

The Knowledge Gap: What Does the Public Really Know About Retirement Risks?

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AMERICAN ACADEMY *of* ACTUARIES



Today's Presentation

- Focuses on
 - System successes and failures
 - Puzzles and Implications
- Builds on results from
 - 2005 Risks and Process of Retirement Survey
 - Focus Groups on Financial Management in Retirement
- Supplemental data in the Appendix

Agenda

- Introduction and context
- The big puzzles and related results
- Moving into future/recommendations

Introduction and Context

- Committee on Post-Retirement Needs and Risks
- Successes and failures
- Context
- Related Studies

SOA Committee on Post-Retirement Needs and Risks

- Focus is on understanding of and mechanisms to assist in distribution phase
- Work
 - Risk Chart
 - Risks and Process of Retirement Surveys
 - 2001, 2003 and 2005
 - Retirement Plan Preferences Survey
 - in conjunction with the Academy
 - Misperceptions Paper
 - Focus Groups on Financial Management in Retirement

Successes and Failures

Successes

<ul style="list-style-type: none">▪ Many people can choose to retire	<ul style="list-style-type: none">▪ Many people are happy in retirement today
<ul style="list-style-type: none">▪ Major reductions in poverty rates among elderly couples – now about 5%	<ul style="list-style-type: none">▪ DB plans provide lifetime income for many retirees today – vast majority of these plans pay benefits as promised
<ul style="list-style-type: none">▪ Employer system has accumulated \$11 trillion in assets – good benefits for long service people in many companies	<ul style="list-style-type: none">▪ Housing values important for retirement wealth
<ul style="list-style-type: none">▪ Employer system results in benefits and savings for millions of Americans who would not have anything other than Social Security without employer plans	<ul style="list-style-type: none">▪ PBGC insurance protects a moderate level of defined benefit plan benefits
<ul style="list-style-type: none">▪ Social Security benefits – major impact on older, disabled Americans plus survivors	<ul style="list-style-type: none">▪ While Americans do not save well on their own, they have come to expect to save in 401(k) plans and 70% to 80% offered plans participate

Successes and Failures

Failures

<ul style="list-style-type: none">▪ About four in 10 retire before they choose – premature retirement often due to job loss, poor health	<ul style="list-style-type: none">▪ Substantial gaps in financial literacy and retirement knowledge and Americans do not save well on their own
<ul style="list-style-type: none">▪ Poverty rates much higher for widows, divorced, single older women – 15% to 20% range	<ul style="list-style-type: none">▪ Some DB plans are underfunded today and PBGC facing financial difficulty
<ul style="list-style-type: none">▪ Many working Americans do not have employer coverage	<ul style="list-style-type: none">▪ PBGC guarantees do not protect entire DB benefit (which some people would consider appropriate)
<ul style="list-style-type: none">▪ While many companies and industries have done well, others have not and bankruptcies have led to job loss and frozen benefits	<ul style="list-style-type: none">▪ People save in 401(k) plans, but many stay in default options, use money too early, and do not invest well
<ul style="list-style-type: none">▪ DB funding rules designed to balance benefit security and tax deductible limits have not worked well under difficult economic scenarios (perfect storm)	<ul style="list-style-type: none">▪ Mobile employees do not fare well in final pay DB plans
<ul style="list-style-type: none">▪ Rules for cash balance plans not clarified	<ul style="list-style-type: none">▪ DB plans are being frozen or terminated

21st Century Challenges

- Demographics: aging population + low fertility = increasing dependency ratios
 - People need/want to work longer
 - Fewer entrants to labor force
 - Stress on intergenerational transfers/pay-as-you go programs
- Adjusting to evolving definition of retirement
- Global competition: pressure on labor costs
- Regulatory uncertainty/litigation
- Living with new accounting rules
- Fewer DB plans with regular income payout
- Low savings rates and financial literacy

Dangers to Future Retirement Security

- Decline in existing systems to provide benefits without employee action and threats to systems
- Lack of knowledge on the part of individuals
 - Retirement planning has been an intuitive process
- Psychological/economic barriers
- Lack of role models
- Failure to act on knowledge
- False sense of confidence about
 - Ability to work later in life
 - Ability to get high returns on investments
 - Not needing long-term care

Big Questions

- What is appropriate role of government, the employer and the individual? How should risk be shared? Can each party realistically meet their commitments?
- What are appropriate eligibility ages to start benefit payments (retirement ages)?
- How important is lifetime income?
- Are there special issues for the boomers, a cohort in the middle of a transition?

Agenda

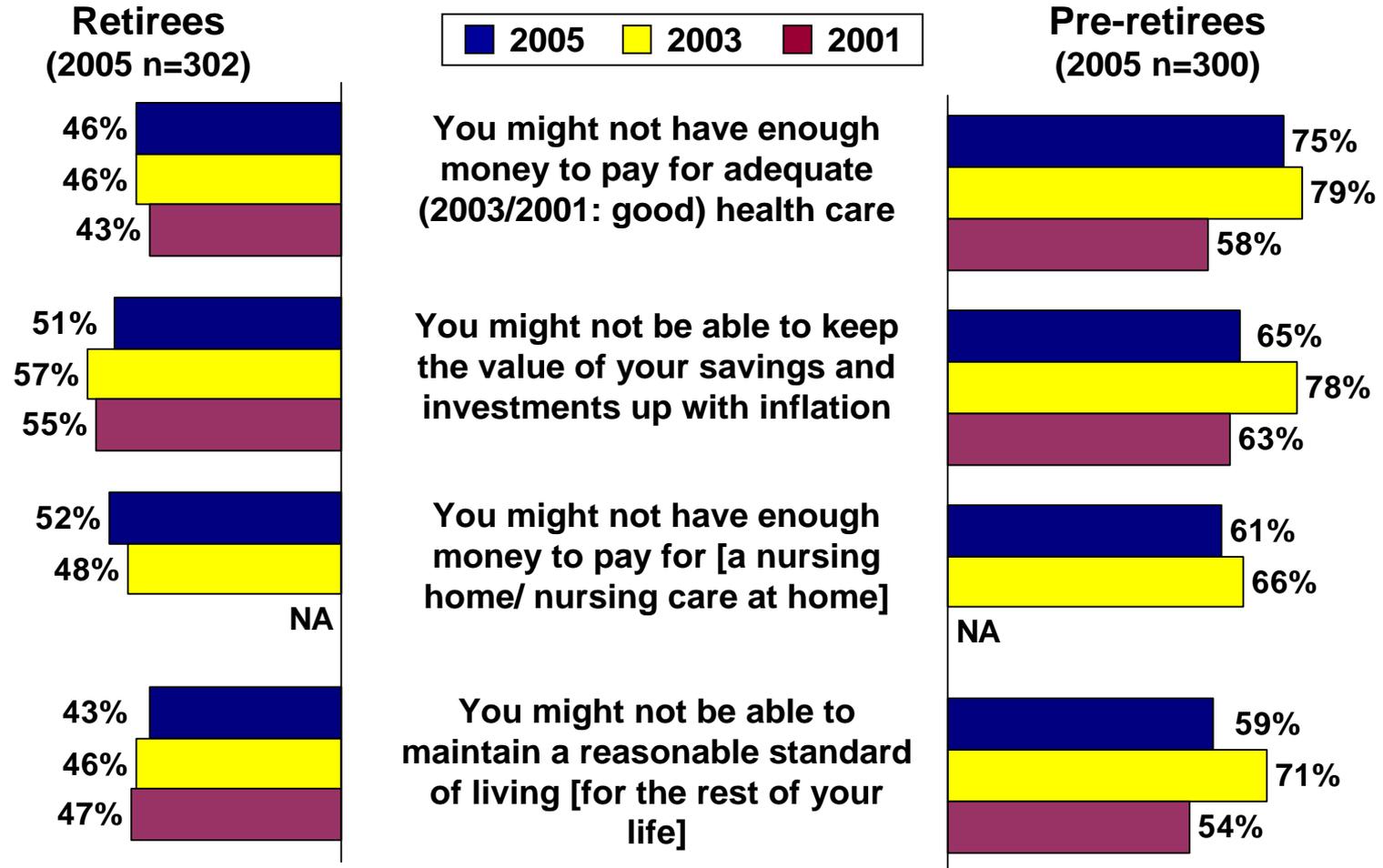
- Introduction and context
- The big puzzles
 - Risk perceptions
 - Longevity
 - Life income
 - Longer work
 - Adequacy
- Moving into future/recommendations

Puzzles Around Risk Perceptions

- Pre-retirees are worried, but worry doesn't translate into action
- Result
 - Retirees' perception of risk associated with level of control
 - Perceive less risk if they have control, even if control generates risk (e.g., investments)
- Both pre-retirees and retirees fail to understand consequences of longevity risk

Concerns About Risk Fairly Constant

How concerned are you that . . . ? (percentage very or somewhat concerned)



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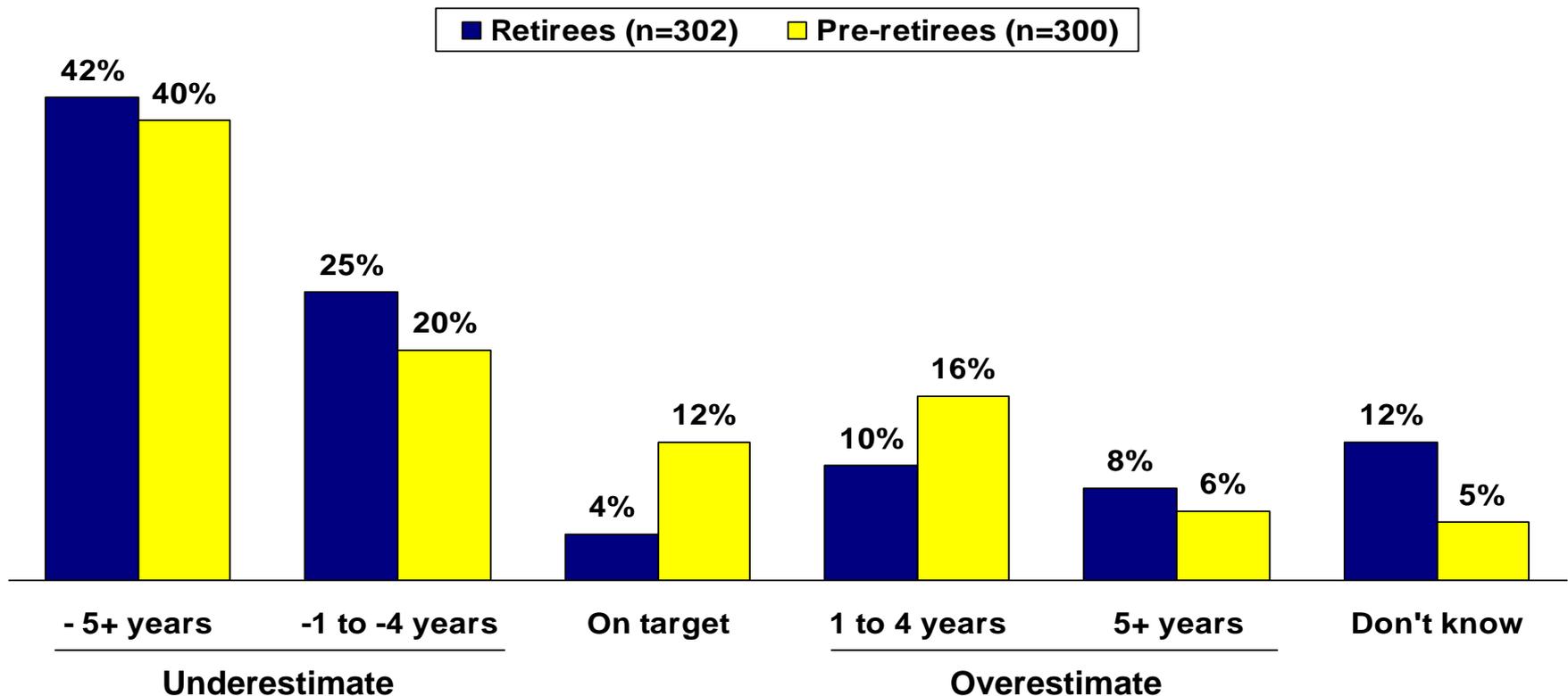
Puzzles Around Individual Understanding of Longevity Risk

