Managing Retirement Payouts:
Positioning, Investing and Spending Assets

Pension Research Council

July 2007

PRC WP2007-16
Pension Research Council Working Paper
Pension Research Council
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This Pension Research Council Working Paper represents a summary of presentations at the Wharton Impact Conference sponsored by the Wharton School's Pension Research Council and Boettner Center for Pensions and Retirement Research, April 2007. Conference co-hosts were John Ameriks and Olivia S. Mitchell. For further information see http://www.pensionresearchcouncil.org/conferences/conf-2007.php. Conference assistance by Susan Warner is appreciated.

Managing Retirement Payouts: Positioning, Investing and Spending Assets

At a recent Wharton Impact conference hosted by the Pension Research Council, an energetic cast of academics, financial experts, regulators, and plan sponsors explored how to help retirees better manage their saving and spending during their golden years.[1] Co-sponsored by The Boettner Center for Pensions and Retirement Research and held at The Wharton School, the event included speakers who evaluated emerging patterns in retirement spending and discussed how to shape new products to help retirees overcome personal finance hurdles.

Economics, finance, taxes, regulation, and human behavior come into play as people seek to develop strategies for disbursing retirement saving, affirms Olivia S. Mitchell, the International Foundation of Employee Benefit Plans Professor of Risk Management, Executive Director of the Pension Research Council, and Director of the Boettner Center. “It’s high time to turn our attention to the decumulation phase of retirement security,” says Mitchell. “Our focus now is forward-looking. How do and how should people think about spending and managing their retirement portfolios during the payout phase?”

The Role of Work in Retirement

Recent trends in retirement play into this picture, as many retirees have returned to some level of paid employment, according to Sewin Chan, Associate Director of Public Policy in the Robert F. Wagner Graduate School of Public Service at New York University. Her work with Ann Huff Stevens, Associate Professor of Economics at the University of California, Davis,

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[1] The research reported here is expected to be published in a refereed volume in 2008. Presentations may be found at http://www.pensionresearchcouncil.org/conferences/conf-2007.php.

indicates that increasingly, retirees are continuing to work even after they officially leave their main jobs. Data from the Health and Retirement Survey show that one-third to half of all workers who partially or fully retire make at least one transition back into the workforce.

“When we think about retirement the traditional path went something like this: work… work… work… retire,” remarks Chan. “But many people now take a more gradual retirement and reduce the amount they work before making the permanent exit from the workforce. Also, there are people who reverse their retirement and go back to the labor force after they exit.” Accordingly, patterns of retiree savings and investment are now shaped by the possibility of a post-retirement return to some level of employment.

“Someone might be willing to take on a riskier portfolio in early retirement knowing he can return to the labor market after a while,” indicates Chan. For many retirees, these so-called “bridge jobs” might last as long as five years, and one-quarter of HRS respondents describe themselves as partially retired. Those who are partially retired work a median of 16 hours a week and 40 weeks a year, according to Chan. She and her colleague also find that, during 1992-2004, about one in eight retirees reversed their retirement status between each biannual HRS. Of those who ever fully retired, seven percent reversed their status to “not retired,” and 19 percent reversed their employment status to partly-retired. Of those who were ever partly-retired, some 30 percent reversed to “not retired;” among persons ever fully or partly-retired, 31 percent said they had become “less retired.”

Chan also outlines key characteristics of retirees who reverse their retirement status: they tend to be younger retirees, married to a non-retired spouse; they are also non-white, in good health, with low financial wealth, and have had many past jobs. These retirees who return to work also report that they did not prefer retirement to the years during which they were working.

Chan intends next to assess why people return to work, particularly when the retirement reversal appears to be unanticipated. Future research must also examine whether retirees return to work due to having underestimated how much retirement resources they will need.

The Retirement Consumption Puzzle

Recently, researchers have described a so-called “retirement consumption puzzle:” compared to pre-retirement, household spending levels have been found to drop 10-20 percent after retirement. Some interpret this to mean that households fail to save enough for their post-work years. Taking a contrary view is Erik Hurst, Professor of Economics at the University of Chicago’s Graduate School of Business. Hurst argues that consumption is a more important indicator of the adequacy of retirement savings, because it reflects actual behavior. He states that “consumption is a proxy for utility and is more informative than whether people attain a made-up target for how much wealth they need at retirement.”

