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WHAT FINANCIAL RISKS DO RETIREES FACE IN LATE LIFE?

BY MATTHEW S. RUTLEDGE AND GEOFFREY T. SANZENBACHER*

Introduction

Rising life expectancy means that many more Americans will reach very old ages. While longer lives are undeniably positive, they also mean that more people will face late-life financial risks for which they may be unprepared. These late-life risks include high out-of-pocket medical expenses; an increased possibility of financial mistakes due to declining cognitive abilities; and the specter of widowhood.

The situation is generally expected to become more challenging, because future retirees will be more reliant on often-modest 401(k)/IRA lump sums rather than the automatic lifelong payment stream of a traditional pension plan. At the same time, a rising Full Retirement Age means monthly Social Security checks will provide less relative to pre-retirement income at any given claiming age. In short, future retirees will likely have less reliable income as they reach advanced ages.

This *brief* reviews research by the U.S. Social Security Administration's Retirement Research Consortium and others on the nature and extent of late-life financial risks. The *brief* is organized as follows. The first section explains how demographic and economic changes are leading to a larger population susceptible

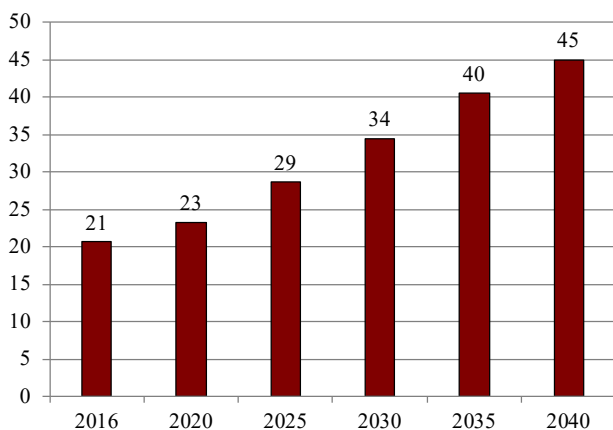
to these risks. The second section explores the nature of the three risks outlined above. The final section concludes that out-of-pocket medical expenses, financial mistakes, and widowhood tend to severely impact the finances of only a minority of older Americans today, but that those threats may be more widespread in the future.

Background

Understanding the financial risks faced by Americans ages 75 and over – a population that is projected to more than double by 2040 (see Figure 1, on the next page) – is important for two reasons. The first reason is that physical and mental health problems become much more pronounced at these ages, meaning that people run the risk of draining their savings through high out-of-pocket medical costs or financial mistakes. The second reason is that people will increasingly face these challenges with 401(k)s, which provide lump sum assets that may be hard to manage with age, especially since initial balances tend to be modest.

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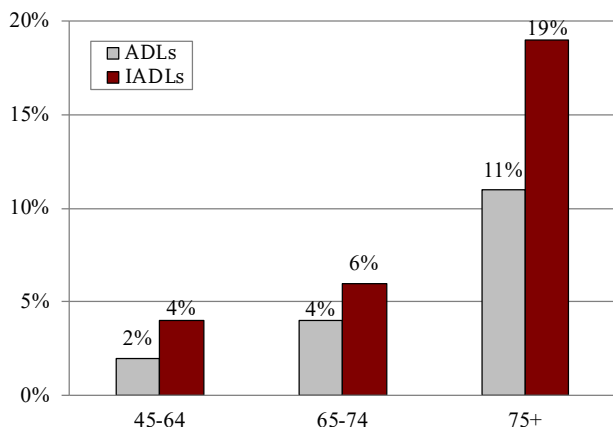
FIGURE 1. CURRENT AND PROJECTED U.S. POPULATION AGES 75+, 2016-2040 (IN MILLIONS)



Source: U.S. Census Bureau (2017).

On the health front, the share of individuals who have difficulty performing basic Activities of Daily Living (e.g., bathing or eating) or more complex Instrumental Activities of Daily Living (e.g., cooking or shopping) increases dramatically after age 75 (see Figure 2). These conditions can require professional in-home care or even long-term care at an institutional facility, both of which are often expensive.

FIGURE 2. PERCENTAGE OF POPULATION WITH ACTIVITY LIMITATIONS BY AGE, 2014



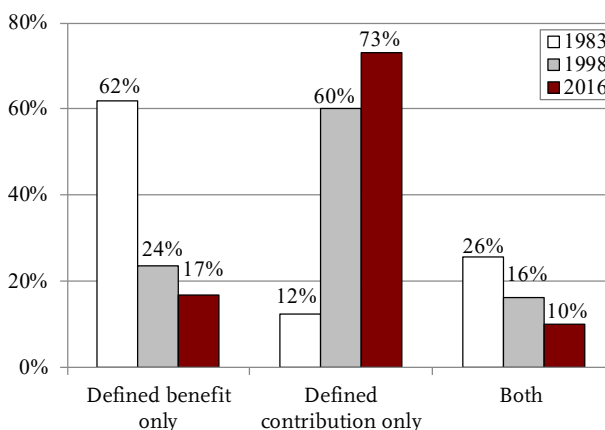
Source: Centers for Disease Control and Prevention, *National Health Interview Survey* (2014).

