Welcome to InFRE's April, 2017 Issue of Retirement Insight and Trends

Retirement InSight and Trends is the quarterly newsletter for the International Foundation for Retirement Education's Certified Retirement Counselors® (CRC®s) to help retirement professionals with the practical application of new retirement readiness, counseling, planning and income management concepts for the mid-market. Find out more about the CRC® and InFRE here.

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April, 2017 InFRE Update: Team1 Volunteers Needed for the 2018 CRC® Practice Analysis Update

retirement-insight.com/april-2017-infre-update-2018-update-practice-analysis-work-certified-retirement-counselors-crc/

By Kevin S. Seibert, CFP®, CEBS, CRC®, Managing Director, InFRE

Kevin S. Seibert, CFP®, CRC®, CEBS – Retirement Planning and Income Management Expert, Managing Director of InFRE

The *Certified Retirement Counselor*® (CRC®) comprehensive examination is designed to ensure that all CRC® candidates possess the necessary knowledge and skills to competently fulfill their responsibilities as retirement counseling professionals. The validity of the CRC® exam is dependent upon the *Certified Retirement Counselor*® (CRC®) Practice Analysis (Practice Analysis), where experienced retirement professionals determine the knowledge and skills deemed important for today's new retirement counselors.

From the Practice Analysis then comes the CRC® Test Specifications, which is the blueprint for the design, creation and updating of the CRC® comprehensive examination.

2018 Practice Analysis Update Preparation

Keeping the Practice Analysis up-to-date is critically important to maintaining a credible CRC® program and to meet National Commission for Certifying Agencies accreditation standards. The most recent update was completed in 2013 by a Practice Analysis Task Force (PATF) of twelve industry professionals who generously volunteered their time and expertise.

In early 2018, InFRE will be forming a new team of 10-12 industry subject matter experts to serve on the 2018 PATF who are reflective of the diversity of practice. The PATF will review the 2013 practice analysis and associated test specifications and make recommendations for updates and changes based on current trends and gaps that may not have been addressed in the last study. The focus of the PATF will be to identify:

- Changes in the practice of retirement education since the completion of the previous practice analysis study;
- Reflections concerning future directions in practice;
- Areas missing from the delineation of domains, tasks, and knowledge; and
- Any knowledge essential to the delivery of services that was not identified in the previous job analysis study.

Results of the Practice Analysis will be documented in a technical report, submitted to the InFRE Board of Standards for review, and published as an examination guideline for future CRC® candidates. The key to a successful Practice Analysis study of the retirement industry is having experienced and thoughtful participants on the PATF from the CRC® certificant community. **PATF volunteers will receive ten hours of CRC® continuing education credit and a waiver on the annual CRC® renewal fees for two years.**

If you are interested in volunteering to be on the 2018 PATF, please contact Kirsten Smith at (214) 305-5579 or email Kirsten at ksmith@infre.org.

Three Steps to Helping Clients Manage Health Care Costs in Retirement

retirement-insight.com/three-steps-helping-clients-manage-health-care-costs-retirement/

By David Armes, CFP®, Principal of Dover Healthcare Planning, LLC

David Armes, CFP®, Principal of Dover Healthcare Planning, LLC

Editor's note: This article is an adaptation of the live webinar delivered by David Armes, CFP® in 2017. His comments have been edited for clarity and length.

You can read the summary article here as part of the 1st Qtr 2017 Retirement InSight and Trends Newsletter, worth 1.0 CE when read in its entirety (after passing the online quiz.

You may also choose to take the full length course Three Steps to Helping Clients Manage Health Care Costs in Retirement – David Armes for 1.0 hour continuing education (CE) credit.

How are healthcare costs different? They increase at faster rates than other kinds of retirement spending. Over the last 20 years, healthcare inflation has risen at an average annual rate of about 2 percent more than other types of consumer inflation. Over time, for retirees who have fixed incomes, as you can imagine, this starts to crowd out other types of spending.

Healthcare costs are also more complex. Probably the most frequent complaint about Medicare is, "What do you do with all of these parts?" Parts A, B, C, and D have different enrollment timelines and rules. Depending on when you enroll, you can put Part A, Part B, and Part D in a Part C plan, which is an Advantage Plan, except that some Advantage Plans don't include Part D, so you have to enroll in a standalone drug plan, and on and on, and after about 20 seconds of that, most people's eyes start to glaze over. Even if it's explained clearly and they understand it for the moment, if they don't deal with it, then they forget what they're supposed to do.

That's different, I think, from other kinds of retirement spending. Housing costs, which is the largest spending category in retirement, are not complicated for most people. They know their options. If they need to cut costs, they can downsize or take out a reverse mortgage. They've been dealing with those issues their whole lives. Medicare and healthcare terminology, though, baffles them, so they don't know what to do.

Costs are unpredictable. They bounce around more than other types of retirement spending, some types substantially so. I recall a conversation a few months ago, during Open Enrollment, with a woman had been tracking her healthcare costs. She was in her early 70s. It had risen about 4 percent a year. Her doctor had just prescribed a brand-name drug for a condition she had. It wasn't a serious condition, but he wanted her to take it. Her costs were going to jump about 40 percent in one year because of that drug. There was nothing she could do, and she was, if not distraught, at least seriously concerned.

The final factor, and we'll talk more about this on subsequent slides, is that, in retirement, the costs are heavily tilted toward later years, in part because they're increasing at faster rates, but also because people are using more medical services.

I think you can start to understand some of retirees' concerns when healthcare comes up in surveys because they have no control at all over the first three of these: healthcare inflation, the complexity of Medicare's rules, and the unpredictability of their own health. They can do some things about the tilt toward later years, but there are also many things they can't do. So, they feel, among other things, very little control over the things that they need to do.

Out of Pocket Healthcare Costs are the Culprit

Just about everybody is aware that costs go up as you grow older, but the incline is more significant than many people are aware of. A planning assumption is that an 85-year-old is going to spend two times as much out-of-pocket

as a 65-year-old in the same year. Using future dollars, if a 65-year-old woman lived to be 95, then she would pay one-fourth of her total retirement healthcare costs after her 90th birthday.

It's not healthcare inflation that's at work here. It's the increased use of medical services. Roughly 80 percent of people with Medicare are in some form of group plan – Medicare Advantage Plans, employer plans, or community-rated Medigap policies – and as we know, all group plans have the same premiums for people regardless of their age or health status, so a premium for a 95-year-old and 65-year-old is the same.

Most people in Medicare are in some form of a group plan, so the reason for this increased spending is not the premiums. It's that they're going to their doctors more often. They're taking more prescription drugs. They're taking more brand-name drugs. They're more likely to use services that are not covered by Medicare for which they have to pay the full out-of-pocket cost.

When I was a Medicare counselor, this is what surprised me. I saw executives of companies, who I knew had to have substantial pensions, coming and saying, "I need to do something about my health costs. They're really starting to hurt." More often than not, it was prescription drug costs. They were in the wrong plan or, in some cases, a Medigap policy.

Any strategy that's effective in controlling healthcare costs is going to have to deal with this latter half of retirement because that's where most of the costs are going to be spent. However, while costs are going up, people are increasingly less likely to do the things necessary to manage those costs. In some cases, it's mental incapacity. In some cases, they're just not as willing to spend the time and effort necessary to do it. So, while the financial stakes are increasing, the likelihood of people trying to manage their healthcare is decreasing.

The Medicare Payment Advisory Commission has done quite a bit of research on this. The overall switching rate among plans for all Medicare beneficiaries is about 13 percent. For people in their 60s, it's 15 percent, but by the time they get to their 80s, it's below 10 percent.

Most clients are concerned about healthcare costs and they want some advice. The Gallup organization, last year, wrote a paper saying that in the 15 years since they started, in 2001, interviewing retirees about their top-two concerns in retirement, the top-two concerns had not changed in any of those 15 years. No. 1 is that most retirees are concerned about not having enough money or about running out of money. No. 2 is healthcare costs, and that's been consistent over 15 years.

At the same time, other surveys show that most financial planners do not try to help their clients manage these costs, maybe because there are so many kinds of coverage, but there's just a lack of information here on the part of financial planners as a whole. When I've spoken at Financial Planning Association (FPA) meetings seen maybe a third to 40 percent of the people say they actively try to help. Other surveys show much lower participation.

The First Step: Make One-Time Estimates of Spending

We're going to talk briefly about three fairly simple ways, I think, to help clients. In most of these steps, the clients are going to do much of the work. They're the ones who have to manage their healthcare costs.

The first way is to make one-time estimates of how much a client may spend on retirement healthcare. Estimates are going to be imprecise by their very nature. I've learned that it's good to come up with a bunch of them. They're going to be different, but there are two possible benefits to doing this. If it's done accurately, it's going to result in a large number.

