Financial Literacy and Post-Retirement Risks: An Actuary Speaks Out

WHILE MANY EMPLOYERS ARE GETTING OUT of the defined benefit pension business, that doesn't mean they don't have an important role to play in ensuring that their employees are adequately educated as to their retirement risks and options.

Research repeatedly shows that there are significant gaps in knowledge about retirement:

› Many people are focused on the short term as they plan for retirement. Retirement planning often doesn't include a serious and deliberate analysis of life and financial issues.

› When planning for retirement, many people (and professional advisers) limit their focus to investment management.

› There is significant misunderstanding about potential life spans and their variability. Many overestimate the amount that can be safely withdrawn from a retirement account. They also consider only average investment returns without weighing the downside risk and results if there are poor years.

› There is little understanding about financial products that are useful in helping to mitigate risk and when they might be most helpful. The most commonly used risk reduction strategy is cutting spending.

› Many people are over optimistic about expected returns on investments and their ability to manage their investments.

In fact, the risks in retirement are complex and interacting. Transferable and poolable risks include increasing longevity, the cost of disability and long-term care, the cost of acute health care, economic loss following the death of a spouse, and investment and interest rate risk. Risks that can't be transferred or pooled include the inability to find a job, premature retirement, family members needing help, and aspects of inflation. And while people when asked repeatedly say that they want guaranteed income in retirement, they usually choose lump sums when given a choice.

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Alternative Roles for Employers

Employers can assume a number of different roles in supporting retirement planning and financial literacy, including:

› Providing retirement and capital accumulation benefits that are paid for and offered to all employees without choice;

› Providing retirement and capital accumulation benefit plans that include optional methods of payout, which can be used as defaults or as options that must be affirmatively chosen;

› Serving as the "purchasing agent" to allow employees access to financial products such as long-term care insurance on a group basis, usually with features and/or pricing that's more favorable than can be obtained in the individual market;

› Creating expectations and providing information about how retirement is usually integrated into the life cycle;

› Advising, educating, acting as a resource for information for employees, and facilitating the organization of employee networks that can help with common interests, such as caregiver issues.

Employers and financial advisers must stress the importance of having a longer-term planning horizon for workers who are nearing retirement. They need to discuss the impact

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of earlier versus later retirement, including the effect on Social Security, pensions, and how long assets are likely to last. Included in this discussion should be information on the variability of life spans, how to translate lump-sum amounts into regular annual income, and options for providing regular income. For workers who are married, survivor benefits and the needs of the survivor must be broached. Finally, there needs to be a discussion of the cost of long-term health care, whether buying risk protection products is a good idea, and alternatives for getting further advice and information.

While this list is basic and obvious, this is exactly the type of information that many retirees haven't used effectively in thinking about retirement, even when it's readily available to them.

Clearly, employers need to provide information on their own plans and benefits (and, in fact, are required by law to provide participants and beneficiaries with a summary plan description for each plan). However, there's little guarantee that employees read or, in some cases, understand these documents. In addition to the documents that they are currently required to provide, employers need to think about offering the following additional information:

› Basic data on life span and recommendations on different income alternatives and risks. If employers don't want to create or assume responsibility for these resources, there may be a role for the Labor Department and nonprofit organizations in filling the gap.
› A strong recommendation for a longer planning horizon that matches potentially increasing life spans and recognizes their variability.
› Information on how to balance between investment management and managing risks. The Labor Department's booklet *Taking the Mystery Out of Retirement Planning* is a good start in that direction.
› Methodology and/or tools to help evaluate the impact of retirement at different times.
› Questions that will help people think about decisions and alternatives. Many of the decisions involve trade-offs and aren't easy.
› An explanation of how lump sums can be used to generate income and the amount of income that can be generated by a specific lump sum, including the communication of potential future income related to account balances or lump-sum values.
› General information about products that can be used to enhance personal risk management and tips about buying them.
› Considerations when choosing and using retirement planning software and financial advisers.

