

thinkpiece

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Comfortable Retirement Goes With a Crunch?

Gemma Tetlow and Matthew Wakefield

Summary

- The credit crunch and accompanying recession have adversely affected large numbers of individuals. Falling asset prices might have affected individuals who are approaching retirement and so might soon be looking to convert some wealth into a stream of consumption. This thinkpiece discusses which individuals in this group might have been exposed to the recent asset price changes.
- Those approaching retirement might have been particularly badly affected by asset price falls. A third of wealth among older working age individuals is held in state pensions and those currently approaching retirement still have a large amount of wealth in DB pensions. However, over a quarter of wealth among older working age individuals is held in housing.
- Relatively little of the wealth of the older working age cohort is held in DC pensions. Most people have some financial assets, but the majority is held in safe savings products rather than risky investments. Consequently, only about two-fifths of wealth is directly exposed to asset price falls.
- Do people have sufficient skills and experience to manage their wealth through uncertain times? Just one-in-seven older working age individuals can calculate compound interest. If there is cognitive decline at older ages, “lifestyled” products may mitigate the impact of this decline in functioning.
- For a minority of those approaching retirement, the recent asset price falls will have had a substantial effect on their stocks of wealth. This group now face some significant short-term decisions about how best to allocate their portfolios and whether or not to delay their retirement. There may be a role here for providers of financial products or the government to help these people make the best possible adjustments.

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CII Introduction: Recent turbulence in the stock market and falls in house prices could be particularly bad news for those approaching retirement with stocks of wealth that they would like to use to fund their consumption. In this article, Gemma Tetlow and Matthew Wakefield, senior researchers at the Institute for Fiscal Studies, consider the extent to which the resources of those near retirement would have been vulnerable to asset price changes. They argue that it is a subset of this group whose wealth would have been particularly exposed, and these individuals may well now be reconsidering asset strategies and even retirement dates.

The credit crunch and accompanying recession have adversely affected large numbers of individuals. In this article, we focus on the impact that falling asset prices might have had on individuals who are approaching retirement and so might soon be looking to convert some wealth into a stream of consumption. We discuss which individuals in this group might have been exposed to the recent asset price changes.

Since the end of 2007, the FTSE All Share index has fallen by about twenty percent and the Nationwide index suggests an average fall in house prices of 11%. These changes could have a large effect on the financial security of those who are approaching retirement. Older individuals who have, for example, already started to draw their pensions will often be largely unaffected. Younger individuals will also tend to be less affected by a direct impact of asset price changes on wealth holdings because they have smaller stocks of wealth on average. They will also have more time to adjust and to recoup any losses through, for example, higher future saving. Furthermore, some who have not yet got on to (or climbed) the housing ladder may actually benefit from lower house prices. It is those who are close to retirement who are most likely to be adversely affected by the fall in asset values. Individuals in this group may still have assets that are exposed to stock market fluctuations, and will also in many cases have lost out if they intended to draw on housing wealth during retirement. Such individuals may now be radically rethinking their short-term plans in the face of sharp declines in asset prices that they will be loathe to crystallise.

Those approaching retirement might have been particularly badly affected by asset price falls

In a piece of research written just before the credit crunch took hold, we argued that “in the absence of unanticipated shocks or macroeconomic events” the asset positions and needs of those reaching retirement in the next ten to fifteen years were likely to be relatively similar to those of individuals who have retired in the last ten of so

years.¹ This thinkpiece is an assessment of whether the crunch and the associated fall in asset prices is the unanticipated event that disturbs our earlier conclusion.

To make this assessment, we will look at how many, and which types of, individuals just pre-retirement have large proportions of their wealth exposed to stock market (and house price) fluctuations. We draw on household survey data from the English Longitudinal Study of Ageing (ELSA) to get a clear picture of the *joint* holdings of different types of assets, and of how holdings relate to other individual and family characteristics. The data include a measure of total net wealth, and of the value of its component parts, namely: – financial assets, state and private pension wealth, housing assets, and mortgage and non-mortgage debts.

