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Hearing on:

“Pension Savings: Are Workers Saving Enough for Retirement?”

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Response to Hearing Questions

Jack VanDerhei, Ph.D.

Research Director

Employee Benefit Research Institute (EBRI)



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Responses to questions from Jan. 31, 2013, Senate HELP hearing: “Pension Savings: Are Workers Saving Enough for Retirement?”

By Jack VanDerhei, research director, Employee Benefit Research Institute

This document provides responses to questions raised by members of the Senate HELP Committee at their Jan. 31 hearing on retirement savings.

- **What is retirement income adequacy?**
 - For public policy analysis, EBRI defines adequate retirement income as having the financial resources to cover basic expenses plus uninsured medical costs in retirement.¹ Many other projections overlook, implicitly or explicitly, uninsured medical costs in retirement, and many simply publish a projected average result that will be correct only 50 percent of the time, without acknowledging these limitations.
 - The foundation for EBRI’s analysis is a stochastic micro-simulation model that was created in 2001 originally to assist three states² in assessing the adequacy of future cohorts of retirees; EBRI’s model was expanded to a national assessment in 2003. The appendix details the studies undertaken as part of our project.

- **What percentage of Baby Boomers and Gen Xers are likely to run short of money in retirement, based on the current system/assumptions?**
 - Approximately 44 percent of Baby Boomer and Gen-Xer households are simulated to be at risk of running short of money in retirement, assuming they retire at age 65³ and retain any net housing equity in retirement until other financial resources are depleted.⁴ However, that includes a wide range of personal circumstances, from individuals projected to run short by as little as a dollar to those projected to fall short by tens of thousands of dollars. Nearly one-half (49.1 percent) of Gen Xers are projected to have at least 20 percent more than is simulated to be needed; approximately one-third (31.4 percent) have between 80–120 percent of the financial resources necessary to cover the retirement expenses and uninsured health care costs; and about 1 in 5 (19.4 percent) are projected to have less than 80 percent of what is needed.⁵

- **Of those projected to run short of money in retirement, how much is the shortfall?**
 - Looking only at those situations where shortfalls are projected, in May 2012 EBRI projected that the shortfalls for Early Boomers (individuals born between 1948–1954) vary from approximately \$70,000 (per individual) for married households, increasing to \$95,000 for single males and \$105,000 for single females. The aggregate retirement income deficit number, taking into account current Social Security retirement benefits and the assumption that net housing equity is utilized “as needed,” as well as uninsured health care costs, is currently estimated to be \$4.3 trillion for all Baby Boomers and Gen Xers.

- **What is the current status of women in retirement?**
 - The challenge of preparing for a financially secure retirement can be even more daunting for women, who tend to live longer than men, are frequently in the workforce for fewer years, and who may earn less than their male counterparts. A recent EBRI analysis has determined that the conditional Retirement Savings Shortfalls for Gen Xer

single females is approximately \$133,000. That value denotes the average additional amount of savings needed at age 65 for at-risk single females in that age cohort NOT to run short of money in retirement.⁶ Moreover, 13 percent of these single females would have shortfalls in excess of \$200,000.

- As one might expect, there is a great amount of variation in the shortfall values for these single females. However, one of the most important predictors of how much shortfall, if any, they will experience is the FUTURE years of eligibility for participation in a 401(k) plan. For example, 17.5 percent of single females in this group who will not work for an employer sponsoring a 401(k) plan between 2013 and the time they reach retirement age will have shortfalls in excess of \$200,000. In contrast, for those with one to nine years of future eligibility, the percentage with shortfalls in excess of \$200,000 drops to 13.0 percent. The percentage decreases to 7.9 percent for those with 10–19 years of future eligibility and only 5.2 percent for those with 20 or more years of eligibility.⁷

- **Factors impacting and influencing retirement readiness:**

1. *Availability of defined benefit (pension) plans.*

- EBRI has previously published (August 2012) an analysis illustrating the tremendous importance of defined benefit plans in achieving retirement income adequacy for Baby Boomers and Gen Xers. Overall, the presence of a defined benefit accrual at age 65 reduces the “at-risk” percentage by 11.6 percentage points. The defined benefit plan advantage (as measured by the gap between the two at-risk percentages) is particularly valuable for the lowest-income quartile but also has a strong impact on the middle class (the reduction in the at-risk percentage for the second and third income quartiles combined is 9.7 percentage points).

