Shifting Responsibility to Workers:

The Future of Retirement Adequacy in the United States

by Allen Steinberg and Lori Lucas

While many 401(k) participants at large companies can expect replacement of nearly 100% of preretirement income, not all workers participate in their 401(k) plan. Moreover, the authors show that even among participants, the extent of retirement preparedness depends on defined benefit (DB) plan coverage and retiree medical benefit generosity. Given recent trends in the elimination of DB plans and retiree medical subsidies and the voluntary nature of 401(k) participation, retirement income responsibility is increasingly shifting to workers. The authors discuss how employers might help workers meet their retirement income needs in this changing environment.

Americans are optimistic when it comes to retirement. The Employee Benefit Research Institute's *2004 Retirement Confidence Survey* finds that 24% of workers are very confident and more than four in ten are somewhat confident that they will have enough money to live comfortably in retirement. Is their optimism well-founded? For the typical worker at a large U.S. company, the answer may appear to be a resounding "yes." After all, the retirement benefits of such workers often include not only a 401(k) plan with company match, but profit sharing and a DB plan. Indeed, many workers may look at the situation of currently retiring peers and assume that early and rich retirement is easily within their reach, too. But delve deeper into the numbers and a different picture begins to emerge. The U.S. retirement system is under considerable pressure from continuing erosion of traditional DB pension plans along with cost and affordability issues that may undermine Social Security and Medicare. Add to the mix high rates of medical inflation and corresponding decreases in retiree medical benefits and it becomes clear that, in the future, employees of large companies are likely to be in a very different position when it comes to retirement than their currently retired peers. Going forward, retirement income adequacy will be increasingly a function of the size of available 401(k) plan benefits. In other words, the responsibility of adequate retirement income is shifting increasingly from corporations and the government to individual workers. The question is: Are they up to the challenge? Retirement income adequacy of American workers is the subject of a new study by Hewitt Associates: *Total Retirement Income at Large Companies: The Real Deal 2004.*

WHAT IS ADEQUATE RETIREMENT INCOME?

Workers and plan sponsors alike are commonly told that, in order to maintain one's standard of living in retirement, 75% to 80% of preretirement income has to

Methodology of the Study

The analysis started with the actual DC account balances, as of January 1, 2003 for each of the 960,000 employees in Hewitt's database. These balances were increased by 18% to reflect market returns for calendar year 2003 and then projected to retirement age assuming a 7% annual rate of return. These account balances were then converted to a single life annuity amount at retirement age, with an annual rate of return of 6%.

The DB amount that would be provided at retirement under the current DB plan—if any—maintained by the employers was also included in the projection. Forty-four of the 62 companies (71%) sponsor an ongoing DB plan.

The primary individual insurance amount that would be provided, using projected pay, under the current provisions of Social Security was also included.

Only those retirement income assets covered by the plan maintained by the participants' current employers were considered. Thus employees' benefits from previous employers were not reflected in the study, unless rolled over into the current employer plan. This would result in a potential understatement of retirement income for low-tenure late-career hires, and should be taken into account when analyzing the results.

Other employer-provided benefits outside of the qualified DB and DC plans were not considered. Since many workers do not maintain large amounts of outside assets, the impact should be modest for many workers.

be replaced on an annual basis in retirement. This figure refers to a 1981 *Report of the President's Commission on Pension Policy,* updated in 2001 under the direction of Georgia State University.

One of the methods used under the 2001 report to define *adequate* retirement income (and the approach adopted by Hewitt in our study) starts with preretirement income. Adjustments are then made for differences in taxes on pre- and postretirement income and the presumed cessation of saving at retirement. As such, the study's definition of *adequacy* is not based on spending patterns pre- and postretirement, but instead on the assumption that a fundamental component of retirement income adequacy is maintaining preretirement living standards.

What the report does not take into account is that retirement income adequacy must reflect postretirement inflation and the lack of inflation indexing of most retirement benefits. In order to maintain one's standard of living in retirement, assuming a 3% long-term annual inflation rate, it is necessary to increase targeted replacement ratios by approximately 10 to 15 percentage points. In other words, to sufficiently account for inflation, retirement savings should actually target income replacement levels of 85% to 95%. The lower end of this range is applicable to lower-wage employees who receive the greatest percentage of their retirement income from the inflation-indexed Social Security program. The higher end of this range is needed for higher-paid employees who receive a lower portion of retirement income from Social Security.

THE CURRENT STATE OF RETIREMENT INCOME ADEQUACY

The new study by Hewitt Associates shows that the typical 401(k) participant is well positioned to replace 85% to 95% of preretirement income when current Social Security and existing profit-sharing and DB plans are taken into account. The study examined the projected preretirement income replacement levels across 62 large companies of the 960,000 employees who were actively participating in their 401(k) plans as of January 1, 2003. For example, an employee with $50,000 in pay at retirement age and annual retirement income of $45,000 would be projected to have a replacement income ratio of 90% in their first year of retirement. In the study, actual defined contribution (DC) balances were used, along with actual employee and employer contribution rates, profit-sharing benefits and projected Social Security and DB income. (See sidebar for more information on the methodology used.)

