IMPROVING RETIREMENT READINESS
for State and Local Government Employees

A white paper prepared for

NAGDCA

by

InFRE®
International Foundation for Retirement Education

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Introduction

Retirement: Then and Now

The idea of retirement is a relatively new concept. A child born in 1900 had an average life expectancy of 47 and many from that era could expect to work for as long as possible and then move in with their children to live out their last days. The notion of stopping work some day because they attained a certain age was never considered except by those who were able to amass their own personal wealth.

With the signing of the Social Security Act in 1935, most Americans could now expect at least a base level of income as they became older. Although the beginnings of private pensions date back to the 1800's, due to social pressures for employers to share in the burden of providing retirement benefits, the real growth in retirement programs came after World War II. These two pillars of income now made the idea of retirement a reality for millions of American workers. Savings could supplement a lifestyle, but for a very large percentage of workers, they primarily relied on getting to a certain age and then trading in their paycheck for pension and Social Security checks. It therefore only took two or three generations from the time of no retirement benefits to a time where Americans think of retirement as one of their inalienable rights.....life, liberty and the pursuit of retirement.

For the past several decades, however, many Americans have not been able to meet their retirement readiness expectations. Most private sector companies have determined that they can no longer afford to maintain the expense of their pension obligations to employees. 401(k) and other employer-provided defined contribution savings programs were initially invented to supplement defined benefit plans but now are often used to completely replace them. As a result, many employers have shifted much of the burden of retirement saving and investing risk to the employee. But as one of the primary pillars for retirement income was taken away, employees did not fully understand the extent of their personal responsibility and make appropriate changes in behavior to address the new retirement risks that they now faced.

Initially, workers were also hindered by the lack of proper tools and educational resources to help them understand the importance of retirement planning and how to build a new self-reliant foundation of income during life after work. More recently, the financial services industry has created a variety of helpful generic tools and educational resources to help encourage employees to save more and invest appropriately. In most cases, however, the focus tends be more on a “number” and the need for financial products instead of specific outcomes. New plan features such as automatic enrollment and automatic plan contribution increases are helping those who still have time. For many others, it may be too late.

Below are just a few of the many survey statistics that provide evidence that the American worker is on the verge of a retirement crisis.

- 57 percent of workers report that the total value of their households’ savings and investments, excluding the value of their primary homes and any defined benefit plans, is less than $25,000.[1]

- Only 13% of workers indicate they are very confident they will have enough money to live comfortably in retirement.[2]

- A typical working-age household has only $3,000 in retirement account assets; a typical near-retirement household has only $12,000.[3]

- Among elderly Social Security beneficiaries, 23% of married couples and about 46% of unmarried persons rely on Social Security for 90% or more of their income.[4]

- More than three-quarters of plan sponsors agree the days of not working in retirement are gone for their participants, with 55% saying they are not confident their participants are saving enough.[5]

These statistics provide convincing evidence that millions of Americans are not prepared for, or even aware of, what is needed for a successful retirement. Baby boomers in particular are approaching this time in their life much differently than previous generations. Issues such as increased longevity, health care costs, solvency of the Social Security system, inflation and uncertain long-term care costs make assessing future retirement needs more challenging than ever before. Without dramatic changes in behavior, a large percentage of 78 million baby boomers and those who follow them will not be able to retire in the same way as their predecessors and many may ultimately need to rely on federal, state and local governmental assistance programs to help them make ends meet.

Going Forward

Due to increasing costs and the economic climate over the past decade, state and local governments (public sector employers) are now struggling to meet their current and future pension obligations in the same way the private sector has been experiencing for years. According to a March 2012 report by the National Conference of State Legislatures, from 2009 through 2011, 43 states enacted major changes in state retirement plans to address long-term funding issues.[6] These changes were designed to reduce pension fund obligations by increasing employee contributions or age and service requirements for retirement, or both, and adjusting benefit provisions in various other ways to reduce costs. Although many states have been unwilling to abandon the traditional defined benefit plan structure, several states now have private sector-like optional defined contribution plans or hybrid plans with a defined benefit and defined contribution component.

As millions more state and local government employees (public sector employees) begin to share the retirement savings and investment risks with their employers, it's time to learn from the early failures and eventual successes of the private sector plan model. Therefore, the purpose of this paper is to explore the implications of current retirement plan and planning trends for state and local government employees and to identify ways to positively change behavior.

I. What Does it Mean to Be Retirement Ready?

Most people would agree that the goal for a successful retirement is to be happy, healthy and financially secure. Benjamin Franklin's *Poor Richards Almanac* even quotes, "Early to bed and early to rise, makes a man healthy, wealthy, and wise."

As more is learned about retirement planning, it is becoming increasingly apparent that retirement readiness needs to be about more than just money and accumulating assets.[7] The problem is that most retirement readiness definitions and measurements (as well as most research) has only focused on the financial side of the retirement equation. Without knowing what it will take to be happy in retirement (desired lifestyle) and the health that may be expected (good or bad), determining retirement readiness based solely on personal finances is non-holistic.

2003: Retirement Readiness Defined for Federal Workers

In 2003, the U. S. Office of Personnel Management (OPM), which oversees all federal personnel and human resources functions for government agencies, informed Congress that they needed a more comprehensive retirement education program but lacked the expertise and resources to develop one internally. The genesis for the need of such a program goes back even further to 1986 when the federal government started the Thrift Saving Plan (TSP) for 3.5 million federal government employees. Congress soon recognized that most plan participants were unprepared to make many of the important retirement decisions needed to address their new retirement risks. They mandated by way of federal law that every federal agency must have a trained "retirement counselor" to provide each employee with such help as required to make informed retirement decisions.

Congress awarded grants totaling $1 million to the International Foundation for Retirement Education (InFRE) to develop a Retirement Readiness Program (RRP) for federal government workers. The result was a survey instrument that took a balanced approach to retirement planning and included questions designed to address issues of physical wellness, the psychological and social aspects of retirement, as well as financial preparation. InFRE was selected because of its non-profit status, experience in conducting credible research, and understanding of the public sector retirement planning issues via a partnership with the National Association of Government Defined Contribution Administrators (NAGDCA) and National Pension Education Association (NPEA).

Recognizing that retirement readiness is based on both knowledge and actions, the emphasis of this project was to create a program to raise awareness and understanding about what is needed to be ready for retirement and a method to evaluate the steps that employees are taking to plan for this life phase. This project focused on the Federal workforce to develop a prototype RRP that could be expanded in the future to address the non-federal public and private sector employee populations.

Over a four year period, a research team of more than 30 highly respected professionals and academics (heretofore referred to as the "panel of experts") with a wide range of experience and perspectives worked together to:

1. Identify and define a universally-acceptable index/metric for measuring the retirement readiness for the federal workers and ultimately the American workforce.

2. Develop a methodology to test both an individual's retirement readiness and the retirement readiness of a broad group of employees in a given department, agency or employer-sponsored plan.
3. Analyze findings and make changes to models that identify best practices and workforce barriers that enhance or retard the retirement readiness of either an employee or an agency.
4. Submit a final report to Congress and OPM[8] presenting analysis, findings, conclusions and recommendations including a working definition of the term "retirement readiness."