2. *Future eligibility for a defined contribution plan.*

- EBRI research has previously documented (May 2012) that the number of future years that workers are eligible to participate in a defined contribution plan has a tremendous impact in their at-risk ratings. Specifically, Gen Xers with no future years of DC plan eligibility would run short of money in retirement 60.7 percent of the time, whereas fewer than 1 in 5 (18.2 percent) of those with 20 or more years of future eligibility are simulated to run short of money in retirement.

3. *Increasing default deferral rates to 6 percent.*

- A plan design feature often suggested as a way to improve retirement income adequacy in 401(k) plans with automatic enrollment is to increase the initial default deferral rate from its current value (typically 3 percent of participant compensation) to 6 percent of compensation. Applying that change to 401(k) plans with automatic enrollment provisions in place, EBRI modeled the impact of making that change, and found that in 2012 more than a quarter of those in the lowest-income quartile who had previously NOT been successful under actual plan default contribution rates would now attain retirement income adequacy as a result of raising the auto-deferral to 6 percent. When employees in the highest-income quartile were analyzed under the same set of assumptions, the percentage of those who had NOT previously been successful (under

the actual default contribution rates) that now were successful as a result of the higher deferral rate was 18.4 percent.

4. *Job changes and default deferral restarts.*

- EBRI research has previously documented (November 2010) the profound influence of plan design variables, as well as employee behavior in auto-enrollment 401(k) plans. Large differences in the probability of having at least 80 percent of pre-retirement income replaced (when 401(k) balances and IRA rollovers from 401(k) plans at job change are combined with Social Security benefits) were found, depending on which plan design factors and employee behavior assumptions are used. For example, if one assumes that an automatic enrollment plan has a feature that automatically escalates a worker's 401(k) contribution by 1 percent of compensation annually and caps employee contributions at 15 percent of compensation, the employee's success rates can vary from 62 percent to 77 percent, depending on whether employees are assumed to opt out of the automatic escalation and whether they are assumed to remember/retain their previous level of contributions when they change jobs vs. reverting back to the plan's initial default.
- Regarding turnover rates, the most recent U.S. Census Bureau data show that the overall median tenure of workers—the midpoint of wage and salary workers' length of employment in their current jobs—was 5.4 years in 2012, compared with 5.0 years in 1983. However, as noted by a recent *EBRI Notes* publication (December 2012), the data on employee tenure—the amount of time an individual has been with his or her current employer—show that career jobs never existed for most workers and have continued not to exist for most workers. These tenure results indicate that, historically, most workers have repeatedly changed jobs during their working careers, and all evidence suggests that they will continue to do so in the future.

5. *Leakage*

- If “success” is defined as achieving an 80 percent real replacement rate from Social Security and 401(k) accumulations⁸ combined, then workers ages 25–29 in the lowest-income quartile (who will have more than 30 years of simulated eligibility for participation in an automatic enrollment 401(k) plan), will only experience a 6.1 percentage point decrease in success resulting from the COMBINATION of cashouts, hardship withdrawals, and loans according to EBRI research⁹. The impact when you add in the impact of loan defaults is less than 1 percentage point higher (approximately 7.1 percentage points for all four factors combined).

Endnotes

¹ The EBRI Retirement Readiness Ratings™ measure the percentage of simulated life paths in retirement that are at risk of inadequate retirement income. A household's simulated lifepath in retirement is considered to be at risk in the baseline version of the model if its aggregate resources in retirement are not sufficient to meet aggregate minimum retirement expenditures, defined as a combination of deterministic expenses from the Consumer Expenditure Survey (as a function of income) as well as some health insurance and out-of-pocket health-related expenses, plus stochastic expenses from nursing home and home health care (at least until the point such expenses are picked up by Medicaid). The resources in retirement are assumed to consist of Social Security (status quo benefits for the baseline version of the simulation); account balances from defined contribution plans; individual retirement accounts (IRAs) and/or cash balance plans; annuities or lump-sum distributions from defined benefit plans; and net housing equity (in the form of a lump-sum distribution at the point that other financial resources are exhausted). This version of the model is constructed to simulate "basic" retirement income adequacy; however, alternative versions of the model allow similar analysis for replacement rates and other thresholds.

