Banking on the Baby Boomers: How Demographic Trends Are Reshaping the Financial Landscape

Are Baby Boomers Financially Prepared for Retirement?
The leading edge of the baby boom generation is now approaching retirement age. Data on income and savings suggest at least some members of this group may not have adequate resources for a comfortable retirement. This article explores the primary sources of baby boomer retirement income, discusses obstacles to accumulating savings, and identifies developments that could unexpectedly change the financial situation of retirees. See page 3.

The Shift Away from Defined Benefit Plans
As businesses struggle with mounting costs and increasing global competition, the trend away from defined benefit pension plans appears to be accelerating. The author argues this shift is made worse by cyclical market volatility and the desire of corporations to shift the costs and risks inherent in these plans to individuals. Although many companies have moved away from defined benefit plans in favor of defined contribution plans (such as 401(k) plans), many others maintain healthy defined benefit plans and are finding creative ways to fund the plans and manage their costs. See page 10.

The Demographics of Housing Demand
A snapshot of U.S. population growth during the past 20 years shows significant increases in the numbers of aging baby boomers and foreign-born individuals. Although these groups differ in age, income, education level, and household size, both are expected to significantly affect the demand for owner-occupied housing. This article looks at how the aging baby boomer and immigrant cohorts are poised to influence the nation’s housing markets in the coming years. See page 17.

Regional Demographic and Banking Trends
The potential impacts of the aging baby boomer generation as well as other key demographic developments are not evenly distributed across the country. Analysts “on the ground” in the FDIC’s eight geographic areas offer insights about the implications of key trends for local economies and the banking sector. See page 24.

How Aging Baby Boomers Are Changing the Financial Marketplace
As baby boomers near retirement age, their financial needs can be expected to change considerably. Many older households have accumulated significant assets in the form of retirement accounts and equity in their homes, and these individuals are likely to prefer relatively low-risk assets as they near retirement. As baby boomers undergo this transition, they are also experiencing the challenge of rising health care costs and a shift in the corporate sector from traditional defined benefit to defined contribution pension plans. Understanding the opportunities these trends present can help FDIC-insured institutions design and offer financial products and services that will meet the unique needs of an aging baby boom generation. See page 34.
The **FDIC Outlook** is published quarterly by the Division of Insurance and Research of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators.

The **FDIC Outlook** provides an overview of economic and banking risks and discusses how these risks relate to insured institutions nationally and in each FDIC region.

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Are Baby Boomers Financially Prepared for Retirement?

After U.S. soldiers returned from World War II, fertility rates rose, resulting in 18 years of higher birth rates from 1946 through 1964—the “baby boom” years. Seventy-six million babies were born in the United States during this time, 12 million more than the 64 million who would have been born during this period if fertility levels had remained at prewar levels. In 2006, these American baby boom children now range in age from 42 to 60.

Many baby boomers are nearing the traditional retirement age of 65. However, reduced availability of pensions with defined benefits, uncertainties related to retirement plans funded largely by employee contributions, and lower levels of savings have challenged financial planning for many baby boomers. This article explores the primary sources of baby boomer retirement income, discusses impediments to accumulating future savings, and identifies some situations that could unexpectedly change retirees' financial situations.

Baby Boomers Are Aging, as Is America

Advances in medicine have increased longevity, resulting in an older America. The percentage of the population that is older has grown during the past century. The number of Americans 65 and older rose 183 percent between 1950 and 2000, more than double the 77 percent increase in the number of Americans under 65. This rapid growth in the elderly population increased the share of the population age 65 and older from 8.2 percent to 12.4 percent. Some of this growth can be attributed to the significant increase in life expectancy that occurred during the 20th century. At age 65, women today are expected to live 25 percent longer than their counterparts in 1960, while men are expected to live 31 percent longer.1 In addition to medical advancements lengthening life spans, the large number of baby boomers approaching 65 will continue to swell that age group.

Declining fertility rates also are contributing to this demographic shift, shrinking the size of subsequent generations. Although fertility rates were lower among baby boomers than among preceding generations, the size of this age demographic meant more parents were having children. Between 1977 and 1995, 72 million babies were born, approximating the 76 million babies born during the baby boom. Nevertheless, the trend of an aging U.S. population is projected to continue through the first half of the 21st century (see Chart 1). Large numbers of baby boomers are now nearing retirement age.

Will Baby Boomers Have Sufficient Income in Retirement?

Baby boomers’ work-related retirement income consists largely of Social Security and pension income. As of July 2005, more than 30 million retired workers were receiving Social Security income, with benefits averaging $960 per month, or less than $12,000 per year.2 Although the Social Security program is designed only as a supplement to other sources of income, during 2003 the majority of senior Americans relied on Social Security as the source for at least 80 percent of their income (see Chart 2, next page).

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1 U.S. Department of Health and Human Services. 2005. Health, United States, 2005; Table 27, Life Expectancy at birth, at 65 years of age, and at 75 years of age, according to race and sex: United States, selected years 1900–2003, p. 167.

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Retirement Income: A Mix of Pensions and Social Security

For retirees to maintain a standard of living reasonably close to what they had while working, employment-related pension income is needed to supplement Social Security. Two basic types of pension plans exist—defined benefit plans and defined contribution plans. Defined benefit plans are traditional employer-funded pension plans that provide a fixed income stream during retirement. In defined contribution plans, the employee makes retirement contributions that may be matched at least in part by the employer.

The distribution of pension plans has changed significantly during the past 25 years (see Table 1). In 2003 and 2004, only 17 percent of workers were covered by defined benefit plans, compared with 41 percent in 1978. Fully 25 percent of workers were not covered under either defined benefit or defined contribution plans.

Defined Benefit Plans and Defined Contribution Plans Have Limitations

Fewer workers are now covered by defined pension plans, and those with coverage may find that the plans have shortcomings. The plans are often less generous than in the past and rarely adjust for inflation. In addition, workers are changing jobs more frequently, and defined benefit plans’ lack of portability is a major issue for participants (see “The Shift Away from Defined Benefit Plans,” page 10, for more information on defined benefit and defined contribution plans).

Defined contribution plans offer the opportunity for workers to accumulate wealth during their working years. Employee salary contributions, in many cases coupled with some matching employer contributions, provide funds for employees to invest throughout their careers. Employees have the potential to accumulate large sums in these savings plans. The outcome depends on (1) employees beginning to contribute early in their

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5 Most defined contribution plans are 401(k) plans. Other defined contribution plans include 403(b) plans (offered by tax-exempt organizations such as churches, schools, and charities), employee stock ownership plans, and profit-sharing plans.

4 In defined contribution plans, the employee is responsible for the investment decisions and assumes the market risks. Defined contribution plans became increasingly popular when the stock market soared in the 1980s and 1990s. Over time, new companies, as well as many older ones, began offering only defined contribution plans, which take the burden of the investment and annuity risk away from the employer.

5 Some defined benefit plans have failed, and others are in financial trouble. Although the vested benefits of failed plans are insured by the federal Pension Benefit Guaranty Corporation (PBGC), there is a maximum insurance benefit. In 2005, the maximum insurance benefit for participants in terminating, underfunded pension plans was $45,614 per year for those who retire at age 65; the amount was higher for those who retire later and lower for those who retire earlier or elect survivor benefits. As a result, the pensions of some higher-income workers may be less than they anticipated or could change should the parent company experience financial difficulties. Some well-known pension failures covered by the PBGC include Kaiser Aluminum, Bethlehem Steel, Polaroid, US Airways, and United Airlines.
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Table 2

<table>
<thead>
<tr>
<th>Age</th>
<th>0 to 2 Years</th>
<th>&gt;2 to 5 Years</th>
<th>&gt;5 to 10 Years</th>
<th>&gt;10 to 20 Years</th>
<th>&gt;20 to 30 Years</th>
<th>&gt;30 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>40s</td>
<td>$13,970</td>
<td>$22,386</td>
<td>$36,832</td>
<td>$74,641</td>
<td>$103,156</td>
<td>—</td>
</tr>
<tr>
<td>50s</td>
<td>17,618</td>
<td>25,208</td>
<td>39,877</td>
<td>83,318</td>
<td>138,382</td>
<td>$131,873</td>
</tr>
</tbody>
</table>


are careers and regularly contributing the maximum allowable amounts, (2) funds being invested wisely, and (3) employers matching contributions. However, based on a review of outstanding 401(k) balances, it does not appear that the average baby boomer has accumulated substantial wealth in their retirement accounts (see Table 2). For baby boomers who were in their 40s and 50s in 2003 and had 401(k) plans, the maximum average 401(k) accumulation was less than $140,000, and many had considerably less.6

In addition to having less-than-desired wealth accumulation in 401(k) plans, some participants compound that problem by borrowing from their plans while working and sometimes having loans outstanding when they retire. In 2003, 18 percent of eligible 401(k) plan participants borrowed from their account and had average loan balances of 13 percent of their account balances.7

Perhaps a more important issue is that employees generally direct the investment decisions and bear the resulting investment risk for defined contribution plans. Further, investment returns for defined contribution plans are not guaranteed and can be greatly affected by market fluctuations. This uncertainty can make retirement planning more challenging. Finally, since defined contribution plans are voluntary, fully 18 percent of employees do not participate at all.8 These factors tend to reduce the effectiveness of defined contribution plans in providing adequate funding for retirement.