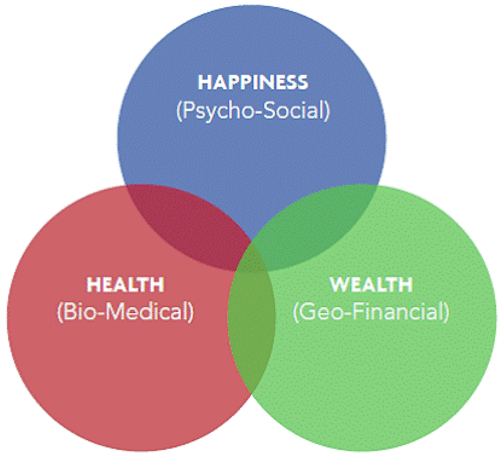
As a first step, the panel of experts wanted to determine what it really means to be ready for retirement and the level of retirement financial literacy of federal workers. The project included applied research using three surveys of over 100,000 employees in the federal government, local governments and the general population, in addition to multiple focus groups of retired employees. Some of the key findings were:

- The majority of Federal employees (more than eight in ten) state they are on track or ahead of schedule in planning and saving for their retirement years.
- More than half of workers expect to retire before age 62, with almost four in ten expecting to retire at age 59 or earlier.
- Nine in ten workers participate in the Thrift Savings Plan.
- Nine in ten Federal employees say they have given their retirement lifestyle at least some thought, and almost nine in ten of those who have given thought to their likely lifestyle have given at least some thought to its cost.
- Three out of four workers anticipate they will need to keep working for some time during their retirement years.
- Less than half have calculated how much they need to save for a comfortable retirement; almost four in ten employees who have calculated this need have estimated/guessed or used a self-created worksheet.
- Only two in ten workers have a primary professional financial advisor whom they use to help them with their retirement plan and investment decisions.
- When asked to rank their <u>most</u> trusted sources for information about planning, half of the workers identify financial professionals (50%), followed by material provided by the employer (38%).
- Almost eight in ten workers would be very or extremely interested in their employer providing additional information about preparing for retirement.
- Workers appear to understand the impact of debt on their retirement savings as almost seven in ten workers have given this significant thought.
- Almost four in ten workers are not confident about their ability to make investment decisions, while less than two in ten believe they have a lot or great deal of knowledge about investing.
- About three-fourths of workers describe themselves as moderate to conservative investors, with less than one in ten (7%) stating a willingness to take substantial investment risks.

Findings from these surveys and other research led the panel of experts to conclude and recognize that retirement planning needs to encompass more than just planning for a retirement savings or income target to be successful. Understanding and preparing for the physical and engagement aspects of retirement are also critical components of a successful retirement preparedness strategy.

2006: A Retirement Readiness Profile Tool is Created for the Federal Government

The final result was a holistic definition of retirement readiness that incorporates all three dimensions of retirement planning as follows:



- **Wealth/Financial Security:** Are workers adequately planning to support the lifestyle they want throughout retirement? Have they established realistic income goals for their future and considered potential risks to their income that can negatively affect their retirement years? Do they understand how much of their income is guaranteed to be there for their lifetime, and can they really afford to retire as soon as they want?

- **Healthy Living**: Do workers recognize and understand their potential personal longevity and that of their spouse? Are they maintaining good health habits in order to remain active in retirement? Have they considered their personal health situation in relation to their retirement lifespan and the number of years their money will likely need to last?

- **Happiness & Engagement**: What are workers' life plans for retirement; what are they retiring "to?" What type of activities are they planning for? Will they work or volunteer? Do they have a network of friends outside of work? Should they relocate, or stay where they are? If married, does the spouse or partner have the same retirement goals and dreams?

In addition to identifying the dimensions of successful retirement planning, the panel of experts determined that the type and level of planning varies based on where the individual is in their working career. The evaluation and determination of the state of readiness is therefore based on how many years an individual has before their expected retirement date as follows:

- **Early career:** at least 25 years before retirement. At this point, most of retirement planning should be focused on understanding and managing income while accumulating wealth.

- **Mid career:** between 10 and 24 years from retirement. By this time, additional attention needs to focus on maintaining overall health while continuing an emphasis on financial preparation.

- **Late career:** less than 10 years from retirement. At this point, more attention should be paid on preparations for total retirement well-being that includes understanding and planning for an engaged and fulfilled retirement.

The individual survey results were then used to develop a retirement readiness profile to be used by Federal agencies in two ways.

- First, the profile can be used as a tool to identify the general readiness of their employees and plan specific retirement financial literacy programs to address the identified issues;

- Second, it can also be used by individual employees to create their own retirement readiness profile and take necessary steps to strengthen any identified weaknesses.

This program can also be considered a workforce management tool as it is designed to help employees understand and recognize when they are really ready for retirement. This awareness may lead to a certain percentage of workers deciding to delay retirement beyond the earliest age they are eligible and allow the employer to retain older, more experienced employees in the workforce.

2007: Adapting the Federal Government Retirement Readiness Program to the Non-Federal Public Sector[9]

OPM also asked InFRE to provide a report on how the RRP created for OPM can be adapted to meet the needs of the non-Federal public workforce by raising awareness of their need to take personal responsibility for their future income and provide them with the tools and resources to help them accomplish this.

The RRP was developed based on Federal government employees and their retirement benefits. This provided a starting point to establish a comprehensive program that examines how well employees are taking personal responsibility and preparing for their future retirement considering the benefits they are expecting to receive from their employer.

The benefit structures within state and local government employers are very similar to those provided to the Federal workforce. Although some benefits are changing, most entities are still providing defined benefit pensions funded by employer contributions and supplemental defined contribution plans funded with employee pre-tax deferrals. Retiree health, disability and long-term care insurance programs are also generally included in the total compensation package providing various levels of benefits that may be funded by the employer, employee or both.

The similarities between the benefits among all public employers – federal, state and local governments – mean that the retirement readiness profile, educational tools and resources could be modified to apply to this entire audience without major changes to the existing program. Although certain features of the retirement readiness questionnaire and educational components may need to be altered to provide a more generic assessment to recognize varying benefit levels, this would not affect the value of this program to accomplish the following for the non-federal public sector audience:

<u>For the Employees:</u>

- Increase awareness that employee benefits alone will not be sufficient to meet future retirement income needs
- Allow them to identify their current short-comings as to their current level of retirement planning

- Identify the steps they need to take to improve their retirement readiness

For the Employer:

- Allow the employer to assess the educational needs of their employees in regard to retirement readiness and planning
- Help them establish goals for on-going educational programs
- Provide a method to evaluate if their retirement educational programs are changing employee behaviors in regard to retirement savings and planning

2007: InFRE General Population *Retirement Readiness* Survey

At OPM's request, a survey of American workers was also conducted[10] by InFRE to apply the retirement readiness profile created for OPM to the general population to evaluate how well they are currently planning for and are prepared for total retirement well-being.

To our knowledge, this was the first time that qualitative measures have been applied across multiple dimensions that consider both attitudes and actions about retirement planning. In regard to the financial aspect of retirement planning, the findings were consistent with other research efforts as it demonstrated that the majority of workers are far from prepared regardless of where they are in their career. However, because it is multidimensional, this effort was also able to evaluate the interactions of the three components of total retirement well-being and found that there is a correlation between planning for financial security, healthy living and happiness during retirement.

The key findings below illustrate the state of retirement preparedness of the American workforce prior to the great recession, and support the notion that it is important to address total retirement well-being in education and guidance programs.

Networking and Engagement

- Although workers are looking forward to retirement, few have concrete plans for what they would like to do during this stage of life. One-third say they have some plans but are mostly just looking forward to having more time for leisure activities, three in ten haven't thought much about it but are looking forward to not working anymore, and 15% are not sure how they will fill their time in retirement. Just 13% say they have many plans for their retirement.
- This lack of planning is borne out by the fact that only one-quarter of workers each have given a great deal or a lot of thought to where they would like to live in retirement; currently add a great deal or a lot of meaning to their life through civic, religious, volunteer, or other activities; and (among married workers) have had a great deal or a lot of discussion with their spouse about their plans for retirement and how to finance them. Just two in ten have given a great deal or a lot of thought to what they will do in retirement to challenge themselves.
- On the plus side, the majority of workers do not rely on the workplace to support their friendships. Two-thirds say at least half of their close friends are outside of work.

Health

- Two-thirds of workers expect to be healthy in retirement: 22% say they will be healthy for as long as they live and 43% expect to be healthy through most of their retirement with some ups and downs. Most of the remainder think they will be fairly healthy but may have some limitations due to chronic conditions (25%).
- Despite this, large proportions of workers are not taking steps that will help them maintain their health in retirement. Two-thirds report they do not exercise regularly, about half admit

they do not eat a healthy diet or maintain a healthy weight, and four in ten say they do not have regular physical checkups.
- Workers expect to live to a median (midpoint) age of 85. However, it appears that many may be underestimating how long they will live, as workers are more than twice as likely to provide a life expectancy that is below average (67%) than to provide one that is above average (24%). In actuality, the proportions of the population who can expect to live for fewer or more years than average are about equal.

