Aging and Retirement

The Impact of COVID-19 and the CARES Act on Retirement Readiness for American Workers

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Executive Summary

Everyone is aware of the impact that COVID-19 has had on the U.S. economy. Unemployment in the U.S. was running at 3.5% pre-COVID-19 and drastically peaked in April at 14.7%. It has steadily dropped to 8.4% as of August 2020[1]. For context, 8.4% represents over 13 million workers unemployed[2].

The U.S. Federal Government stepped in with significant aid, passing the Coronavirus Aid, Relief, and Economic Security (CARES) Act on March 27, 2020. The CARES Act provided over $2 Trillion in aid to employers and workers as well as state and local governments. In particular, the CARES Act included provisions that increased the ability of savers to access their retirement savings accounts. For those workers who suffered job loss and/or health problems due to COVID-19, Coronavirus-Related Distributions (CRDs) provided much needed funds to assist them through short-term financial distress. However, these CRDs will have long-term financial consequences on the worker's retirement readiness. We estimate that for a person age 45, for every $1 of CRD withdrawn, their retirement balance at age 65 would be reduced by over $2.50[3]. According to a study by Fidelity[4], 3.6% of participants took CARES Act withdrawals, and the healthcare industry showed similar results. Also, from the same study, less than 1% took CARES Act loans. It is these participants—those who took withdrawals and loans—that will be particularly affected long-term.

Beyond the leakage from the retirement system due to CRDs, COVID-19 has provided us with an opportunity to examine our retirement system and the general financial wellness of American workers amidst very stressful times. What have we learned, and what can we expect moving forward?

In this paper, we will assess the impact of the CARES Act on workers' financial behavior and examine four major issues caused or brought to light by the COVID-19 pandemic:

1. The need for emergency savings, budgets, and overall financial wellness.
2. Inherent problems with an employment-based retirement system.
3. The benefits of professional asset management in defined contribution plans.
4. The ongoing difficulty of saving for retirement in a low interest rate world.

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[1] Source: https://www.bls.gov/charts/employment-situation/civilian-unemployment-rate.htm
[2] Source: https://www.bls.gov/news.release/empsit.nr0.htm
[3] Source: Author's calculations—see appendix A.
[4] Source: https://sponsor.fidelity.com/bin-public/06_PSW_Website/documents/COVID-19_Fid_trends_insight.pdf; p.5 NOTE: This link was not working for me

CARES Act—Retirement Provisions and Experience

The CARES Act was the largest economic stimulus package ever passed by the U.S. Government[5]. The CARES Act provided direct payment to individuals, supported unemployment benefits, and provided payments to employers and state and local governments. It also included liberalization of certain distribution provisions for defined contribution plans as follows:

1. Distribution Right. Distribution right of $100,000 from the plan (not to exceed the participant's account balance) through December 31, 2020 that is subject to special tax relief.
2. Loan Limit Increase. Increase in the loan limit under Code section 72(p) from $50,000 to $100,000 (or 100% of the participant's account balance, if less) for loans made from March 27, 2020 through September 22, 2020.
3. Loan Suspension. Suspension of loan payment due March 27, 2020 through December 31, 2020 for up to one year.
4. RMD Relief. Suspension of 2020 required minimum distributions.

The first two changes, distribution right and loan limit increase, directly increase affected participants' access to retirement savings. The third, loan suspension, provides a safety valve by temporarily reducing loan repayments. Collectively, these first three provisions reduce dollars in a participant's account. Within the retirement community, this reduction is called "leakage," which are dollars flowing out of the retirement system years before retirement. Studies by Vanguard have shown that participants who choose to access their retirement assets early may experience harsh effects on their retirement funds. According to Vanguard's study, through May 31, 2020, "the median distribution amount was $10,413, the median age was 43, and the median income was about $62,000. If we assume a real investment return of 4%, researchers asserted that median participant distribution would grow to about $25,000 over the next 24 years[6]." The fourth change, RMD Relief, provides relief by removing the requirement to liquidate a portion of your retirement savings. At the time of the CARES Act passage, the markets were down substantially, and no one knew when they would recover. This relief allowed participants to not "sell low," thereby crystallizing losses in their retirement accounts.

