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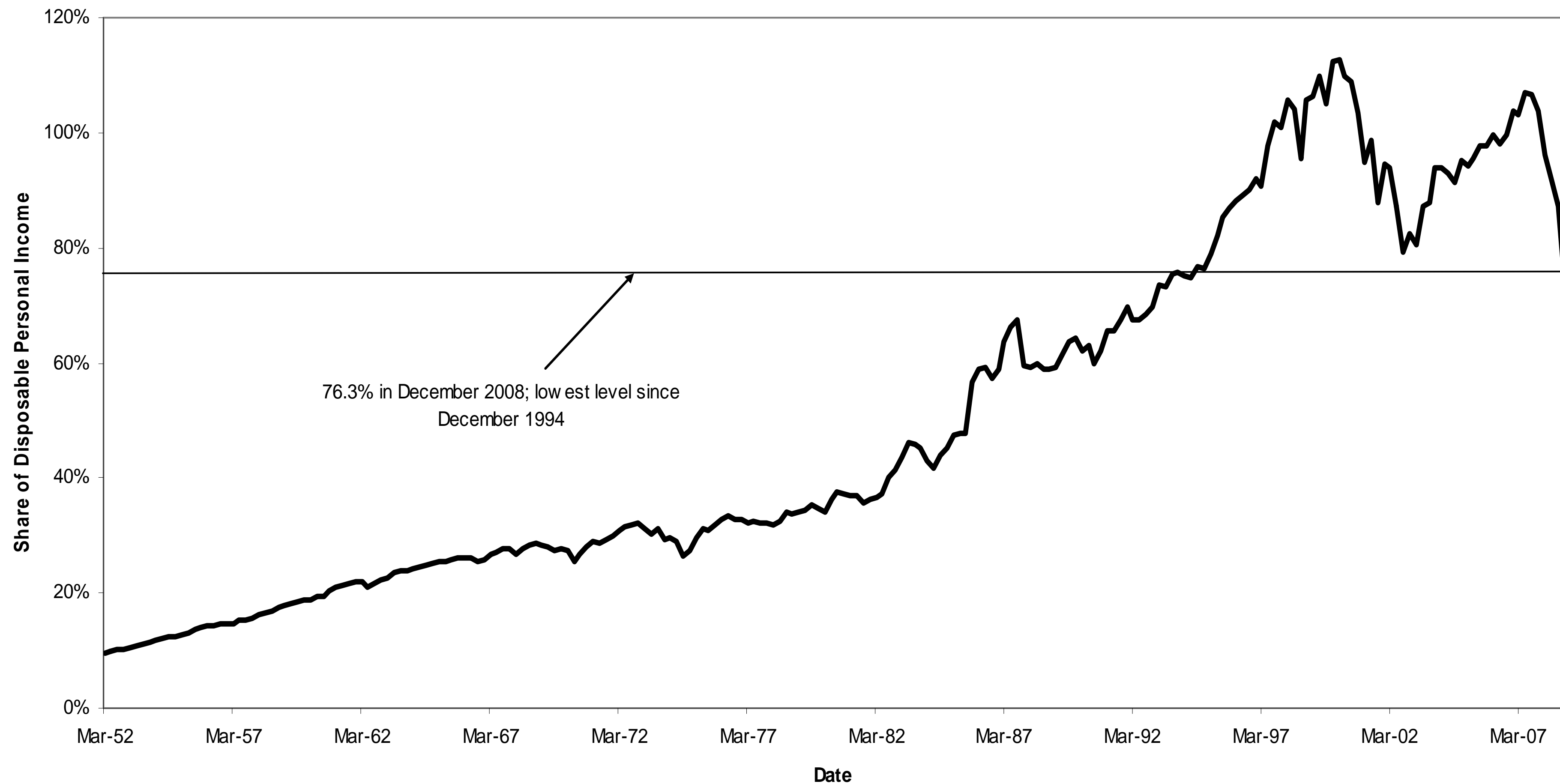
Overview

- The financial and economic crisis has translated into massive wealth losses for American families -- $ 15 trillion through 2008.
- Over time U.S. retirees have become increasingly exposed to a range of risks with their savings: longevity, market, and labor market risks.
- This risk exposure meant more potential volatility in retirement income even before the crisis occurred.
- Secure retirement income will likely decline further and volatility in retirement income will increase due to greater reliance on risky capital income at a time, when asset values have been decimated.

