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Measuring adequacy under the new pension flexibilities

Introduction

The Department for Work and Pensions (DWP) estimated in 2012 that just over 10 million were at risk of having inadequate retirement incomes. Replacement rates are one measure of adequacy; assessing the extent to which retirement income allows individuals to replicate the standard of living they had in working life.

Replacement rates have been brought into question by the removal of constraints to how individuals can access their Defined Contribution (DC) savings, from April 2015. This briefing note considers the applicability and use of replacement rates in the context of the new pension flexibilities as well as other developments, such as the rise of debt levels.

The note starts with an overview of how replacement rates are used. It then considers debt levels in the UK along with a brief overview of issues relating to the interaction of DC pensions and debt in other countries where a liberalised market is in place.

The note considers particular challenges around the use of replacement rates in the context of the new pension freedoms. Finally, the note outlines some opportunities for and approaches to the management of retirement income, suggested by participants in a Round Table event conducted by the PPI and hosted by J.P. Morgan.

Use of replacement rates

Replacement rates are defined as the ratio of retirement income to working life earnings (Chart 1). More information is available in the DWP *"Framework for the analysis of future retirement incomes."*[1]

The replacement rate calculation is sensitive to what is considered as retirement income and what is considered as earnings. For example, this calculation will vary according to whether an individual's income from buy-to-let property is included in the definition of retirement income.

Chart 1 shows, using the DWP framework, that an individual earning less than £12,200 in 2013 would require 80% of this income level in each year of retirement in order to replicate this standard of living during their retirement.[2]

While replacement rates take into account assets, they do not take into account debt and the fact that debt can reduce the amount of DC savings available to provide an income.

Developments around UK debt

Overall, both secured and mortgage debt is lower in the retired than the working population.[3]

For those individuals aged 50 and over, the proportion of individuals in debt decreased between 2006 and 2012. While 39% of people aged over 50 in 2006 had any type of debt, this had decreased to 32% in 2012. However, where individuals were in debt, the extent of the debt appeared higher; median debt increased from £10,200 to £12,000 (not taking into account inflation).[4]

At the same time, sources suggest that these figures may include a higher proportion of individuals aged over 65 with unmanageable levels of debt. Between 2001 and 2011 bankruptcies amongst individuals aged 65 and over increased by 470%.[5]

Chart 1: Replacement rate calculation: Approach taken by DWP

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Measure of pre-retirement income
Average earnings from age 50 until State Pension Age

↓

Apply replacement rate calculated by Pensions Commission, calculated in 2012 terms ←

Earnings in 2013 terms	Replacement rate
£12,200	80%
£12,200 - £22,400	70%
£22,400 - £32,000	67%
£32,000 - £51,300	60%
Over £51,300	50%

↓

Compare with average annual income calculated for the entire retirement period, made up of the state pension and private pensions

Source: DWP (2013) Framework for the analysis of future pension incomes

PPI Briefing Notes clarify topical issues in pensions policy.

It is difficult to know if this is an on-going trend or not. Attitudinal factors associated with particular cohorts of retirees and the economic climate, may have had an impact on this.

Recent developments suggest that the number of individuals with DC savings and debt as they approach retirement, may change over the next decades as subsequent cohorts approach retirement age.

NEST highlighted the possibility that future retirees will have higher levels of debt. Those attributes associated with having debt are likely to be more common amongst future retirees who will have DC savings as a result of being automatically enrolled. These attributes include being a social tenant, in a low income household, a lone parent or having a disability.[6]

International comparisons provide some insight into interactions between the pension system and debt

The UK has a higher level of household debt as a percentage of nominal disposable income than, in particular, some European countries, and the US.[7] While this does not provide any insight as to how this debt is distributed in terms of age, this suggests that the repayment of debt may be an option for how individuals use their DC savings. It also suggests that, if the new pension flexibilities lead to individuals taking on more debt, any increase will be to a relatively high baseline.

Other countries' experiences also suggest that the new pension flexibilities might have an impact on debt in the following ways:

- Individuals might use their DC savings to repay debts that they accrued in their working lives
- Individuals might accrue higher levels of debt on the basis that they are able to access their entire DC savings in order to repay this debt.

