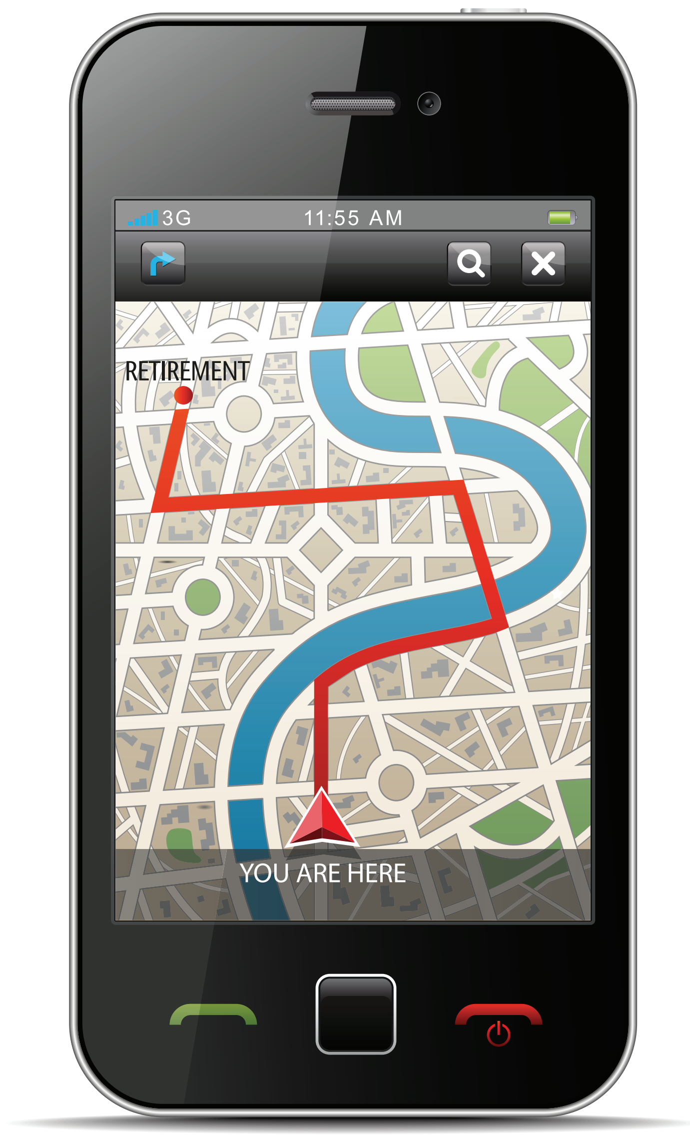
Consulting
Retirement

The Real Deal

2012 Retirement Income Adequacy at Large Companies

Highlights



Aon Hewitt

Study Highlights

Retirement Income Adequacy

There is increasing concern over employees not having enough money to meet their retirement needs. Employees face the risk of having to work longer than desired or decreasing their living standards. Employers face workforce risks if employees are not able to retire as planned. And in light of growing deficits and economic difficulties, the country's social systems are at risk of becoming overwhelmed by retiring workers who are financially ill-prepared for retirement.

To confront these risks, several key questions need to be addressed:

- How much do workers need to retire?
- Will employees be prepared for retirement if they continue doing what they are doing today?
- What can employees and employers do to improve the outcomes?

Aon Hewitt's Real Deal study answers these questions by studying the retirement resources and needs for 2.2 million employees of 78 large US employers. The study projects employees' retirement resources and needs assuming their current behaviors continue. The report then analyzes the risks, measuring employer and employee actions to help improve the outcomes.

The Real Deal study focuses on full-career contributing employees as the baseline. For this purpose, we define "full career" as an employee with the potential to work 30 years or more with their current employer prior to retirement. This allows analysis of the theoretical potential for delivering adequate retirement income through the plans and savings behaviors of today's environment, an analysis of projected risks, and possible solutions to help manage the risks. Focusing on full-career contributing employees allows the study to analyze the effect of an employer's retirement benefits as if they were delivered through a full career, even if employees do not choose to work for a single employer for this length of time.

