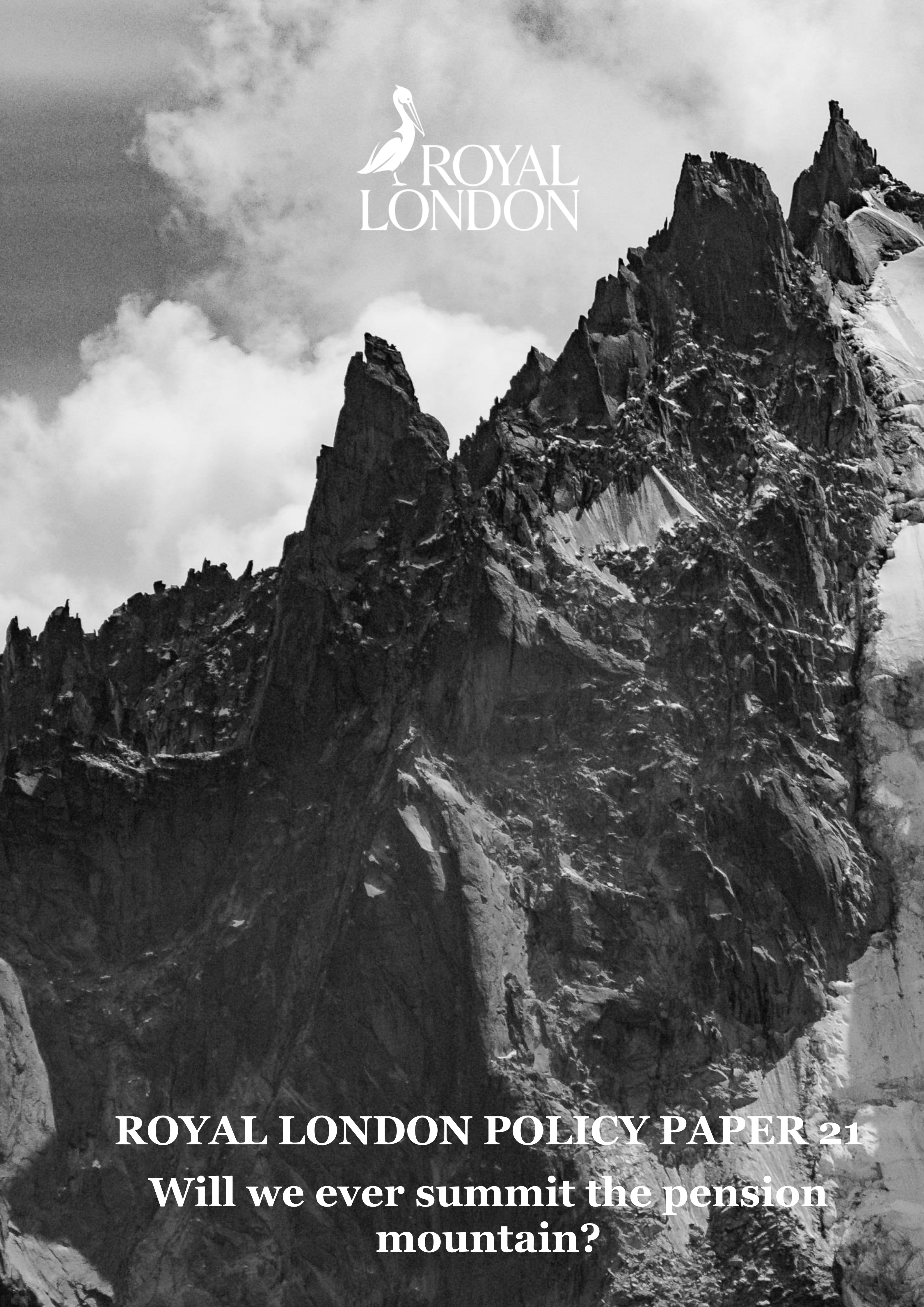

ROYAL LONDON POLICY PAPER 21

Will we ever summit the pension mountain?

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Will we ever summit the pension mountain?

