Original Article

Will future pensioners have sufficient income to meet their needs?

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ABSTRACT Recent pension policy developments in the United Kingdom have mostly focussed on helping people to accumulate assets to fund retirement. Although there has been some research on the use of assets in retirement, most of the research has examined particular assets in isolation. However, less is known and has been considered about what individuals actually need income and assets for in retirement, and how needs might change as retirement progresses. Recent work by the Pensions Policy Institute has brought together assessments of pensioners needs in retirement with evidence about future trends in different sources of income and assets. The findings from this research present some interesting and difficult challenges for future policy.

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MEASUREMENTS OF INCOME NEEDS IN RETIREMENT CAN BE BASED ON BASIC NEED ASSESSMENTS OR DESIRED INCOME LEVELS

There are a number of different ways of measuring needs in retirement.¹ A calculation could be approached by examining the level of income pensioners require in order to satisfy their basic needs. Calculations can also be approached by exploring how much income pensioners require in order to achieve a standard of living that they would find acceptable.

The main calculations of the level of income that would be required to meet basic needs (using, for example, the level of the Guarantee

Credit, or a minimum income standard based on the cost of buying a representative basket of goods) tend to conclude that a single pensioner needs around £130 per week (after housing costs) in 2009 earning terms.² Calculations of what a median-earning pensioner might need to achieve an adequate standard of living in retirement (based on expectations) tend to conclude that they would need around £280 per week³ in 2009 earnings terms.⁴

However for many people in retirement, satisfaction with income is related to whether they are able to achieve the same (or a similar) standard of living to the one which they experienced during their working life, though the levels of income this requires may be far higher than the poverty line or minimum income standard.⁵

For people on median earnings, two thirds of replacement income (after subtracting income tax)

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in retirement could allow for similar consumption levels to those experienced during working life.⁵ The reason that pensioners may not need 100 per cent replacement income in order to maintain similar consumption levels is that for many pensioners, expenses are lower in retirement than they were during working life, partly because of lower taxes and National Insurance.⁵ Retired people also tend to save less of their income (in pensions for example), and are less likely to be paying off mortgages, accumulating assets/investments or supporting dependents. Some pensioners also spend less on goods related to employment, like transportation.⁵

The Pensions Commission determined that for people on a low income, a replacement rate of 80 per cent or above may be necessary to provide pensioners with a minimum acceptable level of income. This is because people on a low income may not have put much of their income in working life towards savings and asset accumulation in the same way people on average to high earnings might have done and because an 80 per cent replacement rate of a very low income may come out below the poverty line.⁵

A replacement rate approach indicates a target income level at the point of retirement. However, even if an individual meets their replacement rate target income level at the point that they retire there is no guarantee that their standard of living will be maintained throughout the duration of their retirement. This is because some elements of retirement income do not keep their value in real terms because they are either indexed to prices (which tend to increase more slowly than earnings) or are not indexed at all (for example, level annuities).

INCOME NEEDS VARY BETWEEN HOUSEHOLDS AND DURING RETIREMENT

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

Figure 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).

desired income measures can provide a useful guide. The level of income required by any pensioner may be dependent on their desired standard of living in retirement, the structure and location of their household and their health needs.

Spending can vary during retirement because of a combination of needs, expectations and spending preferences (Figure 1). A typical pensioner might spend more on recreation and leisure in early retirement, decrease spending around age 75 as they become less mobile, increase spending once again around the age of 85 as a result of disability or health needs and then decrease spending in their 90s as mobility is reduced to a very minimal level.⁶ Any individual pensioner's needs and expectations may be for lower spending than depicted in Figure 1 or for higher spending if, for instance, they acquire disabilities as they age.⁷

It is possible that pensioner households who receive the average level of income for their age group could find it difficult to meet both of the spending peaks in early and later retirement. Some low to moderate income pensioners may be able to meet spending preferences in early retirement depending on their retirement provision; however, pensioners' income tends to decrease during retirement.⁸ Even higher income pensioners may not be able to meet all of their spending preferences solely from pension income if they aim to have a standard of living similar to the one which they experienced in their working life.