Wealth

- While some workers are on track to save the money they will need for retirement (34%), the majority are far behind schedule (56%).
- Half of those participating in a workplace retirement savings plan with an employer match report they contribute the match amount or less. Similarly, half of workers contributed nothing to an IRA, while 30% contributed some money, but less than the maximum allowed. Only 12% contributed the maximum.
- Of those workers who participated in a retirement savings plan with a previous employer, the majority rolled the money over to an IRA (52%) or left it in the plan (29%). However, one-quarter spent the money.
- Although one-quarter of workers have no money earmarked for retirement and one in ten have less than $10,000, another quarter report having sizable piggy banks. One in ten say they have a total of $100,000 to $199,999 saved for retirement and 14% have $200,000 or more.
- Consumer debt is one factor that hinders the building of wealth for retirement. Nearly four in ten indicate that their debt affects their ability to save a great deal or a lot. Moreover, more than one-third of workers say their debt has gone up over the past five years.
- Very few workers say their financial security in retirement is extremely or very dependent on an expected inheritance (5%). In fact, half of workers state they do not expect to receive any inheritances.

Financial Planning

- Just one-third of workers say they know how much they need to accumulate by the time they retire so they can maintain their desired retirement lifestyle. About half of these workers say they determined the amount within the past year.
- Regardless of whether they said they know the goal amount, workers were asked what they thought it should be. Half of those providing a dollar amount cited a goal of less than $500,000.
- Three in ten review and adjust their investment allocations every six months or more often. Another quarter do so about once a year.
- Although a large majority report currently having health insurance (82%), fewer say they have life (72%) or disability (53%) insurance.
- Only minorities of American workers indicate they have a will or trust (29%), medical directive (24%), or power of attorney (24%).

II. How Can We Measure Retirement Readiness?

The cornerstone of the OPM RRP was a comprehensive survey questionnaire of approximately 30 questions that evaluated the three dimensions of retirement planning and scored an individual's retirement preparedness. The participant's retirement readiness profile was also created based on information they provided. The answers to the survey were weighted and scored based on the panel of experts' determination and these scores were then used to create a benchmark for individual retirement readiness specific to career stage (early, mid or late). For example, a question related to social plans in retirement is not weighted as highly for an early career employee as it is for a late career employee.

Each participant received an individual score in each of the three dimensions as well as an overall total retirement readiness score. The resulting number indicated the state of retirement readiness and an assessment of whether or not they are "on-track" for a successful retirement according to the benchmark established by the panel of experts. A methodology was also developed to compile all scores to create a national retirement readiness index of rolled up individual scores against which an individual's results can be compared to their peers.

An effective retirement readiness profile meets the needs of multiple audiences – workers, employers and plan providers. In the OPM program, the goal was to determine a new and updated approach for defining retirement readiness and to provide a diagnostic tool for measuring success that motivates employees in all career stages to prepare for their total retirement well-being, leading to improved financial security throughout retirement years.

- *From the employees' perspective*: the profile provided a method to identify how well they are currently planning for retirement – as compared to where experts say they should be – and increase their awareness of issues that should be considered to successfully prepare for total retirement well-being.
- *From the employers' perspective:* the profile provided an aggregate assessment of their workforce to determine where future education/guidance should be targeted and a method to monitor and evaluate the effectiveness of their efforts.
- *From the plan providers' perspective:* the profile offered a tool that can help customer service staff and guidance counselors more productively meet employees' retirement planning needs in face-to-face or over-the-phone encounters by better understanding the unique needs of the participant audience and developing ways to motivate them to take action.

The General Population Retirement Readiness Survey showed that workers who are identified as "on-track" are more likely to score higher marks overall in all three of the planning dimensions. This finding suggests that there is a correlation between happiness and health planning and financial/wealth planning. For instance:

- Workers who reported they know how much money they need to save for retirement are more likely than those who do not to indicate they have many (20% versus 9%) or some (45% versus 26%) plans for activities in retirement.
- Those who discuss retirement plans with their spouse a great deal or a lot are more likely to know how much they need to save for retirement (40% versus 13% who do not).
- Those who know how much they need to save for retirement are more than twice as likely as those who do not to have given considerable thought to where they would like to live in retirement (41% versus 17%).
- Workers who have planned for retirement challenges either a great deal or a lot are more likely to know how much money they need for retirement (33%

versus 12% who don't know) and have accumulated $50,000 in financial assets (29% versus 14% who have less), have income of at least $100,000 (27% versus 17% with less) and homeowners (25% versus 11% of non-owners).

- Workers who expect to be healthy for as long as they live are more likely to have household income of $100,000 or more (33% versus 19% with less) or have financial assets of $150,000 or more (35% versus 19% with less).

The result of this study was the basis for creating a holistic approach to measuring an individual's retirement readiness using the InFRE Retirement Readiness Profile and also supported the notion that it is important to address total retirement well-being in education and guidance programs.

III. What is the Correct Income Replacement Ratio?

All three dimensions measured in the InFRE Retirement Readiness Program help to determine an individual's retirement needs and wants. Translating that information into an actual spending goal and comparing that goal to retirement resources is a critical step in the retirement planning process.

There are a variety of calculators and software programs designed to perform a retirement gap analysis. Some require a degree in finance to input all the data needed and others are oversimplified and provide information that may do more harm than good. Several software companies have been focusing attention on the growing retirement planning crisis for middle income Americans and have started to create user friendly tools that offer a credible retirement needs analysis.

User friendly and reliable retirement planning tools can be both instructive and motivational. At the same time, it is important to recognize that the output can only be as good as the input. The old saying "garbage in, garbage out" has never been more true than when applied to retirement planning. Perhaps the most critical question asked in any retirement gap analysis questionnaire or calculator is, "how much do you want to spend in retirement?"

Expressed as a percentage of current income, "average" replacement ratios are often provided as a default option or used by advisors to determine retirement spending needs. Understandably, this is because replacement ratios are easy to understand and communicate. It is important to recognize, however, that there is an inherent problem with using replacement ratios based on averages. Although averages can be a very good way to evaluate groups of people, they can be harmful when evaluating the needs of individuals. For example, an individual who makes $150,000 annually prior to retirement may only need to replace 60% of income while an individual who makes $50,000 may need to replace 100%. The average replacement ratio for the two individuals is 80% but neither of them should use that average for planning purposes.

Just as saving has the biggest impact on how big a nest egg will be at retirement, how much comes out of that nest egg each year to fund retirement needs has the biggest impact on how long it will last. Therefore it is critically important that pre-retirees take the time during the retirement planning process to evaluate their personal spending requirements and patterns. They need to look at current expenses and savings to determine what will go up, what will go down, what will stay the same and what will go away completely. They then can use the final total desired spending to determine their personal percentage replacement ratio. Alternatively, using an average percentage replacement ratio to determine their desired spending in retirement is only a guess and a recipe for failure.

1. *The correct targeted income replacement ratio depends on income level, marital status, and phase of retirement*

For decades, the RETIRE Project at Georgia State University has calculated required income as a percent of pre-retirement earnings.[11] As of 2008, the Project estimated that couples earning $50,000 a year required 81% earnings prior to retirement to maintain their standard of living (see table below). Couples earning $90,000 needed 78% of final pay. Singles earning $50,000 needed 80% of final pay versus 81% if they earned $90,000 a year. Lower earning couples and individuals need a higher percent of final pay, because so much of their income is consumed by essential expenses such as food, shelter, etc. that don't decrease upon retirement.

PERCENT OF PRE-RETIREMENT SALARY
REQUIRED TO MAINTAIN LIVING STANDARDS, 2008

Pre-retirement earnings	Two–earner couples	Single workers
$20,000	94	88
$50,000	81	80
$90,000	78	81

Source: Palmer (2008).