When people see a large number and can grasp the potential magnitude of the spending, it may motivate some of them to try to manage their spending better as they go through retirement, and it may cause some of them to change their coverage. In early retirement, people tend to be too optimistic and choose expensive coverage. So, there's some value to this, not as a predictive device but just as something to raise consciousness. A few years ago, Fidelity

took a survey of over 1,000 pre-retirees, and nearly half of them said that they thought their retirement healthcare would cost about $50,000, on average, which is much too low.

One way to do it, if someone is already 65 or older and using Medicare, is by asking them, “Would you like to do some projections of your costs under different scenarios over different time periods?” If they say yes, you would respond by saying, “Could you give me an estimate, then, of how much you spend?” “$2,500 a year,” says somebody with an Advantage Plan. This year, Part B premiums for incoming enrollees are going to be over $1,600. So, that’s somebody who’s an Advantage Plan and who takes one or two generic drugs, a pretty low number. $4,000 is for somebody who takes one or two generic drugs and has a Medigap policy. You just project them straight line.

Make projections based on current costs

For One Person →	$2,500 a year		$4,000 a year	
Time periods	4%	5%	4%	5%
20 years	76,000	86,000	$122,000	137,000
25 years	107,000	124,000	$171,000	199,000
30 years	145,000	173,000	$231,000	277,000

You can also use published estimates for people who have not yet started Medicare. The current-cost would not be a good starting point for projections. None of these include long-term care costs. The costs on the prior slide were for an individual. These are for a 65-year-old couple.

Or use published estimates (future $)

For a 65-year-old couple without an employer plan
(does not include LTC costs)

Organization	Estimate	Life Expectancy	
		Man	Woman
Fidelity Investments	$260,000	85	87
	$355,000	92	94
Health View Services	$435, 000	87	89
Society of Actuaries	$293,000	85	85
	$441,200	90	90

The first two, published in these estimates here by Fidelity (and Health View, were both done in the last year. The Society of Actuaries did theirs three years ago. These are after-tax estimates, in most cases. It's probably a mistake to focus on any of these numbers. There is tremendous variance here; almost 2-to-1. Using different assumptions of healthcare inflation, life expectancy, and healthcare costs, there's that element of unpredictability that we've talked about.

The Employee Benefits Research Institute has the most gravitas here. They've been doing this for 25 years. They do 100,000 Monte Carlo simulations for each of these outcomes, and then they assume that the savings are set aside at the start of retirement. They earn a 7.3 percent after-tax return, which is probably optimistic for a balanced portfolio.

Present value estimates

For a 65-year-old couple without an employer plan

Organization	Estimate	Life Expectancy	
		Man	Woman
Health View Services	$288,000	87	89
Employee Benefits Research Institute			
50% chance of having enough money	$165,000	Median Rx expenditures	
90% chance	$265,000		
90% chance	$349,000	90% Rx expenditures	

Look at the variance depending on the level of prescription drug expenses and the probability that you will have enough. If you want a 90 percent probability and you're in the 90 percentile range of prescription drug expenses, you're going to spend twice as much as if you were in the median Rx drug expenditures and only want a 50 percent chance.

The Second Step: Suggest Clients Choose the Coverage that Best Matches Their Needs

Now we've come to the meat of what maybe retirees need to do and what planners can advise them about: suggest to them that they choose the coverage that matches their needs. Recommend that they reevaluate their coverage each year during Open Enrollment.

Study after study shows that this just does not happen, and that many retirees waste tens of thousands of dollars during the course of their retirement because they never look at their coverage. It's like they had an investment portfolio that they started when they were 65, they never rebalanced it, and they never went back to review it. They just left it alone. Unfortunately, that happens.

Two kinds of coverage: Very comprehensive and less comprehensive

Although it's an oversimplification, we might just say that there are two kinds of coverage: very comprehensive and less comprehensive.

Who should get comprehensive coverage? It's going to be more expensive. People in poor health should get it, and the reason is that they are going to use a lot of medical services, and they're going to use their benefits. Unlike property and casualty insurance, their premiums are not going to go up any more than anybody else's in their rate class because they have excessive claims, so they're going to save money.

There have been studies on this. People who are on disability, or are under 65 and have SSDI, and then who get a one-time enrollment period when they turn 65 to buy a Medigap policy almost always will buy it because they know they will come out financially ahead if they can afford it. Medigap plans here are the proxy that I'm using for comprehensive coverage because most of the Medigap plans – there are ten of them – are very comprehensive, and they're great coverage if you can afford them. The most comprehensive of the Medigap policies, which is Plan F, is the one that's most commonly sold because it generates the highest commissions.

The other people who, if you're matching needs to coverage, probably should get it are affluent people who say, "I can afford it, and I want the best coverage." Medigap plans have no network restrictions. You never have to get prior approvals. You can go to the Mayo Clinic this week and Johns Hopkins next week, and they both will probably be covered. The insurance company never makes its coverage decision in these policies.

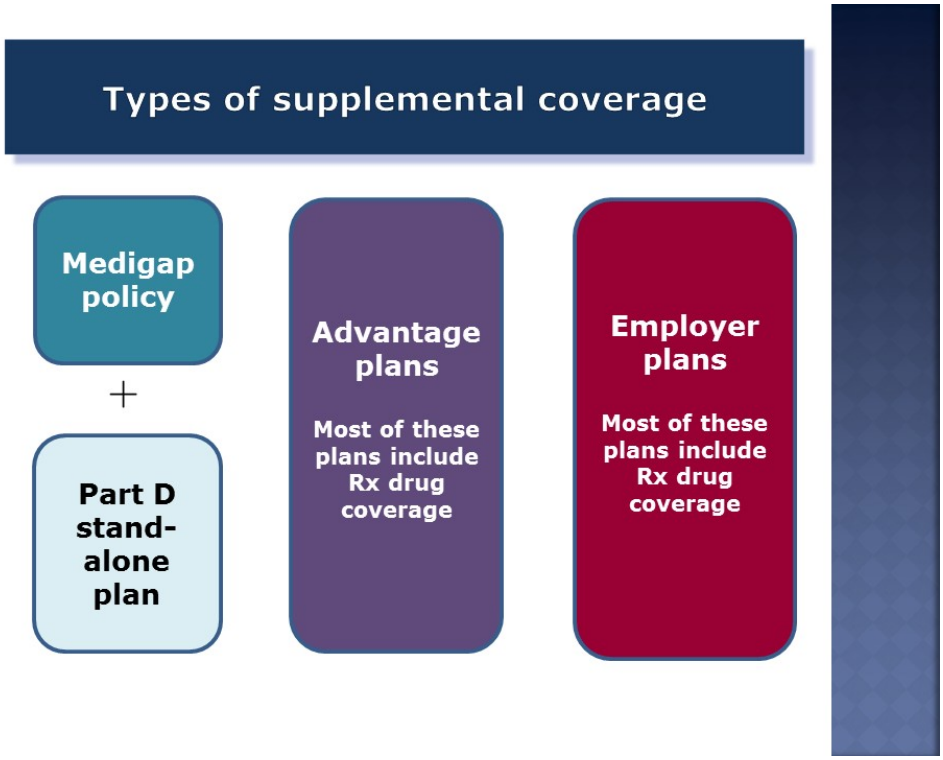
How much does a Medigap policy cost? It varies quite a bit, but I would say $100,000 for someone over a 25-year period. A 65-year-old who lives to 90 will pay $100,000 in premiums. The average starting premium in the United States today is just under $2,400. If you push that out at 4 percent, you're going to come up to about $100,000 at age 90. There are very few medical copayments in that. It would only be for things that Medicare doesn't cover, and you will still have prescription drug costs and Part B premiums. Your entire cost is in the premium, but it's a high cost. If you happen to live to be 95, a 65-year-old buying a comprehensive Medigap Plan F policy will probably pay about $130,000.

The other people who are more or less forced to get comprehensive coverage are people who don't have any good Advantage Plans in their area. The Plains states – North Dakota, Kansas, Wyoming, and South Dakota – all have 50 percent Medigap penetration rates, and that's just because there are not any Advantage Plans there that have their doctors in network. The closest network doctor might be 75 miles away. They are rural areas, and even though you can get in a regional PPO and go to an out-of-network doctor, you may pay 40 percent of cost, and it just makes more sense, for many of those people, to get the Medigap policies.

Who should *not* comprehensive coverage? It's just the reverse side of the coin.

Type of supplemental coverage

Your clients will have one of these three types of coverage.



One is a Medigap policy which does not cover prescription drugs, so you have to get a Part B standalone plan. These policies, because they are expensive, have shrunk as a percentage of the Medicare population. The penetration rate is smaller than it used to be. It's probably about 17 percent today.

Advantage Plans have more than taken up the slack. By the end of this year, probably one-third of everybody in Medicare will be in an Advantage Plan. These are managed care plans. They are HMOs, for the most part, and some PPOs. Most of them include drug coverage. If you enroll in a plan that does not, then you have to enroll in a Part B standalone plan as well.