THE NEED FOR CARE COULD SUBSTANTIALLY AFFECT PENSIONERS' NEEDS FOR INCOME

As pensioners age they are more likely to acquire disabilities; by the age of 90, around 80 per cent of people have a moderate or a severe disability.⁹ Acquiring disabilities is associated with increases in living costs. People with disabilities could incur costs in several different areas of expenditure; for example, they may need to spend more on personal care, personal goods, support in the home, transport, mobility aids and modifications to the home.¹⁰

The second peak in income needs depicted in Figure 1 is related to the need for spending on health as pensioners age. However the figures in Figure 1 represent an average for pensioner spending. Spending needs in later retirement may be lower for some pensioners and higher for other pensioners, especially those who acquire more severe disabilities as they age. The costs of acquiring a disability could increase the need for weekly income by around £50 to £250 for a single pensioner (depending on type and severity level of disability) and by around £25 to £150 for a pensioner couple.¹¹ It is difficult to say what proportion of the extra costs associated with acquiring a disability will fall to individuals, households or to the state, as care and support can be provided in different proportions from a combination of sources including Local Authorities, NHS services, state benefits, community services and family members.

The need for care, whether it is provided to a pensioner in their own home or in a residential home, could result in a substantial increase in income needs. The Government estimates that the average 65-year-old will need care that costs over £30 000 during their retirement, and that around 20 per cent of today's 65-year olds will need care costing over £50 000 during their retirement (p. 98).¹² Pensioners who enter residential care homes will generally incur the greatest care costs at around £12 500 per year on average for care¹² plus around £14 000 per year for the cost of accommodation.¹³ The average stay in a care home is 2 years.¹²

The Government has set up a Commission on the Funding of Care and Support which will consider a range of funding ideas including both voluntary insurance and partnership schemes.¹⁴

WHAT INCOME AND ASSETS WILL FUTURE PENSIONERS HAVE?

Many future pensioners are likely to have a greater variety of income and assets, including housing wealth, available for use in retirement than pensioners today. These will include state pensions, private pensions and other assets, and these may be supplemented or boosted by earnings from longer working lives.

STATE PENSIONS ARE THE MOST IMPORTANT SOURCE OF RETIREMENT INCOME FOR PENSIONERS

Currently, around 11.5 million¹⁵ pensioners (95 per cent¹⁶ of total pensioners) receive income from state pensions, making it, on average, the most important source of retirement income. However, the relative importance state pension income plays for any pensioner household is dependent on what proportion of their total income is from state pensions. 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.¹⁷

STATE PENSION REFORMS ARE LIKELY TO INCREASE THE LEVELS OF INCOME PENSIONERS RECEIVE FROM STATE PENSIONS

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 qualifying years needed for a full Basic State Pension (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.

The recent announcement that the BSP will be subject to a 'triple lock', and be uprated from 2011 with the higher of earnings growth, prices or 2.5 per cent is likely to continue improving state pension income. However, the announcement that once in payment income from S2P will be indexed to the Consumer Price Index rather than the Retail Prices Index is likely to lead to S2P in payment increasing more slowly than previously thought.

Everyone who is entitled to some BSP will receive more income from state pensions than they would have without reform. 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, for example, men with full national insurance records.

In addition to income from state pensions, many people use income from private pensions and other financial assets to help support retirement.

