

# BCG Retirement News Roundup

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Boomershine Consulting Group (BCG) provides this monthly news roundup of highlighted significant articles from the retirement industry – for clients and friends. Retirement plan news has become increasingly pertinent for many audiences these days, including:

- Retirement Plan Sponsors – addressing both private and public sector issues
- Employers – dealing with complicated decision making for their plans
- Employees – educating the Boomer generation that is nearing retirement
- Industry Practitioners - helping to understand and resolve today's significant challenges

We review numerous industry news services daily and will include a collection of timely and significant articles each month concerning compliance, actuarial plan costs (including assumption debates), plan design change issues and benefit trends, as well as other related topics. If you would like to discuss any of these issues, please contact us.

## INSIDE THIS ISSUE

### Public Sector/Government Plans

**Pennsylvania Public School Employees posts 8.83% return for 2014**

**State-Sponsored Pensions Reach 80% Funded Status**

**TWO STATES CONSIDER DE-RISKING LEGISLATION; INSURANCE LAWMAKER GROUP ADOPTS GUIDELINES**

**New Jersey, Pennsylvania Drag Down U.S. Average for Pension Funding**

**Maryland Budget Committee Reduces State's Required Pension Payments**

### Private Sector

**Average retirement ages up slightly from a decade ago**

**Temporary Nondiscrimination Relief for Some Closed DB Plans Extended**

**Asset allocation changes among the U.S.'s biggest pension plans**

**State Street finds pension funds willing to increase risk profile**

**MOST AMERICANS BELIEVE THE NATION FACES A RETIREMENT CRISIS**

## Public Sector/Government Plans

### Pennsylvania Public School Employees posts 8.83% return for 2014

Pennsylvania Public School Employees' Retirement System, Harrisburg, returned 8.83% for the year ended Dec. 31, exceeding its policy benchmark return of 6.66%, and added more than \$4.2 billion in net investment income for 2014, said Evelyn Williams, spokeswoman for the \$51.7 billion pension fund.

“Strong returns were achieved in real estate, up 17.2%; master limited partnerships, up 16.3%; private markets, up 10.4%; fixed income, up 10.3%; U.S. equities, up 11.7%; and risk parity, up 10.2%,” Chief Investment Officer James H. Grossman Jr. said in a new release. “In addition, the board's decision to hedge a portion of our foreign currency exposure in late 2013 added significant value this past year, and that decision is continuing to add value in 2015.”

PennPSERS posted returns of 0.2% for the quarter ended Dec. 31, and an annualized return of 9.61% for three years, 9.43% for five years and 6.35% for 10 years ended Dec. 31.

The pension fund's asset allocation as of Dec. 31 was 20.5% U.S. and global fixed income, 16.3% private markets, 13.5% real estate, 12.5% U.S. equities, 10% absolute-return strategies, 9.3% non-U.S. equities, 6% risk parity, 5.1% cash and cash equivalents, 3.7% master limited partnership and 3.1% commodities.

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### State-Sponsored Pensions Reach 80% Funded Status

The ratio of pension assets to liabilities, or funding ratio, for 131 state-sponsored defined benefit retirement systems was 80% in 2014, up from 74% in 2013, according to a report issued by Wilshire Consulting.

The “Wilshire 2015 Report on State Retirement Systems: Funding Levels and Asset Allocation” is based on data gathered by Wilshire Consulting from the most recent financial and actuarial reports provided by 131 retirement systems sponsored by the 50 states and the District of Columbia. Of the 131 systems studied, 92 systems reported actuarial values on or after June 30, 2014, and the remaining 39 systems last reported prior to June 30, 2014.

Of the 92 state retirement systems that reported actuarial data for 2014, 87% have market value of assets less than pension liabilities, or are underfunded. The average underfunded plan has a ratio of assets-to-liabilities equal to 73%. Those same plans reported pension assets and liabilities of \$2,046.5 billion and \$2,672.0 billion, respectively. The funding ratio for these 92 state pension plans was 77% in 2014, up from 70% for the same plans in 2013. These plans saw their pension assets grow by 13.7%, or \$247.0 billion, from \$1,799.5 billion in 2013 to \$2,046.5 billion in 2014. At the same time, liabilities grew 4.7%, or \$118.8 billion, from \$2,553.2 billion in 2013 to \$2,672.0 billion in 2014. Their aggregate shortfall, or net pension liability, decreased \$128.2 billion over fiscal 2014, from \$753.7 billion to \$625.6 billion.