Employer plans are the best kind of coverage, from a cost perspective, because the employer is paying a portion of the premium. Most plans include prescription drug coverage that's uniform across all plan options. Employer plans can include Medigap policies; they'll take a Medigap policy and subsidize it. They might add benefits to it. They can also include Advantage Plans.

As people age, they're less inclined to do the things necessary to see if they're still in a good policy. If their Medigap policy premiums have been increasing at 3, 4, or 5 percent rates, that's to be expected. If they have been seeing larger-than-usual increases, they might want to see if they can switch to a different insurance company that has lower premiums. They may not be able to do that if they have health problems. They're going to have to undergo underwriting. Medigap still has that provision in most states.

There are eight states that have some protections for people who want to switch insurance companies, but in the other 42 states, they will have to answer health questions or usually a series of yes-or-no questions about their health. They'll also check their drugs to see what drugs they're taking, and then they'll either charge them higher premiums or, in some unusual cases, may decline coverage.

The dilemma in choosing coverage for many people is, “Do I take a very expensive Medigap policy that I know is going to cost me $100,000 or so if I live to be 90, or do I take an Advantage Plan now, which will cut my costs, but then run the risk later, in these 42 states, of not being able to get a policy while, at the same time, starting to see a lot of doctors and needing more treatments? I have to remain in a managed care plan where it’s very hard to find networks that include my doctors, and the prior approvals are a burden.”

What to look for to match coverage to needs

What every person with a Medigap policy should do is check their Part B standalone plan every year. These plans change formularies year to year. It’s just amazing. This is the most volatile type of coverage, not only in the Medicare universe but maybe in all of this country’s healthcare system. It’s just unbelievable.

The Kaiser Family Foundation has done a lot of research on this. 80 percent of the plans that are the lowest-cost plans for a given set of drugs in one year will not be the lowest cost plans the next year, and the average cost difference is several hundred dollars.

This is easily measured in terms of seeing if you’re in the lowest drug plan because you can list your drugs, dosages, and frequencies, and say, “What’s the lowest-cost plan?” and see if you’re in it. 85 to 90 percent of the people in Part B standalone plans are paying too much because they don’t reevaluate their coverage, but it only takes a phone call.

When you find the lowest-cost plan, there are a couple of other things you might look for which will perhaps save some money. There are two refill schedules: monthly refills at the local pharmacy, and mail order. Sometimes, and it varies a lot by plan, one or the other turns out to be much less expensive.

Then, the other thing that can sometimes save money is that some plans, not all, have what they call “preferred pharmacies.” If you are getting local retail refills, then you might want to ask your plan, and you don’t have to wait until Open Enrollment to do this, if your plan has preferred pharmacies. I saw a case just last month whereby walking across the street from a CVS to a Walgreens, somebody could save about $250 a year because the Walgreens was a preferred pharmacy in that particular plan and CVS was not.

So, the bottom line is that if you had to check one thing here, it would be Part D coverage.

With Advantage Plans or managed care plans, you’re really turning over your entire care when you join one of these plans. Now, the plans have to follow Medicare’s basic coverage rules, but what that means is that your benefits are assigned to the Advantage Plan and they take control of your coverage. You live by their plan rules. They have to meet Medicare’s certain requirements, but you want to be fairly careful in choosing an Advantage Plan that you’ve looked at several things.

It’s not feasible, though, for retirees to go in and look at a long list of things to see if this is the best Advantage Plan. It just won’t happen. So, if you looked at two things, the first would be our friend, prescription drug costs, and the second would be out-of-network costs. Even in PPOs where there’s some coverage out of network, it’s not like most employer PPOs where the out-of-network costs are 20 or 25 percent. Many Advantage PPO plans have 40 percent, and I’ve seen 50 percent costs when you go out of network. So, this can be a big cost driver.

The other thing you might look at is Medicare’s overall quality rating for the plan. Medicare has a five-star quality rating. Plans are rated on about 50 criteria; the number changes a little from year to year. Plans that have four stars are better and get bonuses, and a plan with a lot of members can get tens of millions of dollars in bonuses in a year. By law, those bonuses must be reinvested in benefits for plan participants. So, it’s a virtuous circle in the sense that plan get better by doing better, and as they get better ratings, they get more money, which they reinvest in better benefits, which in turn attracts more enrollees. If you can find a four-star-or-higher plan, you probably are going to get additional benefits in that plan, like maybe some dental and vision.

Employer plans come in all shapes and sizes. It's kind of hard to generalize on these. The good thing about employer plans is that they are group plans that you can move about from year to year. I'm retired. I have eight options in my retiree plan, ranging from very comprehensive to managed care plans that are not comprehensive at all. Premiums are much higher for the comprehensive plan, understandably. The drug coverage is the same for all of them, so I don't need to check that in my plan; that may not be the case in all employer plans, since there are so many different kinds.

The nicest feature, I think, of these plans is that you can move about without going through underwriting. So, you'd look and say, "Does my coverage match my need?" If you're in good health, as we said earlier, consider a less comprehensive option. You can always move up the ladder, maybe during the next enrollment period.

There's a subset of employer plans which is a fast-growing trend, and the rules don't apply quite as much here. They're called Medicare private exchanges, and instead of administering the plan, the employer gives an amount to the exchange to be invested on your behalf. It's a health reimbursement arrangement, so there's no tax consequence for you, but you have to buy your coverage through the private exchange. The average, one survey showed, was about $175 a month. So, your former employer contributes $175 a month to a private exchange, and you can spend that, and then you pay the difference, depending on the coverage.

In these plans, you will have to undergo underwriting for Medigap policies. They have Medigap policies in them, but when your employer transfers you to the private exchange, you get a one-time special enrollment period to get a Medigap policy without underwriting. This is the emerging trend, and it's still better than not having an employer plan.

Private exchanges don't always offer as many options as a regular Medicare menu would. Also, they're not administered by the employer. They're administered by the exchange, and the exchange makes its money on commissions. The employer does not pay the exchange. They just transfer the employees to them and say, "You make your money on commissions as you place people in Medigap policies, Part B plans, and Advantage Plans." The good news is that you can call them every year during Open Enrollment, and they have to do an evaluation of your lowest-cost options for drug coverage and others.

Where can our clients get no-cost help?

This would be, in most cases, during Open Enrollment. These lines are all busy, so call early.

1. **800-MEDICARE.** When I was a volunteer counselor, we used to tell people to call in the after-hours, maybe late at night, just to get through. That's the downside of 800-MEDICARE. This is a 24/7 line. They will do drug plan searches. They'll tell you the lowest cost plan for your drugs and compare it to the plan you're in. Then, unique among the phone numbers that we'll see, this number will also automatically transfer you to the plan you want to go in, if you want to switch plans.They will do the same for Advantage Plans. They will identify the premiums and costs, compare them to the plan that you're in, and then they will enroll you in that new plan, if you want to switch, effective January 1st of the following year.

2. **Medicare counseling agencies**. Every state has one, and in many states, every county has one. I work for LA County. You can find your local one at this web address (shiptacenter.org). These people are good with Medigap policies because Medigap rules vary slightly among states, and they won't know that at 800-MEDICARE. These people are very busy during Open Enrollment, so it's good to call them early and make an appointment.

3. **The Medicare Rights Center.** This is a 9 am – 5 pm New York-based national help line. They also are busy during Open Enrollment. These are volunteers, for the most part. They're less helpful on Medigap policies, except for national rules.

4. **Do-it-yourself.** A lot of computer-literate people can do their own Part B searches. We have instructions on our website about how to do it. If they're patient and willing to take 15 or 20 minutes, or maybe 30 minutes the

first time, they can go on and do everything.

This once-a-year exercise of reviewing your coverage and switching when you see substantial savings will save people money. In our business, the people we see are the people who frequently are in their 80s. They come to us, and they have not done anything, and they know they need to do something. Just this last enrollment period, we had a couple who will save $3,500 this year, compared to what they would have paid had they stayed in their other plan.

The Third Step: Coach Clients to Track Costs

The third step in our ways to help is the one that in some ways is not as important. It's just to track costs, which is fairly easy to do.

They add their premiums to their cost-sharing. They can call their insurance company and ask, "How much have I spent out of pocket this year?" Add that to their premiums. Add their Part B premiums. My insurance company for my employer plan will tell me how much I spent last year for drugs. That's a call.

How fast their costs are growing if they've allocated a certain portion of their retirement costs to healthcare – are they growing at 4 percent, 5 percent, or 8 percent? I think this is less important for some people if they do Step No. 2, and estimates are fine.