The study also analyzes different segments of the population under multiple future scenarios. In doing so, the study addresses which employees may fare best, how plan design influences behavior, and how different future scenarios might impact retirement income.

Key Findings

- **11.0 times pay:** An average full-career contributing employee needs this much at age 65, after Social Security, to expect to have sufficient assets to get through retirement.
- **85% replacement ratio:** The pay replacement needed in the first year of retirement (foundation of 11.0 times pay through retirement).
- **2.2 times pay shortfall:** An average full-career contributing employee is expected to have 8.8 times pay in resources at retirement, leaving this shortfall.

Results

The Real Deal study shows that more employees are on track to retire with adequate retirement income when compared to prior studies. Projected retirement income shortfalls for the Real Deal full-career contributor population have improved on average, although only slightly (now 2.2 times pay, down from 2.4). Some of the reasons for this improvement include strong market returns in 2009 and 2010 (compared to the poor market returns of 2008, at the time of our last study), and continued retirement savings by most employees. Almost 30% of employees are now on track to retire comfortably at age 65.

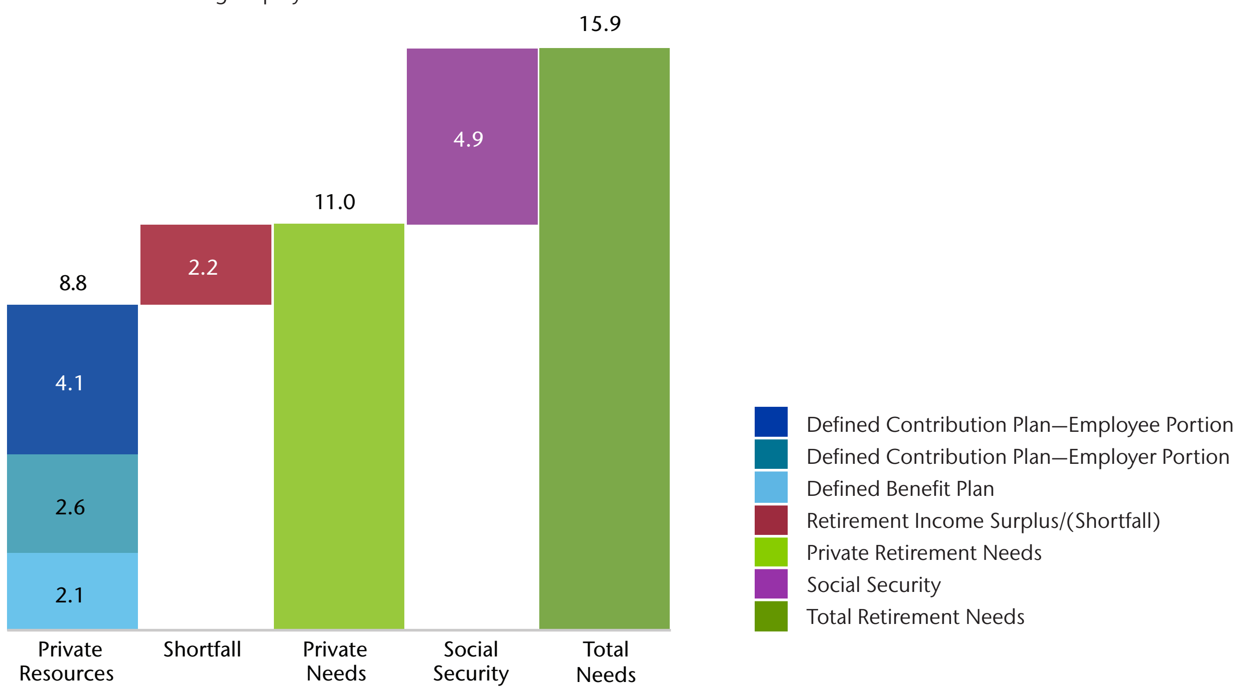
The study projects that the employees who currently contribute to their employers' savings plans and who retire at age 65 after a full career will, on average, accumulate retirement resources of 8.8 times their pay. These resources include accumulations of employee savings in their employers' defined contribution plans (4.1 times pay), accumulations of employers' additions to defined contribution plans (2.6 times pay), and defined benefit pensions (2.1 times pay). The study does not reflect savings or other retirement assets outside of the employer-sponsored plans.