1. Introduction

One of the most frequently asked questions in the world of pensions is 'how much do I need to put into my pension?'. The answer obviously depends on things like how old you are, how much you earn, when you plan to stop work and what standard of living you want in retirement. But one way of answering this question is to think about the pension 'pot' that you need to have built up by the time you retire. Broadly speaking, you want to be able to generate an income from your state pension and your private pension that will allow you to enjoy in retirement the same sort of standard of living that you enjoyed when you were of working age.

As a broad rule of thumb, if your combined pension income in retirement is about two thirds of your pre-retirement gross wage then you shouldn't see a major change in your standard of living when you stop earning.

There are several reasons why you don't need to replace 100% of your pre-retirement wage:

- Once you are over pension age you no longer pay National Insurance Contributions on your income, whereas workers are generally paying NICs at a rate of 12% on a band of earnings;

- Once you are retired you are generally drawing out of a pension, whereas when you are in work you need to set aside some of your wage to put into a pension;

- Once you are retired you are more likely to have paid off a mortgage (though this is changing, as we discuss later) and therefore you no longer need to be able to fund mortgage repayments out of your take-home pay;

- Once you are retired you no longer have work-related costs such as commuting, buying work clothes etc.

- The income tax system is progressive and so a higher proportion of post-retirement income is likely to be covered by the tax free personal allowance and the basic rate band than the income of those of working age;

In terms of pounds and pence, in January 2018 the average wage was £514 per week or £26,728. [1] Someone retiring this year on a full flat-rate state pension would be getting £164.35 per week or £8,546 per year. Table 1 shows the extra income that would be needed from a private pension to bring the average earner up to two thirds of pre-retirement wage in retirement.

Table 1. How much private pension income does the average worker need?

Average earnings (£ pa, Jan 2018)	£26,728
Target income in retirement = 2/3 of the above	£17,819
Less full state pension	*-£8,546*
Gives target income from private pension	**£9,273**

When individuals retire with an accumulated pension pot they are no longer obliged to turn that pot into an income for life by buying an annuity. But looking at the size of pot that would be needed to buy an annuity at the level shown in Table 1 does give us some idea of the scale of what might be needed, and also allows us to track over time how the pension pot target or 'pension mountain' has changed in size.

For the purposes of this paper we assume that someone stops work at age 65, has all of their pension wealth in the form of a single pension pot and uses that fund to buy an annuity which rises each year to provide some protection against inflation but which does not have any provision for a surviving spouse or partner.

Based on current annuity rates, Table 2 shows the size of pension pot that would be needed to generate a pension at the level shown in Table 1[2].

Table 2. How big is the pension pot needed to generate the target income?

Target income from private pension (£ pa)	£9,273
Divided by index-linked annuity rate at age 65	*3.56%*
Gives target pension pot size (rounded)	£260,000

