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Taken for a Ride

Greater Risk Exposure Means Less Income Security for Retirees

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Introduction and summary

U.S. households lost trillions of dollars in the first few quarters of the economic and financial crisis of 2007, 2008, and 2009. Total wealth relative to after-tax income had fallen to its lowest level since March 1995 by the end of 2008. This sharp drop likely had a severe effect on the retirement income security of millions of U.S. households.

Retirement savings have become increasingly individualized, meaning that retirees have had to manage several economic risks increasingly on their own. First, there is longevity risk, or the chance that a retiree will outlive his or her savings. Next, there is market risk, or the probability of an underperforming market and thus less-than-anticipated retirement income. Third, there is idiosyncratic risk, or the chance of unwise or unlucky investment and savings decisions, which can further reduce expected retirement income. Fourth, there is labor market risk, or the possibility of earnings losses alongside financial market declines. All of these risks may have increased over time.

Greater risk exposure has two policy implications. First, risks are an economic cost, and workers should save more than in the past to handle the new costs of greater risk. Investors, for instance, want to be compensated for greater risk with higher expected rates of return. Viewed from a slightly different angle, this means that savers must now accumulate more wealth than in the past to achieve the same level of economic security because their risk exposure with their personal wealth has also increased.

While rising asset prices have helped individuals to accumulate wealth, the personal saving rate fell dramatically before the crisis, leaving families with less of a buffer in case something went wrong. Additionally, individuals' psychological makeup stands in the way of optimal wealth creation. Savers do not regularly rebalance their portfolios; they buy high and sell low, and invest large amounts of their portfolio in employer stock, among other steps that can inadvertently reduce their savings.

The result of unnecessarily large risk exposure became clear to millions of 401(k) plan participants during the financial crisis as the statements detailing the quarterly returns on their investments began to arrive in the mail late last year. The losses were staggering.

The available data clearly show that wealth losses have been large and the drop in retirement income security has been real. Data from the Federal Reserve's Flow of Funds Accounts also show that from 2007 to 2008, total retirement wealth in private- and public-sector pension plans and retirement savings plans dropped by $2.8 trillion (in 2008 dollars).[1] These losses followed a trend toward less diversification and greater leverage in individual savings.[2]

Not surprisingly, losses have been greater in defined contribution accounts than in defined benefit plans, suggesting that the inherent risks in individual accounts are greater than in professionally managed, pooled assets with a longer time horizon, such as defined benefit plans. These losses in individual accounts are further exacerbated by the concurrent burst in the housing bubble. Many families rely heavily on their homes to provide retirement income since they have no retirement savings outside of Social Security by the time they near retirement.

The financial crisis has also accompanied a major economic recession that has contributed to rapidly rising unemployment rates for all groups, including older workers. Working longer is thus not a viable option to compensate for massive wealth losses. Since 1985, U.S. retirees have increasingly supplemented their incomes by working part-time or having a working spouse. The labor force participation rate of older workers increased more in the first year of the most current recession than during the first year of any recession since the early 1960s, but older workers have not been immune from the recession. The unemployment rate for Americans 65 and older soared to 6.2 percent in the first quarter of 2009, the highest level since 1977.[3]

Data at the household level are only available through 2007. These data from the Federal Reserve's Survey of Consumer Finances, though, show that even before the crisis was in full swing, retirees were exposed to a number of risks. The exposure to market risks through less and less diversification and more and more leverage is probably the most visible risk exposure of retirees before the crisis. As stock and house prices fell, retirees thus stood to lose more wealth than would have been the case in the past. This loss of wealth, though, put retirees between a rock and a hard place. After all, retirement income from Social Security and pensions had already been declining, and opportunities to work longer have disappeared, meaning that retirees will have to rely increasingly on risky private savings exactly when risks have materialized and savings have been decimated.

So what now? For U.S. households to reach the same level of retirement income security that they enjoyed before the crisis, total wealth relative to after-tax income may actually have to rise above pre-crisis levels to compensate for the increased risk exposure. That is a tall order considering the large losses that families sustained in the crisis.

Policymakers can help rebuild retirees' personal wealth and reduce the risk exposure of individuals' retirement savings, and thus lessen the need to build up as much wealth as in the past. In particular policymakers should encourage more diversification and less leverage in individual retirement accounts, increase the annuitization of retirement savings, and create more stable labor market options for older workers.

Only time will tell whether current and future U.S. retirees will be able to retire as comfortably as they imagined before the crises. In the meantime, it is important to understand how we arrived at such a delicate retirement income situation in the United States. The following pages of this report detail the current state of the U.S. retirement system, the risks embedded in it, and steps that policymakers should consider to address shortfalls in the existing system.

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all. We believe that Americans are bound together by a common commitment to these values and we aspire to ensure that our national policies reflect these values. We work to find progressive and pragmatic solutions to significant domestic and international problems and develop policy proposals that foster a government that is "of the people, by the people, and for the people."

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