

The Retirement Conundrum

Introduction

The magical age of retirement is somewhat nebulous. For many years, 65 years old was considered the appropriate age of retirement. The idea that age 65 is the magical age of retirement is actually not of this, or the last century. Sixty-five years of age became the accepted age of retirement because the German Rail System (around the 1850's) made 65 the mandatory age of retirement for all railroad engineers. Beyond 65 years of age their "eyesight, reflexes and other faculties" were deemed too "slow and aged" to run the advanced mechanics of a steam locomotive. Today, we still consider 65 as the most accepted age of retirement; however, there appears to be more and more variance from that standard.

Many of a society's norms can be found enshrined in its legal code. In most of the western civilizations' legal codes there are veiled (and sometimes not so veiled) references to what society considers the appropriate retirement age. The USA has ended mandatory retirement at any age; it had been set at 65 years of age for most jobs. In the United States one place that retirement age is referenced is in the payment process by the Social Security Administration. Until recently, the age for receiving full benefits was 65. Now the age for receiving full benefits is dependent on your date of birth. Most baby boomers will not receive full benefits until after age 65, some as late as 68. Some individuals will retire earlier than 65; some will retire later than 65; some retire voluntarily and some are forced to retire by circumstances beyond their control. Unchanged by the SSA is the earliest age when reduced social security payments may be started: presently, that is at age 62.

Some of the individuals that retire earlier than age 65 are able to do so because of shrewd financial planning. However, most "early" retirees are forced into early retirement due to health considerations. Those that retire later than 65 generally have a number of reasons for delaying their retirement; but, always have the ability to sustain work past age 65. Their reasons for delaying retirement are the motivations for this research paper. The paper will also consider retirement planning as a means of better managing the transition of those forced into "early" retirement.

The Question: Where's my tipping point?

"Can I retire?" is a question that around 20 million baby boomers have been asking themselves over the last decade. In many instances, they have asked it more than once.

What defines an individual's tipping point? A retirement tipping point exists when an individual feels comfortable with their individual situation and voluntarily decides to retire. Financial concerns are but one of many concerns that will surface when the individual asks him or herself how the situation feels. The tipping points are as varied as the individuals making the decision. For many uncertainty is the key variable in the retirement decision. Uncertainty comes in many forms (as will be discussed later in the paper). However, uncertainty in any one of the key variables such as health, finances or family commitments will most often cause the individual to delay and in some cases forego their retirement. Research has shown that the removal or assuaging of uncertainty can tip the individual's decision in favor of retiring.

The Key Variables

Financial; How much is enough?

The starting point for most voluntary retirement decisions is calculating an individual's asset base to see if the assets can support the planned retirement.

Traditionally, the minimum amount required to retire, without a drop in an employee's current living standards, has been estimated at 70% - 80% of the employees' current income. At this level the retiree can retire with out a drop in their current living standards. As a side note, the authors hold the personal view that this is on the high end of the scale; but, our current standard of living reflects a savings rate greater than the average person in the USA. Those that save less during their working career will need a higher percentage of their pre-retirement income while in retirement (e.g., 90% or even 120% if currently living beyond their means). The traditional guideline percentage of 70% of pre-retirement income springs from other traditions that might not hold today. For example, the tradition of paying off a house mortgage in synchronization with retirement versus a current practice of refinancing loans that extend the paid off date. Refinancing and home equity loans often are done so as to capture home equity for the purpose of funding present consumption. Both may have the consequence of reducing wealth at the date of retirement.

For most people, the retirement calculation becomes even more onerous when the amount has to be translated to a single value rather than a yearly sum. For example, is \$1,000,000 enough to retire on today? If you had \$1,000,000 in your retirement account could you retire at your current living standards? The answer is "yes" for some UNL faculty and is "no" for some

UNL faculty. The present value of a \$70,000 a year retirement income streaming over 30 years and discounted at 6% is \$1,021,350 (calculated as an annuity due); but this does not include any income from other sources such as social security. A rougher approximation that is simpler (and thus perhaps a better method of explanation for most individuals) is to state that a retirement account should have approximately eleven times (11x) an individual's gross income in savings in order for that individual to retire at the 70% level of their current income.

If the employer would like to encourage earlier retirement, then one technique would be to get the individual employees to increase their savings. Increased employee savings both increases the asset base available to support retirement and reduces the consumption that is habitual during pre-retirement which, in turn, "must" thus be sustained in retirement. Increased assets and reduced consumption in retirement both make a voluntary early retirement a genuine financial option. A retirement date of 60 years of age would require the same retiree to increase their retirement account to \$1,075,769 to cover the extra 5 years (given the same inputs and assumptions as above). This is not a huge increase (approximately \$55,000) in the final saving amount needed to retire 5 years earlier; however, a voluntary early retirement must be valued as a goal before the faculty member will save to achieve that goal.