For the 131 state retirement systems that reported actuarial data for 2013, pension assets and liabilities in that year were \$2,726.8 billion and \$3,704.5 billion, respectively. Of these 131 state retirement systems, 93% were underfunded. The average underfunded plan in fiscal year 2013 had an assets-to-liabilities ratio equal to 71%.

“Global stock markets rallied strongly over the twelve months ended June 30, 2014, augmenting the positive performance of global fixed income and allowing pension asset growth to outdistance the growth in pension liabilities over fiscal 2014,” says Russ Walker, vice president and a member of the investment research group of Wilshire Consulting. “State pension portfolios have, on average, a 66.1% allocation to equities—including real estate and private equity—and a 33.9% allocation to fixed income and other non-equity assets. The 66.1% equity allocation is somewhat lower than the 67% equity allocation in 2004. Perhaps the most notable trend over the ten-year period has been the rotation out of U.S. equities into other growth assets such as non-U.S. equities, real estate and private equity.”

Wilshire forecasts a long-term median plan return equal to 5.99% per annum, which is 1.66 percentage points below the median actuarial interest rate assumption of 7.65%. It is important to note that Wilshire’s assumptions range over a conservative 10-year time horizon, while pension plan interest rate assumptions typically project over 20 to 30 years.

Wilshire Consulting also reported that the aggregate funded ratio for U.S. corporate pension plans increased to 77.2% for the month of February. “We estimate that overall the funded ratio for the sample plan increased by 3.9% from 73.3% to 77.2% in February. This increase was driven by the decrease in liability value of 3.5% versus the 1.7% increase in asset value. The asset result is due to positive returns for equities, while the liability value decreased due to rising corporate bond yields,” says Ned McGuire, vice president and member of the pension risk solutions group of Wilshire Consulting.

## TWO STATES CONSIDER DE-RISKING LEGISLATION; INSURANCE LAWMAKER GROUP ADOPTS GUIDELINES

As more companies offload their defined benefit pension obligations to insurance companies in multibillion-dollar transactions, legislators in some states are starting to take notice and to consider laws that are aimed at protecting retirees.

Lawmakers in two states, Connecticut and New York, are considering legislation that would expand disclosures and protections from creditors for plan participants. And legislators in several other states have expressed interest in developing legislation to deal with pension de-risking issues.

“We’re looking for champions” to push legislation on pension annuity buyouts in the states, said Edward Stone, of Edward Stone Law in Greenwich, Conn., who serves as legal counsel to retiree groups and who has worked with lawmakers in Connecticut and New York on their legislation.

Stone has also been involved in an effort to develop standards that are informing the nascent legislative movement.

He helped a group of state lawmakers, the Troy, N.Y.-based National Conference of Insurance Legislators, develop a set of best practices on pension de-risking, which the organization adopted in November.

The insurance industry was also heavily involved in the effort, as the American Council of Life Insurers, Prudential Financial Inc.—which has received the lion's share of group annuity transactions—and others provided input. Criticism of the group's earlier proposed model act on de-risking also was taken into consideration.

Scott Kaplan, head of Prudential's pension risk-transfer team in Woodbridge, N.J., told Bloomberg BNA that his company “played a leadership role” in helping to develop the best practices as an industry solution—not just a solution for Prudential. The best practices recommendations are “a positive step forward to make sure retirees have retirement security, and not only to make sure that they have retirement security, but also to address any other areas where they may be worried about their pension.”

Prudential also supported the product of NCOIL's efforts “to address any fears, and to increase retirees’ confidence and security in these annuity solutions,” Kaplan said.

Jack Dolan, vice president of media relations for the ACLI, said in an e-mail, “We support the NCOIL resolution which, among other things, stresses the importance of providing consumers clear information. We oppose efforts in the states that would go beyond the compromise contained in the NCOIL resolution.”

Stone, who serves as legal counsel to the Association of BellTel Retirees Inc. and ProtectSeniors.org, and who had drafted NCOIL's model act, told Bloomberg BNA that reaching consensus on the best practices took some effort, but eventually Prudential “was very supportive of our efforts.”