So, what has been the actual experience of workers with CRDs?

Most studies from recordkeepers Vanguard and Fidelity show that few participants took CRDs. According to the above-mentioned studies by Vanguard, only 1.9% of participants initiated a CRD through May 31, 2020. In a study by Fidelity, researchers found that between April 1, 2020 and July 31, 2020, only 3.6% of participants took CRDs[7].

The Need for Emergency Savings, Budgeting and Financial Wellness

For those workers who became unemployed due to COVID-19, the financial stress was immediate and significant. Despite expanded direct financial support from the CARES Act, Fidelity's COVID-19 report shows that about 881,000 workers did tap into their retirement savings with CRDs. Around 53,000 took out loans. These workers were willing to go through the administrative difficulty of accessing their retirement savings to make ends meet. Recovery from these withdrawals will take years—through increased savings and/or by working longer.

[5] Source: https://www.heritage.org/budget-and-spending/commentary/how-big-the-covid-19-cares-act-relief-bill
[6] Source: https://institutional.vanguard.com/iam/pdf/HASITACC_072020.pdf?cbdForceDomain=true; p.9 NOTE: this link is not working for me
[7] Source: https://sponsor.fidelity.com/bin-public/06_PSW_Website/documents/COVID-19_Fid_trends_insight.pdf NOTE: this link is not working for me

Nearly six months into living with COVID-19, it has become apparent that workers need to have emergency savings for unforeseeable crises such as this one. Is six months' worth of expenses enough? Twelve? ProManage suggests that workers accumulate an initial amount of $1,000 in emergency savings and a maximum amount of 4 months' pay. However, 60% of millennials say they don't have enough savings to manage a $1,000 emergency expense[8]. About 52% of Americans say they couldn't handle such an expense, while a third of Americans say they are still in debt from borrowing money to pay for a previous crisis, 33% of whom owe $5,000 or more[9]. Employers can help workers set up expense budgets, establish emergency funds, and provide resources to help their employees achieve overall financial wellness goals.

About 44% of workers who can provide an estimate of their retirement savings needs say they came up with those figures by guessing; some used their current living needs as a basis and others used a retirement calculator[10]. Employers, namely those who offer a managed account service to their employees, should explore ways in which they can offer their employees updated estimates of their retirement funds on a regular basis. Sixty percent of workers would like more educational tools from their employers when it comes to retirement preparation; this preference is "highest among Millennials", at 73%[11]. Financial wellness programs can help workers move in the direction of reducing their high-cost debt, student loans, etc. Many workers are also not very familiar with the details of their spouses' retirement plans; knowing their spouses' progress would give them a more realistic idea of how much money they need to save for retirement. Financial wellness tools can help make employees more aware of the need to consider such factors.

Employers should also consider ways in which they can better facilitate their workers' transition into retirement. Only 36% of workers say their employers help with this shift via opportunities like flexible work schedules; this flexibility can help workers more easily transition from full-time to part-time employees and ultimately to retirees[12].

Inherent Problems with an Employment-Based Retirement System

In the US, we rely on the traditional three-legged stool of retirement savings—Social Security, Employment-Based Plans, and Personal Savings. How much we rely on each part of this system is based on our collective societal decisions. Each part has a substantial role to play to maintain a healthy system. Employment-based plans are now heavily skewed towards defined contribution plans. Workers in the private sector whose only retirement account is a defined benefit pension plan have decreased by 56% since the 1980s[13]. While there are advantages of being enrolled in a defined contribution plan, such as clear tax advantages and easily comprehensible plan provisions, there is ultimately no guarantee of the actual amount of money one will have at the point of retirement. Additionally, in defined benefit plans, the employers take on the financial risk whereas in defined contribution plans, employees carry the risk.