Largest wealth losses since World War II destroys more than a decade of wealth gains

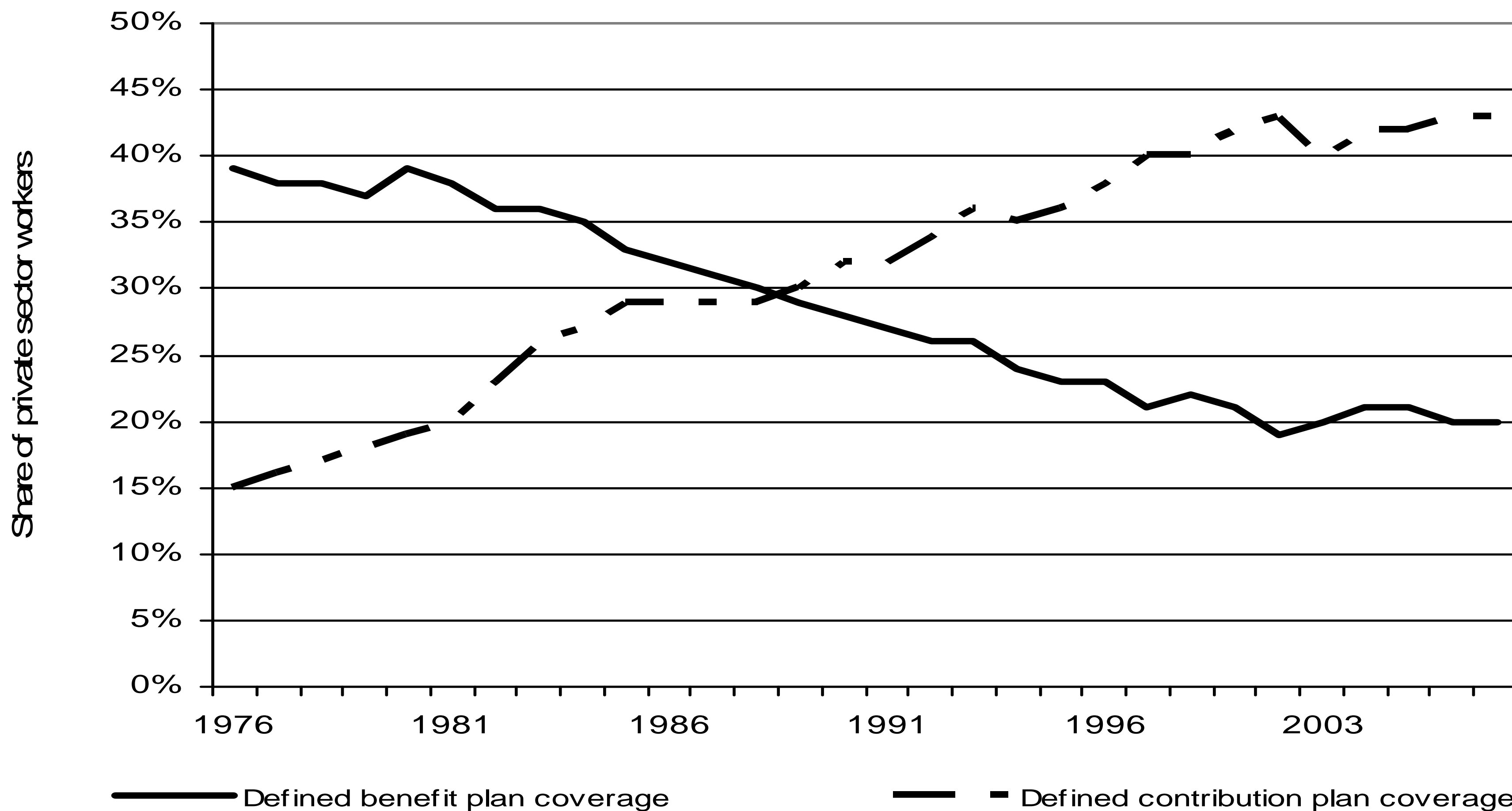
Notes: Calculations on Board of Governors, Federal Reserve System, 2009, Release Z.1 Flow of Funds Accounts of the United States, Washington, DC: BOG.

Losses in retirement wealth set American families back by 15 years



Notes: Calculations on Board of Governors, Federal Reserve System, 2009, Release Z.1 Flow of Funds Accounts of the United States, Washington, DC: BOG.

