Generation VeXed: solving the retirement puzzle

Executive Summary

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Daniela is Head of Policy Research at the Pensions Policy Institute (PPI), and leads the Policy Research team. She has a wealth of experience in conducting quantitative and qualitative research into all aspects of state and private pensions policy, writing articles for journals and national press, and presenting to a variety of domestic and international audiences, including radio and television appearances.

Daniela originally joined the PPI in 2008 and took a short break in 2012 to work as a Committee Specialist for the Work and Pensions Select Committee.

Prior to working in research and policy Daniela was a social worker with vulnerable adults and children. Daniela has an MSc in Social Policy and Planning from the London School of Economics.

Anna Brain – Associate Policy Researcher, Pensions Policy Institute

Anna is an Associate Policy Researcher at the Pensions Policy Institute, and is also studying an MA in Public Policy & Ageing at King's College London. Her research focuses on the implications of demographic population ageing and interactions between pensions, health and social care systems. As a former Management Consultant in financial services, Anna has worked extensively with asset and investment managers, including pension funds, across a wide range of topics including regulatory impact analysis, post-merger integration, portfolio management and execution platforms. She also brings personal insight into the impact of policy on transitions in later life, retirement savings and income, care choices and funding.

Tim Pike, Head of Modelling, Pensions Policy Institute

Tim is the Head of Modelling of the PPI responsible for delivering the models and modelling to support the PPI's current research program. He joined the PPI in July 2015 and since then has analysed the projected implication of pension policies upon many significant groups. These have included the self-employed, women, younger generations, and the Exchequer.

Tim has worked alongside academics and other researchers on collaborative projects including WHeRL and CASPeR. These projects bring multidisciplinary research to widen the research scope to give a more complete view of the implications of interacting areas of policy.

Prior to joining the PPI Tim worked for Legal and General where he spent nearly ten years contributing to a wide variety of actuarial modelling projects, from financial reporting to annuity pricing.

Tim has an MA (Cantab.) having studied mathematics at Fitzwilliam College Cambridge.

The Pensions Policy Institute (PPI)

The PPI is an educational, independent research organisation with a charitable objective to inform the policy debate on pensions and retirement income provision. The PPI's aim is to improve information and understanding about pensions and retirement provision through research and analysis, discussion and publication. It does not lobby for any particular issue or reform solution but works to make the pensions and retirement policy debate better informed.

The PPI is funded by donations, grants and benefits-in-kind from a range of organisations, as well as being commissioned for research projects.

Pensions affect everyone. But too few people understand them and what is needed for the provision of an adequate retirement income. The PPI wants to change that. We believe that better information and understanding will lead to a better policy framework and a better provision of retirement income for all. The PPI aims to be an authoritative voice on policy on pensions and the provision of retirement income in the UK.

The PPI has specific objectives to:

- Provide relevant and accessible information on the extent and nature of retirement provision
- Contribute fact-based analysis and commentary to the policy-making process
- Extend and encourage research and debate on policy on pensions and retirement provision
- Be a helpful sounding board for providers, policy makers and opinion formers
- Inform the public debate on policy on pensions and retirement provision.

We believe that the PPI is unique in the study of pensions and retirement provision, as it is:

- Independent, with no political bias or vested interest
- Led by experts focused on pensions and retirement provision
- Considering the whole pension framework: state, private, and the interaction between them
- Pursuing both academically rigorous analysis and practical policy commentary
- Taking a long-term perspective on policy outcomes on pensions and retirement income
- Encouraging dialogue and debate with multiple constituencies

A Pensions Policy Institute report

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Executive Summary

Without collective action from policy-makers, industry and employers, people in Generation X are more likely to have difficulty achieving an adequate, flexible and sustainable income in retirement than their parents' generation, difficulty which risks being sustained by generations that follow.

