Welcome to InFRE’s October, 2016 Issue of Retirement Insight and Trends

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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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October, 2016 InFRE Update: An Explanation of the Changes Made to the July, 2016 CRC® Exam

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10/11/2016

An Explanation of the Changes Made to the July, 2016 CRC® Exam

Accredited certifications such as the CRC® are required to update every three to five years the practice analysis used that provides guidelines for the structure, content and rigor of their professional exams.

The International Foundation for Retirement Education (InFRE) contracted with Professional Examination Service (ProExam) to conduct a practice analysis of Certified Retirement Counselors® (CRCs). The CRC certification examination is designed to ensure that CRCs possess all the knowledge and skills necessary to competently fulfill their responsibilities as retirement counseling professionals serving the public. The purposes of the practice analysis study were to:

- update the CRC content outline to reflect current professional practice
- ensure the validity and defensibility of the CRC examination
- derive empirical guidance to inform decision making regarding updated test specifications for the CRC examination
- provide empirical support for the accreditation of InFRE's credentialing program including the CRC examination
- provide guidance to InFRE for the development of future training and continuing education

ProExam worked with an eight-member Steering Committee (SC) comprised of retirement counselors who had been active in InFRE volunteers activities, and who represented the range of types of employers, areas of expertise, roles, experience levels, and geographic location. The SC served in a consulting and advisory capacity over the course of the study, providing conceptual guidance to ProExam and the Task Force, reviewing and making recommendations regarding proposed and completed activities. The SC met two times via web-based meetings during the course of the study.

ProExam also conducted a series of interviews with five thought leaders in the field of retirement counseling in advance of the first task force meeting. These interviews were focused on changes in the profession since the last practice analysis was conducted, how those changes might affect the tasks and knowledge included in the test content outline, and any trends or changes that might impact future directions in practice. Members of the telephone interview panel represented different perspectives, roles, employment sectors, and geographic locations.

The Practice Analysis Task Force (PATF) was comprised of nine subject-matter experts. They represented the range of types of employers, areas of expertise, roles, experience levels, and geographic location. The PATF met numerous times over the course of the study via web-based meetings to update the CRC test content outline to ensure it was current, comprehensive, and reflective of retirement counselors working across the range of professional settings and roles.

A Description of the Changes Made to the CRC Exam

As a result of the work of the Steering Committee, the Thought Leaders, and Practice Analysis Task Force, and the results of a validation survey answered by 28% of current CRCs, the following trends and changes in retirement counseling were considered for incorporation into the new, July 2016 exam form:

- The movement away from defined benefits – redesigning – at state level, to share more risk between employee and employer
- The increasing role of defined contribution plans and coordination with defined benefits to maximize retirement security
- More guaranteed retirement income vehicles (modern version of annuitizing)
- More focus on helping people create lifetime income
- New products for retirement counselors to use on an individual basis
  - Advanced life deferred annuities
  - Combination long term care and life insurance
  - Combination long term care and annuities
  - Purchase units in a 401k plan for future lifetime income upon retirement
  - Reverse mortgages
- Mobility of benefits from one employer to another
- Health care issues in retirement planning (Obamacare) – Medicare and prescription drugs
- Process of retirement income management – hot item in industry and academia
  - withdrawal rates – how much expertise practitioner should provide
  - what vehicle to use – many options – what formula
  - asset allocation and product allocation
  - risk tolerance and rate of return
  - annuities – different variations
  - contract annuities
  - distribution of benefits, understanding fees attached
  - longevity insurance [i.e., single premium deferred annuity]within qualified plans)
- Senior fraud abuse.
- Need to recognize the impact of lower interest rates, lower returns on stocks, more challenges to find vehicles of growth
- Customers don’t want to take risks – playing it safe in low-risk assets like money-market funds – don’t even keep up with cost of living
- More recommendation for investments with guaranteed returns such as annuities
  - Need to counsel clients about projected deficit unless some risk is taken
- Options for annuities and other products –not a lot of uniformity of agreement in strategies, methodologies, processes – and how to communicate to clients so they can make informed decisions
- Monitoring and recognition of fees – as more fiduciary responsibility is placed on employers, and recognition of impact of fees over the lifetime of the investment and the worker, much more focus will be put on fees paid
- The industry needs to work more cost-effectively
  - What is the most efficient way to gather information to build a financial plan?
  - How can you process a lot of customers efficiently?

- Fiduciary issues and standards for advisors v. non-fiduciary standards; who is going to be subject to which standards; fiduciary liability; political issues around topic
- Transparency regulation
- Integration of all the defined contribution plans, and advising clients to include all retirement accounts, both employer and individual
  - How to serialize the distribution of those various accounts
  - How work factors into income flow process
  - Sequestration of distribution of accounts
  - Mechanics – including distribution calculations
- Social Security – more emphasis on importance of how and when to take benefits; strategies that can be used to maximize benefits
- Accumulation: TDAs changing to individual contracts; automatic increases and enrollment – used a lot in the private sector and 401(k)s, not so much in 457 world
- Tax law changes – need to keep up with legislative changes – mistakes are made because advisors aren't knowledgeable about these changes
  - how much one can contribute and retain in account
  - avoiding ―tax hits‖ (e.g., taking distribution from IRA – must return in certain time frame or lose tax-deferred status)
  - exceptions to early distribution penalties
- Legislation at the federal level encouraging people to annuitize part of their assets upon retirement
- Increase in roll-over activity due to
  - taking retirement assets from old jobs
  - shopping around for different service, lower fees, level of comfort with advisors
- Helping employees across the retirement lifespan (early-career employees all the way to port-retirement life stage)
  - Focus on automatic contributions to defined contribution plans – not just minimal contribution – need to be meaningful contributions
- Software doesn't keep up with the needs to service clients (e.g., no software to do comparative analysis of returns across different retirement income products offered by different companies) – advisors need to figure out how to do this
- Passive v. active investment and management
- Impact of retirement savings deficit will be a huge issue
- Healthcare costs continue to increase – impacts having enough to make it through retirement
- Challenges – municipal budgets and fear of bankruptcy of municipalities – part of counselor's job is education in reality of situation
- Beyond retirement counseling – some are becoming ―life coaches‖
- Counseling on what they are retiring to – helping clients plan for fulfilling retirement

The new exam form now tests to the following test specifications:

Table 23
Final Examination Specifications

	# tasks	New Test Specs	2007 Test Specs	Change
Domain 1: Identify Needs, Concerns and Goals in Terms of Quantitative and Qualitative Factors by Career Stage/Phase of Retirement	12	25%–29%	30%–34%	-5%
Domain 2: Design Retirement-readiness and Post-retirement Strategies within the Context of the Regulatory, Legal, Operational and Structural Environment	18	27%–31%	24%–28%	+3%
Domain 3: Facilitate the Implementation of the Retirement-readiness and Post-retirement Strategies	9	18%–22%	18%–20%	+1%
Domain 4: Evaluate, Adjust, and Document Retirement Strategies Across Career Stages/ Retirement Phases	6	14%–16%	12%–16%	+1%
Domain 5: Provide Education Materials and Programs	3	8%–10%	8%–10%	No change

We appreciate your support during the upgrading of this new exam form to incorporate the above important changes to reflect the current state of the retirement industry today.

Housing Wealth: A Retirement Asset for the Middle Market

retirement-insight.com/housing-wealth-retirement-asset-middle-market/

10/11/2016

By Shelley Giordano, Chair of the Funding Longevity Task Force

Shelley Giordano, Chair of the Funding Longevity Task Force

Editor's Note*:*

Below is an adaptation of the live webinar delivered by Shelley Giordano in 2016. Her comments have been edited for clarity and length.

You can read the summary article below as part of the 3rd Qtr 2016 Retirement InSight and Trends Newsletter. You may also choose to ***take the full length course here****, worth 1 CRC®, CFP® and/or PACE CE.*

Our focus is on four case studies that will illustrate how the early and proactive use of housing wealth via reverse mortgage can convey significant retirement income security, particularly for the middle market. These findings are especially relevant for women who oftentimes bear the brunt of long-term care, reduced financial resources when their spouse has died, and yet must plan for a longer retirement horizon.

We'll take a look at:

1. how housing wealth can offset market volatility and preserver retirement assets,
2. how establishing a reverse mortgage line of credit can provide funds for long-term care but with very little expense and carrying costs since there are no premiums,
3. how, in divorce, an innovative application of a variety of reverse mortgages can restore or establish equitable housing for both parties, and
4. for women in particular, how reverse mortgage financing can bridge the income gap in order to defer their Social Security.

Reverse Mortgages Today

Dr. Robert Merton, a Nobel laureate in economics at MIT, is literally traveling the globe letting folks know that the one asset most retirees have is a home – decade in and decade out, it's at about 80 percent. If you marry this asset with the fact that they can use a reverse mortgage and it's a non-recourse loan, then there's something new to be thinking about in terms of the retirement income crisis that is facing many people who don't have pensions.

We know that retirees draw down assets as they age, but there is this problem. They have a lot of home equity left at the end. Is there a way to weave that home equity earlier into their retirement plan so they are actually able protect some of their assets and not just be cash poor and house rich?

When you look at how ubiquitous home equity is, you may wonder why it is invisible in retirement planning? For the most part, designations do not test to it. There are a couple of designations that have jumped on board like the Certified Retirement Counselor® (CRC®), but certainly the CFP® designation does not. Broker-dealer compliance officers forbid discussion of housing wealth.

Financial professionals don't get paid on reverse mortgages. Possibly, it's just easier to say, "If you run out of money then we'll turn to your house. We'll use it as a last resort." I've heard a lot of advisors and retirement counselors also tell people they just need to downsize. One of the things that's puzzling about this is, if you look at the recent Merrill Lynch Age Wave Study, you find that most retirees really don't want to downsize. In fact, they're spending an enormous amount of money – something like $90 billion a year – remodeling. It's not just remodeling to meet medical needs, but building big gathering rooms so they can have their children and grandchildren together.

Software does not allow illustrations showing what a plan would look like when you incorporate reverse mortgages versus not incorporating. We hear that there are some changes being made and a few software companies are waking up to that, but as a general rule software that illustrates using reverse mortgages in retirement is not available.

Nobel Laureate Robert C. Merton, School of Management Distinguished Professor of Finance from MIT, wrote the following about reverse mortgages: "It is both a stream of income as a hedge, as an asset. It changes from the former to the latter when the people in the house no longer need it. The reverse mortgage recognizes it by saying as long as you're in the house you pay nothing, even if you live to be 120. When you're not there, your heirs get the unspent cash from the reverse mortgage and they can sell the house, pay the amount due, keep the difference, or let the bank take the house if the amount owed exceeds the value of the house. That's a wonderful contract."

Recent Changes in the Reverse Mortgage Market

If you bring up a reverse mortgage with your clients, they may be shocked. They probably have the same misunderstandings and negative opinions that possibly you do. However, the reverse mortgage market is changing for the better.

The reverse mortgage in the past has always had inherent safeguards, but it was subject to abuse in some cases. So the Reverse Mortgage Stabilization Act of 2013 went a long way to making sure that the possibility of abuse was reduced. So there were four major changes.

1. Brakes were put on the amount of equity that can be used. You can't use too much of it too soon. There are limits on the initial disbursements.
2. Before, a reverse mortgage was marketed to and seen as something for people who had reached the end of their financial ropes. But those folks would not even be eligible for a reverse mortgage today because you have to be able to demonstrate willingness and capacity to meet your tax and insurance obligations.
3. When you're working with any Federal Housing Authority (FHA) mortgage, there are mortgage insurance premiums, both upfront and ongoing. If you're in a position to use your reverse mortgage funds slowly at the outset, your mortgage insurance premium will be discounted to 0.5 percent versus 2.5 percent if you're using it more aggressively.
4. There are now protections for the non-borrowing spouse. There were horror stories when the younger spouse wasn't on title. The husband would die and she would have to leave the house. That can't happen any longer. The non-borrowing spouse cannot be displaced in the event of the borrower's death.

