Retirement income and assets: outlook for the future

Introduction
Recent pensions policy development in the UK has mostly focussed on helping people to accumulate assets to fund retirement. While there has been some research on the use of assets in retirement, most of the research has examined particular assets in isolation.

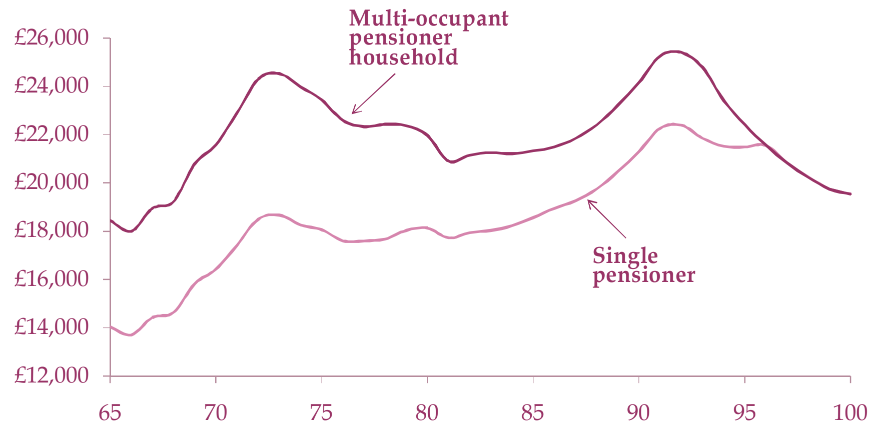
The PPI's Retirement income and assets project considers the evolution of financial needs during the course of retirement and the roles that different sources of income and assets could have in meeting those needs. This briefing note summarises the main conclusions of the first 4 reports in the Retirement income and assets project.[1]

Income needs vary during retirement
A calculation of pensioners' income needs can be approached by examining the level of income pensioners require in order to satisfy their basic needs or by exploring how much income pensioners would require to achieve a standard of living that they would find acceptable.

It is not possible to calculate a single level of income that would be suitable for all pensioners to meet their needs or expectations throughout their whole retirement, though minimum and desired income measures can provide a useful guide. The level of income required by any pensioner may depend on their desired standard of living in retirement, the structure and location of their household and their health needs. Calculations of the level of income that would be required to meet basic needs tend to conclude that a single pensioner would need around £130 per week (after housing costs) in 2009 earning terms.[2]

Chart 1: Pensioner spending could vary during retirement as needs and preferences change

Possible annual household spending for pensioner households retiring at 65 in 2009 (figures in nominal terms)



Source: Life Trust, cebr (2008) *Life Trust Cost of Retirement Report*

Spending can vary during retirement due to a combination of needs, expectations and spending preferences (Chart 1). A typical pensioner might spend more on recreation and leisure in early retirement, decrease spending around age 75 as mobility decreases, increase spending around age 85 as a result of costs arising from health needs and decrease spending in their 90s as mobility is reduced to minimal levels.

Any individual pensioner's needs and expectations may be for lower spending than depicted in Chart 1 or for higher spending if, for instance, they acquire disabilities as they age.

Pensioners are likely to receive more income from state pensions in the future
Currently, around 11.5 million pensioners (95% of total pensioners) receive income from state pensions,[3] making it, on average, the most important source of retirement income.

State pension income is relatively more important for lower income households, who are likely to receive a much larger proportion of their income from state pensions than higher income households.

The Pensions Act 2007 contains reforms to the state pension system which will have the effect of lowering the income threshold for S2P entitlement, reducing the number of quali-

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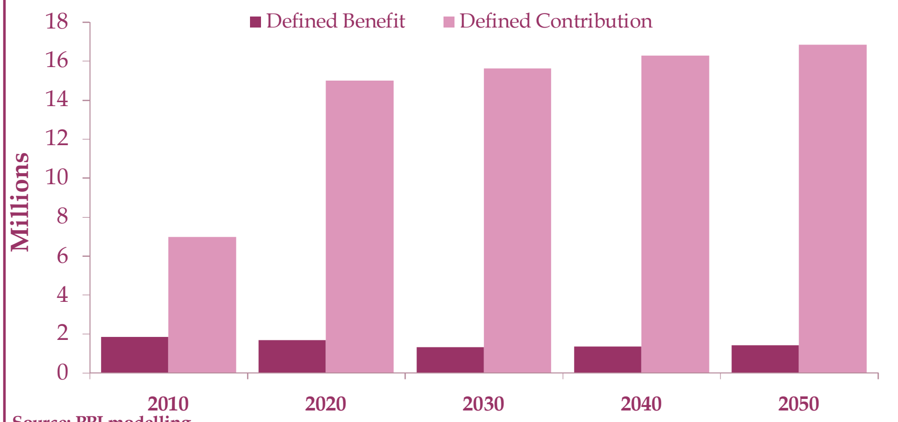
fying years needed for a full BSP and making it easier for carers and people with disabilities to earn National Insurance credits. The state pension reforms are likely to result in an increase in the level of income which most pensioners receive from state pensions.

