Hewitt

Research Highlights

Retirement Income Adequacy at Large Companies: The Real Deal
2010

Retirement Income Adequacy

Retirement income adequacy has become a hot topic for large employers and their employees. Employers realize they face serious workforce issues if employees fail to adequately prepare for retirement. Employees increasingly concede their responsibility in preparing for retirement, yet often do not take the steps needed to adequately prepare. Government officials see the dramatic changes in the retirement system and question whether employees will accumulate enough resources to retire. The key question remains, "Will employees have enough money to retire, and under what standard of living?"

Hewitt's Real Deal study answers this question by projecting retirement resources and needs for 2.1 million employees of 84 large employers. The study begins by analyzing baseline results for full-career contributing employees, where "full career" is defined as those with the potential to work 30 years or more with their current employer. This allows analysis of the theoretical potential for delivering adequate retirement income through the plans and savings behaviors of today's environment.

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

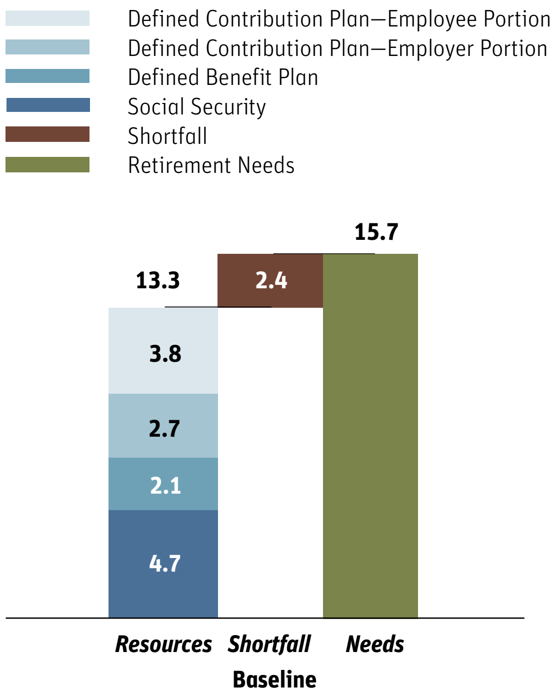
Key Findings

- Employees who contribute to their savings plans over a full career are on track to have retirement resources of 13.3 times pay at retirement age, 15% short of their retirement needs of 15.7 times pay.
- The shortfall grows to 32% when including all employees (both contributors and noncontributors).

Baseline Results

Outcomes for the employees who currently contribute to their employer's savings plan and who could work a full career at their employer, projected using reasonable assumptions, serve as the study's baseline results. The study projects that these employees can expect to accumulate retirement resources of an average 13.3 times their pay upon retirement at age 65. These resources include accumulations of employee savings in their employers' defined contribution plans (3.8 times pay on average), accumulations of employers' additions to defined contribution plans (2.7 times pay on average), defined benefit pension benefits (2.1 times pay on average), and Social Security (4.7 times pay on average).

Figure 1—Retirement Resources Versus Needs—Baseline (Full-Career Contributors)



While significant, these resources fall 15% short of the average retirement needs of 15.7 times pay at retirement these employees are projected to require to maintain their preretirement living standards throughout their postretirement lifetimes. In other words, employees are able to meet about 85% of their predicted retirement income needs at age 65 under the baseline case. Employees saving for retirement will require retirement resources of about 11 times pay at retirement in addition to Social Security (15.7–4.7), on average.

Retirement needs reflect preretirement income levels with adjustments for differences in tax rates, preretirement savings rates, and post-retirement inflation. Retirement needs also capture the difference in medical costs before and after retirement. The 15.7 measure of average needs reflects an explicit assumption that employees will bear the cost of post-retirement medical care, and that medical costs will increase at a rate greater than general inflation. Employees who fail to accumulate adequate resources will likely be forced to work longer or accept a somewhat lower standard of living in retirement.

There is a fairly wide distribution of results among full-career contributing employees. About 190,000 employees (18%) are expected to satisfy 100% of their needs at retirement while about 200,000 employees (19%) are expected to have a shortfall of more than five times pay at retirement age. These differences are largely attributable to individual factors such as the retirement plans in which they participate, their savings plan behaviors, and their gender.