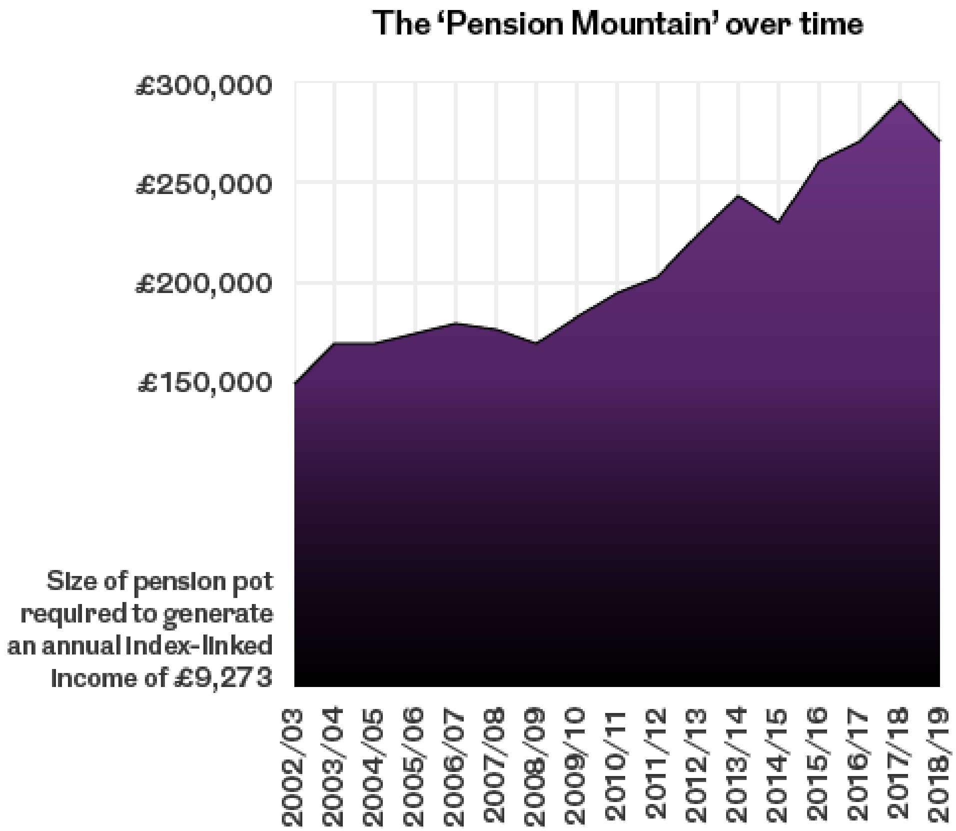
[1] Source: https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/averageweeklyearningsearn01

[2] Note that the exact annuity rate available would depend upon individual circumstances.

2. How has this changed over time?

The amount of money that you need to generate a pension pot of a given size depends on how much annual income an insurance company is willing to offer you in exchange for your pension pot. This is known as the annuity rate. At time of writing (May 2018), a typical person aged 65 could get an annual income of a little over £3,500 for each £100,000 in their pension pot, assuming that they want this income to rise at 3% per year through retirement to keep pace with rising prices. Annuity rates obviously fluctuate from year to year, but over the last decade they have fallen sharply. This is a consequence of improvements in longevity and falls in interest rates. This means that the size of pot that you need to generate any given income level has risen significantly. In Figure 1 we show the 'pensions mountain' that would have been needed over the last decade to generate an annual income at retirement of just over £9,000 per year, which is the income shortfall we identified in the last section.

Figure 1. The 'Pensions Mountain' over time – the size of pension pot needed to generate an annual index-linked income of £9,273 from 2002/03 to 2018/19



Source: Royal London calculations based on historic annuity rates kindly provided by Billy Burrows (www.billyburrows.com)

As Figure 1 shows, the pensions mountain that we all need to climb has become much more daunting over the last sixteen years. Back in 2002/03, a pot of around £150,000 would have bought you an annual income of £9,273 to top up your state pension. In 2018/19, that pot needs to be around £260,000, an increase of nearly three quarters. This is however slightly lower than the peak figure of nearly £290,000 for 2017/18, reflecting a modest improvement in annuity rates in the last year.

3. What other factors might affect the size of the 'pension mountain'?

So far we have made a number of assumptions in order to work out the target private pension pot needed to generate a post-retirement income of two thirds of your pre-retirement gross wage and thereby to maintain your standard of living into retirement. The two most important are:

- That you own your property outright, so you have no rental costs or outstanding mortgage payments;
- That you do not have to budget for potential long-term care costs (such as going into a care home) later in your retirement.