Takeaways

1. Help retirees understand that most of the cost is going to be in later retirement.
2. The most important thing they can do, and maybe the only thing they can do, is reexamine their coverage each year. Particularly early in retirement, it's good to try to give some thought to the long-term implications, "Can I afford a $100,000 Medigap Plan F if I live to be 90?" If they can, fine.
3. There are many non-profit agencies to help retirees review their coverage yearly. What we do is provide evaluations, primarily for people who are entering Medicare for the first time; we also do it for people who are already in. You can go to our website and then to our Services page. At the bottom, there's a link to a sample evaluation.

About David Armes:

David Armes, CFP®, is Principal of Dover Healthcare Planning, LLC, a fee-only firm that assists clients in evaluating their Medicare options. Prior to starting the firm, David served for four years as a volunteer Medicare counselor after retiring from his job as real estate division manager for a large corporation.

David is the author of several published articles about managing retirement health care costs, including the cover story of the October 2017 issue of the Journal of Financial Planning.

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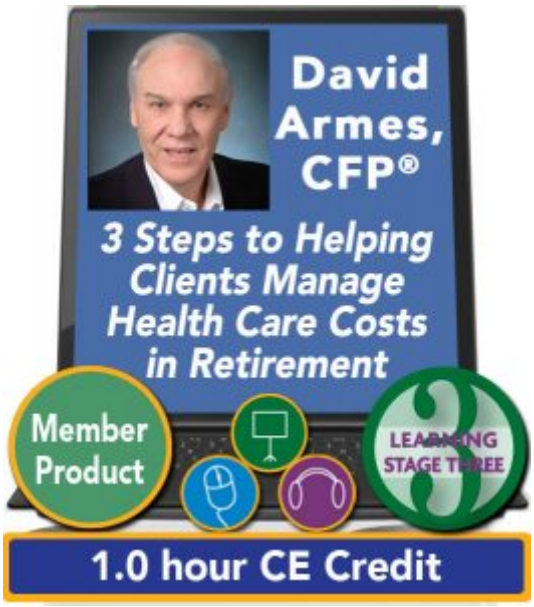

Three Steps to Helping Clients Manage Health Care Costs in Retirement – David Armes

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Wade Pfau, Ph.D., CFA, Author of Insights & Research for Lifetime Financial Planning for the Retirement Researcher

Editor's note: This article is an adaptation of the live webinar delivered by Wade Pfau, Ph.D., CFA in 2017. His comments have been edited for clarity and length.

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You may also choose to take the full length course Fitting Home Equity into a Retirement Income Strategy – Wade Pfau for 1.0 hour continuing education (CE) credit.

By Wade Pfau, Ph.D., CFA, author of Insights & Research for Lifetime Financial Planning for the Retirement Researcher

A lot of advisors did their due diligence about reverse mortgages in the past. But the research and the public policy changes over the past few years indicate that reverse mortgages can be a valuable tool in a retirement income plan in a way that many advisors may not realize because they view reverse mortgages as being high-cost and last-resort options.

Retirement Optimization Plan

The starting point to think about retirement income is not just the financial portfolio; it's everything that the household has available to fund their liabilities in retirement.

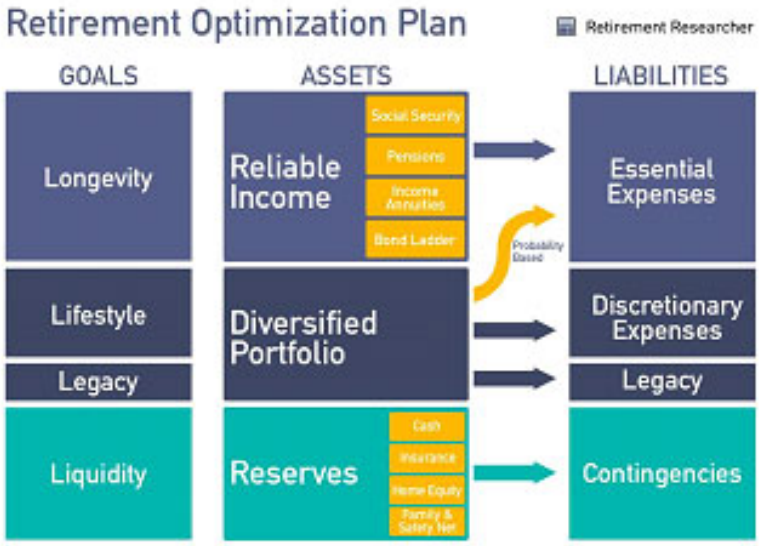
Retirement financial goals can be described in terms of four Ls:

1. "Lifestyle goals" is making sure you meet your overall lifestyle as much as possible for as long as you live.
2. "Longevity" refers to essential expenses, making sure they are covered, and not necessarily reliant on stock market success for as long as one lives.
3. "Liquidity" is having resources available that are not earmarked for any of the other financial goals that provide true liquidity in the sense that they can be spent without offsetting the ability to meet another one of these financial goals, and
4. "Legacy" is just the desire to create a legacy.

Longevity is fixed expenses; lifestyle is discretionary expenses; liquidity covers contingencies, and legacy covers legacy.

How do you deploy assets to best meet goals in an efficient and effective manner?

This diagram shows how people traditionally think of things, with home equity falling in the "Reserves" category. It doesn't necessarily have to be a reserve.



Uses for Reverse Mortgages

How can a reverse mortgage be used? There are four different categories of uses with 14 different ideas – the spectrum of potential reverse mortgage uses – ranging from uses that tend to use the home equity more quickly, to items that will tend to use the home equity more slowly, or possibly never at all.

Portfolio and debt coordination for housing

1. A reverse mortgage can be used to pay off an existing mortgage to get that expense out of the budget. It can make that retiree less vulnerable to sequence risk by taking that fixed mortgage expense out of the budget, which helps to reduce the withdrawal rate. That's a way to manage sequence risk.
2. Transitioning from a traditional mortgage to a reverse mortgage is subtly different from just paying off an existing mortgage. Basically, you could voluntarily make your mortgage payments to pay down the loan balance on the reverse mortgage, but you would then have the flexibility that if there is a market downturn or if something else comes up, you could skip payments. You don't have to pay that loan balance down in advance, and you have more flexibility than with a traditional mortgage where you don't have the option to not make a monthly payment.
3. Home equity could be used to fund home renovations to better allow for aging in place, such as a bathroom or a bedroom on the first floor, a walk-in shower, a handicap-accessible entrance, etc., that allows that person to stay in that home for longer, because most retirees do tend to want to stay in their homes.
4. A "HECM for Purchase" is where a reverse mortgage can be used to purchase a new home.

Portfolio coordination for retirement spending

5. Spend home equity first. You're essentially trying to let the portfolio grow for longer before you start to spend from it. If the portfolio doesn't grow, you've created greater risk for yourself.
6. Less risky strategies have some sort of mechanism to coordinate spending from the reverse mortgage on occasion – perhaps when the portfolio is in bad shape however that may be defined – to help reduce sequence-of-returns risk by reducing the need to take distributions when the portfolio is down, or when assets would need to be sold at a loss.
7. Reduce the need for portfolio withdrawals and turn on the tenure payment, which is a monthly income. It behaves a lot like an income annuity with one very important caveat that needs a big asterisk, which is that it may not be a guaranteed income for life; it's a guaranteed income for as long as the individual is eligible for

the reverse mortgage. Eligibility basically means living in the home and making sure they pay their property taxes and keeping the home in reasonable shape with homeowner's insurance and so forth.

Funding source for retirement efficiency improvements

8. For a retiree to pay a little bit more in the short term to have better outcomes in the long term, they need a resource to be able to pay those short-term higher expenses to benefit over the long term, and that's where the reverse mortgage can fit. Rather than purchasing an income annuity, use a tenure payment from a reverse mortgage.
9. Delaying Social Security is a great way to extend retirement sustainability. The reverse mortgage can be used as a source to fund the ability to delay Social Security.
10. Roth conversions and tax bracket management is about making sure you fill up the lower tax bracket so that you can avoid ever falling into a higher tax bracket in retirement. That might involve paying a little bit higher taxes in the short term to have significantly less taxes in the long term.
11. A reverse mortgage could be used to help fund traditional long-term care insurance premiums to not lose the policy – not necessarily to buy a new policy. They tend to get lapsed a couple of years before they could have been used, and part of that reason may be cognitive decline, but another reason for that may just be traditional policies have seen large increases in their premiums, and maybe the retiree really doesn't feel like they can afford it at that point.