“There is still some friction” regarding disclosure issues, Stone said, but “we're hopeful that we can find a way to let retirees know they'll be as well off as they were before. The goal is to make sure retirees know their pension retirement savings are safe.”

The issue has gained importance as an increasing number of pension plans have turned to two forms of de-risking in recent years: buying group insurance annuities to transfer pension liabilities and offering retirees and beneficiaries lump-sum benefit options.

Since General Motors Co. announced in 2012 that it was transferring its pension liabilities for 42,000 U.S. salaried retirees and their beneficiaries to Prudential Insurance Co. of America, as well as providing a lump-sum option, dozens more large plan sponsors have followed in GM's wake, affecting hundreds of thousands of retirees and their beneficiaries.

According to the LIMRA Secure Retirement Institute, pension buyout sales more than doubled in 2014, to \$8.5 billion in 2014 from \$3.8 billion in 2013. There were 277 pension buyout contracts in 2014, up 28 percent from 217 the previous year, the report said.

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## New Jersey, Pennsylvania Drag Down U.S. Average for Pension Funding

Most states come close to paying their pension bills.

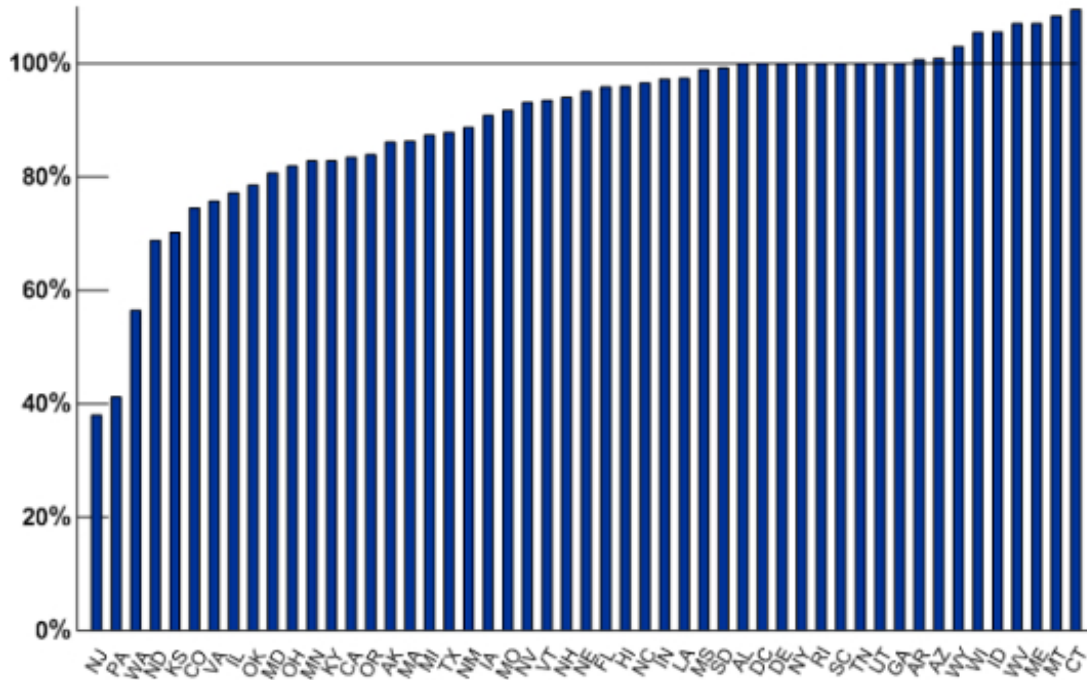
But those which don't—including New Jersey, Pennsylvania and Washington—are disproportionately pulling down the national average, clouding the strong performance in all but a handful of places, a new report says.

From 2001 to 2013, the average pension plan received 84.4% of the annual payments owed to them by state governments, according to the National Association of State Retirement

Administrators, which reviewed data from 112 plans from all 50 U.S. states and the District of Columbia.

Removing only New Jersey and Pennsylvania, the two lowest-paying states at 38% and 41.2% respectively, would cause the weighted average to grow to nearly 90%, NASRA said.

Weighted Average of Annual Required Contributions Paid



National Association of State Retirement Administrators

The huge pension holes facing state and local governments are driven by huge investment losses from the 2008 financial crisis.

Those gaps are also compounded from years of government underfunding.

But NASRA’s report argues most states have made “good faith” efforts to pay those annual required contributions, or ARC, all along.