2. *How expenses change in retirement*

Although the research above helps to see how income replacement may vary based on income and marital status, it still is based on averages within each defined segment of the market. To determine a personal percentage ratio, pre-retirees can start by first evaluating why income needs in retirement are typically less than their working years. Although there are many expenses that could vary from one individual to another after retirement, below are a few of the most prominent:

Savings: If a plan participant is saving for retirement in employer-sponsored and other personal savings accounts prior to retirement, as of the day they retire they no longer have new money to put into those plans. Therefore, the percentage of income saved prior to retirement reduces the anticipated replacement ratio by that percentage and not all people save the same percentage of income. For example, an individual who was saving 5% automatically reduces their replacement by 5% but an individual saving 20% reduces their replacement ratio by 20%.

Mortgage: For many, mortgage payments can account for 20% to 30% of their income during their working years. Those who are able to pay-off their mortgage prior to retirement will be able to substantially reduce their replacement ratio. Others may be making mortgage payments for ten more years after they retire. By itself, this discrepancy between whether or not a mortgage payment exists after retirement makes an average replacement ratio useless.

Taxes: In addition to an existing mortgage, property taxes can also tend to be a large expense for retirees. Some may decide to downsize their home and move to a more tax-friendly environment to reduce property taxes. Others are emotionally tied to their current home and want to stay put as long as they can regardless of the cost. Those that decide to move to a more tax-friendly state may also see a reduction in their state income taxes. In general, employees pay FICA taxes of 6.2% for Social Security on the first $113,700 of salary in 2013 and 1.45% for Medicare on all salary. Therefore, most employees will have their income needs reduced by the total 7.65% after they retire. It's also important for Social Security benefit recipients to know that although their benefits will most likely be subject to income taxes, not all benefits are added to their taxable income.

Health Insurance: Individually paid health insurance can be a major out of pocket expense when one decides to retire before age 65 and becomes Medicare eligible. Even after Medicare starts, out-of-pocket health care expenses can vary significantly depending upon the health of the individual and any supplement insurance they may have.

Life Style: Lastly, studies have shown that some retirees desire and can afford to spend more in retirement than the income they made while working. This greater than 100% replacement ratio is primarily a result of discretionary lifestyle spending on travel, dining out and other entertainment. Although discretionary spending needs tend to go down as retirees settle in to their twilight years, some will be able to anticipate a higher lifestyle after working years and others will not.

3. How spending patterns change during retirement

It also is important to recognize that spending patterns change over a thirty or more year retirement, especially discretionary spending. There are three distinct spending patterns in retirement that affect discretionary spending. In what some refer to as the *Go! Go! Stage,* early retirees will tend to spend the same, if not more, as when they were working.

- At a minimum, early retirees want only to maintain their standard of living.
- At the maximum, they may feel they have earned the reward of their retirement, and are ready to spend at higher levels.
- The retiree may feel (rightfully so!) that it is time to take that year-long trip around the world, or to buy that top-of-the-line Mercedes.
- Health at this stage is often still good, allowing for the "good times to roll."

But eventually age, health and energy slow down the retiree and a transition occurs to the mid-retirement stage called the *Slow Go Stage.*

- Discretionary spending slows, though healthcare spending may rise.
- If bequest planning is in the picture, this may be the stage when the retiree gets very serious about defining specific dollar amounts or property for future heirs.

Finally, the retiree enters into late retirement or the *No Go Stage.*

- Discretionary spending may nearly stop.
- Healthcare may be a major issue, and it may be difficult for the retiree to physically move around.
- Although the graphic indicates the overall expenses will go down in this third stage, be aware that if healthcare costs are not insured, relative spending in the No Go phase could actually be higher than the Go! Go! stage.

In general, essential expenses overall do not decline much as a person progresses through the different stages of retirement, unless the retiree experiences serious health problems. Unfortunately, many of the retirement planning tools available to both advisors and consumers don't consider different spending patterns in retirement and therefore may be overestimating the total spending required.

IV. How Prepared are State & Local Government Employees for Retirement?

Public sector employees have traditionally received attractive retirement, health and disability benefits. These benefits have also been instrumental in motivating workers to remain with their employer for most, if not all, of their working career. While wages for public sector employees have rarely kept up with the private sector, the benefits package has provided an advantage to attract and retain skilled workers and have created a long-standing perception that retirement plan benefits will provide career workers with sufficient income to meet their needs after work.

The low involvement in supplemental retirement plans of public sector employees in financially preparing for a retirement causes a concern that employees may be counting too much on employer benefits to provide their full support in retirement. This concern is growing for the following reasons:

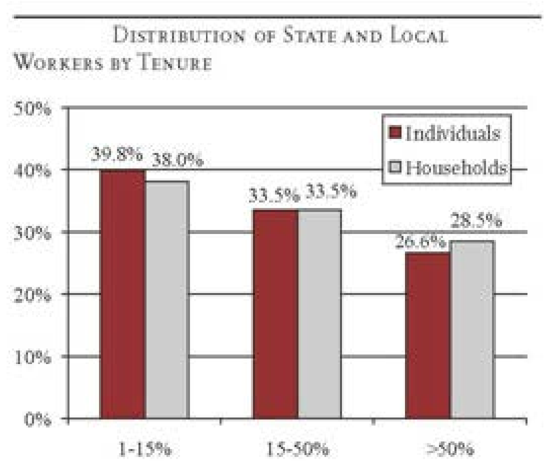
- Employees are underestimating personal longevity and retirement income needs
- State and local government employers are beginning to reduce or eliminate certain benefits

The increasing cost of health and long-term care as well as living longer in retirement translates to the need for more income. Many workers are expecting a more active lifestyle, but not adequately planning for the additional income that this lifestyle cost. Also, few recognize that they must adequately plan for the additional health and long-term care expenses that they may have later in their retirement years.

1. Public sector worker retirement readiness

A 2011 study by the Center for Retirement Research under a grant for Great-West Retirement Services [12] used data from the Health and Retirement Study (HRS), a nationally-representative longitudinal survey of older Americans. The study evaluated the validity of the perception that state-local workers have more than adequate income in retirement.

People might think that when the common 2-percent benefit factor is multiplied by the earnings from a 35- to 40-year career and combined Social Security, most public sector workers might walk out with 100% or more of final pay. This assumes that individuals spend over 30 years in the public sector to generate this level of retirement income. However, an analysis of state-local workers income replacement rates propose that even households with decades-long employees fall short of an 80% percent of pre-retirement earnings replacement.



Source: Authors' calculations from the University of Michigan, *Health and Retirement Study* (HRS) (1992-2008).

This can be explained by:

1. Less than 27% of individuals work in the public sector for more than 50% of their working years (see graph at right).
2. Only 32 percent of workers claim pension benefits immediately after leaving service.
   - Of these, people with 20+ years of service earn a benefit of approximately 49% of pre-retirement pay.
   - Another 27% leave service and take their benefit later. Over time, their benefit declines in purchasing power as prices rise

until they do retire, to the point where the benefit amounts on average to less than 10 % of their final pay.

- 40% leave service without the vesting needed to earn future benefits.

3. On a household basis, those with a state-local worker may also have a private sector worker, which pulls down the average replacement rate of the household. Retirement income replacement rates for private sector workers are much lower as many end up receiving only Social Security.

The following table[13] compares the median income replacement rates for households (versus individuals) for private sector and public sector workers. Public sector workers are more retirement ready than private sector workers, however, the overall replacement rate for workers who spend more than 50% of their career in the public sector is still under 75%.

MEDIAN REPLACEMENT RATES[a] FOR HOUSEHOLDS, INCLUDING FINANCIAL ASSETS, BY EMPLOYMENT HISTORY

Retirement income source	Private sector			State-local sector			
	All	Without pensions	With pensions	All	Percent of career spent in state-local sector: 1-15%	15-50%	>50 %
Social Security	30.3	34.0	29.1	27.1	27.8	27.3	25.8
Social Security + pensions[b]	44.8	34.0	50.0	53.1	43.4	54.2	67.5
Social Security + pensions[b] + Financial assets[c]	51.0	40.5	55.6	60.2	50.9	61.3	72.7

[a] The denominator is the individuals' top five years of earnings in the last ten years indexed for inflation plus income from financial assets.
[b] For those with pension coverage, IRA assets are included in defined contribution wealth; for those without pension coverage, IRA assets are classified as part of financial assets.
[c] The real return on financial assets is assumed to be 2.3 percent.
Source: Authors' estimates from 1992-2008 HRS.