PRIVATE PENSIONS ARE AN IMPORTANT SOURCE OF INCOME FOR PENSIONERS ON MODERATE TO HIGH INCOMES

A total of 67 per cent¹⁸ of pensioners receive income from private pensions, though pensioners on high incomes receive on average a much larger proportion (around 35 per cent of their income) from private pensions than pensioners on low incomes who receive on average between 9 and 14 per cent of their income from private pensions.¹⁹

There are many options for the receipt of private pension income. People in receipt of private pension income, who saved in a Defined Contribution (DC) pension, could receive their income from a retirement income product such as a lifetime annuity or an income drawdown arrangement.²⁰ People who saved in a Defined Benefit (DB) pension in working life, or in some occupational DC pensions, could receive their private pension income directly from their pension scheme.

OTHER FINANCIAL SAVINGS AND ASSETS ARE AN IMPORTANT SOURCE OF INCOME FOR PENSIONERS ON HIGH INCOMES

The majority of pensioners, around 70 per cent,²¹ receive some income from savings and investments; however, saving and investments are a much more important source of income for wealthier pensioners. Pensioners in the top (wealthiest) quintile of the UK net income distribution receive on average 16–19 per cent of their income from savings and investments while pensioners in the bottom four quintiles receive, on average, only 3–6 per cent of their income from savings and investments.²² Pensioners in the top quintile of the net income distribution are much more likely to have a varied basket of assets and income than pensioners in lower income quintiles (Figure 2).²³

THE PRIVATE PENSION REFORMS COULD INCREASE THE PROPORTION OF PENSIONERS RECEIVING INCOME FROM PRIVATE PENSIONS

The Pensions Act 2008 contains three major reforms to the private pensions system, all to be phased in or implemented from 2012. The reforms which affect employers will be phased in to reduce administrative burdens. 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).

Figure 2: Pensioners on low incomes receive the majority of their income from state pensions. Mean gross weekly income of single pensioners by quintile of the UK net income distribution in 2007–2008 prices (AHC).

- Require employers to make contributions of at least 3 per cent of band earnings²⁴ to eligible employee's workplace pension schemes.
- Introduce a new, low cost, national pension savings scheme, called NEST (National Employment Savings Trust).

Assuming that opt-out rates after auto-enrolment are in line with Government expectations of around 25 per cent,²⁵ the proportion of people with private pension savings after 2012 could rise from around 40 per cent of the working age population today (around 14 million people)²⁶ to around 21 million people, or roughly 60 per cent 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 (SPA). 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.

The new Government is committed to the introduction of auto-enrolment but the reforms are currently the subject of a review.²⁷ The review is concentrating on specific issues surrounding the extent of auto-enrolment and the vehicle used for auto-enrolment.

INCOME FROM PRIVATE PENSIONS WILL BE AFFECTED BY CHANGES OCCURRING IN THE PRIVATE PENSIONS MARKET

Although work-based pension provision has traditionally been supplied in the form of 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 new and existing members,²⁸ and for employers to offer membership in DC schemes instead.²⁹ If current trends continue, then active membership in private sector DB schemes could reduce from 2.5 million today, to around 1.5 million active members by 2050 (Figure 3). The trend for DB schemes to be replaced by DC schemes is more prevalent in the private sector than in the public

Figure 3: 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.

sector³⁰ where the predominant form of pension provision remains DB pension schemes.³¹

An expected increase in savers resulting from auto-enrolment coupled with the trend for employers to offer DC scheme membership rather than DB indicates that many more people are likely to be saving 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 (Figure 3).

A SHIFT FROM DB TO DC 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 pensions.³² In private sector DC pensions, employers contribute on average around 7 per cent of salary and employees contribute around 3 per cent of salary. While in private sector DB pensions, employers contribute around 16 per cent of salary and employees contribute around 5 per cent.³³ There is some evidence that employers lower their contribution rates when switching from DB to DC schemes.³⁴

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. In DC schemes, it is the scheme

members who bear the risks of low investment returns, fund losses because of market fluctuations, and poor annuity rates at the point of retirement. While in a DB scheme, the employer is liable for agreed payouts to scheme members regardless of the performance of the invested pension fund.

