

RETIREMENT Plan Trends



A benefits update

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Just One In Five Workers Expected To Save Enough For Retirement

According to a study by human resources consultancy Hewitt Associates, on average, U.S. employees will need more than 15 times their final pay in retirement resources to maintain their current standard of living during retirement, a goal that only around one in five full-time workers is expected to meet.

Researchers noted that, while this estimate of the amount of income needed in retirement has not changed in recent years, meeting projected retirement needs has become a greater challenge for employees who have experienced substantial declines in their retirement savings over the course of the economic downturn. The study found that four out of five workers are currently on track to fall

short of meeting all their financial needs in retirement, unless they take action to improve their savings habits or delay retirement to a later age.

The 2010 analysis of projected retirement needs, which factors in inflation and post-retirement medical costs, showed that employees will

need 15.7 times their final pay in savings and assets to meet their financial needs in retirement, a figure that researchers said is consistent with a prior projection made in 2008. With Social Security expected to provide 4.7 times final pay, the study's authors pointed out that employees will be responsible for accumulating the remaining 11 times final pay from other sources, such as employer-provided retirement plans and personal assets.

Based on an examination of the projected retirement resources of more than two million employees at 84 large U.S. companies, the report indicated that just 18% of employees who contribute to a defined contribution plan and who work a full career are expected to achieve this goal. On

Also In This Issue

- The Role Of Longevity Bonds In Retirement Plans
- Older Americans Buffered Against Life Shocks

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In addition, the findings indicated that many workers who commit to increasing their retirement contributions by as little as 1% each year for five years will be on track to meet most of their financial needs in retirement.

average, these employees are on course to accumulate 13.3 times final pay, including Social Security, leaving a shortfall of 2.4 times final pay, or 15% of their total financial needs in retirement. Of this group, 19% are expected to have a shortfall of five times final pay or more at retirement.

Broken down by retirement plan type, the analysis showed that workers who are not covered by a defined benefit plan and who rely solely on a defined contribution plan to fund their retirement are projected to meet just 74% of their needs in retirement, compared to 91% for employees who are also covered by an active or frozen defined benefit plan.

“This is a wake-up call for employees,” Rob Reiskyt, Hewitt’s leader of retirement plan strategy and design, warned. “While retirement may be a long way off, workers need to start actively saving or be prepared to dramatically reduce their overall spending in retirement. Ultimately, they’re in control of most of the elements that will help determine their retirement outcomes.”

Despite these obstacles, researchers emphasized that workers can significantly improve their situation by making a few minor adjustments to their current behavior. For example, the study found that 26% of eligible employees do not contribute to a defined contribution plan, and these workers will have saved, on average, less than half of what they will need by the time they reach retirement age. Yet, a 25-year-old employee who makes \$30,000 a year can meet all of her retirement needs if she contributes, on average, 11% of her pay each year throughout her career, assuming she also receives an additional 5% employer contribution to her defined contribution account. If, however, the same employee waits until age 40 to join her defined contribution plan, she will need to save an average of 17% of her pay per year to cover her retirement needs.

In addition, the findings indicated that many workers who commit to increasing their retirement contributions by as little

as 1% each year for five years will be on track to meet most of their financial needs in retirement. Under this savings rate escalation scenario, the number of employees who can expect to retire with sufficient retirement assets increases from 18% to nearly 38%, and another 32% will have a shortfall of between just one and two times their final pay.

For example, the study found that, on average, a full-career, contributing employee who saves 7.3% of his pay and whose employer contributes 5% of pay to his defined contribution account is on course to meet 13.3 times his final pay in retirement, with a shortfall of 2.4 times final pay. But, if that employee increases his contribution by 1% each year for five years and maintains this higher savings rate, he will have reduced the savings shortfall to only 0.6 times final pay, accumulating 15.1 times his final pay in retirement.

According to the analysis, employees who delay retirement to age 67 can significantly reduce their savings shortfall, as the retirement needs of these workers decrease from 15.7 times final pay to 14.4 times final pay. At the same time, the retirement resources of employees who continue to save over a slightly longer career span increase from 13.3 times final pay to 14.2 times final pay, or 98% of their optimal retirement savings goal.

The Role Of Longevity Bonds In Retirement Plans

As employers and workers alike become increasingly concerned about their ability to ensure retirement income over the course of longer lives, a study published by the Center for Retirement Research at Boston College has suggested that governments or private companies consider issuing “longevity bonds,” which could help plan sponsors,

annuity providers, and even governments to hedge aggregate longevity risk.

The issue brief, “The Case for Longevity Bonds,” was written by David Blake, Tom Boardman, and Andrew Cairns. According to the authors, longevity risk is borne not just by individuals, but also by private sector sponsors of defined benefit plans, insurance companies selling life annuities, and governments responsible for paying pensions through the Social Security system and public sector defined benefit plans. Institutions can plan for specific longevity risk—or the expectation that some people will die before their life expectancy, and some after—by pooling and relying on the law of averages. By contrast, plan sponsors and governments find it harder to prepare for aggregate longevity risk, which involves the possibility that unanticipated changes in lifestyle or medical advances could significantly improve average longevity.