Wealth crash comes after decades of shifting retirement savings risks onto individuals



Sources: EBSA, 2009, Private Pension Bulletin -- Abstract of Form 5500, Washington, DC: EBSA, and BLS, 2009, National Compensation Survey, Washington, DC: BLS.

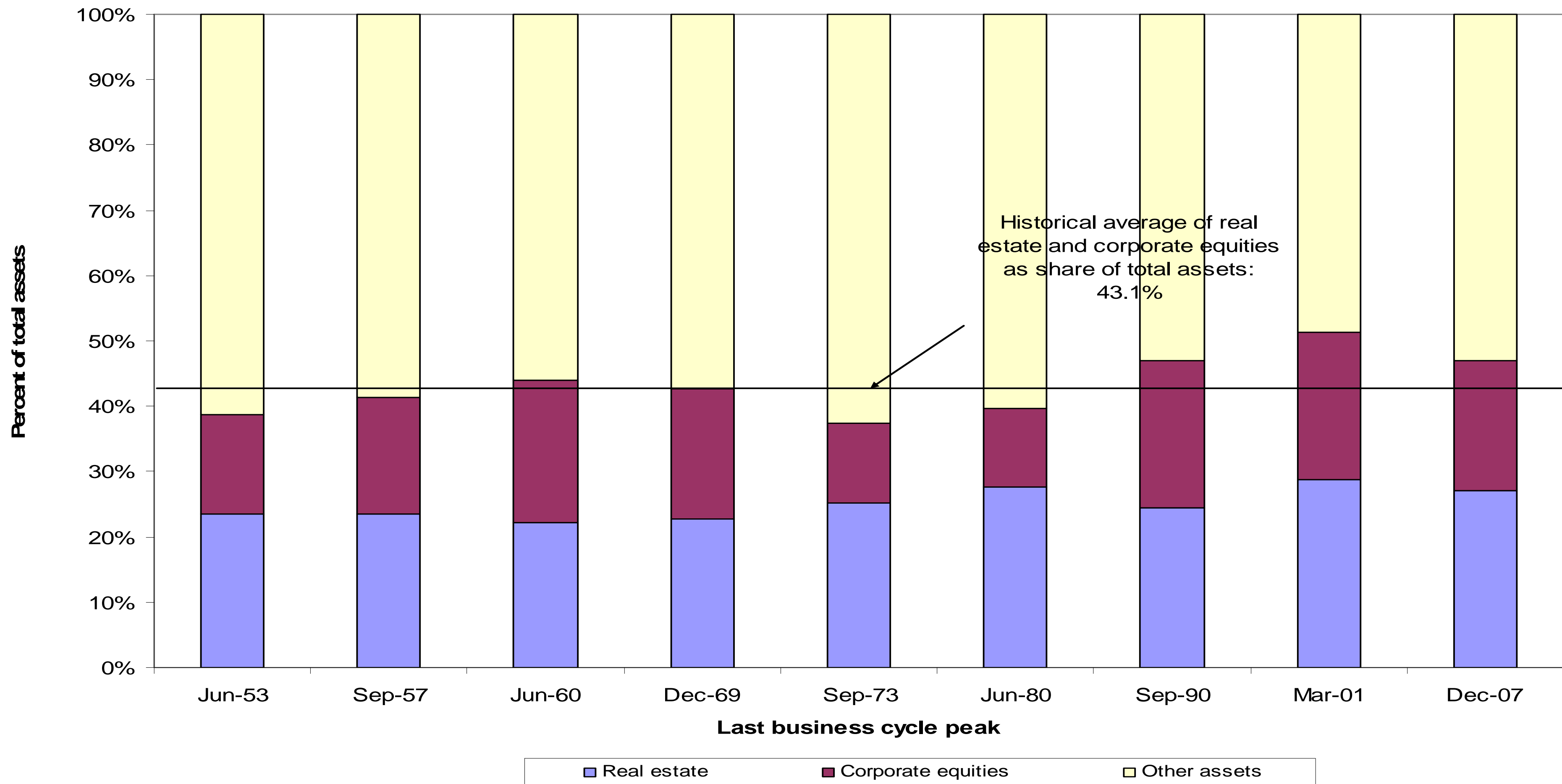
Three retirement risks borne increasingly by individuals with their savings

- Longevity risk:
  - The possibility of outliving one's savings during retirement.
  - Annuity income through Social Security and pensions can protect from longevity risk.