Using the reverse mortgage as an insurance policy

12. Opening a reverse mortgage early on to let the line of credit grow, and only then spend from it if the portfolio is depleted to cover retirement spending.
13. A reverse mortgage could be used to protect the value of the home. Once it's opened, the initial appraised home value is relevant for how much the initial line of credit can be, but after it's set up, the line of credit grows at a variable rate that's completely unrelated to the value of the home. Reverse mortgages are non-recourse loans, so if at the end, the loan balance due is greater than the appraised value of the home, the borrower or their estate is not on the hook for paying that difference. That's what the mortgage insurance fund is there for. It can create a potential windfall, and in that regard, it's a put option on the home.
14. Having the line of credit open for spending shocks, to afford things like in-home care. It's not to pay for a nursing home, because you have to live in the home to be eligible for the reverse mortgage, but to pay for in-home care to avoid having to go to a nursing home, or to pay for other health expenses. There are also some interesting ways to use a reverse mortgage as part of a divorce settlement.

How Does a HECM Work?

(Editor's note: It's important to understand how reverse mortgages work. Please see Wade's book, available at Amazon.com for more detailed explanations than what is covered below.)

The image of reverse mortgages has been changing. They still often have a negative image, but there's been a lot more positive press coverage over the last couple of years. In the old days, reverse mortgage stories were usually focused on someone feeling like they were ripped off by the reverse mortgage. More recently, the story is much more that this can be a helpful part of a responsible retirement income plan.

There has been an effort in public policy to eliminate some of the problems that did exist in the past. The HECM program, Home Equity Conversion Mortgages, is run through HUD (The Department of Housing and Urban Development) and the FHA (Federal Housing Authority). They developed the rules around the program. They have worked over the last couple of years to slow down the rate of borrowing from the reverse mortgage so it's harder to deplete the home equity for questionable reasons.

They also have created protections for non-borrowing spouses who are too young to be a borrower. In the past, if the borrower left the home, that left the spouse in a bad situation. There's now protections for that.

With a HECM, the home title is never turned over to the bank. That's a common misunderstanding – the idea that you lose the title to your home with a reverse mortgage. That was never the case.

One other point: There is an ongoing concern that the initial costs of setting up the reverse mortgage could be in excess of $10,000, but the ability to securitize the loans has made it possible for lenders to lower the up-front cost dramatically in the past couple of years. It is now possible to get a reverse mortgage set up for much less than someone may have seen in the past, but it does require shopping around. There's not a central clearinghouse to see reverse mortgage quotes, so you do have to talk to different lenders, but it is possible in this day and age to get a much lower up-front cost on a reverse mortgage.

The borrower needs to be 62 or older. They need to have full equity in the home; there can't be any other lien on the property. They can use the reverse mortgage to pay off the balance on an existing mortgage if there's enough funds within the reverse mortgage to do that.

They need to demonstrate that they have financial resources to cover property taxes, homeowner's insurance, and home maintenance. They need to go through a counseling session with a counselor approved by the FHA. They need an approved FHA home appraisal. It does have to be the primary residence, so a reverse mortgage can't be used for a second vacation home.

The lending limit is based on FHA rules at$636,150, which is to say it's not that you can't have a reverse mortgage if the home is appraised as worth more than that, it's just that if your home is worth more than this $636,150, the reverse mortgage is based on the smaller of the home's value or this number.

Now, there's a lot of jargon for reverse mortgages, but the keys are:

- the *principal limit*, which is the borrowing amount that you're eligible for
- the *principal limit factor* is the amount you can borrow as a percentage of the home value
- the *expected rate* is the interest rate used to determine how much you're initially allowed to borrow
- the *effective rate* is the variable interest rate that will grow the principal limit in subsequent years.

So, the *expected* rate determines the *initial* principal limit. The *effective* rate determines the *subsequent growth* of that initial principal limit.

The Benefit of Opening a Reverse Mortgage Early in Retirement

The reverse mortgage is basically the only retirement income strategy that benefits from lower interest rates, so with HECMs, interest rates are much more important than age. With everything else, lower interest rates make retirement more costly, but because it's essentially a present-value calculation, lower interest rates for HECMs mean a higher present value, or a higher percentage of the home's value, can be borrowed.

On my website, I have a calculator that can be used to play around with different home values, interest rates, and so forth to get an idea of how much can be borrowed from a reverse mortgage, and also tenure payments and term payments if those options are chosen.

The key is: What if you open it but you don't borrow? The amount of credit you subsequently will have grows over time that the loan balance would have grown. This equation always holds, and this is the secret sauce for why all this recent research is showing the value of a reverse mortgage line of credit as part of a retirement income plan.

It's always going to be the case that opening the line of credit early will allow you to have more credit available than waiting until later to open the line of credit. After opening the line at age 62, at about age 87, the line of credit can

actually bigger be than the value of the home. That's where this idea of a non-recourse loan comes into play. The amount due is never going to be larger than the value of the home, but if somebody waited – this is a more extreme case – until after age 87, they're getting a windfall if they then take from the line of credit in excess of the value of the home.

Again, low interest rates favor HECMs. The lower expected rate leads to a larger initial principal limit, and even though the subsequent principal limit growth would be lower because interest rates are low, if interest rates do eventually increase, that will accelerate the subsequent growth of the principal limit.

Portfolio Coordination for Retirement Spending

This is where most of the research has been focused since 2012.

In 2012, the *Journal of Financial Planning* published two articles written by two different sets of researchers who did not know each other. Basically, both had the same idea at the same time, and that idea was the thesis that strategic use of a reverse mortgage standby line of credit can create retirement income efficiencies through its contribution to managing sequence-of-returns risk in retirement. They used different strategies to draw from the line of credit, but they both basically had some sort of mechanism in place where if the portfolios seem not to be in good shape, then draw from the reverse mortgage and draw from the portfolio when it's in better shape.

Barry Sacks and his brother came first, and then later in the year, this team from Texas Tech University – John Salter, Shawan Pfeiffer, and Harold Evensky – making the very similar point, but with a more sophisticated mechanism for deciding when to draw from the reverse mortgage.

Last year I published an article in the *Journal of Financial Planning* that put a lot of this past research together, comparing everything with one set of market return assumptions and so forth. We're now going to look at seven different strategies for using a reverse mortgage:

1. The first ignores home equity. You're obviously going to run out of money sooner if you ignore home equity, but that just gives us a baseline.
2. The conventional wisdom is home equity as a last resort: Don't touch reverse mortgage until your portfolio's depleted. Then, open the reverse mortgage. The point here is when you do it, you're going to have a lower line of credit than otherwise, but this is the only one of these remaining strategies when you don't open the line of credit as soon as possible. You wait until you first need to use it.
3. The final five strategies all open the reverse mortgage at the start of retirement, and then you can:
    1. Spend home equity first
    2. You could use the Sacks and Sacks coordination strategy, which is simply that when the markets are down for a year, in the subsequent year, you draw from the line of credit. If markets were up this year, then next year, you draw from the portfolio.
    3. Another possibility is the Texas Tech coordination strategy, which is where you create a glide path of how much wealth you should have each year of retirement to make sure your wealth lasts long enough, and then if your actual wealth exceeds that glide path, you draw from the portfolio. You can even pay down your loan balance if you've drawn anything from the reverse mortgage before. When your remaining wealth falls below that critical threshold, then you draw from the reverse mortgage instead of the portfolio.
    4. Use home equity last. So, a common question is, "How is 'use home equity last' different from 'home equity as last resort'?" The answer is they're spent down in the same way. The reverse mortgage is spent at the same time and in the same way, but the difference is "use home equity last" opens the line of credit at the beginning of retirement. "Home equity as last resort" waits until the portfolio is depleted before opening the line of credit.

5. The final option is to set up a tenure payment on the reverse mortgage.

Comparing the seven strategies over 40 years for a 4 percent desired withdrawal rate post-tax, for a $1 million portfolio and $500,000 home:

1. Distributions from the IRA are taxable, so if the full amount is taken from the IRA, it would be a 5.33 percent withdrawal rate to pay taxes at a 25% rate and then have 4 percent left over. So, that's definitely higher than a safe withdrawal rate and you're just spending from the investment portfolio. It's the only one of these strategies that's not comparable because you still have a $500,000 asset that you haven't touched.
2. The next six strategies are all comparable because they use both assets, just in different ways.
    1. The conventional wisdom is the worst way to coordinate spending with a reverse mortgage. Using home equity as a last resort, waiting to open a line of credit, leads to the worst improvements and worst probability of success. Opening that line of credit early really pays off to improve probabilities of success in retirement.
    2. The other five strategies are all just different ways of opening the line of credit at age 62, but different ways of spending from it. "Use home equity first", the tenure payment, and the coordinated strategies behave in a very similar way. "Use home equity last" gives you the most potential to have the line of credit grow before you first tap into it, which ultimately helps to pay off with the highest probabilities of success because then, when the portfolio is depleted, you have more line of credit to continue to draw from.

