Sibson Consulting

ideas

Insights and Strategies

January 2018

Quantifying Retirement Readiness

How to Determine if Your Employees Are on a Smooth Path to Retirement

Many organizations have no idea how financially prepared their employees are for retirement. They may have a number of later-career employees who are nowhere near ready and, consequently, have to work for many more years. On the other hand, there may be a few mid-career employees who already have enough savings to retire and could decide to do so on short notice. Employees who find they must work longer than they expected or who retire unexpectedly early may disrupt the natural progression of the workforce.

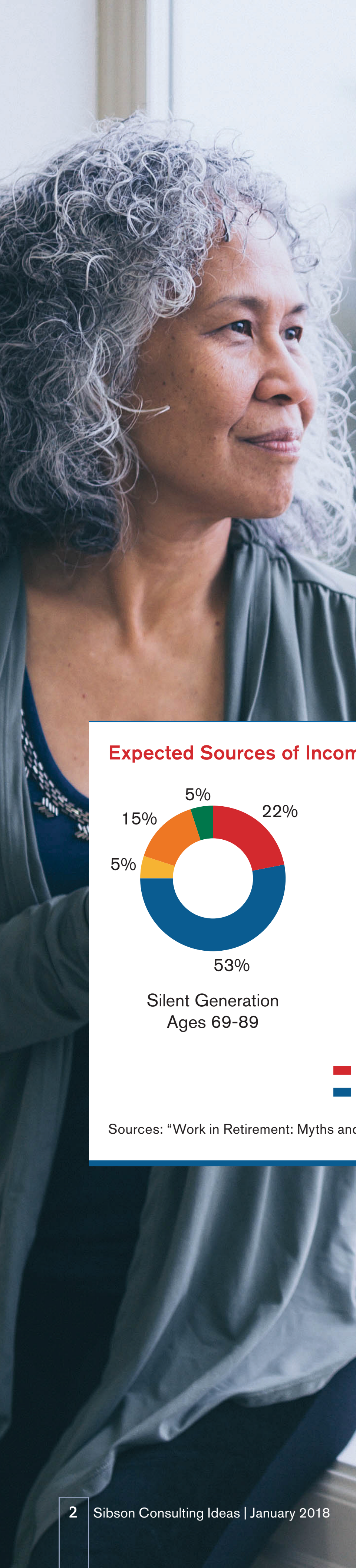
To minimize such disruptions and foster sound workforce planning, it is important for employers to help ensure that employees are on track to a timely retirement of their choice. As such, it is of paramount importance that organizations:

- Understand what constitutes retirement readiness and how it affects the business,
- Identify which employees appear to be on track for timely retirement and which do not, and
- Take steps to help employees financially prepare for retirement.

Sibson Consulting defines "retirement readiness" as the ability to retire with sufficient income to maintain the employee's current standard of living throughout retirement. While some organizations may measure employees' retirement readiness only as they approach retirement age, a more comprehensive strategy is to utilize a retirement-readiness analysis, as described below, to track their employees throughout their careers to help ensure they are financially on target to retire when they want.

This *Ideas*, the second in a series,[1] focuses on how organizations can determine if their employees appear to be financially ready to retire.

[1] The first *Ideas* in this series discussed how important it is for organizations to take the "retirement pulse" of their employees.



Metrics for Measuring Retirement Readiness

A retirement-readiness analysis should include one or more of the following metrics:

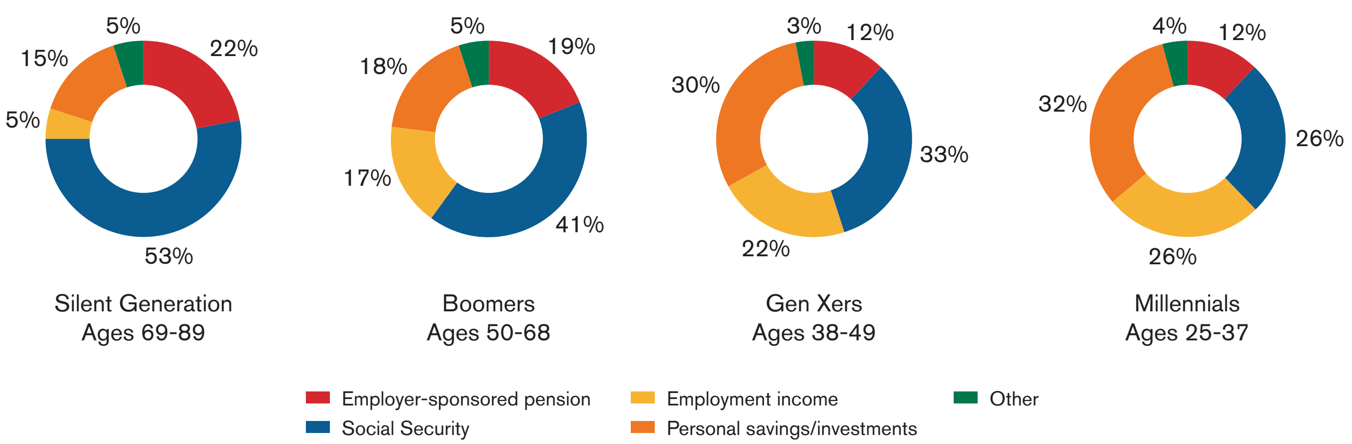
- Replacement ratio,
- Wealth-accumulation target, and/or
- Retirement-readiness grade.

