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The retirement landscape: Hazardous and challenging terrain

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If nothing in life is certain except death and taxes, nothing in life seems quite so uncertain for most workers today as a comfortable retirement. Whether from the perspective of employers, insurers, healthcare organizations, or present and future retirees, the retirement landscape presents a tangle of risks, uncertainties, and challenges:

- Low investment yields make it difficult to grow retirement savings faster than inflation and cause problems for both defined benefit and defined contribution plans.
- Continuing radical increases in healthcare costs threaten even well-planned retirement nest eggs.
- The uncertainty of the length of retirement living creates the need to prepare for a long retirement. Increasing life expectancy due to better lifestyle and healthcare magnifies the issue.
- Longer lifespans may also lead to increased necessity of long-term care, which impacts the value of IRAs and defined contribution plan accounts relative to total retirement needs.
- An uncertain inflation picture increases the difficulty of long-term decision making; inflation risk can undermine retirement adequacy.
- Individuals have been given more control over how to save for retirement and what to do with their savings, but do not have the knowledge, expertise, or guidance to make those decisions.
- Challenging economic conditions make it more difficult for individuals to put aside money for retirement.
- Low interest rates create a host of investing and planning challenges.

Any one of these challenges could fill a book. To show the complexity of the problem, this article focuses on one: record low interest rates.

Starting in January of 2008, in response to the global economic crisis, the Federal Reserve initiated a series of drops in the Federal Funds Target Rate. From a rate of 4.00%, they reduced it to a historic low of 0 to 0.25%, where it remains today. This indicates a continuing opinion on the part of the Fed that the risk of inflation is lower than the risk of continued economic weakness. Another reason for these sustained low rates is the lack of liquidity and lending in the global market.

While there may be economic logic to these actions, low interest rates have significant impacts on the retirement landscape in both the short and long term. For those wishing to finance a purchase or pay off higher-interest debt, low interest rates are great. For those wishing to have steady retirement income, they can be a challenge.

Low interest rates and investment vehicles

While the effect of low interest rates on the economy as a whole is complex and difficult to analyze, low rates have an immediate and obvious impact on retirement funding because they result in lower coupon rates on Treasury bonds and other fixed-income investments. Such "safe" investments in the past have been key to stably funding a given retirement need with a particular amount of assets. The same is true whether it is a vast corporate pension plan, an individual's retirement portfolio, or a long term care insurance plan.

Other investments have more complex and unpredictable relationships with interest rates; take the stock market, for example. Typically, it is thought that by increasing the supply of money available for lending and investing, low interest rates tend to drive stock prices up. The market hit its most recent nadir in March of 2009. Today, it has nearly doubled from that low. Lowering rates does not appear to have harmed stock prices, and likely helped, but the relationship is unpredictable.

Some economists report that businesses are using low-interest loans to purchase stock and drive up share prices, or pay off high-interest debt, or simply shore up their store of available dollars at low rates. Now, with continued economic weakness and rates on the floor, the Federal Open Market Committee is engaging in "quantitative easing"—the practice of creating money to purchase Treasuries and corporate bonds to increase the supply of money in the economy.

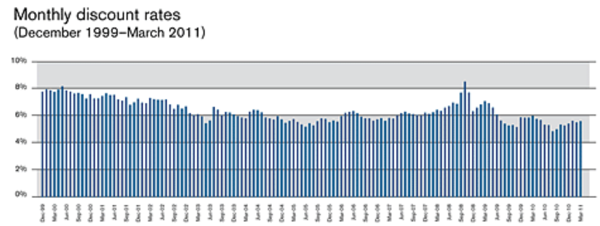

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Exhibit 1 shows the fluctuation of the monthly discount rate since December of 1999. This is the rate used by corporate pensions to calculate pension benefit obligations. Note the lower rates over the last 18 months, especially compared to the higher rates between December of 1999 and the summer of 2002.

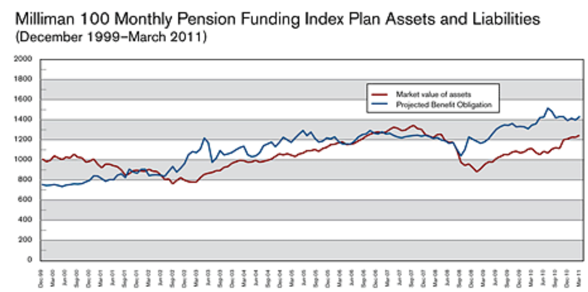

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Exhibit 2 illustrates the movement of both the assets and liabilities for the 100 largest corporate pensions, according to the Milliman Pension Funding Index. Note the blue line in particular, which measures projected benefit obligation (i.e., pension liabilities). These liabilities are significantly higher over the last 18 months than those shown during the high-interest-rate days from 1999 to 2002.

While most people planning for their retirement may not realize it, the fluctuation in interest rates plays a significant role in the funded status of a pension plan.

In any case, the effect of low interest rates on the coupon value of bonds can put traditional retirement strategies to the test. Lower interest rates are not necessarily bad. They can boost the stock market and the economy at large. They also raise the market value of existing bond portfolios exhibiting higher interest rates than are offered on new bonds. However, using bonds as a guaranteed income stream when approaching and living through retirement is a classic part of the retirement "glide path." Institutional investors also rely on bond income to reduce investment risk. In a low interest rate environment, high coupon bonds are sold at a substantial premium that offsets the value of their interest payments.

