DWP Department for Work and Pensions

Research Summary

What does the distribution of wealth tell us about future retirement resources?

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Introduction

This research provides background analysis and context to aid interpretation of data on the distribution of wealth in Great Britain available from the first wave of the Wealth and Assets Survey (WAS).

Rather than simply document differences across the population in their raw form, this analysis is aimed at using evidence from both the initial WAS report and the WAS microdata itself to illustrate what the distribution of private pension wealth and other forms of wealth can tell us about the level of, and uncertainty about, future retirement resources.

People save money and hence build up stocks of wealth for a number of reasons. In this report we focus on interpreting the cross-sectional distribution of wealth in the context of the life-cycle model for saving. The life-cycle model postulates that, if individuals expect their income to vary over their lifetimes (which is likely if they expect to work for a number of years and then retire), they might wish to save during periods when their income is relatively high and draw down on their savings when their income is relatively low in order to smooth their consumption over their lifetimes.

We would expect individuals to have a greater need to build up assets for retirement if they expect their income during their working-age life to be significantly higher than any (non-asset-based) income to which they will have access in retirement.

In Britain, compulsory contributory state pensions and means-tested benefits for pensioners may provide a high level of earnings replacement for those who expect to be on fairly low earnings throughout their working lives. Conversely, those who expect to have high earnings through their working lives may have particular need to save in order to smooth their consumption across work and retirement since state benefits will provide a low level of earnings replacement in comparison. Therefore, we can draw some broad inferences for the patterns of lifetime wealth accumulation that we might expect to see.

We find substantial differences, on average, in the levels of wealth held by households at different ages and with different levels of education.

We also find differences in how households hold their wealth. Given the patterns of wealth holdings observed in WAS, we conclude that there are some groups for whom there may be greater concern about the level of their future retirement resources, while for others either private savings or state benefits look likely to provide a reasonable level of retirement income.

Different types of assets are exposed to different types and amounts of risk. This has a bearing on the potential vulnerability of household asset holdings to shocks such as the financial crisis that occurred in 2008. This report therefore also examines how different the compositions of portfolios are across different groups in the population – defined by age and level of education – and what effect the recent financial crisis might have had on household wealth holdings.

As research has shown that education and lifetime income levels are linked this paper uses the level of education of the household head as a proxy for the level and profile of lifetime income.

Levels of wealth

Low education households (that is, those households headed by someone with no educational or vocational qualifications) tend to hold very low levels of wealth. Half of low education households aged between 25 and 54 have net wealth of no more than about £25,000 per adult in the household.

In contrast, the majority of high education households (that is, households headed by someone with qualifications at degree level or above) aged close to retirement hold far higher levels of private wealth: 83 per cent hold more than £191,000 per adult in the household (including housing wealth).

Mid-education households (headed by someone with below degree level qualifications) hold, on average, higher levels of wealth than low education households but less than high education households.

Among the groups of mid-education households, renters and single parents are more likely to have low levels of wealth, while households with multiple earners are more likely to have high wealth holdings per adult in the household.

Household wealth holdings (both gross and net) are lowest amongst the youngest households and highest amongst households close to retirement, before falling again after State Pension age, consistent with the idea of lifecycle saving.

This ‘hump’ shaped pattern is particularly pronounced among the most highly educated households. Median wealth levels vary less by age among the mid-education group, and less still in the low education group.

Most of the distribution of wealth among the highly educated lies above that of the mid-educated, and this difference increases with age.

Composition of portfolios

We also examine what type of assets households hold their wealth in, focusing on four broad categories of asset: liquid safe, liquid risky, illiquid safe and illiquid risky.

Liquid and illiquid distinguish assets from which it is relatively easy to withdraw money and ones where it is harder to do so, respectively.

Safe assets are broadly defined as those whose value is normally quite predictable – such as savings accounts at a bank or building society or cash ISAs – while risky assets are those asset types whose value can be more volatile – such as shares or investments. For example, property wealth is categorised as illiquid risky, as it is relatively difficult to withdraw money from and is subject to changes in value.

We also present evidence looking specifically at the holdings of unannuitised Defined Contribution (DC) pension wealth and owner-occupied housing wealth.

We find that the composition of portfolios varies significantly by age and education group:

- The low education group, on average, hold more of their wealth in liquid safe assets and hold very few risky assets (aside from, in some cases, their home).
- On average low education households aged 25-34 hold over half of their total wealth in liquid safe assets, however they are the group with the highest proportion of wealth in DC pensions – almost 10% of their assets are in this form.
- The mid-education group hold a much smaller fraction of their wealth in liquid safe assets, on average, than the low education group but they hold more of their wealth in their homes than the high education group do, on average.

- The high education group hold, on average, more of their wealth in explicit retirement savings vehicles (DC pensions, Defined Benefit (DB) pensions and pensions in receipt) than the households with low and mid-education do.

Implications for future retirement resources

With many of the households still many years away from retirement and with only one cross-sectional observation of wealth holdings for each household, we should be cautious of inferring too much from just one wave of data. However, we have made some tentative observations about what the information from WAS 2006-08 can tell us about the prospect for future retirement resources.

Younger high education households have much lower levels of wealth than their older counterparts but they also have many years before they reach retirement. Their final outcomes may well depend not only on how much they save but also how wisely they invest it and what unforeseeable shocks affect asset prices over the next few decades.

For mid-education households there is arguably greater uncertainty about whether their current wealth holdings imply their future retirement resources will be sufficient. They have some qualifications and so this group are, on average, likely to have higher lifetime earning potential than the low education group – thus state benefits will tend to provide a lower level of earnings replacement for this group than for the low education group. However, they have much lower average wealth holdings than the highly educated group and hold a greater proportion of this wealth in their main home.

Younger mid-educated households face the same opportunities and dangers to their future retirement resource accumulation as young highly educated households.

Estimated impact of the recent asset price falls

The actual impact of the financial market and housing market declines during 2008 on households' wealth holdings will depend on many factors. For example, it will depend on exactly how households had their wealth invested, how successfully they managed their money through the market declines and whether or not they were forced to default on their mortgages.

We have made some tentative estimates of how household wealth may have been affected given what we know about the broad composition of portfolios at the time of the first WAS interview and average asset price changes since then.

- We assume that the value of all risky financial assets moved in line with an index calculated from the FTSE all share index and data on total returns to UK equities.
- The value of the owner-occupied main residence is assumed to have been exposed to the change in the nationwide region-specific house price index.
- Other property and land is assumed to have been exposed to the change in the nationwide UK-wide average house price index.
- The value of unannuitised DC pension funds is assumed to have changed in line with an index constructed using information on the average returns earned by DC pooled pension funds.

On average, we estimate that most households will have lost only a small fraction of their gross wealth. However, the proportion of net wealth lost is likely to have been higher for younger households – this is because their gross housing wealth (which is likely to have been affected by house price changes) tended to be largely matched by mortgage debt (the value of which would remain the same even if house prices had fallen) and thus their net wealth position would tend to be more exposed to house price falls.

The average losses of DC pension wealth as a share of total gross wealth from the interview date (2006-08) to 2009 Q3 are fairly negligible for all education level households, as the index showed a large recovery from 2009 Q2.

The full report of these research findings is published by the Department for Work and Pensions (ISBN 978 1 84712 784 6. Research Report 665. July 2010).

You can download the full report free from: http://research.dwp.gov.uk/asd/asd5/rrs-index.asp

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