Baby Boomer Assets May Not Adequately Supplement Retirement Income

While there is no definitive standard for how much a person needs for retirement, many baby boomers appear to have a net worth insufficient to meet basic retirement needs, according to some guidelines.9 In 2004, the median net worth for families headed by baby boomers between the ages of 45 and 54 was $144,700.10 However, these data are somewhat difficult to interpret, as wealth holdings in the United States are skewed toward the top 10 percent of families (see Chart 3, next page). The median family net worth was $1,700 for the lowest 25 percent of U.S. households and $43,600 for those in the 25th to 49th percentile. In contrast, those in the 75th to 89th percentile had median family net worth of $506,800, while the figure for those in the top 10 percent was $1.4 million. These data do not apply only to baby boomers, however. Chart 3 suggests that although many families have a

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9 One research report (Kenn B. Tacchino and Cynthia Saltzman, March 2001, “Should Social Security Be Included When Projecting Retirement Income?” Journal of Financial Planning, table 1) suggested targets for asset accumulation by ages 66 to 67, after taking into account projected Social Security income, that ranged from $226,000 for those whose current income is $40,000 to $1.9 million for those whose current income is $300,000. Another rough rule of thumb suggested for asset accumulation for retirement recommended private savings of 12 to 16 times final salary (Ben Stein and Phil DeMuth, 2005, Yes, You Can Still Retire Comfortably, Carlsbad, Calif.: New Beginnings Press). For example, using the lower end multiple of 12, someone with an income of $50,000 would need at least $600,000 in assets to fund retirement.

fairly substantial amount of assets, a large number have few resources with which to supplement retirement income.

The single largest source of wealth for retirees is often an illiquid asset, real estate.\textsuperscript{11} It is useful, therefore, to look separately at non-real-estate assets for a realistic picture of available assets retirees have accumulated. Although 94 percent of families headed by persons ages 45 to 54 held at least one type of non-real-estate financial asset in 2004, the median holdings of financial assets for this group were only $38,600.\textsuperscript{12} These data include 58 percent of families that held a median of $55,500 in retirement accounts (which include individual retirement accounts or IRAs), but only 18 percent that held the third and fourth largest asset categories, other managed assets and bonds ($43,000 and $30,000, respectively) (see Table 3, next page).\textsuperscript{13} For the average person, financial assets would not last long in retirement.

Inheritance is often considered another option to fund retirement. However, relatively few people will be able to rely on this strategy, or even substantially supple-

\textsuperscript{11} As noted previously in this article, for families headed by persons ages 45 to 54, in 2004 the median family net worth was $144,700, and 77 percent of these families owned a primary residence. The median home market value for these homeowners was $170,000. (Note: The home market value reflects gross value, which may differ significantly from the net equity in the home; figures on average home equity were not available.) Data from Federal Reserve Board 2004 Survey of Consumer Finances.

\textsuperscript{12} See note 10.

\textsuperscript{13} Ibid.

The data presented thus far highlight the need for many baby boomers to increase savings for retirement aggressively. However, those with lower incomes may find this particularly challenging, in part because earnings growth has been skewed toward the highest-income households (see Table 4, next page).

Heavy debt burdens can make wealth accumulation more difficult, because funds used to repay debt cannot be put into savings. By various measures, household debt has risen significantly. For example, household debt outstanding has been increasing steadily as a percentage of disposable personal income, from 70 percent in 1980 to 122 percent as of third quarter 2005.\textsuperscript{15} Further, the proportion of families with very large debt payments relative to income is also rising. In 2004, 13.1 percent of families headed by persons ages 45 to 54 had a debt-to-income ratio greater than 40 percent, an increase of 1.5 percentage points since 2001. This compares with 12.2 percent of all families with a debt ratio above 40 percent, only a 0.4 percentage increase since 2001.\textsuperscript{16}

Another potential barrier to building additional retirement assets is that many older baby boomers have expenses somewhat unique to their age group. As baby boomers approach retirement age, they often become part of what has been called the “sandwich generation.” At this point in their lives, boomers may still be caring for their children and providing for their educational needs through inheritance. For example, in 2003 only 66,000 estate tax returns were filed (estates of $1 million or more), compared with about 2.4 million deaths that year.\textsuperscript{14} Without substantial inherited wealth and in view of the difficulties related to providing sufficient retirement income, personal savings will often be needed to supplement Social Security benefits and pensions related to employment. However, several factors may constrain the ability of lower-income baby boomers to accrue assets to fund their retirements: uneven growth in incomes, significant levels of debt, and high current expenses.

\textsuperscript{14} Estate data are from the Internal Revenue Service. There were 2.4 million deaths in 2002, per the National Center for Health Statistics of the Centers for Disease Control and Prevention (CDC) (www.cdc.gov/nchs/fastats/deaths.htm), and preliminary figures also show 2.4 million deaths for 2003 (see CDC, 2004, “Deaths: Preliminary Data for 2003,” National Vital Statistics Reports 53, no. 15).

\textsuperscript{15} Calculated using data from the Bureau of Economic Analysis and the Federal Reserve Board Flow of Funds.

\textsuperscript{16} See note 10.
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Table 3

<table>
<thead>
<tr>
<th>Type of Financial Asset</th>
<th>Families Holding Assets (percent)</th>
<th>Median Asset Value for Families Holding Assets (in 2004 dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retirement Accounts</td>
<td>52.2%</td>
<td>57.7%</td>
</tr>
<tr>
<td>Pooled Investment Funds</td>
<td>9.6</td>
<td>18.2%</td>
</tr>
<tr>
<td>Other Managed Assets</td>
<td>3.5</td>
<td>6.2</td>
</tr>
<tr>
<td>Bonds</td>
<td>5.2</td>
<td>1.8</td>
</tr>
<tr>
<td>Stocks</td>
<td>22.1</td>
<td>23.2%</td>
</tr>
<tr>
<td>Certificates of Deposit</td>
<td>20.1</td>
<td>11.9%</td>
</tr>
<tr>
<td>Cash Value of Life Insurance</td>
<td>41.2</td>
<td>26.0%</td>
</tr>
<tr>
<td>Other</td>
<td>15.4</td>
<td>12.1%</td>
</tr>
<tr>
<td>Transaction Accounts</td>
<td>87.9</td>
<td>91.8%</td>
</tr>
<tr>
<td>Savings Bonds</td>
<td>22.6</td>
<td>21.0%</td>
</tr>
</tbody>
</table>

Note: Heads of households are between 45 and 54 years old. Asset values do not account for the present value of future Social Security benefits.
Source: Federal Reserve Board, 2004 Survey of Consumer Finances.

Table 4

<table>
<thead>
<tr>
<th>Earnings Percentile</th>
<th>Mean Household Income (2004 Dollars)</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 5%</td>
<td>$150,869</td>
<td>75%</td>
</tr>
<tr>
<td>Next 15%</td>
<td>84,321</td>
<td>35%</td>
</tr>
<tr>
<td>Bottom 80%</td>
<td>31,926</td>
<td>18%</td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau (Historical Income Tables).

Table 5

<table>
<thead>
<tr>
<th>Age of Worker</th>
<th>% Saying They Have Saved for Retirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>35 to 44</td>
<td>60% 71% 11%</td>
</tr>
<tr>
<td>45 to 54</td>
<td>69% 73% 4%</td>
</tr>
<tr>
<td>55 and older</td>
<td>63% 71% 8%</td>
</tr>
</tbody>
</table>

Source: Retirement Confidence Survey 2005 Fact Sheet, “Age Comparisons Among Workers.”

needs while simultaneously facing financial burdens imposed by the health care costs of their aging parents.

