



AT RISK IN RETIREMENT

As life expectancy increases, so does the time that people live in retirement. Yet income replacement rates and asset returns have fallen while medical costs are rising. The result is a growing at-risk population.

WHAT THE INDEX TELLS

The index identifies the percentage of US households that won't be able to maintain their pre-retirement standard of living once members of those households leave the workforce. That figure is calculated by comparing the projected household income of a nationally representative sample to a target replacement income that would allow those households to live as they've been accustomed to living.

The underlying assumption in the calculations is that the household members will work until they reach 65 — somewhat older than the current average retirement age—and annuitize all of their assets. Those households that face a minimum 10% discrepancy between their projected income and the target replacement income are defined as at-risk.

In 2004, the index, which uses data from the Federal Reserve's triennial survey of consumer finances (SCF), showed 43% of US households in this situation. In 2007, which the authors describe as a "good" year, economically speaking, but one that "reflects a world that no longer exists," the at-risk number was barely changed, at 44%.

THE NEW REALITY

The 2007 SCF results clearly do not reflect the new reality. For example, in just a year and a half—from the fall of 2007 to the spring of 2009—the value of equity holdings dropped by \$7 trillion and housing values decreased by \$3 trillion. Both had a major

→ A QUICK LOOK

- 51% of US households are at risk of a reduced standard of living in retirement
- The value of equity holdings dropped \$7 trillion while the value of homes dropped \$3 trillion in 18 months
- Almost 75% of increase in number of at-risk households was the result of falling home prices

The updated National Retirement Risk Index, which Alicia H. Munnell and her colleagues at the Center for Retirement Research released in October 2009, provides quantitative evidence that the concerns people express about living a financially secure retirement are grounded in cold, hard numbers.

impact on the financial expectations of workers approaching retirement since their wealth derives primarily from their homes and their assets in employer-sponsored retirement plans.

To make the National Retirement Risk Index timely, the SCF was updated with data through June 2009. What the projected numbers reveal is that 51% of households are now at risk of living a financially insecure retirement. Not only have the numbers of at-risk households increased, but the degree to which they are at-risk has likewise increased.

While the economic meltdown has taken its toll on lower-income workers, 60% of whom are now at-risk, mid- and higher-income workers suffered greater setbacks, in large part because of the sudden one-time loss of asset value. For example, almost 75% of the increase in at-risk households was the result of declining home prices.

UNDERSTANDING THE REASONS

According to the study, a variety of factors have contributed to the changed retirement landscape.

The US savings rate has been extremely low in recent years, partly as a result of inflated housing values. Currently, the only savings that most workers have are amounts held either in their employer plans or in rollover IRAs funded primarily with assets from those plans. In addition, many people approaching retirement have mortgage debt, something that has not typically occurred in the past. This debt can be attributed to cash-out refinancing of homes that in many cases have since lost value. To that point, home prices fell 19% between the second quarter of 2007 and the first quarter of 2009.

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Interest rates are at historic lows. While this tends to keep inflation down for some purchases, it means that annuitized assets produce less income than in periods with normal inflation rates. Lower interest rates also reduce the amount that people can borrow through a reverse mortgage, which is one component of projected household income. The amount available through a reverse mortgage is further impacted by lower property valuations, which diminish the equity against which the loan is made.

Another factor that contributes to a retirement income shortfall is Social Security's increasing full retirement age (FRA) — the retirement age at which full benefits are available. The FRA is 66 for people born between 1943 and 1954 and then increases gradually to 67 for people born in 1960 and later.

Not only do people have to wait longer to collect their full benefit, but if they choose to start collecting from Social Security before they achieve their FRA because they're no longer working and need the money, they are only eligible for a reduced percentage of their full benefit. Specifically, instead of receiving 80% at 62, as had been the case for people born before 1938, people born between 1943 and 1954 are entitled to 75%. And that reduction is permanent.

Forfeiting 5% — say \$75 of a potential \$1,500 each month — may not seem significant, but any reduction in Social Security benefits has the greatest impact on lower-wage earners since the benefits typically provide a higher proportion of their post-retirement income. What's more, the percentage of their total benefit for which people born after 1955 will qualify at 62 will be gradually reduced until it reaches 70% for those born in 1960 and later.

As the authors of the study cogently note about the dramatic increase in at-risk households, "Ensuring retirement security for an aging population is one of the most compelling challenges facing the nation."

The study, "The National Retirement Risk Index: After the Crash" was written by Alice H. Munnell, Anthony Webb, and Francesca Golub-Sass of the Center for Retirement Research at Boston College. It details the methodology behind the index creation, which uses data from the Federal Reserve Survey of Consumer Finances for 2004 and 2007, adding projected results for 2009. The methodology of the projection is also explained.