A closer look at the categories in which spending declines suggests most employees are setting aside a reasonable amount of savings for retirement, according to Hurst. He compares non-retired 61-65 year olds to retired 66-70 year olds, and finds that the value of their food consumed at home drops 8 percent and food away from home falls 16 percent. Yet total out-of-pocket expenditures decline much less, only by 3 percent, and overall consumption by 1 percent. This is confirmed by international studies from Italy and Britain, along with his own US research that indicates much of the decline in spending by retirees is due to work-related expenses, primarily transportation, clothing, and food consumption. Looking more closely at food consumption, he finds that retirees shift spending on food consumed outside the home to the production of food at home. Food diaries kept as part of the research reveal most retirees are not eating less, but instead are simply preparing food more economically at home. Meanwhile, entertainment expenditures actually increase slightly, he notes. “They’re eating out less but they’re still going to the golf course as much,” he says.

Hurst next examines heterogeneity in expenditure declines based on the value of pre-retirement wealth. He finds that much of the concern about the “retirement puzzle” may be overblown, but there remains a significant portion of retirees – perhaps 25 percent – who are struggling to maintain spending levels after leaving the workforce. Again using data on food expenditures, Hurst concludes that those in the bottom quartile of pre-retirement wealth reported expenditure declines of 31 percent. At the same time, households in the second, third, and top pre-retirement wealth quartiles experienced declines of only 14 percent, 14 percent, and 9 percent respectively. Declines among wealthier retirees are in line with what might be expected in a standard lifestyle model, he argues, but the sharp decline among those in the lowest quarter may indicate those retirees are actually living with less food. The gap between pre- and post-retirement spending is too large to be explained by increased home production of meals.

Hurst also raises concerns about the impact of unexpected retirements, perhaps due to health problems or other shocks, on retirement expenditures. He cites research showing that nearly 30 percent of households report that an adverse health shock was at least moderately important in a decision to retire. Then he marshals additional evidence indicating that those experiencing a health shock are forced to cut back on spending in retirement. According to survey data, 68 percent of those who retired early as a result of bad health cut back on food spending compared to 48 percent who did not retire unexpectedly.

“The average household seems to plan well,” Hurst concludes. “Yet there is a segment – perhaps upwards of 25 percent -- that don’t plan well and do experience a decline, maybe as a result of a health shock. The focus should be on understanding who these households are and what they're about."

Individual Retirement Accounts

As Baby Boomers cross the retirement threshold, they are increasingly being asked to manage the drawdown process from their Individual Retirement Accounts (IRAs). Sarah Holden, Senior Economist and head of the Retirement, Tax and International Research Division of the Investment Company Institute (ICI) offers observations on this topic prepared with Brian Reid, ICI's Chief Economist. It is useful to note that IRAs are now valued at $3.7 trillion in the US, accounting for one-quarter of all retirement saving (up from 10 percent in 1985). As Holden notes, "The action is in rollovers. The bulk of rollovers from defined benefit plans and defined contribution plans end up in IRAs."

It is not surprising that older taxpayers hold the largest share of IRA assets; they peak for persons age 70-74 at over $124,000. Indeed, taxpayers over age 60 account for only 30 percent of total taxpayers but account for 56 percent of IRA assets. To date, IRA withdrawals have been small: in 2004, for instance, withdrawals accounted for only four percent of IRA assets. Tax rules impose a 10 percent penalty for withdrawing IRA funds before the age of 59½, so most people wait; indeed, 45 percent wait to tap them after retirement. Additional exemptions are added for first-time homeowners, medical expenses, higher education expenses, reservists and taxpayers affected by recent natural disasters. Generally IRA withdrawals must begin by age 70½.

Holden and colleagues have developed a model to estimate the probability of IRA withdrawals using a variety of datasets. Their projections show that current IRA withdrawal trends will continue, with higher withdrawals when the head of the household is older, nonwhite or Hispanic, or less educated. Withdrawals are also more likely in households with a mortgage compared to those that rent their homes or own them outright. “Even in the wake of several years of exemptions being in place, we still see very few households tap their IRAs prior to retirement,” said Holden.

