Economic Policy Program

Economic Policy Project

A Diversity of Risks:

The Challenge of Retirement Preparedness in America

September 2014

BIPARTISAN POLICY CENTER

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Founded in 2007 by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole, and George Mitchell, the Bipartisan Policy Center (BPC) is a nonprofit organization that drives principled solutions through rigorous analysis, reasoned negotiation, and respectful dialogue. With projects in multiple issue areas, BPC combines politically balanced policymaking with strong, proactive advocacy and outreach.

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Introduction

Many Americans are anxious about their retirement prospects. In fact, a recent Gallup poll found that not having enough money for retirement is the number one financial worry among Americans.[1] For some, this concern is justified, as they face the daunting prospect of running short of money in their later years.[2] But there is considerable variation in preparedness for retirement, and the challenges are more complicated than many realize.

When evaluating the retirement security landscape, complexity is the one constant. Potential sources of retirement income are numerous and varied, including: continued work (perhaps on a part-time basis), Social Security benefits, drawdown of personal savings, workplace retirement plans, annuities, home equity, financial support from family members, and more. Understanding this patchwork and building a solid foundation upon which to retire is no easy task for the average American.

Additionally, even for those who do accumulate substantial resources, retirees' incomes and living standards are subject to a variety of risks, such as poor investment choices or returns, unexpected medical bills, outliving one's savings, and needing expensive long-term care.

The U.S. retirement landscape is difficult to describe for the "average" person because the state of any particular retiree's finances depends so heavily on which sources of income they have, how much they have, and what life events occur that could drain their nest egg.

The Bipartisan Policy Center's (BPC) Commission on Retirement Security and Personal Savings is examining the U.S. retirement system. Next year, the commission will make comprehensive recommendations to improve the financial security of Americans preparing for and in retirement. In advance of these recommendations, BPC staff is producing a series of white papers to highlight the retirement security challenges that public policy can address.

After a brief overview of the retirement system, this first white paper explores retirement preparedness through the lives of four fictional families, showing how they are preparing for retirement, what they could be doing better, and the risks that they will face over the course of their working years and their retirements.

Retirement Plans

Workplace retirement plans are an important component of the U.S. retirement system. But this leg of the proverbial retirement stool has experienced a major upheaval over the past few decades. Defined benefit (DB) plans, often referred to as pensions, have become increasingly uncommon, and more workers are amassing savings in defined contribution (DC) accounts, such as 401(k)s and 403(b)s. This transition was more accidental than intentional; DC accounts were originally supplements to DB pensions, but today those accounts are typically the sole employer retirement plan offering. In recent years, there have been important innovations in DC plan design, such as auto-enrollment and default investment options that automatically reallocate to more conservative assets as retirement approaches. There is much to learn from the results of these developments as plan sponsors and policymakers continue their efforts to improve the private-sector retirement system.

Defined Benefit

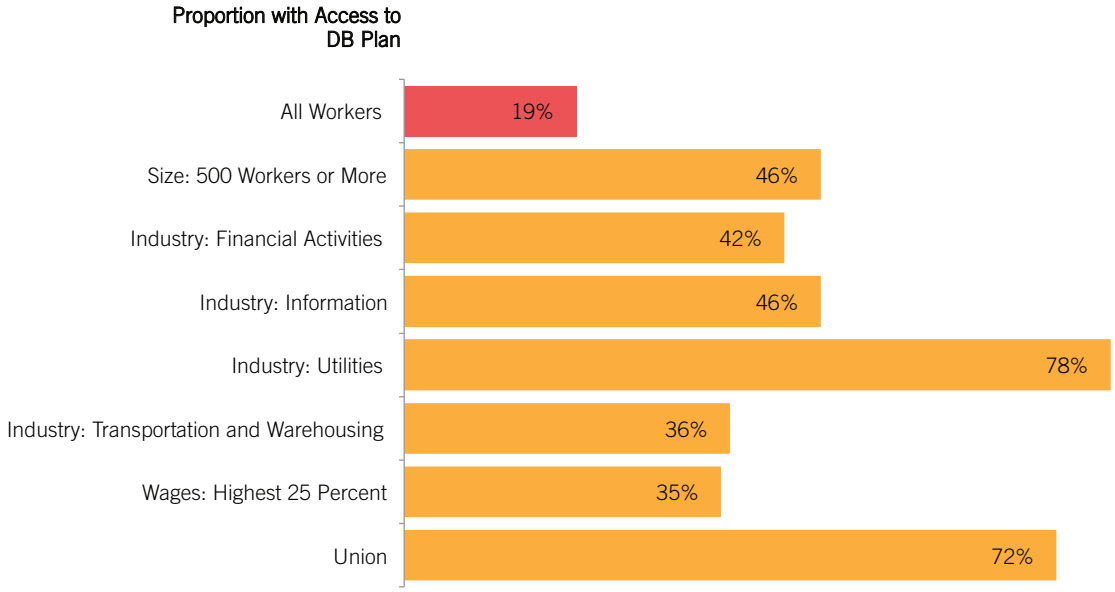
In a DB plan, the employer manages the investments, accepts the investment risk, and must offer the employee the option of a lifetime annuity—a monthly stream of payments through the end of their life (and, usually, any spouse's life). A traditional DB benefit is the classic pension, in which the retiree receives a monthly payment that is based on length of service and final salary (often defined as an average of earnings in the last few years of employment or in a few years with the highest earnings).

More recently, so-called "hybrid" DB plans have become popular, especially cash balance plans. In a cash balance plan, the employer is responsible for making and investing contributions and guarantees a specified rate of return on those contributions (instead of a final percentage of salary benefit), and each employee "owns" a virtual account (consisting of the contributions and the promised earnings) that they can either annuitize or, more typically, receive as a lump sum when they retire or leave the employer.

At this point, the vast majority of employers who had DB plans in the past have closed them to new employees. In 1979, 84 percent of private-sector workers who participated in a pension plan had a DB plan (with about one-quarter of those workers having both DB and DC plans).[i] By 2011, only 31 percent had a DB plan, and over three-quarters of them also had a DC plan.[3]

Fully 26 percent of those who are still in private-sector DB plans are in frozen plans, meaning that the employer has either closed the plan to new participants and/or is limiting additional benefits for existing participants.[4] Employees at private companies that are large, unionized, or in the utilities, information, finance, or insurance fields are among the most likely private-sector workers to still have a DB plan.[ii, 5]

Some Private-Sector Workers Are More Likely to Still Be Offered DB Plans



Source: Bureau of Labor Statistics, Employee Benefits Survey.

i Among non-agricultural wage and salary workers aged 16 and over.

ii This includes the one-quarter of workers who are covered by frozen DB plans that are not open to newly hired employees.

The decline of DB plans has a long history and is due to many factors. Employers who seek more predictable compensation costs have gravitated to DC plans, as required contributions to DB plans fluctuate with asset prices and interest rates, and are typically larger than those for DC plans. Many argue that DC plans are also more appropriate for a more mobile workforce.

The federal government provides insurance through the Pension Benefit Guaranty Corporation (PBGC) to approximately 43 million workers and retirees who participate in private-sector DB plans. If a bankrupt company is unable to pay promised benefits, PBGC assumes the assets and liabilities and pays for the *partial* continuation of benefits, financed by premiums paid by employers with DB plans.

The funding status of PBGC is an ongoing issue as premiums collected and earnings on assets are not expected to be sufficient to pay anticipated future benefit payments. There are two separate trust funds, one for pensions sponsored by a single employer and another for multiemployer pensions, which are established by an agreement among a union and multiple employers. In 2014, PBGC reported that the present value of the projected combined deficit (for both trust funds) in 2023 is about $58 billion and that there is a 90 percent likelihood that the multiemployer trust fund would be exhausted by 2025.[6] Without congressional action, this would result in major cuts to benefits for retirees in failed plans.

Defined Contribution

These days, most private-sector employees with access to a workplace retirement plan are offered a DC plan. Such plans accept employee payroll deductions that are often matched or supplemented by the employer. There are many different types, though 401(k) plans are by far the most popular.[iii]

In a traditional tax-deferred DC plan, contributions and the growth of assets are not subject to income tax until they are withdrawn. A Roth-style DC plan involves after-tax contributions, but growth of assets and withdrawals are not subject to income tax.

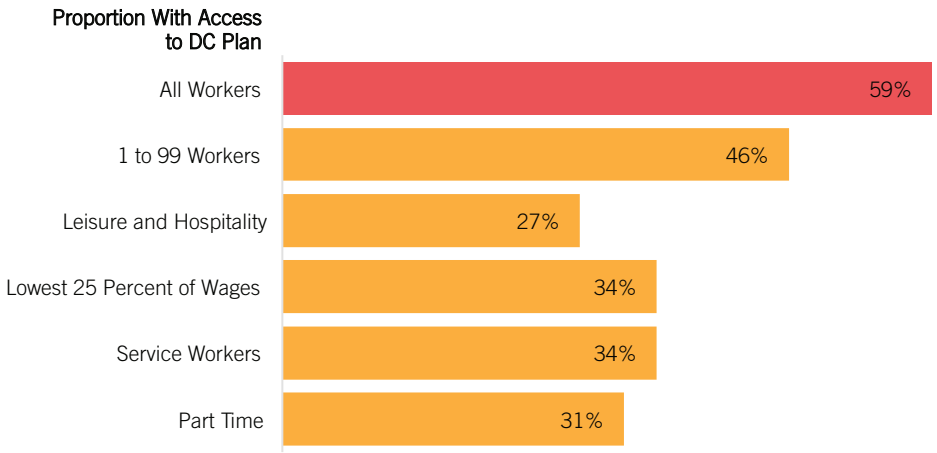
The *payroll tax* treatment is different for employer and employee contributions. Employer contributions (such as a company match) are not included in the payroll tax base. Employee contributions, on the other hand, are made out of earnings after payroll taxes are paid.

In contrast to a DB plan, the employer's financial liability for a workplace DC plan mostly ends at the point of contribution. Individuals in a DC plan make their own investment choices (subject to the decisions of the plan sponsor about what investment options to include), are responsible for the entirety of their investment risk, and must manage withdrawals from the plan themselves. Unlike DB plans, annuity options are usually not integrated within DC plans.

According to the newest National Compensation Survey, approximately 59 percent of private-sector workers had access to a workplace DC account, and 71 percent of those with access—or 42 percent of all private-sector workers—participated.[7] In general, the likelihoods of both access to and participation in a private-sector DC plan are higher for full-time workers, higher-wage workers, and those who work for larger employers. Access to workplace DC plans is least likely in industries with many part-time or seasonal workers, especially leisure and hospitality.

iii Other workplace DC plan types include the Thrift Savings Plan for federal employees, 403(b)s (offered by certain not-for-profit and educational organizations), 457s (for employees of state and municipal governments), Savings Incentives Match Plan for Employees (SIMPLE) IRAs, and Simplified Employee Pension (SEP) IRAs.