New Zealand

In New Zealand, where there is no limit on accessing DC savings, some individuals have used their KiwiSaver (similar to automatic enrolment) savings to repay mortgage debt.[8]

Australia

There has been some suggestion that, in Australia, increased amounts of DC savings in a liberalised pension system have led to higher numbers of individuals accruing mortgage debt.

In 1994-95, approximately 80% of Australian households where the reference person for the household was aged 55-64 owned their own home, and only 10% of these had a mortgage. By 2009-10, the number of home-owning households among this group had increased to 82%, but the number of households in this category with mortgages increased to 30%.[9]

Chart 2: UK individuals have a high level of debt and, in particular, mortgage debt

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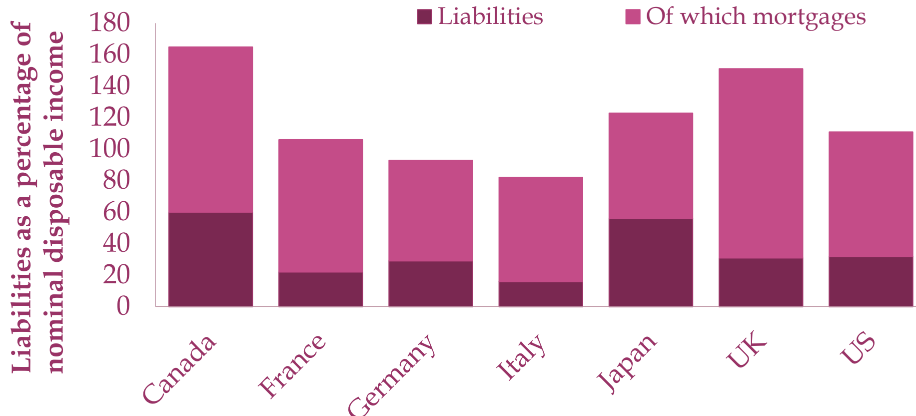
Individuals' liabilities as a percentage of nominal disposable income



Source: OECD (2013) Household wealth and indebtedness

Challenges to the use of replacement rates

- Where individuals elect to withdraw different amounts each year from their DC pot, it is more difficult to use the replacement rate approach (that uses calculations based on the annual income during working life and in retirement).
- Where an individual uses some of their pension pot to repay debt at the beginning of their retirement (reducing the remaining pot), a higher re-

placement rate may be required for them to acquire the same standard of living as during their working life. This would be compounded where future retirees had a higher level of debt.

- Replacement rates focus on private and state pensions and do not take into account other sources of funds, such as inheritances. NEST highlights that, on average, unearned income such as inheritances replaces almost 50% of all pre-retirement income.[10] These types of sources of wealth are unevenly distributed and tend to fluctuate over time, making it difficult to take these into account in replacement rate calculations.

Other developments that may make it difficult to use replacement rate

The use of replacement rates will become increasingly complex where there is growing diversity in individuals' financial circumstances approaching retirement. This diversity makes it more difficult to identify an appropriate replacement rate based on a specific earnings level.

Greater variation in retirement patterns, also brings into question the use of replacement rates. Data from the English Longitudinal Study of Ageing (ELSA) highlights that, for most people, starting to receive private pension income and leaving paid employment do not happen simultaneously.[11]

Other trends that may have an impact on the use of replacement rates include an increase in the number of older people in work and an increase in older people working part-time.

Between 2004 and 2010, the average age at which people left the labour market increased from 63.8 years to 64.6 years for men and from 61.2 years to 62.3 years for women.[12]
A relatively high proportion of older people are working part-time. Overall, two thirds of those individuals aged 65 and over in employment are working part-time (Chart 3).[13]

This complicates the calculation of replacement rates, e.g. where a target replacement rate is applied to a year in which an individual has part-time earning only, this may under-estimate the level of earnings that they require in order to have the standard of living in retirement that they experienced over the course of their working life.

Replacement rates may remain a valuable tool to measure the extent to which the population risks having inadequate retirement incomes

Replacement rates are a broad indication around the level of income that individuals require in retirement. They provide an indication of the extent to which individuals are at risk of having an inadequate retirement income. They also enable the DWP to calculate the proportion of individuals overall who are at risk of having inadequate retirement incomes.