2. The shift to increased employee responsibility for retirement readiness.

Due to increasing costs and the economic climate, public employers are now struggling to meet their current and future pension obligations to retirees much in the same way that the private sector has been experiencing for the past several decades. Although defined benefit plans tend to be maintained as the predominant source of retirement income for most public sector employees, many states now offer optional defined contribution plans or hybrid plans with a defined benefit and defined contribution component. These changes were primarily designed to reduce pension fund obligations by implementing one or more of the following:[14]

- Increasing current and/or new employee contribution levels
- Increasing the age and/or length of tenure required to be eligible for normal retirement.
- Reducing or eliminating cost-of-living adjustments (COLA) for new and/or current employees
- Changing the way pension formulas are calculated to reduce pension benefits
- Offering a hybrid and/or defined contribution plan instead of a traditional defined benefit plan[15]

As a result, the guaranteed income that future retirees will receive from their primary retirement benefits will likely provide a much smaller replacement rate of income. For instance, instead of providing 50% to 70% of pre-retirement income as many current retirees receive today, future benefits will be dependent on the level of employee contributions and their investment decisions. In some cases, younger employees have had defined benefit plans entirely replaced with defined contribution plans as their core retirement savings plan option. As such, defined contribution plans will continue to play a greater role in the retirement preparedness for a large percentage of public sector employees. The need for supplemental savings will be particularly high for low-tenured workers who may not vest in a defined benefit plan (when available) or who may only partially vest in a defined contribution plan.

Also in a similar response as private sector employers, public sector employers are beginning to shift the cost of post-retirement health insurance coverage to employees as well. The percentage of state government units offering health care to retirees under age 65 has dropped from 96% in 2005 to 69% in 2011.[16] There was a similar decrease for retirees over age 65. Furthermore, state governments who do offer retirement health benefits have shifted more of the cost to employees in the form of higher premiums, copayments and deductibles. As a result, many public sector employees who may have been planning on retiring before age 65, when they become Medicare eligible, may need to delay their plans and budget more of their retirement income to cover health related expenses.

Understanding longevity – or the number of years they will have in retirement – is a problem for all workers, public and private sector. The average life expectancy of an individual age 65 is about 19 years or to age 84.[17] This means that approximately 50% of people who are 65 today will live beyond the average of age 84. Therefore, many people who rely on averages will underestimate the amount of years they will live in retirement and consequently the amount of retirement resources they will need. Most experts agree that today's retirees should plan on having enough income to last until they are well into their nineties. Even though not everyone will get there, the alternative of planning for average life expectancy or a little longer could have severe consequences for the many who live longer. So in other words, a plan to die early is not a very good plan at all. Many workers are also expecting a more active lifestyle, but not adequately planning for the additional income that this lifestyle will cost. As a result, any supplemental income they may have accumulated for retirement may not last through their lifetime and be available when it is needed most, such as for unexpected long-term care.

The combination of changing retirement benefits, retirees that are living longer and increases in medical expenses mean that public sector employers are facing a significant challenge to ensure employees recognize that they must take personal responsibility for their retirement readiness. While public sector employers need to continue to use benefit packages as a way to attract and retain skilled workers, they must also find a balance in their communication and educational efforts to inform employees that without personal savings or other income sources, these benefits will likely not be sufficient to meet all of their future retirement income needs.

V. How is Retirement Readiness Different in the Public Sector versus the Private Sector?

Although it is difficult to make additional broad sweeping retirement readiness comparisons between private and public sector employees, some general observations are worth noting.

Tenure - Defined Benefit plans are designed to reward length of service and historically, public sector workers are generally long-term employees. Studies show that whereas defined benefit plans tend to influence longer term service, defined contribution plans tend to influence mobility. With defined benefit plans still as a core retirement planning benefit for most public sector employees, on average, long-term employees certainly tend to have a retirement planning advantage over private sector employees. The Center for Retirement Research at Boston College study referenced above shows that when adding a pension benefit, public employees with more than 50 percent of their career in the public sector typically have a significantly greater income replacement ratio than private sector workers.[18]

Going forward, in instances where there is a greater emphasis on defined contribution plans, younger employees may not be similarly motivated to stay with one employer or in the public sector their entire career. A recent study of Maine public sector workers indicates that over half of the employees leave the public sector before reaching the 5 years of service necessary to vest. Although this study may not be conclusive, the potential for this trend will be worth watching in other states as defined benefit plans become less generous or are eliminated for younger employees entering the public sector workforce.

Social Security Benefits - Approximately 30% of state and local government employees do not participate in the Social Security System.[19] Instead, they may be required to make a similar contribution to their pension plan. Some longer-term employees may think they are eligible for a full Social Security benefit but will ultimately be subject reductions as a result of the Windfall Elimination Provision. Pension benefit formulas for public employees are therefore designed to help mitigate the absence of a monthly check from Social Security, particularly for longer term employees. It is also worth noting that a spouse of a married public sector employee may or may not be a public sector employee themselves and the combination of total household benefits can vary widely. For example, although some public sector workers may not be eligible for Social Security benefits, they may qualify for a spousal benefit under their private sector spouses work record. Regardless, employees who will not receive a check from Social Security or who did not contribute to Social Security their entire career will need to understand and evaluate the impact on their personal retirement readiness and make decisions accordingly.

Investing Retirement Savings - Although there has not been extensive research comparing the investment behavior of public sector employees to private sector employees, one study conducted by ING in 2010 indicates that public sector employees generally prefer to avoid investment risk. The survey indicated that 74 percent of public sector employees are not risk takers and 50% are conservative investors that want to protect savings and avoid possible losses.[20] It is important to keep in mind that this survey was conducted after a period of significant stock market declines starting in 2008. Future studies should also evaluate if some public sector employees consider their defined benefit plan benefits as a proxy for fixed income and therefore may be willing to take more investment risk with managed retirement assets.

Lump-sum distribution option- Another interesting recent development among private sector plans that still have defined benefit plans is an increase in the number of plans that offer a lump sum distribution option at retirement. Between 1991 and 2005, the percentage of plans with a lump sum option increased 38 percent from 14 percent to 52 percent.[21] Anecdotal evidence suggests that when given the choice, a majority of participants elect the lump sum benefit and then do not always invest and spend it wisely.[22] Public sector plans on the other hand are less likely to offer a lump sum option at retirement and promote the idea of a lifetime benefit via annuitization options.

Public Safety Employees – Police, firefighters and other public safety employees are generally offered full retirement benefits from defined benefit plans at earlier ages than general employees and teachers. Many public safety workers may take an unreduced pension as early as age 50. The longer that pension benefits are paid, the more they will be impacted by compounded inflation, particularly for plans that do not have automatic cost of living adjustments. After 20 years, the value of a pension in terms of what it will buy could be cut in half or more. Public safety workers are also less likely to be covered by Social Security benefits than other employees. To maintain their retirement readiness, those who may retire from a dangerous and difficult public sector job in their 50s should consider other employment on a full to part-time basis for another 10 to 15 years.

VI. How Does Retirement Readiness Differ by Gender, Ethnicity and Generation?

Since the early 1990s, many policy, economic and demographic changes have taken place. An analysis of effect of these changes estimates that while future retirees will have higher real incomes and lower poverty rates than retirees today, retirees of the future will generate a lower income replacement rate.[23]

The following sections look at key changes over the last twenty years by gender, ethnicity and generation and are important for retirement professionals to keep in mind as they serve these different markets.

1. Gender[24]

By 2004, 85% of Americans had earned a high school diploma versus 78% in 1990, and 28% had earned a college degree versus 21% in 1990.

During the same time, more women began working outside the home. The percent of women in the labor force increased from 57% to 59% for those over age 16, but increased the most for those aged 55–64 from 45% to 56%, and from just under 9% to 11% for those over age 65. In contrast, the participation of men declined among most age groups, but increased slightly for those aged 55–64 and those over age 65. What does this mean? Higher earnings for women now allow single women to catch up with the retirement assets accumulated by their single male counterparts; the gaps between the level of net worth and assets are closing between men and women for all age groups and wealth segments.