Some Workers Are Much Less Likely to Have Access to a DC Retirement Plan



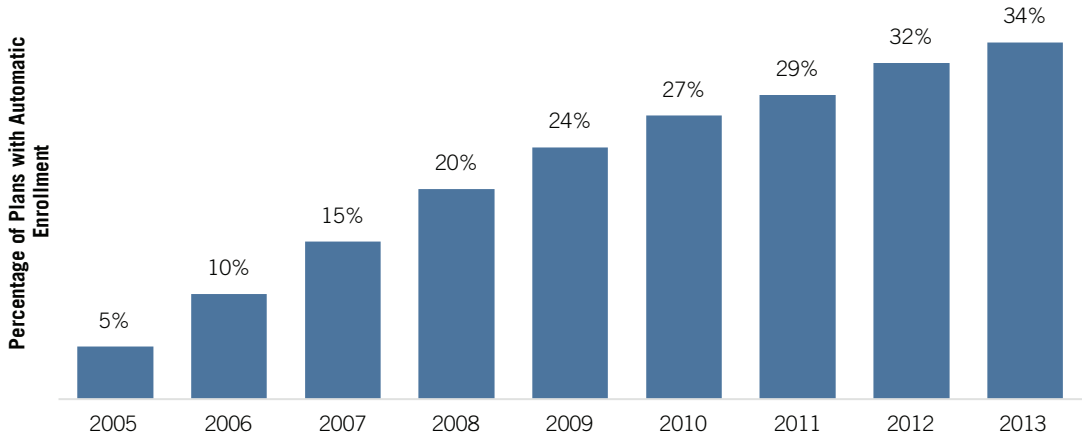
Source: Bureau of Labor Statistics, Employee Benefits Survey.

While 401(k) plans are the most common workplace retirement account, Individual Retirement Arrangements (IRAs) also form an important part of the U.S. retirement landscape. IRAs can serve as a tax-advantaged retirement savings vehicle for those who are not offered a plan at their workplaces; however, they have lower contributions limits ($5,500 for those under age 50, versus $17,500 for 401(k)s).[iv] But much of the assets in IRAs result from workplace DC plan rollovers or DB plan lump-sum distributions. These rollovers can be administratively complicated, and those individuals who have worked for several employers can have several orphaned DC accounts.

Much of the recent history of workplace DC accounts revolves around the rise of automatic features. The most central of these is automatic enrollment, whereby employees have payroll deductions at a default contribution rate directed into their workplace retirement plan unless they specifically direct their employer not to do so. These contributions are invested in a default option, usually a target-date fund, which is a mutual fund that automatically adjusts toward more conservative investments as the owner approaches retirement age.

iv Individuals with access to a workplace retirement plan can also use IRAs.

Increasing Adoption of Automatic Enrollment in DC Retirement Plans



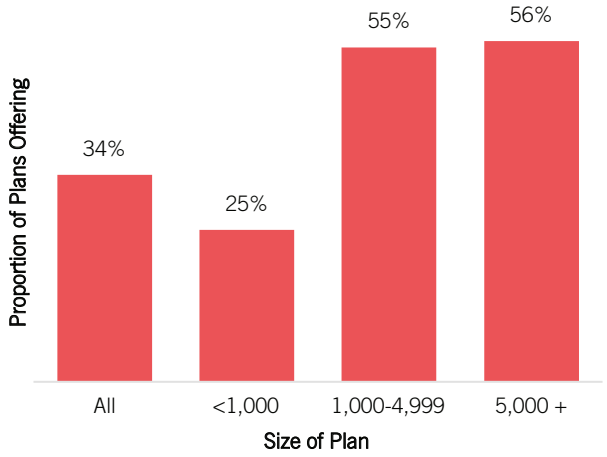
Source: Vanguard, How America Saves, 2014.

Automatic enrollment can significantly increase the proportion of employees who are enrolled in a workplace retirement plan. Studies find that approximately nine out of ten employees who are automatically enrolled into their workplace plan stay in it.[8] One worry with automatic enrollment is that employees are likely to stick with low default contribution levels. (In 2012, the most common default rate was 3 percent).[9] To address this concern, some employers have also implemented automatic escalation, in which the proportion of pay that an employee contributes is increased annually (up to certain limits) unless the employee proactively makes changes. There is also concern that automatic enrollment is increasing the incidence of orphaned accounts, especially from employees with short tenures.

The Pension Protection Act of 2006 (PPA) clarified employers' ability to add automatic features to their DC accounts and the types of investments that are acceptable as the defaults. Since then, there have been speedy increases in the proportion of companies employing automatic enrollment and automatic escalation, and a fall in the number of DC account holders with extremely aggressive or conservative asset allocations.[10]

In 2006, only 14 percent of new DC plan entrants were enrolled via automatic enrollment, but that had risen to 62 percent in 2013.[11] Small plans remain much less likely to employ automatic enrollment, however, so it is also true that the feature still only appears in a minority of plans (34 percent).[12]

Automatic Enrollment Is More Common at Larger Employers



Source: Vanguard, How America Saves, 2014.

Those plans that do use automatic enrollment are increasingly implementing additional automatic features to help participants. Since 2005, the proportion of plans with automatic enrollment that also automatically escalate employee contribution rates has risen from 31 percent to 69 percent. Furthermore, since 2005, the proportion of plans using automatic enrollment that also carry a "smart" default fund choice (i.e., target-date or other balanced fund) has risen from 75 percent to 98 percent.[v, 13] There are concerns, however, that some target-date funds have high fees.

Personal Savings

Individuals can also save for retirement outside of employer plans or IRAs. Savings in taxable accounts, however, are a relatively small proportion of total savings, and are mostly concentrated among higher-income families.[14] These accounts do not benefit from the advantages of pre-tax contributions and tax-deferred build up inside qualified accounts.

v Target-date funds invest in a blend of equities, bonds, and money-market instruments that adjusts toward more conservative allocations as the target retirement date nears.

Social Security

Since the program's enactment in 1935, Social Security's Old-Age and Survivors Insurance (OASI) has grown to become the bedrock of retirement security for most Americans. Some estimate that Social Security accounts for nearly 85 percent of the retirement income for individuals in the bottom half of the income distribution.[15, vi] Americans qualify for Social Security by contributing to the system for at least ten years—or by being married to someone who qualifies.[vii] Almost all employed and self-employed Americans are required to contribute to Social Security; the major exceptions are state and local employees in certain jurisdictions. Those who do qualify receive a check each month until the end of their lives.

Workers pay into the system via payroll and self-employment taxes of 12.4 percent—half paid by the employee and half by the employer—on earned income up to $117,000 (indexed to changes in the national average wage index).[viii] When beneficiaries claim OASI at age 62 or after, the Social Security Administration calculates their average indexed monthly earnings (AIME) based on their highest-earning 35 years of work. Benefits are based on a particular percentage of their AIME that decreases with higher earnings. Benefits are also adjusted so that those who claim earlier than normal retirement age receive lower monthly payments and vice versa for those who claim later than normal.[ix] After a retiree begins receiving benefits, they are adjusted annually to account for inflation.

vi These estimates are based on the Current Population Survey, which has a well-known problem with underreporting income from DC retirement accounts. That bias, however, is less for those at the bottom of the income distribution since they are less likely to have income from DC accounts than those at the top.

vii Couples must be married for at least ten years to qualify for benefits based on their spouse's record. Divorced couples who were married for at least ten years can also qualify based on their ex-spouse's record (regardless of the ex's marriage status).

viii The tax directs 10.6 percent to the OASI Trust Fund and 1.8 percent to the Disability Insurance Trust Fund.

ix The current normal retirement age is 66, which is set to gradually increase to 67 by 2027 under current law.

Spouses who do not qualify for benefits on the basis of their own earnings record are entitled to a spousal benefit that is equal to half of their eligible spouse's old-age benefit. Social Security also has a survivors benefit, which applies to widows/widowers and dependents regardless of whether they qualified for benefits on their own earnings record or through the spousal benefit. When one spouse dies, the survivor keeps the higher of the two Social Security benefits.

Social Security includes a Disability Insurance (DI) program that pays benefits to individuals who leave the workforce due to onset of disability. Social Security also administers the Supplemental Security Income (SSI) program, which is the federal government's largest means-tested, cash-transfer program. It provides financial assistance to disabled, blind, or elderly individuals with very low incomes.

The Withdrawal Phase—Annuities and Long-Term Care

For Americans without a traditional DB pension, Social Security is usually their only source of guaranteed lifetime income. Rarely do DC account participants purchase annuities, which can guarantee a stream of monthly payments for life, instead choosing to manage the drawdown phase themselves.[16]

Most Americans do not have insurance protection from high long-term care (LTC) expenses. Medicare does not cover LTC. Only a small proportion of Americans are covered by private LTC insurance policies. Medicaid, a means-tested safety net program, covers some LTC services, but only for low-income Americans and those who have become impoverished due to catastrophic LTC costs.

Lifetime Income and Private Retirement Plans

Though annuitized benefits are available to DB plan participants and DC account holders can use their accumulated savings to purchase annuities, relatively few participants in private-sector DB plans actually take lifetime, monthly benefits—most opt for a lump-sum distribution—and very few retirees with DC accounts purchase lifetime annuities.[17] Annuities often have complex structures with high fees, and monthly benefits for simpler, lower-fee fixed rate lifetime annuities are highly sensitive to prevailing interest rates when they are purchased.[x] This timing risk can have a significant effect on the income that retirees are able to obtain from annuities. Also, they usually have to be purchased through brokers, rather than being directly available through retirement plans. Yet another inhibitor to wider participation is that many individuals are uncomfortable parting with a large sum of money at once, especially since they do not know whether they will live long enough to make the decision worthwhile.

In addition to longevity risk, participants in DB plans who take a lump sum and DC plan participants who do not annuitize also are exposed to investment risk. If they choose riskier investments during retirement, potential losses could damage their retirement security. On the other hand, investing too conservatively would limit how long savings can last. While many retirees who do not annuitize manage their retirement savings well through the end of their lives, they risk running short if they don't properly manage the funds or if they live longer than they expected. On the other hand, some retirees may unnecessarily hoard their retirement savings out of concerns about outliving their savings or being able to meet unexpected expenses – this can result in a lower standard of living in retirement than is necessary, with individuals leaving behind larger bequests than they intended.

x A fixed, lifetime annuity is an insurance contract that, in exchange for a premium, guarantees a stream of monthly payments for life (and the life of the annuitant's spouse, in the case of a joint-and-survivor annuity). Fixed annuities can be either immediate (where payments start right away) or deferred (where payments start many years from now). Because the premium, usually paid in a lump sum at once, is invested in high-quality bonds, the level of monthly payments generated by the fixed annuity is dependent on prevailing interest rates in the bond market at the time of purchase.

