Phoenix Insights

How much is enough?

Retirement adequacy and the household balance sheet

Interim report

March 2024

In partnership with:

nest insight

Content

Acknowledgement

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About Nest Insight

Nest Insight is a public-benefit research and innovation centre finding better ways to support people's financial wellbeing, now and in later life.

They focus on understanding the needs and goals of those on low and moderate incomes, partnering with employers, product providers and policymakers to identify, invent and test solutions that work for people in the real world. For more information, visit:

Introduction

Before someone can work out how much money to invest for tomorrow, they need to understand what their contributions really cost them today. Currently it is difficult for most people to answer this question.

There are good reasons to say that many defined contribution (DC) savers need to contribute more than they are currently doing. This was already true in the UK before the introduction of automatic enrolment (AE), but the more pressing challenge at that time was that so many workers were not saving for retirement at all. In this sense, AE has been a resounding success, greatly increasing the number of people contributing to a pension through their work. But there remain significant concerns about whether people are saving enough, whether or not they were auto enrolled.

The minimum contribution rate under AE is 8% of a band of earnings. The employee usually makes up half of this amount, net of tax relief. The great majority of people who have been automatically enrolled have never changed that default, and are still saving at that rate[1]. Yet it's become something of a truism to say that 8% is not enough to deliver an adequate retirement income for most people. And even those saving at higher rates may not have chosen this rate for any specific reason. They are often contributing at the default rate set by their employer, or paying the exact amount needed to take full advantage of an employer match. Neither amount will have been set with their specific needs in mind.

Given this, it's reasonable to assume that many DC members aren't saving at an optimal rate. Still, given the diversity of people's financial lives, it's hard to say exactly who is saving too little – or too much.

What's needed is a clear definition of 'pensions adequacy' – the optimal level of retirement income that any given individual should aim for. A number of helpful models have been proposed and there is active debate in the retirement industry and among policy-makers about which is the most suitable. But retirement income adequacy benchmarks on their own can't give definitive answers to the question that's actually facing individual savers: 'How much should I save for retirement?'

For an adequacy model to be meaningful to all, it needs to allow for the enormous differences between the financial lives of different people in different circumstances at different times of life – and for the different strategies they might have. Some will want to maximise their chances of being able to buy a property before they retire. Others will need to tackle the short-term costs of servicing debt. For certain people, the

1 See for instance Nest Insight's series Retirement Saving in the UK.

'right' level of retirement savings will be lower than the amount recommended by traditional models of adequacy at certain times in their lives. In some cases, their target savings rate may be zero, at least in the short term. An understanding these moments will allow for better targeting of nudges and other interventions that can help people make the right choices at the right times.

In this collaboration between Phoenix Insights and Nest Insight, we are exploring the different household and financial circumstances experienced by different groups of people, to develop a more nuanced definition of 'retirement savings adequacy'. This will mean looking beyond the average person and the average retirement outcome. By working out which specific factors make the biggest difference to a worker's optimal savings rate, we can improve our understanding of whether adequacy targets, and the broader retirement savings system, can be better tailored to the diverse needs of real people living in real households.

Research Context

Our work on 'retirement adequacy and the household balance sheet' began in the second half of 2023. We intend to present our modelling approach and a series of findings in the summer of 2024. This interim report outlines the findings from the project's exploratory phase, which involved:

- A review of relevant literature, including economic research about lifecycle models of saving
- A series of interviews with experts from across the retirement savings sector, including a roundtable session – quotations used in this report are taken from these expert interviews
- Exploration of a range of data sources to identify those that would let us investigate the diverse make-up of people's household finances
- Development of modelling methods that will allow us to project households' future financial circumstances, and their retirement incomes
- Creation of a set of model household scenarios that illustrate key differences that exist between real-world households today

Current measurements of adequacy

These activities, and a review of data on the financial experiences of UK households are now informing our modelling approach. We have seen that:

- Simple benchmark targets are effective ways of communicating a savings goal but for many people they will be wide of the mark
- Differences in households need to be taken into account because affordability concerns in the present day vary so widely
- This is true even when we take into account the labour market income of the individual who's paying into a pension
- Even a single difference between two otherwise homogenous households can have a powerful effect on the affordability of pension savings
- There can be significant mismatches between the present day and projected future incomes of many households
- 10-20% of households eligible for auto enrolment[2] are already lagging behind the most common retirement income standard, the Pensions and Lifetime Savings Association (PLSA)'s Minimum Retirement Living Standard.