The study found that the average 401(k) participant at a large company is positioned to replace nearly 100% of preretirement income (99.5%), given current benefits and the current Social Security structure. Moreover, retirement income levels at or above 100% are not limited to those employees who achieve double-digit investment returns or savings rates. Rather, these high retirement income levels are achieved by a group of employees who contribute on average approximately 6% of pay and who achieve investment returns of 7% on a long-term basis (or, stated as a real rate of return, 4% above inflation).

In effect, employees who take advantage of their employer plans and who follow fundamental rules around retirement saving and investing can achieve these retirement income levels. Table I shows a breakdown of retirement income replacement rates by age and service, as well as the average retirement income replacement rate across the entire population of nearly one million participants. In the analysis, retirement age is assumed to be 65 and average pay is capped according to IRS limits. Table II shows a baseline scenario by pay brackets. (See the appendix for a description of how to interpret the charts in this study.)

Projected income replacement rates of older, shorter-tenure workers were considerably lower. However, it is

important to recognize that the study did not take into account non-employer-sponsored benefits, other than Social Security. Presumably, employees in their 50s and 60s, with only several years of tenure at their current employer, would have other sources of retirement income beyond that available from their present employer. However, at the same time, the study found that even employees hired in their 40s can achieve replacement rates of 80% in their 15 to 20 years of participation. These levels of replacement income, coupled with prior employer benefits, should allow midcareer hires to achieve the same replacement ratios as their longer-tenured colleagues.

One concern often voiced regarding the private pension system is that employers will create plans that disproportionately favor highly paid employees. However, the study found that employees in each of the three broad pay categories (current annual pay below $45,000 per year; current pay between $45,000 and $90,000; and current pay over $90,000) tend to be clustered around a fairly narrow range of replacement ratios. As would be expected, the composition of retirement income varies with pay levels, with the lowest-paid group receiving a greater portion of their benefits from Social Security and the other groups doing better under the employer-sponsored plans.

While this view of the retirement income system is encouraging for workers at large companies, the picture becomes clouded when three critical factors are considered:

- The impact of failing to participate in the 401(k) plan
- Retiree medical costs
- Changes in program structure.

The remainder of this article will focus on these three areas.

TABLE I

Retirement Income Replacement Rates by Age and Service—Baseline Model

Retirement Age = 65
Contribution Adjustment = 0%
Interest = 7%
All Employers
DB + DC + PIA

Age	Service 0 – 4	5 – 9	10 – 14	15 – 19	20 – 24	25 – 29	30+	Total
Under 25	9,969 $30,787 127.8%	2,940 $26,601 119.2%						12,909 $29,833 125.8%
25 – 29	45,697 $47,324 126.9%	30,899 $45,260 125.0%	1,877 $37,622 122.9%					78,473 $46,279 126.1%
30 – 34	46,827 $61,176 110.5%	55,114 $61,294 116.9%	17,344 $55,427 121.5%	2,228 $45,388 123.8%				121,513 $60,119 115.3%
35 – 39	38,978 $70,601 95.7%	51,175 $69,455 102.5%	30,970 $72,542 116.6%	19,466 $67,323 124.4%	1,775 $52,369 124.0%			142,364 $69,936 107.0%
40 – 44	34,403 $71,163 81.2%	46,220 $71,815 88.0%	29,882 $76,923 102.3%	33,354 $82,497 116.0%	17,904 $71,300 122.4%	2,915 $55,894 129.2%		164,678 $74,432 99.3%
45 – 49	26,859 $70,075 70.7%	37,058 $68,813 76.8%	24,414 $74,437 89.5%	25,340 $83,978 102.9%	24,038 $87,787 114.0%	19,805 $71,698 120.8%	2,645 $61,916 126.9%	160,159 $75,372 93.7%
50 – 54	19,274 $67,428 61.8%	26,744 $64,761 68.1%	18,582 $68,916 79.1%	18,013 $77,577 91.7%	16,333 $84,657 102.1%	19,552 $85,807 110.8%	17,083 $73,681 119.6%	135,581 $73,968 88.6%
55 – 59	12,140 $64,229 54.0%	18,520 $61,652 60.0%	13,265 $65,256 70.7%	12,533 $71,137 82.1%	10,503 $76,605 92.2%	11,191 $82,010 100.0%	22,249 $84,036 110.2%	100,401 $72,418 82.4%
60+	5,527 $56,411 48.6%	9,564 $53,399 54.0%	7,106 $58,455 63.5%	6,311 $62,717 73.8%	5,011 $64,073 82.8%	4,618 $65,252 90.0%	9,316 $85,601 98.3%	47,453 $64,349 72.7%
Total	239,674 $61,782 95.1%	278,234 $63,483 94.4%	143,440 $69,409 98.0%	117,245 $76,558 105.1%	75,564 $79,245 108.5%	58,081 $77,129 111.4%	51,293 $79,731 112.0%	963,531 $68,457 99.5%