Clearly, the more difficult retirement savings hurdle is to be prepared for retirement at the traditional age. However, once that hurdle is surmounted, then enticing faculty to make the relatively small incremental increases in savings needed to purchase the freedom to choose early retirement is much easier. Also note, that as with the 65 retirement savings age, the sooner the employee starts saving for early retirement the smaller their contributions have to be.

Health and Healthcare Costs: Do You Feel Lucky?

Perhaps the number one concern of most individuals' entertaining retirement is healthcare. The media is replete with numerous dire warnings about the cost of maintaining one's healthcare. These warnings are not without justification. The cost of healthcare has been described as an individual's number one expense during retirement. The media has reported on many a retiree forced into bankruptcy or living in substandard living conditions due to expensive medical procedures. Healthcare poses a two pronged problem for retirees; 1) early retirement (prior to 65) poses one problem and, 2) normal retirement (65 and older) which poses a different problem.

In the current system, an employee who participates in early retirement is responsible for the cost of maintaining their health insurance. In other words, if you retire at 60, the university is no longer responsible for your healthcare coverage. Prior to retirement an individual shares (through a cafeteria plan reimbursement) the cost of healthcare with the employer. Terminating the employer's share of healthcare means with the former employee will need greater savings to fund the early retirement. This is an example of current practices violating the traditional guideline percentage of 70% - 80% of pre-retirement income being needed during retirement. When an employer makes this choice, the employer also is choosing to have employees pursue tactics and strategies for prolonging their employment.

Depending on the current state of an individual's health, retiring early can mean healthcare costs that are prohibitive. When The University of Nebraska chose to segregate retirees in a separate pool containing solely retired (i.e., read: elderly) individuals, the choice

increased uncertainty and increased healthcare retirement expense for retirees and for those planning for retirement. By placing retirees in the retirement pool, retirees who are in good health are lumped together with other “elderly” people who generally have a higher probability of using more healthcare resources, which in turn, raises their actuarial risk and hence their costs. While this segregation can make actuarial sense, it also generates emotional reactions in employees planning for retirement. This emotional reaction might not be able to be counteracted by rationally proportional financial sums. Recall, the employee must feel comfortable with the retirement decision. As one and all know, buying feelings can be very expensive.

After the segregation of the retirees for healthcare cost recovery, it is not uncommon for retirees to confront a \$1,500 per month billing per person (for them and their dependents) for “basic” health insurance. Clearly, the goal of the employer was to incent the employees towards adopting other coverage; but, that decision requires a further emotional separation from the university community. The financial cost of healthcare insurance coverage may then be increased based on their age and their current state of health. When this major cost is shifted by the University of Nebraska to potential retirees late in their career, the impact of uncertainty is increased and is a disincentive to retire. Further, the cost shift is a material factor in calculating the income needed in retirement. For faculty close to the date of their tipping point, both as measured in purely financial terms as well as measured in emotional terms, that cost shift may also force a delay in the arrival of the soonest feasible date for voluntary retirement. The University created a barrier to exit in front of the door it was holding open.

After employees (regardless of retirement status) have reached age 65, they are eligible for Medicare, the government sponsored healthcare provision. Medicare, however in recent years has been cutting back on the benefits available by increasing deductibles and cutting back on co-pays and limiting some expenditures. A testimony to the short fall in Medicare reimbursements is demonstrated by the now thriving business of supplying Medicare Supplemental Insurance. The ever decreasing Medicare benefit coupled with the ever increasing out of pocket expenses for the supplemental coverage, translates into a great deal of uncertainty beyond the mere financial consequences of reaching the voluntary retirement tipping point.

What's a retiree to do now?

Prospective retirees face a variety of questions. Not all of the questions are financial or health related in nature, some are psychological. Generically, university systems have not done a great job of helping their employees to plan for and to look forward to retirement. Given the high price of purchasing feelings with nothing other than cash, all managers should explore how the employer might better prepare the employees for setting, reaching, and accepting their retirement tipping point.

