BMO Wealth Institute™

/Report
CANADIAN EDITION

Saving for retirement: One size does not fit all

The BMO Wealth Institute provides insights and strategies around wealth planning and financial decisions to better prepare you for a confident financial future.

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When it comes to retirement savings, theories, assumptions, and rules of thumb abound. How much money you will need really depends on your personal circumstances and the kind of retirement lifestyle you want. There is no one-size-fits-all solution and common retirement savings theories should be carefully reviewed.

Once you know what you are saving for, there are two key components to a successful retirement: save diligently and review your plan often. Saving diligently for retirement, despite all your expected and unexpected expenses can really add up in the end. Both your circumstances and your view of an ideal retirement can change and that will affect how much you will need. Your plan should be adjusted accordingly.

The case for saving

Canadians are living longer.[1] Five- to ten-year retirements experienced by previous generations are a thing of the past. Now your savings might have to last 25 to 30 years. In addition, the cost of long-term care, should it become necessary, can have a major impact on your retirement savings especially since government subsidies do not cover 100 per cent of the costs. Moreover, when the cost of living goes up but your income does not, your purchasing power declines and the longer you live off your retirement income, the more inflation will deplete the size of your savings.

Depending on your desired retirement lifestyle, government pensions might not be enough to see you through your retirement. On the other hand, while a company pension can help, not everyone is fortunate to have one in place and not all pensions provide the same level of income during retirement.

Women, in particular, need to be conscientious savers.[2] They tend to become the designated caregivers for parents and, eventually, spouses. There could be additional strain on income should expenses suddenly go up because of the need to hire professional caregivers, get housekeeping help or shoulder the cost of assisted living residences or nursing homes if loved ones can no longer live at home. Moreover, women will likely outlive their spouse and could, therefore find their total retirement income from pensions reduced after the death of a spouse.

Regardless of the fact that life can make it very challenging to save regularly for the future, there are many reasons why it is so important to make your retirement a priority. It is prudent to supplement your retirement income with your own savings. Over the years, many different theories and assumptions have been suggested to help individuals understand how much they need to save for retirement. But because everyone's situation is different, using these theories and assumptions can result in either under or over-estimating your retirement needs.

Rethinking these six theories could change your retirement planning

Digesting the vast amount of information available on retirement planning can be time consuming and confusing. It can also very easily lead you to leap to the wrong conclusion. Here are some of the most common theories that require careful consideration:

"I will have enough with the Canada Pension Plan / Quebec Pension Plan and Old Age Security payments from the government."

Previous generations believed that "the government will take care of me"; however, depending on the lifestyle you have in mind, it may not be enough. In fact, these days CPP/QPP and OAS will pay a maximum of approximately $17,400 a year for a 65-year-old ($34,800 for a couple). That is just $1,450 a month ($2,900 for a couple) to cover your rent (or mortgage if you have one), condo fees, taxes, insurance, food, clothing, transportation, entertainment and any other expenses you might have.

It is important to remember that CPP/QPP and OAS are fully taxable and if your retirement income is above a specified annual amount ($66,733 for 2010), you may have to repay a portion of your OAS. So depending on your total retirement income, these pensions may provide you with even less than you might expect.

Bear in mind, however, that not everyone is entitled to the maximum payment. CPP/QPP was never intended to replace most of an individual's employment income. Your CPP/QPP entitlement will be based on how many years you have worked and how much you have contributed, which is based on your income. It is designed to pay a retirement pension at age 65 that is equal to about 25 per cent of the average Year's Maximum Pensionable Earnings (YMPE: $47,200 for 2010) for the last five years.

If you retire early, for instance at age 60, your CPP/QPP payment will be less than the maximum. The following chart shows how much of an individual's employment earnings are replaced by the combined CPP/QPP and OAS pensions. As you can see, if income before retirement is less than $30,000, then the combined CPP/QPP and OAS pension payment will replace almost half of the employment earnings. But for those with higher incomes, government pensions will play a much smaller role in replacing their employment income. Still, the good news is that these pensions are inflation adjusted and are payable for life. Government pensions are a good foundation but will not necessarily be enough to live on depending on the kind of retirement lifestyle you are looking forward to.

Government pensions replacement rate						
Employment Earnings Before Retirement	$30,000	$40,000	$50,000	$60,000	$80,000	$100,000
CPP/QPP & OAS Actual $	$13,703	$16,203	$17,413*	$17,413*	$17,413*	$17,413*
Replacement Ratio	46%	41%	35%	29%	22%	17%

Note: This example is based on a single person receiving maximum CPP/QPP and OAS for 2010. With employment earnings less than the YMPE of $47,200, the CPP/QPP entitlement
is estimated at 25% of earnings before retirement. OAS clawback is not considered.

* This is the combined maximum pension for CPP/QPP and OAS for 2010.

"I am fine; I have a company pension plan."