Overall, both defined benefit plans and defined contributions plans have been affected by the pandemic. The effect of COVID-19 on the financial markets has worsened DB underfunding, which has been a longstanding issue for DB plans; while DC plans are now standard in many parts of the world, they suffer when capital markets underachieve[14]. For those employees who have lowered or stopped their contributions due to COVID-19, the

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[8] Source: https://www.cnbc.com/2019/03/11/how-much-money-americans-have-in-their-savings-accounts-at-every-age.html
[9] Source: https://www.cnbc.com/2018/12/19/60-percent-of-millennials-cant-cover-a-1000-dollar-emergency.html
[10] Source: https://transamericacenter.org/docs/default-source/retirement-survey-of-workers/tcrs2020_sr_retirement_security_amid_covid-19.pdf, p. 89
[11] Source: https://transamericacenter.org/docs/default-source/retirement-survey-of-workers/tcrs2020_sr_retirement_security_amid_covid-19.pdf, p. 111
[12] Source: https://transamericacenter.org/docs/default-source/retirement-survey-of-workers/tcrs2020_sr_retirement_security_amid_covid-19.pdf, p. 118
[13] Source: https://money.cnn.com/retirement/guide/pensions_basics.moneymag/index7.htm
[14] Source: https://www.plansponsor.com/covid-19-made-retirement-system-weaker/

financial hit can be especially damaging. Those who stopped contributing completely and who don't restart contributing will experience additional harm by missing out on future match contributions. Employers should pay special attention to this group of participants; when left to their own, these participants are likely to experience the inertia inherent to voluntary savings systems, like DC plans, which will work to their disadvantage.

If workers are unable to finance their retirement with their employer-based retirement funds, they will need to depend more heavily on Social Security and personal savings. Living off Social Security alone can be quite strenuous. For example, if John is making $100,000 annually and plans to retire at age 70 in 2021, his estimated predicted Social Security earnings in 2021 will be $35,532. One common suggestion is that workers seek to replace 80% of their pre-retirement income upon reaching retirement[15]. However, in a 2012 study by Dimensional Fund Advisors, researchers prorated this income replacement rate for four income groups[16]. The replacement rate ranged from 82% for workers making $25,870 ($29,287 in 2020 dollars) or less annually to 58% for workers making $86,882 ($98,357 in 2020 dollars) or more annually. John's expected Social Security earnings would replace only about 35% of his pre-retirement income.

The addition of personal savings would not provide much relief. According to findings from the Federal Reserve's 2016 Survey of Consumer Finances, the average American family has $40,000 in savings across demand accounts[17]. While a portion of these savings is likely intended for retirement planning, this money will likely be dipped into for a variety of other reasons, such as emergency expenses, mortgages, college expenses, vacations, etc.

Periods of unemployment have a tremendous impact on overall retirement savings. While the current pandemic has aggravated unemployment numbers, this reality is hardly a new one for many Americans, particularly American women. The financial consequences of unemployment periods have long impacted women due to childcare and family care issues. In 2020, 65% of caregivers in the U.S. are female. Since the current U.S. retirement system does not take into consideration these caregiving roles, many women are ultimately left with fewer retirement benefits[18]. Studies show that COVID-19 has brought on more impediments for women's retirement readiness, including: increased child care and elder care costs because of periods of self-isolation and quarantine during the pandemic, salary reduction, an increased divorce rate, and economic insecurity[19].

In many ways, COVID-19 has brought to light the unemployment problem in general, but we are now facing the reality that these high unemployment rates are skewed to lower-paid service employees, most of whom already suffer from low retirement plan coverage. Low coverage rates have spread widely due to the rise in non-traditional work, including gig work, for part-time and self-employed people who do not have an employer-based retirement saving arrangement. It is estimated that the retirement savings gap "will grow by 5% each year to $400 trillion by the year 2050"[20]. Fortunately, several states have been working to amend these disparities with state sponsored alternatives. During the 2020 legislative sessions, at least 20 states and cities have introduced legislation to establish new programs or form committees to look at new state-sponsored retirement options. Several new programs have one or a combination of four retirement models: Auto-IRA, Voluntary Payroll Deduction Roth IRA, Multiple Employer Plan, and Marketplace.[21] Look for more of these programs going forward to help with the retirement plan coverage issue.