Figure 1

Retirement Resources Versus Needs

Baseline

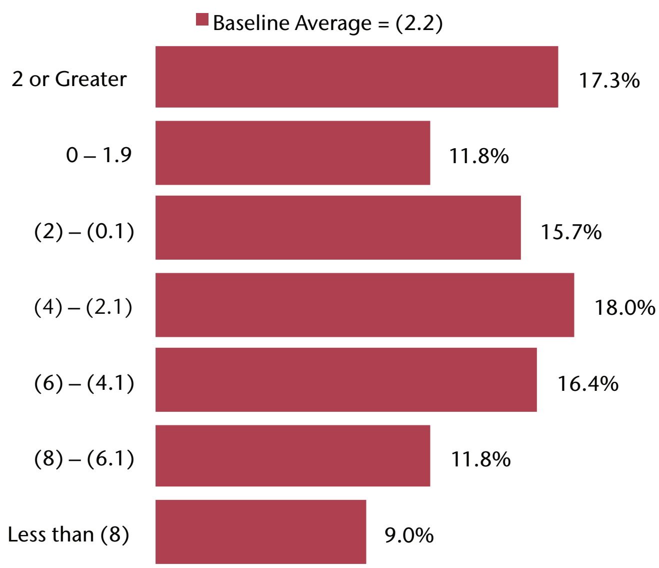
Full-Career Contributing Employees



While significant, these resources fall 20% short of the average projected retirement needs of 11.0 times pay at retirement for these employees. 11.0 times pay represents the retirement resources needed to maintain preretirement living standards throughout an average life expectancy, after reflecting the expected value of Social Security benefits.

In addition to the average 2.2 times pay shortfall, the following graph shows a somewhat broad distribution of results among full-career contributing employees. 29% of these employees are expected to satisfy all of their financial needs through retirement. At the other end of the spectrum, about 21% of employees are expected to have a shortfall of more than 6 times pay at age 65. Individual circumstances such as retirement benefit plan details, individual savings plan behaviors, income levels, and gender all help explain some of the variation in results.

Figure 2
Distribution of Retirement Income Surplus/(Shortfall) Multiples of Final Pay
Baseline
Full-Career Contributing Employees



Full-career employees represent only about half of the total Real Deal population. Projections for the other half of the study employees, including mid-career hires and those not currently contributing to their defined contribution plans, reveal significantly worse results. When analyzing all employees in the Real Deal study, the average shortfall increases to 5.3 times pay. Only about 15% of all 2.2 million employees in the study have positioned themselves to have sufficient resources to meet their needs if they retire at age 65.

Results for the general U.S. population would likely reveal even larger retirement income shortfalls, compared to the results of this study. The Real Deal study uses data from large employers who generally provide larger retirement benefits and more robust employee communication about the need for retirement savings than smaller employers.

Many circumstances have contributed to so many employees being at risk of having insufficient retirement income. Inadequate retirement savings represent the most basic cause of the projected shortfalls. A 25-year-old whose employer provides only a defined contribution plan needs a total annual contribution (employee plus employer) of approximately 15% of pay to retire at 65 with adequate resources. Employers without traditional pensions generally contribute about 6% of pay toward their employees' retirement each year. That means employees need to save about 9% of pay in each of the next 40 years in order to stay on track. According to other Aon Hewitt research, total contributions into defined contribution plans, including employee and employer contributions, comprised 10.2% of pay on average. If employees wait until age 30 to begin contributing, the total annual contribution needed increases to about 19% of pay, highlighting the importance of starting early. Within the entire Real Deal study population, only 1 in 10 under age 30 have 15% of pay or more each year in combined employee and employer contributions.

Saving To Versus Through Retirement

	To Retirement	Through Retirement
Total needs	85%	15.9 times pay
Social Security	29%	4.9 times pay
Private needs	56%	11.0 times pay

"To" retirement is the percentage of preretirement income a person needs in the year of retirement to maintain their standard of living in that year.