On the positive side, data suggest that baby boomers have become more diligent in their efforts to save for retirement. Between 1995 and 2005, the percentage of workers who have saved for retirement has increased for each age category (see Table 5).

Financial Planning Is Becoming More Complex for Aging Baby Boomers

As noted previously, many baby boomers have limited resources to fund their retirement and may find it difficult to add to their wealth. To help overcome these obstacles, it is important for baby boomers to be knowledgeable about their finances and actively plan their own financial futures or seek the assistance of financial professionals. The results of a recent survey focusing on baby boomer preparation for retirement suggest this is not the case among many older Americans; in fact, only 19 percent had engaged in successful retirement planning (defined as always or mostly able to stick to their plan).17 This is notable in light of the investment responsibilities that defined contribution plans place on the individual. For example, a frequently cited concern is that employees often hold too much stock in the company they work for in their 401(k) plans, failing to take advantage of the benefits of a more diversified

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portfolio. In 2003, 36 percent of workers in their 50s had more than 30 percent of their 401(k) account balances invested in their company stock, and 11 percent had more than 90 percent. The results of a financial literacy questionnaire may help explain why this occurs: Only 52 percent of the respondents understood correctly that holding a single company stock offers a riskier return than a stock mutual fund. So, while not all baby boomers need professional advice, it appears that many could benefit from greater assistance in their financial preparation for retirement.

**Even with Careful Planning, Savings May Still Be Insufficient**

Baby boomers who appear to be financially prepared for a comfortable retirement may continue to encounter unexpected challenges. Three areas of risk could complicate even the most carefully designed retirement plans: inflation risk, longevity risk, and risk of underestimated and unexpected expenses.

**Risk of Inflation**

Increases in consumer prices and the risk of inflation have been limited for a number of years, making it easy to forget that not long ago rapidly rising prices were a serious problem in the United States. Although the annual rate of increase in consumer prices, as measured by the consumer price index, has been 3 percent or less since 1992, this index rose at an annual rate of at least 10 percent in every year between 1979 and 1981. Rising prices can deplete the value of a fixed pension benefit and fixed-income investments, and therefore remain an ongoing risk for retirees.

**Risk of Longevity**

Baby boomers need to factor increased longevity into their financial planning. While advances in medicine are increasing average longevity, it remains difficult to predict accurately the length of the retirement period and, therefore, how long accumulated wealth must last.

When uncertain longevity is combined with the risk of inflation, it becomes problematic for even the most experienced planners to prepare for all scenarios.

**Risk of Underestimated Health Care Expenses**

Finally, underestimated and unexpected health care expenses could consume a large portion of retirement savings. For example, in March 2005, Fidelity Investments estimated that the average 65-year-old couple retiring then would need $190,000 to cover medical costs during the next 15 to 20 years. This figure does not compare favorably with the 2004 median family net worth of $144,700 for the baby boomers ages 45 to 54.

**Is the Future Really So Dark?**

This article has explored the question of whether baby boomers are financially prepared for retirement. Data on defined benefit plans, defined contribution plans, and wealth accumulation suggest that many baby boomers may not have adequate resources for a comfortable retirement. Moreover, issues such as uneven growth in incomes, large amounts of baby boomer debt, and high current expenses could make it difficult for baby boomers to increase their savings. Even those who appear financially well prepared for retirement face risks related to inflation, longevity, and health care costs.

However, the financial situation for many baby boomers is not as dire as it may seem. Changing preferences may lead baby boomers to seek a different type of retirement than their parents. For example, baby boomers may choose to postpone their retirement or begin a second career after retirement. Both scenarios would provide an opportunity for them to accumulate additional assets. The labor force participation rate for people ages 65 and older is 20 percent higher in 2005 than it was 25 years ago. Although the bulk of this increase is due to more elderly women participating in the labor force (the labor force participation rate for women ages 65 and older increased 43 percent during

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19 See note 17.


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this period), participation for men in this age group is on the rise as well. Overall, although the financial future for many baby boomers is uncertain, continuing to work later in life may allay financial strains for some.

As longevity continues to rise with the development of new medical technologies, people who are able to work into their late 60s or 70s could become the norm. Life expectancy for people born today is 78 years, approximately ten more years than for people born during the baby boom generation. Should individuals choose to work for a portion or all of this time, this could help mitigate concerns about how prepared they are for retirement.

J. Aislinn Bohren, Economic Research Assistant
Heather Gratton, Senior Financial Analyst
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22 The labor force participation rate is the percentage of the population in the labor force.
The Shift Away from Defined Benefit Plans

As the U.S. population ages, issues surrounding retirement security for baby boomers and future generations loom large. Thirty years ago, employer-sponsored defined benefit (DB) plans that provided guaranteed monthly payments during retirement were a standard employee benefit. However, the number of DB plans has declined sharply in recent years, from 112,208 in 1985 to about 29,600 in 2004. As U.S. businesses struggle with mounting costs and try to remain competitive in a global economy, the trend away from DB plans appears to be accelerating (see Chart 1). In their place, businesses increasingly are offering defined contribution (DC) plans that allow employees to contribute to an individual account owned and managed by the employee, placing more responsibility on employees to save for retirement and to manage their own funds.

Several factors have coalesced to pressure the DB system in recent years. The system was designed when U.S. manufacturing companies such as General Motors dominated U.S. and world markets for generations at a time. In today’s period of fierce global competition, when new companies routinely emerge to challenge the old, employee benefit costs can reduce earnings and hamper flexibility for many companies in old-line industries. In addition, recent periods of negative equity returns and low interest rates have contributed to volatility in the value of pension assets and significant underfunding in a number of plans. Amid these developments, DC plans have gained in popularity among companies as a means to shift some of the cost and risk of retirement savings to their employees.

This article explores some of the cyclical and structural causes of the recent shift from DB to DC retirement plans. It discusses the motivations for companies to shift from DB to DC plans and the specific risks inherent in both types of plans. Although many companies have moved from DB to DC plans, such as 401(k) plans, many others maintain healthy DB plans and are finding creative ways to invest and manage the costs. With 34 million participants, the private single-employer DB system remains a vital, though increasingly less available, component of the retirement infrastructure.

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1 Several types of DB plans exist: private, single-employer plans; multemployer plans available through unions; and publicly sponsored plans offered to state employees. This article focuses on the private, single-employer DB system. (Pension Benefit Guaranty Corporation Pension Insurance Databook, 2004.)

2 Pension Benefit Guaranty Corporation. This figure includes working and retired participants.
The Evolution of Defined Benefit Plans

Although DB pension plans have been around for decades, they gained in popularity during and after World War II as a means to boost employee compensation in an era of binding wage and price controls. Because employers could not increase employees’ pay, they instead offered deferred income in the form of generous health and retirement benefits. As employee benefits became commonplace, they also became a bargaining tool for unions, allowing companies to negotiate future payments in lieu of pay increases, even after wage restrictions were lifted. Historically, then, the majority of workers covered under DB plans tended to be in the unionized, goods-producing and transportation industries, which had a much more significant market presence 60 years ago. In 1945, manufacturing, utilities, wholesale trade, and transportation services made up more than half of the gross domestic product (GDP), and about 20 percent of workers were unionized. Today, those industries represent about a third of GDP, and 12 percent of the workforce is unionized.

Driven by widespread corporate restructuring and movement away from lifetime employment during the 1980s, alternative retirement funding vehicles began to emerge. In addition, employee tenure declined, and traditional jobs in the goods, manufacturing and transportation sectors increasingly were replaced by jobs in the service sector. Companies in newer industries, such as information technology, have been much less likely to sponsor DB plans.

Today, DB plans primarily are offered in the airline, automobile, and manufacturing industries. Many companies in these industries have experienced stiff pressures in recent years from globalization and other market forces, exacerbating the burden of decades of accrued pension liabilities. Even companies that are better positioned in their core businesses and under less pressure are finding it difficult to compete with more efficient rivals that do not sponsor DB plans. Taken together, these factors have created intense competitive pressure to freeze or terminate DB plans in favor of DC plans.

Why Are Defined Benefit Plans Under Pressure?

Interest Rates and Market Returns

Particularly notable of late has been the inherent volatility of DB funding levels. Dubbed “the perfect storm” by some industry observers, the low interest rate environment of the past few years, in tandem with equity market volatility, has negatively affected the net market value of DB plans. The sensitivity of pension plan obligations to short-term fluctuations in interest rates and market performance creates significant uncertainty for plan sponsors about future contribution levels.