Retirement Lockboxes

A novel idea to manage retirement savings would rely on investment “lockboxes,” proposed by a team headed by William F. Sharpe, co-founder of Financial Engines and an emeritus Professor of Finance at Stanford University’s Graduate School of Business who received the Nobel Prize in Economic Sciences for his work in developing models to aid investment decisions. Sharpe focuses on efficient retirement financial strategies along with Jason S. Scott, Vice President of Investment Analysis and Research, and John G. Watson, Fellow at the Retirement Research Center, both from Financial Engines.

Sharpe argues that his work challenges accepted rules for retirement saving and disbursement used by financial planners. For example, the “4 percent rule” has retirees spend four percent of initial wealth every year, assuming funds are invested with a constant percentage in equities ranging from 50 to 75 percent. His team shows that this formula is quite inefficient, volatile, and can lead to bankruptcy or large surpluses. He notes that he evaluated a range of “rules of thumb” offered by financial counselors, “and to be perfectly frank, we didn’t like much of what we saw.” This is because traditional strategies break retirement financial security into two segments: an investment strategy and a spending policy. But “these really need to be interlocked and integrated. To the extent they are not, you can get results that are not as good as your client deserves."

In response, Sharpe's team is developing an optimization strategy leading to maximum utility for clients planning for retirement while avoiding unnecessary market risk. His model proposes a one-to-one correspondence between investment and future spending, resulting in what he calls a "lockbox spending strategy." In this approach, fractions of initial wealth are allocated to virtual accounts or so-called lockboxes. The money in each lockbox would be independently invested, and each year the retiree would spend only the contents of that lockbox designated for that year. Each lockbox would represent a set amount of wealth and an investment rule which can be dynamic. "The point is each lockbox has a strategy which is efficient *vis a vis* its year of maturity," explains Sharpe. "Therefore the whole thing is efficient."

The lockbox concept, in the authors' view, protects against age-related problems in savings and retirement spending. "The lockbox maximizes my expected utility at my current age versus 20 years older -- or dead. I don't want to wait until I get there, because I'll be drooling and I won't know what utility is. The approach allows me to think now about the future me, and act *in loco parentis* for my senile and elderly self."

In commenting on the approach, Stephen P. Zeldes, Benjamin Rosen Professor of Economics and Finance at Columbia University, notes that the model should be extended to include non-traded assets and risks, such as uncertain labor income and housing. Yet he applauds the melding of economics with financial planning in devising strategies for retirement security. "There is huge opportunity for financial economists to use rigorous and realistic models, to work with financial planners to translate and transmit these ideas to the public. We have not done enough of this," he argues. "Academics have been off in their orbit spinning complex models and the practitioners have been off doing their best to explain them. There is surely scope to integrate these."

Variable Annuities and Investment Risk

Much excitement surrounds research on retirement risk management, including work by Moshe A. Milevsky, Associate Professor of Finance at York University in Canada, and Vladyslav Kyrychenko, doctoral student at the Schulich School of Business at York University. Milevsky points out that the market for variable annuities has become a $1.2 trillion industry. In their work, the authors use LIMRA data to examine the behavior of 500,000 policyholders with variable annuities providing a Guaranteed Minimum Income Benefit (GMIB). The riders allow plan holders to annuitize an account at a guaranteed rate for lifetime income. Their main questions are, "How would you allocate assets within a variable annuity if you had an option to annuitize GMIB? Would you take greater risk and how would that vary by age?"

Drawing on a specific firm's evidence, the authors learn that people having a variable annuity increase their risk exposure by 20-25 percentage points when they have a GMIB. The study also uncovers a strong distribution channel effect, with high-risk allocations of around 80 percent when sales are made by career insurance agents, financial planners, wirehouses and banks. Nevertheless, sometimes the GMIB asset allocation restricts owners' choices of portfolio mix. There is also interest in determining the optimal asset allocation for those selecting a GMIB. For example, when an investor with a 40 percent allocation to risky equity is offered a GMIB option at $20 per dollar of lifetime income, he or she will raise the allocation toward high-risk investments to between 70 and 100 percent. So are these asset allocations justified?

Milevsky believes, “in practice, people are taking on more risk. While it may be justified for younger retirees, it is unclear if one can justify this at older ages.”

Another study on annuitization is underway by Jeffrey R. Brown, Professor of Finance, and Marcus Casey, a doctoral candidate in Economics, from the University of Illinois at Urbana-Champaign, along with Wharton’s Mitchell. The analysis observes that life annuities are an important part of lifecycle theory and, according to many studies, would enhance retiree financial well-being. But despite the theoretical benefit of payout life annuities, relatively few people buy them in practice. This disconnect is growing more striking as defined benefit retirement plans are being phased out yet the voluntary payout annuity market remains small.