- Potential variability of life expectancy beyond grasp of most people
- Recent and continuing gains in life expectancy aren't factored into
 - Design of retirement system
 - Personal life expectancy estimates
 - More influenced by parents, family history
- Result
 - More people underestimate than overestimate
 - Financial planners often still focus on average
- Big problem for future

At Least 6 in 10 Underestimate Average Life Expectancy

Until what age do you think the average person your age and gender can expect to live?

Difference Between Population Life Expectancy¹ and Respondent Estimate

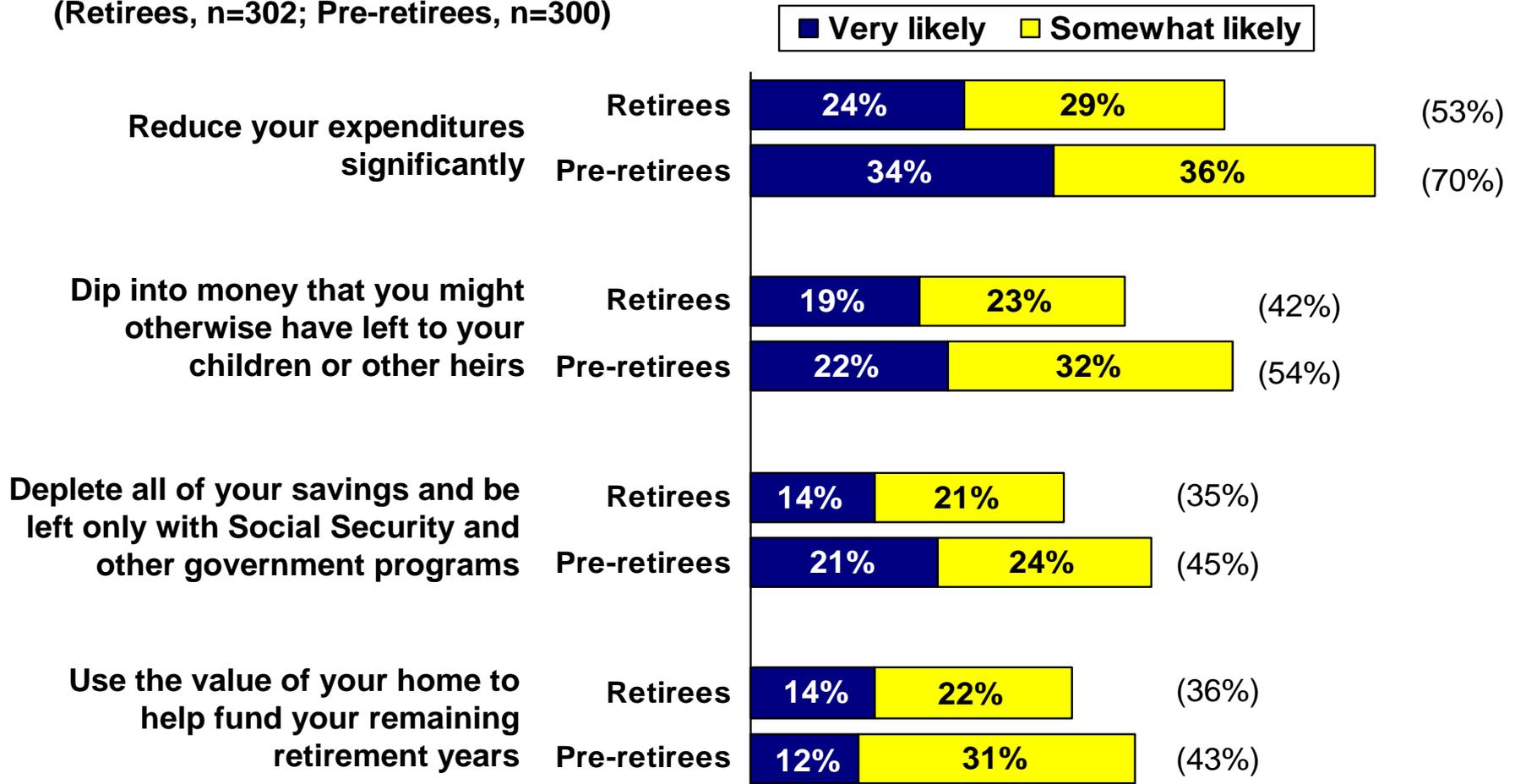


¹Based on UP94 Life Tables projected to 2005.

Few Understand Financial Consequences of Outliving Assets

If you (and your spouse) were to live five years longer than expected, how likely do you think it is that you would have to do each of the following?

(Retirees, n=302; Pre-retirees, n=300)



Agenda

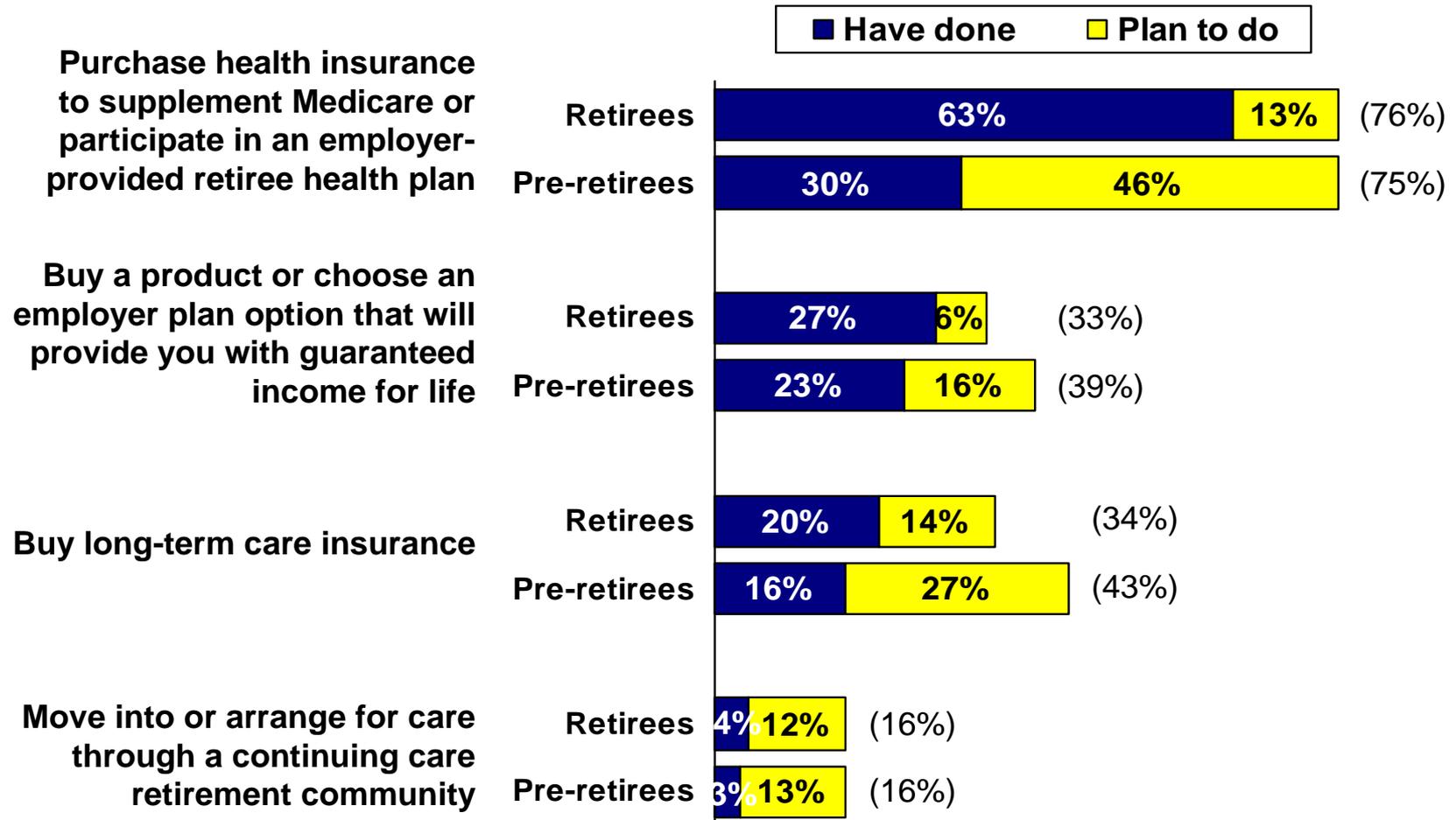
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Puzzles Around Life Income

- We know people prefer lifetime income, but once they leave DB plans, people don't act to ensure this
 - Many self-annuitization strategies
 - Could be because many of today's retirees still have annuity sources other than Social Security
- Result
 - Lack of understanding as to which strategies insure risk
 - More fear of dying young than living long favors certain strategies
- Questions
 - What is the minimum income needed for security for those without DB plans?
 - How do we build awareness of survivor needs?
 - What problems will these choices create?