Because pension payments accrue and are paid out over decades, DB plans are highly sensitive to changes in interest rates. The discount rate used to establish current liabilities (based on an average of investment-grade corporate bonds) is critical in determining a plan’s funding level. The lower the interest rate, the

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3 The first employer-provided retirement plan in the United States was offered by American Express in 1875.
4 Bureau of Economic Analysis, Bureau of Labor Statistics (BLS), Haver Analytics, and FDIC analysis.
5 During the past 30 years, ERISA and applicable sections of the Internal Revenue Code (which also applies to DB plans) have been amended a number of times, making compliance increasingly complex. Defined contribution plans are also subject to ERISA.
6 The recently enacted Deficit Reduction Act of 2006 raised premiums to $30 from $19 per participant. Pension plans are not fully insured. Rather, when a plan is terminated, the maximum amount the PBGC pays to beneficiaries is based on a number of factors and adjusted annually for inflation. In most cases, the PBGC payment represents less than a beneficiary would have received had the plan not been terminated.
7 According to the PBGC, 56 percent of workers covered under DB plans are in the manufacturing, transportation, utilities, and wholesale trade sectors.
8 When a plan is frozen, it generally is closed to new participants, with none, some, or all prior participants accruing additional benefits. When a plan is terminated, the sponsor either purchases an annuity or issues a lump-sum payment to beneficiaries.
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higher the present value of the liability and the annual contributions needed to avoid underfunding. But this is only part of the toll that low interest rates have taken on the net market value of DB plans. Asset returns for DB plans also were reduced in 2000 and 2001 by the combination of low interest rates and equity market losses, a situation that has only gradually improved in the years since then. As corporate DB plans became increasingly underfunded, ERISA and Internal Revenue Code rules began to require that firms raise their annual contributions. In some cases, these plans also incurred additional PBGC premiums as well as “shortfall” charges.

Despite the gradual improvement in asset yields in recent years, 81 percent of corporate pension plans remain underfunded at present; during the past two years the plans have regained only 14 percent of the $392 billion in surplus assets lost over the preceding three years. The Government Accountability Office estimates that in aggregate, DB plans are underfunded by a total of $450 billion, with more than half the largest plans underfunded. It is estimated that unfunded pension liabilities of S&P 500 companies in 2005 were close to $218 billion.

Legacy Costs
Plan sponsors in some traditional sectors of the economy face large “legacy costs” on their balance sheets that are closely related to DB pension obligations. The product of decades of labor negotiations in which corporations and their unions agreed to increased pension benefits in lieu of wage increases, pension costs that were once viewed as comfortably far in the future are now coming due. As more people retire and companies increase productivity by reducing their payrolls, fewer workers are available to contribute to the funding of rising health and pension costs. Moreover, the workforce is not only aging, but people are living longer; the average lifespan of retirees has increased from 68 years in 1950 to 78 today. Hardest hit by these legacy costs are traditional industries, such as airlines and automobile manufacturing, which are facing significant competitive pressure in their core business lines as well as the rising burden of pension obligations and steadily increasing numbers of retirees.

Intense Competition
To cope with severe underfunding, more companies are freezing or terminating their DB plans as part of bankruptcy reorganization or efforts to improve their balance sheets. Recent events in the airline industry illustrate this trend. Faced with rising fuel prices and increasing competition from newer, low-cost airlines, such as Southwest and JetBlue, which do not sponsor DB plans, legacy airlines (major carriers operating under the hub-and-spoke system) have posted a record $32 billion in losses during the past four years, with an additional $4.8 billion in losses projected for 2005. Delta and Northwest filed for bankruptcy in September 2005, joining the ranks of other major carriers in Chapter 11, including United Airlines, US Airways (which emerged from bankruptcy in September 2005), ATA, and Aloha Airlines.

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After filing for bankruptcy in 2002, United terminated its DB pension plan in 2005, saving $645 million a year. Industry analysts also expect Delta, Aloha, and Northwest to turn over their pension obligations to the PBGC. The remaining legacy airlines with defined DB plans face more than $60 billion in fixed obligations during the next four years (including $10.4 billion in pension contributions), which figures to place additional financial pressure on them.

The domestic auto industry has seen a similar weakening in profitability as a result of excess capacity, price competition, changing consumer preferences, and rising employee benefit costs. After announcing an $8.6 billion loss in 2005, General Motors (GM) revealed recently it would begin freezing benefits in its DB plan for salaried workers, replacing it with a 401(k)-type DC plan. GM estimates that by restructuring its pension program from DB to DC, it will reduce its 2006 pension liability by $1.6 billion. When GM announced its plan to freeze benefits in the DB plan, it noted the difficulty of competing with companies that do not carry these legacy costs. GM has fewer than 200,000 U.S. workers, but nearly 1 million retirees and dependents. In 2004, the cost of pension and health benefits for retired GM workers represented $1,784 per vehicle, compared with Toyota, which does not offer a DB plan and whose employee benefits represented only $200 per vehicle. With a retiree-to-employee ratio close to one-to-one, Ford Motors also is having trouble meeting its benefit obligations. Going forward, analysts expect Ford to negotiate with its labor unions to restructure benefits, or possibly even switch to a DC plan.

Increased Investor and Regulatory Scrutiny

Regulators, investors and analysts also have become increasingly concerned about the lack of transparency in DB pension plans and the leeway the current rules provide in reporting a plan’s financial condition. Under current rules, plan sponsors may value plan assets at anywhere from 80 to 120 percent of market value, and earnings may be projected using a long-term expected rate of return, with gains or losses amortized over five years. On the liability side, valuation is based on a four-year weighted average of investment grade corporate bonds, where the rate must fall between 90 and 100 percent of the index. Under this approach, plan sponsors are able to reduce funding volatility by “smoothing” fluctuations in interest rates, making future payment more predictable.

Critics argue, however, that this flexibility allows sponsors to mask the plan’s true health, and that today’s underfunding is due, at least in part, to current rules that allow sponsors to amortize gains or losses on assets and liabilities over extended periods and use credits in lieu of cash contributions. It has been reported in the financial media that the Securities and Exchange Commission is reviewing whether some companies changed their assumptions about pension obligations to meet short-term earnings targets. The agency has not formally charged any company with wrongdoing. In addition, investors and analysts increasingly are wary of the impact pension obligations will have on earnings and cash flow. Since 2002, a number of analyst reports have criticized large corporate funding obligations, and credit rating agencies have noted pension problems as contributing factors in ratings downgrades, such as in the cases of Ford and GM in 2005. A recent Bear Stearns report warned that investors who fail to consider a company’s pension liabilities do so at their own risk.

The increasingly common practice of using the bankruptcy process to shift legacy costs to the PBGC is prompting discussion about the potential for moral hazard (where, to the extent allowed, the plan sponsor may take unnecessary risks or not fully fund the plan, expecting the PBGC will take over the plan in the future)

20 United’s pension obligations were underfunded by about $9.8 billion and represented the largest claim in PBGC history.
23 www.businessweek.com/magazine/content/04_29/b3892001_mz001.htm.
26 The previous benchmark was the 30-year Treasury rate; however, the Pension Funding Equity Act of 2004 temporarily replaced the 30-year rate with the composite index of bonds.
27 Pension overhaul legislation, which attempts to resolve these issues, among others, is now working its way through Congress. In 2005, the House and Senate passed reform legislation, and a conference is currently working to resolve differences between the bills. The Bush administration released its reform proposal in January 2005.
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Critics argue that the ability to socialize pension obligations by shifting them to the PBGC has eroded incentives for companies to rein in these obligations on their own. Further, the series of large DB plan terminations of the last few years has impaired the financial position of the PBGC itself, further fueling the national debate about the future of DB plans. With the PBGC currently operating at a $23 billion deficit, sponsors of healthy plans are implicitly subsidizing plans that are currently underfunded or that have been terminated due to bankruptcy. Legislators and policymakers face the possibility of a taxpayer bailout should the agency not return to solvency before more large terminations occur.30