MILLENNIALS
Born 1981-2000
Aged 19-38 in 2019

GENERATION X
Born 1966 – 1980
Aged 39-53 in 2019

BABY BOOMERS
Born 1946-1965
Aged 54-73 in 2019

The time that members of Generation X have to prepare for retirement is reducing; Generation X will approach retirement over the next 12 to 28 years. This cohort is working and saving during labour market and pensions transitions, and a challenging economic climate, which have increased the complexity of preparing for later life.

The decline in private sector Defined Benefit (DB) provision, reductions in the proportion of future income from State Pensions, and the increase of casual working, mean that Generation X is likely to reach retirement with less income from sustainable sources than those in older generations. A decrease in house purchase among this cohort, a greater likelihood of indebtedness and an increase in the likelihood of the need to provide or receive care at older ages means that those in Generation X are likely to have higher expenditure needs on average than older cohorts, which will further reduce their disposable income and make it more difficult to achieve a suitable standard of living in retirement. Attention and support from policy-makers, industry and employers are becoming increasingly important if interventions are to be made now which could help Generation X improve their quality of life in the future.

This report compares the characteristics and retirement income risks faced by Generation X to those of Baby Boomers and Millennials

In order to understand how work and retirement are changing for Generation X, this report compares the risks they face in later life to those facing Baby Boomers and Millennials, and tracks how the cumulative effect of different savings behaviours and changes to policy, pensions and employment are affecting risk across the generations. Key drivers of retirement risk are identified, and the report concludes each section with implications for policy interventions which could mitigate risks for Generation X and retirees of the future.

Baby Boomers: Born between 1946-1965 and aged between 54 and 73 in 2019 (15.5 million people)

Baby Boomers are the oldest generation in the study. They are likely to reach retirement with higher levels of Defined Benefit (DB) entitlement than younger generations, less Defined Contribution (DC) savings and higher State Pension entitlement. Baby Boomers are more likely to be owner occupiers, are less likely to be in debt and are more likely to have supplementary sources of income such as non-pension savings and assets, and housing equity at retirement than younger cohorts.

Generation X: Born between 1966-1980 and aged between 39 and 53 in 2019 (13 million people)

Members of Generation X will reach retirement with lower levels of DB entitlement than Baby Boomers and more DC savings on average. However, Generation X members will not benefit from a full working-life of automatic enrolment as they will have been in their late 30s or older when their company first auto-enrolled, though some will have been saving prior to automatic enrolment. Generation X members are more likely to work casually, or to be self-employed than Baby Boomers at the same age, affecting their access to workplace pension saving. Generation X members will receive less income proportionally from State Pensions on average. Generation X members are more likely to reach retirement in rented accommodation or with an outstanding mortgage, more likely to have debt, more likely to need to provide or receive care, and less likely to have other savings or housing equity to draw on.

Millennials: Born between 1981 and 2000 and aged between 19 and 38 in 2019 (17.2 million people)

Millennials are the youngest cohort in the study. While Millennials would benefit from attention by policy-makers, industry and employers, the majority of millennials still have time to make decisions or to benefit from policy changes aimed at improving retirement incomes, for example, increases to minimum required automatic enrolment contributions. Millennials are less likely to reach retirement with DB entitlement but will have greater DC savings as a result of benefiting for longer from automatic enrolment. Millennials are most likely of all generations to work casually or be self-employed but could benefit from future policies designed to assist those outside of full-time employed work, to save for retirement. Millennials are the least likely of any generation to reach retirement owning their own home outright, though future policy or economic changes could change the prevalence of house buying or the way that benefits are used to support those renting in retirement.