Legend

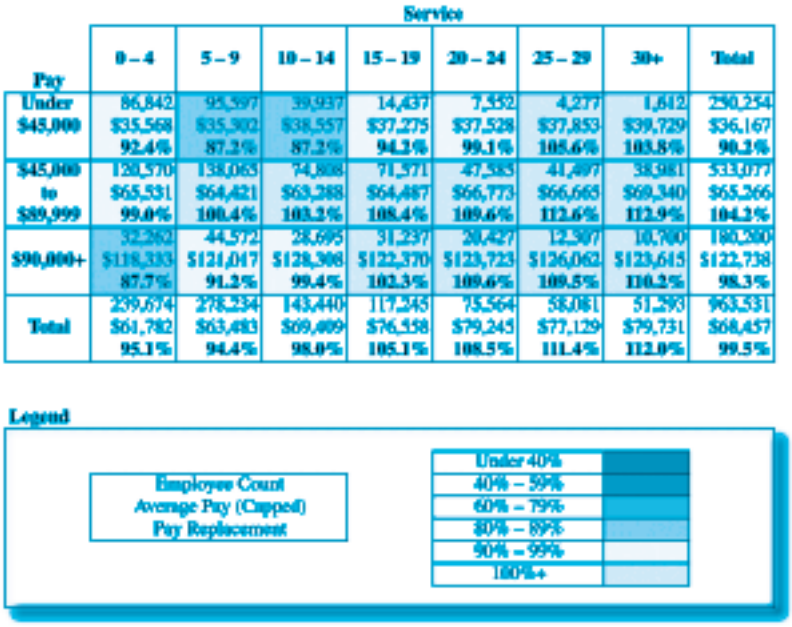
Employee Count
Average Pay (Capped)
Pay Replacement

Under 40%
40% – 59%
60% – 79%
80% – 89%
90% – 99%
100%+

TABLE II

Baseline Scenario by Pay Brackets

Retirement Age = 65
Contribution Adjustment = 0%
Interest = 7%
All Employers
DB + DC + PIA



NONPARTICIPANTS

In achieving the robust rates of income replacement at retirement, the study finds that the 401(k) plan plays a critical role, representing the single largest source of retirement income for the average worker. In fact, 401(k) income is projected to replace over half (51.4%) of preretirement income for the average worker. Social Security accounts for just over a quarter (27.6%) of projected retirement income and DB income is projected to replace about one-fifth (20.4%) of preretirement income. What this means is that people who do not participate in their 401(k) plan are likely to find themselves in a very different situation than the one portrayed above when it comes to retirement income adequacy (the study focused only on those workers participating in their 401(k) plan).

Indeed, retirement income adequacy is not likely to be achieved by workers who fail to use their employer plans, use them well and use them consistently over the course of their careers. The significance of this should not be understated. In 2003, 30% of eligible employees failed to participate in their 401(k) plan by actively contributing during the course of the year.[1] Workers with lower salaries are also far less likely than average to participate. Likewise, participation is lower among younger workers: 55% of workers in their 20s failed to participate in their 401(k) plan. Workers with fewer than two years of tenure participate at less than two-thirds the average rate.

Much has been written highlighting the challenge of transforming nonparticipating workers into 401(k) participants. Lack of participation in 401(k) plans can be attributed to everything from lack of financial wherewithal to procrastination to lack of focus. Many workers, when asked, say they expect to rely on Social Security in retirement. These workers need to understand the critical role of their own retirement savings under the current system.

RETIREE MEDICAL

Many studies and many forecasting tools ignore the impact of retiree medical costs on retirement income adequacy. However, access to employer-sponsored retiree health care is a key factor in determining whether workers can afford to retire. Retiree medical costs vastly complicate the picture. On one hand, the new Medicare prescription drug coverage effective in 2006 represents an additional retirement asset. On the other hand, medical inflation and capped or declining employer subsidies for retiree health benefits can quickly erode the retirement income level generated by the 401(k) and pension plans. Hewitt analyzed the impact of retiree medical costs on retirement income adequacy by taking into account the projected employee costs that would occur under three typical employer plan designs:

- **High employer subsidy—**an employer plan that covers 75% of claims cost
- **Moderate employer subsidy—**an employer plan that covers 50% of costs, but with the employer subsidy increasing at the rate of 3% per year
- **Retiree pay-all/access only,** with no subsidy.

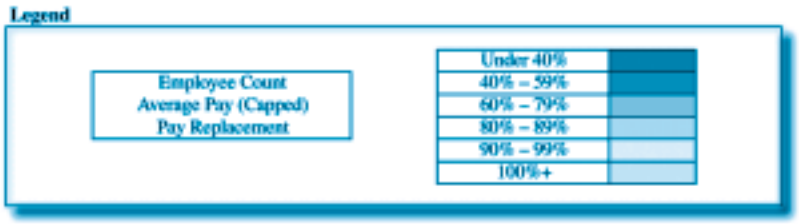
It was assumed that medical inflation would be 15% in 2004, decreasing 1% per year for ten years with an ultimate annual medical inflation rate of 5%. Hewitt sub-

TABLE III

Impact of Retiree Medical Benefits—High Employer Subsidy

Retirement Age = 65
Contribution Adjustment = 0%
Interest = 7%
All DB + DC + PIA
and High Medical Coverage