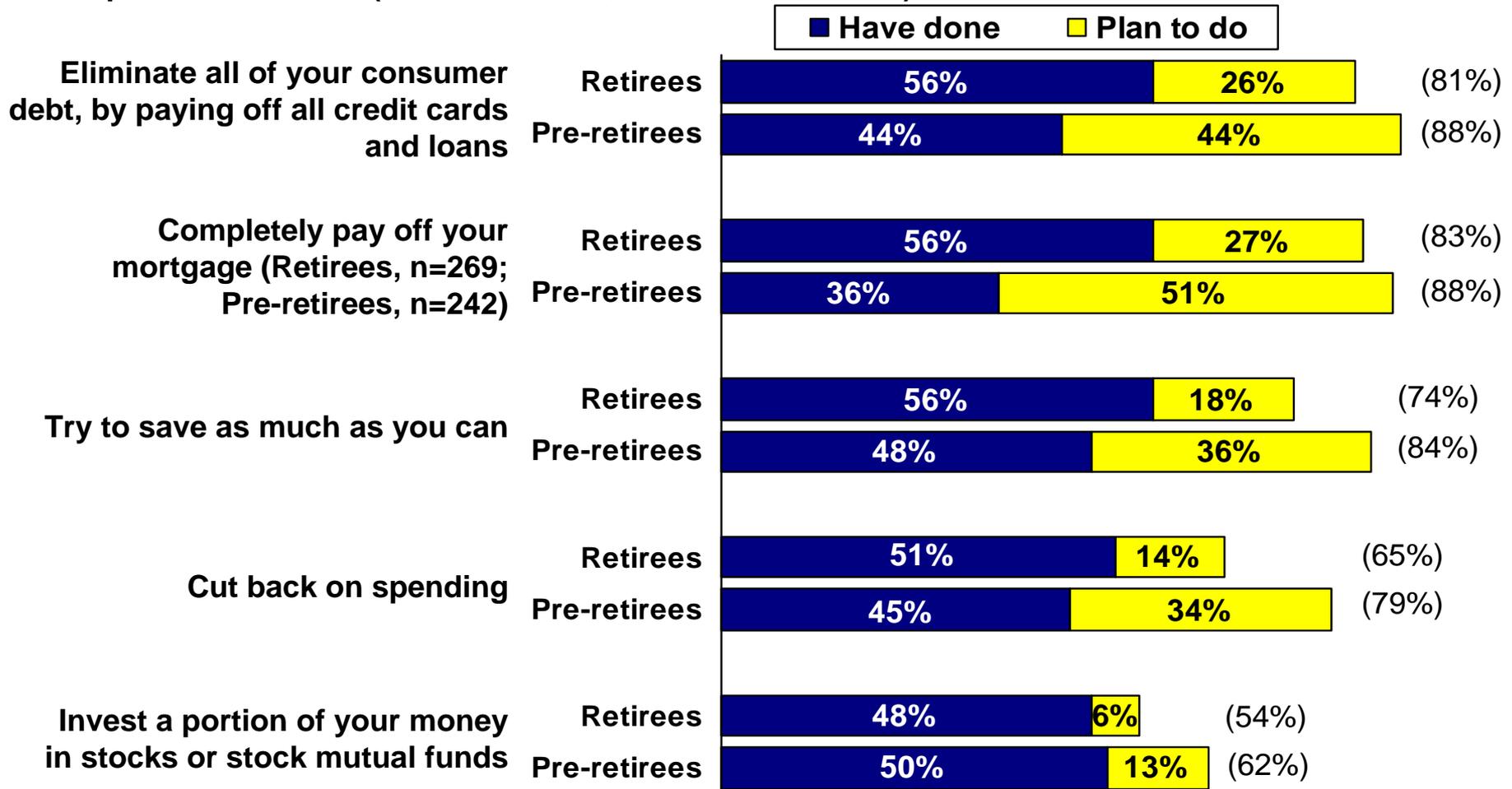
Few Turn to Risk Reducing Products Other Than Supplemental Health Coverage

Please tell me whether you (and your spouse) have done that, plan to do that in the future, or have no plans to do that? (Retirees, n=302; Pre-retirees, n=300)



Instead, Most Try to Manage Risk Themselves

Please tell me whether you (and your spouse) have done that, plan to do that in the future, or have no plans to do that? (Retirees, n=302; Pre-retirees, n=300)



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Puzzles Around Longer Work

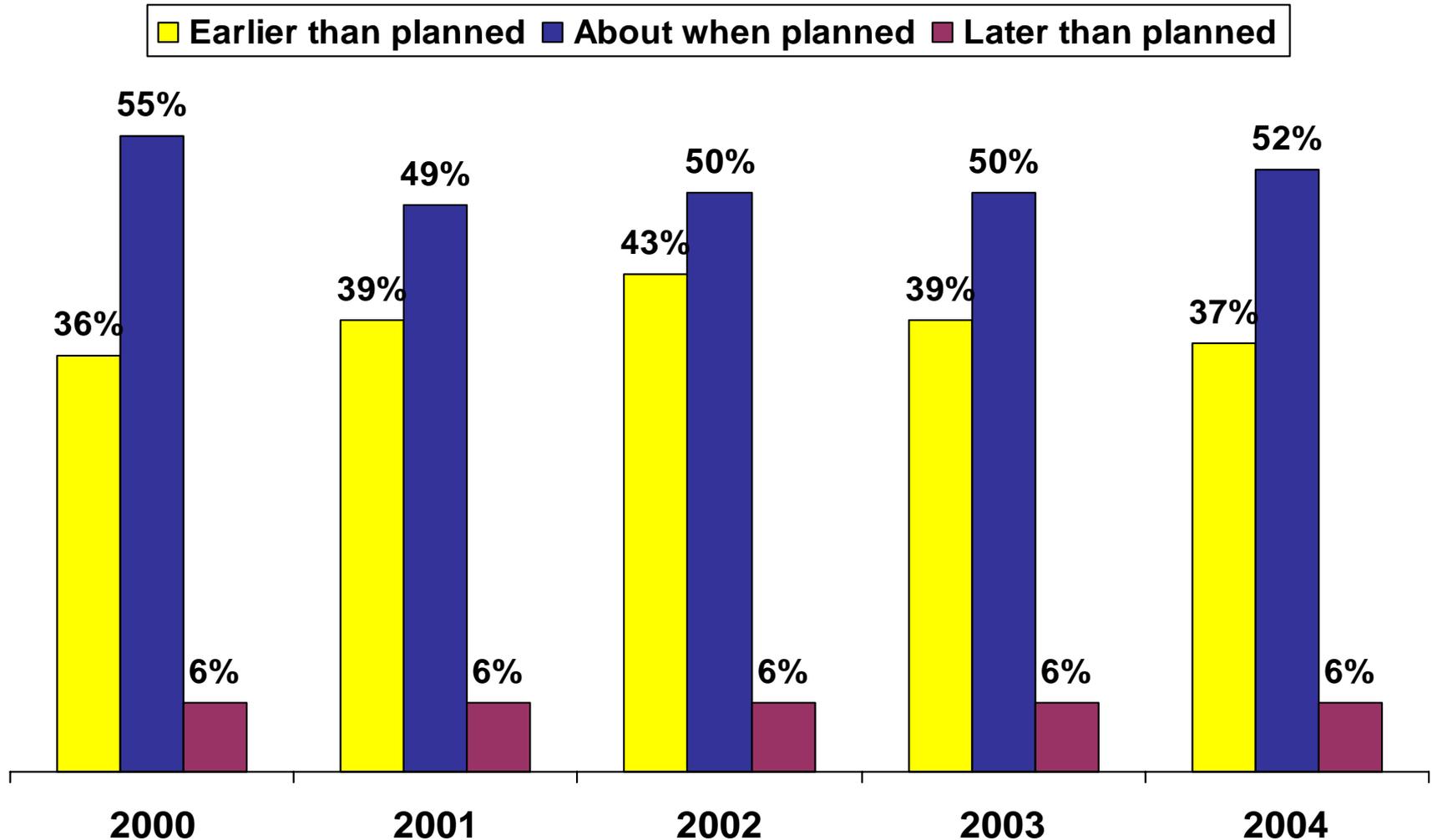
- Many people say they want to work in retirement
- Many people retire earlier than planned
 - Don't plan for premature retirement risk
- Displaced worker research shows it takes longer to get jobs at higher ages
- Other research indicates that older applicants get fewer call backs
 - Age discrimination? Will this change as population ages?
- Result: still unknown what the effect of longer work will be on future retirement patterns

Pre-retirees Expect to Work Longer

How old were you when you retired/began to retire from your primary occupation?
 At what age do you expect to retire from your primary occupation?
 (Among retirees and employed pre-retirees)

Age category	Retirees (%)	Pre-retirees (%)
	2005 (n=302)	2005 (n=253)
Under age 55	34	2
55 to 61	29	12
62 to 64	20	18
65	5	21
66 or older	8	20
Will not retire	--	13
Doesn't apply	3	--
Don't know	2	15

Timing of Retirement Among Retirees



Source: EBRI/ASEC/Greenwald, 2000-2004 Retirement Confidence Surveys

Future Labor Supply Adequate?

- Number of new entrants to labor force will be relatively lower than in past decades
- Number of retirements up (if timing of retirement unchanged)
- Shortages: experts disagree
 - Range of predictions – from none to very big
 - Shortages in some occupations seem inevitable: e.g., nurses, other medical professionals, nuclear engineers, other technical occupations
 - Likely to be specific blue-collar occupations with problems
 - New sources of labor supply: immigration + off shoring
 - Department of Labor projections assume markets clear and conditions adjust

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Puzzles Around Adequacy

- Traditional actuarial view: need 70% - 80% of pre-retirement income (if spend most income pre-retirement) to maintain lifestyle (Aon/Georgia State Study)
- Range of views – from 40% up; assume major changes in lifestyle
- Reasons to spend more or less
- Individual needs change over time
- Result: topic for future research

Focus Groups: Decision to Retire

- Most retired before age 62
- A number were burned out
- Some were offered packages
- Many retired before they planned
- Key findings
 - Informal approach to retirement
 - Very “intuitive” sense of financial needs

Focus Groups: Informal Approach

- Informal approach to retirement
 - Most had a good sense of their living expenses
 - Did not have exact figures or projections how those might change
 - Determined that their Social Security, pension and income from investments could provide for their monthly expenses
- A minority used financial advisor to calculate needs
 - Most went to an advisor after they decided to retire to “check in”
- Decision to retire generally made right before retirement
 - None had targeted accumulations of savings
 - None had targeted retirement date

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The Findings and the Big Questions

- The research can help inform us as we think about these big questions
 - What is appropriate role of government, the employer and the individual? How should risk be shared? Can each party realistically meet their commitments?
 - What are appropriate eligibility ages to start benefit payments (retirement ages)?
 - How important is lifetime income?
 - Are there special issues for the boomers, a cohort in the middle of a transition?