- Market risk:
  - The chance that asset markets perform below their historic average during one's lifetime.
  - Individuals savers are encouraged to use asset diversification as protection.
  - Leverage of homeowners as indicator of market risk.

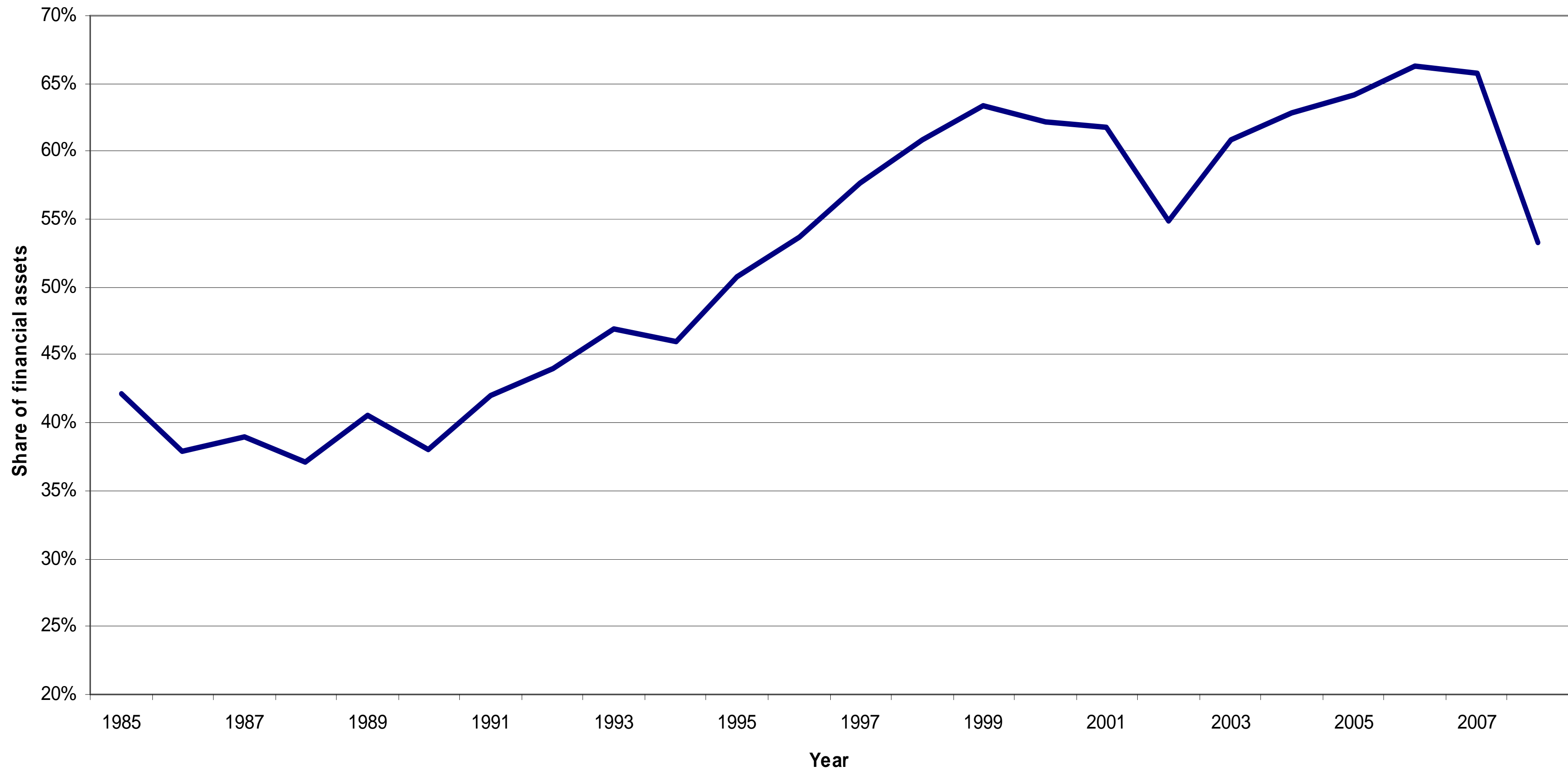
- Idiosyncratic risk:
  - The risk of unlucky or unwise decisions by individuals.
  - Relevance of capital income as indicator of idiosyncratic risk exposure.