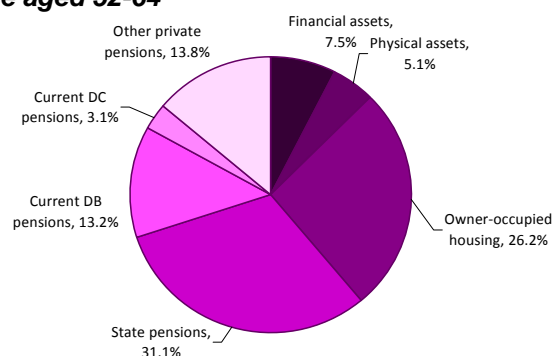
What assets do those approaching retirement have?

There are a range of forms in which people can accumulate and store their wealth. The main types of wealth that people in their fifties and early sixties hold are state pensions, private pensions (both occupational and personal), cash savings, investments and housing – see the figure below.

On average about one-third of the wealth of those aged between 52 and the state pension age is accounted for by state pensions – in other words, future entitlement to draw a non-means-tested pension from the state. This form of wealth will not be directly affected by fluctuations in asset prices. There may, however, be political risks attached to the actual amount of income an individual will receive from the state in future; we return to this question below.

A third of wealth among older working age individuals is held in state pensions.

Figure 1: Composition of total net wealth of those aged 52-64



Source: Authors' calculations using ELSA data for 2002/3.

¹ Banks, J., G. Tetlow and M. Wakefield, *Asset ownership, portfolios and retirement saving arrangements: past trends and prospects for the future*, Financial Services Authority Consumer Research Report 74, <http://www.fsa.gov.uk/pubs/consumer-research/crpr74.pdf>.

Though there has been a well-publicised decline in the number of private sector employers offering defined benefit (DB) pension schemes, this more often reflects schemes closing to new members but not to existing members. Therefore, those now approaching retirement are a cohort for whom occupational DB pensions remain a significant proportion of total wealth. However, this is unevenly distributed across the population, with just one-in-four (27.7% of) individuals aged between 52 and the state pension age currently contributing to a DB pension scheme. As with state pensions, the pension income that an individual will receive from a DB scheme is not directly affected by fluctuations in asset prices. The bigger risks to the wealth of this group are perhaps: (i) that their employer will go out of business leaving a pension scheme deficit, and (ii) that they will be made redundant. In the former case, much of individuals' entitlement would be protected by the Pension Protection Fund. But in either case, the individual will cease to accrue any further pension entitlement, which may result in him having a lower annual pension than he had anticipated.

On average, 13.8% of wealth is held in the form of pensions to which individuals are no longer contributing. The vast majority of it is in pensions – both DB and already annuitised DC funds – from which an income is already being derived. Such wealth will not be directly affected by asset market fluctuations.

This leaves (just) 41.9% of individuals' total wealth potentially exposed to movements in the stock market and to house-price changes. Over half of this (or 26.2% of total net wealth) is owner-occupied housing; about four-in-five of those aged between 52 and the state pension age own their own home, either outright or with a mortgage. Previous cohorts of pensioners seem to have made little use of their housing to fund their retirement consumption. Use of equity release – for example, through formal home reversion products – has been low. What evidence there is on down-sizing suggests that in the past individuals have done this to only a very limited extent.²

On average only 3.1% of total net wealth in this age group is held in DC pensions to which the individual is currently contributing. The generation in question includes quite a large number of individuals with DB occupational pension wealth and would have had the opportunity to make pension saving choices before personal pensions exploded onto the scene in 1988.

² Banks, J., Blundell, R. and Smith, J. (2007) "House price volatility and downsizing in later life", NBER Working Paper 13496, October 2007, forthcoming in Wise, D. (ed.), *Studies in the Economics of Ageing*, Chicago University Press.

Over a quarter of wealth among older working age individuals is held in housing. Relatively little of the wealth of the older working age cohort is held in DC pensions

The proportion held in DC pensions is lower than the 5.1% held in physical assets such as business assets, buy-to-let property, antiques and jewellery. Business assets and buy-to-let property are both likely to be exposed to asset price fluctuations, and the value of businesses and business assets may also have been adversely affected by general economic weakness.