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[15] Source: https://www.fedweek.com/tsp/80-percent-rule-retirement/
[16] Source: http://skylinefinancialnw.com/wp-content/uploads/2015/04/How-Much-Should-I-Save-for-Retirement.pdf
[17] Source: https://www.businessinsider.com/personal-finance/average-american-savings#average-american-savings-balance-by-age
[18] Source: https://www.wiserwomen.org/resources/retirement-planning-resources/andthe-pay-gaps-connected-to-the-retirement-gap/
[19] Source: https://www.marketwatch.com/story/saving-for-retirement-already-challenged-women-then-covid-19-hit-2020-09-14
[20] Source: https://repository.upenn.edu/prc_papers/677/, World Economic Forum in 2017 quoted, p. 2
[21] Source: https://cri.georgetown.edu/states/

Professional Asset Management in Defined Contribution Plans Work

Defined contribution plans require that workers make two key decisions—how much to save and how to invest.

On the savings front in response to COVID-19, it is good news. Data has shown that most U.S. workers did not make any significant investment changes due to COVID-19. In a survey of 9,675 U.S. adults, Forbes Advisor found that only 5% of those surveyed have made any changes to their asset allocation, 4% have lowered their 401(k) and/or IRA contributions, and only 2% have frozen those contributions[22].

On the investment front, defined contribution plans in general started from a good position. A Vanguard study in 2018 showed that 6 in 10 participants had professionally managed allocations—52% were in a target date fund, 4% used managed accounts and 3% used a balanced fund[23].

From this good starting point, participants' investment response to COVID-19 has been excellent. A Morningstar study shows that overall, only 6% of participants changed their investment allocations. Looking deeper in the data, of those participants who are self-directed, around 11% changed their allocation in the first quarter of 2020 while only 2.4% of participants using a target-date fund did[24]. Participants with professionally managed portfolios who changed their portfolios "tended to be older, with longer plan tenures, higher deferral rates, higher salaries, higher balances, and more-conservative equity allocations"[25]. Following is Morningstar's overview of equity allocation changes during the first quarter, where participants are grouped by their investment category and their equity allocations as of December 31, 2019[26]:

[22] Source: https://today.yougov.com/topics/health/survey-results/daily/2020/05/05/ca524/2
[23] Source: https://pressroom.vanguard.com/nonindexed/Research-How-America-Saves-2019-Report.pdf, p. 5
[24] Source: https://www.morningstar.com/lp/keep-your-distance, p. 1
[25] Source: https://www.morningstar.com/lp/keep-your-distance, p. 3
[26] Source: https://www.morningstar.com/lp/keep-your-distance, p. 15

		Equity Allocation (%)							
		< 10	10-25	25-45	45-55	55-75	75-90	>= 90	Average
Panel A % of Participants Changing Allocation by Initial Equity Level	Self-Directors	6.8	15.5	12.5	11.2	12.9	12.3	8.7	10.8
	Target-Date Fund	n/a	n/a	2.8	2.8	2.5	2.2	2.1	2.4
	Default Managed Accounts	1.1	0.7	1.5	1.9	1.6	1.0	1.0	1.3
	Opt-In Managed Accounts	2.7	3.4	2.1	2.5	2.0	1.7	1.3	1.8
Panel B Average Absolute Change in Equity Allocation by Initial Equity Level	Self-Directors	50.1	21.2	19.6	19.5	13.8	12.8	23.7	18.6
	Target-Date Fund	n/a	n/a	22.4	24.5	21.4	18.8	10.9	18.8
	Default Managed Accounts	33.0	11.2	20.2	27.6	27.4	24.8	24.6	25.3
	Opt-In Managed Accounts	39.3	32.6	27.1	22.4	33.1	23.9	30.7	28.3
Panel C Average Change in Equity Allocation by Equity Bin	Self-Directors	50.01	21.2	19.6	19.5	13.8	12.8	23.7	-8.6
	Target-Date Fund	n/a	n/a	22.4	24.5	21.4	18.8	10.9	-11.1
	Default Managed Accounts	33.0	11.2	20.2	27.6	27.4	24.8	24.6	-17.2
	Opt-In Managed Accounts	39.3	32.6	27.1	22.4	33.1	23.9	30.7	-17.4
Panel D Distribution of Equity Allocations by Initial Equity Level	Self-Directors	4.7	1.7	4.5	3.9	26.1	31.0	28.1	100.0
	Target-Date Fund	0.0	0.0	3.7	14.3	22.0	40.9	19.1	100.0
	Default Managed Accounts	0.4	0.9	11.3	14.3	20.0	33.6	10.6	100.0
	Opt-In Managed Accounts	2.3	4.3	6.1	8.2	22.0	33.5	23.5	100.0