There are many considerations when it comes to company pension plans, not the least of which is that only 38 per cent[3] of paid workers had a company-sponsored pension plan as part of their retirement compensation. Then there is the fact that there are many different kinds of plans: the two most common are defined benefit plans and defined contribution plans, both of which pay pensions that are taxable. Since the pension that you will receive from each plan is determined very differently, it is important for you to know which type of plan you have as well as its features and benefits.

With a defined benefit plan, once you retire you receive a specified lifetime monthly income - which is calculated based on your years of service and the salary you earned before retirement. But even a pension that seems generous at retirement loses its value if it is not adjusted for inflation. For example, based on a two per cent year-over-year inflation rate, a $1,000 monthly pension would come to be worth $673 over a 20-year period. Additionally, a company can change the terms of the plan or the type of plan offered, which may alter the amount of pension you will receive. What's more, a company's bankruptcy can also affect your pension if the company has not made all of the required contributions to the plan.

A defined contribution plan does not specify a monthly pension. The funds that have accumulated at retirement are used to provide a pension to you. The plan is generally managed by the employee, similar to managing a personal RRSP. Once you retire, the funds have to be transferred to a locked-in savings plan or used to buy an annuity that will provide lifetime income. However, because the investment risk is shifted to you, any investment gains or losses in your plan affect you directly in terms of how much money you will have for retirement.

Having a company pension plan is certainly better than not having one, but having one is not always enough to guarantee you will have enough income during retirement years.

"I need 70 to 80 per cent of my pre-retirement income."

If your dream is to maintain your current lifestyle in retirement, it is important to focus on your expenses instead of your pre-retirement income because some of your current expenses will disappear once you retire. For example, you may no longer be saving for retirement and you will not be required to make contributions to CPP/QPP and company pension plans. If you are no longer working, all work related costs such as travel expenses will no longer apply to you. What's more, for those who are over age 65, the Canadian government provides various additional income tax credits for seniors which will reduce their overall tax rate. And because of the rules that allow pension income splitting among spouses or common-law partners, taxes paid by a family unit can be reduced.

So by looking at your lifestyle and specifically, who you will be spending your time with, what you will be doing, where you will live, and how your health might impact your plans, you will have a clearer idea of how much you will need. Some people find they can live on much less and others spend just as much or more during their retirement. Understanding what type of retirement benefits you are entitled to and identifying your guaranteed retirement income sources are also important in determining how much you need in personal savings.

"I've heard I need to save $1 million."

When it comes to having enough money for retirement, not everyone thinks of it in terms of a lump sum. In fact, many people see it from a monthly income perspective.[4] People can better indicate how much money they need each month to pay their bills then to come up with the lump sum amount that they need saved at time of retirement to generate the required income. This is one reason why the $1 million amount should not be used as a common benchmark.

The $1 million figure is based on the assumption that you should have saved 20 to 25 times the annual income you will need once you are retired. For example, if you need an after-tax income of $50,000 a year, it assumes that you will need to save $1 million (20 times $50,000). However, depending on your other retirement income sources, i.e. company pension, CPP/QPP and OAS, or the proceeds from the sale of your house, you might not actually need to save $1 million for your retirement. In this case, with additional income from other sources, your dream retirement may only require an income of $20,000 a year from your personal savings. Based on this very basic assumption, you would need to save just $400,000[5] (20 times $20,000).

Regardless of what you will need to live on once you are retired, there are tax implications, unexpected expenses and perhaps a desire to leave an inheritance that will affect how much you will need in retirement savings.

"I will be fine if I only withdraw four or five per cent a year from my savings once I retire."

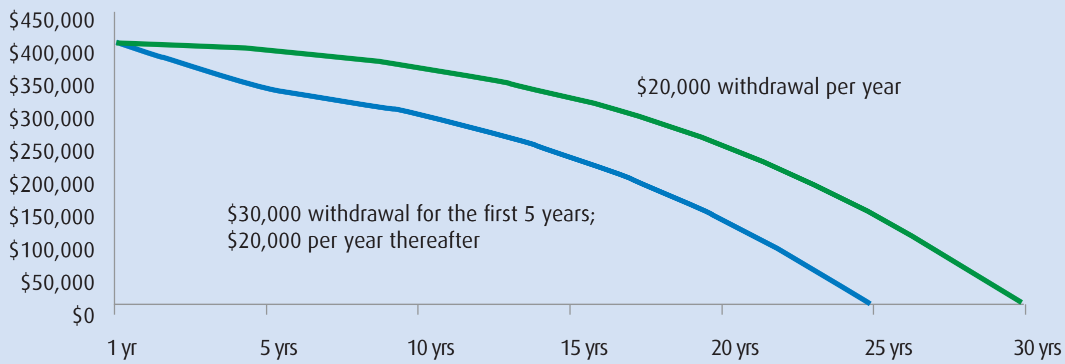
While this is a commonly used assumption to estimate how much can be withdrawn so that savings can last 30 years, the main criteria for how much can be withdrawn is based on investment earnings. If you only withdraw five per cent but your savings earn much more than that, your savings will continue to grow even during your retirement years and you could end up leaving a fairly substantial amount in your estate. However, if your savings earn less than the amount you are withdrawing each year, then you will have a higher risk of running out of money during retirement.