Summary

- Given that
 - More retirement risk is being transferred to individuals
 - The behavioral finance and psychological barriers to retirement planning won't go away
- We need to be aware of the following
 - We will continue to find major gaps in personal risk understanding and poor risk management strategies
 - Widows and very old will continue to be vulnerable
 - Education is desirable, but there are limits on what it can accomplish
 - A substantial minority that retires earlier than expected and a substantial minority that lives longer than expected will be at high risk

What Should 21st Century Programs Look Like?

- Best retirement programs will be those that work without or minimize individual action
- Need to actively develop new ways of risk sharing
 - Sharing risk between employers and employees
 - DB/DC models put all risk on one or the other
 - Use of intra-generational risk sharing models in addition to intergenerational models
 - Other retirement plan models (e.g., TIAA-CREF)
- Traditional Social Security will be very important
- DB plans can still add value
- Need to address health and long-term care systems

What is Actuarial Profession Doing to Create a Better Future?

- Retirement 20/20
 - Exploring new options
 - Current systems put too much risk on employer or employee – seeking a third way
 - Blank sheet of paper
 - Focusing on range of risks and need for pooling
 - Focus on intra-generational vs. inter-generational solutions, role of extended family as well as employer and government

Retirement 20/20 – Moving Forward

- Next step
 - Diverse group of experts to be convened in September 2006
- What will you need to do?
 - Current options are product of current law
 - As new options emerge, enabling legislation likely to be needed



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Appendix

- Focus group study available
- More on risk perceptions
- Labor force shortages
- Phased retirement
- Behavioral finance

Focus Groups on Financial Management in Retirement

- Sponsored by the Society of Actuaries
- Goal: understand decisions retirees make in retirement when they don't benefit from substantial annuitization
- Six focus groups (Hartford, Chicago, Phoenix)
- Participant criteria
 - Ages 60-72
 - Retired two to ten years
 - Financial decision maker
 - Separate groups for married, single individuals

Focus Groups on Financial Management in Retirement

- Financial criteria
 - Investments of \$50,000 to \$500,000 in 401(k) or other employer sponsored plan
 - Total retirement savings of \$100,000 to \$500,000 at retirement
 - \$100,000 to \$2 million in all investable assets (including real estate)
 - At least 25% of income comes from own savings
 - Had hoped to include only individuals whose only annuity source was Social Security but weren't able to find them
- Results will be available at <http://www.soa.org/ccm/content/areas-of-practice/special-interest-sections/pension/post-retirement/>

Focus Groups: Intuition Reigns

- Gave retirees “scenarios” to test how they determined if someone could afford to retire
- Process effective, but intuitive
 - Calculate monthly expenses
 - Add up monthly benefits from Social Security and pension plan
 - Derive shortfall
 - Add up investable assets
 - Multiply investable assets by approximately 6% to derive expected investment income
 - Retirement feasible if expected income fills shortfall

Appendix

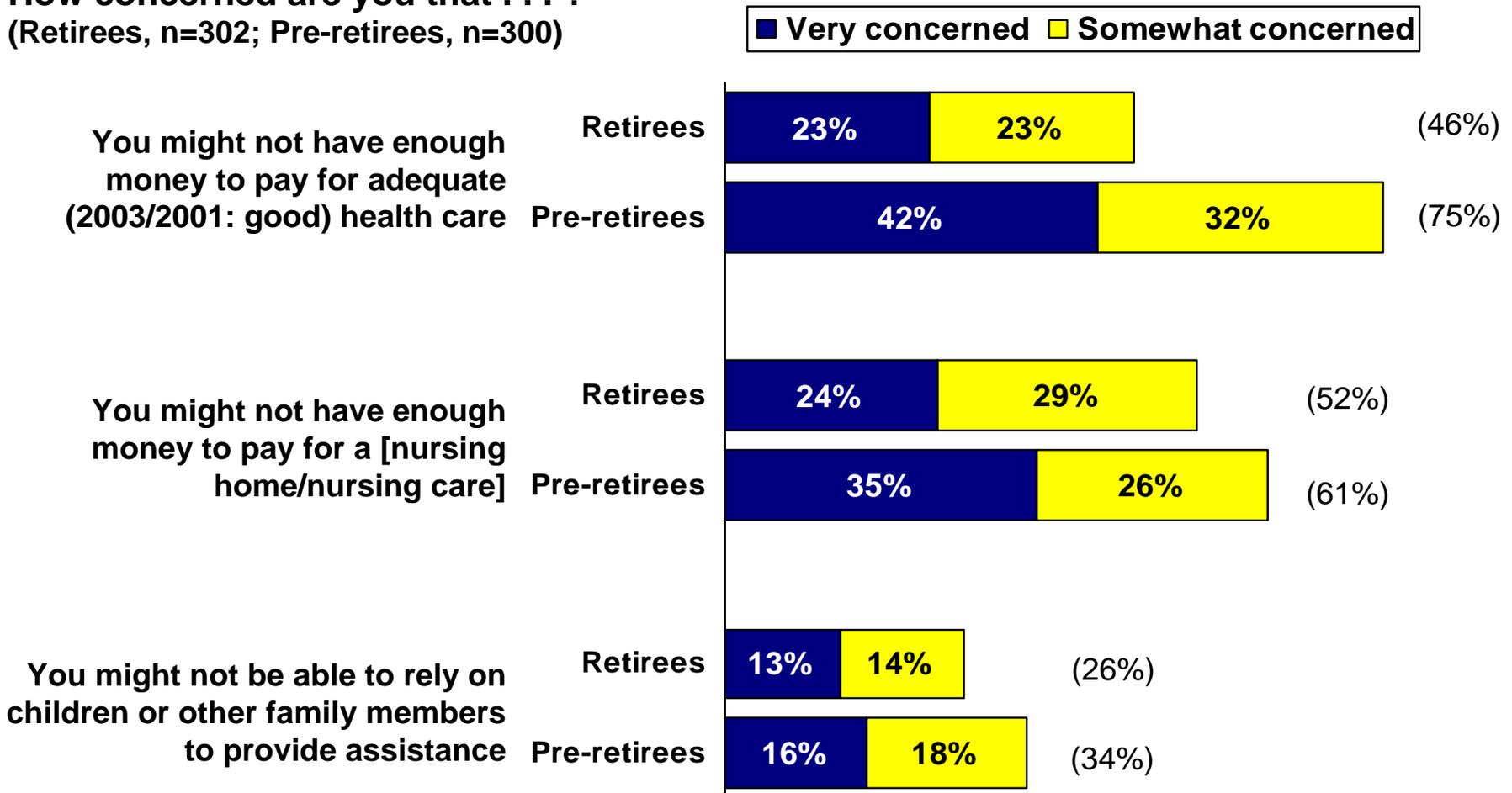
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Health and Long-term Care

- Major concern for retirees and pre-retirees
- Major decline in retiree health insurance
 - Big increases in employer health costs
 - Increases in premiums, co-payments where coverage is offered
- Projected costs of both Medicare and Medicaid represent a major national problem
 - Private long-term care coverage expensive, rarely used
- Very uncertain future

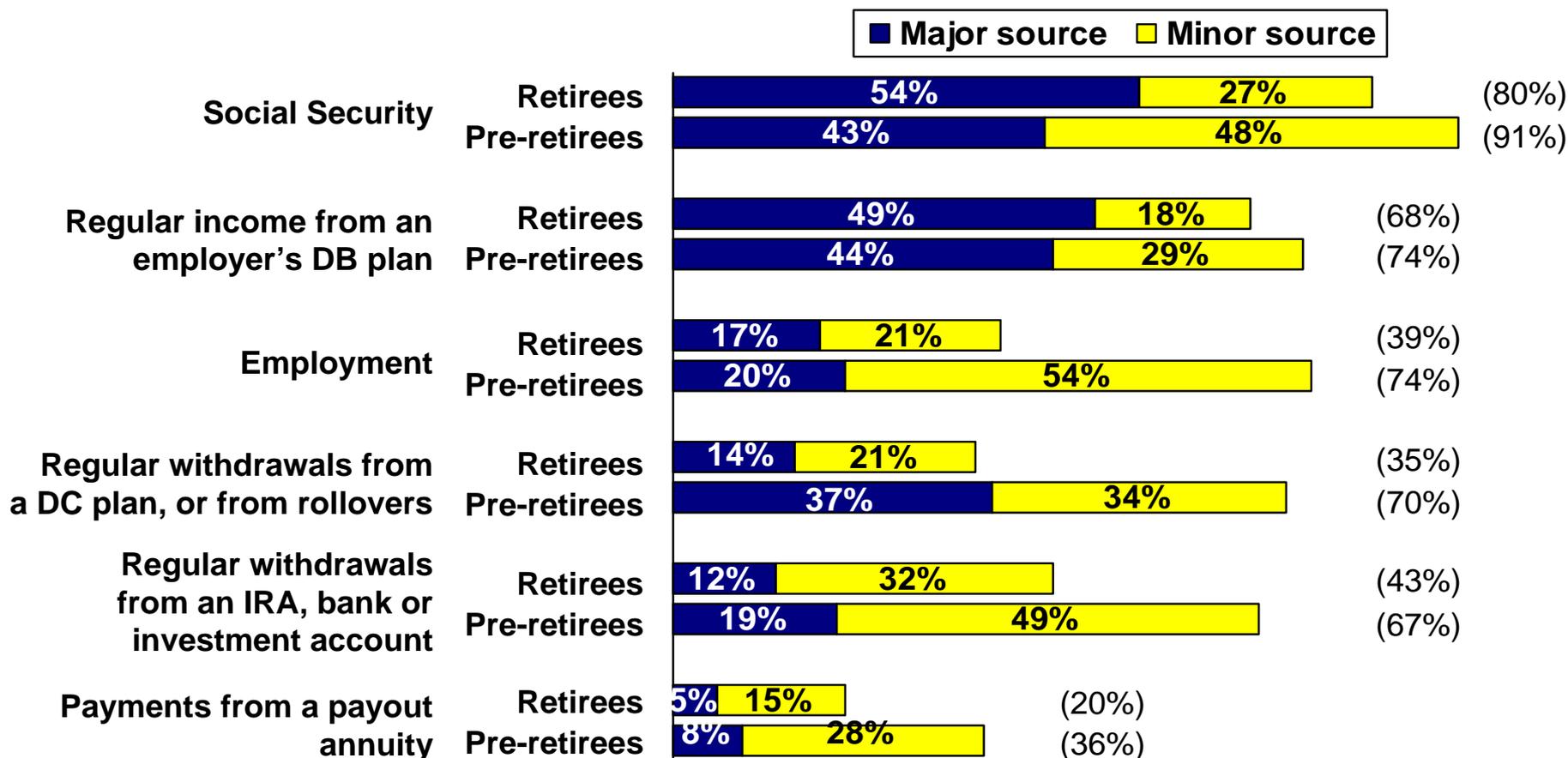
Health and Long-term Care Risks Are Most Likely to Worry Pre-retirees