Age	Service 0–4	5–9	10–14	15–19	20–24	25–29	30+	Total
Under 25	9,969 $30,787 118.2%	2,940 $26,601 108.7%						12,909 $29,833 116.0%
25–29	45,697 $47,324 120.5%	30,899 $45,260 118.1%	1,877 $37,622 115.3%					78,473 $46,279 119.4%
30–34	46,827 $61,176 105.3%	55,114 $61,294 111.7%	17,344 $55,427 115.9%	2,228 $45,388 117.6%				121,513 $60,119 109.9%
35–39	58,978 $70,601 90.9%	51,175 $69,455 97.8%	30,970 $72,542 112.2%	19,466 $67,323 119.9%	1,775 $52,369 118.7%			142,364 $69,936 102.3%
40–44	34,403 $71,163 76.4%	46,220 $71,815 83.4%	29,882 $76,923 98.1%	33,354 $82,497 112.2%	17,904 $71,300 118.2%	2,915 $55,894 124.5%		164,678 $74,432 95.0%
45–49	26,859 $70,075 65.9%	37,058 $68,813 72.1%	24,414 $74,437 85.2%	25,340 $83,978 99.2%	24,038 $87,787 110.6%	19,805 $71,698 117.0%	2,645 $61,916 122.8%	160,159 $75,372 89.5%
50–54	19,274 $67,428 57.1%	26,744 $64,761 63.4%	18,582 $68,916 74.7%	18,013 $77,577 87.8%	16,333 $84,657 98.6%	19,552 $85,807 107.5%	17,083 $73,681 116.2%	135,581 $73,968 84.5%
55–59	12,140 $64,229 49.4%	18,520 $61,652 55.2%	13,265 $65,256 66.2%	12,533 $71,137 78.0%	10,503 $76,605 88.4%	11,191 $82,010 96.6%	22,249 $84,036 107.1%	100,401 $72,418 78.4%
60+	5,527 $56,411 43.9%	9,564 $53,399 49.1%	7,106 $58,455 58.9%	6,311 $62,717 69.6%	5,011 $64,073 78.7%	4,618 $65,252 86.0%	9,316 $85,601 95.4%	47,453 $64,349 68.5%
Total	239,674 $61,782 89.7%	278,234 $63,483 89.3%	143,440 $69,409 93.4%	117,245 $76,558 101.1%	75,564 $79,245 104.8%	58,081 $77,129 107.8%	51,293 $79,731 108.8%	963,531 $68,457 94.8%



tracted retiree medical costs net of subsidies from retirement income levels to determine a "net" replacement income ratio, reflecting the percentage of preretirement income available to meet all needs other than medical.

The analysis finds that retiree medical costs can consume between 4.7% of retirement income (for employees with a high level of employer subsidy) and almost 20% of retirement income (for those with no employer subsidy). In other words, retirement income replacement rates—when retiree medical is taken into account—are reduced from nearly 100% to between 80.8% and 94.8%, depending on the level of coverage. This is true for employees retiring at a "normal" retirement age of 65 and who are relying primarily on Medicare for their health care benefits.

Tables III, IV and V show the impact of the three levels of retiree medical coverage on retirement income adequacy.

Clearly, nearly 95% projected retirement income replacement for workers with high retiree medical coverage still puts workers in an excellent position for retirement. However, for many workers, it is the no-subsidy scenario that is the likelier retirement reality. According to *Health Care Expectations: Future Strategy and Direction, 2004 Survey*, 60% of new hires can expect no post-65 retiree medical coverage. An additional 12% will receive access-only coverage. These workers will find it potentially more difficult than they might expect to maintain their standard of living in retirement as medical expenses eat significantly into their retirement nest egg.

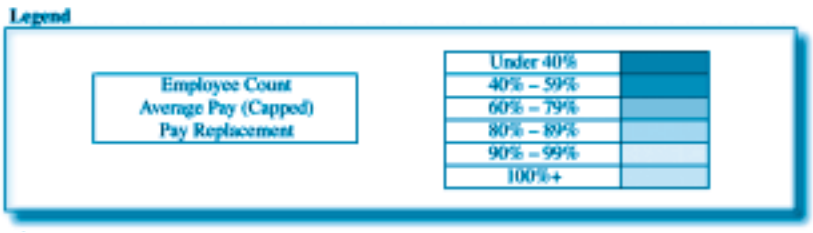
Employees who retire at an earlier age (age 62) will find the impact to be much greater. That's because early retirement includes some period prior to eligibility for Medicare at the age of 65. And, retiree medical benefits can be particularly costly during this pre-Medicare pe-

TABLE IV

Impact of Retiree Medical Benefits—Medium Employer Subsidy

Retirement Age = 65
Contribution Adjustment = 0%
Interest = 7%
All Employers
DB + DC + PIA