The remaining 7.5% of total net wealth is held in financial assets – cash savings or investments valued net of non-mortgage debt. Most people hold the majority of their financial wealth in cash savings rather than investments: more than four-in-five of those aged between 52 and the state pension age have some form of cash savings product, while only half have any investments. However, amongst those with at least some investments, on average just under half of gross financial wealth is held in investments rather than savings accounts.³

Most people have some financial assets, but the majority is held in safe savings products rather than risky investments. Only about two-fifths of wealth is directly exposed to asset price falls.

So, across the whole population of individuals aged between 52 and the state pension age, only about two-fifths of total wealth is financial assets (including stocks and shares, DC pensions and business assets) or housing. In other words, the majority of wealth is not directly exposed to asset price changes. But these averages reflect some individuals holding most of their wealth in stocks and shares (and housing), whilst others have none.

Who might be particularly affected by asset price falls?

There is a small group who are heavily exposed to stock market fluctuations. 22.6% of those aged between 52 and 64 have a DC pension fund that they have yet to annuitise. One-in-four people in this age group with a current DC fund had at least £30,000 in it (see the table). To the extent that people have their DC wealth invested in 'life-styling' pension funds, some of this wealth may have been in less risky assets, but some is likely to have been invested in stocks and shares and,

³ These figures are based on data collected during 2002–03. Though there will no doubt have been growth in the value of investments between 2002–03 and the start of the credit crunch, more recent data (collected in 2006–07) suggests that the proportion of net non-pension wealth made up of financial assets was very similar in 2006–07 to the 2002–03 proportions cited here.

even if individuals hold their entire fund in assets which have not lost value, they may still have been affected as the rates offered by annuity providers fell in the wake of the credit crunch.

Only about two-fifths of wealth is directly exposed to asset price falls

Amongst all those aged between 52 and the state pension age, the median level of wealth held in investments was £2,500 in 2004. But one-in-four people held more than £24,500 in investments.

The group of people who are heavily dependent on wealth held in DC pensions and other types of investments may well be reconsidering their short-term options. To avoid crystallising their losses by annuitising their pension funds or selling their investments immediately, they may decide to delay their retirement while they either wait for their investments to recover or attempt to use the additional years of labour income to save additional amounts. They will also need to think carefully about how to manage their portfolios in the short-term to minimise their losses. Some of these decisions are quite complex, so a key question is: will this group of individuals be able to make the appropriate choices? All these individuals, by definition, have prior experience of more complex financial products. Thus they have some experience of making portfolio investment choices that they could draw on when making current decisions.

Do people have sufficient skills and experience to manage their wealth through uncertain times?

Table: How much wealth do people have in investments and DC pensions?

	% with any	Amongst all those aged 52–64 ...		
		¼ have less than...	½ have less than...	¾ have more than...
Investments	52.2	£0	£2,500	£24,500
		Amongst those currently contributing to a DC pension...		
		¼ have less than...	½ have less than...	¾ have more than...
DC pension	22.6	£1,800	£10,000	£30,000

Source: Authors' calculations using ELSA data for 2002–03.

Alongside experience, greater formal education and higher levels of numeracy might be good indicators of better ability to make financial portfolio decisions. A large number of those aged between 52 and the state pension age have only a limited amount of formal education, with just under half (44.6% of) having no more than a compulsory level of schooling, which was up to age 15 for this cohort. Fewer than one-in-five continued into tertiary education.

The ELSA survey asks respondents to answer a series of 'everyday' mathematical questions. Somewhat surprisingly, given that four-in-five individuals aged 52 to the state pension age have some form of savings account, only just under

one-in-seven (13.5% of) know how to calculate compound interest. Whilst there are many ways to learn about the differences between financial products or product types, and not all individuals need to be highly numerate in order to utilise these mechanisms, a low level of basic understanding of interest and compounding might still be thought to be a barrier to efficient outcomes in markets for financial products. Somewhat more reassuringly for the group with substantial holdings of DC pension wealth and investments, holdings of these types of products are associated with significantly higher than average levels of education and numeracy.

Just one-in-seven older working age individuals can calculate compound interest.

The data on numeracy also indicate that those in their fifties currently seem to be more numerate than those in their sixties. This may be problematic in the present circumstance since it is perhaps most important that those who are nearest to their planned retirement (i.e. in their sixties rather than their fifties) are able to make decisions to take account of recent events.