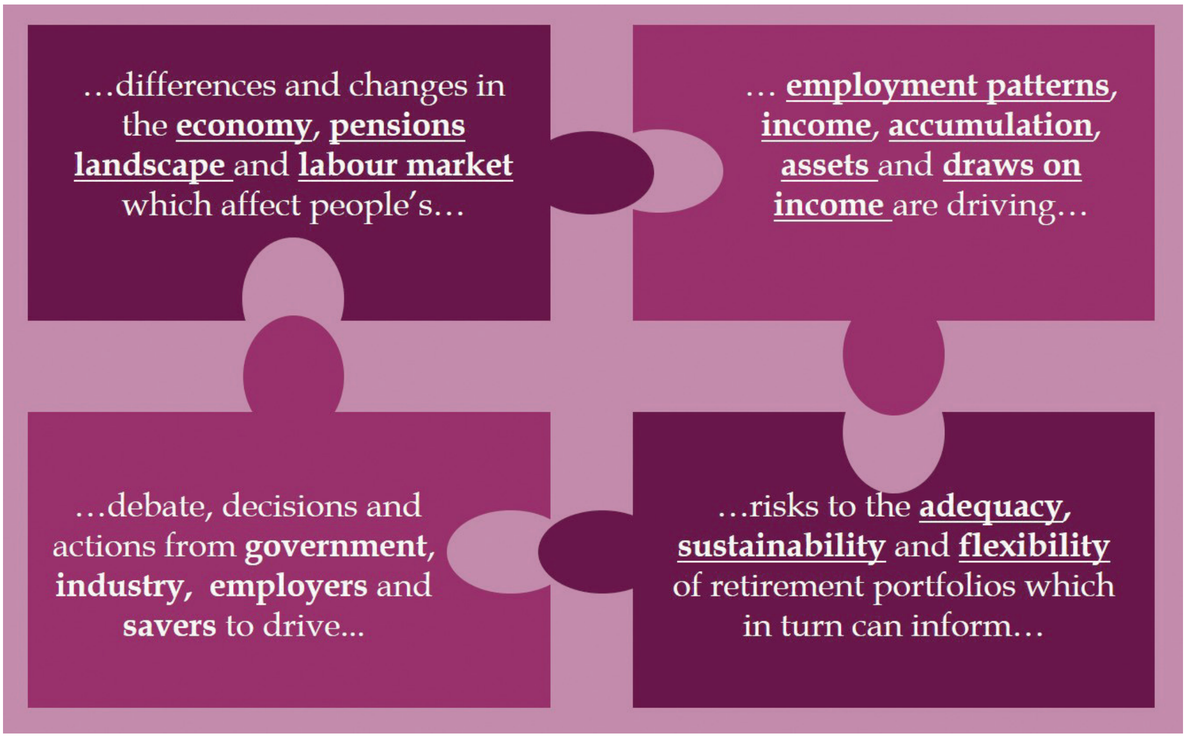
What is a suitable retirement income?

A suitable retirement income can mean different things to different people

Retirement income needs are individual and depend on many factors including the standard of living people had during working life, where they live, housing and living costs, and the health conditions of themselves and their families.

Three principal retirement income goals have emerged from previous PPI research on the changing nature of retirement: adequacy, sustainability and flexibility. This research measures the extent to which employment patterns, income, assets, pension savings, and draws on income might affect the ability of cohorts to maintain adequacy, sustainability and flexibility throughout retirement.

Key risks to cohorts are analysed in the context of labour market, pensions landscape and economic changes. Policy implications are drawn in order to inform debate, decisions and actions from Government, industry, employers to help to tackle the puzzle of reducing retirement risks for Generation X (ExFig1).



Individual behaviour will also play a significant role in mitigating retirement income risks; however, many individuals may be unwilling or unable to make informed decisions without the support of Government, industry and employers.

