Executive Summary

Squeezed in Retirement

The Future of Middle Britain

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A Chatham House Report

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A distinctly UK problem

Provision for income in retirement remains a huge challenge for individuals, families and policy-makers. Although the topic has been much discussed, the debate on the new Pensions Bill in the UK offers an appropriate opportunity to reflect on the future of such provision, and perhaps to draw out lessons for other countries.

The UK is unique among developed economies in the degree of ongoing experimentation in its pension system. Through a series of reforms over two decades it has avoided the fiscal challenge of promising generous state pensions to a growing old-age population. The current Pensions Bill, by raising the state pension age and expanding enrolment in workplace pension schemes, should further contribute to the system's sustainability.

However, the UK has a relatively low level of state pension provision, and unlike in other European countries, the responsibility for personal financial planning and saving for retirement falls on individuals and households. Even if the UK is unlikely to face a crisis in its pensions system, therefore, future pensioners themselves are likely to be confronted by a crisis of expectations and a 'squeeze' in income. Because of low savings rates, middle class households may lack sufficient financial resources in retirement and could experience a considerable drop in their income. As a result, they may be unable to maintain the lifestyle they enjoyed during their working years, one which they may have expected to continue enjoying in retirement. Some may even slip into poverty.

A squeeze on the middle classes in retirement

This Chatham House Report takes a fresh look at how people in the UK save for their retirement and highlights the threat of a mismatch between individuals' savings behaviour and expectations regarding their future lifestyle. If people expect to maintain their lifestyle in retirement – with only marginal adjustments – the report's assessment of future incomes suggests that many from the middle class, middle income groups will be very disappointed.

By projecting retirement incomes forward to 2050, the report shows that the UK's middle class will face an acute 'squeeze' during retirement. This situation is likely to worsen over the coming decades as the shift from defined benefit (DB) to defined contribution (DC) pension schemes reduces the generosity of pension payments schemes. Furthermore, the recent recession has highlighted how vulnerable wealth and pension funds are to economic shocks and reduced annuity conversion rates. Such risks only add to the uncertainty over the benefits to be gained from increased lifetime savings, discouraging already reluctant savers.

This report finds that approximately 15 million UK households in the middle income groups – those with incomes today of between approximately £18,000 and £44,000 – risk a reduction in their income of almost 60% when they retire. Across the UK, 60% of the population – those individuals with incomes today of up to £33,000 – will be reliant on the state pension for more than 50% of their retirement income. And around 10 million households, the poorest 40%, risk having to live mostly off state pension provision that only just provides a minimum standard of living.

The report also finds that the squeezed middle is most at risk from specific macro-economic risk scenarios, including the impact of low bond yields, low house price growth and an accelerated shift out of DB pension scheme membership. In the worst case scenario in which all the risk factors come into play, the middle classes as well as the highest income group would all see their retirement income drop by over 10% by 2050 from the base-case scenario.

The overall scale of the drop in incomes and the potential for dashed expectations about the quality of life in retirement raise the spectre of future political as well as fiscal pressures. Certainly, people can adapt to changing, and adverse, circumstances and modify their expectations. However, a large group of impoverished pensioners could bring significant political pressure to bear on government and increase the prospect of some form of intervention.

But it is not too late to adjust and save

The report suggests that there is a window of opportunity for public policies not only to adjust people's expectations *vis-à-vis* their retirement incomes, but even to persuade them to take the necessary action in order to reduce their savings gap.

If middle class households were to make a significant, but not over-burdensome, increase in their savings – an extra 10% of income between the ages of 45 and 64 – this could substantially boost retirement incomes. Enhancing savings provision in this way could begin to turn around the prospects for adequate retirement income within a relatively short time-frame. However, for middle class, middle income households, the opportunity cost of saving is high. This means that policy measures must be designed to reduce the risks, uncertainties and costs of saving for the long term.

The report's analysis offers several policy options and recommendations:

Government incentives to save. Instead of the current incentives to save through tax relief, the government could offer matching contributions. As a genuine subsidy to savings rather than a deferment of tax payments (as with tax relief on contributions), this would make savings more affordable.

Increasing flexibility. Improving the flexibility of pension schemes can also provide an incentive for households to make pension savings. For younger households, linking pension schemes to Individual Savings Accounts (ISAs) would allow savings to remain in flexible accounts. The Canadian Registered Retirement Savings Plan, which allows for limited withdrawal of savings for expenditure on housing and education, may provide a useful example for UK policy-makers.

Simplifying savings decisions and access to financial advice. The UK's pension system is complex and poorly understood, particularly by low to middle income households. Simplifying the decision-making process through further automation and streamlining of savings decisions would reduce the opportunity cost of obtaining information and processing the advantages of various savings plans. Pension funds could become better aligned with banks, for example, by making it possible to check pension fund status online and make changes to such plans, in the same way that bank accounts can now be accessed online. This would make it easier to transfer surplus financial savings into a pension fund or to change investments within pension funds. Improving access to financial advice should also be a priority and it is not clear whether the government's proposed annual family financial health check under the Consumer Education Financial Body (announced in the June 2010 Budget and due to start in spring 2011) will be sufficient.

Guaranteeing annuity rates. As the recent fall in annuity rates has demonstrated, savers face considerable uncertainty about the conversion of pension savings into future incomes; they cannot be sure what income to expect. This factor is exacerbated by the shift away from DB schemes – which, by their nature, offer certain returns – towards DC schemes. If households were assured about the annuity rates they would be facing at the point of retirement, through guaranteed annuity conversion rates, this would provide an incentive to make further savings into private pension schemes. Policy-makers should investigate the feasibility of such guarantees.

Apart from increasing savings, the 'squeeze' on middle Britain in retirement can be mitigated by:

Reforming the state pension. Simplifying the state pension into a universal flat-rate benefit would capture many low

income households (which might otherwise not qualify for full entitlement) and also enable households to make savings decisions that appropriately reflect their expectations for retirement.

Working for longer. The state pension age is already being raised incrementally. However, there is a strong case for arguing that the current upper limit should be raised from 68 to 70. Our model indicates that if retirement is deferred to 70, retirement incomes could be some 5% higher than in the base-case scenario by 2050. This would help to close the middle income group's retirement income gap, reducing its vulnerability to risk and boosting pension incomes through extra earnings from employment as well as a larger property wealth back-up.

Providing incentives for later retirement will require changes to labour market policies. These could include lower income tax rates for people in employment beyond the state pension age and encouraging flexible working patterns and particular career choices that support later retirement.