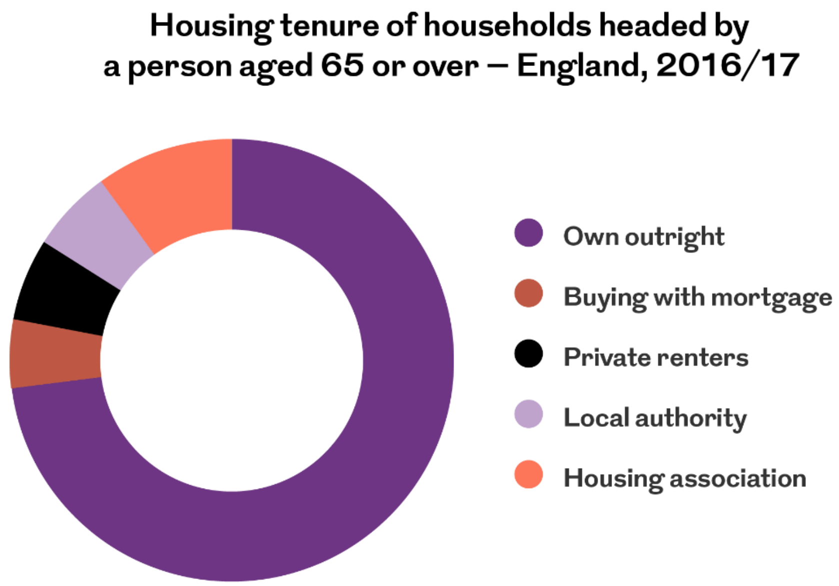
As we discuss below, there is reason to think that these assumptions might not be as safe as they once were, so in this section we consider the impact on the 'pensions mountain' which people have to climb if they were to have to meet additional costs such as housing or care in retirement. We consider each in turn.

a) Impact of being a renter

Data on the housing tenure of older people can be found in the English Housing Survey and is summarised in Figure 2.[3]

[3] https://www.gov.uk/government/statistics/english-housing-survey-2016-to-2017-headline-report

Figure 2. Housing tenure of households headed by a person aged 65 or over – England, 2016/17



Source: English Housing Survey, 2016/17

As shown in Figure 2, in 2016-17 there were 6.55 million households in England headed by someone aged 65 or over but only around three quarters were outright owners as we have assumed to date. Roughly 1.05 million were social renters (renting from a local authority or housing association) and 0.41 million were renting privately. In all, just under a quarter of all households headed by someone aged over 65 was living in rented accommodation.

Rent levels for pensioner households will be very different depending on whether the landlord is a housing association / local authority or a private landlord. Table 3 is based on data from the 2015/16 Family Resources Survey and provides estimates of weekly gross rent levels for pensioners living in social rented accommodation and in private rented accommodation. Note that these rental figures are gross rents and do not take account of any help through housing benefit. We are assuming for the purposes of this paper that the goal is to secure a decent standard of living in retirement without needing to rely on means-tested social security top-ups.

Table 3. Illustrative rent levels for pensioner households in 2015/16

	Annual rent, £ pa
Social tenants	£4,455
Private tenants	£6,554

Source: Author's calculations based on 2015/16 Family Resources Survey

For retired people, these rental figures represent an additional stream of cost which would not be faced by the owner-occupier in our base case. We assume therefore that an additional pension pot would be required at retirement to generate an income to cover this additional expenditure. Table 4 shows the resultant pension mountain for different tenure groups. Note that average (pre-retirement) earnings is assumed to be the same across all tenure types, which is a simplifying assumption.

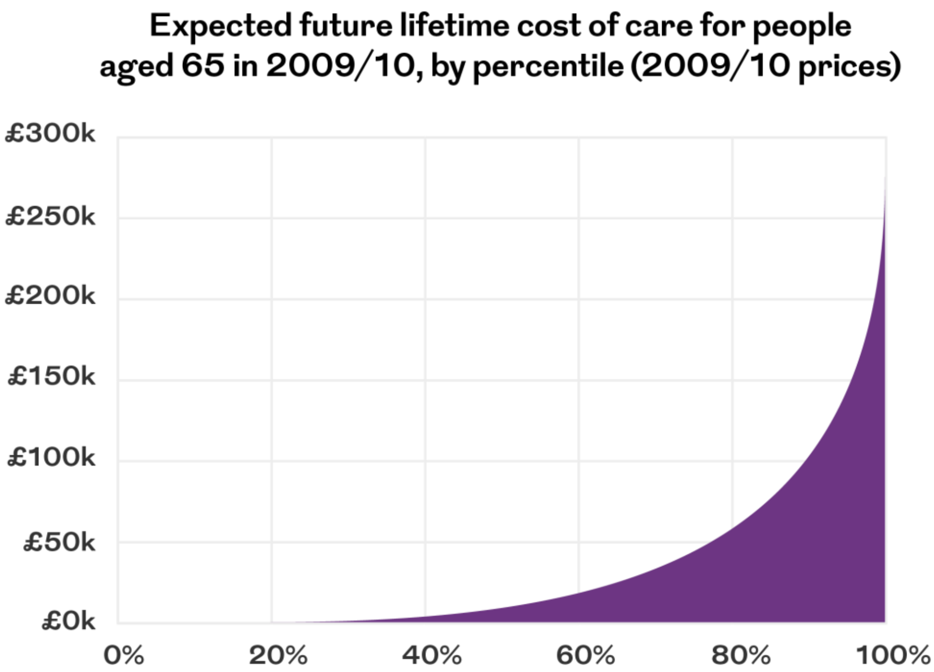
Table 4. Target pension pot for retired households of different tenure types