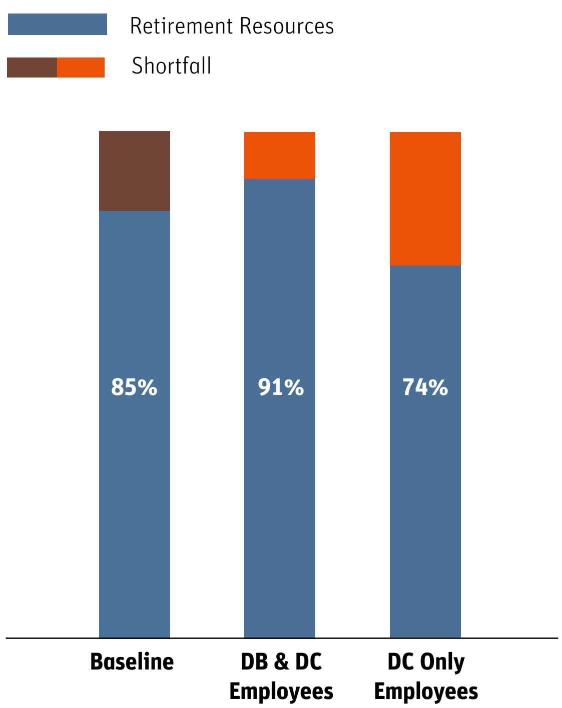
The report uses roughly one million full-career contributing employees as a baseline; not because employers expect employees to stay with the same employer for 30 years or more, but because this approach avoids possible skewing of results due to lack of information about prior employer benefits.

Retirement Plans

The average employee with only a defined contribution retirement plan is not projected to achieve the same level of retirement resources as an employee covered by both defined benefit and defined contribution plans. This is because

DC-only employees tend to participate less and save less (as a percentage of pay) compared to their counterparts who are covered by a pension plan. The average shortfall for employees with access to a defined benefit plan, whether frozen or not, is only 1.4 times pay at retirement age, compared to a shortfall of 4.3 times pay at retirement age for employees with access to only a defined contribution plan. As more employers shift to a DC-only retirement strategy, future generations of retirees may not be positioned to achieve the same levels of retirement resources as their predecessors.

Figure 2—Percentage of Retirement Needs Met—Defined Benefit Versus Defined Contribution



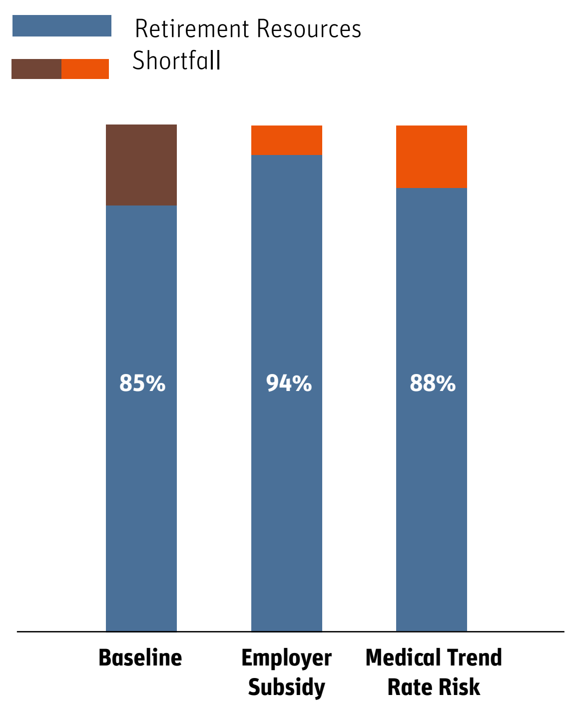
Retiree Medical

Retiree medical costs make up an average of 20% of retirement needs. This study assumes retirees will have access only to group medical plans from their prior employers, without any company-provided subsidy. This study also assumes no significant changes will occur in the current health benefits environment.

If an employer subsidizes 50% of the cost of the retiree medical plan premiums, the retiree's shortfall would decrease significantly and the average retiree would be very close to retirement income adequacy. Although employer-subsidized retiree medical is declining in prevalence, some employers continue to offer this type of benefit to current employees, and access to this subsidy can significantly increase retirement preparedness. To illustrate, if an employer provides a subsidy worth 50% of the plan cost, the percentage of needs met would increase from 85% to 94%, on average.

As health care policy changes over time, it is possible medical costs will increase at a rate lower than currently expected. In order to demonstrate this, a 0.5% decrease in medical trend would decrease future needs. As a result, this would increase the average percentage of needs met from 85% to 88%. While a slightly