One other development that most people are not aware of is there is now a tremendous secondary market demand for reverse mortgages. They are securitized through Ginnie Mae. People don't refinance them when the rates go down. We'll see later, that if you have a line of credit and interest rates go up, that's when you really want to hold on to it. Because of this market demand, if you can help your clients negotiate interest rates, just like on a forward mortgage, it's possible for you to negotiate that set-up fee to less than $500. That's because the demand on the secondary market allows for lender credits which can be applied to the origination fee, the third party fees, and even the upfront mortgage insurance which goes to FHA.

Four things to keep in mind when you get into a discussion with your client about reverse mortgages:

1. The borrower never gives up title to the home and the bank doesn't get the home,
2. The borrower will never owe more than the home is worth; it's non-recourse,
3. If there's equity left over, it will belong to either the borrower or his estate, and
4. The borrower never has to make a monthly payment on the principal or the interest until the last one of them dies, moves, or sells. Caveat: the borrower must keep their property obligations current.

Key Features of Reverse Mortgages

1. More than 90 percent of reverse mortgages out there are FHA-insured Home Equity Conversion Mortgages (HECMs). This means that, just like an FHA loan on the traditional forward side, there is going to be an upfront mortgage insurance premium added to the loan balance and then an ongoing mortgage insurance.

2. Age requirement – one of the borrowers has to be 62. The loan amount available is based on the value of the home and expected interest rate – which is the 10-year swap rate – and your age. But 50 percent is a good rule of thumb for a 62-year-old for right now. If you have a client with a $400,000 house with a $200,000 mortgage, they would be able to transition to a reverse mortgage. They would have roughly $200,000 available and it could serve to pay off that existing mortgage, leaving you with a reverse mortgage where there are no monthly debt payment requirements.

3. Ways in which loan proceeds can be received – you can take a lump sum at the outset sometimes. One of the circumstance is paying off a current mortgage. You can set up a line of credit which can be drawn upon in any amount as long as there is available credit. Or you can take periodic payments for a fixed number of periods over the life of the borrower. If you take it for the life of the borrower, you've basically annuitized your house to provide what is in effect an annuity payment, although it would end if the borrower leaves the house. You can also combine these various versions.

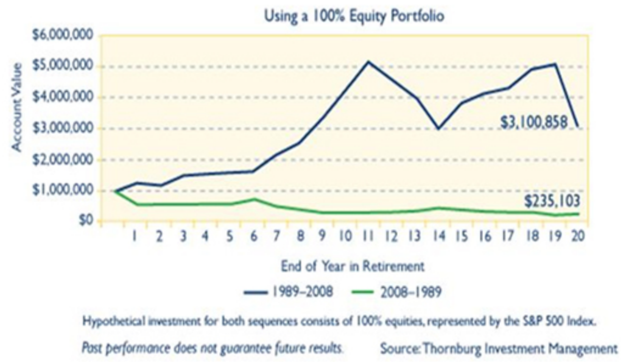
4. Interest rates generally are variable, although there is a fixed rate HECM. Again, the setup fees involve regular mortgage fees. But because it's an FHA mortgage, there is an initial mortgage insurance premium. The cost of that varies based on usage. The borrower cannot be evicted, except for failure to pay property tax or homeowner's insurance or failure to maintain the home. Dr. Merton's favorite point is HECM debt is non-recourse. Repayment is not due until the last borrower has permanently left the home.

Case Studies: Reduce Sequence of Returns Risk with a Reverse Mortgage

Now we'll move on to the case studies and think about ways to prepare for the unknown. Jamie Hopkins Esq., MBA, LLM, CLU®, RICP®, is Associate Professor of Taxation at The American College of Financial Services in the Retirement Income Program and is Co-director of the New York Life Center for Retirement Income. He wrote an article in *Forbes* that is a manifesto for thinking about housing in retirement. "The lack of focus on home on home equity and retirement income planning is nothing short of a complete failure to properly plan and utilize all available retirement assets. This needs to change immediately because strategic uses of home equity, especially reverse mortgages, can save many people from financial failure in retirement and help stem the overall retirement income crisis facing Americans."

Sequence of returns risk means that down markets matter, particularly if they happen early in retirement. Here's an example from Thornburg of the same portfolio, taking systematic withdrawals. The years of returns are just inverted here. So it's 1989-2008 in blue and the same returns inverted from 2008-1989, and continuing to take those systematic withdrawals. 2008-1989 started bear market and 1989-2008 has sustained bull market.

Figure 2. Sequence of Returns Impact on a Hypothetical $1 Million Investment Undergoing Systematic Withdrawals



You may be saying to yourself, “Well, why wouldn’t I just not set up a home equity line of credit (HELOC) instead of a reverse mortgage and get the same result?” There are a few reasons.

1. In 2004-2006 there were billions upon billions of interest only HELOCs written. It seemed like a good idea to just take out a HELOC and just make payments on the interest. The problem is the draw period does end, and then principal and interest payments begin. But because the principal has not been reduced in that first 10 years, there’s a compressed principal payback and considerable payment shock can ensure.
2. HELOCs are not as reliable as a HECM line of credit because it can be frozen, reduced, or cancelled at the bank’s whim usually just when cash flow is most stressed. I’ve heard from so many planners about this. Just when their clients needed help in 2008-2009 their HELOCs were cancelled. In fact, in June 2008 over $6 billion in HELOC credit was frozen. HELOC credit capacity is completely arbitrary. It can be reduced.
3. HECM credit lines keep up with inflation regardless of what collateral value becomes. The HECM line of credit grows in borrowing capacity and that cannot be changed, even if home values drop. Once you set up a HECM line of credit, if the home value sinks, it has nothing to do with the loan. They only look at the value of the house at the beginning. There is never a reassessment of that during the loan.

Dr. Barry Sacks has a PhD in physics in MIT and a JD from Harvard and was a tax and pension lawyer for 40 years. He started thinking about this back in the early 2000s, as he was approaching his own retirement. He was thinking about, “What if I didn’t have to sell my investments after a market downturn?” He developed a strategy where on January 1st, he takes a look at setting aside the upcoming year’s expenses. If the portfolio was up last year, he’s going to go ahead and take his draws from his portfolio. But if the portfolio was down, he’s going to take his draws from a home equity conversion mortgage, reverse mortgage, line of credit.

Dr. Sacks has published in the *Retirement Management Journal* how to protect against sequence of returns risk and reverse dollar cost averaging in conjunction with Mary Jo Lafaye. If in the previous year the market was in negative territory, use the HECM. He compares the conventional wisdom (use up all your portfolio, turn to your house as a last resort) to the new wisdom (coordinate draws from your HECM, depending on what the market has done). He used a historical portfolio performance from 1979-2002 because he wanted to demonstrate what poor early sequence of returns could do to a portfolio under the stress of systematic withdrawals. As you can see, he starts at $27,500 and, regardless of what the portfolio is doing, he takes draws that are keeping up with inflation and constant purchasing power after that initial draw. Inflation was 3 percent in this example.

Protect Against Sequence of Returns Risk and Reverse Dollar Cost Averaging

Barry Sacks, PhD, JD, Mary Jo Lafaye

	4 of first 9 years, negative returns	Conventional Thinking: Last Resort Draw from Portfolio until Gone					New Wisdom: Coordinate with Investments Draw from RM LOC after Down Market				
	Year	Portfolio at Start of Year	Investment Performance	Draw from Portfolio	Draw from ReLOC	Portfolio at End of year	Portfolio at Start of Year	Investment Performance	Draw from Portfolio	Draw from ReLOC	Portfolio at End of year
	1973	500,000	-9.3%	27,500		428,652	500,000	-9.3%	27,500		428,652
	1974	428,652	-15.5%	28,463		338,120	428,652	-15.5%	HECM	28,463	362,168
	1975	338,120	22.3%	29,459		377,493	362,168	22.3%	HECM	29,459	442,932
	1976	377,493	17.9%	30,490		409,013	442,932	17.9%	30,490		486,145
	1977	409,013	-4.1%	31,557		361,905	486,145	-4.1%	31,557		435,859
	1978	361,905	2.2%	32,661		336,552	435,859	2.2%	HECM	32,661	445,535
	1979	336,552	8.0%	33,805		326,998	445,535	8.0%	33,805		444,710
	1980	326,998	15.4%	34,988		337,009	444,710	15.4%	34,988		472,861
	1981	337,009	-1.4%	36,212		296,706	472,861	-1.4%	36,212		430,710
	1982	296,706	25.2%	37,480		324,655	430,710	25.2%	HECM	37,480	539,422
	1983	324,655	13.3%	38,791		323,941	539,422	13.3%	38,791		567,314
	1984	323,941	8.9%	40,149		308,935	567,314	8.9%	40,149		573,872
	1985	308,935	25.2%	41,554		334,734	573,872	25.2%	41,554		666,408
	1986	334,734	15.2%	43,009		336,068	666,408	15.2%	43,009		718,156
	1987	336,068	3.4%	44,514		301,496	718,156	3.4%	44,514		696,613
	1988	301,496	10.3%	46,072		281,809	696,613	10.3%	46,072		717,742
	1989	281,809	20.9%	47,685		283,150	717,742	20.9%	47,685		810,367
	1990	283,150	1.0%	49,354		236,087	810,367	1.0%	49,354		768,472
	1991	236,087	21.4%	51,081		224,524	768,472	21.4%	51,081		870,625
	1992	224,524	5.6%	52,869		181,268	870,625	5.6%	52,869		863,551
	1993	181,268	7.9%	54,719		136,559	863,551	7.9%	54,719		872,810
	1994	136,559	-2.8%	56,634		77,718	872,810	-2.8%	56,634		793,650
	1995	77,718	25.7%	58,617		24,007	793,650	25.7%	HECM	58,617	997,459
24	1996	24,007	11.1%	24,007	36,661	0	997,459	11.1%	60,668		1,040,493
	1997	0	19.3%	HECM	62,791	0	1,040,493	19.3%	62,792		1,165,909
	1998	0	17.0%	HECM	64,989	0	1,165,909	17.0%	64,989		1,287,967
	1999	0	7.8%	HECM	67,264	0	1,287,967	7.8%	67,264		1,315,795
	2000	0	-0.9%	HECM	69,618	0	1,315,795	-0.9%	69,618		1,234,712
	2001	0	-3.7%	HECM	72,055	0	1,234,712	-3.7%	HECM	72,055	1,189,275
	2002	0	-8.6%	HECM	74,576	0	1,189,275	-8.6%	HECM	74,577	1,086,997
				Ending Balances:	$541,087	$0			Ending Balances:	$706,043	$1,086,997

