responsibility, flexibility and ever more choices to make, it is also clear that older workers already need much greater access to all forms of at retirement planning and guidance. This need will grow over time. Whether this need is met through the proposed national scheme for **Money Guidance** or other existing voluntary guidance and educational services, such as those provided by organisations like the **Citizens Advice Bureau** or the **Life Academy**, people need sources of trusted information to help them plan ahead.

New skills challenges for financial advisers

For IFAs, our survey's most trusted source of pensions advice, there will clearly be challenges. Given the complexity of the products involved – tax and benefits, inheritance and probate issues – it is clear that many financial advisers will need to consider how they develop their own skills, by exploring developments such as the **Financial Services Skills Council's** recently launched Later Life Adviser scheme, to become more attuned to the needs to those clients making financial planning decisions at or in retirement.

Personal Accounts

Ensuring a properly targeted approach

Industry needs to work closely with the Department for Work and pensions (DWP) and Parliament in the short-term to ensure that the current Pensions Bill provides legislation which is balanced between the interests of creating personal accounts with the interests of the existing pensions market. The industry also needs to work closely with PADA over the coming years to ensure that personal accounts are truly complementary, and don't act in competition with, existing pension provision. To achieve this end, personal accounts will need to be designed to ensure that they address the particular problem of under-provision amongst the target groups of savers.

Overcoming obstacles to take up

We highlight some persistent obstacles to save – chiefly affordability – which may undermine the successful take up of personal accounts when they are launched. While all forms of private savings face the same difficulties we recognise that personal accounts may be beneficial in helping to make pension savings affordable for those on the margins through introducing the contingent employer contribution. Equally, the use of 'soft compulsion' may help to smoke out some of those who claim affordability to be an issue, whereas in fact it may simply be inertia. We call on PADA to look in more detail at how widespread the issue of affordability will be in preventing take up, particularly amongst the target groups of savers.

A national communications plan to support the roll-out of personal accounts

Alongside this there needs to be a major consumer education campaign by the Government to communicate to the public at large what the perceived benefits of personal accounts will be, and to do so within the context of the benefits already being provided by the existing pensions market. Equally, the Government needs to dedicate major resources to promoting the Money Guidance service so that the target market there also fully understands the benefits of the scheme.

Interaction between private savings and State benefits

Ensuring that it pays to save

There is a clear overlap between the target personal accounts saver and the likely recipient of means tested benefits, including Pensions Credit, Housing Benefit and Council Tax Benefit. The lack of attention paid to these other forms of means tested benefits leaves the 'pays-to-save' debate wide open. The DWP has argued strenuously that people should not be put off saving today on the basis of their concerns about how wide-spread means tested benefits may be in 30 to 40 years time. This is an entirely sensible approach to take. However, with over half (59%) of those respondents under the age of 30 claiming that means tests affect their decision to save, this message is **not** getting through. The Government needs to communicate clearly how its reforms will impact on means testing and demonstrate clearly that the benefits system does not undermine the incentive to save.

Appendix A: The Pensions Index and the Average Savings Ratio

Calculation of the Pensions Index

The Scottish Widows Pensions Index is a snapshot of how well employed and self-employed people in the UK are currently preparing financially for retirement. It is based on those who are of an age – between 30 and state pension age – and an income level – £10,000 or more a year – where they could reasonably be expected to be saving for their old age. The target retirement income is one that will leave most people feeling they are in an acceptable financial position, but which is likely to involve a sacrifice in living standard compared with when they were working.

The level of retirement income which consumers are likely to feel is acceptable will depend largely on their income while working. However, the proportion required is likely to be higher for lower earners than for those who are relatively well-off, and that is reflected in our assumptions. We have set the replacement rate at about 90% of pre-retirement income for those earning £10,000 a year, reducing to 40% for those earning £50,000 a year.

We have built in what individuals might expect to receive in state pensions, taking into account the changes planned for 2010 and 2012. We have assumed that individuals will receive the Basic State Pension in full, and 70% of the maximum State Second Pension based on their earnings.

For private pensions, we have assumed an investment return before retirement (net of charges) of 2.5% a year above earnings inflation, and have based the cost of buying a pension annuity at retirement on the assumptions developed by the actuarial profession for statutory money purchase illustrations (SMPI).

Combining all these assumptions, a contribution of 12% of gross earnings paid continuously from age 30 to age 65 provides around the target income level for most people. As in previous years, we have assumed that anyone saving 12% or more of personal income for retirement is adequately provided for.

Those with defined-benefit pensions need to be considered separately, because there is no direct relationship between contribution levels for individuals and the pension provided. Good defined-benefit pension remain the 'gold standard' of pension provision, and in calculating the Index we have assumed that all those who expect to receive most retirement income from a defined-benefit pension are adequately provided for.