Lack of diversification exposes savers to more risks



Notes: Calculations on Board of Governors, Federal Reserve System, 2009, Release Z.1 Flow of Funds Accounts of the United States, Washington, DC: BOG.

Retirement savings increasingly exposed to equity price volatility



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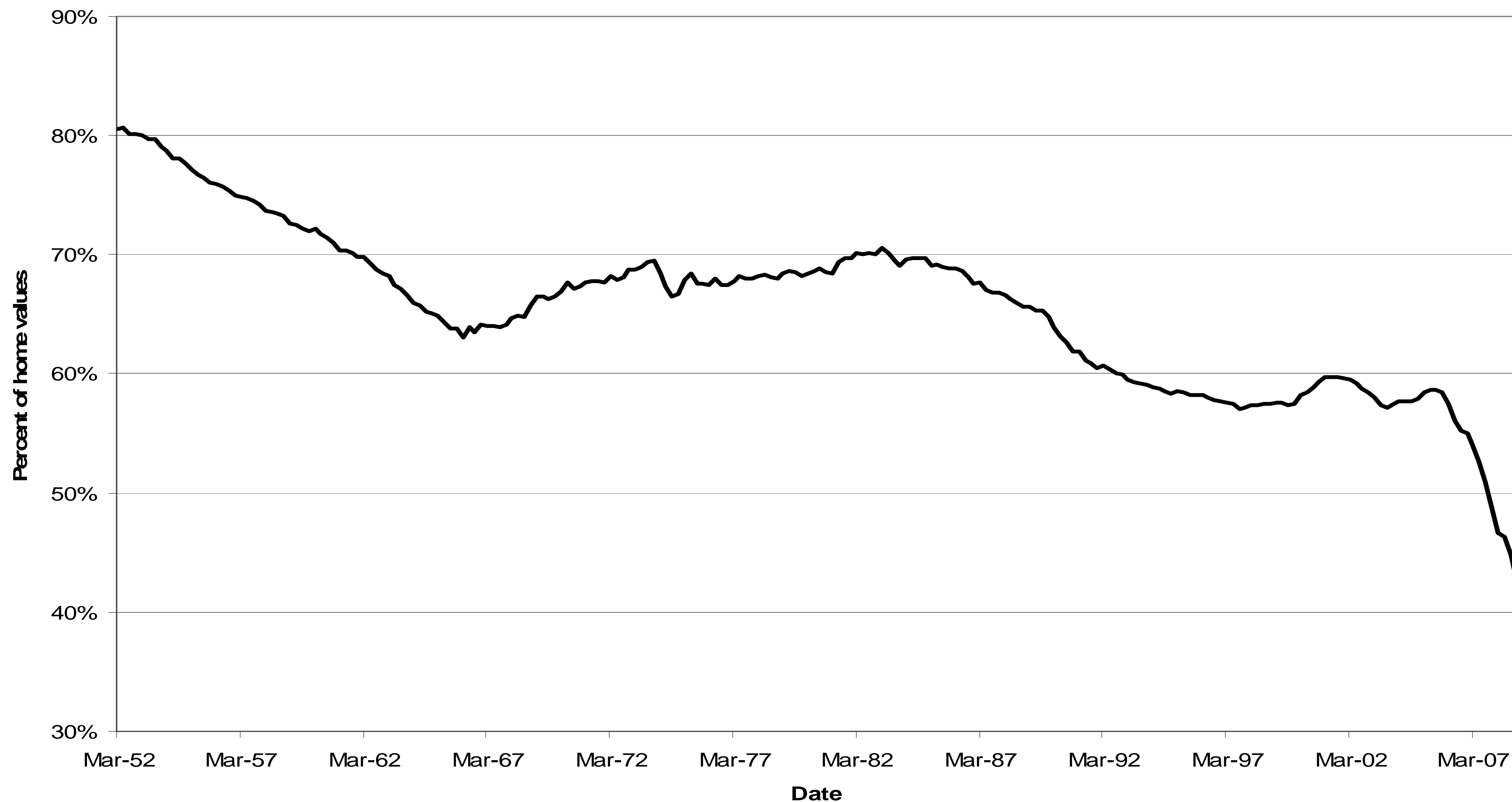
Leveraged households more exposed to asset losses than in the past



Notes: Calculations on Board of Governors, Federal Reserve System, 2009, Release Z.1 Flow of Funds Accounts of the United States, Washington, DC: BOG.