-$541,087 Net

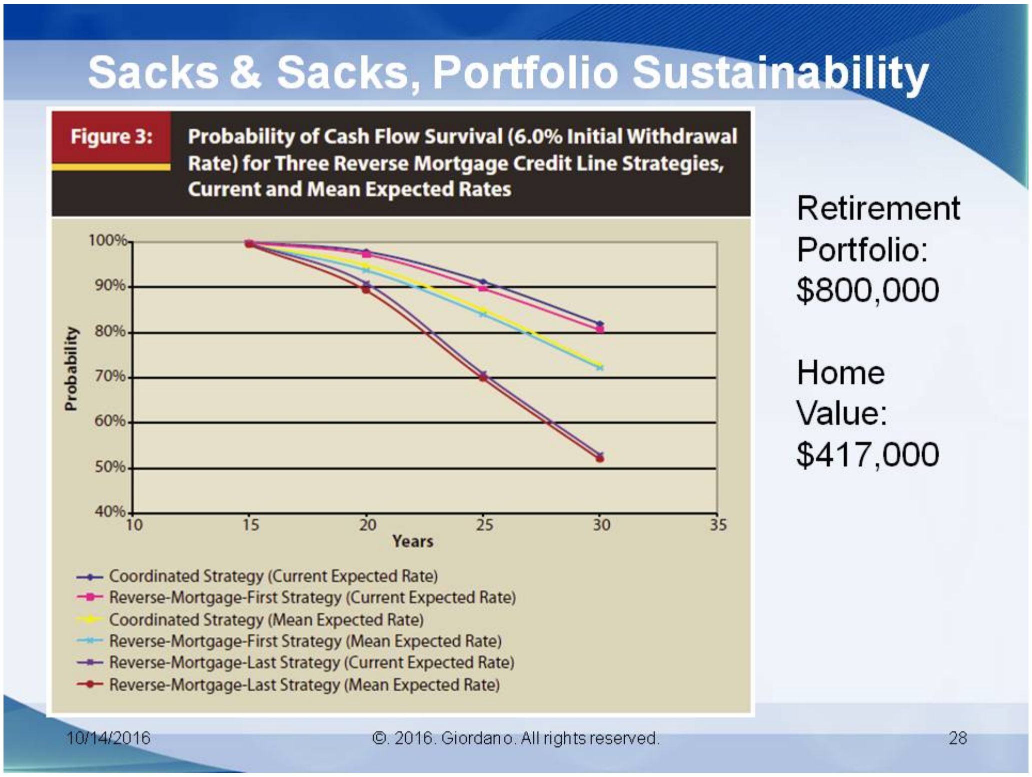
+ $922,041 Net Estate Impact of Coordinated Strategy

+$380,941 Net

As you can see, the client runs out of money basically on year 24, and now we're hoping the reverse mortgage still exists. He's going to take out a reverse mortgage and hope he can get draws of this magnitude from your reverse mortgage 25 years down the road. Using conventional wisdom, the client has zero in the portfolio and has an ending balance of $541.87. Compare this to the new wisdom, where in every year following a negative performance, the portfolio rests and the client draws from the HECM. You can see it's the same draws, but just from the HECM. At the end, we get an ending balance of $706.00 on your reverse mortgage.

But look at what the portfolio did; it's $1 million. It's zero using the conventional wisdom of home equity as a last resort. So you have to ask yourself, would the kids rather have the money or the house? There is a $922,000 spread differential to the estate of one strategy over the other. Pretty compelling numbers.

Dr. Sacks and his brother Dr. Steven Sacks wrote a paper in 2012 in the *Journal of Financial Planning*. They looked at different initial withdrawal rates. When you start at 4 percent, the probability is pretty high that you're going to have enough money to last. We're just showing it at a 6 percent initial withdrawal rate. It demonstrates that, if you use the coordinated strategy, which is using your HECM line of credit in the years following a downturn in the market, the probability of having cash flow survival is way up here. If you use a reverse mortgage as a last resort the probability is way down here.



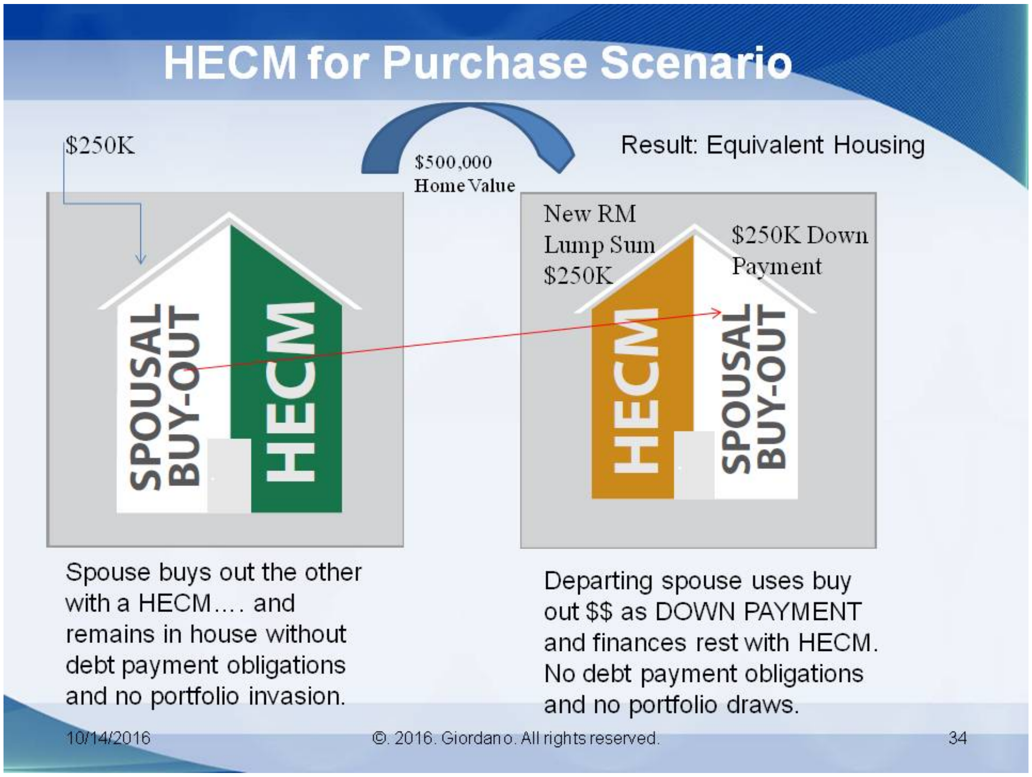
It gives confidence that your client can spend maybe more than the lower initial withdrawal rate. There are findings where there are substantial increases in the cash flow survival probability when home equity is not used as the last resort. Residual wealth after 30 years, even if you take into account the debt on the home, is also twice as likely to be larger. They did find a high ratio to home value to financial portfolio allows for greater sustainability.

Case Study: Grey Divorce and Reverse Mortgages

Unfortunately, more married Americans over the age of 50 are calling it quits. It's more than double for those over the age 65. This creates a problem, since in order to divide assets the marital home often must be sold, since the departing spouse may not want or qualify for mortgage debt on a new house. In grey divorce, it's especially dangerous to divest retirement funds for home purchase or take on traditional mortgage that stresses resources.

So even if the marital house is sold and the proceeds are used to purchase new homes for both parties, this could represent an unpleasant step down for both. Let's say they had a $600,000 house and they both get $300,000. They don't want a mortgage. They don't want to invade their portfolio. You may not know that you can use a "reverse mortgage for purchase". Let's see how that would work in a couple of grey divorce scenarios.

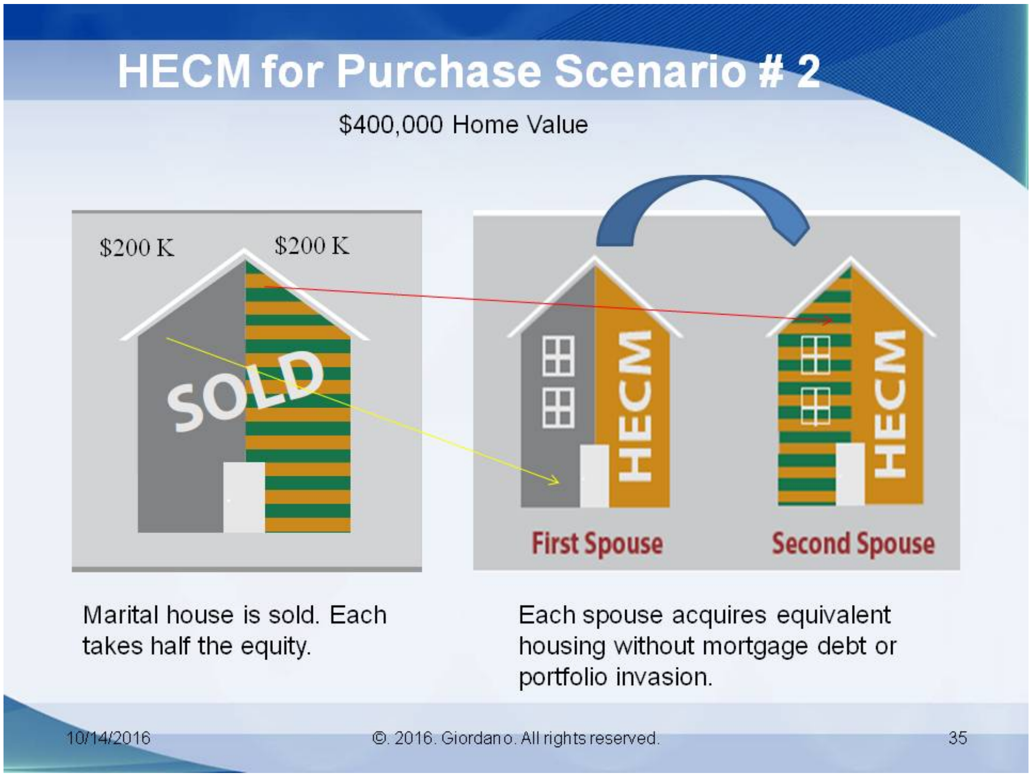
In the first example, the spouse buys out the other spouse in a home equity conversation mortgage and gets to remain in the house without debt payment obligations and no portfolio invasion. The wife puts a HECM on the $500,000.



Following our 50 percent rule, the husband now has $250,000. He can take out a mortgage, move to a different part of the country, or go into his portfolio. He can also settle for a house that costs $250,000 while his wife continues to live in the marital home. But he can also take that $250,000 and leverage it now with his own reverse mortgage – a HECM for Purchase. That will provide $250,000 in financing. So he takes $250,000 down as his monetary investment on his part and will be able to leverage the rest of that purchase price with a HECM for Purchase.

So the departing spouse uses the buyout dollars as a down payment and finances the rest with a HECM. No debt payment obligations are required and no portfolio draws.

Now this time let’s use a $400,000 house.



Let's say the marital home is sold and each takes $200,000. The first spouse is going to put that $200,000 down as a down payment and is going to leverage buying a $400,000 house by using a HECM for Purchase. She comes to the closing table with another $200,000 and she'll be able to live there without making payments on the principle or interest until she dies, moves, or sells.

The husband takes his $200,000 and applies it as a down payment toward his home. He leverages that $200,000 in cash with a HECM for Purchase transaction, which will allow him to buy a $400,000 house. So now everybody has been restored to the kind of housing they're used to, but more importantly, it's equitable housing. Whether they want to let the interest on the reverse mortgage ride or not is up to them.