Adequacy, sustainability and flexibility:

- Adequacy: Adequacy refers to whether retirement income allows people to afford a standard of living which they find acceptable. This often means achieving an income that allows people to replicate working life living standards, though other measures such as how much income people require in order to remain above the poverty line or to meet minimum needs are also used.
- While target replacement rates, of around two-thirds of working life income, have been widely used over the last few decades as a method of determining the income needed in retirement, this approach has become less meaningful over time. Changes to the tax relief given to pensioners, and the consumption patterns of pensioners have meant that two-thirds of working life income may no longer provide the same living standard as it would have two decades ago. The introduction of the pension flexibilities and the rise of DC means that people are more likely to have variable incomes in retirement than a steady annuity or DB income, which means that aiming for a steady level of income throughout retirement has become more complex. Replacement rates are also difficult for people to plan for, when they do not know what their future earnings trajectory might look like or whether they might take time out of work for health or care reasons.
- In this report, adequacy risk is measured by analysing the annual rate of contributions necessary for individuals and households to achieve a minimum to moderate standard of living as defined by the Pensions and Lifetime Savings Association (PLSA). The majority of people modelled for this research will have experienced living standards somewhere between these ranges during working life.
- Sustainability: Sustainability refers to whether retirement income increases with an inflationary measure and is guaranteed to pay out until the death of the recipient. Sustainability is important for maintaining a standard of living throughout retirement. Sustainable sources of income include DB pensions, State Pension entitlement and lifetime annuities.
- Flexibility: Needs change with household changes (for example, divorce, bereavement, children or grandchildren moving in or out) and changes in health and care needs. An income source from which people can withdraw in varying amounts as needs change, such as DC savings, non-pension savings and assets, housing equity, or inherited wealth, is useful for helping people

to meet spikes in expenditure needs and maintain living standards in retirement. Those on very high incomes, above adequacy levels, from less flexible sources, such as DB pensions, may have sufficient income to meet needs as they change while also maintaining living standards.

Generational risks

Table Ex1 shows the proportion of Baby Boomers and Millennials who face the same overall retirement risk as the third of people most at risk in Generation X. The principal risks for Generation X are associated with adequacy and sustainability of retirement income as reliance upon DC savings increases; their overall risk is somewhat mitigated by the likelihood that some of their income will be relatively flexible. In contrast, the strong elements of DB pensions and higher average State Pension provision among Baby Boomers reduces their adequacy, sustainability and consequently overall risk relative to Generation X (26%), but the lack of flexibility they have in accessing these savings offsets these advantages to a small degree. A greater proportion of Millennials face similar overall levels of risk as Generation X (53%) due to a greater reduction in the proportion of income that will come from sustainable sources, the effect of lower earnings in their early careers and the likelihood of indebtedness and not owning their own home in retirement. It may be harder to mitigate adequacy risk in retirement through interventions than sustainability or flexibility, making Generation X a particularly important cohort to focus on.

Table Ex1[1]

• Occupational pension savings (DB/DC) • State Pension savings • Other savings and assets (including housing wealth) • Draws on income: rent, mortgage or debt repayments	• Inflation linked income growth • Duration and longevity • Home ownership • Draws on income: rent, mortgage or debt repayments	• Ease of access • Variation in payment amounts and surplus • Variation in payment frequency • Draws on income: rent, mortgage or debt repayments
▼	▼	▼
ADEQUACY	SUSTAINABILITY	FLEXIBILITY
▼	▼	▼
Retirement Index Score (those at high risk)		
Millennials = 53% **9 million people**	**Generation X = 33%[2]** **4.3 million people**	**Baby Boomers = 26%** **4 million people**

Key differences and changes across the generations

Compared to other generations, the projected retirement outcomes of Millennials are likely to be most impacted by the long-term effect of recent industry, policy and economic transitions including the rise in DC pensions (which carry more risk in both the saving and retirement phases, than DB pensions), introduction of automatic enrolment, rising house prices and declines in wage growth that followed the financial crisis.

1 PPI Modelling using Wealth and Assets Survey data and ONS population estimates

2 Generation X score is derived by taking the third of this cohort at highest risk and then comparing their attributes with those of baby Boomers and Millennials

In contrast, Baby Boomers and older workers are most likely to face risks associated with the cumulative effects of individual employment, earnings and saving patterns throughout working life. Without mitigation, the effect of these trends is expected to become more established over time, potentially compounding the risks younger generations face. Baby Boomers are also most likely to have benefited from historic pension provision and economic cycles.