Long-Term Care and Retirement

Many Americans experience a need for LTC at some point during their retirement years that could deplete their savings prematurely. Institutional or home-based assistance with the activities of daily living—including bathing, shopping for groceries, cooking, or managing medication—can be extremely expensive if LTC needs are intensive and provided over a long period of time. The vast majority of those who reach age 65 will need LTC of some sort before the end of their lives, but the type and amount of care that people need, and thus their spending on LTC, will vary widely—many will spend nothing at all (either because they do not need any LTC or their needs are met by unpaid sources, such as friends and family), while a small minority will face catastrophic costs.[18]

Because catastrophic LTC costs are rare, but needs that require some level of care are relatively common, this is an insurable risk. Only a small minority of retirees, however, carry LTC insurance. A variety of barriers have kept this product from assuming a larger role, including high premium costs, underwriting (applicants generally must undergo a medical evaluation and many are denied coverage), and insufficient planning on the part of many individuals and families for potential LTC costs during retirement. LTC insurance is usually not offered by employers and typically must be purchased by individuals through brokers; sales costs are high, which reduces the value of the product for the price paid. Moreover, companies had trouble pricing LTC insurance when it was first introduced, and there are few carriers left in the market.

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Different Risks for Different People

Americans face many challenges navigating the world of workplace retirement plans, accruing sufficient assets to fund their retirements, and protecting those assets from investment, longevity, and LTC risks. But the truth of the matter is that each family faces different challenges. Some do not have access to workplace plans. Others participate but struggle to accumulate enough savings in their accounts. Others will pass on significant inheritances as long as they don't far exceed their life expectancies or face prolonged or costly LTC needs.

Because the risks that individuals and families face are so context-dependent, explaining the state of retirement readiness with aggregate statistics is difficult. Therefore, to illustrate the retirement readiness challenge, we will introduce you to four families, discuss their levels of preparation for retirement, and explain some factors that put them at risk for being unable to maintain a comfortable lifestyle through old age.

In order, we will introduce you to:

- Thomas, a 35-year-old divorced machine operator with a DB pension.
- Anita, a 39-year-old with several part-time jobs, none of which provide her with access to a workplace retirement plan.
- John and Maria, a 42-year-old paralegal and a 37-year-old administrative assistant, who have access to workplace plans but are not contributing enough to build up sufficient DC assets to maintain their standard of living in retirement.
- Ron and Tina, a lawyer and an accountant, who are both 47 years old and who are making significant contributions to their DC accounts but lack protection from risks of longevity and LTC needs.

We hope that by showing the retirement system through the eyes of these households, it will become clear that: achieving retirement security is hard but not impossible; families face very different risks depending on their circumstances; and policy changes could make more Americans feel and be secure in their prospects for a financially comfortable retirement.

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Thomas: A Traditional Pension

Thomas was recently hired as a machine operator in a manufacturing plant in the Midwest. He is 35 years old, divorced, and earns $30,000 a year. He shares custody of his seven-year-old son, Richard, with his ex-wife. Thomas worked for many years as a waiter and bartender at a family-owned restaurant—where he was not offered any retirement plan—before he took classes at a local community college to get his machine operator certificate. His new employer offers a traditional DB pension plan without any contribution required on Thomas's part.

Thomas is one of a minority of employees in the United States with access to a DB retirement plan. In the private sector, just 19 percent of employees have access to such a plan, and 16 percent participate.[19] Manufacturing workers are more likely than average to be offered a DB plan—27 percent have one.[xi] The fact that Thomas works at a large unionized employer also makes him more likely to be offered a plan—72 percent of private-sector union workers and 46 percent of workers in large firms have access to DB plans. In contrast, Thomas not having a DB plan at his previous job is unsurprising. Only 2 percent of workers in the leisure and hospitality industry and 8 percent of workers in firms with fewer than 100 people have access to DB plans.

Upon retirement, Thomas's DB plan—like a majority of those in the United States—offers him a check every month equal to a fixed percentage of his terminal salary for each year that he works at the company.[xii, 20] In Thomas's case, he will receive 1.5 percent of his terminal salary—around the average rate—for every year that he works at the company.[21] (These benefits vest after five years.) Therefore, if Thomas works for 30 years at the company (until he is 65), he will receive a retirement benefit equal to 45 percent of his terminal salary every year after he retires. The combination of his pension benefits and Social Security should provide him with substantial financial security through the end of his life, replacing the vast majority of his pre-retirement income.

Thomas faces many risks, however, that could sour this financially comfortable retirement. If he loses his job or leaves before retirement—perhaps to take another job, or perhaps due to onset of disability that makes it too difficult to continue his job—his income stream would be diminished, both because he'd get a lower percentage of his terminal salary (because of fewer years employed at the company) and his terminal salary would likely be lower than it would have been at the end of a full career. If he leaves his job before his benefits vest in five years, he would receive no benefit whatsoever.

Additionally, if Thomas retires and claims Social Security when he is first eligible at age 62 (like 45 percent of Americans do), his retirement security will be reduced both by the fact that he retired earlier—as he would need to finance additional years in retirement with fewer savings from working years—and because Social Security benefits are decreased for those who claim before the full retirement age. Even if Thomas stays in his job for 30 years, the company could choose to freeze his pension plan in a manner that prevents additional pension benefit growth before he reaches the large end-of-career accruals. (These large accruals result from salary increases that employees often receive in the late stages of their career, the pension effects of which are magnified by service credit from a long tenure.)

In a worst-case scenario, the plan might become underfunded and the company bankrupt. If the plan does not have enough assets to pay benefits, and the company

xi Workers with a DB plan are also very likely to participate, especially manufacturing workers. Fully 87 percent of all private workers and 91 percent of private manufacturing workers who are offered DB plans at work participate. In DB plans, automatic enrollment is universal.

xii The exact definition varies, but according to the Bureau of Labor Statistics' National Compensation Survey, 81 percent of plans define terminal salary as the average of the highest five years of salary, while 13 percent define it as the highest three years of salary, and the remaining 6 percent define it in some other manner.

is failing and unable to contribute to the shortfall, the plan would likely be taken over by its insurer, PBGC. The agency would probably meet Thomas's full pension benefit, unless he participates in a multiemployer plan, in which case he could face a substantial reduction.

DB Pensions Amid a Mobile Workforce

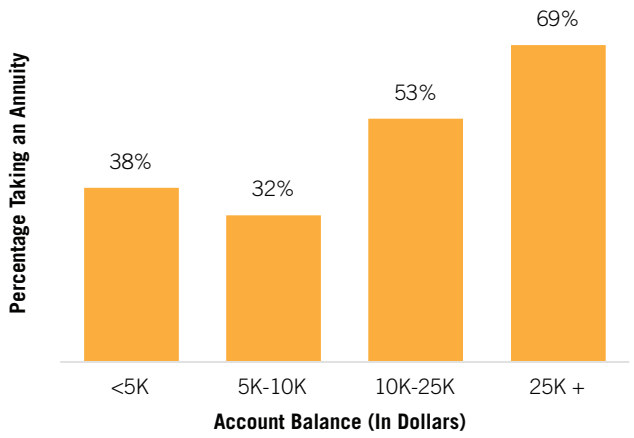
While Thomas will accrue service credit toward a pension as soon as he begins working, he will not gain pension rights immediately. Like 81 percent of workers in DB plans, Thomas will not be entitled to any benefit until he has completed a minimum amount of service. This process is called "cliff vesting," and like most other employees with cliff vesting, his benefits will vest after five years (the maximum allowed by law). The law also allows for "graduated vesting," under which 20 percent of accruals are vested each year from the third to seventh years of service.[22]

In today's world, the median American only spends 4.6 years at their current job, so there is a reasonable chance that Thomas will end up leaving before his benefits vest.[23] If he does so, he will have earned no retirement benefits from his time at the company.

If Thomas stays long enough for his benefits to vest and he reaches the plan's retirement age of 65, his employer will offer him the choice of taking his benefits as an annuity or a lump sum that is actuarially equivalent.[xiii] Statistics suggest that Thomas is likely to forego an annuity that will provide guaranteed income for the remainder of his life (and any spouse's life) and instead select a lump sum. In 2010, the annuitization rate for all DB plans was 66 percent, but this statistic includes many plans that do not allow participants to take a lump-sum distribution.[24] Among plans that do not restrict lump-sum distributions, well under half of participants take the annuity.

xiii All defined benefit plans must provide the option of receiving an annuity, but for many workers, especially in the private sector, taking a lump-sum distribution is also an option—when it is, most take the lump sum.

Workers with Smaller DB Plan Benefits Less Likely to Annuitize



Note: Annuitization rates are for the years 2005-2010 and for ages 50-75 for all DB plans (including cash balance).

Source: Sudipto Banerjee, "Annuity and Lump-Sum Decisions in Defined Benefit Plans," Employee Benefit Research Institute, January 2013.

If Thomas leaves his employer at a younger age, he is even less likely to take an annuity. Only 5.2 percent of workers with a DB plan who left an employer before age 50 took an annuity.[25] If Thomas does elect a lump sum—possibly because he worries about his plan's solvency or believes he will be able to get higher returns by investing the money himself—he faces the risk of outliving that money and eventually having to live on his Social Security benefits alone.

Lump-sum distributions from DB plans can be rolled into commercial IRAs, which can pose additional risks for the beneficiary. While the flexibility permitted in an IRA can be attractive, Thomas, like most of us, is not an investment professional, and he might make poor investment choices or unknowingly face high fees on his investments. If Thomas were to choose an inappropriately conservative or excessively risky investment portfolio or a fund with high fees, he would bear the full risk of any poor investment performance.

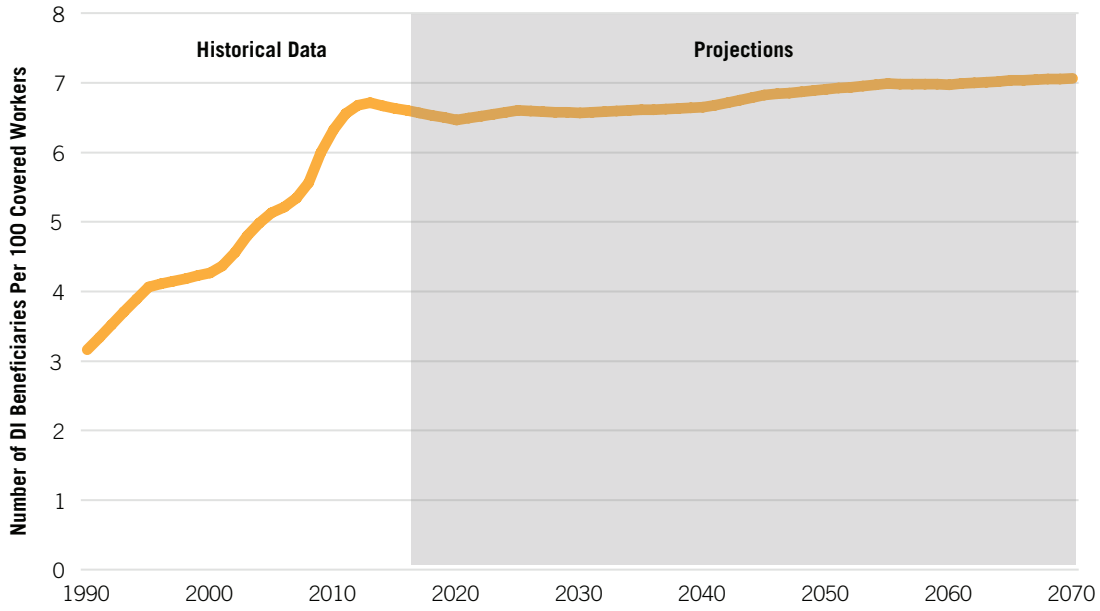
Risk of Becoming Disabled

Thomas also faces some risk of having to permanently leave the workforce before normal retirement age because of the onset of a physical or mental disability. A worker, particularly one in a physically demanding industry, can become disabled and unable to work. In fact, according to the Social Security Administration, roughly one in four young adults today will become disabled before they reach full retirement age. If Thomas does become disabled and meets the eligibility criteria, Social Security DI would likely become his main source of income. Because Thomas has a dependent child, he would receive an additional DI benefit on his son's behalf.