² Studies were performed for Oregon, Kansas and Massachusetts. For additional detail, please see VanDerhei and Copeland (September 2001, July 2002 and December 2002).

³ Of course, deferring retirement age beyond age 65 will improve the situation. Baseline results from the EBRI Retirement Security Projection Model® indicate that the lowest preretirement income quartile would need to defer retirement age to 84 before 90 percent of the households would have a 50 percent probability of success. Although a significant portion of the improvement takes place in the first four years after age 65, the improvement tends to level off in the early 70s before picking up in the late 70s and early 80s. Households in higher preretirement income quartiles start at a much higher level, and therefore have less improvement in terms of additional households reaching a 50 percent success rate as retirement age is deferred for these households. (VanDerhei, June 2011).

⁴ These "at-risk" levels are some 5–8 percentage points LOWER than what was found in 2003, largely due to the growing adoption of automatic enrollment by 401(k) plan sponsors.

⁵ See VanDerhei (November 2012).

⁶ See VanDerhei (May 2012).

⁷ See VanDerhei (June 2012).

⁸ For purposes of this analysis, the term 401(k) accumulations includes 401(k) balances and IRA rollovers from 401(k) plans at job change.

⁹ VanDerhei, *Plug the Drain: 401(k) Leakage and the Impact on Retirement*, DCIA Webinar, February 2012.

Appendix: Brief Chronology of EBRI's Retirement Security Projection Model®

2001	RSPM grew out of a multi-year project to analyze the future economic well-being of the retired population at the state level. EBRI and the Milbank Memorial Fund, working with the office of the governor of Oregon, set out in the late 1990s to see if this situation could be evaluated for the state. The resulting analysis (VanDerhei and Copeland, September 2001) focused primarily on simulated retirement wealth with a comparison to ad hoc thresholds for retirement expenditures.
2002	<p>With the assistance of the Kansas Insurance Department, EBRI was able to create Retirement Readiness Ratings based on a full stochastic decumulation model that took into account the household's longevity risk, post-retirement investment risk, and exposure to potentially catastrophic nursing-home and home-health-care risks.</p> <p>The first state-level RSPM results were presented to the Kansas' Long-Term Care Services Task Force on July 11, 2002 (VanDerhei and Copeland, July 2002), and the results of the Massachusetts study were presented on Dec. 1, 2002 (VanDerhei and Copeland, December 2002).</p>
2003	RSPM was expanded to a national model -- the first national, micro-simulation, retirement-income-adequacy model, built in part from administrative 401(k) data. The initial results were presented at the EBRI December 2003 policy forum (VanDerhei and Copeland, 2003). The basic model was subsequently modified to quantify the beneficial impact of a mandatory contribution of 5 percent of compensation for testimony for the Senate Special Committee on Aging (VanDerhei, January 2004).
2004	The model was enhanced to allow an analysis of the impact of annuitizing defined contribution and IRA balances at retirement age (VanDerhei and Copeland, 2004).
2005	Additional refinements were introduced to evaluate the impact of purchasing long-term care insurance on retirement income adequacy (VanDerhei, 2005).
2006	<p>The model was used to evaluate the impact of defined benefit freezes on participants by simulating the minimum employer-contribution rate that would be needed to financially indemnify the employees for the reduction in their expected retirement income under various rate-of-return assumptions (VanDerhei, March 2006).</p> <p>Later that year, an updated version of the model was developed to enhance the EBRI interactive Ballpark E\$timate® by providing Monte Carlo simulations of the replacement rates needed for specific probabilities of retirement-income adequacy under alternative-risk-management treatments (VanDerhei, September 2006).</p>
2008	RSPM was significantly enhanced for the May 2008 EBRI policy forum by allowing automatic enrollment of 401(k) participants with the potential for automatic escalation of contributions to be included (VanDerhei and Copeland, 2008).
2009	<p>Additional modifications were added for a Pension Research Council presentation that involved a "winners/losers" analysis of defined benefit freezes and the enhanced employer contributions provided to defined contribution plans at the time the defined benefit plans were frozen (Copeland and VanDerhei, 2010).</p> <p>Also in 2009, a new subroutine was added to allow simulations of various styles of target-date funds for a comparison with participant-directed investments (VanDerhei, June 2009).</p>