The incidence of cognitive decline also begins rising after age 75, with the rate of dementia growing quickly from 7 percent for people in their early 70s to roughly a quarter for those in their early 80s, raising the risk of financial mistakes or fraud.¹ And, accord-

ing to the Social Security Administration, a woman age 62 today has a 20-percent chance of becoming a widow by 75 and a 33-percent chance by 85.² In other words, as people age, the risks to their physical health, mental health, and their spouse's health increase dramatically.

On the financial front, the growing group of older retirees facing these physical and cognitive health risks will be much more reliant on 401(k) plans, which provide a lump sum, than on traditional pensions, which provide a stream of income (see Figure 3). DC plans are harder to manage with age, in part because individuals must decide how best to draw down their nest egg.

FIGURE 3. WORKERS WITH PLAN COVERAGE BY TYPE OF PLAN, 1983, 1998, AND 2016



Source: Munnell and Chen (2017).

Of course, risks to retirees' financial health in old age would not be a major concern if people arrived at retirement with sufficient wealth and were unlikely to run out. However, few have large nest eggs; the typical household nearing retirement with a 401(k) today has only about \$135,000 in 401(k)/IRA assets, which – even if annuitized – would only provide about \$600 per month.³ And that number is for people with a plan; nearly a third of all households nearing retirement have no retirement savings. In addition, Social Security replacement rates are declining at any given claiming age due to the increase in the Full Retirement Age. In other words, the future will see an increasing number of older retirees relying on relatively small 401(k) balances and on Social Security checks that do not stretch as far. The question is, what does existing research tell us about the risks that retirees face in late life?

Late-Life Risks

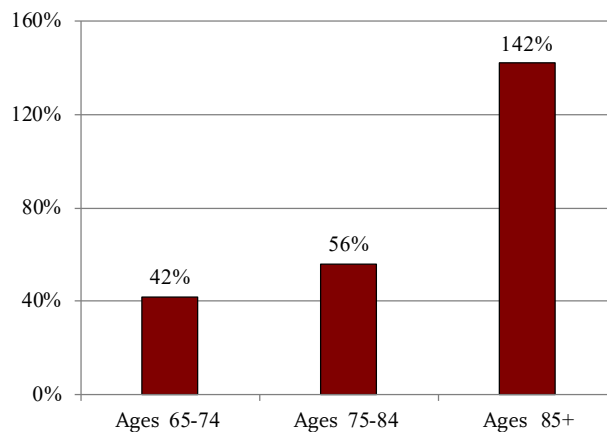
Researchers involved in the Retirement Research Consortium identify three risks to financial health in late life posed by: 1) out-of-pocket costs for both standard health care needs and long-term care; 2) cognitive decline leading to mistakes; and 3) the prospect of widowhood.

Out-of-Pocket Medical Costs

Even though Medicare provides universal health coverage to retirees, out-of-pocket costs can still pose a substantial burden for elderly households, even prior to any need for long-term care. Medicare enrollees pay premiums for Parts B and D and any supplemental coverage; contribute a portion of the cost of Medicare-covered services they receive through copayments and deductibles; and face the full cost of the many services not covered by Medicare (e.g., dental and vision). The question is how much these costs actually threaten financial health. A recent study by McInerney, Rutledge, and King (2017) found that, for those ages 75+, these out-of-pocket costs amounted to about 20 percent of their total income. This share is significant, but perhaps manageable for most households. However, the study points out that, for about 5 percent of households, these standard out-of-pocket expenses eat up over half of total income, potentially causing them to dig into their wealth to make ends meet.

Once long-term care costs are included, the picture becomes slightly less sanguine. A recent study by Jones et al. (2018) estimates that the average household – from their early 70s on – will incur about \$100,000 in total out-of-pocket medical spending including long-term care, and that the top 5 percent of spenders will incur almost \$300,000. Another recent study by Cubanski et al. (2018) illustrates how this tail risk grows with age. Looking at the top 10 percent of spenders, the study shows that, among older households, costs can dwarf income (see Figure 4). Although Medicaid mitigates the risks of these very high amounts for the poor, for those with 401(k) wealth, who tend to be higher income, these costs can end up eating into their wealth.⁴ The saving grace is that about half of the people approaching retirement never require nursing home care, even in old age.⁵ This fact means that although the tail risk tends to be high, costs at the median may be more manageable.