In addition to DI, Thomas is one of the approximately one-third of U.S. workers who are offered private long-term disability insurance at work.[26] This insurance would help him with wage replacement after his injury, and if he eventually claims DI, would continue to supplement those benefits. (Private disability insurance usually replaces a larger percentage of wages than DI.) The private insurance would also assist with accommodations to help him remain in his current workplace if that is possible.

If Thomas entered the DI program, he would join the nearly 11 million DI beneficiaries (in 2013)—both workers with disabilities and their families.[27] Thomas could qualify based on evidence that he has a physical or mental medical condition that renders him unable to work and is expected to either last at least one year or to result in death. In recent decades, there has been a large increase in the number of individuals qualifying for DI with musculoskeletal problems and mental illness—as compared with conditions like cancer, heart disease, or other grave physical ailments—in part due to eligibility changes passed in 1984 that placed greater weight on more subjective complaints, such as

Ratio of DI Beneficiaries to Covered Workers Has Risen and Is Projected to Stabilize



Note: "Covered workers" refers to employees in the U.S. who are covered by the DI program.

Source: Social Security Administration, "2014 OASDI Trustees Report."

pain. Additionally, the number of applications rises during recessions, like the recent one, reflecting the increased difficulty that workers have in finding jobs.

If he was to apply for DI, Thomas could be waiting for a long time—the application process is notoriously lengthy and rigorous. He would have to spend five months without engaging in "substantial gainful activity" before he could apply for benefits. The entire application process takes an average of 18 months, during which time he could not receive significant earned income, which would provide a strong disincentive for him to attempt rejoining the workforce, to the extent that he is able. If his application were accepted, he would probably only see about 40 to 60 percent of his pre-disability income replaced. At an annual income of only about $15,000 per year, Thomas would likely find himself unable to save for retirement or anything else.

Sometimes, Workers Don't Get to Choose

As increasing numbers of employers are transitioning away from their DB plans, Thomas could potentially join the one-quarter of all private-sector workers (and one-third of manufacturing workers) who are in frozen pensions (as of March 2013).[28] A company that decides to transition away from their DB plan can implement a "soft freeze," in which the plan would close to new entrants, or a "hard freeze," in which some or all of the employees covered by the plan also stop earning some portion of their benefits going forward. While a soft freeze would not affect Thomas since he is already enrolled, a hard freeze would impact his preparation for retirement. The situation could be particularly painful if Thomas's plan implemented a hard freeze as he was approaching the end of his career, when employees tend to see salary increases and thus the greatest potential for large benefit accruals.

If his plan is frozen, Thomas, like most workers in frozen plans, would probably have access to an alternative DC retirement saving plan. Very likely, however, that type of plan would present some challenges for Thomas. Having worked for his entire career first without a retirement plan and then with a DB plan that required no effort on his part, a switch to a DC plan could harm his retirement preparedness.[29] In addition, if he were enrolled late in his career, his contributions would have only limited time to grow and compound.

Another risk that Thomas faces as a plan participant is the possibility that his company's DB plan could join the 4,000 plans covering nearly two million retired workers that have failed in recent decades.[30] PBGC's guarantees help to ensure that Thomas would keep a substantial portion of his pension benefits, up to about $60,000 annually if he is 65 years old with 30 years of service when PBGC takes over the plan.[31] (These guarantees increase with age and years of service; employees whose expected pension benefits exceed the guarantee levels could receive less if PBGC takes over the plan.) That guarantee is significant, and Thomas would likely not be one of the fewer than 20 percent of retirees in single-employer plans who experience benefit reductions.

If, however, Thomas's plan were a multiemployer plan, which involve an agreement among a labor union and multiple employers, his pension benefit would be at much greater risk in the event of a plan failure. For example, a 65-year-old retiree with 30 years of experience would have just under $13,000 annually guaranteed by PBGC. Anyone with less experience would have a lower guarantee level, meaning that almost everyone in a multiemployer plan would experience major benefit reductions if PBGC takes it over. Moreover, there is a 90 percent chance that PBGC's multiemployer trust fund will be exhausted in the next decade and, at that point, would be able to pay only a

small fraction of even those modest guarantee levels, absent statutory changes to address this imbalance.

Action Not Required but Risks Remain

In the best-case scenario, Thomas's retirement outlook is very good. After working a long career at the manufacturing plant, the combination of his significant employer-sponsored pension benefits and Social Security should leave him financially comfortable through the end of his life, however long he lives. But Thomas faces a number of risks between now and then that include longevity risk (should he take a lump-sum distribution instead of an annuity), the risk of his plan being frozen or failing, and the risk of losing employment for any reason, including becoming disabled, and not being able to accrue significant savings. While Thomas could alleviate his longevity risk by taking an annuity, many of the risks that he faces are beyond his control—such as the funded status of his DB plan or the financial capacity of the PBGC to back up the plan should it fail. This uncertainty that Thomas faces is reason for concern, and in the worst case, he may be forced to accept a significantly lower standard of living upon retirement.

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Anita: Lacking Access

For many Americans, contributing anything toward retirement is a difficult proposition because they have low incomes, struggle to cover basic living expenses, and are unlikely to have access to a workplace retirement plan. Anita is a 39-year-old single mother with a 15-year-old daughter. Anita and her daughter live in a small apartment in a southern city. Anita works part-time as both a waitress and a call center operator, and she is one of the 36 percent of Americans who does not have access to a payroll-deduction retirement account.

Anita makes about $20,000 a year between her two jobs. She benefits from the refundable Earned Income Tax Credit (EITC), which is worth around $3,000 for a single parent with one child at Anita's level of income.[xiv] She also qualifies for the Child Tax Credit's maximum $1,000 per child benefit.[xv, 32] Importantly, however, Anita will no longer be eligible for either credit once her daughter turns 18.

Anita has almost no assets. She has about $500 in a bank account, but nearly all of each paycheck is spent on basic necessities, such as rent, car payment on a used vehicle (necessary for her to get to work), gasoline and maintenance, food, clothing, and utilities. While she would like to save more money to contribute to her daughter's college tuition, Anita feels that she simply doesn't have the resources to do so. She has had essentially no education on finances and retirement saving and worries about how she'll ever be able to retire—but she isn't sure how to turn that worry into action.

Unless Anita's salary increases rather dramatically, Social Security will be her primary source of retirement income.

There is a Saver's Credit that low- and middle-income Americans can claim on their income-tax returns if they contribute to either an employer DC plan or an IRA; the credit is worth up to $2,000 (for a joint filer who earns no more than $36,000 and contributes at least $4,000 to an account).[33] Even if Anita were able to save a little of each paycheck and put it into an IRA, however, she would not benefit from the Saver's Credit, as she has no income-tax liability and the Saver's Credit is not refundable.

On her current earnings path, if Anita retires and begins claiming Social Security at age 67, her benefits would replace around 60 percent of her pre-retirement income.[34] If she retires earlier, that figure would be lower, making additional years in the workforce one of Anita's few potential options that could materially impact her retirement prospects. While Medicare would cover some of her medical costs and she might also be eligible for limited income support from means-tested programs, retirement security is likely to be a challenge for Anita regardless of the decisions that she makes.

Saving for Retirement Is Unlikely without Payroll-Deduction Access

Anita's retirement security is threatened by the combination of her low income and a lack of access to a workplace retirement plan. Because neither of her part-time employers offer any such plan, she is likely to retire with few assets to convert into retirement income (outside of her promised Social Security benefits). Her situation is common: just 37 percent of part-time workers have access to any type of retirement savings plan, and in certain sectors, such as the leisure and hospitality industries, even fewer (29 percent) have access.[35] Regardless of income level, individuals rarely accumulate significant savings for retirement, such as in an IRA, outside of an employer-sponsored plan. At low income levels, it is especially rare.

xiv The EITC is an income-tax provision designed to reward work. Low-income workers with children receive the largest benefits from the tax credit. Because it is refundable, even those with no tax liability benefit from the EITC, which helps to offset the payroll taxes that these workers pay. For more information, see BPC's blog post on the ETIC, available at: http://bipartisanpolicy.org/blog/economicpolicy/2014/04/18/background-eitc.

xv The Child Tax Credit is partially refundable at up to 15 percent of earned income above $3,000.

There are many reasons that an employer might not offer a retirement plan. In industries where retirement plans are less common, employers may believe that offering a plan is not necessary to be competitive, as low-income workers might prefer higher wages or benefits that can be used immediately (such as health insurance) over retirement benefits. The administrative burden of offering a plan may be a barrier for some employers, especially smaller businesses without dedicated human resources staff or those in industries with high worker turnover. While there are a multitude of retirement plan options that an employer can select—and some of these options are designed to limit employer reporting and legal responsibility—all plans involve some degree of administrative effort, time, and resources, including changes to payroll systems, the establishment of enrollment processes, and additional communication with employees.

Even if Anita were one of the 37 percent of part-time workers offered access at their jobs, she would not be assured of a comfortable retirement. Relatively few part-time workers have access to an employer contribution or match, and since part-time workers tend to have relatively low incomes, they may not have the ability to contribute. For many, a much more pressing demand is to pay down consumer debt, especially high-interest-rate payday loans and credit card debt.

Some Public Income Support Is Available

Because of her income level, Anita is one of the 47 million Americans who qualifies for the federal Supplemental Nutrition Assistance Program (SNAP), formerly known as food stamps. She receives a prepaid debit card every month that can be used for common food products such as fruits, vegetables, dairy products, meats, and fish. SNAP eligibility is based on household size and income, so she would probably become ineligible when her daughter moves out or gets a job of her own. (Anita may become eligible again when she retires and her Social Security benefits are her only source of income.) Furthermore, Anita is limited in the amount of assets (outside of a motor vehicle and retirement accounts) that she is allowed to accumulate while retaining her SNAP benefits. That provides some disincentive for her to save for emergencies, even when she is able to do so.[36, 37]

If Anita keeps her current level of employment, she is unlikely to be eligible for the federal SSI program, which provides stipends to low-income, low-asset individuals who are at least age 65 or blind, as well as individuals with disabilities. As long as Anita does not experience a disability or become blind, she would not be eligible during her working years.