Age	Service 0–4	5–9	10–14	15–19	20–24	25–29	30+	Total
Under 25	9,969 $30,787 91.4%	2,940 $26,601 79.7%						12,909 $29,833 88.7%
25–29	45,697 $47,324 103.0%	30,899 $45,260 99.6%	1,877 $37,622 94.9%					78,473 $46,279 101.4%
30–34	46,827 $61,176 91.5%	55,114 $61,294 98.0%	17,344 $55,427 101.1%	2,228 $45,388 101.4%				121,513 $60,119 96.0%
35–39	38,978 $70,601 78.7%	51,175 $69,455 85.8%	30,970 $72,542 100.9%	19,466 $67,323 108.3%	1,775 $52,369 105.3%			142,364 $69,936 90.4%
40–44	34,403 $71,163 64.8%	46,220 $71,815 72.1%	29,882 $76,923 87.8%	33,354 $82,497 103.1%	17,904 $71,300 108.1%	2,915 $55,894 113.1%		164,678 $74,432 84.3%
45–49	26,859 $70,075 54.6%	37,058 $68,813 61.0%	24,414 $74,437 75.0%	25,340 $83,978 90.5%	24,038 $87,787 102.5%	19,805 $71,698 108.0%	2,645 $61,916 113.4%	160,159 $75,372 79.6%
50–54	19,274 $67,428 46.2%	26,744 $64,761 52.5%	18,582 $68,916 64.5%	18,013 $77,577 78.8%	16,333 $84,657 90.6%	19,552 $85,807 99.9%	17,083 $73,681 108.4%	135,581 $73,968 75.2%
55–59	12,140 $64,229 39.1%	18,520 $61,652 44.7%	13,265 $65,256 56.3%	12,533 $71,137 69.1%	10,503 $76,605 80.2%	11,191 $82,010 89.0%	22,249 $84,036 100.5%	100,401 $72,418 69.6%
60+	5,527 $56,411 34.2%	9,564 $53,399 39.1%	7,106 $58,455 49.6%	6,311 $62,717 60.9%	5,011 $64,073 70.4%	4,618 $65,252 77.7%	9,316 $85,601 89.3%	47,453 $64,349 59.9%
Total	239,674 $61,782 76.0%	278,234 $63,483 76.6%	143,440 $69,409 82.3%	117,245 $76,558 91.6%	75,564 $79,245 96.1%	58,081 $77,129 99.5%	51,293 $79,731 101.8%	963,531 $68,457 83.4%



riod. For example, on a retiree-pay-all basis, pre-age 65 coverage is likely to exceed $5,000 per person per year. The high cost of pre-65 coverage is further compounded by high rates of medical inflation. Also, medical costs are a flat dollar amount and not a percentage of pay. As a result, retiree medical costs have an increased impact on retirees who were lower paid during their employment.

According to Hewitt's projections, the high cost of medical benefits in the years before Medicare availability at the age of 65 results in a projected shortfall for early retirees regardless of coverage: workers retiring early at age 62 are projected to replace only between 58.9% and 75.6% of their preretirement income. For these workers, in the case of the low retiree medical plan (with no subsidy), retiree medical costs consume over 25% of retirement income. Again, this is a likely reality for many workers. According to Hewitt data, 53% of new hires will receive no pre-age 65 medical coverage.[2] Another 15% will receive access-only coverage. Further, EBRI data finds that the majority (61%) retired prior to age 65, with many retirees who retired early citing negative reasons for leaving the workforce such as health problems, disability or downsizing.

CHANGES IN PROGRAM STRUCTURE

If retiree medical is likely to be an area that is increasingly dependent on funding from workers, so is retirement in general. According to Hewitt data, the percentage of plan sponsors offering DB plans to current employees has declined from 83% in 1990 to 68% in 2003 (consisting of 45% of employers with traditional DB plans and 23% with hybrid designs). Cost volatility and a regulatory en-

TABLE V

Impact of Retiree Medical Benefits—Low Employer Subsidy

Retirement Age = 65
Contribution Adjustment = 0%
Interest = 7%
All Employers
DB + DC + PIA

Age	Service 0 – 4	5 – 9	10 – 14	15 – 19	20 – 24	25 – 29	30+	Total
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50 – 54	19,274 $67,428 42.9%	26,744 $64,761 49.2%	18,582 $68,916 61.3%	18,013 $77,577 76.1%	16,333 $84,657 88.1%	19,552 $85,807 97.6%	17,083 $73,681 106.0%	135,581 $73,968 72.4%
55 – 59	12,140 $64,229 35.3%	18,520 $61,652 40.8%	13,265 $65,256 52.7%	12,533 $71,137 65.9%	10,503 $76,605 77.2%	11,191 $82,010 86.2%	22,249 $84,036 98.1%	100,401 $72,418 66.4%
60+	5,527 $56,411 29.8%	9,564 $53,399 34.5%	7,106 $58,455 45.3%	6,311 $62,717 56.9%	5,011 $64,073 66.5%	4,618 $65,252 73.9%	9,316 $85,601 86.5%	47,453 $64,349 56.0%
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Legend

Employee Count Average Pay (Capped) Pay Replacement

Under 40%
40% – 59%
60% – 79%
80% – 89%
90% – 99%
100%+

vironment that many plan sponsors view as unfriendly suggest that the trend away from DB plans is likely to continue. If that is the case, the retirement income adequacy picture portrayed today may give way to a very different retirement income adequacy picture in the future.

To examine the implications, Hewitt studied retirement income adequacy among participants with only Social Security and DC benefits. The difference between retirement income adequacy of "DB plus DC" employees and "DC-only" employees is significant. While participants in DB-plus-DC programs are projected to replace an average of 107.9% of income, employees in DC-only programs are projected to replace an average of 79.8% of income.