2010	In April 2010, the model was completely re-parameterized with 401(k) plan design parameters for sponsors that had adopted automatic-enrollment provisions (VanDerhei, April 2010). A completely updated version of the national model was produced for the May 2010 EBRI policy forum and used in the July 2010 <i>Issue Brief</i> (VanDerhei and Copeland, 2010).
	The new model was used to analyze how eligibility for participation in a defined contribution plan impacts retirement income adequacy in September 2010 (VanDerhei, September 2010), and was later used to compute Retirement Savings Shortfalls (RSS) for Baby Boomers and Generation Xers in October 2010 (VanDerhei, October 2010a).
	In October testimony before the Senate Health, Education, Labor and Pensions Committee on “The Wobbly Stool: Retirement (In)security in America,” the model was used to analyze the relative importance of employer-provided retirement benefits and Social Security (VanDerhei, October 2010b).
2011	In February the model was used to analyze the impact of the 2008–2009 crisis in the financial and real estate markets on retirement income adequacy (VanDerhei, February 2011).
	An April 2011 article introduced a new method of analyzing the results from RSPM (VanDerhei, April 2011). Rather than simply computing an overall percentage of the simulated life paths in a particular cohort that would not have sufficient retirement income to pay for the simulated expenses, the new method computed the percentage of households that would meet that requirement more than a specified percentage of times in the simulation.
	As explored in the June 2011 <i>EBRI Issue Brief</i> , the RSPM allowed retirement-income adequacy to be assessed at retirement ages later than 65 (VanDerhei and Copeland, June 2011).
	In a July 2011 <i>EBRI Notes</i> article (VanDerhei, July 2011), RSPM was used to provide preliminary evidence of the impact of the “20/20 caps” on projected retirement accumulations proposed by the National Commission on Fiscal Responsibility and Reform.
	The August 2011 <i>EBRI Notes</i> article (VanDerhei, August 2011) used RSPM to demonstrate the impact of defined benefit plans in achieving retirement income adequacy for Baby Boomers and Gen Xers.
	In September it was used to support testimony before the Senate Finance Committee (VanDerhei, September 2011) in analyzing the potential impact of various types of tax-reform options on retirement income. This was expanded in the November 2011 <i>EBRI Issue Brief</i> (VanDerhei, November 2011).
2012	A March 2012 <i>EBRI Notes</i> article (VanDerhei, March 2012) used new survey results to update the analysis of the potential impact of various types of tax-reform options on retirement income.
	The May 2012 <i>EBRI Notes</i> article (VanDerhei, May 2012) provided 2012 updates for the previously published EBRI Retirement Readiness Ratings™ as well as the RSS.
	The June 2012 <i>EBRI Notes</i> article (VanDerhei, June 2012) introduced severity categories in the RSS projections for Gen Xers.
	The August 2012 <i>EBRI Notes</i> article (VanDerhei, August 2012) provided additional evidence on whether deferring retirement to age 70 would provide retirement income adequacy for the vast majority of Baby Boomers and Gen Xers.
	The September 2012 <i>EBRI Notes</i> article (VanDerhei, September 2012) analyzed the impact of increasing the default contribution rate for automatic enrollment 401(k) plans.
	The November 2012 <i>EBRI Notes</i> article (VanDerhei, November 2012) reclassified the Retirement Readiness Ratings to provide additional information on those substantially above the threshold; close to the threshold; and substantially below the threshold.

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