

I'm Late! I'm Late!

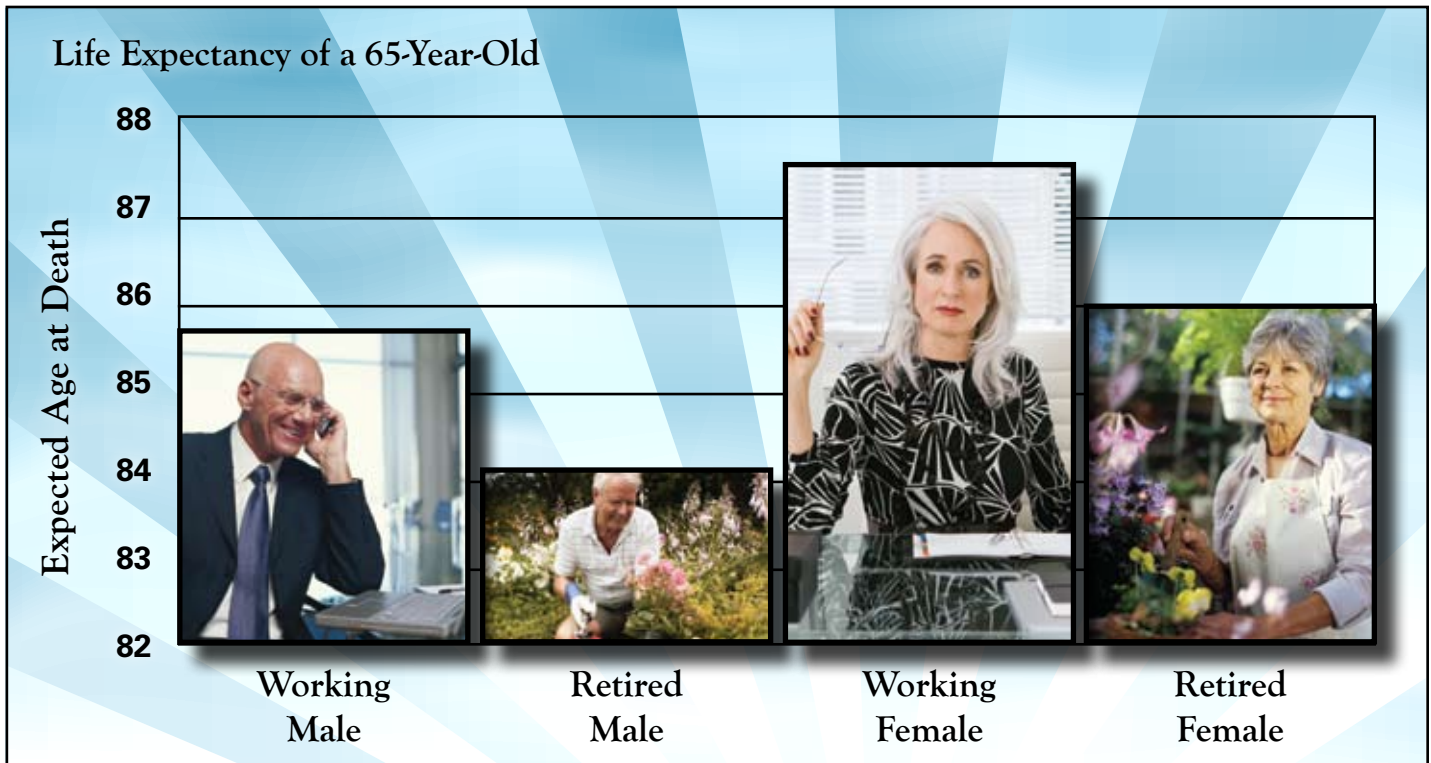
For a Very Important Date!

by Renee Nolte, ASA

When do you plan to retire? Have the recent market drop and current state of the economy forced you to reschedule your planned retirement for a later date? If so, you are part of a growing population postponing retirement. According to a study by Sun Life Financial, almost two-thirds (65%) of current American workers say they will delay retirement at least one year beyond the date they originally planned. A record 55% of Americans now anticipate working past age 67. While earlier surveys cited the primary reason for a later retirement was "to stay mentally engaged," the reason most often cited now is "to earn enough money to live well." (For more information on the survey, visit www.unretirementindex.com.)

Longevity risk

The challenges of planning for sufficient income that will last through retirement have been compounded by the fact that retirees are living longer than ever before. Since 1930, the life expectancy beyond age 65 has increased an average of nearly one month every year. To accommodate increasing life expectancy, the IRS issued new funding rules with the passing of the Pension Protection Act (PPA) in 2006, which mandates the use of mortality tables in pension plan valuations that calculate greater longevity with each passing year. The following table illustrates the life expectancy of a 65 year old given the probability of mortality in use this year:





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It is interesting to note that those still working at age 65 are expected to live longer than those already retired. While some believe that working actually enables people to live longer, others claim that people are more likely to retire early when they believe that they will not live well into retirement.