"Through" retirement is the multiple of pay a person needs at retirement to keep their standard of living throughout the retirement years.

To understand the findings, readers need to be familiar with how this study defines and calculates "adequate retirement income." The calculation starts by assuming a participant will want to maintain their standard of living after retirement. Building on methodology established in the 1981 President's Commission on Pension Policy, we updated assumptions to reflect key findings from the Aon/Georgia State Replacement Ratio studies. Current income is adjusted for expected changes at retirement: elimination of retirement savings, changes in taxes, and changes in expenditures, including medical costs. Medical costs reflect the 2010 Patient Protection and Affordable Care Act (PPACA) provisions as they stand at the time this report was published. This methodology produces an average need in the first year of retirement of 85% of pay.

The amount needed at retirement age to cover retirement expenses through an average life expectancy (age 87 for males, age 88 for females) is 15.9 times pay. This assumes the cost of goods and services will increase over time as will medical expenses, due to inflation. Since Social Security will pay for some of these expenses, the employee will need to have saved 11.0 times pay at retirement through their employer plans and their own savings.

How Can We Improve Results?

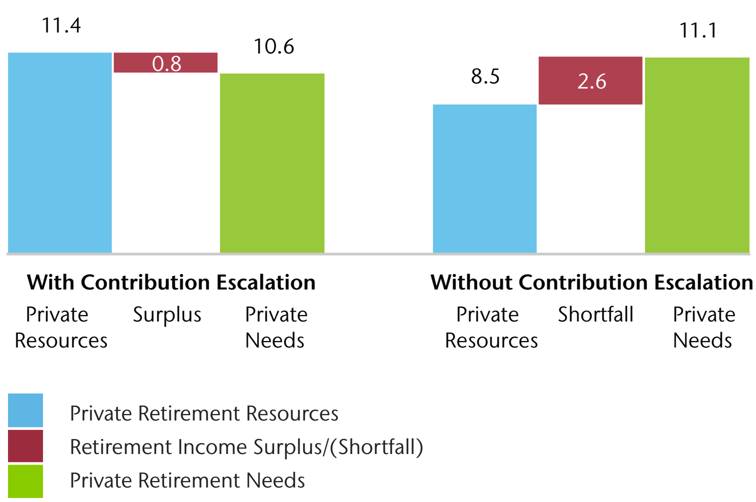
Employers and employees need comprehensive plans to adequately prepare for retirement. Successful employer strategies will likely include, among other tactics, implementing and expanding automatic plan features, offering an array of investment advisory help, and thoughtfully designing plans to motivate and drive optimal employee behavior. Individual employees will need to consider the appropriate retirement age, savings rate, and income distribution solution to achieve a comfortable retirement for their specific situation.

The Real Deal study assesses risks to employers' and employees' strategies, testing the impact of various potential actions. Based on this work, the following actions seem most noteworthy given their potential to directly improve, or substantially mitigate, the risks confronting employees' retirement income adequacy.

Employer Actions

1. **Expand automation.** The 64% of employers who offer automatic enrollment have 15% more employees on track to achieve adequate retirement income compared to employers who do not offer automatic enrollment. Additionally, 53% of the employees who are enrolled in automatic contribution escalation programs are expected to achieve adequate retirement income compared to 26% of those who are not currently automatically escalating their contribution rates. Despite these positive results, employers could do more. Plan sponsors should consider automating their plans using robust defaults. Automatically enrolling employees at 6% of pay (rather than 3%), combined with automatic contribution escalation with a maximum savings rate default equal to IRS-legislated limits (rather than 6% or 10%), can provide a strong foundation for adequate retirement income. Employers should also consider sweeping in eligible non-participants, implementing "quick enrollment," and encouraging automatic escalation through communication initiatives.