The Society of Actuaries[25] has published several papers segmenting the Middle Market and identifying the assets they have available for retirement. The Middle Market is comprised of two segments:

1. the *Middle Mass segment*, which includes the greatest number of households and is generally underserved when planning for retirement income, and
2. the *Middle Affluent segment* which has more investable assets.

(See Tables from the 2010 Survey of Consumer Finances on the next two pages for the age, sex, number of households, and average net income, net worth, financial and non-financial assets (retirement savings) of those in the 25th through 75th percentile of each segment.)

An important thing to note about the Middle Mass and Middle Affluent segments: Most of the Middle Market's wealth (both Middle Mass and Middle Affluent) is in “non-financial” assets, which generally means home equity. The Middle Affluent age 65-74 married segment – only one segment of the 12 – has financial assets greater than their non financial assets.

Middle Mass Segments: Aged 55-64 and 65-74

There are 16.8 million households in the Middle Mass segment between the ages of 55-74, with an estimated median net worth of $41k-$290k, net financial assets of $7k-$96k, and non-financial assets (primarily home equity) of $34k-$221k.

Middle Mass Income and Assets, Ages 55-64

	# of hhds (millions)	*% of Mass Mkt*	*Median income and range*	*Est. median net worth*	*Net non-financial assets*	*Financial assets*
Married	*5.7*	*29%*	*$82,000 Range:$52k-$130k*	*$277,000*	*$181,000*	*$96,000*
Single Female	*2.7*	*13%*	*$32,000 Range:$19k-$55k*	*$41,000*	*$34,000*	*$7,000*
Single Male	*1.8*	*9%*	*$44,000 Range:$25k-$80k*	*$76,000*	*$63,000*	*$13,000*
Total Middle Mass Ages 55-64	*10.2 million*	*= 51% of total mass market households between ages 55-74*				

Middle Mass Income and Assets, Ages 65-74

	# of hhds (millions)	*% of Mass Mkt*	*Median income and range*	*Est. median net worth*	*Net non-financial assets*	*Financial assets*
Married	*3.4*	*17%*	*$56,000 Range:$34k-$93k*	*$290,000*	*$221,000*	*$69,000*
Single Female	*2.2*	*11%*	*$21,000 Range:$12k-$41k*	*$106,000*	*$97,000*	*$9,000*
Single Male	*1.0*	*5%*	*$30,000 Range:$18k-$51k*	*$134,000*	*$122,000*	*$12,000*
Total Middle Mass Ages 65-74	*6.6 million*	*= 33% of total mass market households between ages 55-74*				

Middle Affluent Segments: Aged 55-64 and 65-74

There are 3.3 million Middle Affluent segment between the ages of 55-74, with an estimated median net worth of $185k-$1.24 million, net financial assets of $68k-$632k, and net non-financial assets (including home equity) of $117k- $671k.

Middle Affluent Income and Assets, Ages 55-64

	# of hhds (millions)	*% of Mass Mkt*	*Median income and range*	*Est. median net worth*	*Net non-financial assets*	*Financial assets*
Married	*1.1*	*6%*	*$146,000 Range:$130k-$167k*	*$1,241,000*	*$671,000*	*$570,000*
Single Female	*0.5*	*2%*	*$64,000 Range:$55k-$75k*	*$185,000*	*$117,000*	*$68,000*
Single Male	*0.4*	*2%*	*$85,000 Range:$80k-$97k*	*$339,000*	*$214,000*	*$125,000*
Total Middle Affluent, ages 55-64	*2.0 million*	*= 10% of total mass market households between ages 55-74*				

Middle Affluent Income and Assets, 65-74

	# of hhds (millions)	*% of Mass-Mkt*	*Median income and range*	*Est. median net worth*	*Net non-financial assets*	*Financial assets*
Married	*0.7*	*3%*	*$105,000 Range:$93k-$122k*	*$1,193,000*	*$561,000*	*$632,000*
Single Female	*0.4*	*2%*	*$45,000 Range:$41k-$52k*	*$437,000*	*$299,000*	*$138,000*
Single Male	*0.2*	*1%*	*$60,000 Range:$51k-$70k*	*$551,000*	*$377,000*	*$173,000*
Total Middle Affluent, ages 65-74	*1.3 million*	*= 6% of total mass market households between ages 55-74*				

2. Ethnicity[26]

The United States has become even more demographically diverse since 1990. Hispanics have increased from 9% of the depression baby population born (1926–1935) to almost 16% of the GenX population (born 1966–1975). The black population has grown from 8% of the depression baby population to 18% of the GenX population. Retiree racial composition is projected to shift dramatically as minority-group representation increases.

Retirees that trail at the end of the baby boomer generation and GenX retirees are more likely to be non-white than depression baby retirees. Almost one in five depression baby retirees are in a racial/ethnic minority, compared to 2 in 5 for GenX retirees. The amount of foreign-born retirees is expected to increase from 10% in the baby boom generation to 26% for retirees of GenX. These subgroups are expected to have lower retirement income because they typically have lower earnings than whites.

3. Generational[27]

- Future retirees are expected to have higher incomes with fewer people in poverty. However, they are expected to have lower replacement rates. In other words, their absolute income will be higher than previous generations, but the level of income replaced will be lower, so overall they'll face greater retirement income planning challenges.

- For example, the typical GenX retiree is expected to have $46,000 in annual income at age 67 replacing only 84% of their income. A depression baby retiree has typical income of only $28,000, however it replaces 95% of their income.

- Trailing boomers (born 1956–1965) and GenXers (36%) are more likely to never marry, be divorced or widowed than depression baby retirees (29%). The highest poverty rates are for those who never married, followed by divorcees, and widows. More unmarried retirees means more people enter retirement without access to things that spousal income can improve, such as additional source of retirement income, and economies of scale that come with shared living. They also have more exposure to shocks such as unemployment or disability that can derail retirement.

- It's counter-intuitive, but higher incomes for women actually lowers overall household income replacement rates compared to their predecessors. Lower-earning women today receive higher Social Security spouse and survivor benefits based on their spouse's record versus what they can collect based on their own work record. As women earn more and the income gap closes between men's and women's earnings, the number of women collecting benefits based on their spouse's earnings will fall. Over time this will lower replacement rates, as two people collecting Social Security benefits based on one primary household income replaces a higher percentage of total household income than Social Security benefits collected by two people replacing two earners' incomes.

- Because of this, assuming retirees need 75 - 85% of preretirement income to maintain their living standards, 39% of leading boomers (born 1946–1955), 41% trailing boomers, and 43% of GenXers will miss the replacement target at age 67 needed to maintain their preretirement living standard of living, compared with 35 percent of depression babies.

- Total retirement income (DB plus DC) is expected to average $14,000 for GenXers to $8,000 for depression babies. However, all post depression era generations will have higher overall household income to replace.

- Twice as many GenX retirees will be college educated than depression baby retirees.

- Three times more GenX women are expected to have worked 35 years in the workforce than depression babies.

- GenXers will get one-third of the pension income received by depression babies ($2,000 versus $6,000). However, GenXers will receive more income from retirement accounts than depression babies ($12,000 versus $2,000).

- Leading boomers got the short end of both sticks. As plans switched from DB to DC plans, they missed out on their high accrual contribution years and were left with a shorter time horizon to build their retirement savings before retirement.

VII. Why Should Plan Sponsors Care About Employee Retirement Readiness?

According to SunTrust[28], employers who help their employees save for a secure retirement benefit by:

- Improved reputation in the local community and in the employee community due to happy employees.

- Being a more attractive employer for desired talent.

Employers who do not help employees become retirement ready risk assuming substantial costs for employees who delay their retirement if they're not ready to retire.[29]

- Studies have shown that financially stressed employees average higher healthcare costs, which can then lead to higher insurance costs.

- Workers arriving at retirement unprepared may seek litigation for employers shifting responsibility but not providing tools to become retirement ready

- Financial instability has proven to affect worker productivity on the job

- Morale of younger employees may drop if older employees stay longer due to retirement unpreparedness.