“Despite perceptions that many states have fallen far short of their pension funding requirements, in fact, most states have made a reasonable effort to fund their share of pension contributions,” said Keith Brainard, research director at NASRA, a non-profit group representing retirement-system directors.

States paid just \$27.7 billion in annual pension payments in 2001, following years of strong investment returns. That created political pressures to raise pension benefits – which many

states did – and when the economy stumbled, it sunk asset levels at most plans, according to NASRA. When funded ratios dip, pensions see their required annual payments rise.

By 2013, the annual payments from states had more than tripled, ballooning to \$93.7 billion, according to NASRA.

The annual contributions, which are set based on accounting rules, works much like a mortgage payment, where governments must pay off a principle (the cost of the retirement benefits) with interest (the cost to amortize the unfunded liability), Mr. Brainard said. Cash-strapped states have adopted a variety of techniques to push out parts of those annual payments or take rosier outlooks that lighten the contributions of today.

Connecticut had the highest contribution ratio of 109.5% during the 12-year period surveyed by NASRA, ending with a surplus of \$1.4 billion. Wyoming was next with 108.3% followed by Maine and Montana which tied at 107%.

But Connecticut's contribution status got a big boost due to a bond issuance from 2008 that infused its pension with funds.

Some 17 states and the District of Columbia had fully contributed to their pensions.

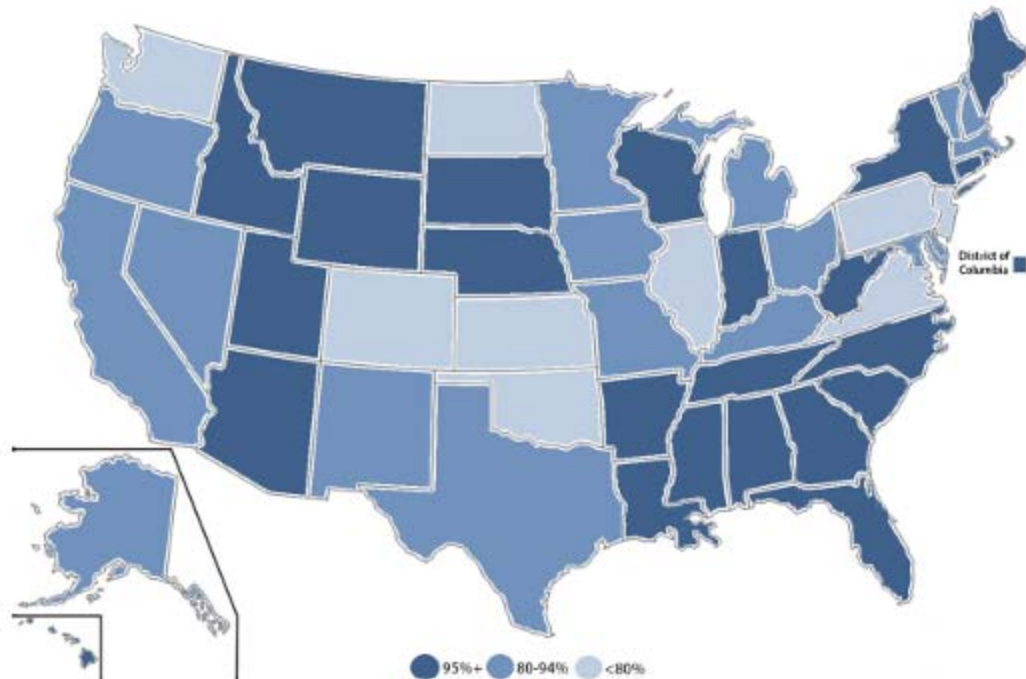
After New Jersey and Pennsylvania, the states with the lowest level of annual payments were Washington (56.5%), North Dakota (68.8%), Kansas (70.2%) and Colorado (74.5%).

The underfunding caused a shortfall of \$23.3 billion in New Jersey and \$14.9 billion in Pennsylvania, according to NASRA.

“Fully funding pension obligations demonstrates that states value retirement benefits as a tool in attracting and retaining public employees,” Mr. Brainard said. The IRS said the final rules under Section 414(d) will apply prospectively and will include a delayed effective date. The final regulations are also expected to provide that a plan will qualify as a governmental plan under Section 414(d) if it covers employees of a public charter school and meets the requirements of the guidance in Notice 2015-7 for periods starting on and after the effective date of the final regulations, even if the plan covered those employees for periods before the final regulations' effective date, when the public charter school didn't meet the requirements.