Brown and his coauthors suggest that people might not annuitize much because they are, in fact, overannuitized: this is because Social Security is a real (indexed) annuity which provides a large fraction of many peoples’ retirement income. The analysts evaluate 1,000 respondents to the Health and Retirement Study who were age 50-64, and ask them to imagine they were age 65 and receiving $1,000 per month in Social Security benefits. They were then asked whether they would be willing to take a benefit that was half that amount, $500 a month, in exchange for a one-time $87,000 lump sum payment. Three of five respondents responded that they would prefer to take the lump sum if it were offered. While some consumers say they would keep the Social Security inflation-indexed life annuity instead of the lump sum, as long as it was actually advantageous, only one-third value the annuity enough to select it if it is worth 25 percent more than the lump sum in present value. The authors also find some “price sensitivity.” This work suggests that a majority of older Americans feel they are over-annuitized.

Healthcare and Long Term Care

Healthcare topics – particularly long-term care issues – are the subject of work by John Ameriks, Senior Investment Analyst in Vanguard's Investment Counseling and Research Group, and researchers from New York University including Andrew Caplin, Professor of Economics, Steven Laufer, a doctoral student in Economics, and Stijn Van Nieuwerburgh, an Assistant Professor of Finance. Their paper examines spending during retirement in an effort to gauge how retirees pace the disbursement of their savings with two ends of the financial spectrum in mind: maintaining just enough money to avoid winding up on Medicaid, or spending beneath their means in order to pass along an inheritance. To explore the extent to which Medicaid aversion or the bequest motive impact retirement spending, the researchers build models built in part on an Internet-based survey of respondents' attitudes toward Medicaid and inheritance.

"People really do diverge widely," says Caplin. "I would say the bequest motive is too important to ignore and Medicaid aversion is too important to ignore." He argues that his models indicate a high level of reluctance to invest in annuities. "People are not going to end up interested in paying a high load for an annuity," he contends. "What they're concerned with is either a lump sum for private long-term care, or they want to leave a bequest and having access to the free cash is important."

Given that, the authors evaluate various ideas for new products that would combine some of the benefits of annuitization while addressing concerns about long-term care and providing bequests. One idea is to protect savings against longevity risk with a deferred annuity that would require lower payments than a standard product, but provide payments if the retiree reaches an advanced age. Another idea would be to offer an annuity product with a long-term care component that would protect against draining a retiree's assets to qualify for Medicaid. Indeed, the authors recommend that a long-term care component be included in the Social Security annuity; this would encourage the retiree's family to become more involved in planning for their relatives' needs. The idea might also lead to better alternatives to the current problem-plagued market for long-term care insurance, which can be intimidating for subscribers, especially older people. "It's hard to argue with an insurance company in the best of times," Caplin points out. "This might not be the time you want to end up in a dispute." Other approaches would help design products taking other financial choices into consideration, for example, accessing housing equity through reverse mortgages. "More broadly," he concludes, "the goal is to identify more holistic products."

Other researchers also like the idea of creating annuities with tier of coverage for long-term care. Mark Warshawsky, Director of Retirement Research at Watson Wyatt Worldwide, and David Brazell and Jason Brown from the US Treasury Department contend that the life annuity and long-term care insurance markets naturally attract opposing risk groups. Life annuities appeal to those with higher than average life expectancies, leading to problems with adverse selection in the market. Those who believe they have a greater chance of needing long-term care are more inclined to seek coverage, but underwriting can prevent coverage for this population.

Warshawsky and coauthors believe it would be useful to combine a life annuity with LTC insurance, as this "allows an annuity to be sold more cheaply and the LTC insurance to be offered to a larger population." The research suggests various ways that such a combined Life Care Annuity (LCA) product could be developed, including as an after-tax annuity, a distribution option in qualified retirement plans, or a component of entitlement reform.