VIII. How Can Employers Improve Retirement Readiness for Employees?

It would be easy to create an extensive list of what employers can do to improve the retirement readiness of their employees. The following is deemed top priority for voluntary savings programs such as 457 and 403(b) plans.

1. Simplify participation and reduce decision-making

A. Make participation as simple as possible for employees (the following is excerpted from NAGDCA's 2012 paper on the Evolving Role of Defined Contribution Plans in the Public Sector)

Limit the number of funds. One of the basic considerations in selecting funds is to limit the number so that participants are not overwhelmed by the choices.[30] This thinking reflects both findings from behavioral economic research and observed results. However, the appropriate number of funds is open to debate. From NAGDCA's paper on the Evolving Role of Defined Contribution Plans research interviews, the ideal number of funds ranged from as few as six (plus target-date funds) to as many as twenty.[31] Another method to simplify the structure for participants is to limit the number of plans. For example, a single plan approach will allow the plan sponsor to negotiate better terms and lower fees while making choices less confusing for participants.

Add auto-enrollment. Research has shown that auto enrollment is effective at encouraging employees to save.[32] Furthermore, increasing the default contribution rate for auto enrollment does not decrease participation. For example, Choi et al. (2004) found that opt-out rates were the same for employees whether the default contribution was set at 3 percent or 6 percent.[33] However, most research has focused on private sector 401(k) plans and, to a lesser extent, public 401(k) and 401(a) plans, but rarely on supplemental public sector defined contribution plans. Currently, only a small percentage of supplemental plans use auto enrollment, and there are differing opinions on its viability.[34]

However, in some cases, auto enrollment may not always be appropriate. Public employees participating in plans with higher employee contributions and defined benefit levels may not feel as much pressure to participate in a supplemental fund. In instances when employers institute a low auto enrollment contribution because of concerns with employee resistance, administrative fees may need adjusting due to the imbalance of relatively small account balances and relatively inflexible administrative costs.[35] In some states, legislation may be required before auto enrollment could be implemented. Finally, auto enrollment could be administratively challenging in governments with unions that have pension plan agreements. Some consensus with the unions about auto enrollment would be needed before implementation, and that may be difficult to achieve.[36] As a result of these issues, the decision to use auto enrollment for supplemental defined contribution plans should be considered on a plan-by-plan basis.

Make automatic escalation available when appropriate. Automatic escalation is almost nonexistent for supplemental defined contribution funds and will likely stay that way for the time being. Because supplemental funds today typically are not expected to have significant asset accumulation, the need to escalate contributions annually does not appear necessary.[37] Rather, auto escalation may be more appropriate for core defined contribution plans or hybrid plans but with a lower cap.

B. Reduce decision-making (the following is excerpted from NAGDCA's 2012 paper on the Evolving Role of Defined Contribution Plans in the Public Sector)

Behavioral economics for retirement savings explores why people do not save enough for retirement. Herbert Simon's "bounded rationality" posits that people are limited in their ability to consider all issues and facets for a complex problem.[38] In regard to retirement planning, people have difficulty predicting factors such as investment returns, cash flows, tax rates, and longevity[39], which leads them to be more likely to accept a default option when making decisions about their retirement savings. Bounded rationality is compounded by "bounded self-control," which is a lack of will power when it comes to savings. Simply put, people do not save enough because they have a much higher near-term discount rate, almost hyperbolic, compared to future discount rates. In other words, they value immediate consumption far greater than delayed consumption, and the longer the delay, the larger the difference. Individuals can be greatly influenced in their decision making by how an issue is framed.[40] For example, framing a savings decision in a way that requires less effort may lead to increased willingness to save.[41]

Research has found several similar behavioral characteristics that can negatively influence investing decisions. Many individuals lack firm preferences for investing, including making the tradeoff between risk and return.[42] Therefore, the framing of investment decisions can greatly affect choices about investment portfolios. For example, having relatively more funds within a particular asset class will lead investors to continue to choose that type of investment, regardless of whether it will produce the best return. Inertia also affects investment decision making. Once an individual makes an investment decision, he or she is likely to leave it unchanged.[43]

Other undesirable retirement investment practices include *chasing returns*, *loss aversion*, and *narrow framing*.[44] When *chasing returns*, individuals rely only on past performance to make investment choices, rather than studying expected returns and risk. This may be because past performance is readily available, even though it is often a less accurate predictor of outcomes. *Loss aversion* causes individuals to invest too conservatively, which minimizes opportunities for growth. Research has found that individuals view losses as 2.5 times more painful than an equivalent gain.[45] Finally, loss aversion can be heightened through *narrow framing*, which looks at investment decisions as isolated events rather than a recurring process. If individuals looked at their choices in a larger context, they might begin to value losses and wins equally, leading to better investing decisions.

Design tools such as auto enrollment or target date funds may help employees arrive at retirement with sufficient savings, but employees will still need education and guidance on how to integrate defined contribution assets with other lifetime income. Some even argue that plan administrators will need to provide retirement advice and retirement planning software to meet employees' needs.

2. Keep costs down and investment quality up

A. Keep plan costs down

Due to their group nature, most defined benefit plans deliver retirement benefits at a lower cost to the employer and employee. They are able to manage longevity risk more efficiently, they are able to experience higher potential returns/invest for the long-term since their time horizon goes beyond an individual's lifetime, and because they don't break assets into individual accounts or utilize retail managed funds, they experience lower costs. In contrast, the expenses and lost income opportunities associated with defined contribution plans can cost employees over one-third of what they could have had accumulated for retirement income.[46]

There are three issues with defined contribution fund management that merit attention by defined contribution plan sponsors to keep more money in the pocket of employees: revenue sharing, fee disclosure, and automation. *(The following is excerpted from NAGDCA's 2012 paper on the Evolving Role of Defined Contribution Plans in the Public Sector)*

Revenue Sharing. This occurs when a portion of the investment-related fees collected from participant accounts is returned to the plan sponsor. It is relatively common practice with plans that use private-sector investment funds. There is some debate about what do with the money that comes from revenue sharing such as using it to offset administrative expenses or returning it to participant accounts, with the former being more common. One concern with revenue sharing is that it may not occur with all funds in equal proportions. Index funds are an example. To the extent that the revenue sharing dollars offset plan expenses, participants who do not invest in funds with revenue sharing receive a disproportionate benefit. Best practice would call for allocating dollars proportionally to accounts, provided the administrative cost of doing so does not exceed the total amount of money received. With the increasing importance of defined contribution funds, which will result in more assets in these accounts and the new U.S. Department of Labor fee disclosure requirements,[47] revenue sharing will receive greater attention in the near future.

Fee Disclosure. The new Department of Labor fee disclosure regulations cover several areas including general plan structure, fees related to administrative expenses, benchmark and performance data for investments, and investment fees.[48] Uncertainties abound in regard to implementation of the regulations and their applicability to public sector plans. NAGDCA is already playing an important role in explaining the regulations, and members will likely seek more assistance in the coming months, including how to best present the data and how much to offer electronically versus in paper format.

Automation. With new fee disclosure requirements and a desire to keep employees informed, plan sponsors and record keepers will be searching for ways to communicate with employees other than through the mail. One option may be to shift from traditional paper to emailing quarterly reports. Unfortunately, some of these automation options may be more difficult for local governments to implement because of the relatively high number of employees without access to computers at work, such as public works employees. This may require employers to maintain employees' personal email addresses as part of their contact information, which could be difficult to track, particularly after they leave employment.

B. Keep the quality of investment options up. (The following is excerpted from NAGDCA's 2012 paper on the Evolving Role of Defined Contribution Plans in the Public Sector)

The increasing importance of defined contribution plans will result in greater attention to their management including ensuring that board members and staff meet their fiduciary responsibilities.