The Transition to Defined Contribution Plans

To reduce costs and manage pension risks, more companies are shifting out of the DB system and into DC plans, in which employees contribute a portion of their salary to an individual account that they own and manage.31 Facilitating this trend was a piece of legislation enacted in 1978 that allowed the deferral of income in retirement plans on a tax-advantaged basis; this section of the Revenue Act of 1978 became Section 401(k) of the Internal Revenue Code. The regulations were finalized in 1981 when the Internal Revenue Service (IRS) sanctioned the use of employee salary deductions as a source of retirement plan contributions.32 Within two years, nearly half of all large firms were either offering or considering a 401(k) plan.33 Between 1985 and 2005, total assets in defined contribution plans grew 560 percent, from $430 billion to $2.8 trillion (see Chart 2).34 According to the Employee Benefit Research Institute (EBRI), about 60 percent of private retirement assets are now held in 401(k) plans and individual retirement accounts (IRAs).35 Employees covered under a DC plan increased from 41 percent in 1985 to 51 percent in 2003, while those covered under a DB plan fell from 80 percent to 33 percent during the same period.36 Despite their relatively recent emergence, DC plans have quickly become commonplace, and are viewed by many companies as a cost-effective alternative to the DB system.37

Employers are not alone in their newfound affinity for DC plans as a vehicle for retirement savings. Many workers have become concerned about relying for their retirement security on employers that may not be in business in 20 or 30 years. Further, as lifetime employment with one company has become less common, employees have begun to prefer greater flexibility and portability of their retirement savings, as well as the ability to manage their own assets. The increased mobility of the workforce has fueled growth in DC plans, as younger employees tend to change jobs more frequently than in previous generations. Payouts under DB plans are typically based on ending salary and tenure; an employee maximizes the DB potential by staying with the company for an extended period. In contrast, DC plans have shorter vesting periods and do

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30 Pending pension reform bills also address PBGC solvency and aim to give the agency more pricing power, while introducing a risk-based premium structure. The PBGC has the authority to borrow $100 million from the Treasury, but Congress must act to provide additional funding.

31 Current IRS rules allow employee contributions of up to $15,000 in 2006.

32 In 1986, the Federal Thrift Savings Plan was established and signaled to the private sector that the DC plan structure was an acceptable alternative.


34 Federal Reserve Flow of Funds.


37 The most popular DC plan type is the 401(k); other forms are thrift savings plans, employee stock ownership plans, and profit sharing plans. Companies also are offering hybrid plans, which combine characteristics of DC and DB plans; the legal and regulatory environment surrounding hybrid plans, however, remains uncertain.
not impose penalties for changing employers as long as fund proceeds are reinvested in another qualified retirement plan.

The expense of DB plan sponsorship has become too much for even some healthy companies that are relatively well positioned in their markets. Some recent examples of the shift from DB to DC plans include large employers in high-tech industries. Verizon Wireless, which opted in 2005 to shift to a DC plan, estimates savings of $3 billion over the next ten years. In January 2006, when IBM froze its pension plan in favor of a DC plan, executives claimed the move would result in savings of $450 to $500 million for 2006, and $2.5 to $3 billion for 2006 through 2010. In 2005, Hewlett Packard also announced plans to freeze its pension plan. Sprint, Motorola, and Lockheed-Martin are among the other companies that have recently announced plans to phase out their DB plans, and many expect the list to grow in the near term.

Who Bears the Risk?

Saving and investing over the long term carry significant risks for companies and individuals. Participants in and underwriters of both DB and DC pension plans must make assumptions over several decades about the direction of interest rates, market returns, and life expectancies that, taken together, will determine the plan’s long-term financial viability. The uncertainties associated with this forecasting process introduce three types of risk: longevity risk, market risk, and bankruptcy risk.

Longevity risk is the risk that plan beneficiaries will live longer than expected. DB plans pay benefits essentially in the form of an annuity. Therefore, a longer average lifespan for beneficiaries raises the expected value of the plan’s liabilities and increases the chance the plan will run short of funds. Certainly, the longer average life expectancy of retirees in recent years has contributed significantly to the financial pressure facing DB plans. In the case of DC plans, however, longevity risk is borne by the individual. This tends to convert longevity risk from a factor that could bankrupt a pension plan into one where the beneficiaries risk outliving their financial assets. Instead of receiving a guaranteed amount each month during retirement, retirees must plan and invest, taking distributions according to their specific circumstances. This is in contrast to DB payments, which generally are not adjusted for inflation and cannot be exhausted, mitigating the possibility of over- or under-consumption. Further, in a DB plan, employees cannot cash out before retirement, as they can in DC plans.

Market risk affects the value of DB plans in two ways. First, the value of the assets held by DB plans is determined by the returns, which typically take the form of stock dividends and capital gains as well as interest earned on fixed-income investments. To the extent that market returns or interest rates underperform expectations, the value of DB plan assets may not grow fast enough to keep pace with the obligations. In addition, the market value of a DB plan’s liabilities is determined in part by discounting at a market rate of interest. In this case, low interest rates can increase the market value of DB plan liabilities and force a refunding of the plan. By comparison, the market risk associated with DC plans is concentrated on the asset side. Lower-than-expected interest rates and market returns drive down the asset value of DC plans and make it more likely that beneficiaries will outlive their financial assets.

DC plans tend to push longevity risk and market risk off the corporate balance sheet and onto the household balance sheet. What do employees get in return for assuming these large, long-term risks? Besides the opportunity to make more decisions for themselves, employees in DC plans are rewarded with a significant reduction in the risk that their retirement benefits will be reduced or eliminated by bankruptcy or other forms of repudiation. As long as the assets and liabilities of the DB pension plan reside with a corporation that could file bankruptcy or terminate or modify the plan over its long life, the beneficiary could experience a significant decline in lifetime benefits. Corporate bankruptcy, which shifts pension liabilities to the PBGC and often...

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38 The cost difference between these types of plans is striking: DB plans cost companies $2.21 per hour, on average, compared with $0.27 for DC plans. (Bureau of Labor Statistics, September 2005. Employer Costs For Employee Compensation.) Millman estimated that for the 100 companies in its survey, pension expenses increased $4.1 billion dollars in 2004, producing an aggregate pension cost of $18.3 billion.


40 The need for financial education is significant; however, employers are restricted in what advice they can provide employees. Certain provisions of the proposed pension reform legislation would make it easier for employees to access investment advice and allow automatic enrollment of employees.
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results in substantial reductions in benefits, is one example of bankruptcy risk. But perhaps an even more common and less visible risk that faces DB plan beneficiaries is the erosion of pension and health benefits that could occur through negotiation and fiat during the life of a DB agreement. It is perhaps in this regard that DC plans offer the greatest perceived value to today’s workers by simplifying and solidifying the ownership rights they have to the proceeds of their retirement plan.

What Is the Future of Defined Benefit Plans?

The decision to maintain a DB pension plan or move to a DC plan is one that companies weigh carefully as they balance the sometimes conflicting needs and expectations of employees and shareholders. Despite the market and structural forces that have pressured DB plans and the companies that offer them, some 34 million working and retired Americans depend on company-funded plans to provide for their retirement. Many companies continue to fund their own retirement plans because they feel these programs reward loyalty and give them an edge in hiring and retaining the best people. However, the recent trend has been for more companies to bypass DB sponsorship altogether. It is likely that competitive pressures will continue to force companies to consider terminating their DB plans and offering alternative types of retirement savings programs to their employees.

In today’s volatile business environment, where corporate structure changes frequently and large bankruptcies are not uncommon, many employees may feel more secure controlling their retirement assets and making their own investment decisions. Under DC plans, the advantage of portability is attractive to younger workers, in particular, and helps to offset the longevity and market risks they bear. However, neither structure eliminates risks entirely, and employees and employers must continue to work together to arrive at mutually beneficial ways to manage the risks inherent in long-term retirement saving and investment.

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The author wishes to acknowledge valuable comments received on previous versions of this article from Stephen C. Gabriel, Senior Financial Economist, and Devin W. Sloss, Student Intern.
The Demographics of Housing Demand

Traditionally, anticipating the demand for owner-occupied housing involves the analysis of several underlying factors, including interest rates, local economic conditions, rent levels, population growth, and affordability. However, market analysts also place emphasis on the demographic characteristics of population growth when assessing trends and preferences for housing, as shifts in age and family composition affect demand. What key demographic trends are currently influencing the demand for housing in the United States, and how will these trends continue to affect the market?

Two distinct demographic groups, baby boomers and immigrants, dominate all other groups by sheer size (see Chart 1) and, for boomers, their wealth. Both already have shaped housing markets and contributed to rising levels of homeownership. Retiring boomers influence demand for housing as they downsize, trade up, and invest in second homes. Immigrants, typically characterized by larger and younger households, will strengthen demand for owner-occupied housing as they age and live longer in this country.