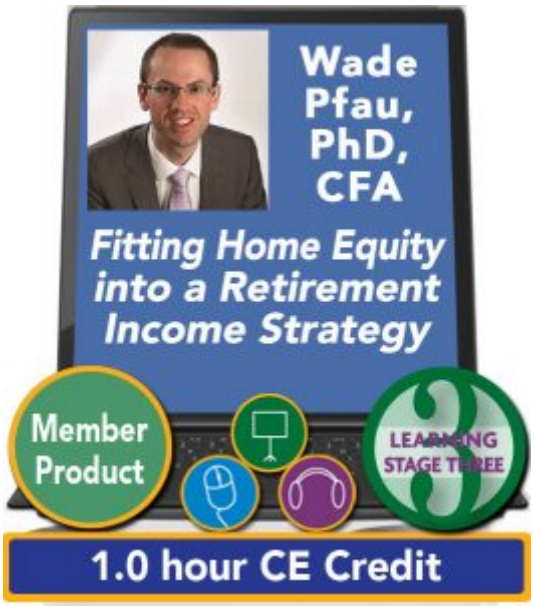
Takeaways for Advisors

- The conventional wisdom – the idea of opening a reverse mortgage only after everything else has failed – hurts retirement sustainability. HECM should not be a last resort.
- The media coverage is more positive. You will have more clients asking you about reverse mortgages.
- The strategic use of the HECM program can improve retirement sustainability and support a larger combined legacy. It works because it helps to manage sequence-of-returns risk, and because of that growing line of credit.
- Low interest rates favor the reverse mortgage, unlike pretty much every other retirement strategy.
- HECM is something that's really going to be helpful to the middle-class/middle-income market.
- It can be beneficial to wealthier individuals, too, but it's comes down to the ratio of the value of the home to the value of the portfolio. If someone has a $6 million IRA and a $600,000 home, they can still benefit, but the benefits are increasingly greater if they have a $500,000 portfolio with a $500,000 home. The ratio of those two numbers is what matters, and the bigger of the value of the home relative to the portfolio, the greater the benefit of the reverse mortgage.

The HECM definitely has the potential to help the middle class, and responsible use of it can improve retirement income efficiency.

About Wade Pfau:

Wade D. Pfau, Ph.D., CFA, is a Professor of Retirement Income in the Ph.D. program for Financial and Retirement Planning at The American College. He also serves as a Principal and Director for McLean Asset Management, helping to build retirement income solutions for clients, and Chief Planning Strategist of software provider inStream Solutions. He holds a doctorate in economics from Princeton University and publishes frequently in a wide variety of academic and practitioner research journals on topics related to retirement income.



Fitting Home Equity into a Retirement Income Strategy – Wade Pfau

Wade hosts the **Retirement Researcher** website (we recommend subscribing to his email list*), and is a monthly columnist for Advisor Perspectives, a RetireMentor for MarketWatch, a contributor to Forbes, and an Expert Panelist for the Wall Street Journal. His research has been discussed in outlets including the print editions of The Economist, New York Times, Wall Street Journal, Time, Kiplinger's, and Money Magazine. He recently authored his first book, **Reverse Mortgages: How to Use Reverse Mortgages to Secure Your Retirement**. It is available through Amazon.*

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Change in Household Spending After Retirement: Results from a Longitudinal Sample

retirement-insight.com/change-household-spending-retirement-results-longitudinal-sample/

By Sudipto Banerjee, Ph.D. Employee Benefit Research Institute (EBRI)

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Introduction

Spending is one of the crucial economic factors in retirement, so it is very important to understand the spending patterns of retired households and the causes that drive their spending behavior. Understanding spending patterns not only will help current retirees succeed, but it will also help policymakers, employers, financial firms, and advisors assist current workers to have a successful retirement.

This report attempts to quantify how household spending changes in the immediate years following retirement. Banerjee (2012, 2014) has shown that spending declines for retired households as they age. Those age trends in spending have been derived from cross-sectional samples, but this study has used panel data to track the changes in retirement spending for a fixed group of households.

The standard economic model of life-cycle consumption predicts consumption smoothing over a person's lifetime; in other words, it predicts consumption is continuous through retirement and does not drop. However, the evidence on this is mixed. Banks, Blundell, and Tanner (1998) have shown that British households reduce consumption precisely at the ages associated with retirement. Bernheim, Skinner, and Weinberg (2001) have shown that U.S. households also reduce certain components of consumption sharply following retirement. This apparent contradiction between the life- cycle model and measured behavior is referred to as "the retirement consumption puzzle."

On the other hand, Aguila, Attanasio, and Meghir (2011) find that non-durable consumption remains unchanged at retirement, so they conclude that there is no evidence of a retirement consumption puzzle. Hurd and Rohwedder (2008) report small declines in household consumption over retirement and argue that these changes are compatible with the life-cycle model. This report does not make any attempt to test the validity of the life-cycle model; rather, using more recent and higher-quality data, it documents the spending changes that U.S. households actually make in the years following retirement. Results clearly show that overall average and median household spending does decline in retirement, although some households experience increased spending as well.

Data

Two sources of data are used for this study. First is the Health and Retirement Study (HRS), which is a study of a nationally representative sample of U.S. households with individuals over age 50. It is the most comprehensive survey of older Americans in the nation and covers topics such as health, assets, income, and labor-force status in detail. It is a biennial longitudinal survey with questionnaire waves in even-numbered years beginning in 1992. The initial sample consisted of individuals born between 1931 and 1941 and their spouses, regardless of their birth year. Newer cohorts have been added in the following years. The study is sponsored by the National Institute on Aging (NIA) and the Social Security Administration (SSA) and administered by the Institute for Social Research (ISR) at the University of Michigan. The labor-force status of the respondents is used from HRS for this report.

The other source of data is the Consumption and Activities Mail Survey (CAMS), which was started in 2001 as a supplement to the HRS. From the participants in the 2000 HRS, 5,000 households were selected at random and mailed the CAMS questionnaire. In couple households, the questionnaire was sent randomly to one of the two spouses. Since 2001, CAMS has been conducted every two years, with 2013 the latest round of available data. CAMS contains detailed household spending information. This study uses the RAND version of the CAMS, which combines the data across all survey years into a user-friendly format and is easier to use for longitudinal analysis.

Hurd and Rohwedder (2008) also use data from the first three rounds (2001, 2003 and 2005) of CAMS for their study. However, CAMS 2001 and 2003 has fewer spending categories than the later survey years, and as a result, total spending is not comparable across waves. For this reason, Hurd et. al. (2015) suggest in the RAND CAMS Data Documentation that "For research purposes that are sensitive to changes in spending at the household level, researchers should consider limiting their analyses to CAMS Waves 2005 onward." For this reason, this report uses CAMS data from 2005 through 2013.

Spending Categories

The main spending categories are defined as follows:

- **Durable:** Sum of all spending on durable goods, such as refrigerator, washer/dryer, dishwasher, television, computer.
- **Non-Durable:** Sum of all spending on non-durable goods, such as gifts, clothing, charity, dining out, medication/medical supplies, utilities, food and beverage, health insurance, telecommunications, tickets, trips and vacations, personal care, hobbies, sports, housekeeping services and supplies, yard services and supplies.
- **Transportation:** Sum of all spending on up to three automobile purchases, vehicle insurance, vehicle maintenance, car payments or vehicle financing, and gasoline.
- **Housing:** Sum of all spending on housing, including mortgage interest, rent, home/renters insurance, property taxes, home repair and maintenance (supplies and services).
- **Total Spending:** Sum of durable, non-durable, transportation and housing spending.

It is important to note that housing and total spending data do not include mortgage principal payments. Mortgage principal payments can be considered as savings or investments. Building home equity can be considered as a savings goal by many, and people can choose to invest in their homes instead of other investments by paying more than the required principal payments, so mortgage principal payments are excluded from the spending variables. All the spending amounts are expressed in 2013 dollars.

Definition of Retirement and Sample Selection

One of the problematic aspects of the report is the categorization of "retired households." There is no set definition for a retired household and retirement can be fluid. People can go back to work for pay, even after they have "retired." The issue is compounded for couple households with both spouses working.

With those concerns in mind, this report defines retirement in the following way:

- For singles, their self-reported retirement status and date of retirement is used, provided they have worked for pay prior to their stated date of retirement; if they report going back to work for pay at any point after they "retire," they are dropped from the sample at that
- For couple households, if only one spouse reports working then the definition is the same as single households. However, if both spouses report working, then the higher earner is called the primary worker and the self- reported retirement status of the primary worker is used, provided he/she has worked for pay prior to retirement. If the primary worker reports going back to work at any time after he or she "retires," then the household is dropped from the sample at that

The study uses CAMS data for the years 2005, 2007, 2009, 2011, and 2013. Households have to be observed at least once before retirement, so only households that retired in 2006 or after are included in the sample. Their preretirement spending corresponds to the last household spending observed before the household was deemed retired. Post- retirement households are observed after one to two years, three to four years, and five to six years.