SSI benefits "top off" any retirement income (usually from Social Security) up to $721 per month for an eligible single retiree. Anita doesn't meet the categorical or income criteria to receive SSI benefits today, and if she remains employed with a similar income until retiring and claiming Social Security at age 67, her Social Security benefit would be a bit too high for her to be eligible for SSI. Additionally, the SSI resource test is stricter than the SNAP resource test; a single person cannot have more than $2,000 in countable assets to receive SSI benefits, and retirement account assets are counted toward this limit.[38] For individuals with lower incomes than Anita, these asset tests are an impediment to savings for virtually any purpose, including retirement.

Medicare Would Cover Most—but Not All—Health Care Costs in Retirement

Anita would become eligible at age 65 for Medicare, which covers services such as hospital visits, short stays in skilled nursing facilities, doctor services, and prescription drugs. But Medicare has premiums and beneficiary cost-sharing,

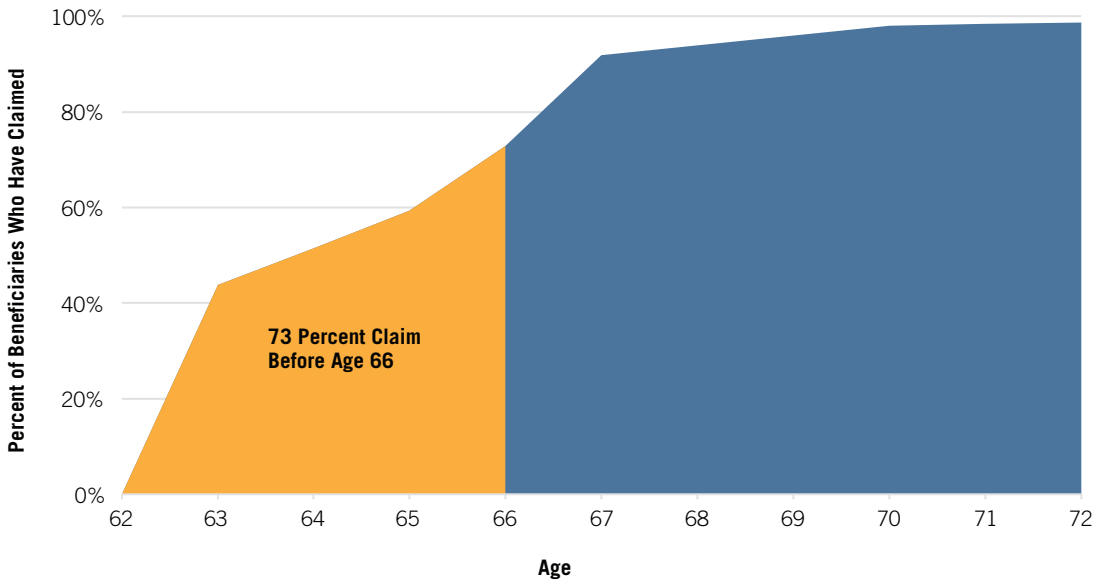
and does not provide coverage for every health care service that a beneficiary might need. Anita's income both before and during retirement is high enough that she would not qualify for Medicaid coverage, which covers all Medicare premiums and cost-sharing, plus some other services not covered by Medicare.

When she retires, Anita would probably qualify for one of the Medicare Savings Programs and for a Part D Low-Income Subsidy, which would cover her Medicare premiums and a portion of her out-of-pocket spending on outpatient drugs.[39] Still, she would have many out-of-pocket health care expenses, including cost-sharing for physician visits, procedures, or hospitalization (or for supplemental insurance to cover Medicare's cost-sharing). She could also choose to purchase additional coverage for services Medicare does not cover, including dental, vision, hearing, and LTC, but spending on either insurance or on the care itself would probably strain her already tight budget.

Delaying Retirement; Increasing Benefits

While Anita knows very little about retirement finances, she does know that her Social Security benefits will be based only on her highest-earning 35 years of work. Since she does not anticipate that her income will increase significantly after she is first eligible to claim Social Security benefits at age 62, she is strongly considering retiring and claiming Social Security as soon as she is eligible.

Large Majority of Social Security Beneficiaries Claim Benefits Before Full Retirement Age



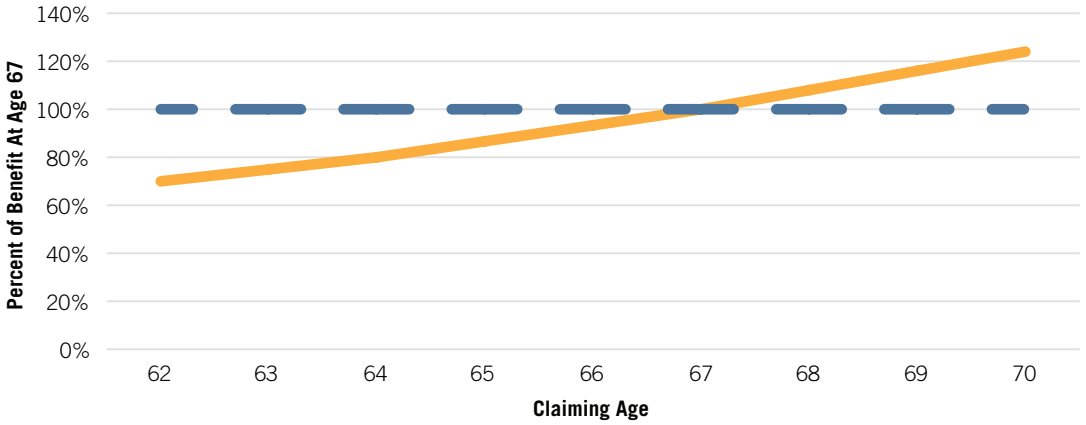
Note: Data are for 2012 and are interpolated for ages 67-70 and 71-75. Excludes conversions from DI to OASI at age 66.
Source: BPC Analysis of Social Security Administration, Annual Statistical Supplement to the Social Security Bulletin, 2013.

She would not be alone: A large proportion—32 percent of men and 38 percent of women—claim Social Security benefits early at age 62, and individuals with lower incomes, such as Anita, are more likely to claim before reaching their full retirement age (67, in her case). If she claims benefits at age 62, her annual benefit would be around $8,000, which is 70 percent of the benefit that she would receive if she waited to claim until age 67.[xvi, xvii] This reduction would significantly impact her retirement security, but she isn't aware of this at all.

On the other hand, if Anita continues to work (and delays claiming benefits until) *later* than age 67, she could increase her annual Social Security benefits by 8 percent *per year*. For example, if she could delay receiving benefits until age 70, she would receive about $3,000 extra in annual benefits (compared to if she had begun collecting at full retirement age). Of course, continuing to work as a waitress at age 67 could be quite difficult for her. Since she doesn't know about the advantages of doing so, she is very likely to retire as soon as she can and lose out on those additional benefits.

If Anita does claim benefits at age 62, she might be able to continue to work while receiving benefits. Workers who earn income while claiming benefits are subject to a provision called the Retirement Earnings Test, which acts to reduce benefits when a beneficiary is working in exchange for increased benefits later in retirement. For example, if Anita claims at age 62 and continues working, she would receive $1 less in Social Security benefits for every $2 earned above an annual limit ($15,480 as of 2014) until she reaches full retirement age. In exchange, she would also receive actuarially adjusted higher benefits when she reaches age 67; whether she experiences an overall lifetime benefit gain or loss from this provision depends on how long she lives.

There Are Significant Benefits Awaiting Those Who Delay Claiming Social Security



Note: Benefit increases are based on Social Security actuarial adjustments only and do not take into account the possible impacts of working longer on average career monthly earnings.

xvi If Anita continues to work and has income that positively impacts her average career monthly earnings, the difference could be even more pronounced. All benefit comparisons in this section exclude that factor.

xvii If Anita claims Social Security at age 62 and has no other income, her income level would be low enough to qualify for a small SSI benefit (less than $100 per month). In most states, she would also qualify for full Medicaid benefits, which would cover her Medicare premiums and cost-sharing, plus services not covered by Medicare, including LTC.

Though Anita could continue working, she would certainly notice the lower-than-expected Social Security benefits and might be unaware that the lower current benefits would be offset by higher future benefits. In any case, she might view the drop in benefits that would accompany her earnings as an incentive to leave the workforce or limit her earned income to the $15,480 threshold. The reality is that most retirees do not work—the civilian labor force participation rate for Americans aged 65 to 69 was about 32 percent in the second quarter of 2014.[40]

A Secure Retirement Would Be Hard to Come by

Anita would likely experience a significant drop in her standard of living in her retirement years. As she nears retirement, her income needs will decrease somewhat because her daughter would presumably no longer be financially dependent on her. But with less than $12,000 in annual Social Security benefits (assuming she claims at age 67) constituting her only source of retirement income, she would probably find it difficult to make ends meet. Because Anita rents her apartment and owns no home or property, she would have continued rental expenses to pay throughout retirement and would not be able to take advantage of home equity by selling her home or taking out a reverse mortgage. While she would likely remain eligible for some food assistance through SNAP, other living expenses—such as clothing, transportation, and utilities—would consume most, if not all, of her Social Security income. Even without the costs of raising her daughter, retirement would probably be very financially challenging for Anita.

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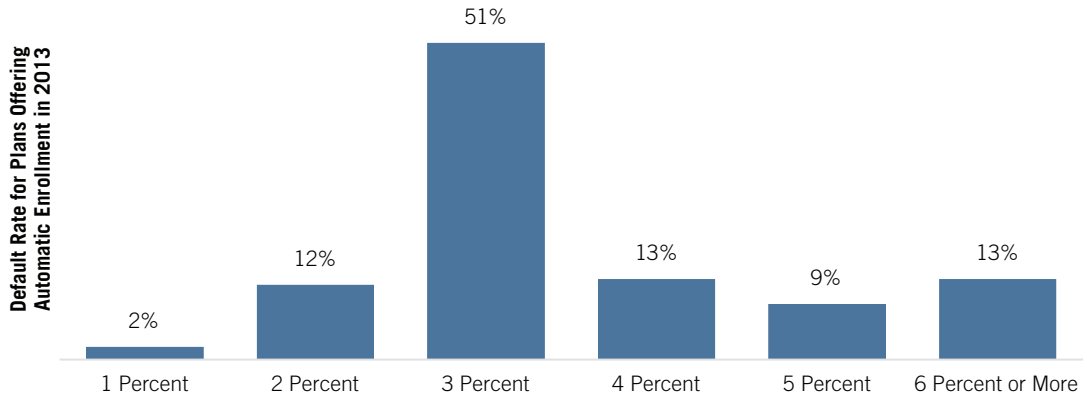
John and Maria: Not Saving Enough

Access to a payroll-deduction retirement savings account isn't enough to ensure a secure retirement if the workers aren't making sufficient contributions. John, 42, and his wife Maria, 37, are one such couple. John is making $50,000 this year as a full-time paralegal at a law firm. Maria works full-time as an administrative assistant with an annual salary of $35,000. She has been in and out of the labor force since high school to care for her aging parents and to finish her associate's degree. Over the past several years, the couple has prioritized paying down a combined $60,000 in student loans. Because John just recently paid off his education debt and Maria still has $5,000 outstanding, saving for the long run has proved challenging so far.

