How Much and What Risk Should Individuals Bear?

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Outline of presentation

- Aggregate risk
  - Investment
  - Longevity
  - Catastrophic health care
- How much can annuitization help?
- Modification of defined benefit plans
  - Pension freezes are one example
- 401(k) risk
  - Coverage
  - Contribution
  - Cashouts
- How much can automatic enrollment help?
Median Percentage of Compensation That Must Be Saved Each Year Until Retirement For a 75% Confidence Level For Funds To Cover Basic Expenses* (Limited to 25%; assumes current Social Security and housing equity is never liquidated)

* Basic expenses = basic living expenses and any expense associated with an episode of care in a nursing home or from a home health care provider

Annuities require less savings for the same degree of retirement income adequacy

- Repeated the same analysis as previous slide
  - This time we assume that all DC and IRA balances were annuitized at retirement age

- RESULTS → complete annuitization of the balances would decrease the additional amount needed to be saved to ensure retirement income adequacy at the 75 percent level
  - By an average of 30 percent!
  - although there is some variation from one group to another

- Why is this the case?
  - Pooling of risk in a group vs self-insuring

Source: Jack VanDerhei and Craig Copeland, "ERISA At 30: The Decline of Private-Sector Defined Benefit Promises and Annuity Payments: What Will It Mean?" May 2004
Median Percentage of a Worker’s Annual Pay Needed to Offset the Impact of a Pension Freeze in 2006, by Pension Plan Type and Current Age (assumes 8% annual rate of return)

Change in Median Replacement Rates from 401(k) Accumulations for Participants Reaching 65 Between 2030 and 2039

- Lowest income quartile:
  - Baseline: 51%
  - Variable coverage: 23%
  - Always contribute: 60%
  - Never cash out: 64%

- Highest income quartile:
  - Baseline: 67%
  - Variable coverage: 28%
  - Always contribute: 72%
  - Never cash out: 72%

Median Replacement Rates From 401(k) Accumulations for Workers Turning 65 Between 2030 and 2039

Lowest income quartile

- All Eligible Workers: 23%
- Automatic Enrollment (3%; Money Market Fund): 37%
- Automatic Enrollment (6%; Life-Cycle Fund): 52%

Highest income quartile

- All Eligible Workers: 56%
- Automatic Enrollment (3%; Money Market Fund): 52%
- Automatic Enrollment (6%; Life-Cycle Fund): 63%

Source: Sarah Holden and Jack VanDerhei, The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Contributions at Retirement, EBRI Issue Brief/ICI Perspective, July 2005