'Credit Crunch' Will Hit Retirees in Unequal Ways

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(PhysOrg.com) -- How severely retirees will be affected by the continuing financial crisis and subsequent "credit crunch" depends to a considerable extent on the kinds of retirement plans they rely on for retirement income, according to a University at Buffalo Law School professor who specializes in the regulation of retirement plans and other employee-benefit plans.

"Retirees in the United States commonly rely on one or more of three sources of income: Social Security, employer-provided pension benefits and individual retirement savings arrangements such as 401(k) plans, 403(b) plans and individual retirement accounts," says UB Law Professor James A. Wooten. "Retirees who receive pensions from Social Security or their employer should see little effect from the financial crisis, while individuals who depend on a 401(k) plan or an IRA may be hit hard."

Social Security is the most important source of income for U.S. retirees. Social Security, Wooten observes, is a "defined-benefit" plan. Retirees receive a stream of regular cash payments (an "annuity") based on a formula in federal statutory law. "Because Social Security retirement benefits are based on a formula," he says, "the annuity payments that retirees receive do not depend on the short-term performance of financial markets."

Employer-sponsored pension plans are another very important source of retirement income. Like Social Security, employer-sponsored pension plans are "defined-benefit" plans that traditionally have paid retirees an annuity. "As with Social Security," says Wooten, "the annuity a retiree receives from a defined-benefit plan does not depend on the short-term performance of financial markets. So the turmoil in financial markets will not affect the annuities paid to current retirees."

Over the longer term, however, volatility in the financial markets may have a big effect on employer-sponsored pension plans. "If a defined-benefit plan's investments perform poorly," Wooten says, "the employer that sponsors the plan will have to make larger financial contributions to fund the benefits it has promised. Recently a number of private-sector employers have dropped their traditional pension plans, which provided annuities to retirees, and replaced it with a 401(k) plan, which does not offer annuities. The increased burden of funding traditional pensions may accelerate the trend away from defined-benefit plans and toward 401(k) plans."

A third important source of income for retirees are individual retirement savings arrangements, which include "defined-contribution" plans, such as 401(k) and 403(b) plans and individual retirement accounts (IRA). An individual who participates in a defined-contribution plan or holds an IRA contributes to a personal account that resembles a savings or mutual-fund account. The individual's employer also may make contributions to the account. The amount of funds the individual has available for retirement depends on how much the individual and his or her employer contribute to the account and how well the investments in the account perform. In contrast to Social Security and employee-sponsored defined-benefit plans, a person with a 401(k), 403(b) or IRA account bears investment risk, according to Wooten.

"If the investments in the account do well," Wooten says, "the account holder will have more money for retirement. If the investments do badly, the account holder will have less retirement income available. For retirees, this will mean reducing consumption or increasing income (by, for example, getting a job). For employees, it is likely to mean deferring retirement."

Wooten is the author of "The Employee Retirement Income Security Act of 1974: A Political History," a book-length study of the most important federal law regulating private-pension plans. More recently, he prepared a study of pension-funding issues for the Ontario Expert Commission on Pensions, which is conducting a comprehensive review of the regulation of retirement plans in Ontario.

Provided by University at Buffalo