Retirement *Readiness* Resources

› The SOA, working with the Academy, LIMRA International, the Employee Benefit Research Institute, and the International Foundation for Retirement Education, has identified a range of risks and performed several studies that look at knowledge of post-retirement risks and how people invest their assets at retirement (**http://www.soa.org/research/pension/research-post-retirement-needs-and-risks.aspx**). Detailed reports are available for all of them. I would point particularly to four surveys on public knowledge of post-retirement risk that were conducted in 2001, 2003, 2005, and 2007. Special reports were prepared on the 2005 survey focusing on the risks of retirement, the impact of retirement risk on women, longevity and retirement risk, and the process of retirement.

› A report detailing the response of focus groups on spending and investing in retirement is also available. The report looks at how retired people with significant 401(k) balances decided when to retire and how they invested their money and offers excellent insights into the short-term thinking that many of them used. A new survey based on this study is just starting and will build on the focus group results, working to quantify and expand them. Results are expected later this year.

› Two reports have been prepared summarizing information on public misperceptions about retirement risk and information on how to fill the gaps.

› The Academy and the SOA jointly studied retirement plan preferences to get insights into what plan provisions people preferred.

› The SOA, LIMRA, and InFRE did a study several years ago to understand how retirement planning software handles post-retirement risks and found many gaps. This report is very helpful in identifying questions that people should ask in choosing and using software. An update to this study is underway.

› The Actuarial Foundation partnered with the Labor Department to create *Taking the Mystery Out of Retirement Planning* and, with WISER, the Women's Institute to a Secure Retirement, to create *Making Your Money Last a Lifetime* and *Seven Life Defining Decisions*. All are available at **www.actuarialfoundation.org**.

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Employers must also recognize that while education is good, it has its limits. An ideal education program needs to respond to the limitations of retirement literacy and be offered on company time so as to maximize its efficacy. And employers need to focus on default options for the distribution phase. There's been a great deal of discussion about default options for investment and auto-enrollment, but more discussion is needed on the distribution end, particularly default options in defined contribution plans. As a start in that direction, the Society of Actuaries has issued a call for papers on the broad topic of pension distribution options.

Group purchasing of financial products for voluntary purchase is an excellent way to enable employees to get a better deal and be assured that the design and provider of the product have been subject to due diligence. If an employer doesn't want to offer group purchase of annuities directly, it can work with a third party and use an individual retirement account to hold funds until the annuity is purchased.

Most important, employers need to enable those who want to retire gradually (as well as those who want to work longer but on a different basis) to continue their employment.

The Role of Government and Nonprofits

Some employers provide retirement and investment planning advice to employees, often using an outside service. It is to be hoped that more will do so. However, most of the advice offered is limited with regard to the post-retirement period. I think we need to find a way to supplement current advice with other resources. The matter is complicated because there aren't any "right" answers.

One of the challenges is that there are always trade-offs, and personal preferences can dictate what the best answer is for any individual. It's my opinion that the most appropriate goal is enabling people to make informed choices.

There are also matters on which knowledge gaps exist. Expected life spans and their variability are generally recognized, but the first hurdle to understanding is a lack of awareness and focus on these matters. Even when awareness grows, however, disagreement still exists as to a solution.

Employers are very concerned about fiduciary liability, and most will probably not want to invest a lot of money and time in preparing the information I recommend. However, there are governmental and not-for-profit resources that could be effectively used by employers, including information from the Labor Department, the National Association of Insurance Commissioners, the Actuarial Foundation, and WISER, the Women's Institute for a Secure Retirement. Because workers often rely heavily on their employers for information, there would be a tremendous benefit were employers to direct their employees to these resources and help them see where they fit into their retirement planning.

Dreams for a Brighter Future

I hope that the readers of this article will work to bring stakeholders together to improve the post-retirement system. I would love to see workers improve their awareness of the variability of life spans and gain a general understanding of the options for timing of retirement and the implications. We also need a strong social safety net that recognizes that more than 4 in 10 older women alone currently depend almost entirely on government programs for their retirement security. Employers need to expand default options to include some timed purchase of life income and consider offering risk-protection products on a group-purchase basis that present a portfolio of options to protect against different risks. Finally, software needs to be developed that handles the post-retirement period well and clearly. ●

This article is based on Rappaport's Sept. 19, 2007, testimony at an ERISA Advisory Council meeting on financial literacy and the role of the employer. This article is solely the opinion of its author. It does not express the official policy of the American Academy of Actuaries; nor does it necessarily reflect the opinions of the Academy's individual officers, members, or staff.