

Society of Actuaries Research Provides Insight for Navigating a Treacherous Pension Environment

A series of surveys that explores how the public perceives retirement risks and manages related financial resources has uncovered interesting results. Read on for a detailed explanation. BY ANNA M. RAPPAPORT

For many years the Society of Actuaries (SOA) has been focused on the structure and health of the American retirement system, initiating numerous research efforts and organizing multidisciplinary forums to further the debate. The SOA's Committee on Post-Retirement Needs and Risks (CPNR) is particularly concerned about the distribution phase at which point previously accumulated funds are withdrawn and used in retirement. Driving this concern has been the accelerating long-term trend towards defined contribution plans with increasing numbers of defined benefit plans being frozen and terminated. With the shift to a much greater emphasis on defined contribution plans, individuals are increasingly responsible for understanding and managing post retirement risks.

The underlying structure of a retirement plan and how employers educate their workforce on the plan can play a significant role in helping individuals manage these risks. A major part of the CPNRs' work is research, including a series of surveys that explore how the public perceives retirement risks and manages related financial resources. To set the stage, this article provides a brief description of fundamental examples of conflicting stated perceptions and behavior, resulting in uninformed decision-making on the part of retirees. It then further discusses these examples in light of the results from the third survey in this aforementioned series, the 2005 Risks and Process of Retirement Survey.



This article also discusses results from a series of focus groups conducted last fall on how retirees manage assets in retirement. In this study and several others, focus group participants and others surveyed indicate a preference for lifetime income with fairly diverse options for how it would be received. However, in reality, few buy annuities and when there is a choice, most prefer lump sums to lifetime income. This apparent contradictory behavior was the motivation for the Society of Actuaries sponsoring this series of focus group sessions to explore the underlying rationale for how retirees make investment decisions.

Research Methodology

The 2005 Risks and Process of Retirement Survey was conducted by telephone to Americans ages 45 to 80. The survey participants include retirees and pre-retirees at all income levels. The focus groups consisted of retirees who were two or more years into retirement and had lump sums of \$100,000 to \$500,000 to invest at retirement. In addition, the retirees did not have assets of more than \$1,000,000 in total. The focus groups were conducted separately for married and single retirees.

Conflicting Behavior and Stated Perceptions

Here are some examples of situations in which individuals have a tendency to say one thing and do another, and heavily rely on emotion:

- Pre-retirees have significantly greater concern about risks than retirees, but their worry and concern about post-retirement risks does not usually seem to translate into action. Reducing spending is a much more popular risk management strategy than buying risk protection products, like annuities and long-term care insurance.
- Pre-retirees and retirees both say that having lifetime guaranteed income is very important to them, but when given a choice of a lump sum or lifetime guaranteed income, they generally prefer a lump sum and few choose a lifetime income product.

- Longevity risk is simply not well understood by retirees and pre-retirees, and they have a tendency to approach it with intuitive, rather than logical reasoning. Compounding the problem is that financial planners focus on the average expected age at death, rather than factoring in the obvious variability. To make the situation worse, individuals consistently underestimate their own life expectancy, making them vulnerable to outliving their assets.
- The combination of increasing individual responsibility, misunderstandings about the real risks of retirement and a failure to plan with a long-term perspective has created a treacherous road ahead for many individuals embarking on this phase of their lives. Actuaries should view this confluence of events as a challenge to devise ways to minimize the danger. The results of the research described in this article help illuminate the road conditions today for retirees and shine a light ahead on improvement in future routes.

Highlights of 2005 Survey Findings

Pre-retirees are much more concerned about post-retirement risk than retirees. The most important risks were healthcare, long-term care and inflation. These are discussed in more detail later. There are remarkably few differences in responses between the 2001, 2003 and 2005 surveys. Differences that exist are found primarily among pre-retirees. Although concern about several retirement risks increased from 2001 to 2003 among pre-retirees, levels of concern measured in 2005 receded to those in 2001 (except for concern about having sufficient resources for adequate healthcare). Between the 2001 and 2003 surveys, the poor state of the economy and the events of 9/11 propelled many to be more cognizant of retirement risk.

Both the surveys and the focus groups tend to show that there is little systematic long-term thinking about risk management. One of the primary conclusions of the focus groups is that much of the thought process for retirement risk is intuitive and emotional, rather than logical and methodical.

The results of this research are particularly revealing to actuaries serving as personal actuaries and those supporting a variety of different types of financial systems including pension plans, health plans, annuities and other financial products.

Healthcare and Long-Term Care Risks

Of the various risks examined in the survey, both retirees and pre-retirees express more concern about healthcare needs and costs (together with inflation) than any other risks. Roughly half of retirees express concern about having enough money to pay for extended care at home or in a nursing home (52 percent very or somewhat concerned) or that they may not have enough money to pay for adequate healthcare (46 percent). Pre-retirees are even more likely to say they are concerned about these risks.