Generation X is particularly complex and of significant concern because it is experiencing the effects of both broader landscape changes and labour market trends. They have had limited time to respond to declines in DB and State Pension provision or benefit from the introduction of automatic enrolment, and have limited time ahead to make up for the cumulative effect of historic savings and labour market behaviour. Addressing these challenges will require collective action to reduce the number of people in Generation X facing risk in retirement, which may in turn benefit future generations.

Box Ex1 highlights some of the high-level differences between the projected retirement outcomes of Generation X, Baby Boomers and Millennials based on people's current employment, spending, earning and savings behaviour.

Box Ex1[3]

- People within Generation X are at higher risk than Baby Boomers but at lower risk than Millennials of not achieving a suitable income in retirement.
- The profiles of people within each generation are diverse. Older members of Generation X are more likely to face risks that are characteristic of Baby Boomers, whilst younger members are often more similar to Millennials.
- Overall, the proportions of men and women at high, medium and low risk are comparable within each generation, but the underlying challenges facing men and women are significantly different. The requirements for women to achieve a suitable retirement income, such as the contributions they may need to make, are higher than men within each group.
- The proportion of women at high risk relative to men increases with age as the cumulative effect of lower earnings and non-linear employment patterns impacts pension savings, but the proportion at women at high risk is falling as female employment rates rise.
- The proportion of people in DB schemes is falling with each successive generation, but in every generation the proportion of women enrolled in DB schemes is higher than men due to higher rates of public sector employment.
- As the proportion of people enrolled in DC schemes increases with each generation, the contrast in adequacy and sustainability between DB and DC savers becomes more evident as DB savers make up increasingly large proportions of low risk groups.
- In all generations, self-employed workers and those in manual or routine occupations are most at risk, but without taking action to increase DC contributions, the decline of DB means that more individuals in intermediate or higher paid roles could find themselves at risk of not achieving suitable retirement income than in previous generations.

3 PPI Modelling using Wealth and Assets Survey data and ONS population estimates

Inheritance may be used to increase the adequacy, sustainability and flexibility of some future retiree's income portfolios. However, it is not possible to project who might inherit or how much inheritance could mean, as the wealth of some members of older generations is likely to be spent on care.

Government, industry and employer interventions

The next section discusses the three main drivers of retirement risk for Generation X and how Government, industry and employer interventions can be used to help mitigate their effects.

Labour market changes

Generation X has higher rates of employment, particularly among women, and are likely to have longer working lives than Baby Boomers. While this offsets some risk, they are proportionately more likely to have non-linear employment patterns including part-time or casual work, self-employment, job changes and career transitions. Together these factors present significant long-term risks to the adequacy, sustainability and flexibility of future retirement income. Groups at particular risk are:

- Women: 54% (2.1 million) of Generation X in the high risk group are women. Although female employment rates are increasing, women in the UK are significantly more likely to take time out from work, work part-time and receive lower pay than men, which limits their ability to make pension contributions. As a consequence, women in their late 50s have on average just half the private pension wealth of men the same age (from both DB and DC savings),[4] a difference which equates to over £100,000 on average (£106,200 women, £226,500 men) by age 65.
- Those who leave the labour market early due to health reasons: Health is a crucial factor for labour market exit. Those who leave work due to ill health or the need to provide care will generally cease contributing to a workplace pension and have longer retirements to support. Rises to State Pension age (SPa) may mean that some members of Generation X will find it harder to work up until SPa.
- Part-time and casual workers: Part-time and casual work is associated with lower levels of pension contributions as people in these positions are less likely to be eligible for automatic enrolment. The proportion of people working part-time is increasing; part-time employment rose from 22% in 1992 to 26% in 2018.[5] Casual work is also increasing; the proportion of workers on zero-hour contracts increased from 1% in 2010 to approximately 3% in 2019.
- The self-employed: Self-employment is associated with low levels of pension saving. The proportion of those in self-employment rose from 12% of workers in 2001 to 15% in 2017.[6]

4 PPI Modelling

5 PPI Analysis of ONS (2019a)

6 ONS (2018a)

Government, industry and employer interventions could help mitigate risks associated with employment (Box Ex2).