	Owns outright	Social tenant	Private tenant
Average earnings (£ pa, Jan 2018)	£26,728	£26,728	£26,728
Target income in retirement = 2/3 of the above	£17,819	£17,819	£17,819
Less full state pension	*-£8,546*	*-£8,546*	*-£8,546*
Plus post-retirement housing costs	-	*+£4,455*	*+£6,554*
Gives target income from private pension	**£9,273**	**£13,728**	**£15,827**
Target pension pot based on 3.56% annuity	**£260,000**	**£385,000**	**£445,000**

As Table 4 shows very clearly, having to fund a significant rent out of post-retirement income means that a much higher pension pot is required to avoid a fall in living standards at retirement. In particular, a private renter needs roughly an extra £185,000 in retirement to cover off their rent in order to leave them in the same position net of housing costs as an outright home owner.

b) Impact of care costs

The report of the 2011 Commission on Funding of Care and Support (the 'Dilnot' Commission) found that lifetime care costs vary hugely from individual to individual. For roughly a quarter of the population total costs will be negligible, because they will die before needing a significant amount of care. For many others, the cost will be relatively modest and will be met from their assets. But for a minority, such as those who spend a prolonged period in later life in residential or nursing care, the total cost could be huge. This data is summarised in the following chart taken from the analytical section of the report of the Dilnot Commission, page 26:



Source:
http://webarchive.nationalarchives.gov.uk/20130221121551/https://www.wp.dh.gov.uk/carecommission/files/2011/07/Volume-II-Evidence-and-Analysis1.pdf

In our base case we have assumed that the person at age 65 will not have to find money to pay for care costs, and this assumption seems reasonable for around a quarter of those reaching age 65. If we look at the remaining three quarters who will have some care costs, and take the median of this group (that is, we look at the 62nd percentile of the distribution as a whole) the above chart suggests a figure of around £30,000 might be appropriate for 2009/10. Assuming inflation of around 2.5% pa for the following 8 years would give us a figure in the region of around £36,000 in today's prices.