Weighted Average of Annual Required Contributions Paid



National Association of State Retirement Administrators

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## Maryland Budget Committee Reduces State's Required Pension Payments

Earlier this week, Maryland lawmakers approved a state budget that carries implications for the state's pension fund.

Under the new budget, the state's annual contribution to its pension system will be reduced by \$75 million annually.

The state's official actuarial contribution remained untouched; but the state had also promised to make supplemental contributions to the system, on top of the actuarially-required payments.

It's the supplemental contributions that were slashed.

More from the Maryland Reporter:

The committee switched payments into the pension system to the full actuarial contribution but it did not totally eliminate a supplemental payment into the pension fund promised to state teachers and employees when their own salary contributions into the system were raised in 2011.

The state will now pay an extra \$75 million into the pension fund each year, not the \$150 million expected next year or the \$300 million initially promised.

“We get to full 80% funding by 2023” as planned, said Del. Ben Barnes, D-Prince George’s, chair of the pension subcommittee.

“I’m having heartburn for us not keeping our commitment,” Del. Mike McKay, R-Allegany.

“The actual funding is reasonable is if we were doing it the whole time,” said Del. Tony McConkey, R-Anne Arundel. “If we have a couple of bad years [on investment returns], we’re not going to be where we need to be.”

State Treasurer Nancy Kopp, chair of the State Retirement and Pension System Board of Trustees, expressed the board’s rather muted objections to the move.

“The board is concerned that, to the extent proposal for further changes deviate significantly from the reforms adopted [in 2014], such changes ... might result in a pattern of reduced funding that threatens the viability of our shared goals to properly fund the System to ensure the full payment of all benefits that have been promised.”

The Maryland State Retirement and Pension System managed \$45 billion in assets as of December 31, 2014.

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## Private Sector

### Average retirement ages up slightly from a decade ago

In 2013, the average retirement age in the U.S. was about 64 for men and approximately 62 for women, according to a research note published by the Center for Retirement Research at Boston College. The authors define retirement age as “the age at which the labor force participation rate drops below 50%.”

The average retirement age among men was 63.92, up 0.3 percentage points from a year earlier and up about 1.3 percentage points from a decade earlier. The average retirement age among women was 61.93, down 1.1 percentage points from a year earlier but up 0.9 percentage points from a decade before.

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### Temporary Nondiscrimination Relief for Some Closed DB Plans Extended

<http://www.irs.gov/pub/irs-drop/n-15-28.pdf> Sponsors of certain closed defined benefit plans got some good news from the IRS on March 19 — it has extended temporary relief from nondiscrimination rules under Internal Revenue Code Section 401(a)(4) for another year. The extension applies to DB plans that provide ongoing accruals but that have been amended to limit those accruals to some or all of the employees who participated in the plan on a specified date. The IRS made the announcement in Notice 2015-28.

The IRS provided this relief in Notice 2014-5, 2014-2 I.R.B. 276, and it was applicable for plan years that begin before Jan. 1, 2016. Notice 2015-28 extends that relief, and makes it applicable for plan years that begin before Jan. 1, 2017. Notice 2015-28 will appear in IRB 2015-14, which will be issued on April 6, 2015.

Closing a DB plan often occurs in conjunction with an amendment that provides new or greater contributions under a defined contribution plan intended to replace accruals under the DB plan for new hires or other employees to whom the DB plan is closed.

Notice 2014-5 permits certain employers that sponsor a closed DB plan and a DC plan to demonstrate that the aggregated plans comply with the nondiscrimination requirements of Section 401(a)(4) on the basis of equivalent benefits, even if the aggregated plans do not satisfy the current conditions for testing on that basis.

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## Asset allocation changes among the U.S.'s biggest pension plans

Many of the largest pension plans made significant changes to their asset allocation in 2014. Among the nineteen members of the \$20 billion club—a group of U.S. listed corporations that each have worldwide pension liabilities in excess of \$20 billion—no fewer than nine increased their allocation to fixed income by 4% or more during the year.