In some cases you have no choice in how much you withdraw. For instance, if you have a Registered Retirement Income Fund (RRIF), your withdrawals are based on your age. At age 60, it is mandatory to withdraw 3.3 per cent and at age 65, it is 4 per cent, but at age 71 the minimum withdrawal increases to 7.38 per cent and continues to increase in subsequent years. However, while you are required to withdraw substantial amounts from your RRIF, you can continue to keep the money invested by contributing to a Tax Free Savings Account (TFSA) or other savings plans.

Many retirees say they spend much more in the first few years of their retirement because they do the things they had put off while working such as travelling extensively, making major purchases and living out of the country for part of the year. Using the earlier example of $400,000[6] in retirement savings and a withdrawal of $20,000 per year, these savings will last 30 years. However, if withdrawals are higher in the first five years, assume $30,000 per year, and then lower for the remainder, assume $20,000 per year adjusted for inflation, the savings will run out in 25 years. Add to that, any potential health or care-giving costs that might arise later in life would require even higher withdrawals and running out of money could become a reality.

To make your money last longer, the best practice is to not spend more than you normally would in the first five years of retirement so you are not depleting your saving so quickly in the early years.

Retirement savings duration



Note: This graph shows how long your retirement savings will last based on how much you withdraw each year. Assumptions: Non-Registered Account; 2% Inflation Rate; 35% Tax Rate; 6% Rate of Return (2% Interest, 2% Capital Gain, 2% Dividend); Payment frequency is annual and at end of year

"Delaying my retirement a few years will not make that much of a difference."

Aside from the social and mental benefits of working for as long as you can, the financial benefits cannot be overlooked either.[7] Delaying retirement allows your retirement assets to continue to grow because you are not making withdrawals. You are still earning employment income, which means you can continue to add to your retirement assets. Therefore, you will likely have accumulated more savings when you do retire.

Continuing with the same example, $400,000[8] in savings can pay an after-tax indexed amount of $20,000 per year from age 60 to 90. If you delay retirement until age 62, and do not make a withdrawal for two years because you are still receiving employment income, your savings can continue to grow. If you earn six per cent on your savings, when you do retire at age 62, your savings can pay an after-tax amount of $22,500 from age 62 to 90. That is an additional 12.5 per cent more in annual income.

Delaying retirement even a few years can make a big difference in your savings and how long those savings will last.

The bottom line

There are many considerations when it comes to planning your retirement. Your age and health may affect your lifestyle. When you retire, whether you have outstanding debts going into retirement and your expected retirement expenses will help determine how much you will need to save for retirement. Therefore, it is important to know your retirement goals and objectives, identify your sources of retirement income and start planning as early as possible.

Retirement planning is a dynamic process. You may find that your retirement goals and lifestyle choices change over time and consequently, the amount of money you need will change. Depending on the post-retirement life you want to live, it is probably not prudent to count on just company and government pensions. Unforeseen events such as illness, the need to care for a family member or spouse, and market volatility can also affect how much money you will need for retirement and how long your retirement savings will last.

Questions you need to ask yourself to figure out how much you need to save for your retirement:

- When do you want to retire?
- Will you own or rent a home?
- Where will you live?
- Will you stop working or work part-time?
- Will you volunteer, start a business, or go back to school?
- How often will you eat in restaurants, go to the theatre and/or movies and travel?
- How is yours and your spouse's health?
- Do you have family members or friends you need to care for?
- Do you plan to leave an inheritance?

Determining how much money you will need to save is unique for each individual, and it is more complex than simply using a rule of thumb. There is no one-size-fits-all solution. All the more reason for you to consult a trusted advisor to create a personalized retirement plan and identify options available to you. Most importantly, your retirement plan should be reviewed regularly to ensure you are on track to reaching your retirement goals.

1 Statistics Canada, CANSIM, table 102-0511
2 Retirement for One - By Chance or By Design, BMO Retirement Institute, January 2009
3 Statistics Canada, Pension Plans in Canada and Labour Force Survey, 2007
4 The BMO Retirement Trends Study, 2005
5,6,8 Assumptions: Non-Registered Account; 2% Inflation Rate; 35% Tax Rate; 6% Rate of Return (2% Interest, 2% Capital Gain, 2% Dividend); Payment frequency is annual and at end of year.
7 Boomers Revise their "Retire-By" Date as Financial Landscape Changes, BMO Retirement Institute, April 2009

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