Unlike Anita, both John and Maria are fortunate enough to have access to payroll-deduction retirement plans at work. John's law firm offers a 401(k) plan with a 50 percent match on the first 6 percent of employee salary, and he was automatically enrolled at the default contribution rate of 3 percent. This plan design is quite common—about one-third of U.S. employers that sponsor DC plans used automatic-enrollment in 2013, and about half of such employers set a 3 percent default contribution rate.[41]

Most Automatic Enrollment Plans Default into a 3 Percent Contribution Rate

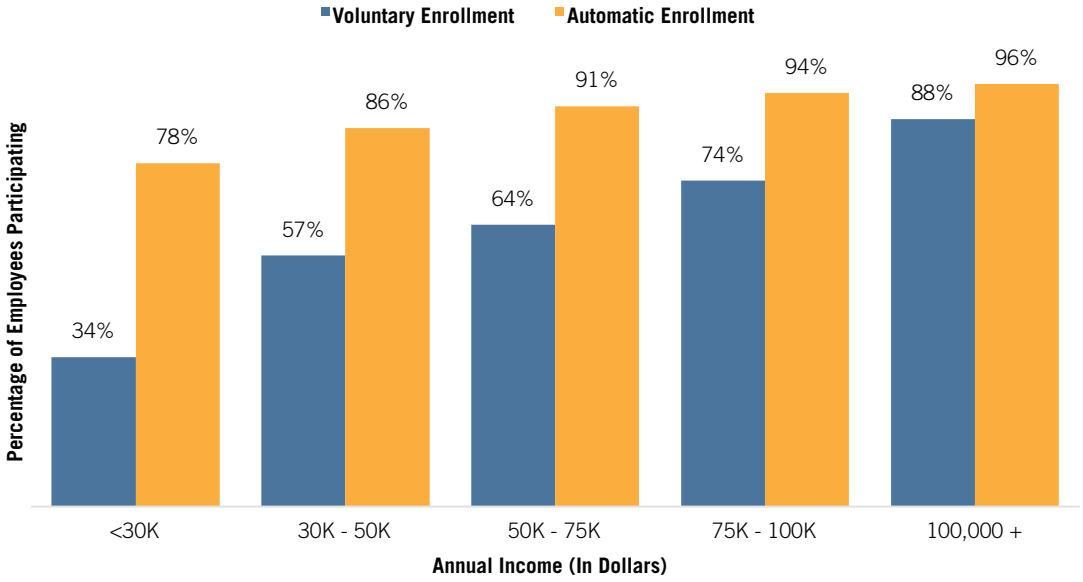


Source: Vanguard, How America Saves, 2014.

Like many other workers who are automatically enrolled in their workplace retirement plans, John continues to contribute at the default rate even though he is not fully taking advantage of his employer's match. There is evidence that workers like John who are automatically enrolled at a low rate would likely contribute at a higher rate if they had proactively enrolled.[42] Unlike many other companies with automatic enrollment, his employer does not offer automatic escalation, which would increase his contribution rate annually, up to a pre-set cap. If John changes jobs (or loses his job) and decides to cash out the balance of his account, taxes could eat up a significant portion of the relatively small amount that he has accumulated to that point.

Maria is also offered a 401(k) at work, but she was not automatically enrolled, and her plan falls into the one-third of plans that do not offer any match.[43] Maria received information on the plan when she took her job, and she and John considered contributing. They originally shied away from making a decision, however, because they were overwhelmed with the number of investment choices and weren't sure how much to contribute, and neither of them has thought about the option since that time.

Lower-Income Workers Much More Likely to Participate with Automatic Enrollment



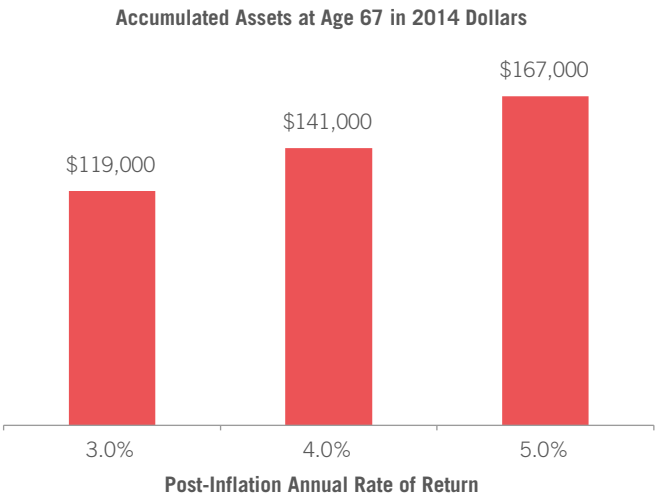
Note: Participation rates are for those offered a plan serviced by Vanguard.
Source: Vanguard, How America Saves, 2014.

John and Maria both have stable jobs and access to payroll-deduction retirement accounts and will both be entitled to Social Security benefits when they retire. But their retirement savings combined with those benefits would not be enough to maintain their current standard of living unless they drastically increase their saving rates. Neither John nor Maria understands personal finance particularly well, and they cannot afford to consult a financial planner. By the time they get around to reevaluating their situation, it may be too late. Moreover, the very real possibility that Maria may outlive John by a number of years poses an additional threat to her retirement security.

A Very Small Nest Egg

John's salary has grown by 1 percent each year (in inflation-adjusted terms) since he took his job five years ago and was automatically enrolled in the firm's DC plan. If that pay track continues until he is 67 years old, John's 401(k) would total only about $167,000 before income taxes in today's dollars, even under the hopeful assumption of 5 percent annual asset growth after inflation. By comparison, if both John and Maria work continuously until retirement and get annual 1 percent raises, their family's combined income would be $108,000 when John turns 67. In other words, even under very optimistic circumstances, John's 401(k) balance would be less than twice the household's annual income when he retires – almost certainly less than they need for a comfortable retirement.

Insufficient Contributions Lead to a Small Nest Egg



Note: The figures above assume constant contributions of 4.5 percent of pay from ages 37 to 66 based on a salary of $50,000 at age 42 and 1 percent annual pay raises.

Source: BPC Calculations.

Some of John and Maria's post-retirement income would come from Social Security and their consumption needs may diminish somewhat as their kids (whom they plan on having soon) are no longer dependent upon them and their tax rates fall. But Social Security's progressive benefit formula means that middle-income earners like John and Maria don't receive particularly high income-replacement rates from the program.[44] If they both wait until full retirement age to claim Social Security, they will be entitled to a total of about $38,000 annually, which is less than half of their pre-retirement income. Those benefits, in combination with John's 401(k) balance, would not be enough to ensure a financially secure retirement.

Job Turnover, Rolling Over, and Cashing Out

Given John's relatively small 401(k), he and Maria face acute risks when he changes jobs. If John leaves his employer, he would have to choose whether to leave his accumulated savings in his employer's plan, roll his savings into an IRA or his new employer's plan, or take a cash distribution.

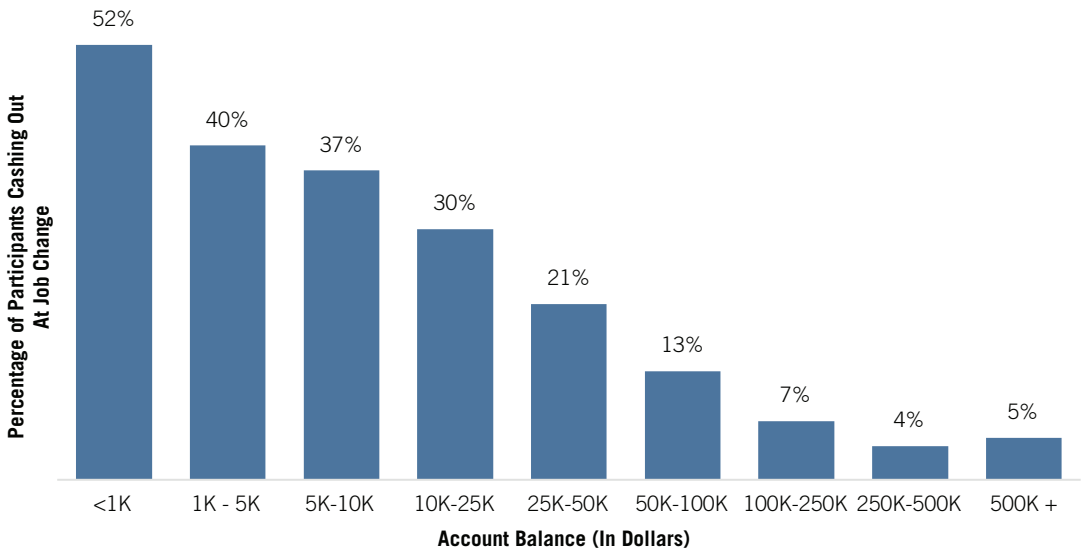
If John moves to another law firm, there is a chance that he would not be offered a 401(k) plan. Only 60 percent of workers in the professional and business services (including law firms) had access to DC plans in 2013.[45] Even if John is offered a plan, rolling over into a new employer's plan can be complex, including waiting periods for employer-to-employer rollovers and paperwork from both employers that isn't always easy to decipher. John and Maria may have trouble managing the rollover since they have only limited financial knowledge.

John could also opt to stay in his current firm's plan, though many employers impose policies that push employees away from that option, such as charging higher plan fees to separated employees and reducing former employees' control over their accounts. Moreover, having multiple 401(k) accounts outstanding can be difficult to manage.

If John rolls over his account into a commercial IRA, he would be presented with a vast array of investment options, many of which may not be particularly well-suited to his needs or which may carry much higher fees than options under an employer 401(k) plan. Moreover, unlike 401(k) plans, IRAs are not subject to the fiduciary rules set forth by the Employee Retirement Income Security Act (ERISA)—a situation that can lead to conflicts of interest in the advice that servicers give to IRA plan participants.[46]

The option that John may be most likely to take is cashing out, which is probably his worst option. It is particularly popular for younger workers and those with smaller account balances. One-third of workers who leave a job in their forties take a cash distribution, and one in three 401(k) plan participants has cashed out at least once.[47] Those cash-outs come at a significant cost—early withdrawals from 401(k)s and traditional IRAs are subject to ordinary income tax and an additional 10 percent surtax.[48]

Workers with Smaller Balances Are More Likely to Cash Out Their Retirement Accounts



Note: A worker is considered to have cashed out if they do not remain in the plan, complete a rollover, or set up an installment payment plan (for current retirees).
Source: Vanguard, How America Saves, 2014.

Job turnover creates short-term cash needs, which can be particularly acute for middle- and lower-income workers, and taking a cash distribution provides immediate relief. There is evidence, however, that cash-outs severely damage the retirement readiness of workers, especially those in the lower parts of the income distribution.[49]

The Lifelong Burden of Student Debt

Maria continues to carry a small debt burden ($5,000), while John just finished paying off his student loans last year. Maria went to college right after high school but dropped out after two semesters. She has since returned to school and finished an associate's degree. John and Maria financed their educations with a combined $60,000 in loans. Over the past several years, they have focused on paying down this debt.