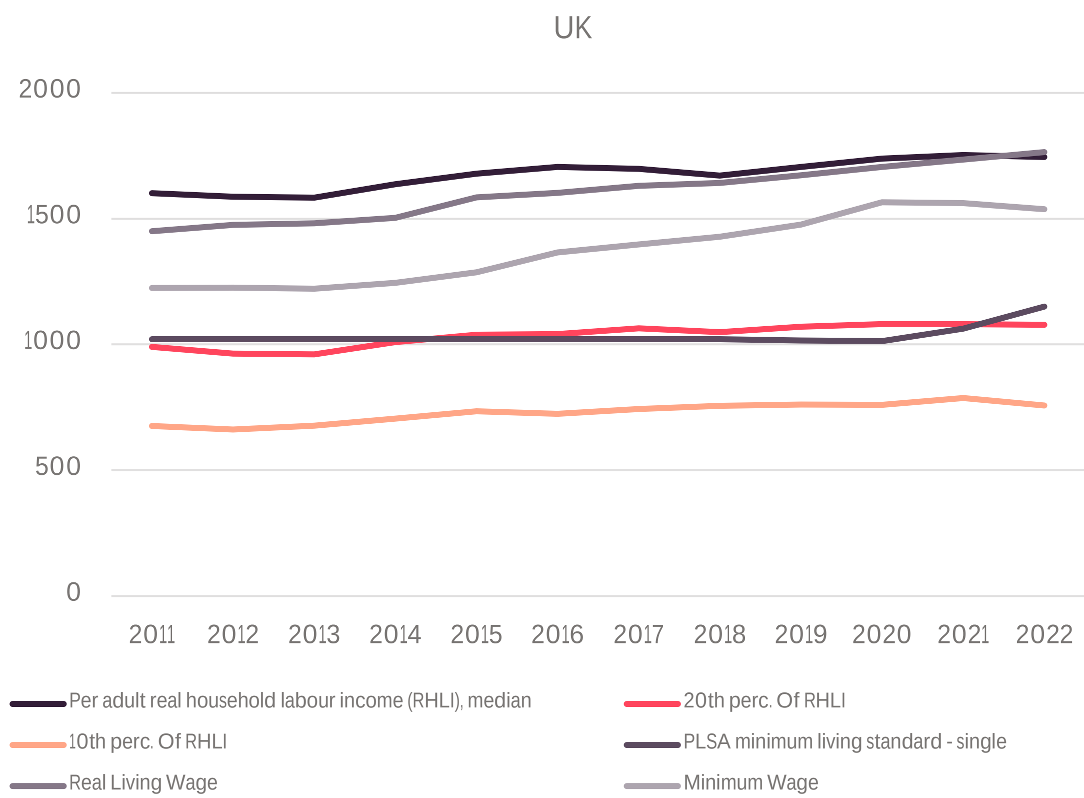
[2] In this context, a 'household eligible for auto-enrolment' is one where at least one member of the household is in the eligible income bracket for auto-enrolment. It does not necessarily mean they have actually been auto-enrolled. The percentage in question varies by UK region, and by the definition of 'per individual income'.

This final point is illustrated in figure 1, where we compare the median, lowest 10% and lowest 20% levels of per adult household labour income against three income benchmarks:

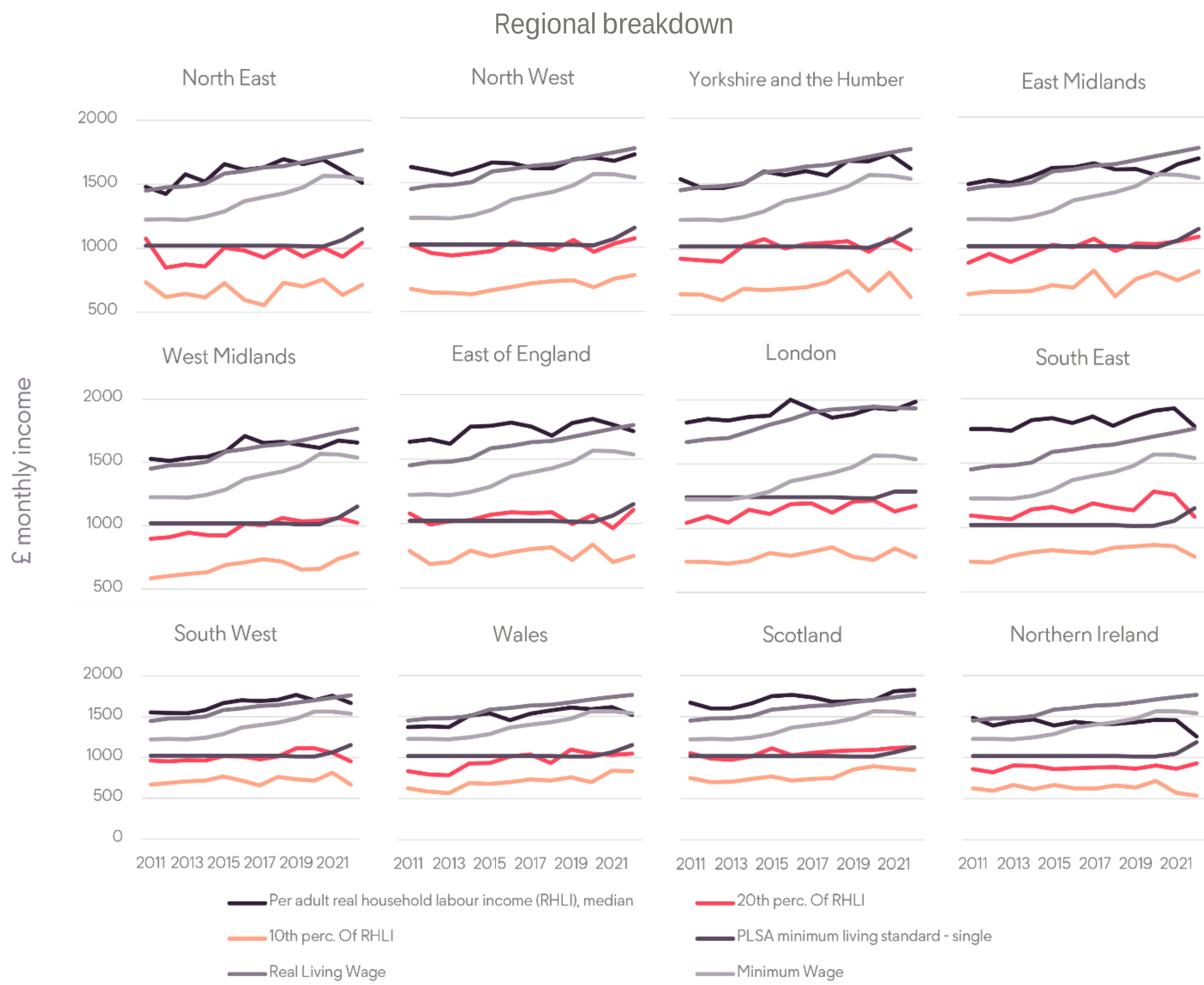
- The PLSA minimum retirement income standard
- Statutory minimum wage
- The Real Living Wage as recommended by the Living Wage Foundation.

The fact that so many people fall below the PLSA minimum during their working lives is especially stark when we consider that the PLSA standard is meant to represent a baseline income for a person in retirement. It does not take into account a raft of costs affecting working-age people, including housing, commuting or childcare cost. This highlights the challenge of trying to define adequate targets for retirement when many people who are in work are nonetheless experiencing significant cost challenges[3].

Fig. 1: Per adult household labour income versus income benchmarks



3 For recent analysis of these pressures at the lower end of the earnings spectrum see for instance the Joseph Rowntree Foundation's analysis at https://www.jrf.org.uk/news/hardship-deepens-as-millions-find-the-poverty-line-further-out-of-reach



Source:
Understanding Society: Waves 1-13, 2009-2022. UK Data Service. SN: 6614
Note: The sample include individuals between ages 23 and 66. The benchmark income measures of statutory minimum wage for over 23's and the Real Living Wage by the Living Wage Foundation are computed based on 35-hour working week. The PLSA standards and the Real Living Wage vary for London versus the rest of the UK. All income measures are adjusted at 2023 prices using annual household expenditure deflator.

How can we improve these measurements?

What's clear is that an 'adequate' level of savings should not involve someone having a lower standard of living in working life than they can expect to have in retirement. But living standards are affected by a wide range of factors, not just people's incomes. Taking this into account, we are developing a simple model that will help us decide the potential optimal retirement savings choices for different households who are living in different circumstances.