Replacement Ratio

Fundamentally, retirement readiness means the accumulation of sufficient income for retirement. The most direct metric for retirement readiness is the replacement ratio, which defines the required income for retirement as a percent of income just before retirement.

According to a 2016 U.S. Government Accountability Office study on retirement security, most employees would need a replacement ratio between 70 and 85 percent to maintain their pre-retirement standard of living.[2] Although there is certainly a range of acceptable percentages, Sibson considers 80 percent a reasonable benchmark. Part of the replacement income will come from Social Security and other retirement vehicles; savings and other assets will need to cover the rest. The proportion of these sources will vary by generation.

Expected Sources of Income in Retirement by Generation



Sources: "Work in Retirement: Myths and Motivations," Merrill Lynch Retirement Study conducted in partnership with AgeWave, 2014. Reprinted with permission.

> More than 70 percent of employees think not having enough money is the major reason people are unable to retire when they want.
>
> Source: The Society of Actuaries' 2015 Risks and Process of Retirement Survey

[2] Source: "RETIREMENT SECURITY. Better Information on Income Replacement Rates Needed to Help Workers Plan for Retirement." U.S. Government Accountability Office, March 2016.

When employees start accumulating retirement wealth and when they begin drawing from this accumulation both are key to determining an appropriate savings rate.

Most replacement ratios use a retirement age of 65. Employees who plan to retire before that age will need to accumulate more savings to attain the same replacement ratio for the additional years in retirement.

Further, because of the number of savings years and the power of compound interest, the age at which employees start saving for retirement is also important. The following table details the required savings rates to attain an 80 percent replacement ratio based on varying initial savings ages and anticipated retirement ages. The first part of the table shows required savings rates that will likely provide sufficient income for retirement (75 percent chance). Using the rates in the second part of the table will increase that likelihood to 95 percent.

Early Savers Have a Strong Head Start, but Higher Savings Rates Increase the Likelihood of Retirement Readiness

	75 Percent Likelihood of Having Sufficient Income			95 Percent Likelihood of Having Sufficent Income		
	Start Saving at:			Start Saving at:		
Retire at:	25	35	45	25	35	45
62	11%	20%	39%	20%	31%	54%
65	8%	14%	26%	14%	25%	37%
67	6%	11%	20%	11%	20%	28%
70	4%	7%	12%	7%	11%	17%

Savings rate (percent of pay) required for a medium earner to attain an 80 percent replacement ratio

Source: Sibson Consulting, 2018

Why Focus on Income?

Describing retirement assets in terms of annual income in retirement resonates with people because it helps them understand those assets in terms of their current standard of living.

Most employees need less income during retirement than when they are working because:*

- They will pay less income tax,
- Taxes for funding Social Security cease at retirement,
- Work-related expenses are reduced or eliminated,
- Social Security benefits are either partially or fully tax-free, and
- They may no longer need to save for retirement.

* These decreases can be offset to a greater or lesser degree by other items, such as increasing healthcare costs.

Overall Retirement Readiness

While Sibson's analyses focus on the perspective of the employer and the plan, ultimately, employees' account balances are just one component of their overall retirement readiness. Not only will they have Social Security, but they may also have pension plan benefits and Individual Retirement Accounts as well as spousal and other sources of income. Ascertaining whether individual employees are ready to retire may involve a full assessment of their financial needs and all sources of income and/or wealth.

Wealth-Accumulation Target

Although using a replacement ratio as a measuring stick is easy to understand, it may be much harder for employees to measure progress towards meeting their goals. That is because a large percentage of savings is account-balance based (*i.e.*, not expressed in terms of an annual income).