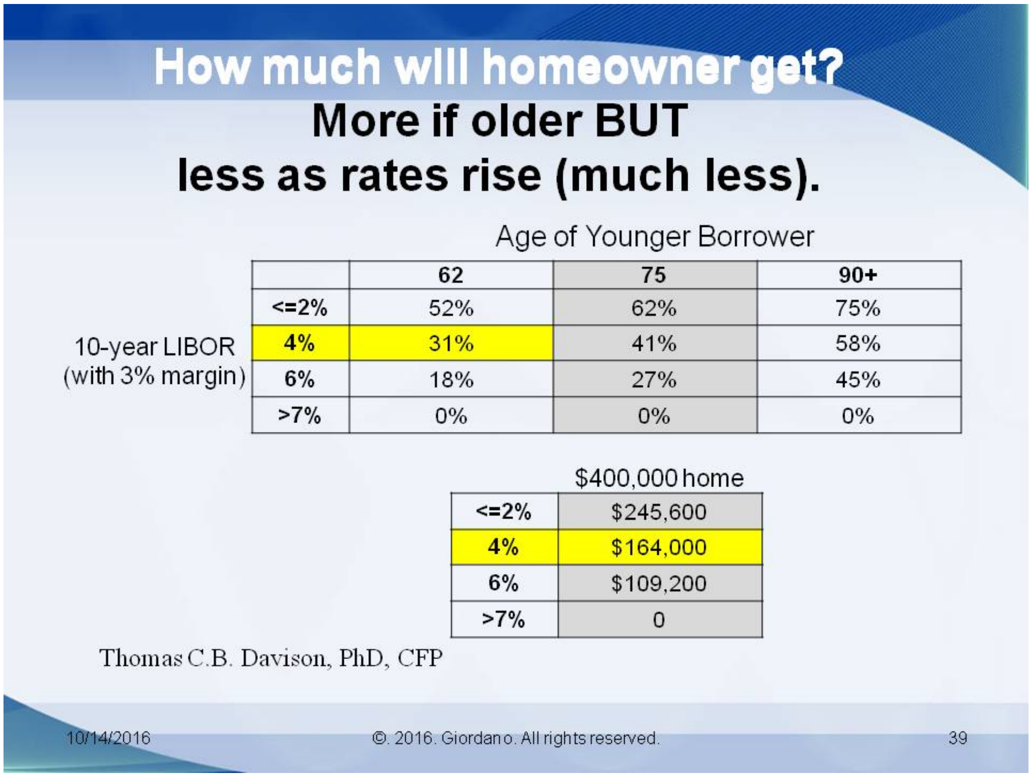
Case Study: Long-term Care and a HECM Line of Credit

In this case there are no long-term care premiums. Instead, you establish a HECM line of credit at retirement outset and then you use it only if you need it. It's going to function like insurance. The HECM line of credit is hedged against an inflation and declining home values because its future value is guaranteed.

Any HECM transaction where there is an existing line of credit is contractually obligated to increase that line of credit every single month at a rate set at closing. It cannot be changed. If you're in the habit of telling your clients to wait until they get older and they'll get more money, guess what? There have been FHA changes in the last 10 years that have reduced the percentage available three times and raised the cost of insurance twice in the past 10 years.

When interest rates rise, funds available on the HCM line of credit decrease. You want to get into a reverse mortgage when interest rates are low if you possibly can. You may not qualify for a reverse mortgage if your financial situation changes down the road. Carrying costs are basically nil for a line of credit. If you haven't drawn the money, it's not incurring interest and MIP charges.

So how much will the borrower get? It's true they can get a little more if they're older, but that advantage gets erased as rates rise. So the point of this is that the amount of money you're eligible for in a reverse mortgage is much more sensitive to interest rates than to age.



At a 4 percent rate, a 62-year-old would be eligible for 31 percent. This is a higher rate. This is where we are today. But a 75-year-old would only be eligible for 41 percent.

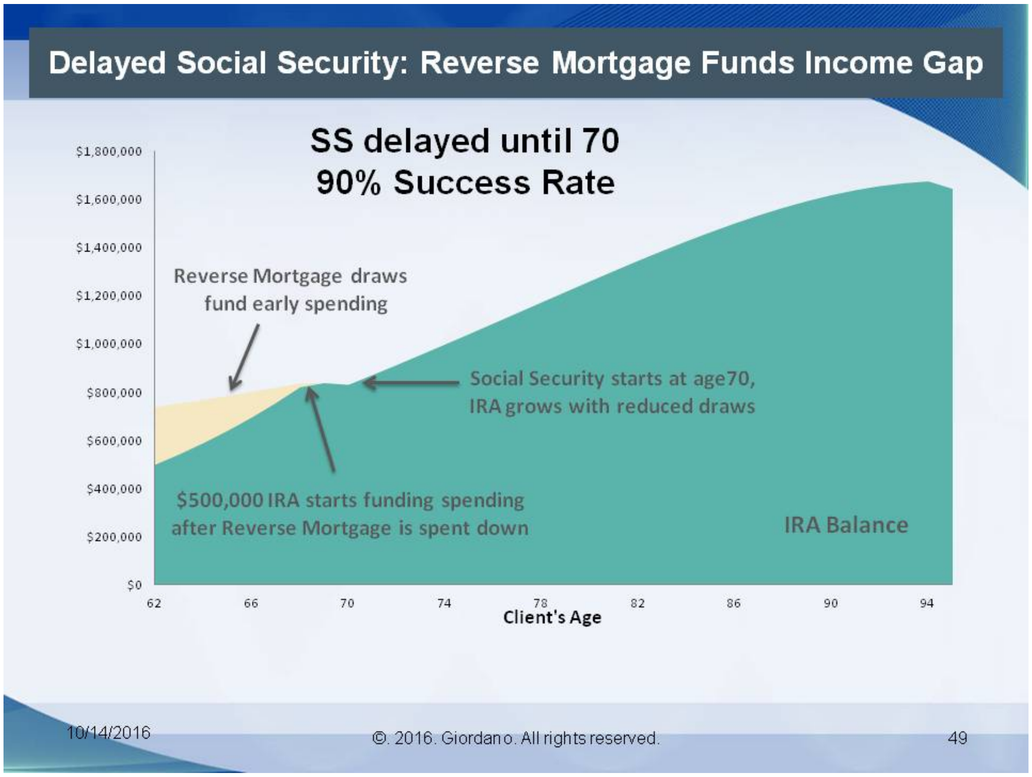
Look at the difference when rates change on a $400,000 house for a 62-year-old – what the actual dollars are. You move from this interest rate and are eligible for $245,000. But if rates go up, you're only eligible for $164,000. So please don't let anybody tell you, "I'll just wait until I'm older and I'll get more money." That is a really risky strategy.

Case Study: Using a Reverse Mortgage to Maximize Social Security

Say we have a single woman, retired, turning 62, and expects to live to age 95. Living expenses are $87,000 per year. If she were to begin her Social Security at full retirement age, it would be $2,500 a month. She does have a pension of $5,000 a month. She has $500,000 in an IRA. She would be eligible for $240,000 from her reverse mortgage line of credit. She is a California resident, which means she gets whacked on taxes.

So we know deferring Social Security to age 70 provides 132 percent of the full retirement age benefits, so a lot of folks would understand that that can make a big improvement in retirement income security. If she were to start taking her Social Security at age 62 and not have a reverse mortgage, and draw on her IRA, in 95 percent of her lifetime she's going to run out of money. That doesn't give her much confidence.

But what if she delayed her Social Security and instead took draws from her reverse mortgage for income? It lasts until age 68 and then for two years she has to take all of her spending net of her pension from her IRA. But at age 70, that big nice Social Security check starts to show up. So why does this work so well? She has more assets to spend. She added $240,000 of home equity to her $500,000 IRA. She allowed her Social Security to be delayed by the reverse mortgage funding six years of spending. The reverse mortgage funded that first six years of spending.



Her investment portfolio was untouched until age 68, so she got six extra years of growth before she started withdrawing. Reduced sequence risk reduced the possibility that early on she was going to take withdrawals when bad returns hit early. Her investment portfolio draws after age 70 were reduced by the largest possible Social Security contribution.

If you've not thought about that, like all mortgages, proceeds from a reverse mortgage is debt. It's not income, so you don't pay taxes on it. A reverse mortgage dollar in a 33 percent tax bracket has the spending power of $1.50 if she'd taken it from an IRA she had to pay taxes on. It's debt, but it's real spending money at the moment.

About the author of "Housing Wealth: A Retirement Asset for the Middle Market":

Shelly Giordano founded the Funding Longevity Task Force and serves as Chair. This team of researchers, gerontologists, financial planning practitioners, and lenders is devoted to helping Boomers understand how powerful their housing wealth could in planning for a more secure retirement. Shelley has been a pioneer in reverse mortgage lending, having begun her career almost two decades ago.

As Chair of the Funding Longevity Task Force, Shelley works to further its mission to bring quantitative analysis to the role housing wealth can play in retirement, specifically "to develop and advance, for Boomers and their financial advisors, a rational and objective understanding of the role that housing wealth can play in prudent planning for retirement income."

Shelley Giordano, Chair of the Funding Longevity Task Force

Retirement Speakers Bureau

Grey Divorce and Retirement

10/11/2016

By [Andrew Samalin, CFP, EA, CDFA](), Expert in Divorce and Retirement

Andrew Samalin, CFP, EA, CDFA, Expert in Divorce and Retirement

Editor's Note:

Below is an adaptation of the live webinar delivered by Andrew Samalin in 2016. His comments have been edited for clarity and length.

*You can read the summary article below as part of the 3rd Qtr 2016 Retirement InSight and Trends Newsletter. You may also choose to **take the full length course here**, worth 1.5 CRC®, CFP® and/or PACE CE.*

It is likely that there isn't anyone who hasn't been affected by it, either personally, or through a family member, a friend, or someone who you work with. So, it is, for better or for worse – and many times, both – that divorce is in the vernacular of our society. It is a trying and difficult event that people go through. Our role as professionals is to smooth the road as much as possible.

Our objectives for today:

1. How an equitable statement does not necessarily mean an equal split of assets.
2. How divorce may affect Social Security for each spouse.
3. How retirement assets and pensions can be divided.

Asset Division in Divorce

Assume Jack is age 58, Mary is 62, and they have decided to end their 28-year marriage. They have two grown children. Mary wants to stay in the house.

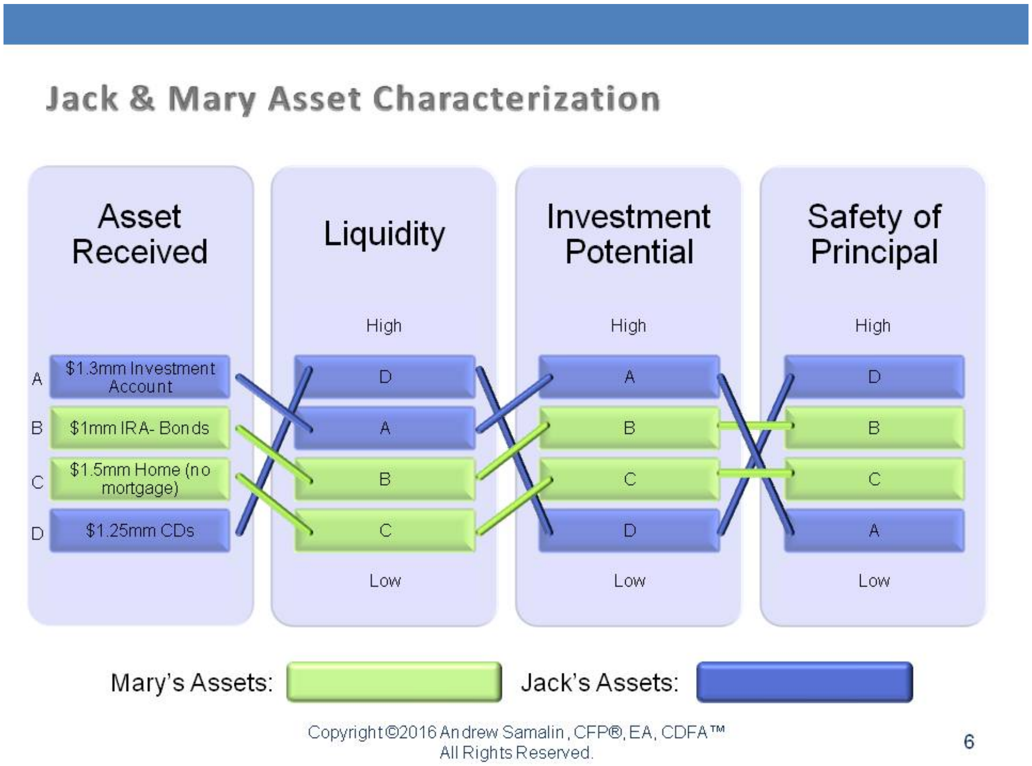
Their home is valued at $1.5 million, and there's no mortgage. They have a $1 million IRA, $1.25 million in CDs, and a non-qualifying investment account worth $1.3 million in company stock, which doesn't pay any dividends.