The extent of how strongly demographics influences the housing market is a hotly debated issue among industry analysts. For example, a study by Mankiw and Weil in 1989 forecasted a dramatic decline in home prices over the next 20 years.1 This forecast assumed that as baby boomers age, demand for single-family homes could not be sustained by the much smaller “baby bust” generation. With the benefit of hindsight, however, we see that the housing market has boomed in many areas during the past 13 years, while the average price of homes continues to appreciate. In fact, the close of fourth quarter 2005 marked the sixth consecutive quarter of year over year double-digit home price growth nationwide.

More recently, economist Dean Baker of the Center for Economic and Policy Research has cautioned that population growth is not driving the recent appreciation in home prices and will do little to sustain current price levels.2 Rather he predicts the housing market, which he believes is sustained by borrowing against inflated home values, will suffer the same fate as one of its precipitating factors—the stock market boom of the late 1990s. This perspective contrasts with the opinion of other industry experts who predict only a moderate slowdown in prices in certain regions of the country as the market is bolstered by increased demand for housing in retirement communities and continued high levels of immigration.3 This article examines the impact of baby boomers and immigrants on the nation’s housing sector and provides insights on how these groups may influence and sustain demand for years to come.

Baby Boomers and the Housing Market

The baby boomer generation includes some 78 million persons who were born between 1946 and 1964, the first of whom begin turning 60 this year.4 This generation is not only the country’s largest, but also its highest paid and most educated. Comprising some 26 percent of the U.S. population, baby boomers represent the wealthiest generational group, with more than $2 trillion in estimated spending power. According to the 2000 Census, the boomer cohort represents just less than a third of the population in the states of Alaska, New Hampshire, Vermont, Maine, and Maryland.

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A study of baby boomers born in the 1950s, published in the University of Southern California’s Lusk Review, reveals correlations between this cohort and movements in the housing market. When this group reached 20 years of age, many moved to rental units, stimulating the construction of apartments in the suburbs as well as the rejuvenation of some central cities. By the late 1970s, this slice of boomers entered prime homebuying years, stimulating demand for housing and a ramping up of home prices. According to the 2000 Census, boomers were the largest homeowner group, representing approximately 40 million of the 111 million American households. Although baby boomers may no longer be the dominant force driving demand for traditional single-family homes, this key demographic group will remain an influential component of the owner-occupied housing market as a whole.

Currently, the homeownership rate peaks at 84.5 percent for individuals between the ages of 70 and 74. David Berson, Fannie Mae’s chief economist, has suggested that the peak rate of home ownership may rise further to age 74 or 75 as a result of improved health and greater longevity. As boomers move toward peak ownership age, per capita home equity increases and may influence the housing market as a source of funds for second homes, downsizing, trade-up purchases, or relocation to age-specific communities.

Moving into Retirement

Baby boomers are poised to enjoy a longer, healthier, and more active retirement than any previous generation. Observers predict this will shape postretirement lifestyles and homebuying decisions. Traditional determinants of housing demand, particularly interest rates, do not restrict this group as strongly as they do most other age cohorts. According to Pulte Homes, a developer specializing in active adult communities, 50 percent of clients in this market pay in cash, making this segment of the population relatively “rate insensitive.”

How strongly will boomers affect the housing market as they enter retirement? According to the results of the Pulte Homes’ May 2005 Baby Boomer Survey, more than half the respondents intend to purchase a new home for retirement, and at least 40 percent will downsize. Developers are anticipating this influx of boomer retirees. According to the National Association of Home Builders (NAHB), seven of the ten top U.S. home builders are designing and building housing for adults older than 55. In fact, during the first half of 2005, one-third of the revenue of Pulte Homes was attributed to homes for older buyers, and the company predicts this could grow to 40 percent of its business. Although baby boomers’ demand for particular types of housing is expected to increase, certain unanswered questions about this demand remain. How do industry experts expect boomers’ housing choices to deviate from prior generations of retirees? Three factors—location, lifestyle, and leisure—tell much of the story.

Location

Unlike earlier retirees’ preference for the Sunbelt, research shows boomers favor retirement destinations that are more scattered across the country. Charles Longino, author of Retirement Migration in America, has identified shifts in retiree migration patterns. Although Florida remains a popular destination, Longino notes mountainous areas in the West and smaller states of the South are becoming increasingly popular. For example, boomer migration patterns from 1990 to 2003 show this demographic group grew in the Pacific Northwest, Florida, and selected areas of the South, as well as in areas that previously had attracted significant numbers of these individuals, particularly the Washington, D.C., Minneapolis, Atlanta, and Dallas metropolitan areas (see Map 1, next page). In addition, baby boomers show greater propensity to “age in place”—continuing to live in the same geographic area. Developers are responding to these changing preferences and shifts in population concentrations. For example, Pulte Homes is planning 22 active adult communities, half of them in cold-weather states, including Illinois, Michigan, New Jersey, and Ohio.

8 Pulte Homes is one of the nation’s leading home builders, ranking at the top in the delivery of homes in 2005. Under the Del Webb brand, Pulte is the largest builder of active adult communities. The company conducted a survey of 1,814 individuals ages 41–69; the results, released in Pulte Homes—Baby Boomer Survey, May 2005, show boomers’ housing preferences, plans for retirement and lifestyle.


The Demographics of Housing Demand

Map 1

The Baby Boomer Cohort Shifted Increasingly to the West, to Florida, and to Select Areas of the South between 1990 and 2003

Note: Mapping the ratio of 40- to 55-year-olds in 2003 to 25- to 44-year-olds in 1990 shows concentrations of this cohort increased in the Pacific Northwest, Florida, and selected areas of the South. Areas with ratios greater than one imply a net increase in the number of individuals in the baby boom cohort.


Lifestyle

Current baby boomer homebuyers are downsizing, but at the same time want homes with more amenities than they owned in the past. Developers increasingly are appealing to trade-up buyers who prefer single-family, one-story homes with more floor space and upscale amenities, such as high ceilings and large garages. This trend is even more apparent among younger boomers, who exhibit a stronger inclination for luxury features.

Developers also are taking note of the fact that aging baby boomers are living more active lifestyles than previous retiree cohorts. Active adult communities, built for individuals ages 55 and older, feature gyms and computer labs with high-speed Internet access, and are appearing near major urban areas (Washington, D.C., Chicago, and Northern New Jersey) with high concentrations of boomers who are staying connected to the workforce. Another housing trend, college-oriented retirement communities, is gaining popularity, reflecting the desire of many retirees to continue their education.

Leisure

Although the number of boomers owning second homes is smaller than previous retiree generations, the sheer size of this group is fueling the second-home market. The Homeownership Alliance, an organization that educates the public about housing and home-
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ownership issues and trends in the United States, estimates this generation will boost second-home housing starts by 125,000 annually through 2013.14

David Lereah, chief economist of the National Association of Realtors (NAR), attributed strong second-home sales in 2004 to the presence of boomers and predicted their influence will continue to fuel this market: “It’s likely over the next decade that second-home sales will remain historically high. The boomers are still in their peak earning years and have both the wherewithal and the desire to purchase vacation homes and investment properties.”15

Immigrants and the Housing Market

Boomers and immigrants occupy opposite ends of the demographic spectrum in terms of age, wealth, and family size. Immigrants are on average a distinctly younger and less wealthy group. The Census Bureau estimates roughly 12 percent of the present U.S. population is foreign born. This cohort represents a diverse mix of origins, ages, education levels, and economic backgrounds. The 2000 Census shows more than half the foreign-born population originated in Latin America, with 9.2 million immigrants coming from Mexico. China ranked second as the birthplace of 1.5 million immigrants. The median age of the adult foreign-born population is slightly lower than the native born, with 36 percent between the ages of 18 and 34, compared with 31 percent of the native-born population. Latin American immigrants, in particular, are a younger group, with 43 percent between the ages of 18 and 34. Results of the 2000 Census also show the average annual wage of foreign-born workers was about 75 percent that of natives, or $27,000. States with the largest share of immigrant populations were California (26.2 percent), New York (20.4 percent), New Jersey (17.5 percent), Hawaii (17.5 percent), and Florida (16.7 percent).