A critical consideration in the development of these combined products will be tax policy; the 2006 Pension Protection Act has provisions for combined products after 2009 in which life annuity components would be treated as separate contracts, but there remain questions about how the premiums would be treated. For instance the PPA greatly enhances the tax advantages of purchasing a LCA with a LTCI rider by eliminating tax on charges for LTCI premiums. Deductibility of LTCI premiums would generate further tax benefits. Several unresolved issues remain with regard to the requirements and tax treatment of a LCA in a qualified retirement plan, the researchers note. Another area of confusion is how a disability component would be treated: would it be considered an incidental benefit or a form of health insurance which would fall under different regulation? If treated as a contingent annuity under current law, a LCA would offer significant tax advantages relative to other LCA structures.

Christopher Bone, Executive Vice President and national retirement practice leader for Aon Consulting, concurs on the regulatory issues, saying they are “wildly complicated,” as he lists the sources of complexity in managing retirement risk including IRS codes, fiduciary rules, and employment law. “On top of this, if something comes out of the annuity marketplace, there is the overlay of 50 state regulators,” he points out.

Practical Issues in Retirement Payouts

One topic of practical interest to virtually all retirees is when to start collecting Social Security benefits. James I. Mahaney, Vice President, and Peter C. Carlson, Pricing Actuary, both from Prudential Financial’s Retirement Income Strategies group, evaluate this point by focusing on income phasing. Specifically, Mahaney states that deciding whether to take Social Security benefits early or delay receipt is a question deserving a hard new look, given recent changes in Social Security eligibility rules, the transition from the defined benefit to a defined contribution environment, tax considerations, and the current low-interest climate. "A lot changed with Social Security in recent years, so people should revisit Social Security taking a risk management perspective. It's not just about returns," states the author. He also suggests that workers nearing retirement need to consider their Social Security benefits as part of an overall approach to retirement security, including the IRA and other saving.

When retirees do not annuitize their saving, they need to depend on three factors to guarantee retirement security. Mahaney points out that "they need positive market returns, they need to pick the right investments, and they need to not trip themselves up with their own behavioral biases." Yet research suggests that retirees typically do not earn close to market returns, and many forecasters predict lower future returns for stocks and bonds than in the recent past. At the same time, new Social Security eligibility changes are taking effect, including a boost in the age for full retirement from 62 to 66, and an eight percent increase in Delayed Retirement Credits for those who delay Social Security payments until age 70 (for those born after 1943). New rules also allow married couples to file for and then suspend receipt of Social Security benefits on attaining full retirement age. Delaying taking the primary earner's benefit early increases the monthly benefit, the longer the couple waits. There is also a so-called "tax torpedo," which hits retirees when taxes finally come due on tax-deferred saving triggering higher income taxes and taxes on Social Security benefits.

Overall these changes have altered the view that retirees should cash in early and use their Social Security payments to earn interest. Now, with lower interest rates, along with the tax consequences and new benefits for delaying Social Security take-up, retirees should tap IRA and other private savings first and delay their government benefits as long as possible, according to

Mahaney. “The conventional wisdom, which had people defer income from tax-qualified sources, and get their Social Security early, is not the most efficient way to take retirement income.” In his view, the source of the difference between tactics arises from the fact that the Social Security Administration’s calculations are based on population mortality statistics and ignore the impact of taxes, while the Prudential research reflects taxes and other factors.

Practical aspects of the annuity market are also of keen interest to Kelli Hueler, President and CEO of the Hueler Companies, a Minnesota technology and independent research firm specializing in stable value products. She seeks to transform delivery of payout annuities, a goal which is sometimes daunting. “Depending on the company, saying the word “annuity” can be equivalent to uttering profanity,” notes Hueler. “It is not a word that carries a warm and generous feeling.” One reason, she argues, that there are serious and fundamental flaws in the way most plans offer annuities to participants. The biggest problem is that annuitization is most often an all-or-nothing decision.

“If you ask a room full of people to hand over 100 percent of your retirement assets to an organization with little flexibility and where you could lose all control of your money when you annuitize, would you do it?” she asks. Answering in the negative, she proposes instead that a successful annuitization program requires flexibility. As a result, companies will do better if they create products which build in partial annuitization; this would allow retirees the opportunity to annuitize over time and with different providers. She also argues that meaningful competition in the annuity market is essential, since there is wide variability of insurance quotes over time and across companies. Inflation is another factor to take into consideration with annuities. “People don’t understand the value of inflation protection in the payout phase,” she emphasizes. “We have not educated people properly." Her firm offers comparative bids in a standardized platform in the expectation that volume may help bring pricing down.