Both have their concerns. Jack is concerned that his job is in jeopardy. He is employed, by a major bank and earns $350,000 a year. Mary happens to be extremely risk-averse. She isn't prepared to work. She has no experience in finances. Both have reasonable credit scores.

The divorce settlement requires Jack to pay Mary $135,000 a year for ten years. Mary is also awarded the house and the IRA, and Jack keeps the investment account and the CDs, which is what they were looking for in terms of their risk profiling.

Here is an analysis that's not necessarily divorce financial planning, but is something you should be familiar with when evaluating divorce and its effect on retirement security. In the graph below, Jack's assets are in blue and

Mary’s assets are in green. There are four different categories, going from left to right: assets received, liquidity, investment potential, and safety of principal.



Asset A is the $1.3 million investment account. You can see that it has reasonably high liquidity, the investment potential is very high, and the safety of principal is low. On the other hand, Jack also gets Asset D, which is the $1.25 million in CDs. Again, it has high liquidity, low investment potential, and high safety of principal. So, he bookends it with regard to risk and reward.

Mary, on the other hand, gets what she was looking for. She wants the house, and she wants the retirement to be well in hand. So Asset B, the $1 million IRA in bonds, has low liquidity, reasonably low potential, and reasonable safety of principal. The home, has very low liquidity, reasonable investment potential, and safety of principal.

Of course, apparent safety may not equal actual safety. Let’s look at Jack’s income allocation, the income of $350,000, of which he pays Mary $135,000 for ten years. He has living expenses and taxes of $175,000, and savings of $40,000. The income paid through maintenance, aka alimony, is deductible to the payor and is taxable to the payee under Sections 71 and 215 of the Code. Mary, on the other hand, has to show that as taxable income.

Mary has living expenses and taxes of $90,700 and savings of $44,000. She will have a home with no mortgage and a great retirement plan. However, is Mary safe? What is she missing? The reality is that she’s cornered into a liquidity trap, and it could be totally unintentional and innocent.

What if Jack loses his job? This happens all the time, so let’s talk about their respective choices. Jack has no retirement plan, they’re both in need of income, and Mary’s asset base is at risk.

Potential solutions for Mary are:

1. Have her attorney assert her rights to collect the maintenance payment.
2. Create liquidity at or near the time of the divorce settlement with a home equity line of credit (HELOC), and have Jack cosign.
3. Use the settlement document and a canceled maintenance check to get a standard mortgage.

4. In the event that that's not possible, divide the IRA into smaller pieces and start a 72(t) program (a substantially equal, periodic payment program).
5. Mary is 62, so consider a reverse mortgage on the home. If needed it can be repaid from the maintenance currently in arrears.
6. What about her Social Security?

Now, what about Jack? Jack has this obligation of a $135,000 payment, but the reality of it is that his circumstances have changed. His attorney would likely have the annual maintenance payment reduced due to a change in circumstances. Many settlement agreements have change-in-circumstances clause because, at the end of the day, if they were married, their circumstances certainly would have changed, and their marital lifestyle would have changed, so it's not unreasonable to assume that while Mary is expecting a certain level of income, due to this compression in income, then so too would her lifestyle change just has Jack's had.

Another option for Jack is to negotiate a lower margin rate and borrow off of existing assets, incurring a reasonable interest rate while making sure that the assets remain in place for future retirement.

Remember, Mary was given the retirement account. Jack can increase his cash flow by restructuring current investment accounts into higher income-producing assets so that he can bridge that gap. Maybe instead of becoming a growth investor, he is now a value investor or a bond investor.

At the end of the day, something needs to happen, and both parties have their rights and their obligations with regard to that. The thing I would like for all of you to take away from this is that if cash is king, liquidity is queen. Both of them are critical, and the ability to maneuver financially is a great source of comfort for our clients. Keep in mind that we're talking about creating liquidity on the outset of the divorce negotiations. This is something that could create a release valve for both of them to maneuver through challenging circumstances.

Divorce and Social Security

There is a tremendous amount of poverty with regard to the non-moneyed ex-spouse – again, traditionally the woman – where there isn't enough income. What's interesting is that there is an institutional bias against the non-moneyed spouse, in my opinion, at the Social Security Administration.

This is not a political comment. It's a comment that, as the non-moneyed spouse, they are entitled to get 50 percent of the working spouse's benefit at no cost to the working spouse. What that means is that the moneyed spouse gets 100 cents on the dollar, but the non-moneyed spouse, assuming they weren't working, only gets 50 cents on the dollar, but the rent that each of them needs to pay is identical. I think that's changing.

If you are divorced, your ex-spouse can receive benefits based on your record, even if you've remarried, if:

1. Your marriage lasts ten years or longer
2. Your ex-spouse is unmarried
3. Your ex-spouse is 62 or older
4. The benefit that your ex-spouse is entitled to receive based upon his or her own work is less than the benefit would have received based on your work, and
5. You are entitled to receive Social Security retirement or disability benefits.

Here's the takeaway for everyone: You need to ask your client how long they're been married. I would confirm that length, and then if it's close to ten years, make sure the client and their counsel are aware of this ten-year break-even. Imagine the circumstance that they're a couple of months away from the ten years, and you didn't tell them. That would probably cause a call to your E&O carrier.

A lower-earning spouse can receive 50 percent of the higher-earning, ex-spouse's benefit at full retirement full retirement age. In addition:

1. If they remarry, they generally cannot collect benefits on their former spouse's record unless their later marriage ends (by death, divorce, or annulment).
2. If the higher-earning spouse has not applied for retirement benefits, but can qualify for them, the lower-earning spouse can receive benefits on the higher-earning spouse's record if they have been divorced for at least two years.
3. If the lower-earning spouse is eligible for retirement benefits based upon their record AND the higher-earning spouse's benefits, the Social Security Administration (SSA) will pay based on the higher amount, drawing first from the lower-earning spouse's record, and the balance from the higher-earning spouse's record until it equals the higher amount.

Keep in mind that if they are working while receiving benefits, the retirement benefit earnings limit still applies.

Divorce and Retirement Assets

Generally, retirement plans include defined benefit plans (pensions), defined contribution plans, (401(k)s, 403(b)s, 457s and SEPs), IRAs, nonqualified plans (stock options, ESOPs, deferred comp), and compensation plans that are future-based, merit-oriented, and employer-optional. One of the negotiations in divorce is how to split these plans.

How do you split them? There are a couple of ways. With each one of them, by the way, it's critical that you have a professional draft some of these documents. These have some very, very serious ramifications if they're done incorrectly or incompletely, and a lot of times, people don't know the questions to ask, so they don't know what they don't know. Because the prices are so reasonable to have a very qualified drafter of a qualified domestic relations order (QDRO), make sure that you engage and become familiar with someone in your local area and hand this work off to them because it's very, very important.

How do you divide a defined contribution plan? If it's such that it's 50-50 in a community property state, or 70-30, or 30-70, depending on what the agreement is, that then gets coded and the QDRO gets drafted. It gets reviewed and signed by a judge. The clients sign it. The attorneys sign it. It goes to the human resources department, and the funds then get split. The funds then go from the employee's plan and account into the non-employee spouse's account or their IRA.

There are multiple ways of configuring this. Some plans will allow for the non-moneyed spouse to maintain an account, but again, this is extremely specific to the summary plan document set up by the company, and the QDRO language needs to match what is available to the participant.

What about IRAs? Are they covered under a QDRO? No, they're covered under a letter of authorization. You need to get to the securities firm to determine the requirements to execute that division of the assets, but generally, it requires a letter of authorization along with a signed divorce decree or separation agreement. Do not transfer those assets before those documents are in place. You do not want to be accused of creating a distribution, and thus a taxable event out of a retirement plan.

How do you monetize retirement assets if your client needs income? In the case of a defined contribution plan, the 401(k) can be rolled into the IRA. The alternative payee, meaning the non-employee spouse, can take the cash from the 401(k) on the way to the IRA penalty-free; however, taxes are due. But once it is in the IRA and the client is under 59 and a half, 10 percent penalty is due, as well as taxes. What about a 401(k) loan? Up to 50 percent of the vested balance, with a maximum loan amount of $50,000, generally must be paid back within five years.

But what if they didn't do it on the way? What if they didn't pull out cash on the way from a 401(k) into the IRA?

Earlier we offered a solution for Mary with regard to the Section 72(t), a very interesting and underutilized section of the Code that allows you to get access to cash without penalty through substantially equal periodic payments. Payments must be greater than five years or until the client is 59½, whichever is longer. Once the payments start, they can't stop.

There are three methods of computing 72(t) distributions: the minimum distribution method, the fixed amortization method, and the fixed annuitization method. Each end up with a different result. Let's say there is a million-dollar IRA. You do not need to monetize the entire million. You can move, let's say, $100,000 or $200,000 into a separate IRA and do a 72(t) based on that, leaving the balance of the larger account alone. If you find that you need more money, that's fine; move another chunk over into another IRA to do 72(t) distributions.

What about a defined benefit plan? They may not have cash values; they are an actuarial construct, and there could be a lump sums due, or payments made. That's the definition of a pension, in many cases, where the company is guaranteeing a certain level of monthly cash flow from the day of the retirement until death, or to some other term.

Defined benefit plans can only be split by a QDRO. There are two ways to split the assets: shared interest or separate interest. What's the difference? In the separate interest, the alternative payee's benefits are adjusted to their own life expectancy. Separate-interest QDROs don't include a joint and survivor protection. The employee is free to elect any form of benefits for their remaining share. There's no right of reversion to the employee if the alternative dies first. We're taking a 30,000-foot view on this; this can get very technical.

With a shared interest, an alternative payee shares the employee's benefits once they are in pay status. There is slightly less control for the ex-spouse. The alternative payee must wait until the employee goes into pay status. The benefits revert back to the employee upon the alternative payee's death. The employee must choose joint and survivor benefits to ensure payments to the alternative payee will extend benefits after the employee's death.

Grey Divorce and Divorce Financial Planning

Divorce Financial Planning has been getting a lot of media lately, so here is a little bit of a primer on what is divorce financial planning.

Divorce financial planning takes place from the date of the commencement to the end of the divorce. Post-divorce asset management happens once the case is settled. These are two very different businesses. You need to pick one and do only one. Other attorneys will call you out on an attempt to do both.

Divorce financial planning requires extensive tax experience, valuation degrees, and/or real estate experience. It doesn't mean you need to be a pro or an expert in each one of those field; it's impossible to be an absolute expert in every single field. There is an awful lot of tax work here; valuation is important; and it is extremely important to be adept in real estate. You can't just say, "Well, let's just sell the house and invest the money." That's malpractice, because it could very well be that that house is important to Mr. or Mrs. Jones.

What are the pros and cons of divorce financial planning? Pro are that it's very technical and you really add value. Cons are that it takes a lot of time, it takes a lot of focus, and, frankly, it takes a lot of heart because it's challenging as a human being to ignore what's going on at the table and be that professional that sticks to the task at hand, which is for you to assist your client through the process.

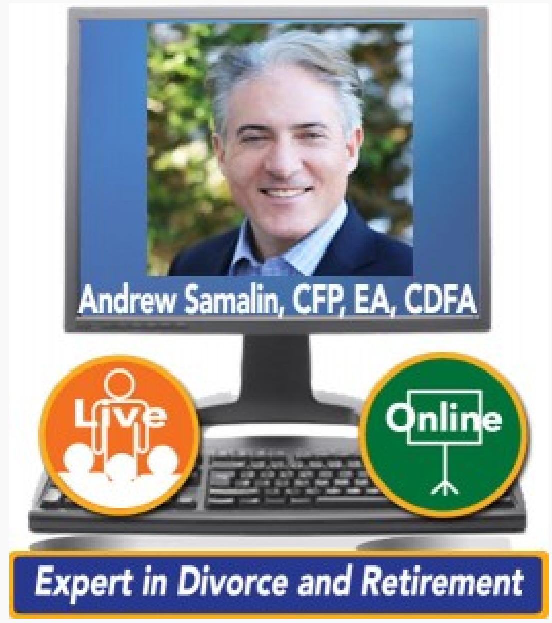
What is the compensation structure? There is no quid pro quo. You don't give away divorce financial planning in exchange for asset management. As the ex-president of the Association of Divorce Financial Planners, I can tell you that we will not allow someone to become a member if they don't have an hourly compensation structure. You should be paid in the same way that the attorneys and mental health professionals get paid. Why? It removes bias, and it is that removal of bias that allows us to have a profession.