Some groups, such as women, carers, and very low earners are likely to benefit substantially more from the reforms than people who already tended to accrue enough qualifying years to receive the full rate of BSP, .e.g., men with full National Insurance records.

Chart 2: The number of savers in private sector DC pensions could increase substantially after the reforms

Number of people saving in private sector DB and DC pension schemes by 10 year intervals



Source: PPI modelling

More pensioners are likely to receive income from private pensions in the future

Currently, 67% of pensioners receive income from private pensions, though pensioners on high incomes receive on average a much larger proportion (around 35% of their income) from private pensions than pensioners on low incomes who receive on average between 9% and 14% of their income from private pensions.[4]

The Pensions Act 2008 contains three major reforms to the private pensions system, all to be phased in or implemented from 2012. The reforms in the Act:

- Require employers to automatically enrol eligible employees into a work-based pension scheme (employees have the option to opt out).
- Require employers to make contributions of at least 3% of band earnings[5] to eligible employee's workplace pension schemes.
- Introduce a new, low cost, national pension savings scheme, NEST (National Employment Savings Trust).

Assuming opt-out rates after auto-enrolment are in line with Government expectations of around 25%,[6] the proportion of people with private pension savings after 2012 could rise from around 40% of the working age population today (around 14 million people) to around 21 million people, or roughly 60% of the UK working-age population, once the Government's reforms are fully implemented. This could result in the proportion of pensioners receiving income from private pensions rising as successive cohorts reach State Pension Age.

Some pensioners are also likely to receive higher levels of income from private pensions than they would have without reform as a result of compulsory employer contributions.

Private pension income levels will depend on employer responses to reform

The reforms may increase the cost of pension provision for most employers because auto-enrolment is likely to result in higher levels of participation in pension schemes and because of the requirement for employers to contribute at least 3% of band earnings for employees who remain opted in.

Employers may be able to pass on cost increases in a number of ways, for example, by charging higher prices, awarding lower wage increases, passing the costs on to shareholders, or reducing their levels of contributions into employees' pension schemes. Although surveys of likely employer responses have been conducted, they cannot predict with certainty how employers will respond to the reforms.

There are likely to be more savers in DC pensions in the future
Though work-based pension provision has traditionally been supplied in the form of Defined Benefit (DB) schemes, the last two decades have seen an acceleration in the trend for private sector DB schemes to close, either to new members or to both new and existing members, and instead offer membership in Defined Contribution (DC) schemes.

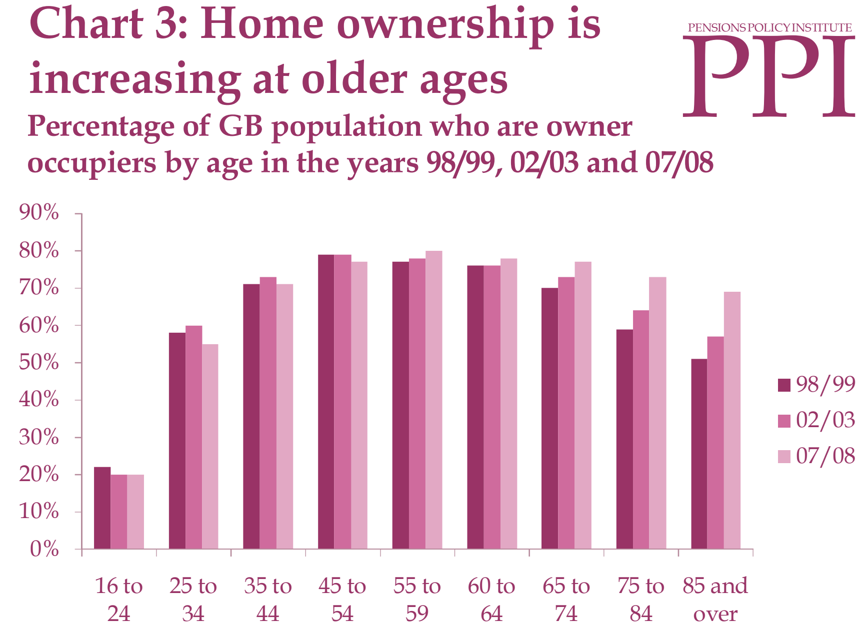
Expected increases in savers resulting from auto-enrolment coupled with the trend for employers to offer DC scheme membership rather than DB, means that more people are likely to save in DC pensions in the future than are saving in them today. Active membership in DC schemes could reach around 17 million by 2050, compared to an estimated 5 million today (Chart 2).

The amount held within DC pension funds could grow from around £600 billion today to between £700 billion and £900 billion (2009 earnings terms) by 2050, depending on how employers and individuals respond to the private pension reforms.