How concerned are you that . . . ?
 (Retirees, n=302; Pre-retirees, n=300)



Social Security and DB Plans Major Sources of Income for Today's Retirees

Please tell me whether each of these is/you expect each of these sources will be a major, minor, or not a source of income for you. (Retirees, n=302; Pre-retirees, n=300)

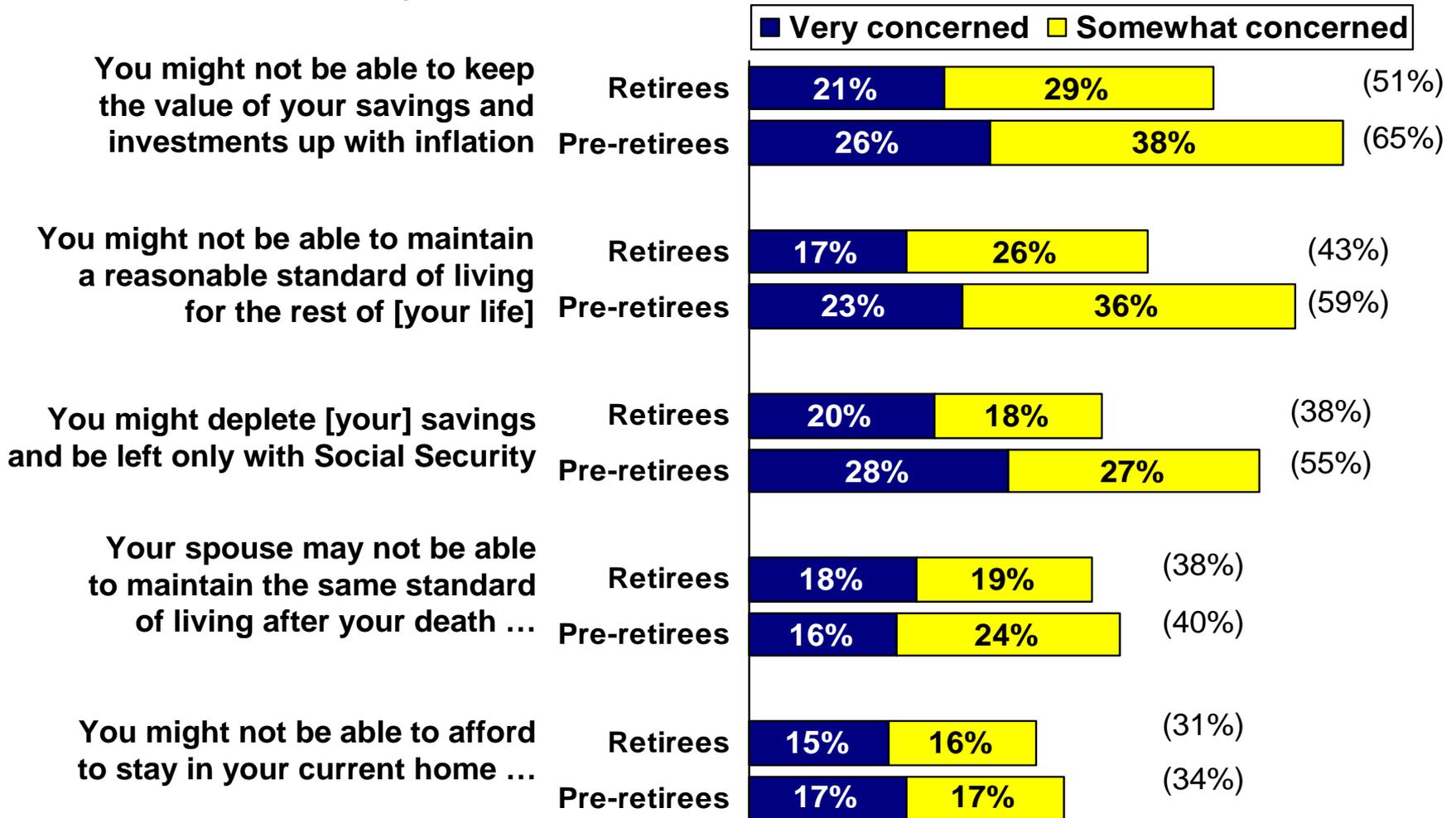


Inflation

- Second most important risk concern
- Focus groups indicate that little is done to address the issue
 - Survey shows little understanding of effect of inflation
- Experience of last few years
 - Big increases in health costs and premiums
 - Otherwise modest inflation
- Very serious long term issue

Inflation Continues to be a Top Concern of Retirees

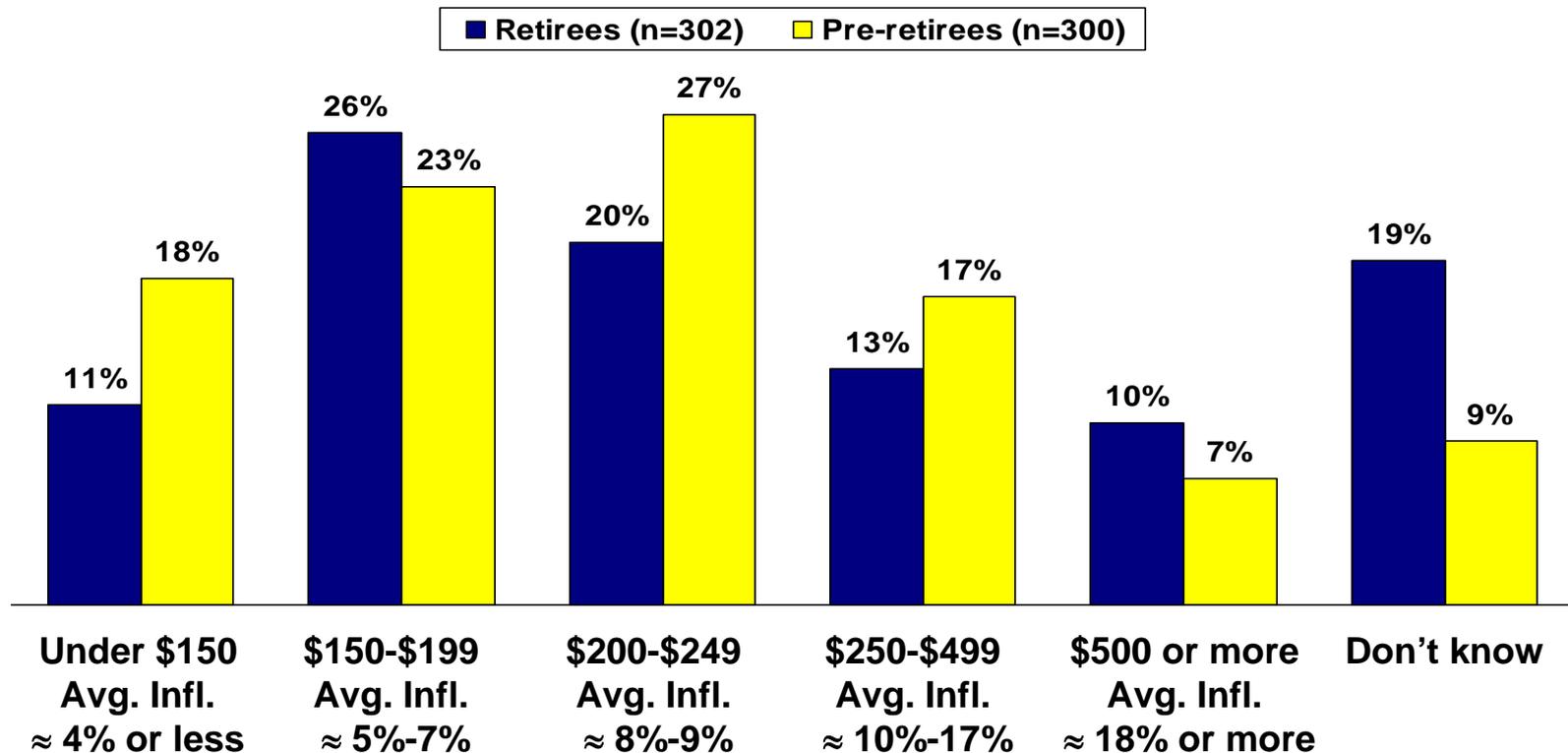
How concerned are you that . . . ? (Retirees, n=302; Pre-retirees, n=300)



Half Think That Prices Will Be at Least Double 10 Years From Now

Suppose your weekly groceries today cost you \$100. How much do you think they will cost in 10 years?

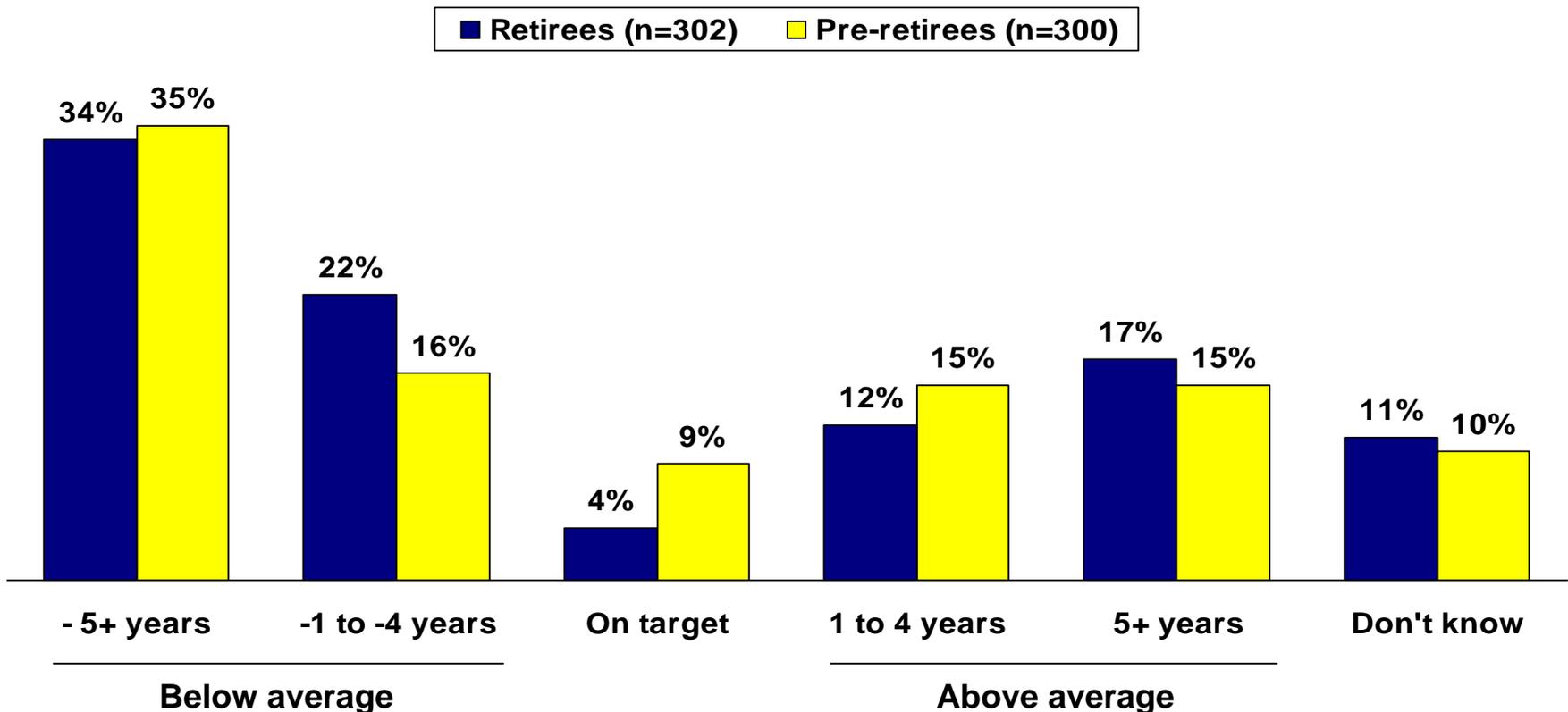
Cost of \$100 of Groceries in 10 Years



While Half Cite Personal Life Expectancies Below Average . . .