FIGURE 4. 90TH PERCENTILE OF OUT-OF-POCKET HEALTH SPENDING AS PERCENTAGE OF TOTAL INCOME BY AGE, 2013



Note: These data include standard health care costs and long-term care costs.

Source: Adapted from Cubanski et al. (2018).

The conclusion from these studies is that, to date, out-of-pocket costs pose a risk to some retirees, but mainly to those in the tail of the distribution of costs. People in the middle bear a noticeable burden that likely crimps their standard of living, but might not put their finances at risk. However, analysts expect out-of-pocket health costs to continue to grow faster than retirees' income, meaning that these costs may have more of an impact on a larger portion of the distribution in the future.⁶

Managing Money with Declining Cognition

In addition to the risk of high out-of-pocket medical costs, aging individuals can experience a decline in their ability to manage their money, which increases the risk of making routine financial mistakes and of falling victim to fraud. These risks will only be more acute in the future, as households' entire retirement savings – their 401(k)/IRA assets – are potentially more vulnerable to an act of fraud, instead of just a single monthly pension check. The basic issue is that financial skill tends to deteriorate for many in their 70s. At first, minor things start occurring, like forgetting to pay certain bills.⁷ However, when severe decline such as dementia sets in, the vast majority of people lose the ability to manage their finances at all.⁸

While many individuals can get help from a non-impaired spouse, Belbase and Sanzenbacher (2017b) point out that aging households are more vulnerable to mismanagement when the financially savvy spouse dies early or becomes cognitively impaired – especially because that spouse may be unaware that he is slipping until it is too late.⁹

Not surprisingly, the risk of falling victim to fraud rises with age. Compared to 40-somethings, seniors are more likely to be solicited by fraudulent investment schemes, and nearly one in six seniors reported losing money in such a scheme.¹⁰ One reason they may be vulnerable appears to be overconfidence. Many seniors report being confident in their financial aptitude, but nonetheless get basic financial literacy questions wrong. When they do, Gamble, Boyle, Yu, and Bennett (2014) find that they are more likely to be the victims of fraud down the line.

While the financial challenges of cognitive decline clearly are cause for concern, the size of this problem to date seems to be relatively small. A key reason is that those who do need help with their finances often get effective assistance. For example, Belbase and Sanzenbacher (2017a) find that about 85 percent of dementia sufferers have some form of help managing their money, and they fare as well in avoiding severe financial hardships as those without a cognitive impairment. Still, those who get no help are about 7 percentage points more likely to experience severe hardships such as difficulty paying for food, housing, and medical bills (see Figure 5).

And while Belbase, Sanzenbacher, and King (2018) report that Social Security’s Representative Payee program (which assigns a third party to receive and manage someone’s benefits) could be one way to help, it is not frequently used even by those with dementia and is not designed to assist with any non-Social Security income.

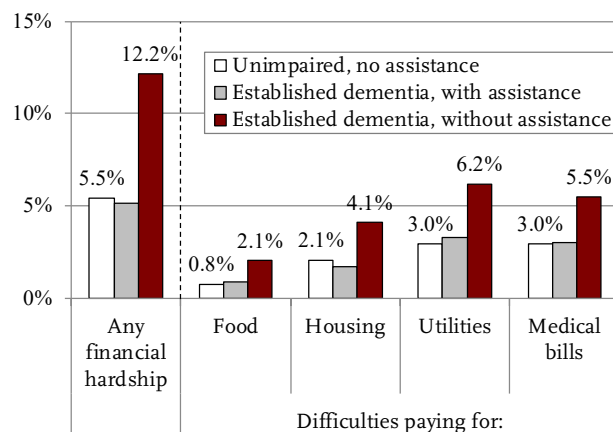
The takeaway from these studies seems similar to those on out-of-pocket expenses: the financial threat posed by cognitive decline is smaller today than it may be in the future. So far, cognitive decline has affected the finances of some individuals, but far from a majority. The mitigating factor seems to be having a source of help, and most people have it. However, in the future, having such assistance will be more important, as less income comes from Social Security and traditional pensions and more comes in a lump sum that is more vulnerable to fraud. In addition, tomorrow’s retirees will have fewer children to support them than their parents did, and children are a primary source of financial management assistance.¹¹

The Risk of Widowhood

In the past, widowhood resulted in poverty for many women – but recently that risk has declined. According to Munnell, Sanzenbacher, and Zulkarnain (2018), the poverty rate for widows dropped from 20 percent in 1994 to 13 percent in 2014 due to women’s increasing labor force participation and education. Furthermore, that study predicts that the poverty rate for widows will continue to drop, partially because marriage has become more “selective” – higher socioeconomic status (SES) individuals are more likely to be married today than those with lower SES. Although, it is worth noting that this research on poverty assumes Social Security benefits remain unchanged; if benefits were reduced to improve the program’s long-term financial situation, poverty rates could worsen again.