Figure 3
Private Retirement Resources Versus Needs
Employees With and Without Automatic Contribution Escalation
Full-Career Contributing Employees



2. **Offer an array of investment advisory help.** A recent Aon Hewitt and Financial Engines Study[1] showed that employees who take advantage of investment help can increase returns by as much as 2% or 3%. The Real Deal study shows that just a 1% difference in future return on assets can increase retirement resources by 2 times pay. Employers should consider offering investment advisory help through an array of alternatives to meet employee needs. These include access to online investment advice, managed accounts, pre-mixed investment alternatives such as target date funds, seminars, personal financial planning, and lifetime income solutions.

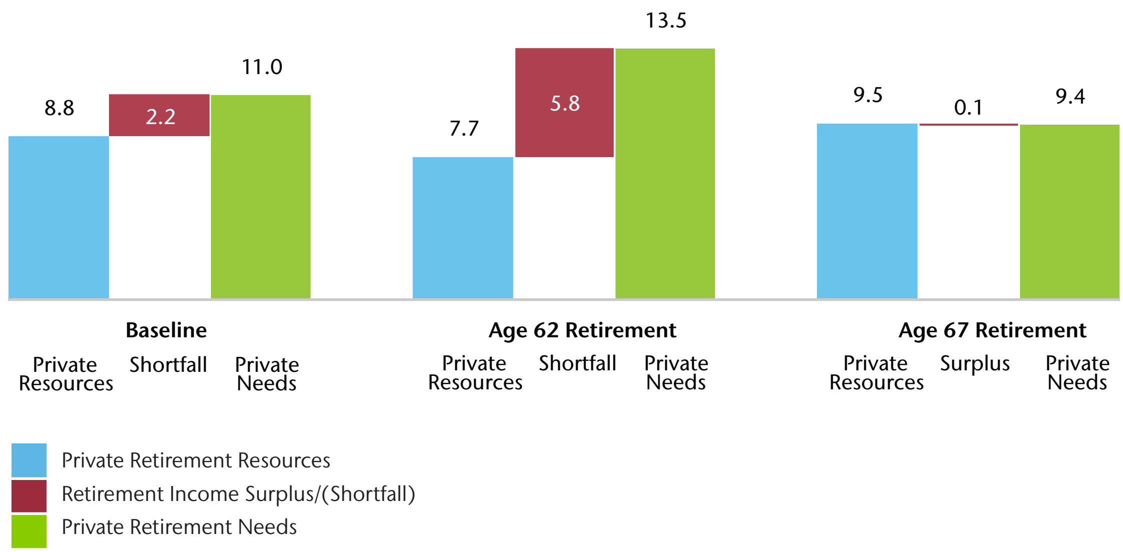
3. **Design plans thoughtfully.** Employers should consider the impact their plan design may have on participant behavior. Many employees choose to save at the maximum match rate in their retirement plan. For example, if the plan matches 100% on up to 6% of pay, many employees save 6% of pay, even though this is below the rate needed to deliver adequate retirement income. The study demonstrates that if low-savings employees increase their savings rate to the maximum match rate in their employer's plan, they would still face an average shortfall of 1.5 times pay.

1 "Help in Defined Contribution Plans: 2006 Through 2010", September 2011 by Financial Engines and Aon Hewitt.

Employee Actions

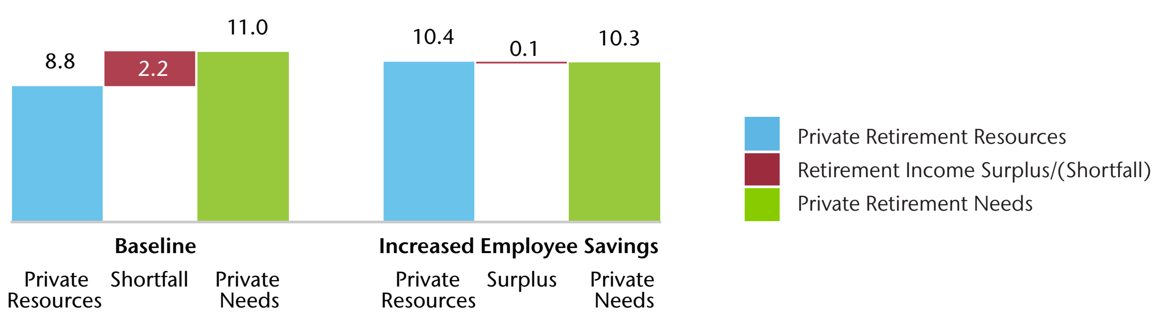
1. **Retire later.** The Real Deal analysis shows that deferring retirement to age 67 allows almost 50% of employees to achieve adequate retirement income compared to 29% of employees when retiring at 65. Retiring later improves the outcomes in two ways. It allows extra contributions and investment returns to grow for two more years. At the same time, it reduces retirement needs by shortening the period over which resources will need to be spread. However, many employees actually end up retiring before age 65 and often before they had planned to retire. Early retirement both curtails savings opportunities and increases retirement needs.