Most retirees and pre-retirees purchase products to ensure that they can receive adequate healthcare. Three-quarters of retirees (76 percent) and pre-retirees (75 percent) indicate they have or plan to purchase coverage to supplement Medicare or participate in an employer-sponsored retiree health plan. In contrast, retirees and pre-retirees are more likely to try to save for long-term care costs rather than obtain insurance for this risk.

Financial Risks

Financial risk is a key consideration for survey participants and driven by their increased responsibility for managing investment fund returns. In the survey, inflation was also one of the top three concerns for both pre-retirees and retirees. As indicated earlier, there is a seeming contradiction in the research on the approach to managing assets in retirement. In general, survey respondents and focus group participants indicated a preference for guaranteed life income, but they actually employ other strategies. Results show that retirees and pre-retirees are most likely to try to protect themselves against financial

risks by increasing savings, decreasing debt and cutting back on spending.

Results from the focus groups corroborated earlier observations that retirees tended to prefer managing their assets by themselves. A number of them made little or no adjustment to their self-management of assets at the time of retirement, but those who hired financial counselors frequently made changes based on the advice of the counselor. As with the survey results, reducing spending was a favored risk management strategy of focus group participants.

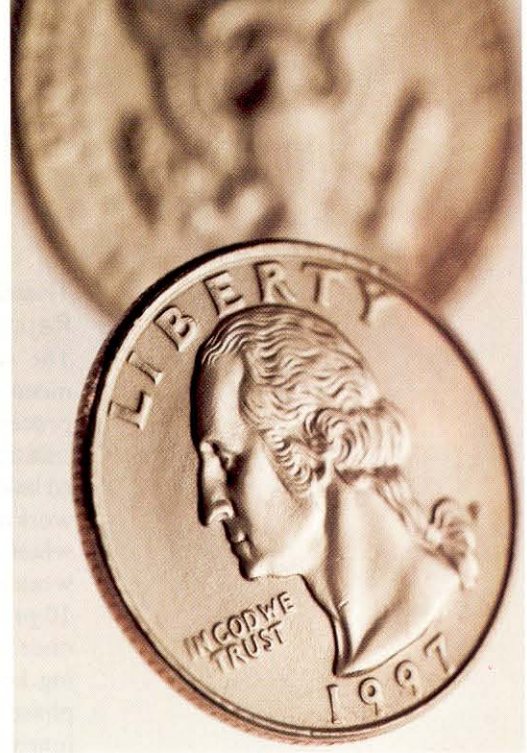
Overall, understanding of life expectancy appears inconsistent and respondents are more likely to underestimate than overestimate it.

The findings point to some interesting opportunities. Most retirees have not considered how the value of their house can be used to fund their retirement. A number of different financial products, including reverse mortgages, can be purchased to tap home equity. This may prove to be an important source of funding for many retirees.

Life Expectancy

Overall, understanding of life expectancy appears inconsistent and respondents are more likely to underestimate than overestimate it. The importance of this topic is evidenced by the Society of Actuaries' exploration of longevity in several broad-based activities. Recently, a call for papers was issued for the third in the SOA's "Living to 100" series of symposia. This third symposium, planned for January 2008, invites authors to weigh-in on the implications of long life, a topic that was featured in the June 2005 issue of *The Actuary*.

In addition, a report highlighting longevity risk has been issued in conjunction with the 2005 survey.



The Retirement Process and Phased Retirement

The surveys focus on the process of retirement as well as knowledge about risks. The process of retirement is changing with the transition into retirement no longer predicated solely on an all-or-nothing decision to stop working. Although most retirees indicate that when they retired they did so by stopping work all at once (69 percent), less than four in 10 pre-retirees think they will stop work all at once (38 percent). A special report highlighting key findings and related commentary on phased retirement has been produced in conjunction with the full report of the 2005 Risks and Process of Retirement Survey. A challenge to actuaries is to design systems that support phased retirement in all of its incarnations.

On a related note, the SOA has been actively working to develop new ideas for financing of retirement in light of this evolution of the nature of work. As an initial effort, a call for papers was issued last fall under the theme of “re-envisioning retirement” in anticipation of a symposium this spring. Papers from the symposium will be published in an SOA online monograph later this summer. This symposium represents an early step in a long-term project being undertaken by the SOA’s Pension Section Council. Watch out for further related activities sponsored by the Pension Section.