Until what age do you think that you, yourself, can expect to live?

Difference Between Population Life Expectancy¹ and Personal Life Expectancy

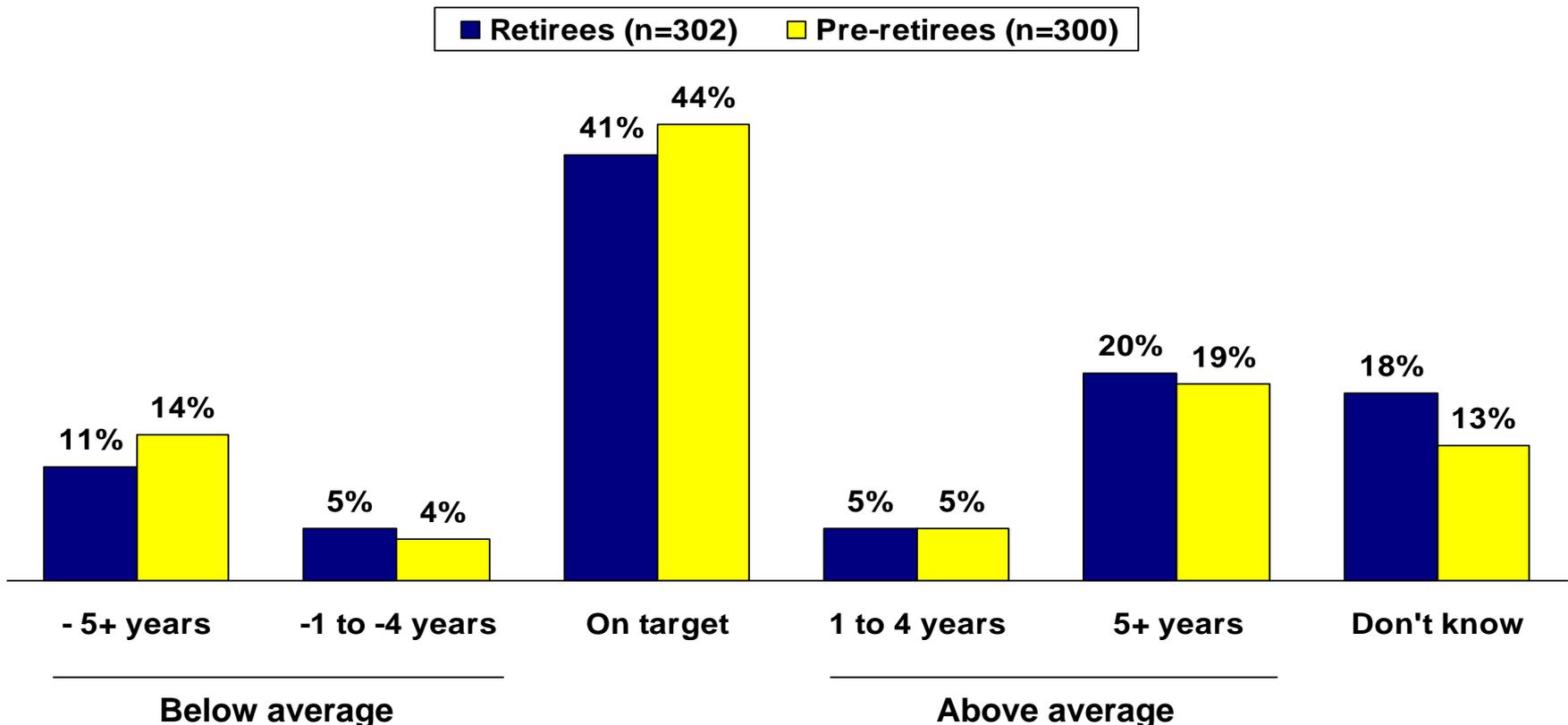


¹Based on UP94 Life Tables projected to 2005.

... Most Think Their Personal Life Expectancies Are Average or Longer

Until what age do you think the average person your age and gender can expect to live?
Until what age do you think that you, yourself, can expect to live?

Difference Between Personal Life Expectancy and Respondent Estimate



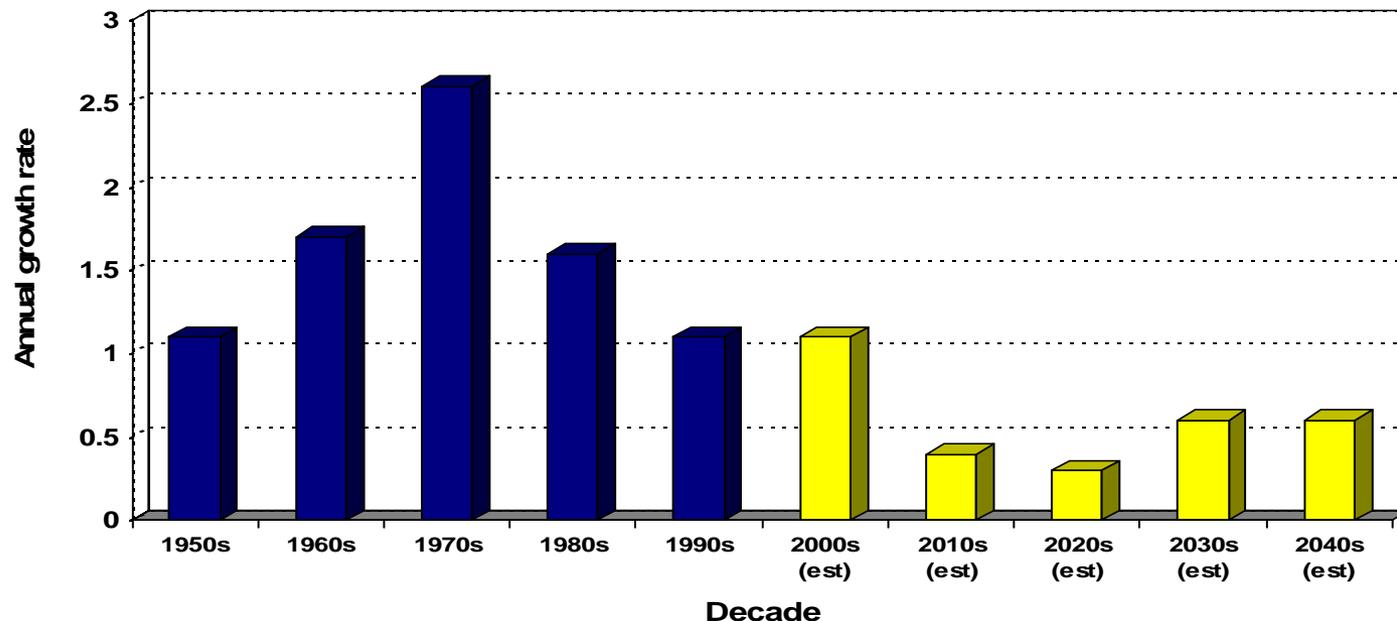
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- **Labor force shortages**
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Puzzles Around Labor Shortages: Will Opportunities Be There?

- Wide range of views around future shortages of workers
 - Labor force growth predicted at 1.1% per annum over 2002-2012 period
 - But growth of only 0.6% per annum 2000-2050

Actual/projected civilian labor force growth rates



Source: Horrigan, "Employment Projections to 2012: Concepts and Context,"
Monthly Labor Review, February 2004

Puzzles Around Labor Shortages: Will Opportunities Be There?

- BLS projections based on assumption that labor market clears
- Many ways to clear a labor market
 - Immigration, technology, work organization, outsourcing, flexible workers, overtime
- We expect shortages in some occupations and industries but will this overall lead to more opportunities for seniors?
- Will workplace evolve to make it easier for seniors to work (e.g., age discrimination, part-time work)
- The experts disagree about labor shortages

Source: Horrigan, "Employment Projections to 2012: Concepts and Context," *Monthly Labor Review*, February 2004

Puzzles Around Labor Shortages: Can Older Workers Meet the Demand?

- Study by Richard Johnson on the trends in job demands among workers aged 55 – 60 between 1992 – 2002
- More older workers now in jobs that don't require physical demands
 - 2 of 5 older workers in jobs that never required much physical effort
- But
 - The share of older workers whose jobs always require substantial physical effort did not fall significantly over the last decade
 - 1 in 5 workers report their jobs almost always require substantial physical effort
 - Level of non-physical demands has increased significantly, increasing difficulty and stress of those jobs
- Conclusion: “When devising ways to encourage older adults to delay retirement and remain at work, policymakers should provide an adequate safety net for those adults whose demanding jobs and health problems force them to retire early.”

Source: Johnson, “Trends in Job Demands Among Older Workers, 1992-2002,” *Monthly Labor Review*, July 2004

Labor Shortages Will Create Opportunity ...

"Shortages in a wide range of occupations that are evident today provide a glimpse of greater shortages to come. Current trends point to chronic shortages across the entire spectrum of the occupations and industries, but most especially in those that offer the greatest potential for economic growth and rising incomes over the next 30 years. Over the next 30 years, the labor force needed to maintain current per capita growth in the standard of living will increase to nearly 200 million, but current growth of the working age population, productivity growth trends and current labor force participation rates point to an available labor force of only 165 million. The shortage may reach a total of 35 million workers – 21% more than the available labor force – in 2031."