François Gadenne, President and CEO of Retirement Engineering, Inc., focuses on the need for entrepreneurial thinking in the payout market. He believes that retirement products are on the brink of a revolution, with banks, brokers and other financial players acting as the potential third-party enablers. Gadenne argues that "investors must become consumers. Right now they are not consumers; they can't go buy a pound of income at the grocery store." But the key is "products that are intuitively packaged, like groceries at the store." All parties in the retirement finance industry will ultimately play a role in the standardization process, including regulators."

Joseph Piacentini, Chief Economist and Director of Policy and Research at the Department of Labor's Employee Benefit Security Administration, agrees that saving shortfalls, health shocks, and other surprises can and do pop up in retirement, prompting demand for innovative products that can overcome obstacles to retirement security that arise. Yet he emphasizes the need to prove that new products must really work. New products, he said, also put pressure on regulators. "The regulatory environment comes into play in a big way," he said. "There are uncertainties, obstacles and unintended consequences; see for instance the tax rule complexity." When overseeing mandatory programs such as Social Security, incentive schemes such as tax laws, or private systems such as pensions, Piacentini believes that the government must be careful not to create new problems.

Some analysts propose that annuitization should become the default way to pay out pensions and IRAs, though there is much debate on the theme. David Laibson admits that usually he is a fan of defaults, but he adds that "one of the hallmarks of successful default is when the subject receives the default and says ‘I’m glad you defaulted me into that vehicle.’ The challenge with annuities is that we analysts think annuities are desirable, but the general public has a very mixed view and puts up resistance.” Offering annuities as an option might work, but making it part of a default might be premature, in his view. First we must “explain to the public why we believe annuities are valuable, without tying peoples’ arms behind their back,” he concludes. By contrast, Gadenne believes that making an annuity a default payout scheme would benefit retirement security. He proposes that the idea could be made more palatable by new third-party enablers, for example, a form of reinsurance for long-term longevity risk. “The government may be the ultimate re-insurer,” he says. “The point is to focus on a program of research that would be desirable, like defaults.”

Will Housing Equity Finance Retirement?

Todd Sinai and Nicholas Souleles, both Associate Professors of Real Estate at The Wharton School, examine whether retirees will tap into their housing equity appreciation to finance retirement. Using the U.S. Survey of Consumer Finances (SCF) the authors show that indeed, home prices have increased substantially – approximately 40 percent between 2000 and 2005. Meanwhile, upwards of 60 percent of individuals’ net worth is typically tied up in housing. Using the SCF, Sinai and Souleles first document the rise in net worth and housing values, as well as equity and debt patterns since 1989 to determine how much housing equity can be consumed in retirement. Then the authors look at the relationship between home equity and net worth and find that, overall, the ratio has not changed dramatically over time. For individuals, however, the ratio does shift.

“It changes over people’s lifetimes, becoming less liquid as there is more housing in their net worth,” notes Sinai. “People still have a house when they’re 85, but not a whole lot in their savings account.” He also points out that while housing values have indeed contributed to a rise in net worth, not all of that increase can be attributed to home appreciation. “One thing that can easily be happening is that when housing values go up they take on debt, put it in the stock market and that will give you this kind of pattern,” says Sinai. The authors also examine patterns in housing debt. “The loan-to-value ratios are going up, but not a lot,” Sinai states. “To keep the ratio constant, people who experience appreciation are converting some of that appreciation to debt but are not increasing their aggregate debt level massively.”

So how much housing equity can be consumed in retirement? Sinai explains that even if home values appreciate, retirees still need to pay something for housing if they sell their house to cash in on its appreciation. His paper challenges the standard treatment of home equity as a liquid asset that is available for consumption. Even after selling a home that has appreciated significantly, retirees still need somewhere to live. Often rental units or other forms of housing have also gone up in price, eating away at the amount of appreciation that retirees can tap.

The authors construct two models to determine how much equity would actually be available for non-housing consumption in retirement. The models are based on terms for current reverse mortgages and on an idealized reverse mortgage offering maximum liquidity. They predict that the median 65-year-old household could only tap 34 percent of its housing equity, or about $36,000, and 15 percent of those households would have not housing equity available. By age 90 the amount of home equity available for consumption would rise to 84 percent, or about $94,000. Using current reverse mortgage programs, before fees the median 90-year-old household could spend up to 75 percent of housing equity. Of the 75 percent of 65-year-olds with reverse mortgage amounts exceeding housing debt, the median could only consume half their housing equity. “For young retirees, existing reverse mortgages don’t help at all,” indicates Sinai. “We have had a sizeable increase in housing values leading to an increase in net worth, but not all of that is consumable,” he concludes. “We need to take that into account -- the fraction that is consumable has not changed, although there is a real change in what is available to seniors as housing values have gone up.”