One of the biggest problems occurs when retirement plans designed around higher interest rates enter a low-rate environment. For example, many DB plans—even ones that seemed conservatively valued just a few years ago—face higher-than-planned-for liabilities due to low interest rates, in turn increasing contribution requirements and P&L expenses. This is also true for individuals projecting their retirement needs. If they have been saving toward a goal based partly on eventual bond income, their plan may need to be revised. If bonds cannot provide sufficient income, individuals will come to rely more heavily on riskier investments.

Real estate and related investments are another potential area for retirement funders to invest. To say the least, both commercial and residential real estate have underperformed in recent years. These market realities have further influenced central bankers to keep rates low (although the relationship between the Federal Funds Rate and mortgage rates is far from lockstep). Even record low interest rates have apparently failed to stimulate the market.

Low interest rates do benefit both individuals and corporate property buyers and owners who are purchasing property now or who are able to refinance. In the long run, they may help stimulate the recovery of real estate markets, which would help investors in those markets whether individual homeowners or large institutions. Of course, relatively low interest rates were a contributing factor in the bubble whose popping created today’s challenging conditions in the first place, a lesson that we hope regulators will not forget. And low interest rates increase inflation risk, which in turn creates more risk for retirees.

Defined benefit (DB) retirement plans

With asset values dropping 20% to 35% in 2008, formerly well-funded DB plans found themselves projecting insolvency. This was on top of sweeping changes to DB funding brought about by the Pension Protection Act (PPA) of 2006. By reducing the "asset smoothing" period from five years to two years, and by prescribing the way liabilities are calculated, the PPA effectively accelerated funding requirements for pensions. Additionally, for U.S. state and municipal governments, this comes on top of underfunded pensions. The exact quantity of underfunding is currently open to debate, with some suggesting the shortfalls total trillions of dollars and others suggesting the funding gap is not nearly so high.

Long term care insurance (LTCI)

LTCI has been in the news quite a bit in the past year or so, with major players either requesting significant rate hikes or going out of the market altogether. Because of its long time horizon, LTCI relies on returns on invested premiums for a substantial amount of the money it uses to pay claims. Underfunding has resulted partly from products priced with long term interest rates that were substantially higher than what is available in the market today. New policies are generally priced with lower interest rates taken into account, which increases premium levels and therefore influences the marketability of the product. Interest rate hedging strategies are available to insurers; however, the current low interest rate environment makes that strategy less attractive. Accounting rules may also influence the viability of hedging strategies.

Living benefits

A kaleidoscope of options characterizes the annuity market. Annuities with guaranteed lifetime withdrawal benefits (GLWB) or guaranteed minimum income benefits (GMIB) offer a "floor" of protection against poor returns and help to address longevity risk. They are the most popular type of variable annuity sold in the market today. They provide a good option for baby boomers because, unlike government bonds, in addition to the guaranteed minimum income for life, they also allow for market participation if asset values grow. However, if the low interest rate environment persists, the benefit levels offered today may become unsustainable. To continue offering existing levels of benefits (and therefore maintain the marketability of these products), insurers will have to fundamentally change the way they manufacture and design these guarantees.

Personal retirement savings

From the perspective of individuals in retirement or about to retire, low interest rates present a number of issues. The foremost issue is that their nest egg grows more slowly. Low interest rates increase the temptation to take on home equity debt or other types of debt to finance a better retirement lifestyle. Low interest rates tend to drive up the value of older long -term bonds with higher coupon yields; individuals could be tempted to sell their high-coupon long-term bonds at a profit, giving up a guaranteed income stream for immediate gains. This is not necessarily bad, as it may offer a way to increase retirement assets, but needs to be considered in the context of the overall retirement horizon and strategy.

Many individual retirees rely on the equity in their homes as a retirement resource. The drop in residential real estate values is extremely problematic for retirees who planned to draw on the equity in their homes (through a reverse mortgage, for example). However, it is good for retirees who wish to invest in real estate now.

Perhaps most importantly, the Fed’s strategy of holding interest rates low and engaging in quantitative easing carries risks of inflation. The Fed is carefully monitoring the inflation picture and working hard to stimulate the economy without negative consequences. However, it is possible that we could go through at least some period of high inflation, which can have serious consequences for retirees as they find the purchasing power of their savings eroded.

What does the future hold?

With high unemployment, slow growth, and low inflation, many commentators expect that interest rates will remain low for a year or more. Given the gradual pace of the recovery so far, it is likely that interest rates will not return to pre-bubble levels for some time. Some point to Japan as a cautionary tale, where interest rates have remained effectively 0% for more than a decade.

Entities managing DB plans, annuities, and LTCI are all looking for alternative investment strategies and plan structures that will enable them to stay solvent. Individuals who are saving for retirement should not rely exclusively on received wisdom about how much to save and where to put it, as the "rules of the game" are changing.

More broadly, just this brief examination of the effect of low interest rates demonstrates that the challenges of funding retirement are complex, dynamic, and interconnected. Whether you are an insurer selling LTCI, a financial firm selling annuities, a pension fund manager looking to keep a plan solvent, or a worker looking to retire at a reasonable age, new strategies are necessary to meet the challenges of the post-crash retirement landscape.