RETIREMENT SECURITY

A Discussion with Alicia H. Munnell

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I&WM: How do you define "retirement security"? What are the key assumptions underpinning that definition (e.g., longevity, age of retirement, etc.) and is there advice you would offer those saving for retirement?

Munnell: Retirement security is the ability for a household to maintain its pre-retirement standard of living. The National Retirement Risk Index, produced by the Center for Retirement Research at Boston College, shows that half of households will fall short of meeting this standard when they retire. This outcome assumes that they retire at 65 and that they annuitize all of their financial wealth plus the proceeds of a reverse mortgage on their house. Thus, it is not a "Chicken Little" exercise; the assumptions are optimistic in that people, on average, actually retire before 65 and most do not annuitize their financial assets or take a reverse mortgage. Hence, people need to save more, work longer, and consider using their home equity.

I&WM: How does the decumulation stage of retirement differ from the accumulation stage and what additional advice would you provide retirees and those considering retirement? How does the seemingly perpetual rock-bottom interest-rate environment change your response?

Munnell: Decumulation is much harder than accumulation. People know how long they have to accumulate money, but they do not know how long they have to draw down their retirement assets. I used to worry that people would spend down their assets too quickly and run out of money. More recently, I am more concerned about the opposite problem—that they will cling to their nest eggs and unduly restrict their standard of living in retirement.

One way to solve this problem is to purchase an annuity. Our favorite type of annuity is an advanced life deferred annuity (ALDA), whereby the individual purchases the product at age 65 and the payments begin much later, say age 85. This arrangement allows people to consume all of their non-annuitized assets between 65 and 85 because they know they will have the annuity income kicking in once they reach 85. In short, it protects them against outliving their resources and this protection is relatively inexpensive compared to an immediate annuity.

Rock-bottom interest rates increase the importance of thinking about an annuity because it is impossible to get much income out of accumulated balances otherwise.

I&WM: It is often quoted that retiree spending needs drop dramatically in retirement. Is this a valid assumption? If so, why do you profess the elderly need a separate price index?

Munnell: Required resources do drop in retirement because households no longer have to save for retirement, have no more work-related expenses, no longer pay payroll taxes, and—in most cases—have paid off their mortgage. For this reason, financial experts generally suggest that retirees need about 70–75 percent of their pre-retirement income to maintain their standard of living after they stop working.

This drop in the required level of consumption is really unrelated to the price increases that retirees face on the goods and services that they do consume. The traditional argument for a separate price index is that healthcare costs, on which the elderly spend a disproportionate amount of their budget, have been rising faster than other goods. Recent evidence, however, shows that the overall Consumer Price Index for the elderly (CPI-E) and the CPI for the general population are very close, so I don't view this discrepancy as a burning issue.

I&WM: Is a checklist worthwhile when someone is considering retirement (or will be retiring imminently)? If so, what are the biggest mistakes you think retirees make, and could you provide a 10-point checklist of items to consider?

Munnell: I would offer a three-point checklist. The biggest decision is when to claim Social Security. Would-be retirees should ask themselves whether they could delay claiming Social Security until age 70, when they receive their maximum monthly benefit. They could either: (1) keep working until 70; or (2) retire earlier but delay claiming Social Security until 70 by using some of their 401(k) savings to support themselves. The second biggest issue is how to draw down accumulated savings. The choice is either buying an annuity, again preferably an ALDA, or using some rule of thumb. For a rule of thumb option, our work has shown that the IRS Required

Minimum Distribution rules are actually a fairly good guide to follow for drawing down assets. The third issue is for households to consider their home as part of their retirement income portfolio. Tapping home equity—either through downsizing or a reverse mortgage—is an important way to increase monthly income.

I&WM: How is retirement for today's boomers different from their parents who preceded them, GenXers, or millennials (with the overhang of student debt, etc.) who will follow in the future?

Munnell: Increasingly, people are retiring entirely dependent on 401(k) plans rather than on traditional defined benefit pensions. These new arrangements mean that people have to worry about investment risk and the potential of outliving their resources, risks that were borne by the employer in a defined benefit world. At the same time that today's workers are facing a shift in the nature of employer-provided plans, they also will face declining Social Security replacement rates as the program's "full retirement age" continues its gradual increase from 65 to 67. In addition, health-care costs are high and rising and people are living longer. Finally, for millennials, student debt is an additional concern because it can delay when they begin saving for retirement and when they buy a house.

I&WM: What impact could the large unfunded deficit for public sector plans have on state/municipal workers and taxpayers? In what ways could the deficit change how state workers think about retirement savings and what should our legislators be doing today to limit those effects?

Munnell: In the aggregate, state and local government pension plans have assets to cover about three quarters of their promised liabilities. Some plans have higher funding levels; others have lower levels. In the wake of the financial crisis, many states have reduced cost-of-living adjustments, raised employee and employer contributions, and reduced benefits for new employees. In the end, the core benefits for current workers and retirees are guaranteed and will have to be paid by taxpayers. New hires with reduced benefits may well decide to save more than their older counterparts who have a more generous pension plan.

I&WM: The Obama administration has proposed state-based retirement plans for the private sector that would not be subject to the Employee Retirement Income Security Act of 1974. What are your views on this offering?

Munnell: At any given point, about half of private sector workers are not covered by a retirement plan in their workplace. Therefore, covering the uncovered is a major priority and one that should be addressed at the federal level through a national automatic individual retirement account program. But, given the lack of action at the federal level, the state initiatives are essential and should be encouraged. The Obama administration's attempt to clear away the regulatory underbrush should enable these initiatives to move forward.

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