Immigrants’ influence on the housing market is based largely on the current considerable size of this group and its potential for significant growth. The volume of immigration expanded in the late 1970s, and the number of immigrant households increased 16 percent during the 1980s. Strong immigration during the 1990s contributed to a greater minority share of first-time homebuyers.16 Between 1990 and 2000, the number of foreign-born households in the United States grew to just under 12 million, 50 percent of which were owner-occupied households. This increase in foreign-born homeowners represented 20 percent of the overall increase in U.S. homeowners—twice that of the prior decade.17 The influx of immigrants continued to strengthen through 2003, contributing to growth in household formation, homeownership, and construction of rental units. This impact will become more pronounced as immigrants’ native-born children—second-generation Americans—mature.

Although immigrants are becoming homeowners in greater numbers, their initial impact is most apparent on rental markets. Between 1990 and 2000, the increase in foreign-born households comprised three-quarters of the net growth in renters.18 However, homeownership rates among immigrants increase with their age and the length of time an immigrant lives in this country (see Chart 2).19 For example, more than half the growth in immigrant homeownership during the 1990s is attributed to individuals who arrived before 1990. Significant levels of immigration, as well as the

16 During the 1990s, approximately 1 million people per year were part of the migration flow to the United States, nearly two-and-a-half times the number in the 1970s.
18 Ibid.
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Immigrant Population Growth Surged between 1990 and 2000, Concentrating in Top U.S. Metro Areas

Map 2

Note: Honolulu, not shown, is one of the traditional immigrant gateways.

Traditional large immigrant gateways are cities where the proportion of immigrants in 1990 exceeded 11.1 percent but experienced a below-average rate of immigrant population growth between 1990 and 2000.

Slow-growth immigrant destinations are cities where the proportion of immigrants in 1990 was less than 11.1 percent and experienced a below-average rate of growth in the immigrant population between 1990 and 2000.

New immigrant gateways are cities where the proportion of immigrants in 1990 was large, greater than 11.1 percent, and experienced an average rate of immigrant population growth between 1990 and 2000 that exceeded 55 percent.

New fast-growing hubs are cities where the proportion of immigrants in 1990 was less than 11.1 percent but experienced an average rate of immigrant population growth between 1990 and 2000 greater than 55 percent.


relative youth of the foreign-born population, continues to affect housing demand as immigrant homeownership rates rise in tandem with length of residence.

Immigrant Households: Concentrations and Composition

Foreign-born households traditionally have concentrated in or around “gateway” cities, such as Los Angeles, New York, Miami, and Boston (see Map 2). Although still concentrated in metropolitan areas, during the last decade immigrants increasingly have populated areas that have not been traditional points of entry. For example, foreign-born populations in North Carolina, Georgia, Nevada, and Tennessee grew at least 145 percent between 1990 and 2000.20

Although immigrant homeowners in large part are concentrated in metropolitan areas, two-thirds reside in suburban rather than central city neighborhoods.21

Cities classified as “new immigrant gateways” have the highest homeownership rates for the most rapidly growing groups of immigrants. For example, according to 2000 Census data, the Latino ownership rate exceeded the national Latino average in 10 of the 12 new immigrant gateway cities, and the Asian rate exceeded the national Asian average in all 12 cities. While “traditional gateway” metro areas continue to have the largest immigrant communities, they also have the


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Chart 3

In Central Cities, Population Growth and Slowing Household Formation Show Immigrants’ Influence

Source: Brookings Institution Center on Urban and Metropolitan Policy.

lowest rates of foreign-born homeownership.22 This is attributed to high turnover rates, increased competition for space, and the fact that these urban areas tend to be characterized by high housing costs and a greater percentage of residents living in rental units. The cost of housing in new immigrant gateway metro areas reflects immigrants’ generally lower income level. In fact, 20 percent of immigrant-owned homes are valued at $90,000 or less in these areas, compared with only 9.8 percent in traditional gateway cities.23

Immigrants tend to populate ethnically homogeneous neighborhoods, a trend that has spurred population growth and homeownership in the new gateway cities and has sustained the foreign-born population in the traditional hubs. Census data from the ten largest U.S. metropolitan areas show that between 1990 and 2000, the number of white and black individuals living in homogeneous neighborhoods declined 10 percent. However, the opposite was true for Latinos and Asians. Individuals in these ethnic groups are more likely to live in neighborhoods where their group makes up at least 50 percent of the population.24

Household composition and size are significant predictors of the volume of future housing demand. Foreign-born households’ living arrangements differ from that of native-born households. Contrary to boomers’ declining household size, immigrant households are more likely to include more family members, married couples with children, and adults beyond the head or spouse.25

Although central city population growth in the late 1990s reached a three-decade high, household growth for these metros declined to a three-decade low, as fewer households were formed with more family members (see Chart 3). A rate of household growth that lags population growth suggests pent up, or future, housing demand. This divergence was most evident in “melting pot” metro areas with significant growth in the immigrant population.26

These trends suggest immigrants will be attracted toward specific regions of the country and favor homes designed to accommodate larger or extended families. However, the extent of immigrants’ impact on housing demand depends on the availability of financing.

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22 Papademetriou, Demetrios, and Brian Ray. March 2004. From Homeland to a Home: Immigrants and Homeownership in Urban America. Fannie Mae Papers. The authors differentiate between metropolitan areas that have been traditional points of immigrant entry and places of residence, and those that are new. Among the traditional large immigrant gateways are Los Angeles-Long Beach, CA; San Francisco, CA; Honolulu, HI; Miami, FL; El Paso, TX; Ventura, CA; New York, NY; Jersey City, NJ; Boston-Worcester-Lawrence-Lowell-Brockton, MA-NH; Stockton-Lodi, CA; San Diego, CA; Newark, NJ; Fresno, CA; Orange County, CA; and Bergen-Passaic, NJ. New immigrant gateways include Vallejo-Fairfield-Napa, CA; Chicago, IL; San Jose, CA; Bakersfield, CA MSA; Riverside-San Bernardino, CA; Oakland, CA; Washington, DC-MD-VA-WV; McAllen-Edinburg-Mission, TX; West Palm Beach-Boca Raton, FL; Middlesex-Somerset-Hunterdon, NJ; Houston, TX; and Fort Lauderdale, FL.

23 Ibid.


opportunities for lower-income individuals, as affordability is a major obstacle to immigrant homeownership.

A number of programs encouraging minority and immigrant homeownership were introduced in the 1990s. Flexible mortgage financing and other initiatives made home purchasing feasible for groups historically unable to afford or qualify for a mortgage. Despite such initiatives, however, there are significant hurdles to immigrant homeownership. In 2003, Fannie Mae conducted a survey of Spanish-speaking households, currently the largest immigrant group and the group expected to grow 75 percent during the next two decades. The study concluded that affordability issues and lack of understanding of the market were barriers preventing these individuals from achieving homeownership. A similar study conducted by the Homeownership Alliance surveyed Hispanics’ outlook about homeownership. Although a majority of participants stated they would prefer to own a home, lack of knowledge about credit ratings and the mortgage process, as well as a language barrier, prevented them from doing so.

The Bottom Line

Clearly, shifts in two dominant demographic groups—immigrants and baby boomers—will continue to influence housing demand in the future. The long-run fundamentals of demand appear to remain favorable, due in large part to strong growth in immigrant households and future housing needs of their children. In addition, the housing preferences of the graying but active boomer cohort and the need to replace aging housing stock are expected to sustain the production of as many as 2 million new homes annually during the next ten years.27

Some skeptics cite a slowdown in household formation to an annual average growth of only 1.5 percent during the past five years, down from 2.5 percent in the late 1970s. However, current housing projections indicate that with inflows of immigrants consistently underestimated and likely to increase, as well as increased longevity of the overall population, net household growth during the next decade may actually exceed that of the baby boomers’ entrance into the market in the 1970s.28 Although overall household growth did slow in the past five years, growth in households in the 45-to-54-year cohort was almost double that of the nation as a whole, averaging 2.8 percent growth between 2000 and 2004. Furthermore, one in five U.S. households in 2005 was headed by either a foreign-born individual or a second-generation American, a share that likely will increase.

Demographics are not the sole determinant of future trends in the nation’s housing market; however, they are a key indicator of the size and nature of demand for housing. Boomers and immigrants will continue to stimulate demand, but in different sectors of the housing market. As boomers retire and downsize, they will fuel demand at the upper end of the market, with a focus on amenities.29 Immigrants, on the other hand, will look for less expensive housing to accommodate larger family size. In addition, geographic concentrations of baby boomer and immigrant populations will determine those housing markets that will be most significantly affected, particularly those areas where overlap occurs between the two groups, such as Florida and Texas. Going forward, these two distinct demographic groups appear likely to continue to drive increases in demand for U.S. housing.