Edward E. Potter, President of the Employee Policy Foundation
October 11, 2001 letter to
John Boehner, Chairman, Committee on Education and Labor
US House of Representatives

Labor Shortages Won't Exist

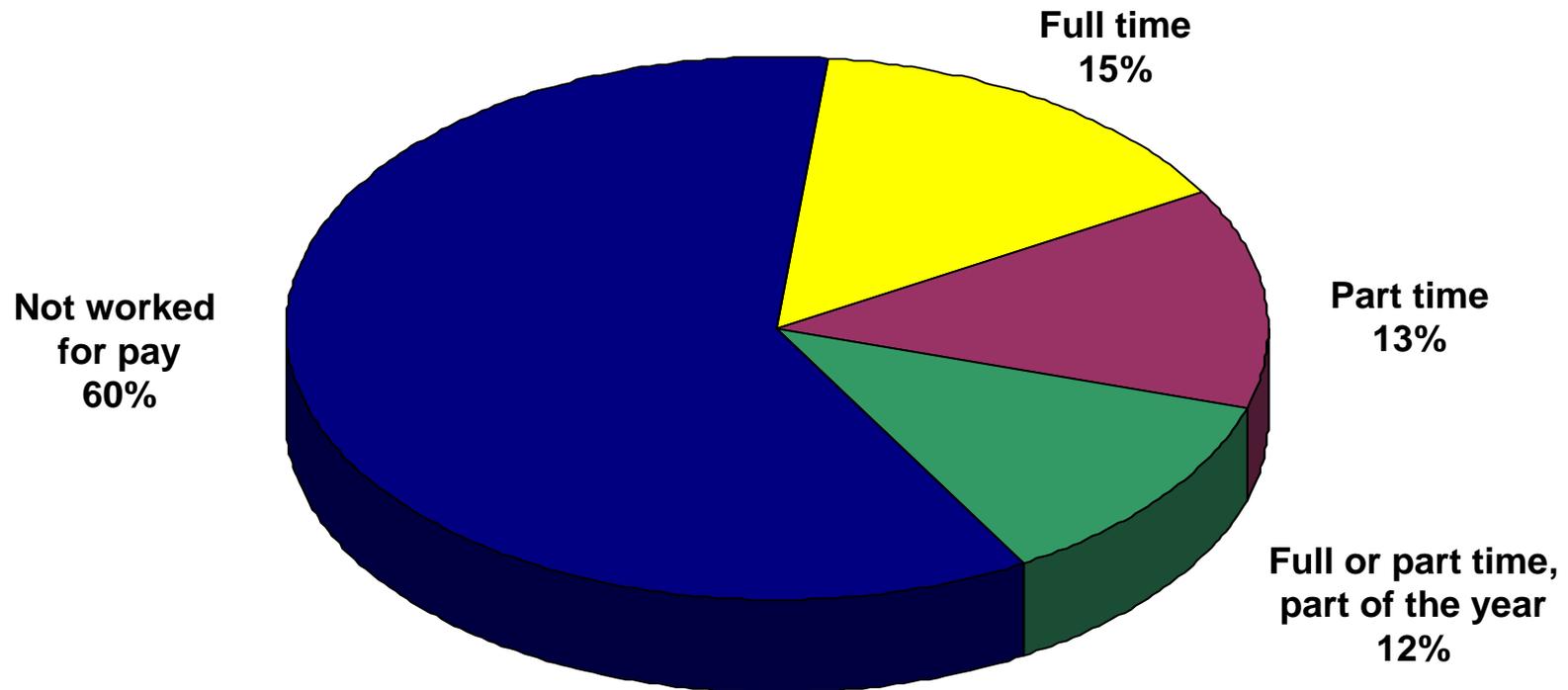
- Peter Cappelli, professor of management and director of Wharton's Center for Human Resources, says that predictions of a labor shortage are false:
 - Even though the baby-bust group is 16% smaller than the baby-boom group, not every subgroup is smaller (e.g. college enrollments have not dropped as a higher percentage are enrolling in college.)
 - **Predictions of a labor shortage are based on the unrealistic idea that baby-boomers will retire at age 65. Many boomers will work past age 65, although they may change the work they do.**
 - Individual companies do not usually reflect the demographic profile of the United States. Companies' profiles reflect their own histories, and the periods of time when they were growing and changing. Some companies are older, some are younger.
 - Shortages in specific occupations or locations are a different issue. It seems quite likely that at a minimum there will be shortages in specific occupations.

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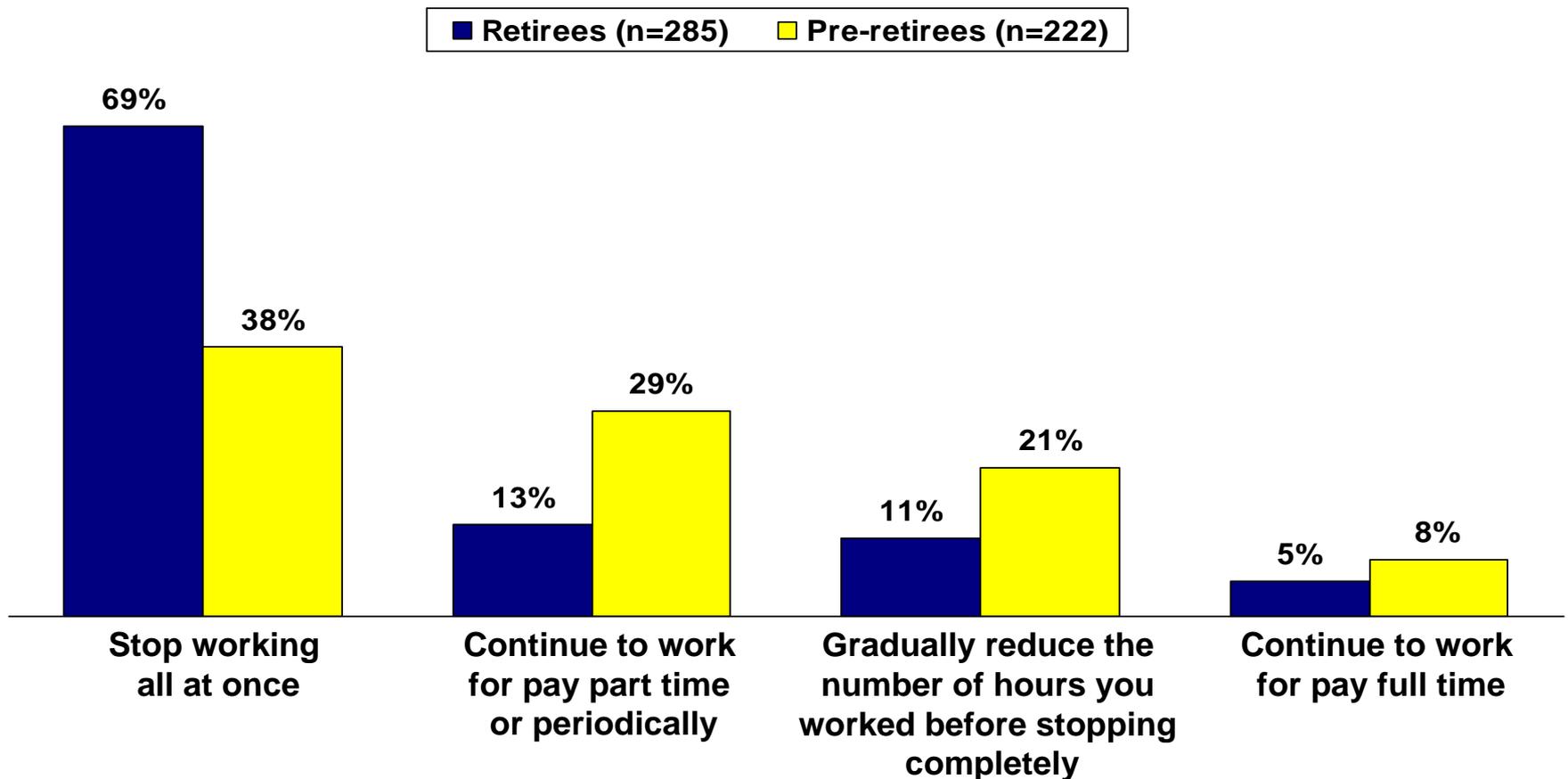
Phased Retirement Already Exists Informally

In the past 12 months, have you worked for pay . . . ? (Among retirees providing retirement age from primary occupation, n=274)



And Phased Retirement Will Likely Increase in the Future

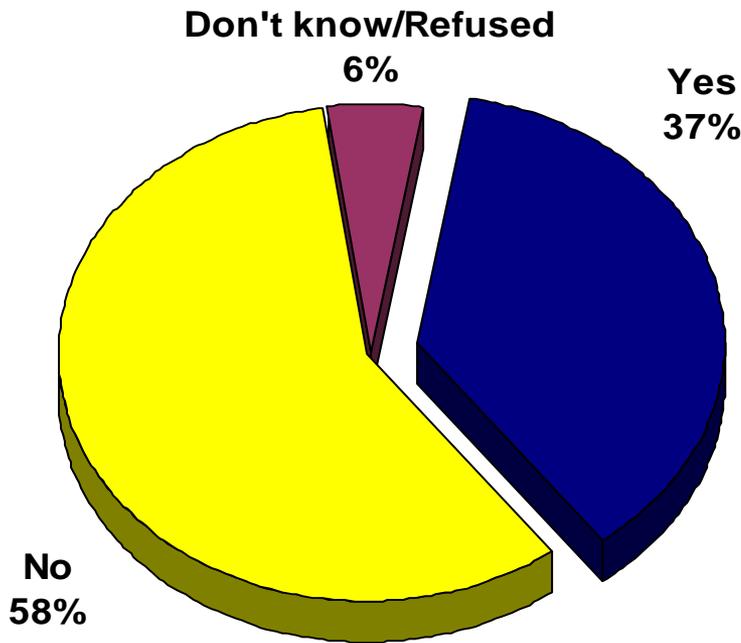
Which statement comes closest to describing how you retired/plan to retire from your primary occupation? (Among those providing retirement age from primary occupation)



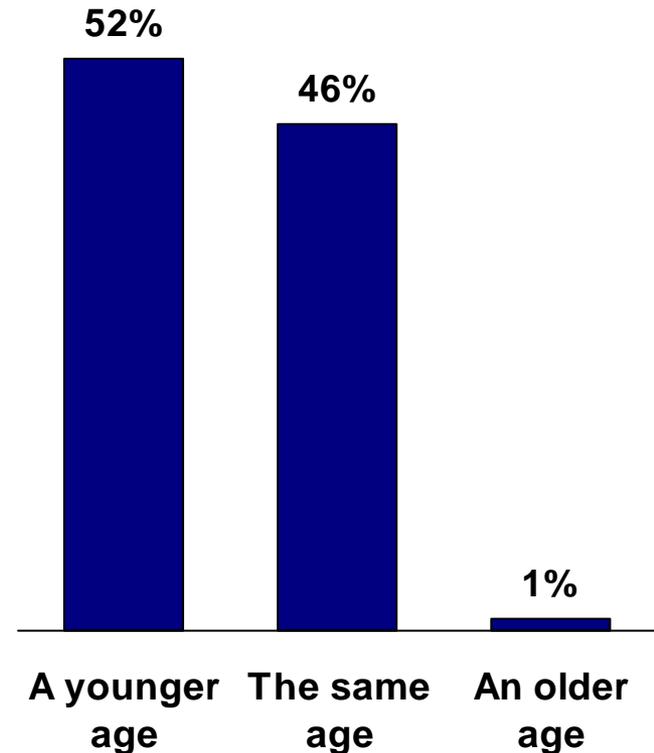
Many Pre-retirees Would Alter Plans if Could Collect Pension During Phased Retirement.