The Scottish Widows Pensions Index therefore tracks the percentage of those aged between 30 and 64 (30 and 59 for women) and earning £10,000 or more a year who are either relying mainly on a defined-benefit pension or saving at least 12% of earnings for their retirement (including any pension contribution by their employer).

The Scottish Widows Average Savings Ratio is the average percentage of earnings being saved for retirement by those in the Index group, but excluding those relying mainly on a defined-benefit pension.

Savings that are included

While pension arrangements remain the most common and most tax-efficient method of saving for retirement, many people use alternative savings vehicles such as ISAs, perhaps with a view towards moving funds into pension closer to retirement.

In calculating the Pensions Index and the Average Savings Ratio, we have taken account of all savings specifically intended to contribute towards retirement income. These comprise company and employee contributions to employer-sponsored pensions, individual contributions to personal and stakeholder pensions and non-pension savings. We have not included non-financial assets such as residential property.

Groups that are tracked

While we are able to track preparation for retirement against many different criteria, there are three key differentiators that we monitor every year:

Gender: Women have always lagged behind men in pension provision, and we measure whether the gap is growing or shrinking.

Age: We divide the index between those aged 30 to 50, who are generally some distance from retirement, and those aged 51 to 64, who are approaching retirement.

Earnings: We monitor three bands to see the effect of earnings level on retirement preparation – £10,000-£29,999, £30,000-£49,999 and £50,000 and over.

Changes to methodology

There was one significant change to this year's survey that will affect the Index and Ratio in future years.

In previous years, we have asked respondents to indicate amounts saved in bands. For example, one band might be for savings of between £76 and £100 a month. For the first time this year, we asked respondents to input an actual amount. This should give a more accurate picture. However, it had two effects:

1. The percentage of people responding "Don't know" increased. For example, of the group used to calculate the Savings Ratio, 29% answered "Don't know" on their non-pension savings, compared with just 6% last year. We have assumed that those who don't know how much they are putting aside are saving the average amount, but where this group is large there is a possibility that it could affect the outcome.
2. In previous years we have assumed that everyone in each band saved the average amount for the band. So, for example, we assumed that those saving between £76 and £100 a month were saving, on average, £88. In fact, in this year's survey where we asked for amounts the average was almost £99. While this was an extreme case, all averages were above those assumed last year, possibly because people tend to input a round figure when estimating savings, and the round figures tend to be at the top of the bands. In addition, for those saving more than our highest band, which went up to £1,500 a month, we assumed average savings of £2,000 a month last year, whereas the average this year was actually £2,432 a month.

Because the year-on-year comparison is more significant than the absolute level of the Index and Ratio, we have calculated both on the same basis as last year, using the mid-point of each band. If we use the more accurate information now available, the Pensions Index would increase from 51% to 57%, and the Average Savings Ratio would increase from 8.7% to 9.6%. From 2009, we will revise the calculation basis so that we use the actual amounts, with 2008 then setting the benchmark.

Comparison with Personal Accounts

There are key differences between our assumptions and the proposed minimum contribution rate for personal accounts:

- We have assumed that only those over age 30 are likely to save seriously for their retirement, whereas auto-enrolment into personal accounts will start at age 22.
- We have assumed that only those earning over £10,000 a year are likely to be able to afford to save significant amounts, whereas auto-enrolment into personal accounts will be for everyone earning over £5,000 a year.
- We have assumed a contribution rate of 12%, whereas the minimum for personal accounts is 8%.
- We have applied the contribution rate to total earnings, whereas for personal accounts it only applies to earnings over £5,000 a year.

The effect of this is that our assumption leads to higher retirement income at all earnings levels above £10,000 a year. For personal accounts, the approximate replacement rate is 75% of pre-retirement earnings at £10,000 a year falling to 30% at £50,000 a year. These levels are appropriate for personal accounts if we assume that higher earners will generally take action themselves to ensure they are adequately provided for, but for the purpose of the Pensions Index we believe it is right to target a higher replacement rate.

Footnotes

i	Financial Risk Outlook – FSA, 2008, p.32
ii	Financial Risk Outlook – FSA, 2008, p.30
iii	UK Consumer Price Inflation, Bank of England – March 2008, p.7
iv	The Office of National Statistics – CPI: Detailed figures for 15 April 2008
v	Lipper Feri Report – UK Fund Sales Report – May 2008, p.1
vi	ABI Research Paper No. 8 – Pension Annuities – May 2008, p.1&2
vii	Pensions Bill Impact Assessment – DWP, 2008, p.22
viii	ABI Research Paper No. 8 – Pensions Annuities – May 2008, p.15
ix	ABI Research Paper No.8 – Pensions Annuities – May 2008, p.13
x	The Office of National Statistics – Annual Survey of Hours & Earnings November 2007

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