We're doing this by working out:

- which financial factors most affect the affordability of retirement contributions
- what trade-offs households need to make between their present and future financial health
- how to change their strategies when circumstances change
- how to protect against the risks of the most negative financial outcomes they might encounter.

In doing this, we hope to address a number of important questions:

- For any given group of workers, what are the near- and long-term trade-offs involved in assigning each marginal pound of earnings to a pension plan, rather than other potential uses?
- Which groups of workers might be seen as over- and under-saving for retirement?
- To what extent can scheme defaults meet the needs of different groups of savers?
- What does this tell us about the kinds of interventions that may be needed at different life stages or at key milestones?

In our work to date, we have addressed these questions by exploring differences in the financial circumstances of working-age individuals and their households, in the present day. This has already provided compelling evidence that 'retirement savings adequacy' needs to be considered in the context of wider financial capability, and this interim report presents some highlights from this evidence. The modelling that we are now going on to do will show how different households might trade-off between the present day and later life, to understand what savings adequacy could mean to them.

Key findings to date

In this section, we draw on empirical evidence to explore the variations in individual and household circumstances. We then consider which variables best reflect individual and household circumstances. We use data from the UK Household Longitudinal Study or Understanding Society, and include individuals of ages 22 and 65, who are in paid employment and earn monthly gross income above £833 and below £6,000. We have chosen this subset of the Understanding Society sample to capture a working age population that is eligible for auto-enrolment, and representative of low to middle income individuals.

In summary, we will see that:

- If we only look at the average values of key indicators, we fail to recognise the diversity of circumstances experienced by UK households
- Many households are experiencing significant affordability challenges in the present day that will affect their ability to defer income into retirement savings
- Labour is only one source of household income – housing benefit in particular is an important source of income for many households
- Even taking this into account, many people aren't currently meeting key income benchmarks, and many are below key benchmarks of retirement income during their working lives
- It can pay to prioritise saving towards a housing purchase – provided this is affordable
- Priorities change over the life-course, and any metric of retirement savings adequacy will need to be adjusted from time to take account of the more significant changes.

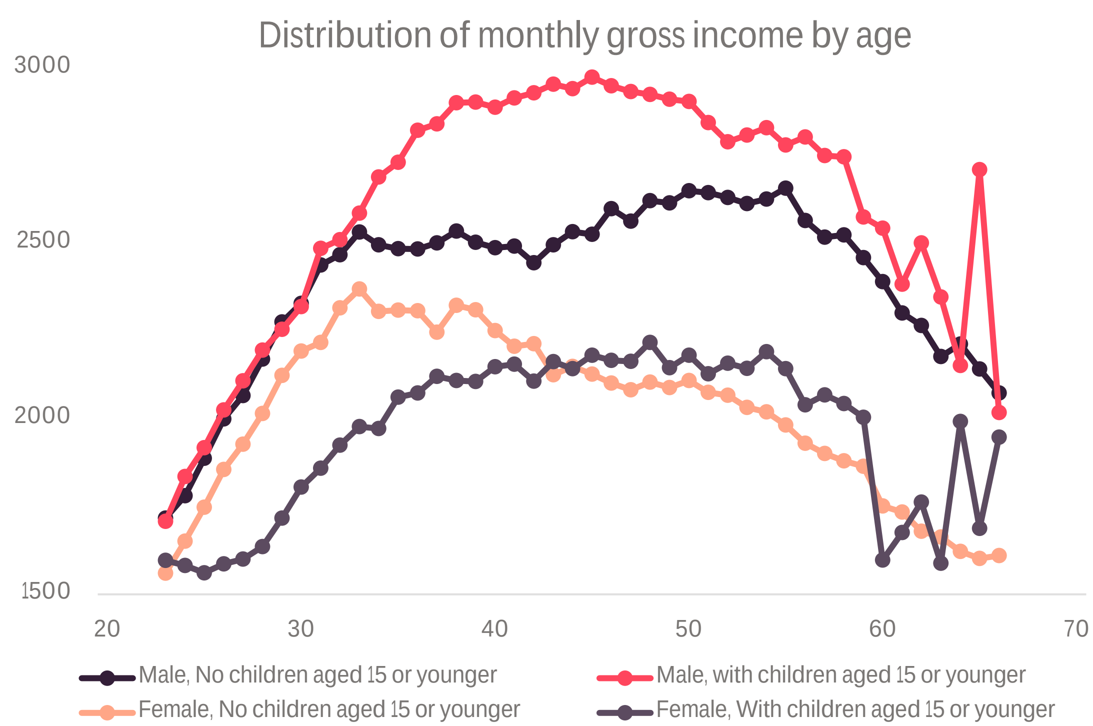
Averages do not reflect the diversity of households

When looking at these household data, we have begun by considering present-day income across the household. This is, of course, a major factor in both the affordability of payments into a retirement account, but also of the standard of living to which the household is accustomed in the present day.