If [the] law were changed so that you could cut back on your working hours and ... start collecting some of your pension, would this change your plans for retirement? (Among those expecting to receive pension from last employer, n=105)

If yes: Do you think you would start to retire at . . . ?

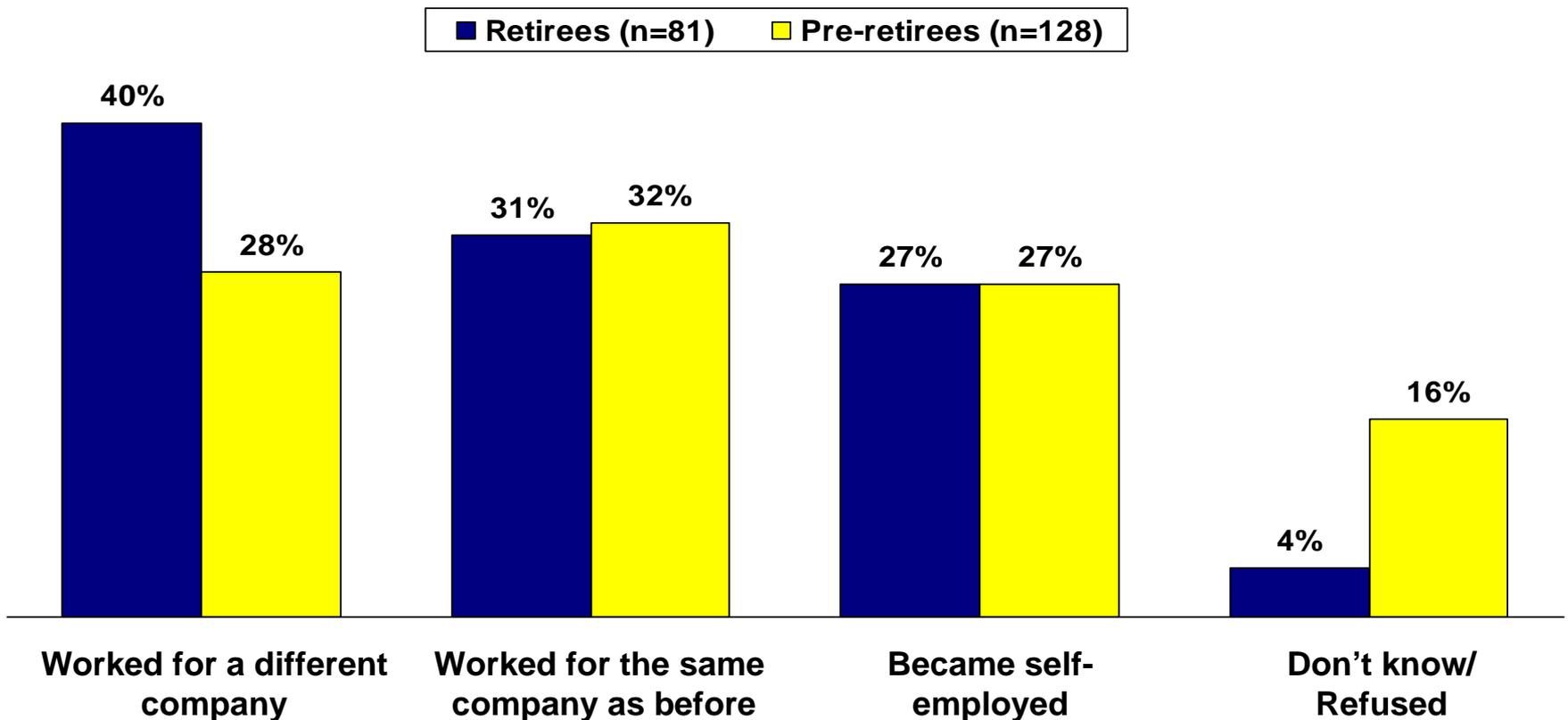


➔
(n=41)



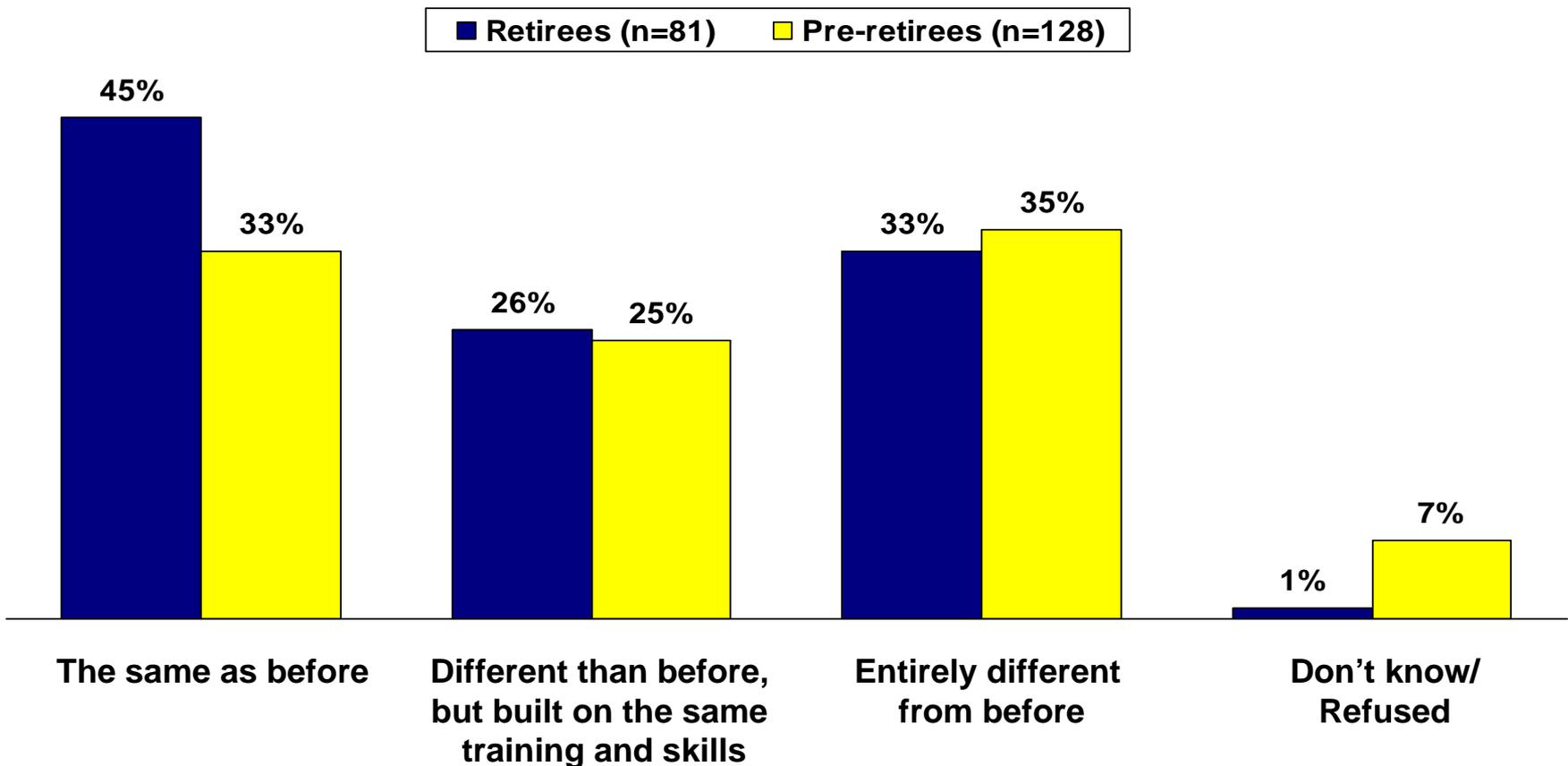
1 in 3 Continue to Work for the Same Company as Before Retirement

When you worked in retirement, which statement comes closest to describing what you actually did?/After you retire, do you think you will . . . ? (Among those continuing to work in retirement)



A Majority Use Training and Skills from Their Primary Occupation

When you worked in retirement, which statement comes closest to describing what you actually did?/Do you think the work you do for pay in retirement will be . . . ?
(Among those continuing to work in retirement)



Pre-retirees Don't Consider Premature Retirement Risk

What event or situation occurred at age X that leads you to say you retired at that age? (retirees) / What event or situation do you anticipate occurring at that age that leads you to say you will retire? (pre-retirees)

Top mentions (multiple responses accepted)	Retirees (n=242)	Pre-retirees (n=231)
Stopped working completely	22%	20%
Health problems/became disabled	19%	5%
Company closed/downsized	11%	--
Started receiving pension	10%	18%
Switched to another career	7%	4%
Family member had medical problem	5%	--
Got tired of working/ready to retire	5%	2%
Had enough money to stop working	5%	19%

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Findings from Behavioral Finance

- Motivating individuals to plan for retirement is extremely difficult
 - The payoff for behavioral change is quite uncertain
 - Workers do not easily buy the idea of payoffs in the distant future
 - The promise of pleasure tomorrow means pain today
 - The wrong decision yields instant gains
 - There is no immediate tangible reward for saving now
 - The savings decision can be postponed without immediate penalty
 - There are no functional deadlines for action

Psychological Barriers

- Pre-retirees don't actively react to retirement risk because of the lack of a visceral risk perception
 - No emotional experience of retirement risk
 - Risk perceptions are more influenced by association and affect-driven processes than analytical processes
 - Risk carries low emotional intensity and perceived threat
 - Abstract representation of future (living on 50% of income) versus concrete reality of alternate (buying vacation home)
- Retirement risk psychologically uncomfortable
 - Action requires contemplation of own demise

Source: Elke U. Weber, "Risk Perception in Risk Management Decisions," from Mitchell and Utkus, *Pension Design and Structure*, Oxford University Press, 2004