Retirement Plan Services

Understanding Longevity Risk and the Impact on Retirement

If you took a poll of your employees and asked them what age they want to retire, it's likely that many would tell you age 65. How did age 65 come to be the "norm" for defining retirement age? According to historians, age 65 was introduced in Germany as normal retirement for its public retirement system back in the late 1880s because that was the typical life expectancy of a German male.

By the time America moved to social insurance in 1935, the German system was still using age 65 as its retirement age. This, however, was not the major influence on the Committee on Economic Security (CES) when it proposed age 65 as the retirement age under Social Security.

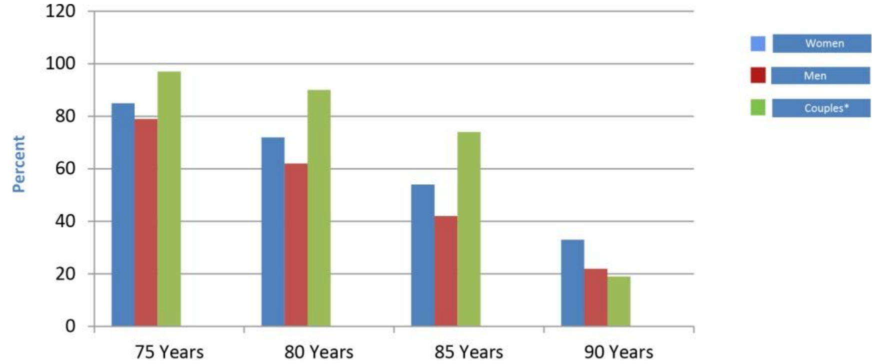
The CES based its decision on general observations about prevailing retirement ages in the few private pension systems in existence at the time and, more importantly, the 30 state old-age pension systems then in operation. Roughly half of the state pension systems used age 65 as the retirement age, with the other half using age 70. Taking all this into account, the CES planners made a rough judgment that age 65 was probably more reasonable than age 70. Interestingly however, is that life expectancy *at birth* in 1930 was indeed only 58 for men and 62 for women.

Since that time, life expectancy has increased dramatically. According to data compiled by the Social Security Administration:

- A man reaching age 65 today can expect to live, on average, until age 84.3.
- A woman turning age 65 today can expect to live, on average, until age 86.6.

And those are just averages. About one out of every four 65 year olds today will live past age 90, and one out of 10 will live past age 95. This last statistic puts significant pressure on Americans regarding retirement savings, Social Security benefits, housing expenses and medical costs just to name a few.

The following table obtained from the Social Security Administration 2015 Trustees Report reflects the probability of living to specific ages



*At least one lives to specific age

Longevity risk for an individual is defined as living longer than expected and, as a result, exhausting savings, dying in poverty or burdening relatives. No one ever "plans" to live this way in retirement. Unfortunately, living longer doesn't mean living better. It's estimated that the average expenditure during retirement for medical costs will exceed $200,000 per retiree.

According to the Bureau of Labor Statistics ("BLS"), in 2014, over 30 percent of the U.S. population age 65 and over continue to stay in the labor force. Many continue working in order to stay active and involved. However, over 25 percent of civilians stay in the workforce because they need money to make ends meet. Delaying retirement can mean an annual increase in Social Security benefits of 8 percent, making it attractive for individuals to delay retirement beyond their "normal retirement age." For example, the graph below shows the amount of the Social Security benefit a person born in 1960 or later would receive based on the age collection begins:

The BLS also shows that, although food, entertainment, and education costs decrease for retirees, older Americans experience a higher degree of inflation due to the cost of health care.

Even with access to employer sponsored retirement plans, Americans still don't save enough. A recent article in Money Magazine noted that 1-in-3 Americans have no retirement savings. In a survey conducted by the Employee Benefit Research Institute, retirement savings fall short for many workers. The chart below reveals that 45 percent have less than $10,000 set aside for retirement.

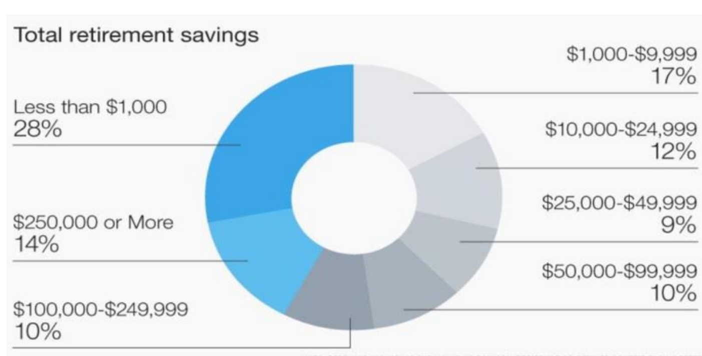


*Image courtesy of The Employee Benefits Research Institute

So how can plan sponsors make a meaningful impact on their employees' retirement readiness and minimize longevity risk? Plan sponsors are addressing these concerns through plan design. According to the 58th Annual Survey of Profit Sharing and 401(k) Plans conducted by the Profit Sharing Council of

America, over 54 percent of 401(k) plans have an automatic enrollment feature. The most common default deferral is 3 percent of pay although 16 percent of plans have default rates of 6 percent. In addition, 65 percent of these plans automatically increase default deferrals an average of 1 percent per year up to 10 percent. The result of automatic enrollment and automatic escalation is that these plans have an average participation rate of over 86 percent. In fact, plans with less than 100 employees exceed 90 percent participation. The downside of automatic enrollment without automatic escalation is that employees fail to increase their default percentage and don't save enough for retirement. So it's important for plan sponsors to re-evaluate not only whether to implement automatic enrollment but also to encourage employees to save more through either annual automatic increases or voluntary annual increases to their deferral percentage.

The continued popularity of loans presents another savings problem for participants. Loans reduce the account balance available to create tax-deferred growth. This can have a devastating effect on savings. According to a study conducted by T. Rowe Price, the average loan balance increased for the seventh straight year to $9,075, meaning participants are taking larger loans. Roughly 47 percent of plan sponsors still allow two or more outstanding loans to be taken. Sponsors should review their plan design and evaluate why they offer participant loans. In 2015, more sponsors moved to only allowing one outstanding loan. Building on that momentum, sponsors should also consider promoting educational materials and tools that can show how loans affect participant savings and delay their retirement.

The single most important decision individuals can make about retirement is to take responsibility for funding it themselves. Living expenses, Social Security, health care costs, family needs and future employment are all uncertain.

Automatic enrollment, automatic escalation, investment diversification and employee education all play an important part in helping employees achieve retirement readiness and lessen the risk of running out of money in retirement. Our Corporate Retirement Plan Services team at CIBC can assist you with reviewing your plan provisions and help redesign it to help ensure it meets the growing needs of your employees. Contact any member of our team at (312) 564-3806 for more information or visit our website at: https://us.cibc.com/en/commercial/corporate-retirement.html.