Chart 3: Proportion of workers who work part-time increases sharply for workers aged 65 and over

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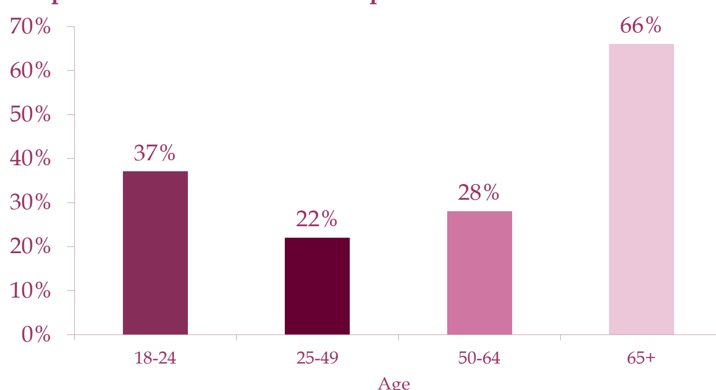
Proportion of workers who work part-time



Source: Reproduced from DWP Older Workers Statistical Information booklet

The rest of this briefing mote summarises discussions from a Round Table conducted by the PPI and hosted by J.P Morgan.

Other approaches are available that can help people to provide for an adequate retirement income

Replacement rates can be problematic because they are not meaningful to pension savers.

NEST research highlights an alternative approach. This estimated the threshold income for a 'comfortable retirement' to be around £15,000.[14]

As well as considering the level of income needed to pay household bills, this research considered determinants of quality of life such as individuals' satisfaction with their life, and whether they feel comfortable in financial terms.

While levels of well-being continue to rise as pensioners have higher incomes, up to incomes of £40,000, £15,000 is the 'tipping point' at which significant numbers of people feel more positive about their standard of living.

Opportunities for and approaches to the management of retirement income in the new pensions landscape

Individuals are positive about retirement

The fact that individuals are positive about retirement provides an opportunity for a more positive approach with a focus on the things that individuals can do with their retirement income.

It would be beneficial for any talk about retirement income to become part of normal conversation. A straightforward question like 'Have you got enough?' might resonate with pension savers.

The consideration of all sources of income, wealth and debt together represents an opportunity for individuals

There is a tendency among individuals and government to consider pension wealth separately to other sources of wealth in retirement. This is reflected in the use of replacement rates. However, in practice, individuals may make the best use of their pension savings if they structure these as a package that includes their other assets and sources of income, such as the state pension, and debts. The new pension flexibilities provide an additional opportunity for individuals to do this.

Real life case studies may help savers to better understand the benefits of pension saving

People like to know what other people are doing, and this may be an avenue for exploration as a way of encouraging pension saving.

It may be possible to link retirement income decisions to event triggers

The main determinant of inadequate retirement incomes is undersaving by individuals. Individuals tend to take action too late when their ability to act is already compromised. Events in individuals' lives hold the most resonance—and that messages around retirement saving might be linked to trigger events. While this idea may need further exploration, the following types of events could be meaningful:

- Fully repaying student debt
- Starting a first job/changing job
- Marrying or divorcing
- Fully repaying mortgage

Conclusions

While the application of replacement rates is more challenging under the new pension flexibilities, they remain valuable as a way to measure the extent of individuals having inadequate retirement incomes.

It should be possible to frame retirement decisions in a more positive way in the new pensions landscape. This offers opportunities to target discussions and education around pension savings.

1, 2 DWP (2012) *Framework for the analysis of future pension incomes*
3 WAS Wave 2 2008-10 in NEST (2014) *The future of retirement*
4 PPI analysis of ELSA Wave 6
5 Independent (2013) *Pensioners face bitterness and bankruptcy in retirement as debt levels soar*
6 NEST (2014) *The future of retirement*
7 OECD (2013) *Household wealth and indebtedness*
8 Inland Revenue (2013) *KiwiSaver, early retirement withdrawal survey*
9 Estimates provided by Challenger
10 NEST (2014) *The future of retirement*
11 IFS (2012) *The evolution of pension wealth and contribution dynamics*
12 ONS (2012) *Average age of retirement rises as people work longer*
13 DWP (2013) *Older Workers Statistical Information booklet*
14 NEST (2014) *Retirement realities: Tomorrow's worth saving for*

J.P.Morgan Asset Management

The PPI is grateful to J.P. Morgan Asset Management for hosting a Round Table event at which these issues were discussed.

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