

How much should your clients start saving now? EBRI knows

By Editorial Staff Fri, Mar 27, 2015

The traditional 'replacement rate' method of gauging retirement savings adequacy ignores the risk of outliving one's savings, post-retirement investment risk, and nursing home costs, according to the Employee Benefits Research Institute.

New research from the Employee Benefit Research Institute (EBRI) tells workers how much they need to have saved for retirement at different ages and how much, at a given age and income level, they should contribute to their defined contribution plans to achieve financially successful retirements.

The EBRI analysis presents the required contribution rates for those starting to save at ages 25, 40, or 55. It also presents the minimum account balances required for those contributing to their plans at 4.5%, 9%, and 15% of salary, and shows how much they should have saved at a particular age threshold to be “on track” for a successful retirement. For instance, the EBRI found the following savings rates and probability of success for people starting with zero savings:

- For a 25-year-old single male earning \$40,000 a year, with a total (employee and employer combined) contribution rate of 3% of his salary until age 65 would result in a 50/50 chance of retirement income adequacy.
- By saving 6.4% of salary, he would boost his chances of success to 75%. Women that age would need more because of their longer average life expectancies.
- A 40-year-old male earning \$40,000 would need a total contribution rate of 6.5% of salary to have a 50/50 shot at a financially successful retirement. Saving 16.5% of salary would produce a 75% chance of success.
- A 55-year-old male making \$40,000 would need to save 24.5% of his salary each year to have a 50/50 chance of a successful retirement.

EBRI also estimated how much a worker should have saved by a particular age for a successful retirement, depending on salary, contribution amounts, and desired odds of success. The analysis yielded the following answers for a single male age 40 contributing 9% of salary each year:

- At a salary of \$20,000 a year, he would need to have already saved \$14,619 for a 50% chance of retirement success.
- At a salary of \$40,000 a year, he'd need a minimum balance of \$47,493 in savings for a 75% chance of success.
- At a salary of \$65,000 a year, he'd need \$4,616 of pre-existing savings for a 90% chance of success.

For those who are younger and have higher savings rates, the required pre-existing savings level goes down, EBRI noted.

“This analysis answers two key questions: How much do I need to save each year for a ‘successful’ retirement? How large do I need my account balance to be after saving for several years to be ‘on-track’ for a successful retirement given my future contribution rate?” said EBRI research director Jack VanDerhei, the report’s author, in a release.

These questions cannot be answered by the commonly used “replacement rate” planning tool, which uses a percentage of income as an optimal savings goal. The replacement rate method ignores the risk of outliving one’s savings (longevity risk), post-retirement investment risk, and nursing home costs. The RSPM model includes those factors in its simulations.

EBRI used its proprietary Retirement Security Projection Model to calculate the savings amounts needed at different contribution rates, salary levels, and ages for both genders, for a successful retirement. EBRI measured success in retirement by the probability of not running out of money to cover average expenses and uninsured health care costs.

For simplification, the modeling excludes net home equity and traditional pension income. It does not factor in pre-retirement leakages or periods of non-participation.

The full report, “How Much Needs to be Saved For Retirement After Factoring in Post-Retirement Risks: Evidence from the EBRI Retirement Security Projection Model,” is published in the March 2015 *EBRI Notes*, online at www.ebri.org.

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