> To look at the earnings needs of someone in isolation from their household introduces a blind spot in their financial circumstances. Understanding of earnings needs and income pressures comes at the household level where expenditure is determined.
>
> *Tim Pike, Pensions Policy Institute*

Age is known to be a good predictor of an individual's income pathway over their lifecycle. However, when factoring in individual characteristics and circumstances, including sex and having children, we can see noticeable differences in individuals' income levels (Fig.2). Having children is associated with higher incomes for men, while for women, it is associated with much lower income in their 20s and 30s, with a reversal by the mid-40s. The irregular pattern for males and females in their 60s is due to fewer individuals in their 60s having children aged 15 or younger.

Fig.2: Linear prediction of monthly income by age, sex and having a child



Source: Understanding Society: Waves 1-13, 2009-2022. UK Data Service. SN: 6614

Note: The figure shows the linear prediction of mean income by age, sex, and having a child. The prediction is based on the sample of individuals aged 22 to 66. It only includes individuals who are employees at their main job and whose gross monthly labour income is between £833 (the minimum threshold for qualifying for pensions automatic enrolment) and £6000.

When we look at males and females responsible for at least one child aged 15 or younger, we can see that the income differences are driven by responsibilities for a child, which in most cases are covered by women. The irregular patterns for males responsible for a child, as well as males and females in their 60s are due to smaller numbers.

These trends highlight labour market and financial vulnerabilities for women, and confirm the need to look at household-level income in a way that reflects individual circumstances.

Many households face significant affordability pressures in the present day

The individual circumstances of households within the same age-income group can differ greatly. This translates into a diversity of challenges that households are facing. As exhibited in Fig. 3– Fig.5 there is clear variation in the likelihood of developing mortgage or bill arrears at most income levels, though individuals with labour income in the lower end of distribution are overall more likely to develop arrears. Yet individual labour income cannot be the main driver of these challenges, as there are spikes in arrears across all bills for different income-age groups.

These differences in affordability today illustrate the complexities of circumstances that households find themselves in, and the challenging decisions individuals face when asked to make trade-offs between present-day and future priorities, and the affordability of surrendering income into long-term savings.

> There seems to be a lot of social pressure saying you should be saving for retirement. But actually, if at the end of the month you've only got £100 or £200 to spare, or often less, particularly with things like childcare costs as well - it just all adds up.
>
> *Vivien Burrows, International Longevity Centre*

By way of illustration, an individual in the age group 33–40 with monthly labour income in the range £833–£1150 faces around a 14 per cent chance of being behind on rent or mortgage payments today. To them, questions about their financial priorities at retirement age will feel less urgent. On the other hand, as Fig 4 shows, there is a high probability of arrears among people aged 41–47, at least in the first three quintiles of earnings. So what happens to the same individual who is still struggling with all bills by the age of 45 but is simultaneously saving for retirement? Whether this strategy is deliberate or not, it creates a risk that the benefits of any gains in retirement savings may be offset in part by the arrears they carry into retirement.

It perhaps goes without saying that these kinds of liquidity pressures on households are, at the time of writing, at historically high levels. This has been borne out in a range of economic analyses, for instance the January 2024 wave of the Hargreaves Lansdowne Savings & Resilience Barometer[4] highlights the affordability challenges faced by households at the lower end of the income distribution. It also shows that any gains in financial resilience metrics following the Covid lockdowns have already eroded, with levels falling back to pre-pandemic levels.