Growing labor force participation increases exposure to labor market risks

- The employment to population ratios for workers 65 years and older reached record highs with 29.4% (65-69 years) and 16.9% (70-74 years) in 2008.
- The unemployment rates for these groups also rose to historically high levels: 4.2% (65-69 years) and 4.7% (70-74 years) in 2008.
- In 2009, EPOP ratios have stayed high, but unemployment rates have jumped to more than 6% (65-69 years) and more than 7% (70-75 years). These are the highest unemployment rates on record.
- Older workers are more attached to the labor market because they need to work.

Longevity risk exposure low, but rising after 2004 for middle class.

- The share of retirees who have annuity income exceeding twice the poverty line – a proxy for basic income security – jumped to 23% in 2004 from 13-16% in prior years before dropping to 20% in 2007.
- The share of retirees who have annuity income exceeding the poverty line steadily grew from a low of 32.3% in 1995 to 44.7% in 2007.
- Increases in both measures likely associated with strong labor market of the 1990s and thus rising Social Security benefits and strong stock market and thus well performing pension plans.
- The rise in longevity risk for middle class follows terminated pension plans, weak labor market, and scheduled Social Security benefit cuts.
- That suggests that the drop will continue for the foreseeable future.

Market risk exposure high among retirees

- A growing share of retirees hold equities – 46.1% in 2007.
- Equities make up a comparatively high share of financial assets – a close to record high average of 42% for retirees with any equity holdings in 2007.
- Housing makes up large share of all assets for retirees who are homeowners – a record high average of 63.2% in 2007.
- The heavy concentration of assets in owner-occupied real estate and corporate equity left retirees overly exposed to sharp declines in asset markets.

Retirees increasingly indebted

- Record high share of retirees – more than 48% in 2004 and 2007 – owe some debt.

- Median debt to income amount reached record high of 65.6% in 2007 for retirees with debt.

- Home equity out of home values stayed low during housing boom, although it improved slightly after 1998, suggesting a gradual deleveraging before the crisis.

- House price declines after 2007 could mean a rise in leverage. A 20% home price declines would mean a drop in the share of home equity out of home values for retirees who are homeowners to 65.2% instead of the 72.2% actually recorded – far below the historic low of 70%.

- Future increases in debt among retirees will depend on financial market regulations and on risk assessment by lenders. In the short-run, declines in indebtedness are more likely than increases.

Dependence on capital income declined before crisis

- The share of retirees with capital income has decreased over time, but grew slightly to 42.2% in 2007 from 39.4% in 2004 – far below the 60-65% in the late 1980s.
- The relative importance of capital income as source of income dropped over time. Among retirees with capital income, the median income share of capital income fell to less than 10% in 2004 and 2007.
- At the same time, though, the average real amount of capital income soared to a record high of $30,600 in 2007.
- These figures reflect the large underlying inequality of capital income as a source of retirement income. Fewer retirees have capital income. Those, who do, see large absolute increases, but relative declines in capital income.
- Capital income could become pressure valve for many retirees, just as asset values have declined sharply.

Importance of earnings for retirees has remained steady

- Share of retirees with earnings: 16-20% between 1989 to 2007 without a clear trend.
- Share of earnings out of retiree income if earnings exist: 45-53% without a clear trend.
- But, retirees are getting older, possibly reflecting a longer labor force attachment before retirement. Average ages of retirees increased from 1989 to 2007 by about 1.5-2.0 years – faster than what could be explained by longevity increases alone.
- Further delays in onset of retirement are hard to imagine due to labor market obstacles (supply and demand) for older workers.

Conclusion

- There is a rising risk exposure among retirees even before the crisis:
  - Longevity risk grew as the protections from Social Security and pensions declined. This is especially true for middle class families.
  - Market risk was relatively high due to widespread equity holdings with a growing concentration of financial assets in corporate equities.
  - Market risk was also high because of large shares of house values out of total assets.
  - Idiosyncratic risk was high due to comparatively large leverage of homeowners.
- As these risks materialize, retirees could turn to labor earnings and capital income, but both will be depressed due to recession and financial crisis.

Policy implications

- Retooling pensions for 21st century
- Update defined contribution plans
- Social Security reform to boost protections for lower-income families