To the extent that the difference in numeracy across age groups reflects cognitive decline rather than differences across cohorts, this may also highlight a need for product designers and policy makers to build "lifestyled" products so that financial decisions taken in early or middle working life are robust to shocks that occur nearer retirement when decision making abilities may be less sharp. Good data on how numeracy and cognitive function relates to retirement choices has only become available recently and so research relating to this topic is still ongoing. Research by colleagues at IFS suggests that while cognitive function predicts the level and composition of wealth,⁴ it is a less strong predictor of how well individuals smooth their consumption and income across retirement.⁵ This indicates that the existing institutional setting may give some degree of protection to those with low cognitive skills. However, further research is needed to examine more carefully the mechanisms involved.

If there is cognitive decline at older ages, "lifestyled" products may mitigate the impact of this decline in functioning.

⁴ Banks, J. and Z. Oldfield (2007), "Understanding pensions: cognitive function, numerical ability and retirement saving", *Fiscal Studies* 28(2) (<http://www3.interscience.wiley.com/journal/117977106/abstract>).

⁵ Banks, J., C. O'Dea and Z. Oldfield (2009), *Cognitive function, numeracy and retirement saving trajectories*, mimeo, Institute for Fiscal Studies.

Concluding Thoughts

Recent falls in the stock market and house prices present clear risks to at least the short-term financial security of those people approaching retirement who have a large proportion of their wealth held in these assets. However, as we have discussed above, among the cohort currently approaching retirement it is actually a relatively small group who might be heavily affected in this way. Indeed, an important factor highlighted by the evidence we have discussed is that the asset price falls cannot be described as generally affecting given generations in a certain way, but rather they affect different people within each generation in somewhat different ways. For the pre-retirement age group a relatively small proportion will have had their wealth particularly adversely affected by recent events. These individuals are likely to be considering their financial portfolio decisions, and perhaps even rethinking their planned retirement date. It is a challenge for policymakers and providers of financial advice to support them in making good choices at a crucial time.

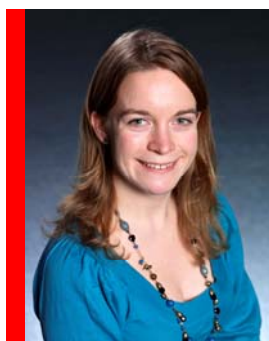
Given a general policy shift towards increased personal saving for retirement, it may seem surprising that falls in house prices and (particularly) in the stock market, have not had a broader impact on those approaching retirement. The reason why they have not is that, since the accumulation of retirement resources takes many years, trends in provision also take many years to feed through into outcomes. Thus the drift away from DB pensions has not substantially affected the current over 50s. Rights accrued in DB pensions will not have been directly affected by recent falls in asset prices.

On the other hand, knock on effects, particularly on state provision, could mean that the crunch

does eventually have a broader impact on the resources of future (and even current) pensioners. One third of all wealth for those in their fifties and early sixties is comprised of promised future pension income from the state. So one risk to the living standards of pensioners is the extent to which future state support for pensioners falls victim to budgetary cutbacks by the government in the wake of the recession. Difficult decisions about spending priorities will face whoever wins the upcoming General Election and it remains to be seen whether the 2006 promise to relink the basic state pension to earnings growth in 2012 will be fulfilled. Many current and future pensioners are, or expect to be, heavily reliant on state support in retirement. Thus, these are groups who are potentially vulnerable to a crunch on the public purse.

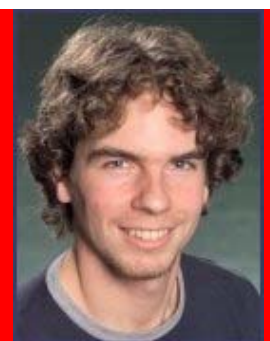
For a minority of those approaching retirement, the recent asset price falls will have had a substantial effect on their stocks of wealth. This group now face some significant short-term decisions about how best to allocate their portfolios and whether or not to delay their retirement. There may be a role here for providers of financial products or the government to help these people make the best possible adjustments. However, given the nature of retirement provision for the majority of those currently approaching retirement, most will not be directly affected (to any large extent) by the asset price falls. The bigger risk for this group may be political.

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