Retirement to a lot of individuals is not a financial but a psychological barrier. Most faculty do not have a plan for how they want to spend their retirement years. That uncertainty alone can continually push back the retirement tipping point. There is a number of large organizations that have avoided this problem by hiring retirement planners to sit down with their current employees over a certain age to help plan and identify the benefits of retirement. At these *mandatory* meetings there are both financial and social planning sessions. The financial

planning sessions, of course, empower each employee to take advantage of their own future by promoting savings and investment. Nearly all faculty can achieve their financial security with such planning assistance. The social planning sessions may be far more important since financial security is a necessary but is not the only requirement for reaching the retirement tipping point. In social planning questions such as "What are you going to do in retirement?" and "What hobbies do you have?" help the employee build the vision of retirement that makes retirement an attractive destination rather than a dreaded end state.

Retirement specialists have found that the response to retirement is much better if (1) individuals have thought about the future (after retirement), and (2) are shown a positive picture of life after work. Some firms will even run subsidized travel for "retirees only" in order to promote retirement and to maintain the communities formed at work.

A lot of university faculty have the vision of the "Wal-Mart Greeter" retirement package: nothing to do and not being appreciated in doing it. This negative view delays the retirement decision. Accordingly, retirement specialists recommend having retirement "success stories" drop by the work place (retirement lunches, etc.) to have these individuals extol the virtues of retirement, and to show that there is life after one hangs up their lecterns.

As a side note, a number of faculty have indicated to the authors that those faculty have no intention of retiring until they leave the classroom in a horizontal manner. Each of these faculty admittedly have the current financial ware-with-all to retire. These faculty have satisfied the necessary financial condition for retirement; but, they see no future in doing so, and thus have not satisfied the psychological condition for retirement. Given that the probability of long-

term health problems, chronic illness and/or disability increases with the onset of age, it is more likely that university employers will confront a management problem different than faculty dying at their desks. Faculty who do not retire are far more likely to challenge the university's healthcare funding and culture for managing faculty disability. This then begs two questions: 1) Does a university that creates barriers to exit save money in both the short run and the long run? and, 2) Just how long is **that** short run?

Who turns down supplemental income?

Many employees that are eligible for retirement plan to work past retirement because there is no penalty for additional employment under the rules in the current Nebraska system. In other words, any income gained after retirement age is considered an extra benefit and will be treated as a bonus. True, once one initiates the flow of Social Security income while still employed they will confront special taxes on that Social Security income. This may result in far less of that Social Security income reaching the retiree's pocket. However, what does reach the retiree's pocket can be used to fund additional retirement savings or can be used to support increased current consumption without the need for "reducing" savings. Staying generates a bonus. In contrast, retiring triggers an increase in one's monthly healthcare insurance costs and reduces coverage, which is perceived as a penalty.

Individuals past retirement age have a tendency to view this income as the best of both worlds; they get social security, pension, and a regular pay check. Double dipping and a salary, as it were. Once these individuals get use to having this financial windfall they are reluctant to give it up. It becomes a supplemental income from a "part-time" job (the standard university 9

month academic contract with a holiday during the summer months). This part-time job also comes with great healthcare benefits. The elderly employee gets to vacation in the summer months and teach during the school year. Additionally, some faculty further negotiate a partial retirement, generally, with a reduced research and/or service commitment when the commitment reduced was viewed by the faculty member as one of the less desired aspects of the employment.

This confluence of incentives encourages an environment that may be corrosive to the university. It can encourage disaffected persons to remain and to engage in counter-productive behaviors. In non-egregious cases it could take a number of years for the university using ordinary processes to identify and to terminate these individuals "for cause". As the system has recently experienced, some do not leave of their own volition and instead seek to free-ride.

A State Retirement System vs. TIAA-CREF: Which pulls the tipping point closer?

The University of Nebraska retirement system is called a defined contribution system. Under a defined contribution system the pension income is dictated by the retirees' financial contribution. Many states have a state retirement system which is called a defined benefit system. The retirement income in a defined benefit system is usually dependent on work life longevity. A defined benefit system generally increases your retirement benefits up to a certain limits as your longevity in the system increases. For instance, some state systems will grant employees 2.5% per year of their average "high five" upon retirement. In this example an employee with 30 years of service would receive 75% (i.e., 30 years x 2.5%) of the average of their highest five years of salary. This benefit is not paid until the individual retires, so they are not automatically eligible to receive this benefit for age consideration. In other words, if they

chose to work they do not collect retirement. Also most of these plans have either an age or a longevity cap. For example, no further credit is made to the account after the individual has been employed for a defined number of years or reaches a certain age. In effect the employee is choosing to work for a smaller fraction of their salary.