Box Ex2

How could Government, industry and employer interventions mitigate retirement income risks associated with employment?

Government/regulators:

- Mitigate retirement income risks for people who are unable to work
- Incentivise education and retraining
- Promote access to employer contributions for workers in different types of employment
- Address low incentives for the self-employed to save into private pensions

Industry:

- Develop products that support non-linear pension saving, for example, pension products which allow for contribution levels to vary with changes in working patterns, increasing contribution levels when members are in full-time work in order to make up for time out or periods of casual working
- Continue to provide and develop information, support and platforms for consolidating pension pots
- Engage with members during "teachable" moments

Employers:

- Support employees with caring responsibilities and those returning to work after career breaks
- Support extended working lives through phased and flexible retirement
- Create and transform jobs to meet the needs of specific demographic groups, for example, creating training roles for older manual workers
- Maintain commitment to reducing the gender pay gap
- Signpost potential long-term effects of career choices

Changes in the pensions landscape

As a result of policy and market changes, and rising longevity, average incomes from DB pensions will decline over time, average incomes from DC pensions will increase, and future retirees will receive proportionally less of their retirement income from State Pensions. Generation X bears greater risk of saving insufficiently into DC pensions, reaching retirement with less sustainable income, and receiving a lower proportion of retirement income from the State Pension. Some risk also arises from the complexity of the pension system and the frequent changes in policy, which can make understanding the system and planning for the future difficult; although the Government has been attempting to simplify the State and private pension system through, for example, the introduction of the new State Pension (nSP) and stricter regulation of private pension schemes.

- Generation X will have less time to benefit from automatic enrolment: Millennials who are automatically enrolled and remain saving will contribute to their pensions for a longer time than members of Generation X who began saving for the first time through automatic enrolment. For example, a woman who saves 8% of total earnings into a DC pension from age 22 to SPa could retire with DC pot 148% larger than a woman who saves 8% into a DC pension from age 42 to SPa.
- Younger generations will receive proportionally less income from the State Pension than older generations: As a result of the introduction of the new (flat-rate) State Pension and the removal of the option to accrue entitlement to the additional earnings-related State Pension, younger generations will receive proportionally less income, on average, from the State Pension than older generations, though some individuals, for example, the self-employed, carers and those who receive a significant proportion of income from benefits, will receive a higher State Pension under the new system. 46% of Generation X aged 43 to 52 will receive a State Pension income around £13,000 lower over their lifetime than they would have received under the old State Pension system while fewer than 25% of Baby Boomers will receive a lower State Pension.
- Members of Generation X will generally receive less income from sustainable sources: DB and State Pension income is sustainable because it increases with inflationary indices and is paid out for the member's lifetime.

Generation X will receive less income from DB pensions than Baby Boomers, and will accrue less entitlement to State Pensions than they would have done under the old system. Therefore, members of Generation X may find it harder to ensure that their retirement income is sustainable throughout their retirement.

- Some members of Generation X with DB income may transfer against their best interests: As a result of less flexibility, falls in interest rates, increased Cash Equivalent Transfer Values and bad press associated with some DB schemes, a significant number of people are transferring their DB pension entitlement into DC pots, which do not protect from inflation, investment or longevity risk. This means that some members of Generation X who are in a position to generate a sustainable income in retirement, may forgo the opportunity. However, for some people, transferring a DB pension may make financial sense.

Government, industry and employer interventions could help mitigate risks associated with pension saving (box Ex3).

Box Ex3

How could Government, industry and employer interventions mitigate retirement income risks associated pension saving?