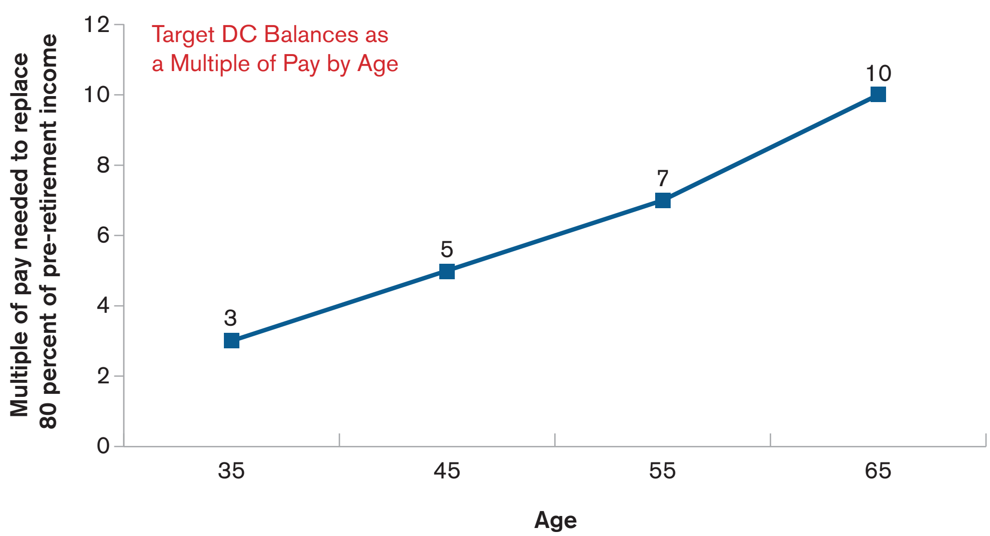
The wealth-accumulation target defines retirement readiness as a specific amount of savings by retirement age. It is similar to the replacement ratio; however, it focuses on the total savings an employee needs to generate the required replacement income. According to one study, an employee would need 11 times pay to retire at age 65 and replace 85 percent of his or her income. At age 67, he or she would need eight times pay.[3]

Determining the wealth-accumulation target can be complex. This is because some sources of retirement income are not easy to translate into an accumulation amount. For example, Social Security and benefits from defined benefit (DB) plans are usually expressed as an annual amount payable rather than an accumulation value.

Similar to replacement ratios, there is no one "right" answer for a wealth-accumulation target (*i.e.*, which multiple of pay is right for an individual). It is important to consider a range around the target the employee is striving to attain. With that said, Sibson believes that, assuming retirement at age 65, a multiple of 10 is a reasonable target.

An important advantage of using a wealth-accumulation target as a retirement-readiness measurement is that it carves a path to retirement that employees and the organization can readily track along the way. For example, if an employee's target at retirement is 10 times pay, and he or she plans to defer 6 percent annually until retirement, he or she should have saved about five times pay by age 45 and about seven times pay by age 55.

Tracking Employees' Progress Towards Retirement



Source: Sibson Consulting, 2018

[3] "The Continuing Retirement Savings Crisis." National Institute on Retirement Security, March 2015.

However, these multiples will vary, depending on certain factors, including:

- Future deferral rates,
- Other sources of retirement income (*e.g.*, a DB pension plan), and
- The desired likelihood of having sufficient income (*e.g.*, 75 percent).

To better understand the impact of some of these factors, see "Detailed Analysis of Wealth-Accumulation Targets" (http://www2.segalco.com/quantifying-ret-ready-add).