Source: https://www.morningstar.com/lp/keep-your-distance, p.15

Morningstar's study ultimately concludes that participants who used either target-date funds or managed accounts led to a lower likelihood of a participant making changes to his or her portfolio allocation during the first quarter of 2020, and as the S&P has recovered to pre-COVID-19 levels, the participant reaction to "stay-the-course" has paid off.

Despite the uncertainty surrounding the future of retirement readiness post-COVID-19, most workers remain hopeful and trust in retirement planning experts to manage their retirement savings plan. Three in four workers are likely to enroll in automatic escalation features; four in five workers "find automatic enrollment appealing"[27].

[27] Source: https://transamericacenter.org/docs/default-source/retirement-survey-of-workers/tcrs2020_sr_retirement_security_amid_covid-19.pdf, pp. 96-110

Ongoing Difficulty of Saving for Retirement in a Low Interest Rate World

Interest rates continue to be held down by global central banks. The Federal Reserve announced plans to make "changes to its long-term strategy that are designed to help the central bank meet long-elusive inflation goals"; this will likely keep interest rates low for longer so that prices go up and job opportunities expand[28].

The federal as well as state governments are working to support economic growth. Ultimately this should lead to increased profits, which should translate into a strong labor market, especially in low-income and moderate-income communities[29]. For those workers saving and investing for retirement, these monetary policies are challenging. On one hand, one can invest in low-risk, fixed income securities, however, the current rates are very low. The alternative is to invest in higher-risk securities. While offering the possibility of higher returns, these risky investments expose the participant to higher risk of losses. For those participants near or at retirement, this risky tradeoff presents a significant challenge. In 2017, an estimated 32%[30] of retirees used a financial advisor, but in 2020 this number has risen to 39%[31]; thus, we expect participants to seek professional advice services to help them through this time. Workers' ability to handle financial upsets or crises also seems to be largely impacted by whether or not they work with professional advisors; when asked how financially prepared they would be to handle a 25% loss in savings due to market decline or bad investment decisions, 45% of those who worked with an advisor felt prepared, compared to the 25% who did not work with an advisor[32]. Also, with the passage of the Setting Every Community Up for Retirement Enhancement (SECURE) Act in late 2019, we expect plan sponsors to slowly adopt more retirement income solutions—on both a guaranteed and non-guaranteed basis—in the coming years.

Conclusion

The COVID-19 pandemic has caused international distress on physical, mental, and financial levels. While government efforts on both federal and state levels have provided short-term relief for workers, many Americans will face long-term financial consequences, such as changes in retirement dates, increased need for higher deferral rates and emergency savings, and loan repayments. There are, however, a number of ways for employers to help their employees get back on track on the road to retirement. Whether it's by streamlining the transition from worker to retiree, implementing more financial wellness resources, exploring investment changes, or providing more opportunities for professional asset management, employers can move in the direction of ensuring retirement readiness for their employees.

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[28] Source: https://www.cnn.com/2020/08/27/business/fed-powell-inflation-jackson-hole/index.html
[29] Source: https://www.federalreserve.gov/newsevents/speech/powell20200827a.htm
[30]Source: https://www.soa.org/globalassets/assets/files/resources/research-report/2018/risk-process-retirement.pdf, p. 67
[31]Source: https://www.soa.org/globalassets/assets/files/resources/research-report/2020/2019-risks-process-retirement-survey.pdf, p. 141.
[32]Source: https://www.soa.org/globalassets/assets/files/resources/research-report/2020/2019-risks-process-retirement-survey.pdf, p. 56.

Appendix A

To reach this estimate, we projected forward on an account balance of $200,000 with the following assumptions about the participant:

a. Age: 45
b. Annual Pay: $50,00
c. Withdrawal: $10,000
d. Future Real Return: 4%
e. Pay Growth: 1%

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