In any case, poverty is an extreme measure of financial stress. A broader potential concern is how widowhood will affect the ability of women to maintain their standard of living in retirement. Sass (2018) points out that the increasing reliance on financial wealth introduces new challenges that will likely mean widows can replace less of their pre-retirement income than in the past. Munnell and Eschtruth (2018) provide one counterintuitive reason for this increased reliance – women are working more and earning more relative to their husbands. Because of

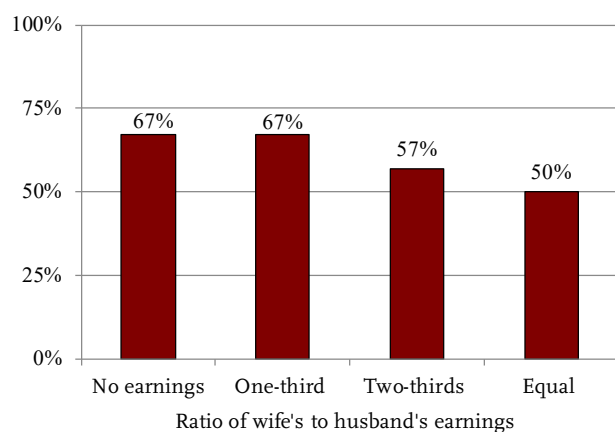
FIGURE 5. INCIDENCE OF FINANCIAL HARDSHIPS BY COGNITIVE HEALTH STATUS AND AVAILABILITY OF AID



Source: Belbase and Sanzenbacher (2017b).

the way Social Security widow benefits are designed – with a widow entitled to the larger of her own benefit or her husband’s – this change means that widows’ household income from Social Security drops more than it used to when a husband dies (see Figure 6). So, while poverty may be less likely in the future for widows, a drop in their standard of living or the need to dig into their wealth might become more common.

FIGURE 6. WIDOW BENEFIT AS A PERCENTAGE OF COUPLE’S COMBINED BENEFIT, BY RATIO OF WIFE’S-TO-HUSBAND’S EARNINGS



Note: This example assumes both spouses claim at the Full Retirement Age and the husband’s benefit replaces 40 percent of his pre-retirement earnings.

Source: Munnell and Eschtruth (2018).

Indeed, Poterba, Venti, and Wise (2017) report a modest drop in wealth for today’s women who experience widowhood, although they point out that research based on today’s retirees – who often still have considerable amounts of annuitized wealth – may not say much about the future. Consistent with the other threats faced by older Americans, widowhood may affect women’s finances more in the future than it does today.

Conclusion

The United States is facing a challenge – the number of individuals ages 75+ is growing, and this group will be more reliant on 401(k) wealth and less on traditional pensions and Social Security. This *brief* focused on three risks to their financial health: 1) out-of-pocket medical costs; 2) cognitive decline; and 3) widowhood. The takeaway from the research literature seems to be that, so far, these risks adversely affect some retirees severely, but this outcome may not be that common. However, in the future, a growing number may experience such an outcome. The silver lining is that these challenges can be seen in advance, so researchers, policymakers, and individuals themselves have time to develop and implement solutions.

Endnotes

- 1 Belbase and Sanzenbacher (2017a).
- 2 U.S. Social Security Administration (2018).
- 3 See Munnell and Chen (2017).
- 4 Poterba, Venti, and Wise (2017) report a modest increase in the share of married couples with less than \$100,000 in financial assets following worsening health.
- 5 Hurd, Michaud, and Rohwedder (2017).
- 6 In their study, Cubanski et al. (2018) expect the share of income paid to out-of-pocket costs to grow by roughly 20 percent for Medicare beneficiaries between 2013 and 2030.
- 7 Indeed, the Alzheimer's Association (2018) cites forgetting to pay bills as a possible early sign of Alzheimer's.
- 8 Korniotis and Kumar (2011) and Belbase and Sanzenbacher (2017b).
- 9 Hsu and Willis (2013) find that households often do not change management of their finances from the spouse with dementia to the unimpaired spouse until after the dementia diagnosis.
- 10 FINRA (2013).
- 11 See Belbase and Sanzenbacher (2017a).

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