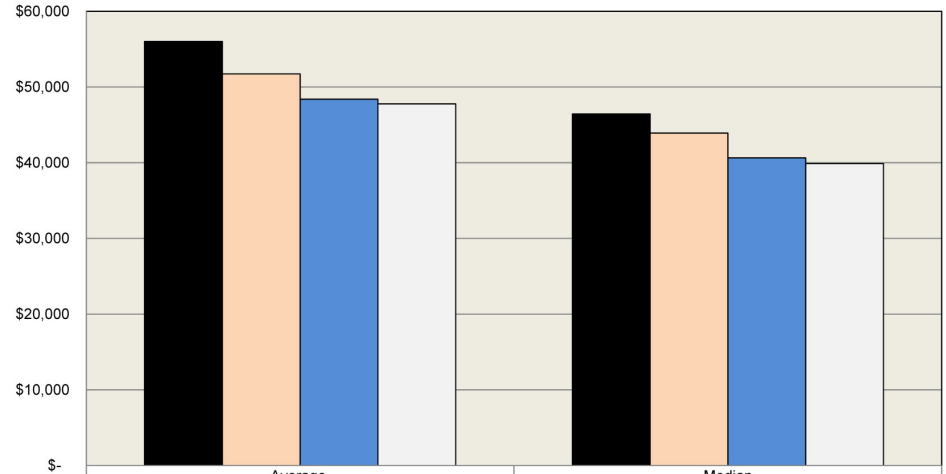
Also, if the marital status of any household changes after retirement then the household is dropped from the sample at that point, because changing marital status can affect the spending levels of the household. This method allows the same group of households to be analyzed over time (longitudinally), which is a major advantage data.

Change in Spending

Total Household Spending

Figure 1A shows the change in total household spending in the years following retirement. Both average and median (midpoint) spending levels are reported. The preretirement average and median household spending are $56,006 and $46,452, respectively. After one to two years of retirement, the average drops to $51,721 and the median drops to $43,901. So, in the first two years of retirement, average household spending drops by 7.7 percent and median household spending drops by 5.5 percent. The decline in average household spending continues in the following years. By the sixth year of retirement, average household spending ($47,766) drops by 14.7 percent and median household spending ($39,888) drops by 14.1 percent.

Figure 1A
Total Household Spending (in 2013 $s) in the Years Surrounding Retirement (Mortgage Principal Payments *not* Included)



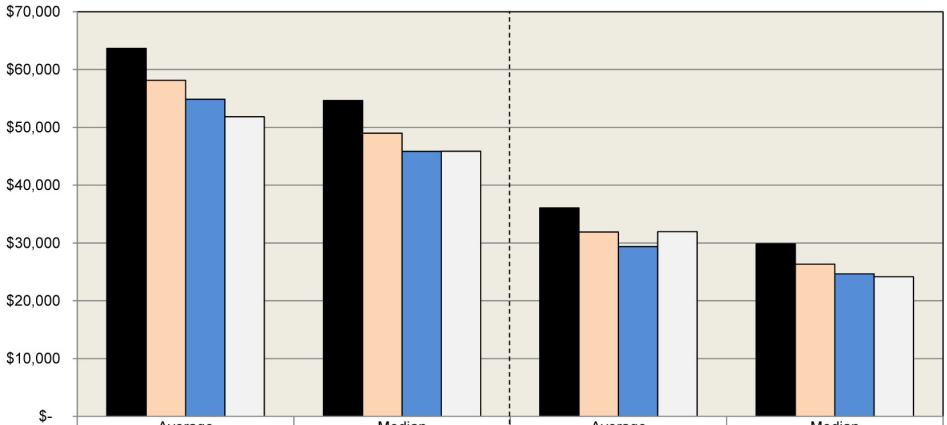
	Average	Median
Preretirement	$56,006	$46,452
After 1–2 years	$51,721	$43,901
After 3–4 years	$48,384	$40,651
After 5–6 years	$47,766	$39,888

Source: Employee Benefit Research Institute estimates from the Health and Retirement Study (HRS) and the Consumption Activities and Mail Survey (CAMS), 2005–2013

But these reductions slow down after the fourth year of retirement. For example, by the fourth year of retirement, average spending drops by 13.6 percent of preretirement spending, which means the additional drop in the fifth to sixth year is only 1.1 percentage points. Similarly, for median spending, the spending falls quickly at first and then slows down.

Figure 1B shows Figure 1A by marital status. The general trend of a steady decline over the first six years of retirement is present for both couples and singles. For couples, the median household spending drops by 10.3 percent (from $54,626 to $48,982) in the first two years and by 16.0 percent (from $54,626 to $45,872) by the sixth year of retirement. For singles, the respective drops are 11.8 percent (from $29,842 to $26,328) and 19.0 percent (from$2 9,842 to $24,153). So singles show slightly higher spending drops than couples in percentage terms.

Figure 1B
Total Household Spending (in 2013 $s) in the Years Surrounding Retirement, by Marital Status (Mortgage Principal Payments *not* Included)

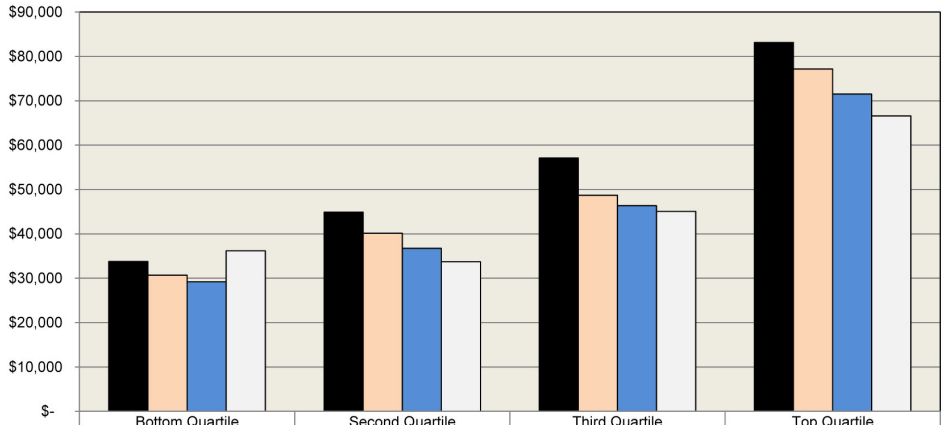


	Couple		Single	
	Average	Median	Average	Median
Preretirement	$63,674	$54,626	$36,085	$29,842
After 1–2 years	$58,133	$48,982	$31,886	$26,328
After 3–4 years	$54,870	$45,841	$29,367	$24,643
After 5–6 years	$51,846	$45,872	$31,944	$24,153

Source: Employee Benefit Research Institute estimates from Health and Retirement Study (HRS) and the Consumption Activities and Mail Survey (CAMS), 2005–2013.

Figure 1C shows Figure 1A by household preretirement-income quartiles. The steady drop in retirement spending can be seen in almost all income groups, although the bottom-income quartile shows an increase in spending after five to six years of retirement. For the top-income quartile, household spending drops by 7.2 percent in the first two years after retirement (from $83,147 to $77,152) and 19.9 percent by the sixth year of retirement.

Figure 1C
Total Household Spending (in 2013 $s) in the Years Surrounding Retirement, by Preretirement Income Quartile (Mortgage Principal Payments *not* Included)



	Bottom Quartile	Second Quartile	Third Quartile	Top Quartile
Preretirement	$33,783	$44,895	$57,123	$83,147
After 1–2 years	$30,711	$40,165	$48,699	$77,152
After 3–4 years	$29,190	$36,749	$46,382	$71,518
After 5–6 years	$36,183	$33,731	$45,087	$66,603

Source: Employee Benefit Research Institute estimates from Health and Retirement Study (HRS) and the Consumption Activities and Mail Survey (CAMS), 2005–2013.

Durables

Durable spending consists of only five durable goods—and, appropriately, the median expenditure is zero both before and after retirement. The average goes down in retirement, but by either measure, durables constitute a very small portion of total spending. As might be expected, durable spending is higher for higher-income groups. Durable

spending broadly goes down for all income groups as households enter retirement, although there are slight increases in the fifth or sixth years of retirement for the bottom half of the income distribution.

Non-Durables

Non-durables constitute the bulk of the spending and the declines in this category are in line with the decline in total spending—although slightly higher in percentage terms. For example, in the first two years of retirement, median non-durable spending goes down by 6.3 percent (from $23,881 to $22,378). By the sixth year of retirement, median non-durable spending is down 17.4 percent (from $23,881 to $19,737), and average non-durable spending is down 16.5 percent (from $29,817 to $24,885).

Transportation

Transportation spending shows the highest spending reduction in the first two years of retirement. This is expected, since commuting to and from work constitutes the bulk of transportation expenses for most people. Average transportation spending drops from $13,671 to $10,745 (a 21.4 percent drop) in the first two years of retirement, while median transportation spending drops from $7,193 to $5,387 (a 25.1 percent decline) during the same period. The subsequent drops in transportation spending are small.