"One can speculate that employers with higher-paid employees simply can also afford richer benefit levels, or that these employers have a greater need to encourage stable, long-term employment."

Table VI and Table VII compare the differences in the level of retirement replacement income for employees who have both the DB and DC plans and those who have the DC plans only.

One critical difference between the DB-plus-DC employers and the DC-only employers is the demographic structure of the workforces. The DB-plus-DC employers have far higher pay levels (average pay of $74,246) than the DC-only employers (average pay of $54,920). This difference is most pronounced in the pay distributions at these different employer groups. Approximately 23% of the DB-plus-DC group have pay over $90,000; in contrast, only 9% of the employees in the DC-only plans were in this top-paid group. Conversely, the DC-only group has a far higher percentage of employees with pay under $45,000 (46%) than the DB-plus-DC group (17%).

Still, significant differences in retirement income levels persist even when the analysis focuses on comparable employee subgroups at these two types of employers. The lower-paid group (pay under $45,000) at the DC-only employers has average pay of $35,995 and an average replacement income ratio of 79.2%. The lower-paid group at the DB-plus-DC employers has average pay of $36,365 and an average replacement income ratio of 102.8%. Similar results occur for the midpay group—at the DC-only employers, the replacement income ratio is 80.3% and at the DB-plus-DC employers, the ratio is 111.8%—and for the highly paid group it is 79.7% vs. 101.4%.

Another important difference is that DC-only employers reflect a workforce with far less tenure: 63% of the employees at DC-only companies have less than ten years of service and 80% have less than 15 years of service. In contrast, in the DB-plus-DC group, 50% of employees have less than ten years of service and 64% have less than 15 years of service. With tenure playing such a significant role in retirement accumulation—and with outside assets not being taken into account in this analysis—this will clearly place downward pressure on DC-only retirement income adequacy. Nonetheless, even the retirement income replacement rates of long-service DC-only employees do not keep up with those of DB-plus-DC employees.

While it appears that DC-only employers simply do not provide DC benefits that allow employees to keep up with their counterparts at DB-plus-DC employers, it is difficult to draw too many conclusions from these differences. One can speculate that employers with higher-paid employees simply can also afford richer benefit levels, or that these employers have a greater need to encourage stable, long-term employment. On the other hand, one could also speculate that the DC-only employers are focusing on plans that better meet the needs of their shorter-tenured workforce.

Whatever the reason, a clear message is that as employees are increasingly being asked to shoulder the responsibility of retirement income adequacy, employers will need to encourage higher-quality participation—especially when only a DC plan is available and especially among younger employees. Plan sponsors may also need to manage employees' expectations when it comes to early retirement.

SOFTENING THE IMPACT

What can employers do to help employees soften the impact of retiree medical and retirement program changes on retirement income adequacy?

First, it is important to show employees the complete retirement picture. The results of several employee surveys clearly show that workers do not do a good job of facing up to the reality of their potential retirement future. Employers can help by providing retirement forecasting software that is comprehensive, quick and easy to use. They can also use existing communication channels to reinforce the notion that retirement savings is a shared responsibility and that it's up to the employee to do his or her part by taking advantage of the 401(k) plan.

On the other hand, workers are good at procrastinating when it comes to long-term saving, often preferring the instant gratification of consuming today. Employers can help by creating a sense of urgency and relevance. Capturing employees' attention and getting them to take action can be done by targeting messages based on individual situa-

TABLE VI

Impact of Program Structure on DB-Plus-DC Group

Retirement Age = 65
Contribution Adjustment = 0%
Interest = 7%
Entire DB + DC Group
DB + DC + PIA

Age \ Service	0 – 4	5 – 9	10 – 14	15 – 19	20 – 24	25 – 29	30+	Total
Under 25	5,812 $33,548 **142.1%**	1,704 $26,931 **135.2%**						7,516 $32,048 **140.5%**
25 – 29	31,694 $50,874 **136.9%**	19,315 $50,428 **140.0%**	1,302 $39,013 **134.2%**					52,311 $50,414 **138.0%**
30 – 34	32,527 $65,925 **119.5%**	35,625 $67,814 **129.2%**	10,958 $60,948 **135.3%**	1,641 $46,250 **132.1%**				80,751 $65,683 **126.2%**
35 – 39	27,390 $76,317 **103.0%**	33,331 $76,776 **113.0%**	21,120 $79,684 **127.3%**	15,522 $70,847 **130.5%**	1,329 $53,627 **130.7%**			98,692 $76,027 **116.3%**
40 – 44	23,595 $77,759 **87.4%**	29,515 $79,862 **97.1%**	19,933 $83,973 **112.7%**	27,134 $85,632 **120.8%**	14,571 $74,163 **127.2%**	2,507 $56,697 **133.5%**		117,255 $80,269 **107.8%**
45 – 49	17,892 $78,369 **75.7%**	22,794 $76,772 **84.6%**	15,472 $81,631 **99.0%**	19,790 $87,502 **108.2%**	19,274 $91,440 **118.8%**	16,887 $73,460 **124.2%**	2,390 $62,483 **129.0%**	114,499 $81,215 **101.7%**
50 – 54	12,338 $76,540 **65.7%**	16,222 $72,602 **74.3%**	11,509 $74,779 **87.2%**	13,672 $80,383 **96.9%**	12,710 $87,844 **107.5%**	16,310 $88,763 **114.3%**	15,515 $74,999 **121.6%**	98,276 $79,466 **96.3%**
55 – 59	7,562 $73,160 **56.5%**	10,997 $70,711 **64.7%**	8,204 $69,539 **77.3%**	9,501 $72,630 **86.6%**	7,919 $77,919 **97.6%**	9,091 $84,051 **103.9%**	20,156 $85,389 **112.2%**	73,430 $77,538 **89.5%**
60+	3,299 $64,048 **49.5%**	5,356 $61,559 **57.2%**	4,221 $59,954 **69.2%**	4,544 $62,343 **78.2%**	3,559 $64,025 **88.0%**	3,373 $65,044 **95.2%**	7,827 $87,498 **102.1%**	32,179 $68,662 **79.3%**
Total	162,109 $67,781 **103.0%**	174,859 $70,840 **104.8%**	92,719 $75,741 **108.5%**	91,804 $79,551 **110.7%**	59,362 $82,135 **114.0%**	48,168 $79,179 **115.5%**	45,888 $81,043 **114.5%**	674,909 $74,246 **107.9%**