A DB to DC shift could mean some people will receive lower income from private pensions
DC pensions could yield lower pension income than DB pensions primarily because contribution rates are often lower in DC pensions than in DB.[7]

Chart 3: Home ownership is increasing at older ages

Percentage of GB population who are owner occupiers by age in the years 98/99, 02/03 and 07/08



Source: (DWP) Family Resources Survey, 2002, 2004, 2009

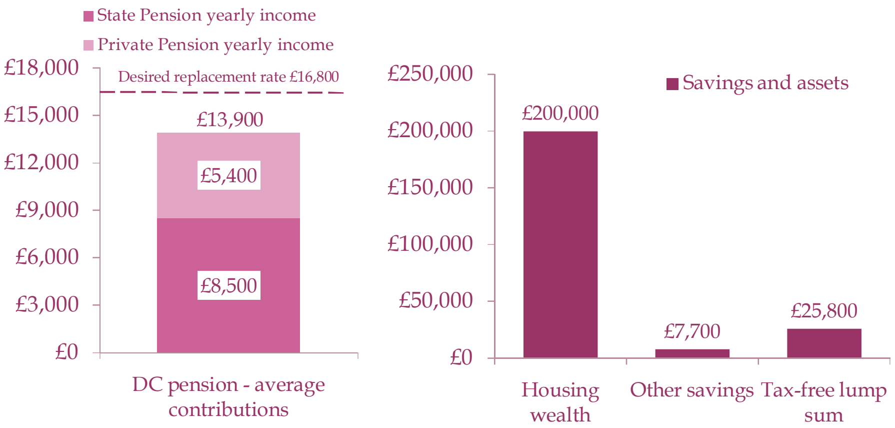
The shift from DB to DC could also affect private pension income levels because, by offering a DC scheme rather than a DB scheme, employers can pass on some of the risks associated with hosting a pension scheme to their employees.[8]

Workers with DC pensions may need to contribute above average levels
PPI case studies of hypothetical individuals found that some moderate to high earners who contribute to DC pensions at average levels of 10% of salary may not have sufficient state and private pension income to achieve a desired standard of living in retirement. In order to provide their desired retirement income solely through state and private pensions, many people may need to have a minimum of 15% of their salary contributed to their private pension, and in some cases people may need to contribute more in order to meet desired retirement income.

In future there may be more scope for pensioners to use housing wealth to help support retirement
The use of housing wealth to support retirement may grow in the future, as the proportion of older households with housing wealth increases (Chart 3). Home ownership is currently highest amongst 55-59 year olds. As this generation gets older there may be higher levels of home ownership amongst people in their 60s, 70s and 80s. If people continue to enter retirement with current levels of housing wealth, then there could be home ownership levels of 80% among people over State Pension Age within the next few decades.

Chart 4: Median earners may not meet replacement rate from state and private pension income alone

Median Earning Man's estate - with DC pension (average & minimum contributions) at SPA in 2009 earnings terms



Source: PPI modelling

Pensioners may use more complex sources of retirement income in future

PPI modelling indicates that some future low earners may find it easier to replicate working-life living standards from state pensions and state benefits in future but that some moderate to high earners, especially those saving in DC pensions, may need to supplement pension income with income from other savings and assets.[9]

Future moderate to high income pensioners may wish to use an array of income and assets to fill gaps in pension income, including housing wealth (Chart 4). Longevity increases and changes to the default retirement age may also create more scope for working after SPA in future in order to boost retirement income.

More people will need financial advice or information in future

More varied and mixed baskets of assets and income in the future will mean that more people are making decisions for the first time regarding the accumulation of savings and investments in working-life and their use in retirement. Advice and information services will need to be able to support people who are likely to have to make more choices and more complex financial decisions about their retirement savings during their working life, at the point of retirement and during retirement.

Conclusions

Findings from the retirement income and assets project indicate that many future pensioners are likely to have a greater variety of income and assets, including housing wealth, available for use in retirement. Reforms to state pensions could result in pensioners receiving more income from state pensions in future. Auto-enrolment and changes in the private pensions market mean that in future many more people will be retiring with DC private pension savings.

The amount pensioners are likely to receive from private pensions will depend on employer and individual responses to the Government's private pension reforms and subsequent contribution levels. Many people will need to contribute more to their pension during working life, work longer, or run down savings, investments or housing wealth to achieve a standard of living in retirement they might consider acceptable.

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[1] To download reports: www.pensionspolicyinstitute.org.uk
The PPI wishes to thank the sponsors of this project: Age Concern and Help the Aged, the Association of British Insurers, the Department for Work and Pensions, the Investment Management Association, J. P. Morgan Asset Management, and Prudential PLC.

[2] Guarantee Credit & www.minimumincomestandard.org

[3] ONS 2006 based population projections, principal projections and DWP (2009) *The Pensioners' Income Series*

[4] DWP (2009) *The Pensioners' Income Series*

[5] £5,035 to £33,540 in 2006/07 earnings terms

[6] DWP (2009) *Factsheet: People benefiting from private pension reform: explanation of participation estimates* www.dwp.gov.uk

[7] In the private sector average DC contribution levels are 7% employer, 3% employee, average DB contribution levels are 16% employer, 5% employee

[8] DC scheme members generally bear the risks of low investment returns, fund losses due to market fluctuations, and poor annuity rates at the point of retirement

[9] PPI (2010) *Retirement income and assets: outlook for the future*

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