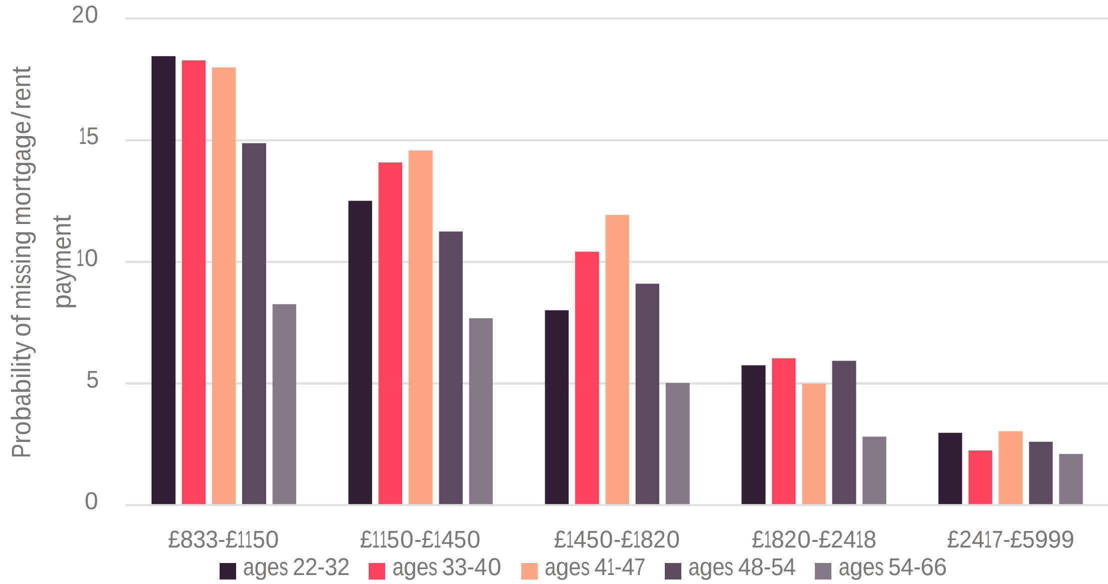
Fig.3: Probability of being behind on rent / mortgage by individual income groups

Source: Understanding Society: Waves 1-13, 2009-2022. UK Data Service. SN: 6614

Note: The sample includes individuals aged 22 to 66. It only includes individuals who are employees at their main job and whose gross monthly labour income is between £833 (the minimum threshold for qualifying for pensions automatic enrolment) and £6000. Within the specified range of age and income, five quintiles of gross individual labour income and age are created.

[4] https://www.hl.co.uk/features/5-to-thrive/savings-and-resilience-comparison-tool/savings-and-resilience-barometer-report-january-2024

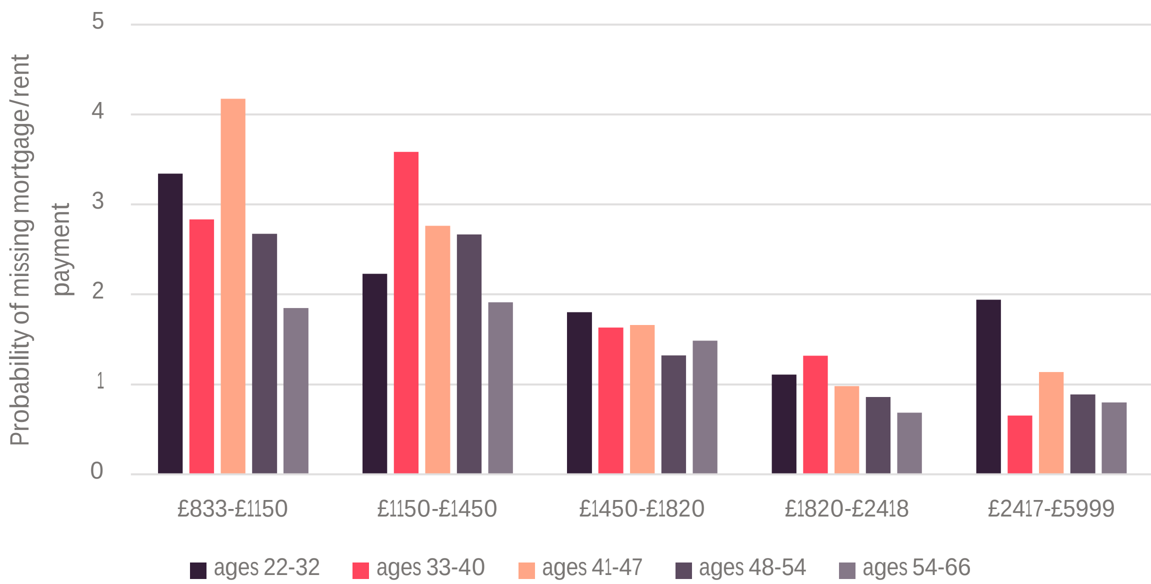
Fig. 4: Probability of being behind on some bills by individual gross labour income and age quintiles



Source: Understanding Society: Waves 1-13, 2009-2022. UK Data Service. SN: 6614

Note: The sample includes individuals aged 22 to 66. It only includes individuals who are employees at their main job and whose gross monthly labour income is between £833 (the minimum threshold for qualifying for pensions automatic enrolment) and £6000. Within the specified range of age and income, five quintiles of gross individual labour income and age are created.