Legend

Employee Count Average Pay (Capped) Pay Replacement

Under 40%
40% – 59%
60% – 79%
80% – 89%
90% – 99%
100%+

TABLE VII

Impact of Plan Structure—DC-Only Employers

Retirement Age = 65
Contribution Adjustment = 0%
Interest = 7%
Entire DC-Only Group
DC + PIA

Age	Service 0 – 4	5 – 9	10 – 14	15 – 19	20 – 24	25 – 29	30+	Total
Under 25	4,157 $26,925 **107.8%**	1,236 $26,145 **97.1%**						5,393 $26,746 **105.4%**
25 – 29	14,003 $39,288 **104.3%**	11,584 $36,643 **100.0%**	575 $34,472 **97.1%**					26,162 $38,011 **102.2%**
30 – 34	14,300 $50,373 **90.1%**	19,489 $49,375 **94.5%**	6,386 $45,953 **97.8%**	587 $42,979 **100.5%**				40,762 $49,097 **93.6%**
35 – 39	11,588 $57,090 **78.4%**	17,844 $55,779 **82.8%**	9,850 $57,228 **93.6%**	3,944 $53,452 **100.4%**	446 $48,621 **104.3%**			43,672 $56,170 **85.9%**
40 – 44	10,808 $56,763 **67.5%**	16,705 $57,598 **71.8%**	9,949 $62,800 **81.6%**	6,220 $68,824 **94.8%**	3,333 $58,783 **101.1%**	408 $50,962 **102.5%**		47,423 $59,998 **78.2%**
45 – 49	8,967 $53,525 **60.7%**	14,264 $56,094 **64.4%**	8,942 $61,989 **73.0%**	5,550 $71,412 **83.9%**	4,764 $73,008 **94.8%**	2,918 $61,505 **101.1%**	255 $56,601 **106.9%**	45,660 $60,719 **73.5%**
50 – 54	6,936 $51,218 **54.9%**	10,522 $52,671 **58.6%**	7,073 $59,375 **66.0%**	4,341 $68,740 **75.3%**	3,623 $73,475 **83.1%**	3,242 $70,938 **93.3%**	1,568 $60,638 **100.3%**	37,305 $59,485 **68.4%**
55 – 59	4,578 $49,478 **50.0%**	7,523 $48,410 **53.2%**	5,061 $58,313 **60.0%**	3,032 $66,458 **68.0%**	2,584 $72,577 **75.6%**	2,100 $73,174 **83.0%**	2,093 $71,015 **90.5%**	26,971 $58,476 **63.0%**
60+	2,228 $45,103 **47.2%**	4,208 $43,012 **49.9%**	2,885 $56,263 **55.0%**	1,767 $63,679 **62.5%**	1,452 $64,193 **70.1%**	1,245 $65,813 **75.7%**	1,489 $75,630 **78.3%**	15,274 $55,263 **58.7%**
Total	77,565 $49,245 **78.6%**	103,375 $51,038 **76.8%**	50,721 $57,835 **78.8%**	25,441 $65,755 **84.6%**	16,202 $68,656 **88.5%**	9,913 $67,169 **91.6%**	5,405 $68,596 **90.7%**	288,622 $54,920 **79.8%**

Legend

Employee Count Average Pay (Capped) Pay Replacement

Under 40%
40% – 59%
60% – 79%
80% – 89%
90% – 99%
100%+

tions and personalizing communication so that employees understand the impact of their decision making on their own retirement future. Deadlines can motivate workers to stop procrastinating and take action today.

Workers are also easily thwarted in the savings process by barriers such as complexity and overwhelming choice. As such, making it easy for employees to participate and contribute to the 401(k) plan is key. One way to increase participation and the quality of participation is by giving employees more opportunity to automate the 401(k) plan. Features such as contribution escalation can help employees save more for retirement by allowing them to have the amount they contribute to the 401(k) plan increased in small increments automatically over time. Likewise, employers can provide automatic rebalancing to enable employees to keep their 401(k) plans on track without constant intervention.