According to the study, the presence of such a “non-hedgeable risk,” especially in the face of increasing demand for annuities, creates two problems for pension plan sponsors. First, significant growth in annuity purchases could result in an unhealthy concentration of risk among a small number of insurance companies, and these providers could become insolvent if mortality rates were to decline faster than predicted. Second, the presence of a risk that cannot be hedged could raise the cost of and reduce income from annuities.

Given these challenges, the authors proposed the development of a longevity bond, which can be used by defined benefit plan sponsors and annuity providers to manage aggregate longevity risk. While the characteristics of longevity bonds could vary, they may, for example, pay coupons only and provide no principal repayment; pay the first coupon when a given cohort reaches age 75, when the longevity risk starts to rise; or continue to pay coupons until the maturity date of the bond, typically around 40 years after the issue date. The bond coupons payable each year would depend on the

proportion of the cohort that is alive that year. If the population survivorship is higher than expected at a given age, the bond pays out higher coupons, but if it is lower, the coupons are lower, as well.

While a bond of this kind should provide a hedge to pension plans and annuity providers, some basic risk will remain because plan members or annuitants may not have the same mortality over time as the cohort the bond is based upon, researchers observed. However, longevity bonds could be issued for specific demographic groups, according to gender, age, and socioeconomic status. According to the authors, “a small number of suitably designed bonds should provide an appropriate balance between hedge effectiveness, liquidity, and pricing transparency.”

Longevity bonds could, in theory, be issued by private companies, including the pharmaceutical industry, which stands to benefit if people live longer lives. However, the authors said, the government may be better suited to issuing such bonds in the required volume. Moreover, the government has an interest in promoting an efficient and well-functioning annuity market, and safeguarding the solvency of insurance companies. Further, once the longevity bond market matures, the capital markets could take over in issuing the bonds. While the issuers of the bonds should be able to charge a risk premium, researchers recommended that bonds be priced so that they are attractive, not just to insurers, but also to defined benefit plan sponsors who do not currently face solvency capital requirements.



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Older Americans Buffered Against Life Shocks

Although the onset of poor health or the loss of a spouse can present considerable personal challenges for older individuals, most retired households have

adequate financial buffers that allow them to absorb these shocks without radically reducing their consumption, according to a new study published by the University of Michigan Retirement Research Center.

Written by University of Michigan economics professor Matthew D. Shapiro, “Buffering Shocks to Well-Being Late in Life” addresses the issue of how well insured older Americans are against changes in health and the death of the spouse. Because these events are among the dominant shocks faced by aging households, Shapiro said, “understanding how these shocks affect them is of paramount importance for assessing their well-being and for designing policies that bear on their well-being.”

The report’s findings are based on data from the Health and Retirement Study (HRS) and its Consumption and Activities Mail Survey (CAMS). Rather than focusing on payments arising from private or public insurance, the study examined how consumption responds to declining health and widowhood. According to the report, consumption is a measure of ultimate economic well-being, so this approach provides a direct measure of the extent to which households are protected against poor health or loss of a spouse.

Using this consumption metric, the study found that households are substantially buffered against health and widowhood, and this protection is provided by their private assets and insurance coverage and by insurance through the Social Security and Medicare programs.

In terms of health, having an additional chronic diagnosis has no direct effect on the level of non-medical consumption, even though it leads to a substantial increase in out-of-pocket

medical expenses. While the findings indicated that self-reported poor health does depress non-medical consumption noticeably, Shapiro said that this effect appears to be mainly related to the desire to consume, rather than the ability to finance consumption. The study therefore concluded that the resources available to older Americans, including private and public health insurance and their own financial resources, allow them to sustain consumption, even when in poor health.

In addition, people are well-buffered in terms of consumption against the loss of a spouse, with both men and women experiencing a decline in household consumption of 25% to 30% upon being widowed. According to Shapiro, this decline is very similar to the amount by which the consumption of the average single household differs from that of the average married household. The results also suggested that, while the decline in consumption among male widows is largely autonomous and is not attributable to a reduction in income, the drop in consumption among female widows is somewhat mediated by a decline in income and wealth. Nonetheless, Shapiro noted, the consumption reductions for new male widows and new female widows is about the same.

Shapiro pointed out, however, that economic well-being, as measured by consumption, should not be confused with overall well-being. “Overall well-being likely will fall as a consequence of poor health even if consumption of goods and services is maintained,” he said. “Indeed, the finding of this research that self-reported poor health depresses consumption even after controlling for the out-of-pocket expenses implies that poor health adversely shifts utility.”



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