Those preparing for retirement must take their personal longevity risk into consideration, consult with their financial planners and adjust retirement plans accordingly. The following paragraphs illustrate the different sources of retirement income and reveal the impact a later retirement date can have on the amount of benefit received.

Defined benefit pension plans

In a defined benefit pension plan, a participant's benefit accrual is not allowed to stop, and the rate of benefit accrual can't be reduced once the participant has reached normal retirement age (typically age 65). An exception to this rule occurs when a plan limits the years of service or participation that may be taken into account in the benefit formula. In such instances, regardless of age, when the maximum years are reached, no additional years are included in the benefit formula.

If compensation tends to fluctuate or is expected to decline beyond normal retirement age, the plan's definition of final average pay will determine the extent of the impact. Many plans define average compensation as the highest consecutive years of pay (typically 4 or 5) over the course of employment. Some plans, however, will only include the highest paid consecutive years just prior to retirement.

Numerous pension plans define late retirement as the greater of (a) the actuarial equivalent of the normal retirement age benefit, or (b) the accrued benefit at the late retirement date. In other words, this provision provides a benefit at least as large as the benefit at age 65, adjusted for interest and the later commencement of the benefit. The actuarial equivalent of a benefit at age 70 can be 60-90% greater than the age 65 benefit, depending on the definition of actuarial equivalence. If this "greater of" provision is not included, the benefit is the accrued benefit at the actual retirement age.

To demonstrate this point, let's suppose Alice participates in an employer-sponsored pension plan providing a benefit of 1% of compensation, multiplied by years of service. She has the option to retire at age 65 after completing 35 years of service. Her compensation has averaged \$36,000 annually. She can retire with a monthly benefit of \$1,050 ($1\% \times \$36,000 \times 35$), but she decides to continue working until age 70, earning \$36,000

per year. At age 70 her accrued benefit increases to \$1,200 ($1\% \times \$36,000 \times 40$). Since the plan provides for actuarial equivalence, her age 65 benefit increases 70%. By delaying commencement of the benefit, Alice would then begin receiving \$1,785 when retiring at the age of 70.

To gain a better estimate of life expectancy, it is necessary to consider factors such as lifestyle, nutrition, health, age and gender...It is often surprising to learn your predicted lifespan, but it can be an invaluable tool when planning for retirement.

Defined contribution plans and personal savings

A 2008 survey conducted by the Employee Benefits Research Institute (EBRI) found that heads of households age 55 and over have retirement account balances under \$100,000. This is not enough to cover current average post-retirement healthcare costs, let alone living expenses. In theory, a prolonged retirement date will yield a higher account balance, whether in the form of personal savings or a 401(k) type of plan. This does not, of course, hold true every year due to fluctuating markets (unless the account is held in fixed interest investments).

If the employer contributes to the plan, contributions must continue according to plan provisions, even after normal retirement age, as long as the participant continues to complete the hours required in order to receive a contribution.

To illustrate this, let's refer back to Alice's situation. In addition to her pension plan, she also contributes 10% of her monthly compensation to a 401(k). Her employer matches 50% up to 6% each month. If, at age 65, her \$100,000 account balance grows 5% per year, by age 70 she will have \$154,076, a 54% increase.

Social Security

In 2008, the annual average Social Security benefit was \$17,000 for men and \$10,800 for women, replacing 25-45% of pre-retirement income.

Under current law, if a retiree's full Social Security Retirement Age is 67, a benefit is reduced about 1/2 of 1% for each month benefits commence before age 67. After age 67, benefits increase 2/3 of 1% for each month the benefit is deferred. Additional income earned after full Social Security Retirement Age will increase the benefit even more. However, delaying receipt of Social Security after age 70 will not increase the benefit.

Social Security benefits are based on the employee's highest 35 years of earnings. If one has fewer than 35 years of work at retirement age or earns higher amounts after retirement age, any additional years or higher amounts of compensation will also be factored in to increase a Social Security benefit. If we were to estimate Alice's Social Security, she would be eligible to receive \$1,866 at age 65 or \$2,640 at age 70, a 41% increase.

The Sun Life Financial study previously mentioned also revealed that confidence in Social Security benefits has declined from 22% to 16% over the last year. The Social Security system is underfunded and benefit cutbacks are likely. This could mean unfortunate news for the newer generations entering the workforce. Historically, cutbacks are scaled to more significantly impact younger workers who have more time to plan for changes in benefits before actually becoming eligible for them.

Planning

To gain a better estimate of life expectancy, it is necessary to consider factors such as lifestyle, nutrition, health, age and gender. The following websites offer life expectancy estimators containing questions regarding personal and family health, eating habits and exercise: www.livingto100.com and www.bluezones.com. It is often surprising to learn your predicted lifespan, but it can be an invaluable tool when planning for retirement. Another great resource designed for retirement planning is the benefit estimator available on the Social Security website (www.socialsecurity.gov/estimator). It can approximate a benefit based on specific age and salary history.

It's important to remember that timing can significantly impact the various sources of income that you may receive during retirement. A careful analysis of the benefits, and the factors which influence them, is crucial. No one can know precisely how long retirement will last, but it is smart to make those years as financially secure as possible.