The defined benefit system retirement plans through these caps generate a psychological terminus benefit for the employer. The psychological effect of this type of plan is to encourage retirement. Individuals under these state retirement plans see that if they work full time, then they do so for the differential between their full time pay and their retirement income. In the above example the faculty member goes to work so as to earn 25% of the pre-retirement salary. The thought of working full time for 25% of that individual's pay is a great inducement for that individual to retire. Also because there are contribution limits, this offers less of a supplemental income incentive (as previously discussed).

Note how the defined benefit plan contains both a financial and psychological aspect when compared to the defined contribution plan. Financially, the employee under a defined benefit retirement plan does not get retirement income until retirement, but could start Social Security income. Whereas, the defined contribution (e.g. TIAA-CREF) plan employee has a different financial choice. The defined contribution employee has the choice of starting retirement income or not, independent of the starting of Social Security income, as well as independent of ending employment income. The emotional aspects also are different. The defined benefit state retirement employee is more likely to emotionally view the retirement income coming in the form of a state check more similar to the state check for salary than is the

defined contribution employee to view a pay check as the same as a TIAA-CREF check. Thus, the TIAA-CREF covered employee sees a bonus upon making the choice to start the flow of retirement income whereas the state retirement plan employee may see a poor choice in not substituting one state check for another while at the same time reducing work done to trigger that state check. It is both financial and emotional.

The cost of healthcare for elderly employees: Who gets the uncertainty?

Much has been made about the cost of healthcare for employees. Employers feel great pressure to bring this burgeoning cost under control. A short run truism is that if employees delay retirement, then employers continue contributing to those employees' healthcare packages. Also elderly employees, or their spouses, have an increasing higher risk of major health problems and incurring catastrophic cost for the employer.

The time to get employees to think about retirement is when they and their dependents are healthy. Early planning adds less uncertainty to the employee's retirement plan. Once they get sick it is much harder for the employer to convince the employee to retire and many times the employer has to "greatly sweeten the pot" in order to counteract the cost of the new uncertainty, and thereby get the disabled employee to their tipping point. Also note, every time the employer changes (either increase or decrease, but particularly decreases) healthcare benefits the employer unwittingly forms the employees' world view that the future is uncertain. That increasing uncertainty discourages employees from planning for retirement. In the short term, any decrease in benefits disproportionately pushes back all near-term voluntary retirement tipping points, both

because of increased unplanned financial requirements, but also so because of the emotional cost of that new uncertainty.

What of Spousal, and other Dependants, Considerations?

If a dependant of an elderly employee gets sick and the employee starts incurring significant medical costs, then retirement for that individual get put on the back burner. Both the draw down of savings and the increased uncertainty of their financial expenses will generally keep that individual working solely for the healthcare benefit. This unintended employment will generally continue until the situation on the home front is resolved, and the system has paid all the medical expenses. The older a patient is the longer it takes to resolve most medical problems, therefore, the recovery to the voluntary retirement tipping point might be long delayed. In some cases patients never get better (as measured by return to pre-illness level of medical expenses) and become a perpetual expense for the system, and in these cases the elderly employees feel as if they never can leave.

There is also the case where a spouse is younger than their partner; or, less frequently, there is a dependant child still in the home. That the employee might be older than a dependant is not unusual for employers like the University of Nebraska with a predominately male workforce and a surrounding culture where husbands tend to be older than wives. In these cases, if an employee wants to retire at 65, but the younger spouse is not eligible for Medicare coverage, the employee often lacks the financial resources to retire; especially after factoring in healthcare insurance costs. Purchasing medical coverage for these dependants (e.g., COBRA) is extremely expensive and may delay the retiree's retirement date to the date when the spouse is

eligible for Medicare. However, after having passed the traditional retirement age, the employee often is tempted to keep on working for many of the reasons mentioned above.

Benefit Consistency: Cost or Benefit for the Employer?

Part of the perceived risk of uncertainty that a prospective retiree has to consider is the ever changing retirement plans offered by the employer. Because the employer must manage in the short term subject to available budgets, the employer often changes the benefit package while seeking to serve a changing employee base. However, given the retirement rules and environment external to the employer are in a constant flux it is a challenging task to plan retirement. So challenging, some do not attempt the task. If the policy and procedures within the system change as well, then it becomes almost an impossible task for most individuals. As a consequence of the employer being flexible in the short term, the employee is incited towards being inflexible in the long term. The employee who does plan must plan for a retirement nest egg that is sufficient to meet **all** feasible scenarios rather than merely sufficient to meet most reasonable scenarios. Necessarily, every exercise of employer flexibility that reduces benefits is a choice by the employer that can push employees away from their individual voluntary retirement tipping point.