Figure 4
Private Retirement Resources Versus Needs
Age 65 (Baseline), Age 62, and Age 67 Retirement
Full-Career Contributing Employees



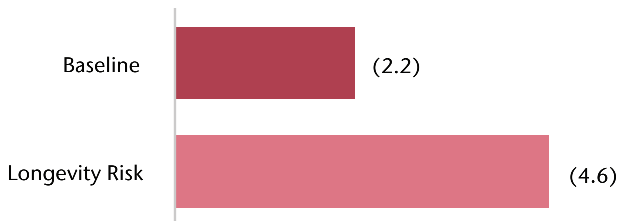
2. **Save more.** As employers reduce their retirement benefit programs, employees need to increase their focus on personal savings. Increasing the savings rate by just 1% of pay each of the next 5 years, and then maintaining that higher savings rate until retirement, will allow the average employee to retire at age 65 with adequate income. Increased savings drives significant improvement for younger employees, and somewhat limited change for those closer to retirement. A median combined employer and employee contribution rate of 17% of pay produces adequate retirement income for all current full-career contributors (some of whom have pension benefits).

Figure 5
Private Retirement Resources Versus Needs
Baseline and Escalation of Savings Rate 1% for 5 Years
Full-Career Contributing Employees



3. **Manage income efficiently through retirement.** A retiree self-managing the distribution of their retirement assets will likely need to plan for a period longer than the average life expectancy or they will face a 50% risk of running out of money. In order to cut the risk from 50% to only 20%, an employee must save an additional 2.4 times pay, which would cover roughly six additional years in retirement. Many would argue group-insured lifetime income products, with features such as minimum monthly benefits and preservation of principal, provide more efficient protection than self-insuring against longevity risk.

Figure 6
Retirement Income Surplus/(Shortfall)
50th Percentile (Baseline) and 80th Percentile Life Expectancy
Full-Career Contributing Employees