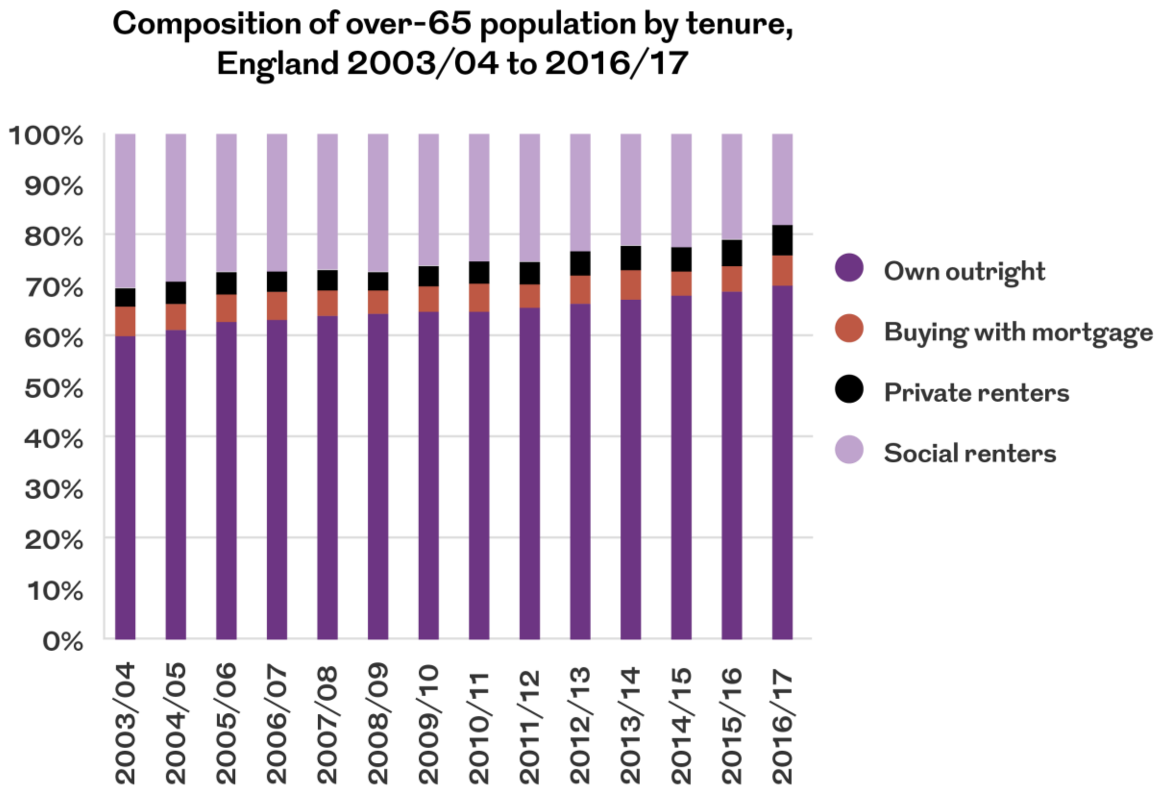
Most care costs fall in the latter part of retirement, so if the median person needing care is likely to end up spending around £36,000 perhaps in their eighties, they will not need an extra £36,000 at age 65. If we suppose that they were to set aside a fund at age 65 and invest it for twenty years at an average annual real rate of return of 2%, they would need a pot of a little over £24,000 at retirement to cater for potential care costs.

4. Impact of changes in housing tenure

a) Historic trends

The English Housing Survey allow us to look back to 2003/04 and track the changing tenure make-up of the over 65 population. This is shown in Figure 3.

Figure 3. Composition of over-65 population by tenure, England 2003/04 to 2016/17



Source: English Housing Survey, 2003-04 to 2016/17

Figure 3 shows that the proportion of pensioners who own their own home and have paid off their mortgage in full has risen significantly over the last decade or more. At least in part this is likely to reflect the impact of the 'right-to-buy' policy introduced in the 1980s which allowed local authority tenants to buy their own home.

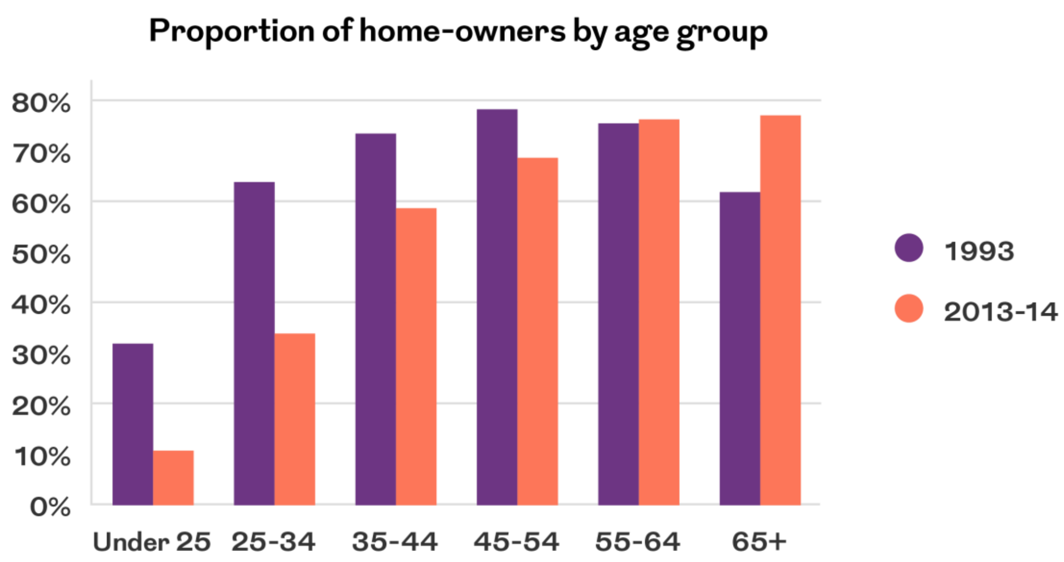
In the short-term, the good news is that this means that more people in retirement are similar to our 'base case' in that they no longer have rent or mortgage interest to pay out of their retirement income.