AN INCREASE IN PRIVATE DC PENSION SAVING MEANS THAT MORE PEOPLE WILL USE THE ANNUITY AND RETIREMENT PRODUCTS MARKET

As a result of auto-enrolment and the shift from DB to DC, a greater proportion of pensioners will retire with private DC pension savings in future than is currently the case. There are an estimated 5 million people saving in DC pensions today.³⁵ By 2020 there could be around 15 million people saving in a DC pension, and by 2050 there could be around 17 million people saving in a DC pension. 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 respond to the private pension reforms.³⁶

As a result of this, in the future the retirement products market will face a greater number of new customers, and the annuity and retirement products market will need to hold and manage a larger proportion of people's wealth in retirement than it does today.

AUTO-ENROLMENT COULD CAUSE THE FINANCIAL PROFILES OF PENSION SAVERS TO CHANGE

As a result of auto-enrolment the financial profiles of people who purchase annuities is likely to change in the future to include more people on low to moderate incomes (the target group for NEST).³⁷ An increase in low to moderate earners saving in private pensions may affect average pot sizes, as low to moderate earners may make smaller pension contributions than higher earners. As the numbers of people with private pension savings increases, and especially the number of people with small pots, it will be

necessary to ensure that appropriate advice, information and products are made available so that people can maximise their income in retirement.

MORE PEOPLE WILL NEED FINANCIAL ADVICE OR INFORMATION IN FUTURE

Shifts within the private pensions and savings landscape mean that in the future people may be required to make more choices regarding their savings than they needed to in the past.

Changes such as the shift from DB to DC will mean that many new and existing savers will need to make more complex choices regarding pension investments and retirement income than previous generations.

People may have more complex combinations of income and assets to manage in future. Some people, especially higher earners, could have baskets which include state pension entitlement, residual DB pension entitlement, DC pension savings, other financial savings and assets, housing assets, and earnings.

Within the new pensions and savings landscape, more people are likely to need some kind of information or advice to support them in making these complex financial decisions. This is likely to be even more true if, as proposed the compulsory annuitisation requirement for DC pensions in the United Kingdom is relaxed.³⁸ If all individuals have the choice between annuitisation and an alternative form of income drawdown, decisions around how to convert a pension fund into an income become more complex.

OTHER INCOME AND ASSETS CAN BE USED TO SUPPORT RETIREMENT

Another way that people might attempt to increase their income after SPA is by working longer. Working longer can increase income in retirement by allowing pensioners to use their earnings to fund living costs after SPA or by allowing pensioners to save their earnings to use during later retirement. Working longer can also increase retirement income if people defer taking

their state or private pensions while working. If people defer taking their state pension they will receive extra income from it when they do take it (in the form of a lump sum or an extra supplement to their pension). If people continue contributing to their private pensions after SPA they can increase the amount of their pension pot by the amount of extra contributions and investment returns (in the case of DC pensions) or by any additional years of entitlement (in DB pensions).

In addition to income from state pensions, private pensions and other financial assets some people use, or have the potential to use, housing wealth to help support retirement.

Alongside pension wealth, housing wealth is one of the largest asset classes held by UK households.³⁹ Ten per cent of all working people expect property to be their main source of retirement income⁴⁰; however, many people do not consider housing wealth as a way of saving for retirement.

There are several ways in which pensioners can use housing wealth to support retirement. Owning your own home can reduce living costs, as, for example, no rent has to be paid and a mortgage is generally paid off by retirement. Homeowners can use housing equity to provide extra income or a lump sum when required, for example using reverse mortgage or equity release products. Property can also be used as part of an investment portfolio, or provide rental income (for example, from a second home).

However, housing wealth is unequally spread across the population, and so not everyone will have housing wealth that can be used to support retirement. A large number of people have little or no housing wealth, while a relatively small number of people have high levels of housing wealth: 10 per cent of people over age 50 own a third of all of the housing wealth held by people over age 50. Twenty per cent of people over age 50 have no housing wealth.⁴¹

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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