Training on investments. Training on investments is generally recommended for board members and anyone with fiduciary responsibility.[49] Although having financial expertise is not a prerequisite for serving on a retirement fund board, building knowledge about investment approaches and options, selecting managers, and overseeing investments are core fiduciary responsibilities. Without proper training, board members cannot question their record keeper or consultant about fees, benchmarks, fund management, etc. Appreciating the importance of training, NAGDCA helped found in 1997 the International Foundation for Retirement Education (InFRE) that offers plan administration and counseling education for professionals involved with public sector defined contribution plans.

Written Investment Policy Statements. One of the most important responsibilities of supplemental and core defined contribution plan fiduciaries is the selection of funds. By selecting a particular fund, the fiduciary is making an implicit recommendation. Board members and staff need to perform strong due diligence in their research, selection, and management of funds and fund managers. The investments should be screened for charges and expenses, manager tenure, size of the fund, past performance, risk levels, volatility, and changes to fund operations.[50] Written investment policy statements can greatly assist in that effort by providing guidance and continuity in decision making.

Actively Overseeing Investment Options. Once chosen, investments require sustained oversight. For example, fiduciaries must ensure that managed funds are actually being effectively and actively managed, particularly since defined contribution plan participants pay higher fees for this service. The plan should have established investment policies and benchmarks that are followed consistently with performance updates done quarterly. To help with this work, hiring an investment performance consultant can be extremely beneficial. In addition to fund performance, fiduciaries need to make sure the fees charged for management are reasonable and transparent. Recommended practice is to bid out services for record keepers and fund managers on some recurring basis. Finally, administrative and investment fees need to be available to employees in a readable and accessible format. Oversight of investments takes resources, time, and effort.

3. Use outcome-based income projections

The Department of Labor is considering providing guidance on retirement income illustrations. The language and concepts being considered are limited to pension benefit statements of defined contribution plans. Helping employees see how supplemental savings translates into retirement income will help to increase employee awareness of their personal retirement funding risk. *The following is excerpted from the Department of Labor's Fact Sheet on Retirement Income Illustrations (May, 2013)*

- A participant's pension benefit statement would show his or her current account balance and an estimated lifetime income stream of payments based on such balance. The lifetime income illustration would assume the participant had reached normal retirement age as of the date of the benefit statement, even if he or she is much younger.

- For a participant who has not yet reached normal retirement age, his or her pension benefit statement also would show a projected account balance and the estimated lifetime income stream based on such balance. A participant's current account balance would be projected to normal retirement age based on assumed future contributions and investment returns. The projected account balance would be converted to an estimated lifetime income stream of payments, assuming that the person retires at normal retirement age. This account balance and the related lifetime income payment would be expressed in current dollars.

- Both lifetime income streams (i.e., the one based on the current account balance and the one based on the projected account balance) would be presented as estimated monthly payments based on the expected mortality of the participant. In addition, if the participant has a spouse, the lifetime income streams would be based on the joint lives of the participant and spouse.

- Pension benefit statements would contain an understandable explanation of the assumptions behind the lifetime income stream illustrations. Pension benefit statements also would contain a statement that projections and lifetime income stream illustrations are estimates and not guarantees.

IX. Summary

Public sector employers have started to adjust their retirement plan benefits offerings and shift more of the risk of saving and investing for retirement to their employees. The combination of changing benefits, retirees that are living longer and increases in medical expenses mean that public sector employers are facing a significant challenge to ensure employees recognize their new retirement readiness responsibilities. Lessons from the same shift within the private sector over the past several decades tell us that, without help, most public sector employees will not able to clearly understand their new personal risks and make informed retirement planning decisions.

Therefore, public sector employees retiring in the future will be in jeopardy of not having adequate resources and many may ultimately become somewhat dependent on their former employers in the form of social assistance. While public sector employers need to continue to use benefit packages as a way to attract and retain skilled workers, they must also find a balance in their communications to inform employees that without personal savings or other income sources, these benefits will likely not be sufficient to meet all of their future retirement income needs.

Public employers and retirement plan providers can help plan participants accept their new retirement planning risks and responsibilities by:

1. Offering personal retirement assessment tools that measure retirement readiness on a holistic basis. This means not only looking at an employee's wealth and financial needs component, but also their health and happiness preparedness.

2. Expand education programs to address various retirement planning needs (not just investing decisions) related to public plan differences, gender, ethnicity and generation.

3. Encouraging participation in voluntary savings plans by using best practices plan features that simplify decision making, reduce costs and offer outcome-based income projections.

Although there is not a one size fits all solution, a commitment to a retirement readiness evaluation program combined with ongoing education programs and enhanced savings plan design features will create a strong foundation for positively impacting needed changes in public sector plan participant behavior.

About NAGDCA

NAGDCA's mission is to unite representatives from state and local governments that service and support defined contribution plans. NAGDCA provides an environment to foster growth in professional development of its members through networking with peers, educational opportunities, and information sharing that includes comprehensive publications, reports, and surveys. NAGDCA will promote and support federal legislative initiatives for the advancement of retirement plans. www.nagdca.org

About InFRE

InFRE is a 501(c)(3) non-profit education foundation devoted to enhancing the retirement preparedness of the American worker. Since 1997, we have accomplished our mission by operating as a highly respected independent and objective educational resource for public and private sector retirement planning focused advisors. NAGDCA, the National Pension Education Association (NPEA) and the Center for Financial Responsibility at Texas Tech University were founding partners of InFRE and we continue to work closely with all three organizations and other industry professionals to:

- Offer the highly credible Certified Retirement Counselor® (CRC®) retirement counseling certification program for retirement planning professionals
- Create a stand-alone retirement income planning training program designed to help retirement planning professionals create a lifetime income plan for their clients and plan participants
- Develop a series of retirement plan administrator training modules focusing on the day-to-day responsibilities of public sector plan administrators
- Conduct numerous research projects (including working with the Federal Office of Personnel Management to develop a retirement readiness assessment for use by the federal government workforce)
- Implement scholarship programs which allow university students to attend retirement industry conferences.

About the Authors

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Kevin Seibert has more than 30 years of experience in retirement benefits, financial planning, and financial education. He is a leading expert in retirement income planning and co-author of a series of professional education courses on managing retirement income presented to more than 15,000 advisors and retirement counselors since 2004 in live, print, elearning and audio formats.

Kevin is recognized as a Certified Financial Planner (CFP®) by the College of Financial Planning, and is a Certified Employee Benefits Specialist (CEBS), and has been awarded the Certified Retirement Counselor (CRC®) certification from InFRE. Kevin earned his MBA in finance from the University of Wisconsin and received his undergraduate degree in finance from Miami University of Ohio.

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Betty Meredith is the Director of Education & Research for the International Foundation for Retirement Education (InFRE), whose purpose is to increase the retirement readiness of the American worker through professional retirement certification and continuing education, and Managing Member of the Int'l Retirement Resource Center. Betty oversees incorporation of research findings and best practices into InFRE's retirement certification study and professional continuing education programs in order to help retirement advisors and counselors more effectively meet the retirement preparedness and income management needs of clients and employees.

Betty has been involved in client/employee education since 1989 as a retirement education consultant to fulfill the goal of providing practical, easy and application-oriented financial education for the American worker to learn the basics of controlling their money, planning for their future and making informed retirement income planning decisions. She has written four consumer financial and retirement planning self-study workbooks and created over twenty workshops used in the general marketplace and the employer markets. Thousands of employees have used her employee/client education materials in employer and corporate training workshops by prominent financial institutions such as Charles Schwab & Co., Standard & Poor's, Morgan Stanley Dean Witter, Chase, Nationwide Retirement Solutions, as well as state public sector retirement systems.

She is also co-author of a professional development guide on retirement income management and related workshops. She also produces a monthly live webinar professional development series for retirement professionals, and writes a regular column on serving the retirement needs of the mid-market in the Journal of Financial Planning. She is the past Chair of the Communication and Education Committee for the Plan Sponsor Council of America (PSCA); served on the Board of Governors for the International Foundation for Retirement Education (InFRE); was an adjunct instructor for the International Foundation for Employee Benefit Plans' (IFEBP) "Designing Effective Retirement and Financial Education Programs" certificate course; and is a member of the Financial Planning Association (FPA), the Association for Investment Management and Research (AIMR), and the Society of Financial Services Professionals.

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