Fig. 5: Probability of being behind on all bills by individual gross labour income and age quintiles



Source: Understanding Society: Waves 1-13, 2009-2022. UK Data Service. SN: 6614

Note: The sample includes individuals aged 22 to 66. It only includes individuals who are employees at their main job and whose gross monthly labour income is between £833 (the minimum threshold for qualifying for pensions automatic enrolment) and £6000. Within the specified range of age and income, five quintiles of gross individual labour income and age are created.

It can pay to save towards a housing purchase – provided this is affordable

The comparisons above are relatively simplistic in that they do not take into account people's future financial experiences. In the second phase of our collaboration, we will use modelling techniques to compare the present and future financial footings of illustrative household personas under a range of different sets of probable outcomes. There are a set of financial factors that will significantly affect the way in which these households will need to prioritise present day versus retirement incomes. Perhaps the most critical of these, and the greatest challenge to 'one size fits all' targets for retirement income, is housing.

As is often noted, levels of home ownership among future retirees will be much lower than they are among the current cohort of people reaching retirement age. A recent report from the Pensions Policy Institute (PPI)[5] predicts that the proportion of households owning their own home in retirement could fall from 78 per cent to 63 per cent by 2041. The same study estimates that the percentage of retirees living in private rentals will rise from 6 per cent to 17 per cent over the same period.

Clearly, this matters. On the one hand, for those paying rent in retirement, this cost can create a significant drain on their retirement incomes. A recent report from the Institute of Fiscal Studies (IFS) demonstrates that while the State Pension is generally sufficient to keep households out of retirement poverty, this often is not the case for single people who are private renters and for whom housing benefit doesn't cover their housing costs.

Priorities change over the life-course

We believe the household data we've analysed on this project provides compelling evidence for a nuanced and contextual approach to retirement savings adequacy. It has also allowed us to generate several household personas, which will now be the basis for our comparative modelling of different retirement savings strategies.

All these data represent the present-day reality of actual UK households, using recent panel data. Clearly, though, these descriptions of 'standard' types of households are not static. People's consumption and spending power changes during their working lives. Standard economic models of retirement saving assume that the goal is to smooth consumption across a working life. The idea is that, at certain stages of their careers,

[5] https://www.pensionspolicyinstitute.org.uk/media/fjgla1kv/20231130-the-uk-pensions-framework-2023-final.pdf

people's income will outstrip their consumption, allowing them to save the surplus for retirement. Across the whole life course, consumption is flattened to a horizontal line.

Yet we only need to look at the current inflationary context to see that consumption capacity fluctuates during working life. Even in less stretched economic times, the changing size of the household causes significant changes, and as we've already seen , many careers include periods of non-earning, or reduced wage growth. Household breakdown, for instance at divorce, completely changes the calculus for each individual that subsequently establishes their own separate household.

Taking all of this into account, an individual will need to revisit their retirement saving strategy at different points in their life. A sustained period of reduced consumption should imply a reduction in lifetime retirement saving. Formation or breakdown of a family will alter both short- and long-term priorities.

> How much you should be saving really depends on where you are in terms of life stage and there isn't really a fixed rule that would work for a whole lifetime.
>
> *Paul Cullum, Frontier Economics*

Furthermore, people's ability to predict and prioritise future outcomes becomes greater as they age. An individual who's followed a very general rule of thumb, or a savings default, at the start of their working life, might hone in on a more specific strategy as their longer-term household composition and future income because more certain. A young person who believes their future income will grow significantly might deprioritise retirement savings for the time being; but if they fail to achieve this goal by mid-life, this might change their plans.

Conclusion

For all these reasons, our modelling will involve revisiting our household personas at different points between the present day and retirement, based on projections of a range of probable future scenarios they might encounter.

We look forward to sharing the results of this process with a wide range of stakeholders in the summer of 2024.