Julia Coronado, Associate Director and Senior Economist at Barclays Capital, notes that Hurst’s paper is similar to her own work indicating many people may be doing a better job of saving for retirement than is widely believed. However, she considers that peoples’ apparent inability to plan for health shocks could constitute failure to save adequately for retirement.

“There’s nothing more predictable than you’re going to have a health shock as you age,” she points out. “Is there tension between the findings that people plan well for what they choose, but not for health shocks?” Regarding the work on retirement reversals, Coronado believes it prompts a question about whether concerns about the adequacy of Social Security should be framed as a labor participation issue, not a savings problem. In regard to the Sinai/Souleles work, she notes that 25 percent of early Baby Boomers have already moved, unlocking net worth accumulated through a rise in home prices. “I think increasingly people are going to move,” Coronado indicates. “But whether they move or not, they are taking some of their home equity and putting it into financial assets. They do seem to be rebalancing their portfolios.” In overview, she concludes: “We don’t have a saving crisis. Most people are saving well, though a minority of the population is vulnerable.” Of course, as David Laibson, Professor of Economics at Harvard University, points out, while people may be smoothing out spending to make their retirement saving last, the public sector is dissaving for retirement massively – witness the huge unfunded liability for Medicaid and Social Security.

Regulatory Issues and Retirement Saving

How to protect workers' nest eggs is a topic of concern for Phyllis C. Borzi, Research Professor in Health Policy at the School of Public Health and Health Services at George Washington University, and Martha Priddy Patterson, Director of Human Capital Total Rewards in the Washington office of Deloitte Consulting, LLP. The authors note that Baby Boomers are approaching retirement heavily dependent on their own 401(k) savings which have replaced corporate defined-benefit plans for many workers.

The average 401(k) savings for 50-year-olds is $128,000 and $141,000 for those at age 60, she notes, which leads Borzi to state that: "There will be a lot of people retiring with more money than they ever had before in their life at one time to manage in the 401(k) lump sum. The fear is they will simply not know how to manage it and they will be subject to pressure from some who want to relieve them of their 401(k) burdens – to move them to their own pockets." She believes that many governmental and market protections against risk to income disappear at retirement. While they are working, workers' wages typically track inflation and most have some form of health, disability and life insurance. Meanwhile, recurring income mitigates investment risk. At retirement, some of these protections may disappear. "Good health and a long life can become more of a threat to you as you get older and wonder how you are going to make the money last," she says. This work lays out the legal and regulatory frameworks for various retirement finance products, primarily insurance, with a form of guarantee, and securities which are regulated, but not guaranteed.

"Although there are many layers of regulation, we don't know whether they are effective," notes Borzi. "If you think you have the right to sue for securities fraud, then talk to the Enron retirees who lost value in their 401(k)s." She stresses a need for better financial education, as much of the current regulation is geared toward disclosure, which may not be enough to protect ill-informed financial consumers. "Strong and visible enforcement as a deterrent is needed, to encourage adoption of financial products for retirement payouts that hedge against retirement risks," she argues.

The US regulatory system seems complicated when viewed from abroad. For instance, David McCarthy from London's Imperial College Tanaka Business School finds it astonishing that many regulations govern the retirement arena. In Britain, he notes, attempts at regulating insurance products and pension have resulted in numerous scandals which "caused many people to question very deeply the entire ret savings industry. As a result many people who would otherwise invest pensions have chosen instead to buy their homes." Also, he argues, "tax regimes affect wealth transfers, some of which to my amazement can carry on for generations." Additionally he believes that in Britain the notion of Medicaid aversion is less powerful because of the country's national health system. "In Britain we're already on Medicaid, but even with that safety net for health shocks, people in the United Kingdom don't buy annuities either." In fact, he contends that bequest motives are more complex, because one way to protect bequests is to buy an annuity that would provide income and preserve other savings throughout the retiree's life.