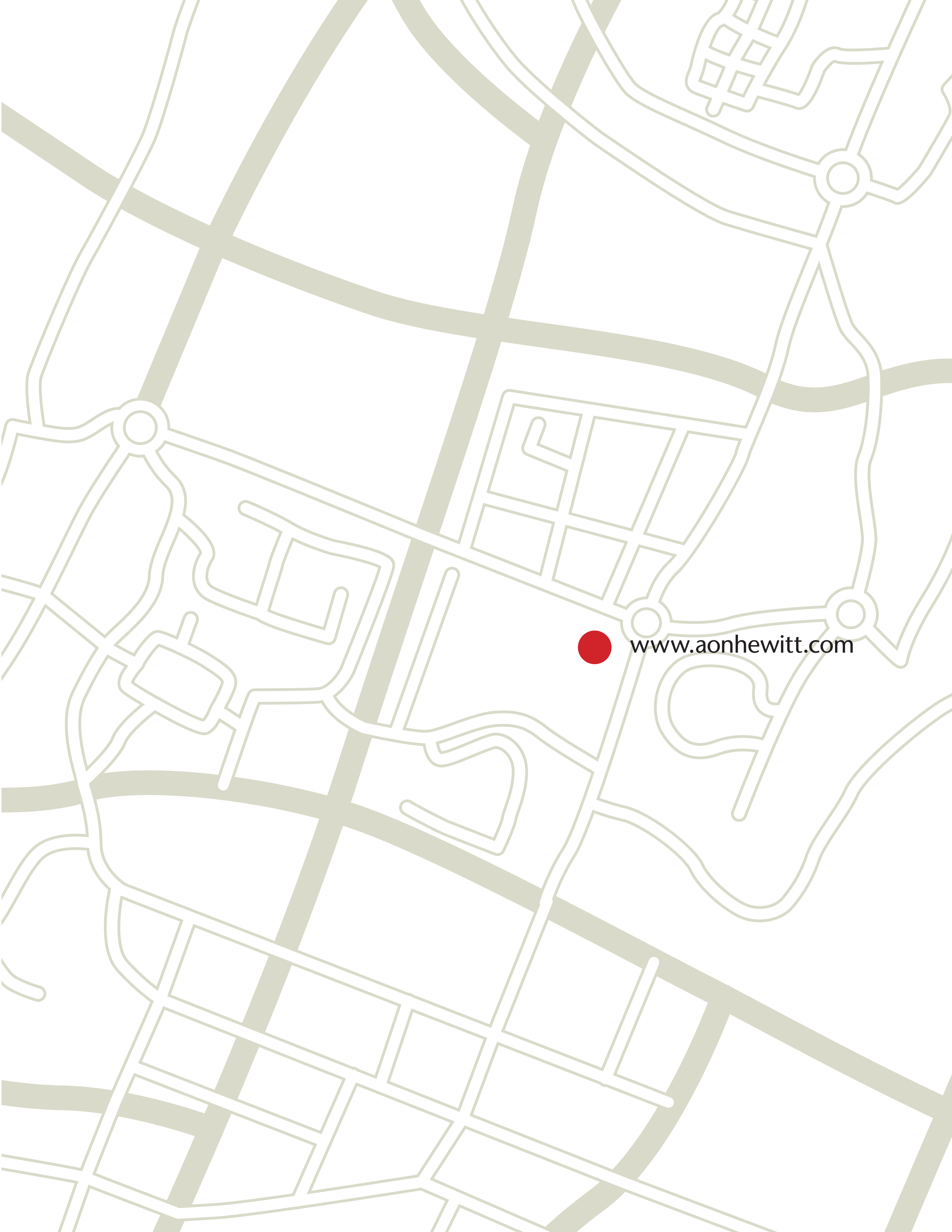
Conclusion

The results of this study provide an indication of how well employees at large companies are preparing for retirement. Results have improved slightly compared to prior studies, because of factors such as strong asset returns and continued employee savings for retirement.

The study indicates employees who save for retirement over long periods of time and who invest appropriately can accumulate benefits that are reasonably close to what they might need to maintain their preretirement standard of living during retirement. However, the study also indicates that approximately 70% of full-career contributing employees are not on track to retire with adequate financial resources.

Specific future action steps should improve the projected results. Most importantly, employers can expand their use of automation (to get more money in the system) and the defaults associated with automated features, help employees improve their results through an array of investment advisory help, and pay careful attention to their retirement plan design. Employee actions include targeting a realistic retirement age, saving at robust rates, taking advantage of financial help when offered, and seeking lifetime income solutions. Other action steps, beyond the specific details of this report, include minimizing leakage (e.g., retirement plan loans and withdrawals), and increasing retirement plan communications.

The ability to improve retirement readiness in the U.S. will require a concerted effort by all stakeholders. There are many ways for employers and employees to address the risks of retirement adequacy. Important future initiatives include employers measuring and monitoring the projected results for their workforce, focusing on the key influencing factors such as automation, investment help, and plan design, while increasing awareness and promoting employee action through personalized communication. Ideal solutions will improve outcomes with little or no increase in employer cost.



www.aonhewitt.com

About Aon Hewitt

Aon Hewitt is the global leader in human resource solutions. The company partners with organizations to solve their most complex benefits, talent and related financial challenges, and improve business performance. Aon Hewitt designs, implements, communicates and administers a wide range of human capital, retirement, investment management, health care, compensation and talent management strategies. With more than 29,000 professionals in 90 countries, Aon Hewitt makes the world a better place to work for clients and their employees.

For more information on Aon Hewitt, please visit www.aonhewitt.com.

AON Hewitt