John and Maria's student loans have affected their ability to save for retirement in multiple ways. Student loan debt repayments continue to reduce John and Maria's disposable income, which prevents the couple from putting aside much extra money for large expenses and retirement. The strain on their budget has also played a role in John's reluctance to consider increasing his contribution rate and in Maria's original disinclination to participate in her employer's 401(k). When this debt is paid off, the couple might increase their saving for retirement—but they also might not. Even if they do, by starting later, they have missed out on many years of investment growth.

John and Maria have been unable to save enough to purchase a home and are still renting. There is some evidence that rising student loan debt is impeding home purchases.[50] Though John and Maria would probably be able to purchase a home at some point, delays in doing

so decrease the probability that they would be able to pay off their mortgage before they retire or that they would become homeowners with much time left to make larger contributions to their retirement accounts.

For workers like John and Maria, barriers to homeownership may also be barriers to retirement security, as these workers' homes are often their largest financial assets. In retirement, home equity can be directly converted into retirement income, either through a traditional sale or through the use of a reverse mortgage. In the best of circumstances, reverse mortgages allow homeowners to receive regular (usually monthly) cash advances from a lender against the value of the property, thereby slowly drawing down the owner's equity on the home. The loan does not become due until the borrower dies, sells the house, or moves out of it, and the homeowner's liability to the lender is usually limited to the value of the home at the time the loan comes due.[51] Reverse mortgages are complicated financial products that are not for everyone, and only about 2 to 3 percent of eligible homeowners take advantage of them.[52]

The Role of Social Security

On John and Maria's current earnings path, their Social Security benefits would replace only a modest portion of their income in retirement. Furthermore, John and Maria may not know about the benefits of delaying retirement. Social Security benefits are actuarially adjusted for each year that benefits are delayed, so John's benefits would be increased by 8 percent for each year that John holds off claiming after he reaches his full retirement age at age 67. There are almost no other assets that offer such a generous rate of return since those benefits would also be adjusted for inflation after he begins claiming them.

Therefore, if both John and Maria could delay claiming until they reached age 70—either by working longer or by retiring and spending down their 401(k) assets rather than claiming Social Security—they would get approximately $10,000 extra in annual benefits, almost certainly improving their overall financial outlook. On the other hand, if they retire when they are 62 rather than at 67, their combined annual benefit would be about $12,000 less.

Given their modest 401(k) accumulations, the structure of Social Security's survivor benefit further threatens John and Maria's retirement security. According to the Centers for Disease Control and Prevention, life expectancy for American women turning the age of 65 in 2010 was 85 (or 20 additional years of life), whereas for men it was 83 (or 18 additional years).[53] Since Maria is five years younger than John, she would very likely outlive him, possibly by a significant margin.

John has been steadily employed and has consistently had higher income than Maria, so his Social Security retirement benefit would exceed hers. Under Social Security's spousal benefit structure, when she reaches full retirement age, Maria would collect either her own individual benefit or one that is equal to 50 percent of John's benefit at full retirement age, whichever is greater.[54] When John dies, she would be entitled to a survivors benefit that is equal to the greater of either of their individual benefit levels.[55] On average, women need 83 percent of joint income in order to be as well off living alone as they were living with their husbands.[56] Switching to John's full benefit alone would be a reduction of much more than 17 percent in her income, probably necessitating a reduction in her standard of living.

Access Alone Is Not Enough

John and Maria both hold well-paying, stable jobs and have access to retirement savings plans at work. However, their story demonstrates that access to savings vehicles may not be enough. Due to a lack of financial resources, inertia, and outstanding student debt, John and Maria have not set aside as much as they need. Their knowledge of financial

matters is only modest, leaving them unaware of how insufficient their current savings levels are and preventing them from taking advantage of options from which they could benefit, such as Maria's 401(k) plan and the entirety of the match at John's employer. They also haven't done any planning for the possibility of outliving their savings or considered what their likely Social Security benefits would be. In short, without changes to their current savings behavior and perhaps improvements to their budget picture, John and Maria are unlikely to be well-prepared for a long retirement.

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Ron and Tina: Old-Age Risks

Some Americans are preparing adequately for retirement and will probably be fine. But they still face risks that could jeopardize their retirement security. Ron and Tina, both 47 years old, are one such couple. Ron is a lawyer at the firm that he joined ten years ago. This year, he will earn about $110,000. Tina is an editor and will make $60,000 this year.

Both Ron and Tina have access to retirement plans through their employers and participate in them. Ron opted into his firm's 401(k) plan when he was first hired and has raised his contribution level over time to 9 percent of his salary. His firm also matches 50 percent of contributions on the first 6 percent of salary, so his total contribution level (employee plus employer) is currently 12 percent of salary.

Tina, on the other hand, has worked for a number of different firms and was automatically enrolled into her current employer's 401(k) when she switched jobs. Though the default contribution rate was just 3 percent, she was automatically escalated at a rate of two percentage points per year up to 7 percent, and her employer contributes 5 percent of salary to all of its participants' accounts. As a result, Tina's total contribution level also stands at 12 percent of salary.

Ron and Tina's daughter is set to graduate from the state's flagship public university in the same year that Tina turns 50. The couple plans to start maxing out contributions to a Roth IRA in Tina's name once they no longer have to pay their daughter's tuition.[xviii] They briefly considered using the money to take an expensive vacation, but they sat down with a financial planner and decided to take a more modest vacation and put the remainder toward paying down their mortgage faster than they had intended and saving for retirement.

While they have saved well for years and have been responsible with their money, Ron and Tina are not free from threats to their retirement security. If they make an inappropriate investment choice or there is a significant market downturn as they approach retirement, they could face a substantial reduction in their accumulated wealth. Moreover, if Ron or Tina (or both) need expensive LTC for a prolonged period of time in retirement or live substantially longer than expected, their accumulated savings, in conjunction with available government assistance, may not be sufficient to maintain their standard of living.

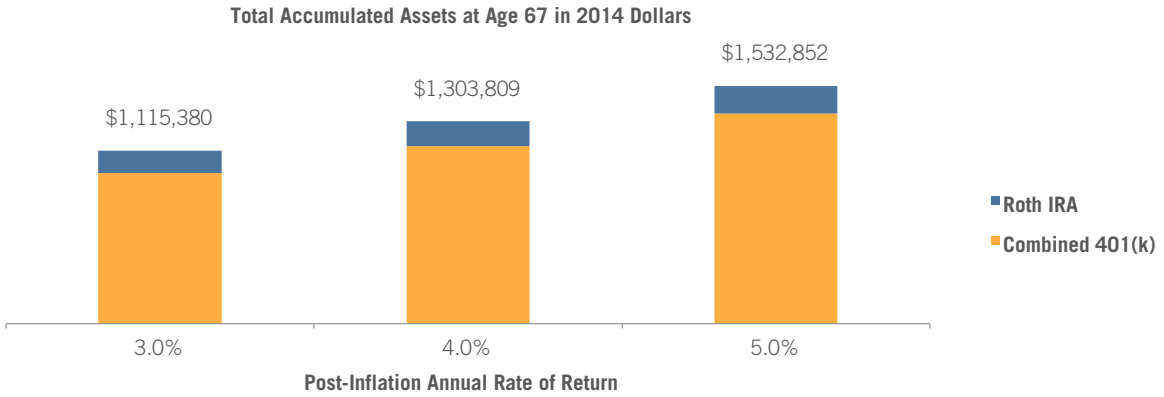
Investment Uncertainty

In all likelihood, contributing 12 percent of combined salary for most of the way throughout their careers should put Ron and Tina on track to be financially secure in retirement. If they follow through on their contribution plans, they would have more than $1 million in savings (in 2014 dollars) at retirement even under the relatively conservative estimate of 3 percent real returns on their assets.[xix]

xviii For married couples filing jointly with combined modified adjusted gross income of less than $181,000, the 2014 Roth IRA contribution limit is $5,500. Individuals over the age of 50, however, are eligible to make an additional $1,000 of catch-up contributions each year, increasing the maximum contribution for Tina's Roth IRA to $6,500 each year.

xix This calculation also assumes that they each receive 1 percent real annual raises, contribute at 12 percent of combined salary every year, and make contributions for $6,500 annually to their Roth IRA between when Tina turns 50 and 67.

Sufficient Contributions Result in Large Account Balances



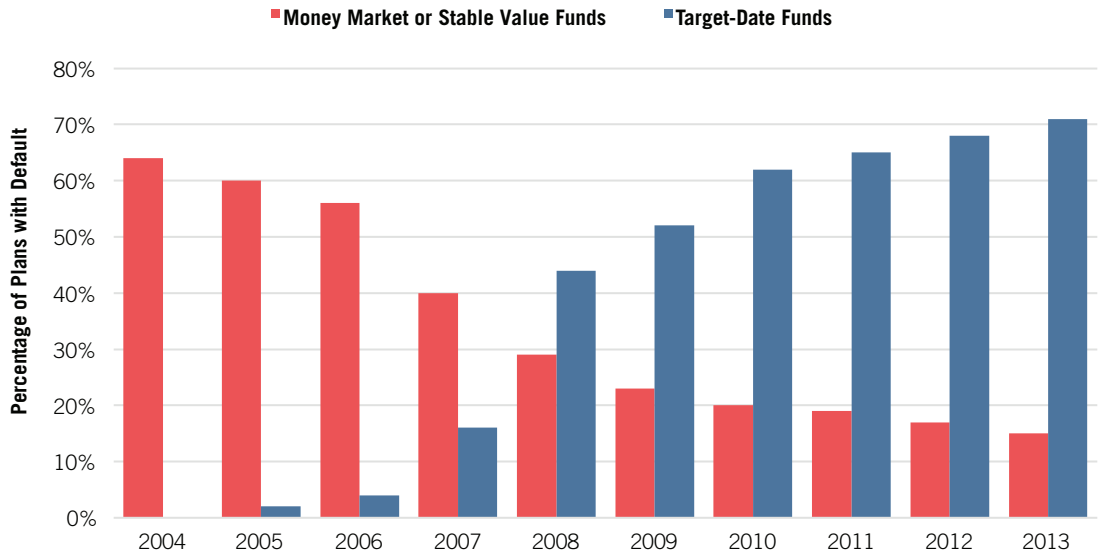
Note: Assets above are totaled for the year in which each member of the couple turns age 67. The figures above assume contributions according to the formulas stated in the text from ages 34 to 66 for Ron and 43 to 66 for Tina based on 1 percent annual salary growth.

Source: BPC Calculations.

In addition to their retirement account balances, on their present track, Ron and Tina would both be entitled to significant benefits from Social Security, summing to an annual total of more than $55,000. Although this would be only about one-quarter of their pre-retirement income (assuming continued 1 percent annual raises, in real terms), the combination of their significant savings and their decreased needs in retirement—for money to pay taxes, save, pay off their mortgage, and raise their daughter—should allow them to continue living a similar lifestyle.