Figure 3—Percentage of Retirement Needs Met—Retiree Medical Influences



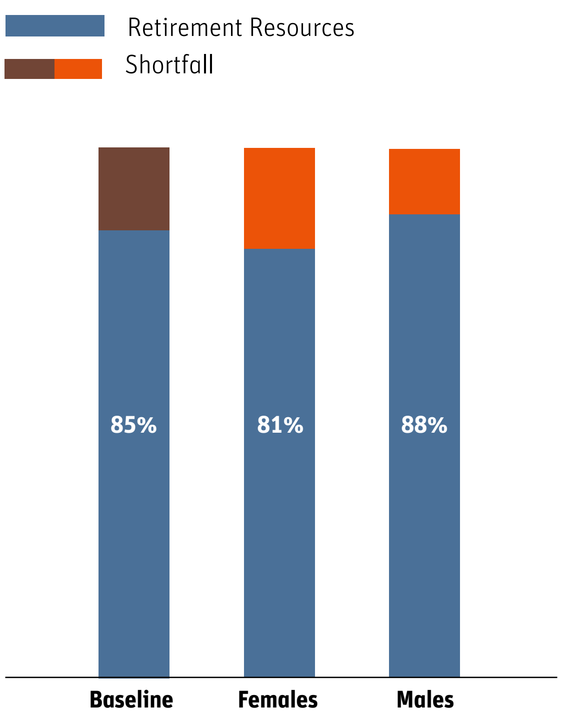
lower trend rate can help retirees reduce projected retirement income shortfalls, the sensitivity demonstrates it will take a significant shift in health care policy to make up for the loss of employer-provided retiree medical subsidies.

The passage of national health care reform was occurring while this report was being drafted. As indicated, retiree medical costs are a significant part of retirement needs. The future direction of health care in the U.S. marketplace, both in terms of availability and cost to retirees; the impact on taxation before and after retirement; and the impact on future medical cost trend will have an impact on the results of this study.

Gender Differences

Females and males in our study have similar age, service, and savings profiles. However, females tend to have lower pay and smaller account balances. The average projected shortfall for women is higher by 1.3 times pay at retirement (3.1 times pay for females versus 1.8 times pay for males). The primary reasons are females' lower pay and additional life expectancy of about two years (10%) over a typical male's life expectancy at age 65.

Figure 4—Percentage of Retirement Needs Met—Gender Differences



Behavioral Changes

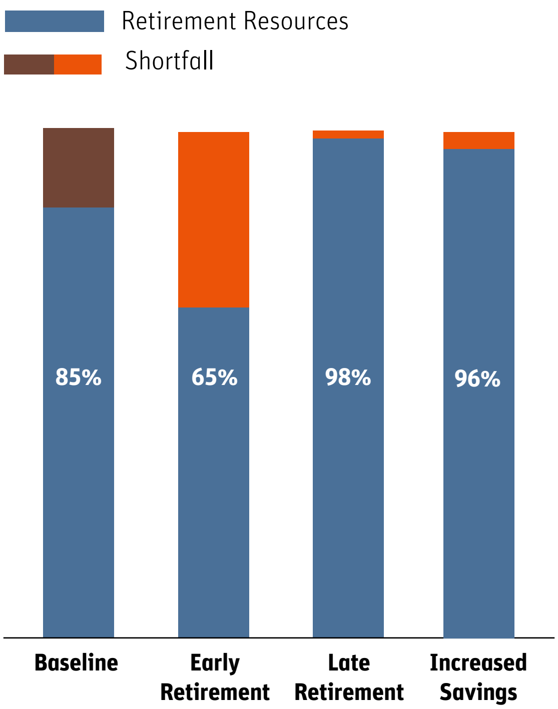
Employees control a number of elements that will help determine their retirement outcomes.

- Early retirement (age 62) significantly increases the shortfall employees will see at retirement due to fewer years of savings, the increased cost of medical care before Medicare eligibility, and increased years over which to spread retirement resources.

- Late retirement (age 67) significantly improves projected retirement income adequacy. On average, employees come very close to having sufficient resources to meet all their needs by working two additional years. This is due to extra savings accumulation, increased Social Security benefits, and fewer years over which to spread retirement resources.

- Besides retiring later, saving more has the biggest positive impact on future adequacy potential. If employees increased their savings rates by 5% of pay, their shortfall would be reduced to 0.6 times pay at retirement for full-career contributing employees, meeting 96% of retirement income needs.

Figure 5—Percentage of Retirement Needs Met—Behavioral Changes



Risks to Retirement Income Adequacy

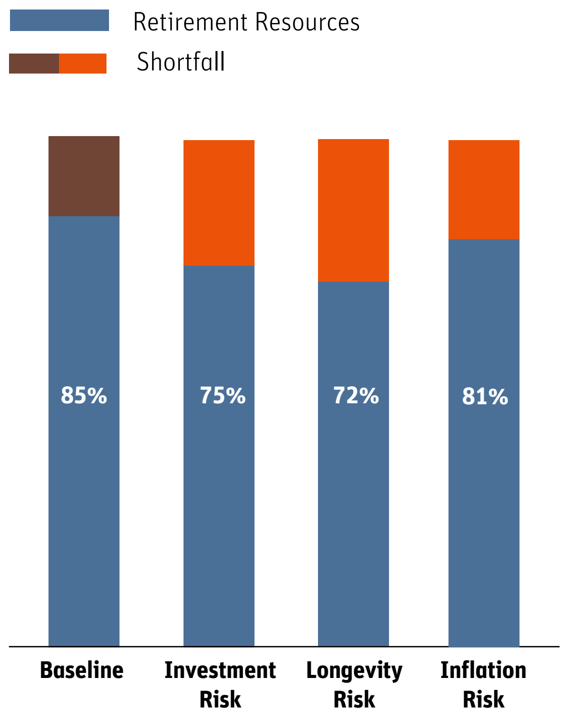
Employees face many risks, both as they prepare for retirement as well as through their retirement years. This study highlights three key risks: investment risk, longevity risk, and inflation risk. Each of these risks can seriously impact retirement income adequacy.