A couple of weeks ago, we discussed the development of the funded status of those large plans, based on data in the recently-filed 10-K reports. A new note by Justin Owens digs deeper into those reports and looks more closely at the assumptions and objectives of the plans, and at the impact these are having on contributions and investment strategies. I'll pick up here on just a couple of the points it makes.

Little change in 2013; much change in 2014

On the surface, it may appear to be surprising that so many of these plans would make significant increases in their fixed income allocations in 2014. After all, in 2013, only one did so and, indeed, four reduced their fixed income allocations by more than 4% that year.

The change is less surprising if we take into account the importance of funded status in driving asset allocation decisions. The signs were there, as I noted a year ago: “Now that pension plans are better funded, big asset allocation moves could follow.” That this did indeed happen is further confirmation of the strong link between asset allocation and funded status for many pension plans. If the pattern holds, we ought to expect less change in 2015 (since funded status fell sharply in 2014.) But there is a wild card here, which I'll come back to in a moment.

The herd has broken

It would be a mistake to assume that all of these plans are following the same strategy, however. Many have clearly tied their asset allocation to their funded status and at least a couple have formally described these policies. But some others have not. Not every corporation is setting the same goals for their pension plan, and not every plan is following the same strategy. The days of peer group comparisons being a major factor in decisions are long gone.

Here, again, it is easy to say this with hindsight. And, with hindsight, it is clear that the Pension Protection Act of 2006 (PPA) was an important turning point. But the signs were there at the time. In a report published<sup>1</sup> shortly after the passage of that Act, I said:

I believe we'll see a breakup of the pension plan herd. Corporate pension plans have for decades tended to pursue similar objectives, adopt similar asset allocation policies, and rely on similar strategies. But change is being driven by a number of different pressures, and these pressures are going to push different plans in different directions. The impact of the Pension Protection Act of 2006 will be different for a well-funded plan than for one designated 'at risk',

and it will be different for a corporation which is sensitive to cash flow than for one primarily concerned about earnings.

As a result, I argued, we should expect strategies to diverge—not a remarkable statement today, but one that went against decades of prior experience when it was written. The extent to which this has happened is highlighted by some of the examples Justin Owens’ note provides: discretionary contributions above the mandated minimum at Raytheon and United Technologies, but full advantage of funding relief taken by GE and some others; aggressive adoption of liability-driven investing (LDI) at Ford and GM, but a reduction in fixed income allocation at Lockheed Martin; risk transfer activity (offering lump sum payouts) at United Technologies and Boeing. A clear case of each corporation looking for the strategy that fits.

The wild card—interest rates

Any discussion of asset allocation—and especially the allocation to fixed income—at the present time would be incomplete without a mention of the level of interest rates. It has long been a widely held view of many in the pension community that interest rates are likely to rise. It can be tough to buy bonds when interest rates are seen as low, and the expectation of rising rates has probably acted as a dampener on LDI activity for a number of years now.

So the comments above about the changes to asset allocation should be taken in that context. While the distinction between tactical and strategic motivations is a level of detail beyond what is generally available in the 10-K reports, it seems fair to assume that both strategic and tactical considerations were at play. And, as we look ahead to 2015, it seems likely that both are going to be important once again.

An aside: as I went back over the 2006 report quoted above, I was amused to find that I’d gone on to say “Some strategies will stand the test of time better than others, and a new normal may emerge.” Yes: some of us really were using the phrase “new normal” in 2006. Don’t let anyone else tell you they thought of it first!

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## State Street finds pension funds willing to increase risk profile

The trends, as determined by a global study of more than 130 large pension funds by State Street, are clear: sponsors are re-evaluating their attitude toward risks as they seek to deliver value in a difficult investing environment.

How difficult? Interest rates are low and are expected to remain low for many years, a backdrop that causes a fund's future liabilities to stay high. Equity markets, the main asset class that can juice returns, are highly valued, which presumably makes further gains more difficult.

So what to do, given that pension funds have agreed to pay their retirees until they head to the beyond?

According to State Street's survey – the first by the institution and which focused on developments in 15 countries – the risk re-evaluation means plan sponsors will increase their risk appetite over the next three years, all part of a greater hands-on involvement.

Indeed, three-quarters of the respondents expect to increase their risk appetite. They will do that by “making a major shift in allocations to less-familiar asset classes such as alternatives to drive growth and meet long-term liabilities.” And the funds will pursue that goal by placing “big bets on alternatives,” a group of assets that includes hedge funds, private equity, direct loans, infrastructure and real estate.