Amongst renters however a somewhat different pattern emerges. The proportion of older households who are renting from a social landlord has noticeably declined, whilst the proportion of older households with a private landlord seems to be edging up each year. In absolute terms, the number of private renters aged over 65 is now at a record 414,000 compared with 220,000 at the start of the period. This means more pensioners needing a pension pot in excess of £440,000 (see Table 4) rather than the £260,000 needed by owner-occupiers.

b) What could the future hold?

Whilst the rise in home ownership amongst retirees is good news in terms of the affordability of retirement, there is reason to think that home ownership rates may have peaked for those approaching retirement.

Figure 4. Proportion of home-owners by age group, 1993 and 2013-14



https://www.cml.org.uk/news/news-and-views/710/

Figure 4 shows that the proportion of home owners among the over 65s has risen sharply in the twenty years up to 2013/14, but that home ownership rates have not improved for the 55-64 age group and are substantially lower for lower age groups. This suggests that, over time, the number of people in retirement who will have to meet the costs of rented accommodation out of their pension income could begin to rise quite sharply.

Recent research published by the Resolution Foundation[4] suggested that around 1 in 3 of the 'Millennial' generation could find themselves renting 'from cradle to grave'. This would substantially increase the pensions mountain faced by this age group and indicates that currently minimum savings rates for workplace pensions are likely to be substantially short of what this group needs to be saving if it is to avoid a sharp fall in living standards into retirement.

5. Will we ever summit the pension mountain?

In the past, it was reasonable to assume that a target income of two thirds of pre-retirement earnings would be needed to maintain living standards into retirement. For many people, that target would be delivered by a combination of a state pension and a final salary workplace pension. The challenge for future generations of workers is that neither of these assumptions any longer holds true.

The target of two thirds of pre-retirement income is based on two assumptions which may be increasingly untenable. The first is that we can assume that all housing costs (beyond routine house maintenance) have ceased in retirement. The second is that we will not have to fund substantial care costs out of our retirement income. For growing numbers of people these assumptions will not hold.

In terms of pension policy, the best response remains measures to help people build up a larger pension pot so that they are better placed to meet the costs of renting in retirement. This means improving automatic enrolment so that:

- Coverage is improved, with more self-employed people and lower paid workers starting to build up a pension pot;

- Contribution rates are increased, with default step-ups from the mandatory 8% contribution rates when people get pay rises;

But tackling this issue goes much wider than pensions policy, and includes labour market policy, housing policy and social care policy. Measures which would help to address the issues in this paper include:

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[4] https://www.resolutionfoundation.org/publications/home-improvements-action-to-address-the-housing-challenges-faced-by-young-people/

- Action to tackle the declining home ownership rates among younger workers, including increasing the supply of affordable homes;

- Support for older workers to enable them to keep contributing into a pension for longer;

- Support for insurance against potentially 'catastrophic' social care costs, so that people are not expected to save individually enough to cover unpredictable levels of care.

Whilst annuity rates may gradually rise, which would bring the 'pensions mountain' back from its peak level, the risk of facing housing and care costs in retirement will push the top of the mountain further out of reach. We urgently need a 'joined-up' policy approach to this issue lest we have a generation of workers who simply cannot afford to retire if they want a decent standard of living in retirement.