Barring any large market downturns as they near retirement, Ron and Tina are invested in smart asset allocations that would likely yield decent returns. The default investment for Tina's 401(k) was a target-date fund and Ron chose to invest his 401(k) in the same. As they approach their retirement date, these funds automatically rebalance their holdings away from higher-yield, higher-risk assets (like equities) toward increasingly conservative assets (like bonds, cash, and money market funds). In general, target-date funds are an excellent way for individuals to maintain an appropriate asset allocation with minimum hassle—but some of these funds have high fees attached that can sap the growth of retirement savings.

Target-Date Funds Have Replaced Money Market as Common Default in Last Decade



Note: Money market funds are invested in low-risk, low-return short-term debt. Target-date funds invest in a blend of equities, bonds, and money-market instruments that adjusts toward more conservative allocations as the target retirement date nears. The remainder of plans (not shown above) have default funds that maintain a relatively constant balance of stocks, bonds, and money market instruments.

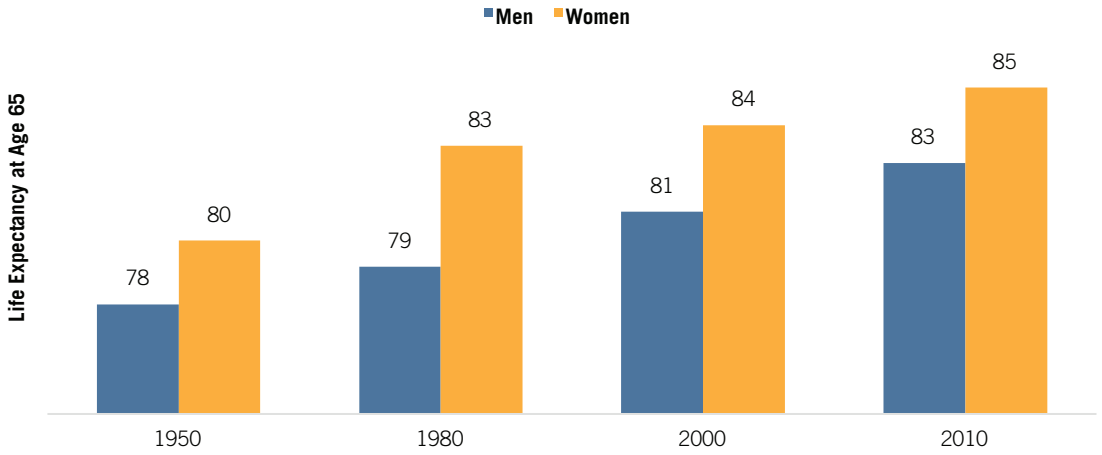
Source: Vanguard, How America Saves, 2014.

While Ron and Tina have made a simple investment choice that should yield reasonable returns, many Americans make ill-suited investment choices. A portfolio with only stocks risks being subject to wide swings in value and one with too few equities will likely yield modest rates of return (especially in the current environment of low interest rates). A 2014 Vanguard report found that 24 percent of participants in its DC plans had equity allocations of either less than 10 percent or greater than 90 percent. This share is down from 48 percent in 2004, but significant numbers of Americans are still making unbalanced investment choices that potentially threaten their retirement security.[57]

Outliving Savings

Americans are living longer than ever before: Life expectancy for Americans turning 65 in 2010 was 84, up from 81 in 1980 and 79 in 1960.[58] While these aggregate numbers hide the fact that Americans who are poorer, less educated, and black have made only very modest gains in longevity, Ron and Tina would likely live for quite a while after they retire.[59] Financing a long retirement can be a challenge, especially since expenses might increase due to severe or chronic health problems and the onset of disability.

Retirees Spending Longer in Retirement



Source: Centers for Disease Control, "Health, United States, 2013."

Ron and Tina's situation—significant expected longevity after they retire, no DB pension that guarantees income for life, no plans to buy an annuity with their 401(k) account balances, and Social Security benefits that alone would be insufficient for maintaining their standard of living—is reasonably common for upper-middle- and high-income Americans and makes outliving savings a real risk. The Employee Benefit Research Institute projected that 14 percent of those in the highest quartile of pre-retirement wages would run short of money in retirement. But if Ron and Tina live especially long lives, their risk would nearly double. Among the longest-lived quarter of the highest pre-retirement income quartile (i.e., one-sixteenth of the population), 27 percent of individuals will run short of money by the end of their lives.[60]

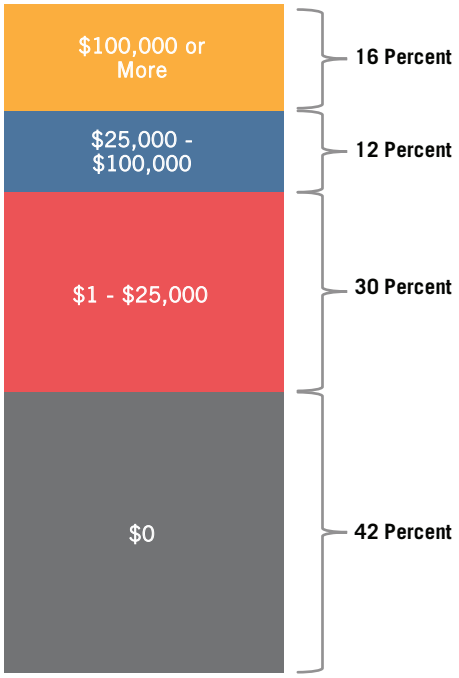
Ron and Tina could mitigate their longevity risk by annuitizing some or all of their assets, but they are unlikely to do so. Their 401(k)s do not offer lifetime annuity payout options, which are lacking in 87 percent of 401(k)s.[61] Many plan sponsors avoid including annuities because of concern regarding their legal liability if the annuity provider failed to make promised payments.

In order to annuitize their savings, Ron and Tina would have to conduct research on their own to find an annuity product that suits their needs, which can be difficult. Additionally, some annuities are complex and have very high fees. It is therefore unsurprising that only 19 percent of relatively wealthy retirees with a small or no DB pension annuitize some or all of their savings and that even two-thirds of those who annuitize do so with less than half of their savings.[62]

Long-Term Care Risk

Ron and Tina also face the risk of needing to pay out-of-pocket for expensive LTC for assistance with daily living. It is likely that Ron and Tina eventually will develop difficulties performing activities of daily life like eating, bathing, managing medication, or food shopping and would need some LTC. Approximately 70 percent of those who reach age 65 will need LTC at some point in their lives.[63]

Projected Long-Term Care Payments for Those Who Reach Age 65 Vary Significantly



Source: Commission on Long-Term Care, Report to Congress, 2013.

Ron and Tina could potentially turn to informal, unpaid sources of care, like each other or their daughter, for help when these needs occur. Many elderly Americans—including some of the 42 percent of 65-year-olds who will incur no LTC expenses before the end of their lives—receive unpaid care.[64] But if either Ron or Tina dies, their daughter moves out of the area, or their needs become overwhelming in intensity or duration, they would likely need paid care.

Spending on these services—which can range from several hours per week with a home health aide to nursing home services or installations of special accommodative home equipment—can quickly run into the tens or even hundreds of thousands of dollars. For example, if Ron dies and Tina develops dementia, she might need round-the-clock care in a skilled nursing facility for more than a decade and could easily incur more than $1 million in LTC expenses, which would overwhelm even their substantial retirement savings. Although such high needs are relatively rare, approximately 16 percent of Americans turning 65 will use paid LTC services in excess of $100,000 through the end of their lives.[65]

A major health episode resulting in the need for LTC would leave Ron and Tina with limited options. They probably do not plan to purchase private LTC insurance. Only 10 percent of Americans over the age of 50 have such insurance, and several major LTC insurers have recently left the market.[66] Medicare does not cover LTC services. Thus, Ron and Tina would have to spend down their personal savings to cover the expenses.

If their LTC costs are particularly large, Medicaid does cover LTC and pays for about two-thirds (roughly $131 billion in 2011) of all LTC spending in the country.[67] But Ron and Tina would not be eligible for Medicaid until they "spend down" virtually all of their assets and then additionally spend a substantial portion of their income on health and LTC. Moreover, while every state's Medicaid program covers nursing home services, coverage for other services varies by state. Depending on the state that they live in, Medicaid might not cover the particular service that they need in their current setting (such as at home or in assisted living) even if they become eligible.

A Comfortable Retirement? Maybe

Ron and Tina are following a sensible path to retirement. For years, they've both put away substantial portions of their relatively high incomes and have made appropriate investment decisions—and they're looking to save even more. They have positioned themselves well for a comfortable standard of living in retirement. Yet even they

are not immune from threats to retirement security. Ill-advised or simply unlucky investment choices, longevity, and LTC costs could negatively impact their retirement security, especially if they do not take steps to protect themselves, such as considering annuitization and LTC insurance.

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A Diversity of Risks and One Great Unknown

Preparing for retirement is challenging for many Americans. No one wants to experience a substantial drop in living standard in old age, when many of us will have less ability to work. The risks of not saving enough, not having enough retirement income, and outliving one's savings are significant. While many have substantial retirement savings or can count on a good amount of pension income, many do not, and very few Americans are adequately protected against all of these risks.

The challenges are diverse: some do not have access to workplace retirement plans, which is the mode by which the vast majority of private retirement assets are amassed; others have access, but do not participate or contribute too little; some are exposed to the risk of DB plan failures; and many will struggle financially if they live an especially long life or need prolonged and expensive LTC.

The difficulty of overcoming these threats to retirement security is compounded by the complexity of the U.S. retirement system. For many Americans, tasks as critical to retirement security as projecting Social Security benefits, rolling over 401(k) savings to a new employer's plan, and managing withdrawal from multiple savings sources can be overwhelming and confusing. Even the most proactive retirement planners may face difficulties in navigating the system and protecting against risks.

There is one great unknown that is relevant to almost every current and future American retiree—the solvency of Social Security.[68] The OASI Trust Fund is projected to become depleted in the first half of the 2030s, at which point payroll and self-employment tax revenue would only be sufficient to cover about three-quarters of scheduled benefits.[69] (Even more urgent, the program's DI Trust Fund is scheduled for exhaustion in 2016.)

While the estimated Social Security benefits for the illustrative families in this paper assume that benefits remain as scheduled, the reality is that no one knows what benefits will be for retirees two or three decades from now. Policymakers have a variety of options to address the looming insolvency of the trust funds, including changes to both benefits and taxes. While an across-the-board reduction of benefits seems unlikely, if it were to occur, it would have an especially adverse effect on retirees who depend exclusively or mostly on Social Security. This is an important unknown that must be addressed, both to help individuals plan for their own retirements and to have a better sense of retirement readiness across the population.

In this paper's case studies, we have detailed just some of the largest risks that individuals face when thinking about their retirement security. Given the range of issues involved, there is no one-size-fits-all policy solution to help Americans meet this challenge, which calls for thoughtful action by the nation's leaders. That is why in 2015, BPC's Commission on Retirement Security and Personal Savings will make recommendations, based on a holistic view of the retirement system, to address this subject—one that should matter to every single American as they look down the road into their future and hope to see a familiar and comfortable lifestyle within reach.

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