Robert Baillie, chief executive at State Street Trust Company Canada said, “There's more of a shift toward alternative assets. The smaller allocation they had traditionally is not sufficient to generate the return they need.”

Specifically, the survey showed 60% of the respondents will increase their existing allocation to private equity, while 25% will invest in hedge funds for the first time.

Even so, investing in hedge funds does come with problems including “lack of transparency which, from a governance perspective, makes pension plans nervous,” noted Mr. Baillie, whose company provides services to one trillion dollars of Canadian assets. (Globally, State Street, which has had a presence Canada for 25 years and which employs 1,300 people, provides services to US\$29 trillion of assets.)

A vast increase in assets managed in-house is another key survey conclusion. From now on, 81% of pension funds plan to manage more of their assets in-house. In general this trend is easier for the large pension funds to effect: Mr. Baillie expects Canadian funds, which are below the top 10 in assets, to be part of this move. He also expects passive management and cash management to be at the forefront.

Lower costs associated with in-house management (as well as better oversight of the assets) is the main reason for the impending change. The report notes that external management can cost 46 basis points, or five times what internal management costs.

Other funds are moving to de-risk. Recently BCE became the first pension fund outside of England to purchase longevity insurance: in essence, if the covered group of retirees live longer

than expected, the extra payments will be provided by Sun Life, the insurer that provided the policy. Longevity insurance has potential to grow (in England it's become a US\$100 billion business), though the concept is particularly appealing to large pension funds with a high percentage of retirees. In Canada about a dozen private sector funds could be candidates to follow BCE.

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## **MOST AMERICANS BELIEVE THE NATION FACES A RETIREMENT CRISIS:**

National Institute on Retirement Security has released a new nationwide public opinion research report entitled "Retirement Security 2015: Roadmap for Policy Makers/Americans' Views of the Retirement Crisis." Some of the more specific findings are that:

- An overwhelming majority of Americans believes there is a retirement crisis. Some 86% agree that the nation faces a retirement crisis, and 57% strongly agree there is a crisis.
- Three in four Americans remain highly anxious about their retirement outlook, but the concern has dissipated slightly as the economy has recovered. Seventy-four percent of Americans say they are concerned, down from 85% in 2015.
- Even though Americans feel slightly less stressed about their retirement prospects, support for steady and reliable retirement income from a pension is high and growing. In fact, 82% say a pension is worth having because it provides steady income that will not run out, while 67% indicate they would be willing to take less in pay increases in exchange for guaranteed income in retirement.
- Americans continue to feel that leaders in Washington do not understand their struggle to save for retirement, and they strongly support efforts by states to set up retirement plans for those workers without access to an employer sponsored plan. Eighty-seven percent of Americans say Washington policymakers do not understand how hard it is to prepare for retirement, while 84% say Washington needs to do more to help ensure retirement security.
- Americans see retirement benefits as a job feature that is almost as important as salary. Salary is viewed as important by 75% of Americans, and retirement benefits are close behind at 72%.
- Americans express strong support for pensions for public employees. Few Americans realize that 75% of public pension costs are paid for with employee contributions and investment returns. Eighty-seven percent of Americans say pensions are a good way to recruit

and retain qualified teachers, police officers and firefighter. But, only one-fourth of Americans understood that public employers pay for 25% or less of public pension costs. More than eight out of ten say that all employees, not just the public sector, should have a pension. Eighty-seven percent of Americans say pensions are a good way to recruit and retain qualified teachers, police officers and firefighters.

- Protecting Social Security benefits is increasingly important. Some 73% of Americans say it is a mistake to cut government spending in such a way as to reduce Social Security benefits for current retirees, up from 67% in 2013. When it comes to benefits for future generations, 69% oppose cutting government spending that reduces Social Security benefits. Americans are divided when it comes to increasing the amount of Social Security benefits by delaying the withdrawal of benefits at an older age: 42% agree with a delay while 50% disagree.

This biennial nationwide public opinion research is the fourth poll that measures how Americans feel about their financial security in retirement, and assesses their views on policies that could improve their retirement outlook. It is intended to serve as a tool for policymakers, thought leaders and retirement service providers as they work to stem the retirement crisis and re-fortify the U.S. retirement infrastructure.

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