Housing

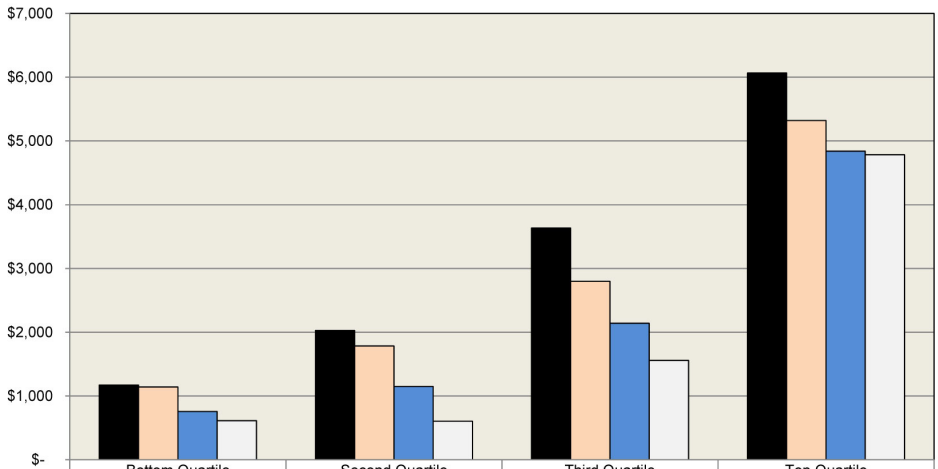
The final set of spending is on housing, which, as noted earlier, excludes mortgage principal payments. Median spending on housing during the first two years of retirement drops from $9,070 to $7,800 (a 14.0 percent drop) and to $6,167 by the sixth year (a 32.0 percent drop).

Mortgage Principal Payments

Although this report does not consider mortgage principal payments as spending (hence those payments are not included in housing or total spending) for the reasons mentioned above, some people may still view the payments as an expense, since they have to write a check every month to their mortgage lender. Consequently, it would help to know how much households with a mortgage are paying down in mortgage principal (and therefore gaining in equity) in retirement.

The median payment on mortgage principal is $2,198 preretirement, but drops to zero after retirement. Figure 6B shows the change in average principal payments by income quartiles. Payments go down for all income groups as households move into retirement. Not surprisingly, payments are higher for higher-income groups.

Figure 6B
Mortgage Principal Payments (in 2013 $s) in the Years Surrounding Retirement, by Preretirement Income Quartile



	Bottom Quartile	Second Quartile	Third Quartile	Top Quartile
Preretirement	$1,171	$2,027	$3,634	$6,064
After 1–2 years	$1,140	$1,784	$2,800	$5,319
After 3–4 years	$758	$1,150	$2,141	$4,839
After 5–6 years	$613	$604	$1,560	$4,783

Source: Employee Benefit Research Institute estimates from the Health and Retirement Study (HRS) and the Consumption Activities and Mail Survey (CAMS), 2005–2013.

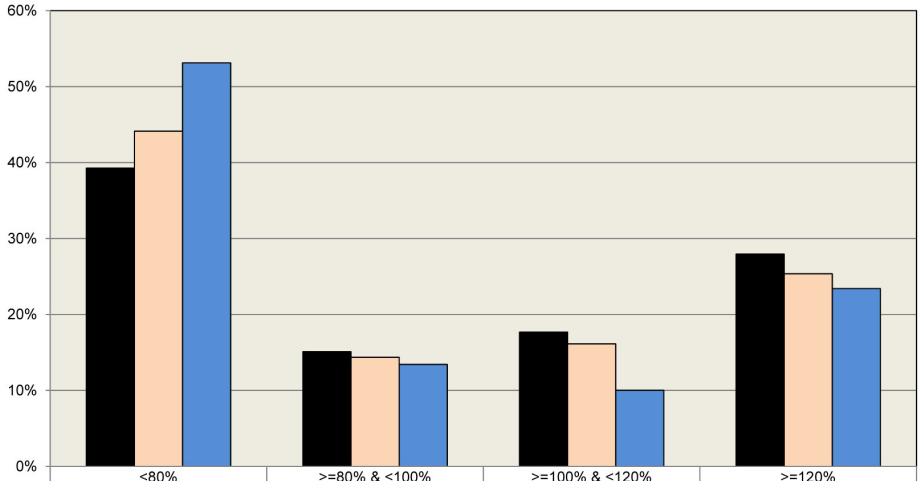
Spending Does Not Decrease for Everyone

Although *average* spending goes down in retirement, that does not mean *every* household experiences a drop in spending as they enter retirement. For some, expenses may not change at all, and for some they may even increase. During the first two years of retirement, 45.9 percent of households actually spent more than their preretirement levels. This number goes down as they move deeper into retirement: After three to four years in retirement, more than 2 in 5 households (41.5 percent) spent more than their preretirement levels. After five to six years in retirement, 1 in 3 households (33.4 percent) still spent more than their preretirement levels. But it is not necessarily the case that the same households spent more than their preretirement levels in all those years.

A possible explanation for this could be that people may want to splurge as they enter retirement by traveling or spending on their hobbies. If such spending were a function of income, it might be expected that those who spent more than their preretirement levels are concentrated at the top of the income distribution. That is not the case. The first-, second-, third-, and fourth-income quartiles spend percent, 49.5 percent, 45.8 percent, and 45.4 percent more than their preretirement income, respectively. This indicates that households that experience higher spending immediately following retirement are spread across the entire income distribution.

Among those who spend less, it is also not clear how much less they spend in retirement. Figure 9 makes an attempt to address this. Post-retirement spending is expressed as a percentage of preretirement spending and divided into four bands : less than 80 percent of preretirement spending (Band I); more than or equal to 80 percent of preretirement spending but less than 100 percent of preretirement spending (Band II); more than or equal to 100 percent of preretirement spending but less than 120 percent of preretirement spending (Band III); and more than or equal to 120 percent of preretirement spending (Band IV).

Figure 9
Frequency Distribution of Post Retirement Spending as a Percentage of Preretirement Spending (in 2013 $s)



	<80%	>=80% & <100%	>=100% & <120%	>=120%
After 1-2 Years	39.3%	15.1%	17.7%	28.0%
After 3-4 Years	44.1%	14.4%	16.1%	25.4%
After 5-6 Years	53.1%	13.4%	10.0%	23.4%

Source: Employee Benefit Research Institute estimates from the Health and Retirement Study (HRS) and the Consumption Activities and Mail Survey (CAMS), 2005–2013.

Figure 9 shows that within the first two years of retirement, almost 2 in 5 households (39.3 percent) spend less than 80 percent of their preretirement levels. As they move deeper into retirement, more and more households enter Band I. By the sixth year of retirement, a majority of households (53.1 percent) are in Band I. On the other side, in the first two years of retirement 28.0 percent of households spend more than 120 percent of their preretirement levels (Band IV). But the numbers of household go down as the years in retirement go up. Nevertheless, after five or six years in retirement close to 1 in 4 households (23.4 percent) are in Band IV. There are significant percentages of households in the middle two bands, but their numbers go down as their time in retirement goes up. Consequently, a lot of

households (46.9 percent) spend more than 80 percent of their preretirement levels even after five or six years in retirement, even though the trend predicts that their numbers go down with more years spent in retirement.

Conclusion

A person's financial success of retirement depends on two key components—savings accumulated during working years, and spending during retirement years. Quantifying these two components and the underlying behavior patterns is essential to understanding how people are likely to succeed in retirement. This report focuses on spending in retirement by documenting how household spending changes in the years immediately following retirement and analyzing the spending patterns of a fixed group of households up to six years after their retirement.

Major findings include:

- Household spending dropped at the beginning of retirement. Median household spending dropped 5.5 percent of preretirement spending in the first two years of retirement and 12.5 percent by the third or fourth year, after which the decline slowed down.
- Although average spending in retirement fell, a large percentage of households experienced higher spending following retirement. In the first two years of retirement, 45.9 percent of households spent more than what they had spent just before retirement. By the sixth year of retirement, this fell to 33.4 percent.
- In the first two years of retirement, 2 in 5 households (39.3 percent) spent less than 80 percent of their preretirement spending. By the sixth year of retirement a majority (53.1 percent) of households did so.
- In the first two years of retirement, 28.0 percent of households spent more than 120 percent of their preretirement levels. By the sixth year of retirement 23.4 percent of households did so.
- A very small percentage of the average household budget was spent on durable goods; the median household spent nothing on durables in retirement.
- Transportation accounted for the largest drop in spending during the first two years of retirement. Median spending on transportation went down by 25.1 percent in the first two years of retirement, although spending cuts in subsequent years were small.
- The median household had a mortgage payment before retirement but none after retirement.

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