Workers in surveys and focus groups again and again express frustration and uncertainty when it comes to the decisions that need to be made for retirement saving and investing. This can be countered through decision support tools that allow workers to fully understand their choices at the point of need. A good example is loan modeling tools that show workers who are considering taking a loan the potential impact on retirement accumulation. Proactive communication that reminds people to participate early, increase their savings, and diversify and rebalance can also help keep employees on track and make them confident that they are addressing the right areas in managing their 401(k) plans.

Workers often underestimate the impact of cost of different investment vehicles on retirement income adequacy. However, the Hewitt study found that the difference between high-cost retirement investment vehicles and low-cost ones was significant when it came to retirement income adequacy. For a participant between 25 and 29 years of age and with zero to four years of service, the study found that investing in actively managed institutional funds with an average weighted expense ratio of 0.44% results in 77.1% of income being replaced at retirement age 65 via the DC plan.

However, if this same group of participants were to invest in full-cost retail mutual funds, with a typical annual expense ratio of 1.33%, DC income replacement is projected to drop to 63.8%. In other words, the accumulated balances are reduced by nearly one-fifth for employees in this scenario who invest in full-cost retail mutual funds vs. institutional funds. Managing fees and ensuring they are reasonable is a key fiduciary duty for employers and reducing them can have a positive impact on employees' retirement savings—potentially increasing plan balances by hundreds of thousands of dollars by retirement age.

EBRI data from 2004 has found that 68% of workers believe they will do some type of work for pay after retirement; 64% of that number gave as their reason the fact that they enjoy working and want to stay involved.

"Structuring retirement programs that allow employees to reduce hours toward the end of their careers, possibly supplemented by payments from the employer's qualified retirement plan, has been the subject of ongoing discussion for many years."

Structuring retirement programs that allow employees to reduce hours toward the end of their careers, possibly supplemented by payments from the employer's qualified retirement plan, has been the subject of ongoing discussion for many years. For employees who are concerned about retirement income adequacy and/or retiree medical costs, a program that moves them closer to adequate replacement income levels without necessarily continuing full-time employment may be very attractive. Such a program will appeal to workers, many of whom will wish to continue working after retirement, as well.

When faced with the reality of what they are likely to need in retirement and what they are likely to have, workers may be tempted to easily concede defeat. It is important to demonstrate that improving their retirement income adequacy prospects is not beyond the average worker's means. Hewitt's study found that retiring at the age of 67, just two years later than the traditional expected retirement age and contributing an additional 2% of savings to a 401(k) plan can provide a significant boost to the retirement income of employees (including those in the DC-only environment). According to the study, by making

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APPENDIX

Hot Zones Analysis

The "hot zones" chart is a tool often used by Hewitt to display replacement income ratios. Each cell in these charts summarizes key results for employees within five-year age and service groupings—including the number of employees in the cell, average pay and pay replacement percentage. Also, the cells use color to reinforce those areas in need of attention; the lowest replacement ratios are shown in "hotter colors" (darker shades of blue) while the highest ratios (over 100%) are in "cooler colors" (lighter shades of blue).

Legend: The colors used in the hot zone charts contained in this report are as follows:

Under 40%
40%-59%
60%-79%
80%-89%
90%-99%
100%+

Each cell in a hot zone chart displays information about the participants described in the cell and the retirement income levels for those participants. The cell below contains data for 25,340 participants with current average pay of $83,978. The retirement income ratio for these individuals is displayed both explicitly (102.9%) and through the use of the cell's color.

these changes to retirement age and savings rate, over half of employees in DC-only plans may achieve replacement income rates in excess of 80%, even after they have paid their retiree medical costs. The difference among younger workers is most marked under this scenario, with the increased savings growing over time.

CONCLUSION

The employer-sponsored retirement system, in conjunction with Social Security and Medicare, has performed very well over the past few decades. Moreover, employees nearing the end of their careers under the traditional benefits package including final pay DB, 401(k)/matched savings plan and employer-provided retiree medical will continue to benefit from the value provided to them under that system.

However, employees impacted by recent trends such as the elimination of DB plans and of retiree medical subsidies, will be in a far less favorable position if they approach retirement without changing their course. These changes may include saving more, retiring later and taking phased retirement. And although more of the responsibility for retirement income adequacy is shifting to employees, in turn, employers will play a critical role in reshaping employee behaviors and attitudes, through education, plan design and planning tools. The role of encouraging employees to maximize the value of their 401(k) benefits will become more critical than ever in this new retirement reality. ◀

Note: *This article was adapted from* Total Retirement Income at Large Companies: The Real Deal, *originally published in 2004 by Hewitt Associates LLC.*

Endnotes

1. Hewitt Research Report: *How Well Are Employees Saving and Investing in 401(k) Plans: 2003 Universe Benchmarks.*
2. *Health Care Expectations: Future Strategy and Direction, 2004 Survey,* Hewitt Associates, Lincolnshire, Illinois.