Government/regulators:

- Explore policies for increasing automatic enrolment contributions, such as increases to minimum levels or auto-escalation
- Be aware that policy changes affecting the State Pension are likely to have a significant impact on the standard of living of most pensioners
- Consider increasing the personal allowance for pensioners or changing pensioner tax bands
- Implement proposed automatic enrolment review recommendations; reducing lower earnings band to £0 and lowering eligibility age to 18

Industry:

- Continue to explore and develop products which provide both sustainability and flexibility, for example, annuity/income drawdown hybrid products
- Ensure that advice takes into account the potential risks associated with transferring DB entitlement and that trustees are aware of the risks
- In conjunction with for example, the Pensions Dashboard and the PLSA living standards targets, provide members with online tools for calculating how they could meet lifestyle targets by increasing contribution levels
- Work with employers to provide financial education in the workplace

Employers:

- Pay contributions at above automatic enrolment minimum levels and offer matching contributions

Economic changes

Different economic climates have put upward pressure on the cost of living (predominantly accommodation), and downward pressure on inflation adjusted wage growth, meaning that younger cohorts are earning less and housing is more expensive. This affects the affordability of both pension contributions and housing. The economic downturn has also led to lower returns on contributions and lower equity growth in housing. As a result of reduced wage growth, higher living expenses, and the changing availability of credit, Generation X are more likely to reach retirement with debt than older cohorts and may need to both save more and make higher contributions in order to achieve a similar standard of living to older workers:

- Higher debt levels: Higher levels of debt during working life are associated reduced affordability of pension contributions. Those who reach retirement with debt will have less disposable income available in order to achieve a suitable standard of living. Household debt levels are growing: the average debt-to-income ratio has risen from 115% in the decade 1998-2008 to 135% in the decade 2008-2018.[7]

7 FCA (2019a)

- Affordability of pension contributions: All cohorts have been affected by weak earnings growth in the past 10 years, though Millennials have seen the most dramatic impact. Lower earnings growth is associated with lower living standards in retirement and lower levels of disposable income available to use for pension contributions.
- Affordability of housing: Fewer people are buying houses and those who are, are buying them at older ages. Average house prices have increased by almost 4 times in the past 30 years. The average age of first-time house purchase rose from 25 for Baby Boomers to around 30 for Generation X.[8] Generation X members are more likely than Baby Boomers to reach retirement without owning their own home outright. Renting or paying a mortgage in retirement is associated with a lower standard of living as a result of higher draws on income.
- Lower returns on pension contributions: A prolonged period of low interest rates resulted in people who started saving for retirement between 1975 and 1995 benefiting from higher rates of investment return than those who started saving later (10.5% on equities and 6% on gilts between 1975 and 1995, compared to 3.7% on equities and 4.3% on gilts between 1995 and 2015). If trends persist, younger savers will need to contribute more to achieve similar sized pension pots.[9]
- Lower equity growth in housing: recent increases in house prices mainly benefited Baby Boomers who bought property when prices were relatively low. Generation X tended to purchase houses nearer to the top of the price rises and benefited less from the growth, while spending more on their property purchases. This means that Generation X will have accrued less equity in their homes for potential use in retirement.
- Renting in retirement: The need to pay rent in retirement, is the most significant indicator for a reduction in disposable income and corresponding reduction in standards of living. The risk is further compounded, because those renting in retirement who have saved into a private pension may lose eligibility for Housing Benefit, thereby reducing the incentive to save into a private pension for those likely to rent in retirement.

Government, industry and employer interventions could help mitigate risks associated with renting in retirement and debt (Box Ex4).

Box Ex4

How could Government, industry and employer interventions mitigate retirement income risks associated with renting in retirement and debt?

Government/regulators:

- Look at ways of ensuring that it is profitable for all, or most, workers to save in a private pension, even those renting in retirement

Industry:

- Ensure that people who come into contact with industry services are provided with prompts for debt support and guidance

Employers:

- Employers who provide financial education could ensure debt support is included in this
- Smaller employers could be provided with referrals to support and guidance to distribute among employees

8 FCA (2019a)

9 FCA (2019a)