Tax law and retirement saving issues are also the subject of work by Victor Hallman, Lecturer in Insurance and Risk Management at The Wharton School, who offers a closer look at inheritance regulation. His research examines how retirees use income-tax-favored savings plans to pass along wealth to succeeding generations or to charity. Citing studies showing that retirement assets as a percentage of gross estates for federal estate tax returns are on the rise, he states that, in 1992, they accounted for 5.7 percent of assets for male decedents and 2.3 percent for female decedents; by 2001, the percentage grew to 11.2 percent for males and 5.5 percent for females. Much of the increase, in his view, is due to changes in policy, particularly the rise of Roth savings plans as well as IRS rulings favorable to high-net-worth individuals seeking to protect assets for succeeding generations. “The emergence of the Roth is going to be very significant in this respect primarily because it grows tax free, but the minimum distribution rules do not apply to the original owners,” he says. In addition to the existence of tax-oriented savings plans, Hallman says that investment professionals are now expert in helping people shelter savings from estate taxes.

Hallman offers some specific suggestions for changes in tax policy that could return to the original concept that tax-subsidized retirement accounts be used for the support of participants in their old age, but not to transfer wealth. These would include eliminating the exclusion for net unrealized appreciation, life expectancy payouts for individual non-spouse beneficiaries with payouts longer than 10 years, and “inherited IRA” payouts. He also indicates that applying minimum distribution rules to Roth IRAs during an owner’s lifetime would achieve this end.

Robert Pozen, Chairman of MFS Investment Management, worries that Roth plans will have a significant negative impact on future tax collections. “To let everybody get into a Roth is a significant political put-off to the future,” he says. “You’re collecting a little money now and eliminating this tax flow for 30 to 50 years. These are revenue bankrupters.”

A Financial Planner Perspective

Insights from clients moving into retirement are offered by Harold Evensky, from the wealth management firm, Evensky & Katz. He worries that prior generations tended to purchase something only when they needed it, while he believes that Baby Boomers buy something whenever they want it. For this reason, he contends, Boomers are prone to undersave. Also, he argues, that in the past, "as people got older and got sicker expenses went down. But today, not only are people living longer, but they are also continuing to spend at the same or an increasing rate." A related point is that market returns may not live up to Boomers' expectations. He finds that many clients say they anticipate earning 12 percent returns on their investments per year, while academics were forecasting returns of around 7 percent. "And now we think it will be less than 6 percent," he said. "That means past assumptions are out the window." He proposes that during retirees' peak withdrawal years, a reasonable asset mix is between 35% and 65% in stock. He further points to market volatility as a threat to retirement savers and argues that luck can play a large part in retirement security. Retirees who enjoy a big market return early and declines just before retirement fare better than savers who suffer declines early and big gains later.

Evensky also believes that retirees face what he calls "lifestyle" risk. After working their entire lives, retirees suddenly have more time to spend money on travel or other pursuits. "They now have time," he finds, "and time costs money." He compares retirement risk to Pascal's wager on whether God exists. If one disregards the possibility, the consequence of eternal damnation is severe. "You can live a wild and woolly life and if there is no God, there are no consequences. On the other hand, if you if you live a wild life and there is a God, the consequences are going to be really bad." Retirees who play it safe may pass up some luxuries in life, but doing without those comforts outweighs the risk of running out of money in retirement due to unexpected longevity or sudden inflation, Evensky argues. “It’s not just the probability, but the consequences of being wrong,” he emphasizes.

Many older individuals don’t understand how much it takes to support retirement; indeed he mentions that only 24 percent of savers fear outliving their saving and far too many believe they can spend 10 percent of their assets per year in retirement – a rate which disposes them to running short. Instead, his approach favors modeling clients’ cash flow needs. To provide both liquidity and strong returns, he splits a client’s total savings into an investment portfolio and a short-term cash flow reserve amounting to two years of cash flow and a five-year lump sum. The cash flow reserve provides regular income in retirement, but the investment portfolio can be rebalanced regularly to provide strong returns. Annuities present a conundrum for retirement planners because clients are looking for safety and flexibility: while an annuity offers security, it is not flexible. Reverse mortgages, thus far, are not a major force in the market but they may be important in the next 15 to 20 years. “For clients who don’t want to move out of their houses, a reverse mortgage is a way to restructure assets to maintain the lifestyle and pass risk on to the next generation,” notes Evensky. Finally, for many people, just a few more years of paid employment can make a huge difference to retirement wellbeing.