What type of practitioner is this practice model good for? You really can't delegate it, and you really can't scale it, so you need time to do it. You also need time to get great at it; it's a constant learning process. You're going to learn about other great fields: law, taxes, and the human condition. Believe it or not, being a great divorce financial planner makes you a great financial planner for your non-divorce work.

About the author of "Grey Divorce and Retirement":

Andrew Samalin, CFP, EA, CDFA, Past president of the Association of Divorce Financial Planners, is a 25 year veteran financial specialist assisting attorneys, CPAs and other professionals manage their families', firms', and clients' financial planning and wealth management needs.

Samalin has focused his practice on divorce financial planning and other challenging financial transitions through his SEC Registered Investment Advisory firm Samalin Investment Counsel, LLC and affiliate Samalin Divorce Finance, LLC. He specializes in helping clients with personal financial analytics and wealth management needs on a fee-only basis.



Andrew Samalin, CFP, EA, CDFA, Expert in Divorce and Retirement

Retirement Speakers Bureau

Retirement Security

10/11/2016

*The following article highlights information provided in the **March 2016 GAO Report to Congressional Requesters, [RETIREMENT SECURITY – Better Information on Income Replacement Rates Needed to Help Workers Plan for Retirement](#)**.*

Better Information on Income Replacement Rates Needed to Help Workers Plan for Retirement, March 2016

An excerpt from GAO-16-242 for retirement professionals.

Why GAO Did This Study

Part of DOL's mission is to promote the retirement security of America's workers, a goal that has become increasingly challenging. One tool for assessing the adequacy of retirement income is the replacement rate.

However, recommendations for the replacement rate that a household should target vary widely, in part because of the diverse underlying assumptions used to develop the rates. GAO was asked to review what consumption in retirement looks like and how target replacement rates are developed.

GAO examined (1) whether and how spending patterns vary by age, (2) key factors used to develop target replacement rates, and (3) the usefulness of information on such rates provided by DOL. GAO analyzed data from the BLS's 2013 Consumer Expenditure Survey, the most recent available; analyzed 59 articles and reports that discussed how to develop, calculate, or evaluate replacement rates; collected non-generalizable information from 14 retirement services firms and financial planners recommended by researchers and actuaries who have studied replacement rates; and reviewed DOL materials and interviewed officials.

What GAO Found

Household spending patterns varied by age, with mid-career households (those aged 45-49) spending more than older households. For example, according to 2013 survey data from the Bureau of Labor Statistics (BLS), mid-career households spent an estimated average of around $58,500, while young retiree households (those aged 65-69) spent about 20 percent less. While the share of spending was consistent for some categories, other categories had larger variations across age groups. For example, housing expenses comprised the largest share of spending regardless of age, while older households spent more out of pocket on health care than mid-career households. Spending was less variable across age for low-income households compared to other households. For example, there was not a significant difference in average spending between mid-career and young retiree households in the lowest income quartile, compared to an approximately $20,000 difference for the highest income quartile. These variations in spending patterns have implications for the resources households need to maintain their standard of living in retirement.

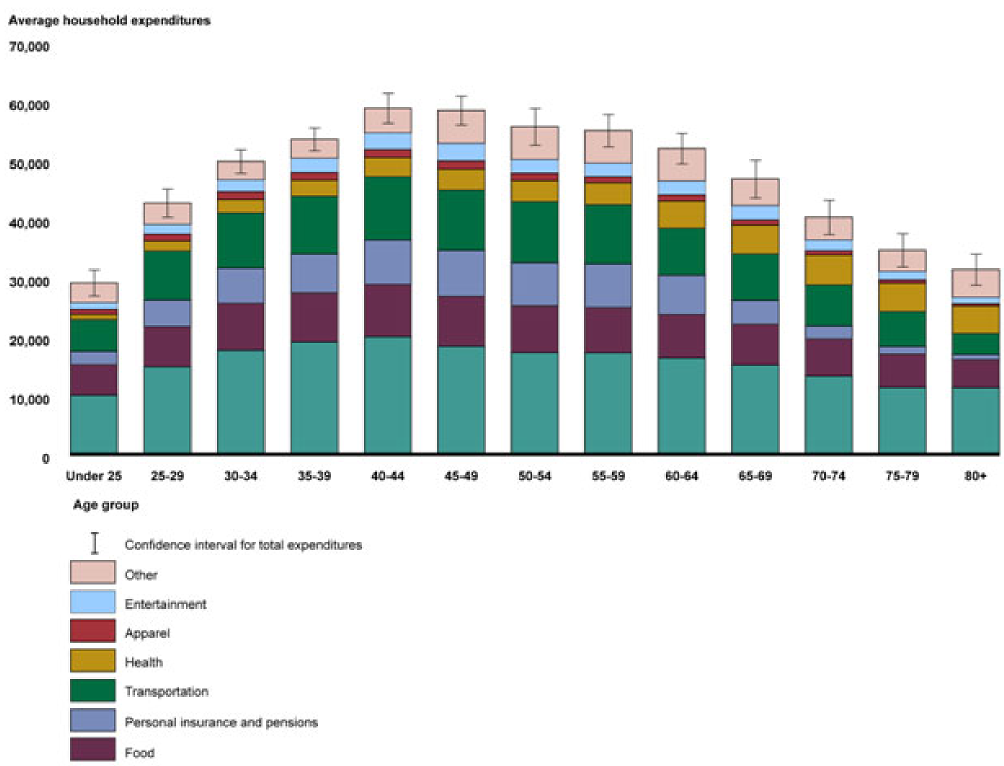
Researchers and financial industry professionals develop target replacement rates—the percentage of income to aim for in retirement— based on certain key factors, including spending, household characteristics, and pre-retirement earnings. GAO's analysis of the literature found that calculating an appropriate replacement rate can be complex. For example, there is debate over whether households that have raised children should target a lower replacement rate than households that have not. In addition, a worker's pre-retirement earnings could be defined as earnings at the end of the worker's career or as average earnings over the course of the career. Despite these complicated considerations, target replacement rates cited in the articles and reports GAO reviewed typically range between 70 and 85 percent. Some financial industry professionals told GAO that they develop customized targets that take into account workers' assets and expected spending, while others questioned the usefulness of replacement rates.

Whether older Americans will have adequate income in retirement has been a longstanding concern for several reasons including the decline in defined benefit pensions, the growing responsibility for individuals to save for retirement through employer-sponsored defined contribution plans or on their own, and the financial challenges facing Social Security. To better predict how much income Americans will need once they leave the workforce, many researchers use target replacement rates—the percentage of pre-retirement income needed to maintain a certain standard of living in retirement. In recent years, numerous studies on the replacement rates that households should target have not resulted in a consensus recommendation, in part because estimates are heavily dependent on the underlying assumptions used to develop them. To accurately interpret the implications for retirement adequacy it is important for policy makers and individuals to better understand how these targets are developed.

Older Households Spent about 20 Percent Less than Mid-Career Households in 2013

Based on our analysis of 2013 CE data, mid-career households had one of the highest spending levels, while older households generally spent less.[15] More specifically, in 2013, mid-career households—those aged 45- 49—spent an estimated average of about $58,500, while young retiree households—those aged 65-69— spent about $46,800, or 20 percent less overall (see Figure 1).[16] We also analyzed spending across two broader age groups: pre-retirement households (aged 50-64) and post-retirement households (65-79). We found that the difference in spending between broader age groups was similar to the comparison between mid-career and young retiree households using 5-year age groups. The estimated average total spending for post-retirement households was about 77 percent of the spending levels for pre-retirement households.

Figure 1: Estimated Average Annual Household Expenditures by Age, 2013



Source: GAO analysis of 2013 Bureau of Labor Statistics Consumer Expenditure Survey, Interview Survey data. | GAO-16-242

Spending was lower among mid-retiree and older retiree households compared to mid-career and young retiree households (see Table 2). For example, mid-retiree households (aged 75-79) spent an average of around $34,700, or 26 percent less, than young retiree households. Average spending for older retiree households (aged 80 and older) was slightly less than mid-retiree households at around $31,400, although differences were not statistically significant.

Table 2: Estimated Average Annual Household Expenditures for Select Age Groups, 2013

Average annual household expenditures (rounded to nearest $100)

Expenditure type	Mid-career (45-49)	Young retirees (65-69)	Mid-retirees (75-79)	Older retirees (80+)
Housing	$18,400	$15,200	$11,400	$11,300
Transportation	$10,200	$7,900	$5,900	$3,600
Food	$8,500	$6,900	$5,600	$4,800
Personal insurance and pensions	$7,800	$4,100	$1,300	$900
Health	$3,500	$4,900	$4,800	$4,700
Entertainment	$3,000	$2,400	$1,400	$1,100
Apparel	$1,400	$900	$500	$400
Other	$5,600	$4,500	$3,600	$4,700
Total	**$58,500**	**$46,800**	**$34,700**	**$31,400**

Source: GAO analysis of 2013 Bureau of Labor Statistics Consumer Expenditure Survey, Interview Survey data. | GAO-16-242[i]

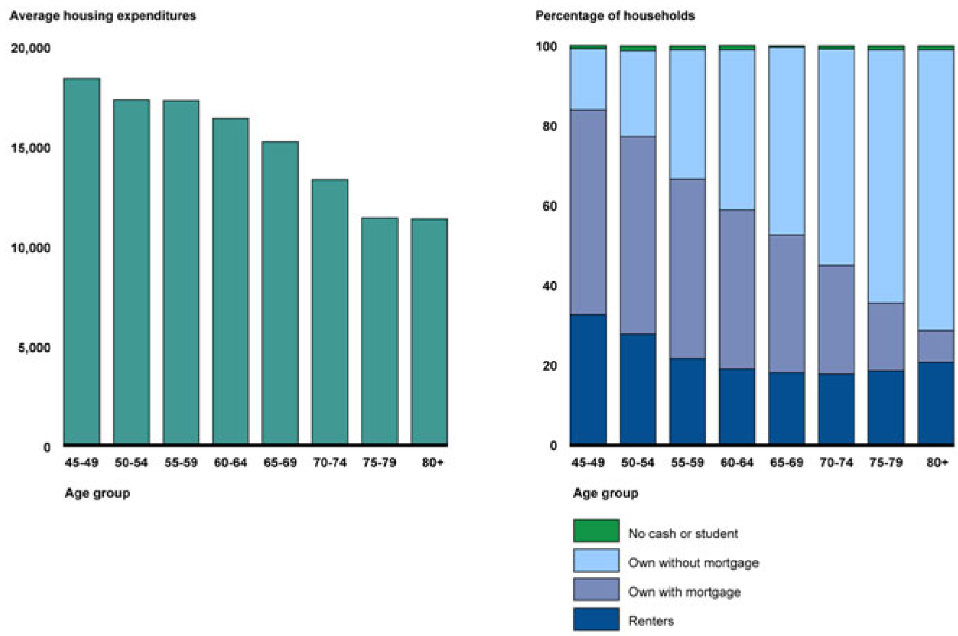
The patterns in total spending may, in part, reflect variations in average household size and priorities. The average household size for mid-career households was about 2.9 people as compared to about 2.1 people for young retiree households. The average household size was approximately 1.7 people for mid-retirees and 1.5 people for older retirees. Patterns in spending may also be affected by the age composition of other members of the household. Lower spending for older households could also be indicative of different priorities. For example, one large relative difference in spending was attributable to the personal insurance and pensions category. Mid-career households may be more concerned with contributions toward retirement resources than older households who could already be retired.