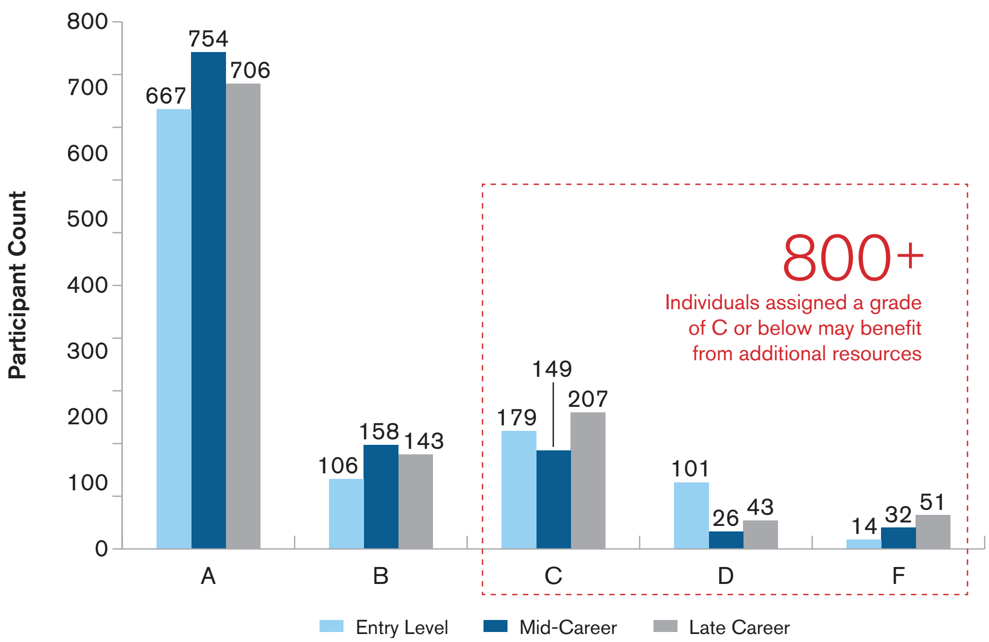
Retirement-Readiness Grade

Replacement ratio and wealth-accumulation target can provide specific goals to aim for. Without accompanying them with some detailed math, they tend to become just numbers that fail to give employees a feel for how they are doing. Providing a qualitative assessment of their progress so they can see if they are falling short can be the key to engaging employees. It can also encourage them to address any shortfalls.

Sibson has developed an easy-to-understand retirement-readiness grade: an A, B, C, D or F. This grade scores an employee's current standing based on his or her age plus the expectation that he or she will attain an appropriate level of retirement readiness. The grade is determined by projecting an employee's current profile, and reflects the expected replacement ratio, the likelihood of attaining the threshold, and the variability of potential outcomes. Sibson develops specific targets in consultation with the HR team.

Segmenting a population by grade can help isolate groups that need special attention. For example, the graph below reveals that employees late in their career have the largest number of grades of C and below.

Retirement Readiness Grade by Career Stage



Source: Sibson Consulting, 2018

Good Data
= Good Analyses

Having an HR information system with organized data is the foundation for a good retirement-readiness analysis. Some HR departments still lack this function, which makes it more difficult to perform efficient forecasting and planning.

Determining Each Employee's Retirement Readiness

Working with your HR department, Sibson uses organizational data and human capital knowledge to produce retirement-readiness analyses. We calculate each employee's replacement ratio, wealth-accumulation target and/or retirement-readiness grade based on readily available information, including age, service, salary, retirement account balance and asset allocation.

An employee's retirement profile covers many of the factors that could potentially affect his or her ability to retire in a timely fashion. Sibson calculates the metrics and, importantly, presents the results in an easy-to-read fashion. These can include both detailed cohort analysis for HR and personalized communications for each individual.

Key Takeaways

Organizations need to understand what constitutes retirement readiness and where each of their employees — especially those nearing retirement — stand on the readiness spectrum. This involves understanding what savings employees need to attain a secure retirement, gathering financial and other data on all employees and then "running the numbers" to determine how each employee stacks up.

Once this information is clear, the next step is to develop and implement strategies to help employees retire when they want to. These may include plan design analysis/changes, educational materials or communications campaigns to affect behavioral changes, and more. This topic will be covered in the next *Ideas* in Sibson's retirement-readiness series.

How We Can Help You

Sibson's strategic deeper dive into DC plan data helps plan sponsors analyze changes in staffing based on growth, unexpected early retirements and aging workforce populations. In addition to workforce planning — from rewarding critical roles and high-potential employees to considering investment decisions and deferral patterns and even integrating employee engagement — DC analytics can reveal useful insights that shape your HR recruitment and retention strategy. Sibson uses methodical diagnostics to create customized reports about your plan's patterns that are measurable and actionable.

Questions? Contact Us

For more information about retirement readiness and/or to discuss how Sibson Consulting can help you help your employees prepare to retire, contact your Sibson consultant, the nearest Sibson office or one of the following professionals:

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Important Note

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Strategic DC Analytics: Powerful Data for Attaining HR Goals

Analyzing participant-level data strategically can both uncover HR issues in your organization and identify DC plan successes and challenges. The following areas highlight different perspectives of your workforce to examine:

- **Retirement Readiness** Are your employees transitioning successfully into retirement as they approach the latter part of their careers to allow for successful workforce planning?
- **Employee Deferral Patterns** Are certain groups of employees decreasing their deferrals to the DC plan, and, if so, why?
- **Employee Engagement** Have you considered the correlation between employee engagement with the DC plan and overall employee engagement with your organization?
- **Rewarding Critical Roles** While your DC plan benefits all of your employees who participate, are your key employees utilizing the plan appropriately? Are you allocating your retirement contributions in line with your desired performance allocation?
- **Investment Decisions** Do the asset allocations of certain participants indicate that they may not be investing wisely?

Sibson creates customized reports based on your DC plan data to unearth compelling information regarding both HR issues and DC plan patterns. We then partner with you to develop an action plan that can subsequently be measured for success.

We hone in on specific employee groups to see differences in plan behavior, which can help identify cohorts that may or may not be appropriately benefiting from the DC plan, as well as other notable group tendencies.

Learn more about Sibson's Strategic DC Analytics services.

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