Investment risk measures the impact of a decrease in pre- and postretirement returns of 1% per year.

Longevity risk measures the financial risk of living longer than an average lifetime. To illustrate, we have extended the employee's expected lifetime from the 50th percentile lifetime (86 for females and 84 for males) to the 80th percentile lifetime (93 for females and 91 for males).

Inflation risk measures the impact of an increase in postretirement inflation of 0.5% per year. Inflation erodes a retiree's purchasing power, and the percentage of needs met drops accordingly.

Figure 6—Percentage of Retirement Needs Met—Investment, Longevity, and Inflation Risks



Other Employee Groups

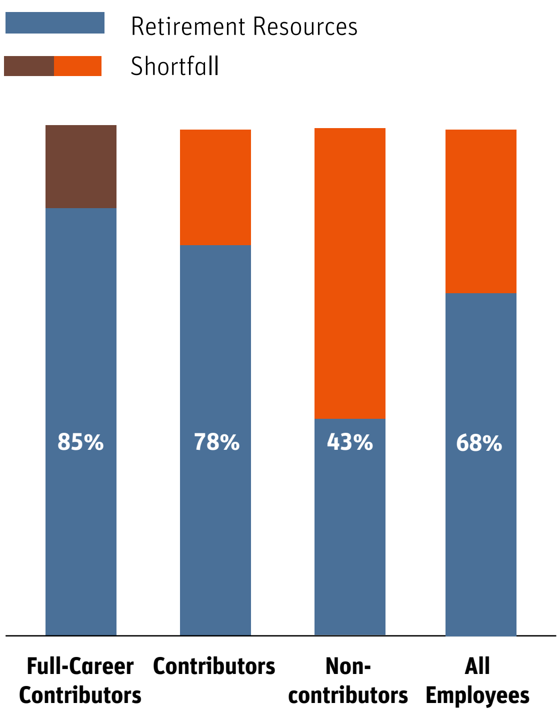
In addition to full-career contributors, the study analyzes results for other employee groups.

- All contributing employees, including mid- and late-career hires, are projected to have 78% of retirement needs met. For companies who have a lot of employees hired in mid- or late career, this analysis may be particularly relevant. Note that to the extent mid- and late-career hires keep benefits earned at other employers for retirement, they have better incomes than are reflected in these projections.

- Not surprisingly, noncontributing employees' resources are projected to total only 43% of needs. These employees will have to drastically change their behaviors, work far longer than their peers who are contributing, and/or significantly decrease their standard of living during retirement.

- All employees in the study are projected to have 68% of their retirement needs met, on average. This analysis gives employers the best view of retirement preparedness for employees overall.

Figure 7—Percentage of Retirement Needs Met—Population Segments



Conclusion

The importance of achieving retirement income adequacy in the U.S. cannot be emphasized enough. The results of this study can be viewed as an indication of how well employees at large companies might be prepared for retirement. In comparison to the prior Hewitt Real Deal studies, the retirement readiness of employees has not changed substantially—even given the significant market adjustments experienced recently.

By analyzing full-career contributors, the study indicates employees who actively save for retirement over long periods of time and who invest to achieve a reasonable investment return can accumulate benefits from employer plans and Social Security that are reasonably close to what they might need to maintain their preretirement standard of living during retirement. However, the study also indicates that only 18% of full-career contributing employees are on track to have adequate retirement resources.

While the study assumes the status quo on plan design and on employees' saving and investing behaviors, opportunities exist to use the results and improve the retirement readiness of future employees. By analyzing various risks and behavioral changes, the study indicates strategies that should improve retirement readiness for employees in the future. For example, employees retiring at age 67 should have a far greater chance of retiring with sufficient assets, versus those retiring at age 65 or earlier.

The ability to improve retirement readiness in the U.S. will require a concerted effort by all stakeholders. Employees can take a number of actions to improve their retirement outcomes—such as working longer, saving more, resisting loans and withdrawals of retirement assets, and investing more efficiently. Employers can review the adequacy of their plans and consider changes that would increase benefits or improve employee behavior. Government can provide a regulatory environment for benefits that encourages employers to invest in retirement plans and deliver adequate retirement income for life to employees.

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