Moreover, we found that in 2013, age groups varied in how much they spent, including on basic needs, such as food, and non-essential items, such as entertainment. Such fluctuations in spending have implications for the resources households will need to maintain their standard of living. More specifically, spending levels are indicative of how households allocate resources based in part on different needs and lifestyle preferences, and are an important consideration when planning for retirement.

Housing Was the Top Expense Regardless of Age, and Older Households Spent More Out-of-Pocket on Health Care

While the share of spending was relatively consistent across age groups in some categories, there were larger variations by age for other categories. On average, housing was the largest spending category for all age groups. For example, households aged 45 and older consistently spent about a third of total expenditures on housing.[20] More specifically, young retiree households spent about 83 percent of the amount that mid- career households spent for housing, on average (see Figure 2). However, the composition of homeowners varied widely by age group. For example, the proportion of homeownership without a mortgage for young retiree households was three times higher than for mid-career households.[21] Housing expenditures include expenses such as maintenance, operations, and utility costs that can be incurred regardless of ownership status.

Figure 2: Estimated Average Annual Household Housing Expenditures and Housing Status, 2013 [ii]



Source: GAO analysis of 2013 Bureau of Labor Statistics Consumer Expenditure Survey, Interview Survey data. | GAO-16-242

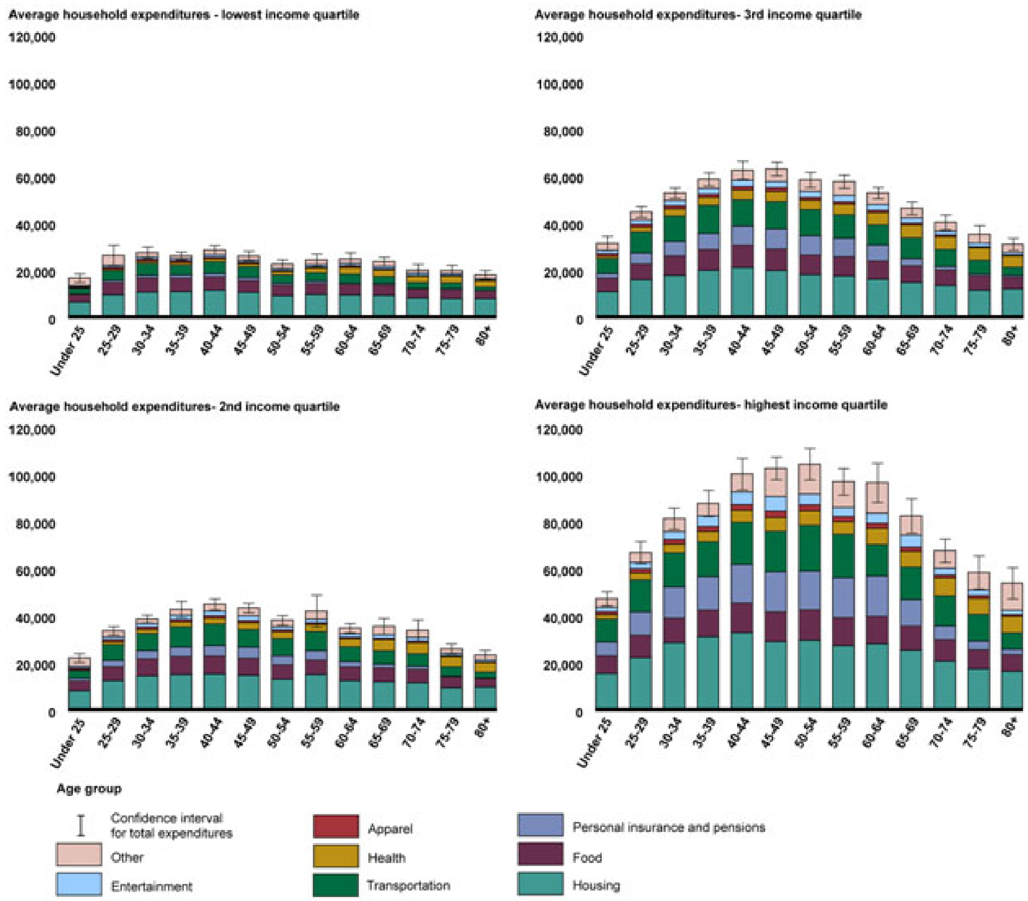
In contrast to other spending categories, health care was a larger expense for older households. For example, young retiree households spent an average of around $4,900 on health care, compared to about $3,500 for mid-career households. Older retiree households spent a large share on health care—15 percent of total spending—which was more than double the share that mid-career households spent on health care.

The age at which expenditures peak also shows how spending patterns varied. For example, the amount a household spends on apparel was estimated to peak at age 42, which was significantly younger than for entertainment, where the amount a household spends was estimated to peak around age 52. Spending on items such as apparel and transportation may be more relevant during a household's working years. Further, spending in some categories may increase with age as households have more time or resources for certain expenses, such as recreational activities.

Unlike for Other Households, Spending Was Relatively Flat Across Low-Income Households Regardless of Age

Spending levels across age groups were relatively similar for low-income households, while spending levels were more variable for high-income households (see Figure 3).[25] More specifically, the difference in average total spending for low-income households between the mid-career and young retiree age groups was not statistically significant, while the difference across these same age groups was over $20,000 for the highest income quartile.

Figure 3: Estimated Average Annual Household Expenditures by Income Quartile, 2013 [iii]



Source: GAO analysis of 2013 Bureau of Labor Statistics Consumer Expenditure Survey, Interview Survey data. | GAO-16-242

Though low-income households had much lower overall spending than mid- or high-income levels, they spent a larger share on necessities like housing and food, which could have implications for their respective replacement rates. Low-income young retiree households had an average of around $23,500 in out-of-pocket spending, with 39 percent spent on housing and 19 percent on food. In comparison, high-income households in the same age group spent about $82,200, of which 31 percent was spent on housing and 12 percent on food. While spending levels provide information on consumption, expenditures do not necessarily equate to a household's level of consumption. For example, a household could consume the same amount of food at different expenditure levels based on the difference in cost between preparing food at home versus eating out. Additionally, households may spend money on goods they are not consuming themselves, such as charitable contributions or gifts. Alternatively, some low-income families may receive benefits from public assistance programs that allow for higher levels of consumption than out-of-pocket spending indicates. For example, households may be eligible for programs that offset some of the costs of certain expenses, such as reduced-price school lunch or subsidized housing. Nevertheless, with a substantial portion of spending going toward basic expenses, households with limited resources may not have much flexibility to adjust spending levels. Consequently, a household's socioeconomic status could affect the level of resources required to plan for future spending needs.

Changes in Spending Are Important to Account for When Deciding How Much Income Should Be Replaced in Retirement

We found that accounting for how a household's spending may change in retirement is an important step in determining a target replacement rate— that is, a recommendation for how much pre-retirement income an individual or household needs to replace in retirement.[30] According to the articles and reports we reviewed, assumptions need to be made about the direction and size of a number of expenses, including housing, health care, entertainment, and consumer goods. For example, a retired household may spend less on housing if it pays off a mortgage or downsizes at retirement (see Table 3). Alternatively, spending on housing may increase if a retiree moves into specialized senior housing. The amount a retired household will spend on health care may fluctuate because health care costs can be variable and premiums and out-of- pocket medical costs may rise. Further, spending on entertainment and consumer goods may also fluctuate, according to the articles and reports we analyzed. Entertainment spending could increase because retirees have more leisure time, or alternatively, it is possible that it decreases due to the prevalence of entertainment-related senior discounts. In addition, spending on consumer goods and services, such as ready-to- eat foods or car repairs, may be less in retirement than before because retired households have more free time to engage in in-home production, which includes activities like cooking and household chores and repairs. Moreover, consumer durables purchased prior to retirement, such as furniture or household appliances, may continue working well into retirement and may not need to be replaced.

Table 3: Spending Considerations That Could Inform a Target Replacement Rate

Spending on housing	Housing expenses may change in retirement. For example, housing costs may go down if a retiree pays off a mortgage right before or during retirement or a retiree downsizes or moves to an area with less expensive housing. On the other hand, housing costs may go up if a retiree moves to specialized senior housing.
	Mortgages may not be paid off at the beginning of retirement. According to our analysis of the 2013 Consumer Expenditure Survey data, 35 percent of households aged 65-69 are paying down a mortgage.
Spending on health care	Health care costs may be more variable in retirement.Health care premiums and out-of-pocket medical costs may change.
Spending on work-related expenses	Work-related expenses, such as work clothing, meals outside the home, and transportation decline after retirement.
Spending on education	Retirees who finish paying off their children’s education right before retirement may need to replace less income.
Spending on entertainment	Entertainment expenses may go up for some retirees and down for others. For example, retirees have more leisure time and may spend more on entertainment. On the other hand, retirees may be able to stretch their dollars on entertainment due to senior discounts.
Spending on other consumer goods	Households may engage in more in-home production after retirement and, therefore, spend less money overall. Consumer durables purchased prior to retirement may last into retirement or may need to be replaced less often.
Theoretical views on consumption	Individuals may want to smooth consumption over a lifetime, or, more specifically, the marginal utility of consumption. However, consumption or spending patterns in retirement may fluctuate over time. For example, at the beginning of retirement, retirees may spend money on things like travel. Later on, their overall expenses may drop. As retirees age, expenses may rise again due to increased need for health care.
	Households may spend less in retirement for two reasons. On the one hand, they may spend less because they are content with consuming less, in part because they enjoy leisure time in addition to consumption. Alternatively, they may spend less because they have less income.

Spending from savings and assets	Some researchers have suggested considering whether people use their savings and assets for spending, and how to account for that when developing a target replacement rate.
Debt	Retirees may have major debts to pay off. Debt accumulation or reduction could affect the replacement rate a household will need to maintain its standard of living.
Socioeconomic status before retirement	Replacement rate targets may vary by income level. For example, lower-income households may need a higher replacement rate because they spend a relatively high proportion of their income on non-discretionary expenses such as food, clothing, shelter, and health care.
Taxes	Taxes may be different before and after retirement. After retirement, many retirees pay less of their income to taxes because they are no longer subject to Social Security payroll taxes, Social Security benefits are partially or fully tax free, and, according to some researchers, there are more income tax deductions for those aged 65 and over. In addition, retirees may be in a lower income tax bracket than prior to retirement. This decreases the percentage of income that needs to be replaced in retirement.
	People may move to a different state at retirement and, consequently, face higher or lower income taxes.

Source: GAO analysis of articles and reports discussing income replacement rates in retirement. | GAO-16-242

Household Size Also Affects Income Needs in Retirement

According to the articles and reports we reviewed, household characteristics, particularly household size, play an important role in determining a household's expenses, its income needs in retirement, and a target replacement rate (see Table 4). For example, the presence of children could also affect what a target replacement rate should be.

Researchers do not agree on how having had children affects a retired household's income needs. According to some researchers, retirees will focus on maintaining spending on themselves and will not need to replace income that went toward their children's consumption. Further, some researchers have hypothesized that after children move out, the household will save more; and because the household saves more, leaving less money to spend during its remaining working years, the percentage of income that needs to be replaced in retirement is reduced. On the other hand, other researchers have theorized that once children move out, households may not actually consume less. Instead, the parents may choose to use the money they had spent on their children on themselves. Thus, the percentage of income needed to be replaced in retirement may not be lower for retirees who had children versus those who did not.

