



RATING RETIREMENT READINESS

One of the perplexing things about planning for retirement is knowing whether you'll have enough money to meet your needs.

In their 2010 update of "The EBRI Retirement Readiness Rating™ Retirement Income Preparation and Future Prospects," Jack VanDerhel and Craig Copeland

- Identify the percentages of the US population, by age and pre-retirement income, at risk of having inadequate retirement income
- Explain why they believe those percentages have dropped since 2003 when the initial study was done
- Examine the impact of major policy changes that could affect retirement security

This analysis was a major undertaking that combined historical data, records of tens of millions of 401(k) participants, and statistical simulations to project the potential experiences—and the financial consequences of those experiences—that people can expect to confront as they retire. This unique perspective differentiates the work from a number of other studies of the risks people face in retirement.

WHAT'S "AT RISK"?

VanDerhel and Copeland use the phrase "at risk," to identify retired people who will be unable to afford their basic needs and pay for custodial care if they need it. Their estimates of basic needs, differentiated by family size and income, were derived from the US Bureau of Labor Statistics 2008 Consumer Expenditure Survey. To create a baseline, they assumed that everyone retires at 65, and they defined "running short of money" as the point at which the expenses people face begin to exceed their after-tax annual income from Social Security and a defined benefit pension, if they have one, and they turn to retirement savings, if they have any.

The authors project that nearly half—47%—of the oldest group in their study, the baby boomers born between 1948 and 1954, will find themselves unable to cover these costs throughout retirement.

→ A QUICK LOOK

- More than 40% of households are "at risk" of having too little retirement income.
- The percentage "at risk" dropped significantly from 2003 to 2010.
- Auto-enroll defined contribution plans boost long-term financial security.
- Potential cuts in Social Security and Medicare could be offset for most by 3% additional government-mandated savings.

That percentage drops for younger boomers—born between 1955 and 1964—and then rises slightly for Generation X—born between 1965 and 1974.

In addition to looking at the impact of age, the authors analyzed the impact of pre-retirement income on how well people will fare financially in retirement. They acknowledge that the findings confirm what they anticipated, and what retirement research consistently shows: that those who have earned the least before they retire are in the greatest danger of having too little money after they leave the workforce.

Households whose pre-retirement income places them in the lowest one-third of earners can be expected to find themselves without the retirement income needed to cover basic costs and health care 70% of the time. This percentage drops to 41.6% for the middle one-third of earners, and to 23.3% for the top one-third. (Curiously, while the authors are explicit about the age ranges of the three groups they studied, in the case of income they variously segmented the groups by income thirds or income quartiles but did not provide dollar figures for those segments. In the appendix they again divided the population into income thirds and used annual income ranges of less than \$20,000, between \$20,000 and \$39,999, and above \$40,000.)

THE GOOD NEWS

What is surprising, though, is VanDerhel and Copeland's finding that the "at risk" percentages have dropped in statistically significant ways in every category since 2003, a development they label as "optimistic." In 2010, the "at risk" number of older boomers was 12 percentage points lower than in 2003. For younger boomers, it was 11 points lower, and for Gen X, almost 13 points lower. The only segment for which the decrease was negligible was the lowest income oldest boomers.

The authors attribute this improvement to the introduction of automatic enrollment, automatic escalation of contribution rates, and diversified default investments for qualified retirement plans—provisions of the Pension Protection Act of 2006. Further, their modeling determines that having 20 years or more of eligibility to participate in a defined contribution plan reduces "at-risk" status by 40 percentage points, from 60% at 65 to 20% at 45 or younger.

POLICY CHANGES

In explaining the goals of their research and methodology, the authors point out that "policymakers need to understand what percentage of the population is likely to fail to achieve retirement security," as well as how changes in policy and individual behavior would affect the current reality.

To provide that information, VanDerhel and Copeland simulated the impact of three hypothetical policy changes the federal government could mandate to counter the combination of an aging population and declining resources.

[..."at risk" percentages have dropped in statistically significant ways in every category since 2003...]

These changes would entail a reduction in Social Security benefits in 2037, an income-based modification of Medicare benefits, and a mandatory 3% contribution to an individual savings account in addition to current FICA taxes.

Logically, all three of these changes would impact Gen X more negatively than the older cohorts. When the simulated results of the three potential policy modifications were combined, however, their overall "at-risk" levels increased only negligibly—0.03 percentage points. However, the simulations projected a significant gap based on income levels: an "at risk" increase of 7.1 percentage points for those in the lowest income segment and an "at risk" decrease of 7.3 percentage for the highest income segment.

ADDITIONAL FINDINGS

The study also examined how much more individuals would have to save to reach retirement security up to 70% or 90% of the time. The goal is deemed virtually impossible for those who would have to save 25% or more of their salaries, including low-income earners in every age group. However, the goal does appear achievable at the 70% level for many younger boomers and a large percentage of Gen Xers. At the 90% level, however, success seems likely to be limited to only those in the highest income segment, based on the simulations of possible retirement experiences.

The report leaves the reader optimistic, on the one hand, that automatic enrollment in defined contribution plans, automatic escalation of contributions, and diversified default investments are improving the prospects for a secure retirement for many, especially younger, participants. But there is still reason to be concerned that personal savings will be inadequate to meet any shortfall.

Jack VanDerhel and Craig Copeland, "The EBRI Retirement Research Rating:™ Retirement Income Preparation and Future Prospects," EBRI Issue Brief, no.344 (July 2010).