Turning Risk into Opportunity: How Actuaries Can Help Meet Changing Needs

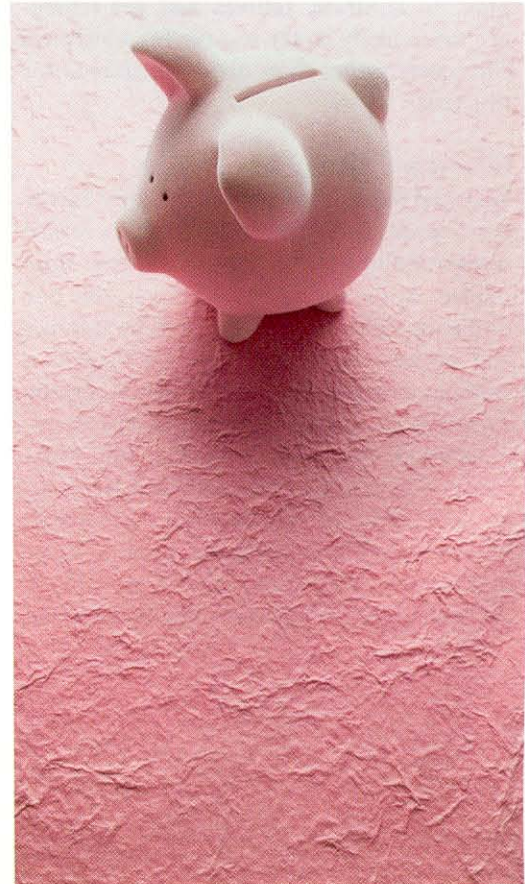
Developing a clear understanding of post-retirement risk and the challenges of managing it offers numerous opportunities for actuaries in different areas of practice. In thinking about these issues, it is important to break down traditional practice silos and adopt a holistic approach. As actuaries contemplate future efforts, they should take a macro view and

consider individually purchased insurance and annuity products, employer sponsored benefits and group purchase programs, and Social Security and government entitlement programs. Actuaries have a role in all of these and all can be important components of a new retirement paradigm.

There are two approaches to dealing with a lack of retirement planning knowledge: targeted educational programs and benefit programs that produce good results without knowledge or action on the part of participants through default options. Evidence shows that many choose to stay in default options even when they have choices. Therefore, well-structured default options can achieve desirable results for these retirees.

The gaps in personal knowledge about retirement reinforce the importance of employer-sponsored retirement programs, education and advice. Employers should consider support for risk management strategies through providing appropriate benefits, financial planning educational programs and group financial product offerings. Actuaries have a role in all of

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these vehicles for empowering employees and making them better equipped for the challenges of retirement.

There are many products on the market today meeting certain retirement needs, but there are also opportunities for creative thinking. For instance, three areas that have been endorsed by the market, but have barely scratched the surface for their potential are longevity insurance, combination products and substandard annuities. All of them can benefit from actuarial ingenuity.

Reports Available Online

The full report from the 2005 and previous surveys can be found on the Society of Actuaries Web site at www.soa.org. The focus group report and several reports highlighting findings from the 2005 survey will be made available as they are completed during 2006. These key findings cover the Risks of Retirement, the Process of Retirement, Longevity and Retirement Issues Related to Women.

Turn Risk into Opportunity: Be Open to New Solutions

We need to be open to new solutions. I have a dream and hope that I can inspire readers to take a blank page approach as they think about retirement in the future. There has been a great deal written about automatic enrollment and balanced lifecycle investment funds in 401(k) plans. Payouts are generally in lump sums, and where annuities are offered in plans, it is generally an all or nothing option at the time of disbursement of funds. My vision is a new default option: Leave funds in the plan from retirement until age 70 and pay out 4 percent of the principal each year in monthly installments. At age 70, annuitize 10 percent of the balance in a joint and 100 percent survivor annuity. At ages 71 to 74, do the same, so that a total of 50 percent has been annuitized. Until the full 50 percent is annuitized, allow the participant to opt out of the default option and actively decide whether to annuitize or not any unannuitized funds.

I find this option extremely desirable because:

- It allows flexibility after retirement.
- It provides a level of guaranteed life income.
- It compels people to consider annuity income and conveys a message in favor of it.
- It recognizes the value of phased annuitization.
- It is consistent with the trend of gradual retirement.
- It provides an adequate pattern of payout and allows redesign as needs change.

Can this concept become a reality today? Probably not. Regulatory problems and employer concerns with such an option would include minimum distribution rules, the "safest annuity rule" applied to defined contribution plans, fiduciary requirements, and other compliance hurdles. But, if we think about this from a blank-sheet-of-paper perspective, none of these objections matter for the moment ... what really matters is that you bring your creative energy to tackling the challenges we are now facing!

Do you have a dream? Will it help the retirement system? Then think seriously about participating in the Society of Actuaries' ongoing efforts toward re-inventing retirement. As Christopher Reeve once said, "So many of our dreams at first seem impossible, then they seem improbable, and then, when we summon the will, they soon become inevitable." ■

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