Table 4: Household Characteristic Considerations That Could Inform a Target Replacement Rate

Marital status of household	The replacement rate needed for a married versus single household may be different because the cost of living for a couple is not twice the cost of living for a single person. Couples benefit from economies of scale because they share some resources, such as housing. Accounting for these economies of scales may be useful.
	Different target replacement rates may be useful for married households where only one spouse worked versus married households where both spouses worked.
	It may be difficult to identify a target replacement rate for a married household if the members of the couple retire at different times, especially if there is a substantial age difference between the two members of the couple.

	Potential changes in the composition of the household (e.g., change from married to single or vice-versa) could affect the replacement rate a household will need in retirement.
Role of children in the household	Some researchers have argued that retirees' goal will be to maintain spending on themselves only and, thus, households that had children before but not after retirement will need a lower replacement rate in retirement.
	Researchers have also hypothesized that after children move out, a household not yet retired will start saving at a higher rate, which could reduce the percentage of income needed to be replaced in retirement.
	On the other hand, other researchers have hypothesized that once children leave, households may not actually consume less and save more. Households may have become accustomed to a certain level of spending. Thus, the amount of income needed to be replaced in retirement may not be lower for retirees who had children.
	Retirees may have adult children move back into their house and, as a result, these children continue to be an expense.
Age of household at retirement	Target replacement rates for those retiring earlier may be lower. These households may be saving at a higher rate since they will not have as many years to save for retirement. As a result, they will be living off a smaller percentage of their income before retirement.

Source: GAO analysis of articles and reports discussing income replacement rates in retirement. | GAO-16-242

Target Replacement Rates Can Vary by Pre-Retirement Earnings Level or if Different Definitions of Earnings Are Used

Low earners had the highest target replacement rates and high earners the lowest target rate, according to studies we reviewed. Some of the studies in our review developed different target rates for workers based on earnings level before retirement. While these studies did not use the same earnings-level groups, their conclusions were consistent. Specifically, Aon Hewitt projected that workers earning under $30,000 would need a 98 percent replacement rate and that workers earning $90,000 would need to replace 79 percent of their income.

Lower earners may need a higher replacement rate for three reasons. First, as discussed earlier, they may spend a relatively high amount of their income on non-discretionary items. Second, research has shown low-income households save less than higher-income households. Thus, the reduction in saving in retirement will be less substantial for low-income households and they may need a higher replacement rate. Third, because low-income households pay little in taxes, they receive little in the way of tax saving in retirement.

In addition, how pre-retirement earnings are defined and calculated can have important implications for target replacement rates. More specifically, developers of target replacement rates must decide upon a period of earnings to use. Two options cited by the articles and reports in our review are final average earnings and average earnings over the course of a career. A final average earnings measure uses the average of annual earnings for a period of time leading up to retirement. Career average earnings measures, on the other hand, use the average of annual earnings over the course of someone's career, adjusted for inflation or wage growth. Furthermore, because different definitions of earnings can affect the final target replacement rate, it is important to understand how earnings were calculated and indexed. For example, adding up separate replacement rates provided by defined benefit plans and Social Security benefits to come up with a total replacement rate may not be accurate if the two rates did not use the same type of pre-retirement earnings or index these earnings the same way.

Other decisions may need to be made about how to account for work histories or changes in earnings or phased retirement. For example, women often have shorter careers than men. They tend to take a greater number of breaks from the labor force to care for children and elderly relatives. As a result, a replacement rate that uses career average earnings could be distorted by these breaks. In addition, changes to earnings late in a career can have a substantial effect on target replacement rates if final average earnings are used to calculate pre-retirement income.

Phased retirement could also change a target replacement rate, depending on how it is incorporated into the calculation. For example, if workers phase into retirement by reducing their hours and earnings over a number of years, then using the average of the final 5 years of earnings could result in a much lower measure of pre-retirement income than using career average earnings. Similarly, how retirement income is defined can have implications for target replacement rate recommendations.

Conclusions

Income replacement rates may be a helpful gauge for younger workers who have time to contribute more to retirement plans or adjust their saving. They can also be a useful metric for low- and middle-income households that may find they need to plan for replacing a substantial portion of their pre-retirement income in retirement. These households, in particular, may find they need to spend a sizable portion of their retirement income on basic needs, such as housing and health care.

Social Security's progressive benefit structure will help these households, but they will need other sources of income in retirement through defined contribution plans, pension benefits, or other means to make up the difference. At the same time, however, reports and articles we reviewed demonstrate that developing a customized replacement rate requires careful consideration to appropriately balance all of the underlying assumptions, including those related to determining pre-retirement and retirement income. The wide range of recommended target replacement rates cited in research indicates that there is no rule-of-thumb that will work for everyone.

Given these factors, workers may have difficulty understanding what target replacement rate to use based on their circumstances. Further, workers may have trouble operationalizing this information into a realistic savings strategy. This difficulty could be compounded by challenges in understanding how to convert defined contribution account balances into a potential income stream. If workers are unable to translate retirement account balances into income replacement goals, the benefit of replacement rates as a metric or guide is limited.

A copy of the full report can be found here .

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Footnotes

[15] We analyzed the 2013 CE data, which was the most current version of the survey at the time of our analysis. The unit of analysis in the CE is consumer units that comprise (1) all members of a household related by blood, marriage, or other legal arrangement, (2) a person living alone or sharing a household but who is financially independent, or (3) two or more persons living together who make joint expenditures. For the purposes of this report, we refer to consumer units as households and we define spending as direct out-of-pocket expenditures. The 95 percent confidence intervals for average total spending are between $56,014 and $60,890 for mid-career households (aged 45-49) and between $43,586 and $49,996 for young retiree households (aged 65-69). The 95 percent confidence interval for the difference in spending levels between the two groups is between $7,634 and $15,688. For exact estimates and additional information on the confidence intervals, see appendix III.

[16] For ease of presentation in this report, we used various age groups as proxies to represent different stages of working and retired life for points of comparison. Similar to other literature analyzing retirement consumption, we use

age 65 as a representation of retirement age. Accordingly, we selected 5-year age groupings based on their relation to this retirement age. For example, we used households aged 45-49, who are near the middle of the age group range and younger than retirement age, as a representation of the mid-career stage. We also chose three different age groups as points of comparison for various stages of retirement: young retirees are represented by households aged 65-69, those closest to retirement age; mid-retirees by households 75-79, who are several years older than retirement age; and older retirees by the oldest households, those aged 80 and older. However, actual career and retirement status by age would depend on individual household circumstances and is not known based on their age grouping. For example, some households in the "young retiree" group may not yet be retired, and some households younger than 65 could be retired.

[20] Housing expenditures include mortgage interest payments but not payments on mortgage principal. While mortgage principal payments may be significant for some families, we found that including these payments did not substantially alter spending patterns observed since housing was a major expense regardless of whether mortgage payments are included. For more information on our analysis of mortgage principal, see appendix II. For the share of spending on housing for households aged 45 and older, the 95 percent confidence intervals are within +/- 2 percentage points. For additional information on housing expenditure estimates and confidence intervals see appendix III.

[21] According to Survey of Consumer Finances estimates, homeownership has declined from a rate of 68.6 percent in 2007 to 65.2 percent in 2013. According to the American Housing Survey, about one-third of elderly households had a mortgage in both 2007 and 2013. Specifically, from the 2007 American Housing Survey, an estimated 5.3 million out of 18.3 million (or 29 percent) of elderly homeowners had a regular or home equity mortgage. According to data from the 2013 American Housing Survey, an estimated 7.1 million of 21.6 million (or 33 percent) of elderly homeowners had a regular or home equity mortgage. See Board of Governors of the Federal Reserve System, "Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances" *Federal Reserve Bulletin*, vol. 100, no. 4 (2014); U.S. Census Bureau, *American Housing Survey for the United States: 2007*, Series H150/07 (Washington, D.C.: 2008); and U.S. Census Bureau, *2013 American Housing Survey for the United States* (Washington, D.C.: 2015).

[25] Income categories were defined by age-specific income brackets. As a result, for a given age group, each income bracket has approximately the same number of households. For income quartile ranges, see appendix I.

[30] Our analysis focused on total replacement rates, that is, the ratio of all income in retirement—including from Social Security, pension benefits, and retirement savings—to pre-retirement earnings. For this analysis, we reviewed 59 articles and reports discussing income replacement rates in retirement. These reports were published in academic journals or by research centers or international organizations. We sought to identify a number of considerations that researchers, policy makers, and financial professionals incorporate into their assumptions when developing, calculating, or evaluating target replacement rates. However, because analyzing the merits and disadvantages of each consideration was outside the scope of our work, we are not endorsing any of the considerations presented in this report. For a complete list of reports and articles reviewed and more information on our methodology, please see the bibliography at the end of this report. Also, for more information on factors that could inform a target replacement rate in addition to spending, household characteristics, and pre-retirement earnings, see appendix IV.

Endnotes

[i] Notes: Age groupings are based on the age of the reference person, or the person who rents or owns the home, for the consumer unit. There may be adults in the consumer unit who are older or younger than the reference person. Similar to other literature analyzing retirement consumption, we use age 65 as a representation of retirement age. For ease of comparison purposes, we use age groups to represent various stages of working and retired life based on their relation to this retirement age.

However, actual career and retirement status would depend on individual household circumstances and would not be known based on their age grouping. A consumer unit can comprise (1) all members of a household related by blood, marriage, or other legal arrangement, (2) a person living alone or sharing a household but who is financially independent, or (3) two or more persons living together who make joint expenditures. For the purposes of this report, we refer to consumer units as households. We did not adjust spending levels for household size. The "other" category of spending includes expenditures for reading, tobacco, alcoholic beverages, education, cash contributions, personal care, and miscellaneous expenses. The "personal insurance and pensions" category

[ii] Notes: Age groupings are based on the age of the reference person, or the person who rents or owns the home, for the consumer unit. There may be adults in the consumer unit who are older or younger than the reference person. A consumer unit can comprise (1) all members of a household related by blood, marriage, or other legal arrangement, (2) a person living alone or sharing a household but who is financially independent, or (3) two or more persons living together who make joint expenditures.

For the purposes of this report, we refer to consumer units as households. We did not adjust spending levels for household size. Housing expenditures include expenses such as rent, utilities, and mortgage interest payments, but do not include payments on mortgage principal. For more information on mortgage principal, see appendix II. The "no cash or student" category represents housing that is occupied as student housing or without payment of cash rent. The percentage of households in this category for all age groups over 45 was around 1 percent or less. For all average housing expenditure estimates in this figure, 95 percent confidence intervals are within +/- 9 percent of the estimate itself. For housing status shares in this figure, 95 percent confidence intervals are within +/- 4 percentage points. For additional information on the confidence intervals for the estimates in this figure, see appendix III.

[iii] Notes: Age groupings are based on the age of the reference person, or the person who rents or owns the home, for the consumer unit. There may be adults in the consumer unit who are older or younger than the reference person. A consumer unit can comprise (1) all members of a household related by blood, marriage, or other legal arrangement, (2) a person living alone or sharing a household but who is financially independent, or (3) two or more persons living together who make joint expenditures. For the purposes of this report, we refer to consumer units as households. We did not adjust spending levels for household size. Income categories were defined by age-specific income brackets. As a result, each income bracket at each age group has approximately the same number of households. See appendix I for income quartile ranges. Income includes some non-wage sources from public programs, such as Supplemental Security Income and unemployment compensation. The "other" category of spending includes expenditures for reading, tobacco, alcoholic beverages, education, cash contributions, personal care, and miscellaneous expenses. The "personal insurance and pensions" category includes deductions for government and railroad retirement, private pensions, and Social Security. According to Bureau of Labor Statistics officials, the private pensions category includes defined benefit, defined contribution, and individual retirement accounts. Housing expenditures include expenses such as rent, utilities, and mortgage interest payments, but do not include payments on mortgage principal.

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