Cynthia Angell, Financial Economist
Clare D. Rowley, Economic Assistant


28 Ibid.
29 Riche, Martha Farnsworth. February 2003. How Changes in the Nation’s Age and Household Structure Will Reshape Housing Demand in the 21st Century. HUD Issue Papers on Demographic Trends. Riche notes the pronounced income inequality in the growing older population, citing Census data showing that the income for households that have raised their families but are not yet retired is generally higher than the average for all households. This supports findings by NAHB and Blanchard relating to baby boomers’ preference for amenities to accommodate their active lifestyles.
Regional Demographic and Banking Trends

The aging of the baby boomers is becoming an increasingly important public policy issue for this country.\(^1\) Demographers, health care professionals, and policymakers, among others, are concerned that as the ratio of elderly persons (those ages 65 and older) to the working-age population increases during the next two decades, expenditures for health care and other support of the elderly will fall on a proportionately smaller labor force. However, the potential impacts of the aging baby boomer generation as well as other key demographic trends are not evenly distributed across the country (see Map 1). For example, baby boomer populations are heavily concentrated in New England, the Northwest, the Rocky Mountain states, and metropolitan areas in the Midwest. The growing elderly segment of our nation’s population, however, is concentrated in the Great Plains, the Southwest, and Florida.\(^2\)

This uneven distribution of baby boomers and elderly highlights several regional demographic trends. For example, domestic migration, or population shifts occurring within the United States, has been significant. During the past few decades, baby boomers and younger working-age people have moved from rural to urban areas in search of employment, leaving behind a disproportionate number of elderly residents. In addition, retirees have flocked to states such as Florida, Arizona, and Nevada because of the warm climates and amenities. Domestic migration may become more important as the number of baby boomers moving to retirement locations continues to increase. Improved communication technologies, including the Internet, have greatly improved the availability of information about employment opportunities, enabling workers to search for jobs across the country.\(^3\)

Another key regional demographic trend is international migration, the impact of which also is not felt equally across the country.\(^4\) Immigrants from Latin America and Asia, who represented 78 percent of legal

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\(^1\) The “baby boom generation” and “baby boomers” refer to persons born between 1946 and 1964.


\(^4\) According to the U.S. Census Bureau, net international migration is defined as “(1) net migration of the foreign born, (2) net movement from Puerto Rico, (3) net movement of the U.S. Armed Forces, and (4) emigration of the native born. The largest component, net migration of the foreign born, includes lawful permanent residents (immigrants), temporary migrants (such as students), humanitarian migrants (such as refugees), and people illegally present in the United States.” www.census.gov/popest/topics/terms/national.html.
immigrants to the United States during the 1990s, settled in California, Arizona, New Mexico, and Texas. In addition, an estimated 7 million unauthorized immigrants lived in this country in 2000; more than two-thirds immigrated from Mexico, and these individuals tend to be concentrated in the southern states. These and other key demographic trends are examined in this article as analysts from the FDIC’s eight geographic areas offer insights about the implications of these trends for local economies and the banking industry.

**Atlanta Region**

*Relatively large and growing elderly populations, as well as strong international immigration, have spurred increased banking activity.*

The elderly represent an important demographic in many areas of the Atlanta Region (see Map 2), particularly in Florida and West Virginia, where this group ranks among the highest in the nation. The relatively large number of elderly residents in Florida is due to high levels of retiree in-migration. However, in West Virginia, as well as the Region’s other rural areas, this situation may be the result of younger individuals leaving to pursue economic opportunities. Notable exceptions to significant concentrations of the elderly in the Region are the Atlanta metropolitan area, North Carolina’s Research Triangle, and Northern Virginia.

Although Florida is expected to continue as a magnet for retirees, its deteriorating housing affordability may become problematic for some retirees. This may spur greater numbers of residents to relocate from the coast to areas of the Region where home prices are lower, such as the South Carolina Low Country and Myrtle Beach areas.

The level and pace of international migration has ratcheted upward in the Southeast. Although widespread across the area, immigrants from outside the United States choose to reside in a few specific areas, such as South and Central Florida, metropolitan Atlanta, and Northern Virginia (see Table 1, next page). Combined, these areas represented more than half the Region’s international migration between 2000 and 2005.

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6 Source: Immigration and Naturalization Service (historical). Figures do not include West Virginia, for which Census figures were not available.
Banking on the Baby Boomers

Table 1

<table>
<thead>
<tr>
<th>County</th>
<th>International Residents (000s): 2000–2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dade County (FL)</td>
<td>252.1</td>
</tr>
<tr>
<td>Broward County (FL)</td>
<td>96.9</td>
</tr>
<tr>
<td>Fairfax, Fairfax City + Falls Church (VA)</td>
<td>70.7</td>
</tr>
<tr>
<td>Palm Beach County (FL)</td>
<td>46.9</td>
</tr>
<tr>
<td>DeKalb County (GA)</td>
<td>46.3</td>
</tr>
<tr>
<td>Orange County (FL)</td>
<td>41.6</td>
</tr>
<tr>
<td>Gwinnett County (GA)</td>
<td>34.3</td>
</tr>
<tr>
<td>Fulton County (GA)</td>
<td>34.3</td>
</tr>
<tr>
<td>Hillsborough County (FL)</td>
<td>29.3</td>
</tr>
<tr>
<td>Cobb County (GA)</td>
<td>29.2</td>
</tr>
</tbody>
</table>

Source: U.S. Census Bureau, Economy.com.

Chart 1

Several Factors Have Led to Population Changes in the Chicago Region

<table>
<thead>
<tr>
<th>State</th>
<th>Population Change</th>
<th>Natural Growth</th>
<th>International Migration</th>
<th>Domestic Migration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illinois</td>
<td>400</td>
<td>300</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>Ohio</td>
<td>400</td>
<td>300</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>Michigan</td>
<td>400</td>
<td>300</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>Indiana</td>
<td>400</td>
<td>300</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>400</td>
<td>300</td>
<td>200</td>
<td>100</td>
</tr>
<tr>
<td>Kentucky</td>
<td>400</td>
<td>300</td>
<td>200</td>
<td>100</td>
</tr>
</tbody>
</table>

Note: Natural growth is the number of births minus the number of deaths. Source: U.S. Census Bureau.

of Deposits data, banks and thrifts operating in the counties in the Southeast with a relatively high volume of international migration also reported some of the greatest increases in bank branching activity. Similarly, demand by the elderly for financial products and services differs from other demographic groups and is expected to influence bank product development and marketing decisions. (See “How Aging Baby Boomers Are Changing the Financial Marketplace” on page 34 for an overview of how the financial needs and preferences of the baby boom cohort are expected to change as they near retirement and the opportunities this presents for the nation’s insured institutions.)

Chicago Region

Relatively low population growth, a result of domestic out-migration, has contributed to heightened competition among banks.

The Chicago Region is characterized by a below-average rate of population growth because of domestic out-migration. In several states, domestic out-migration exceeded total population growth, while other states experienced relatively low rates of in-migration (see Chart 1). Two factors are responsible: a decline in the number of jobs, particularly in the manufacturing sector, and the out-migration of retirees to warmer climates. Except for Kentucky, every state in the Region experienced net domestic out-migration in the 20–29 age cohort, apparently because individuals in this group sought job opportunities elsewhere. Illinois and Ohio also experienced out-migration of baby boomers, and out-migration of elderly occurred in all states in the Region. Despite these shifts in population, however, the percent of the elderly population is expected to grow due to an aging baby boomer population.

International in-migration offset some or all of each state’s domestic out-migration. However, this in-migration occurred unevenly as most individuals settled in larger metro areas, such as Chicago or Detroit. In general, the population in suburban counties near larger metro areas grew most significantly.

The Region’s relatively weak population growth could dampen overall household wealth, which, in turn, could constrain sources of insured institution deposits, particularly for those banks and thrifts operating in affected areas. In addition, a smaller potential customer base likely will heighten competition among institutions. Generally, during the past five years, community institutions in counties with relatively slow rates of population growth have reported lower levels of growth in assets (7.0 percent), loans (6.5 percent) and deposits (7.1 percent) than those operating in areas with relatively high rates of population growth (asset growth of 12.9 percent, loan growth of 14.3 percent, and deposit growth of 12.9 percent).7

7 Low population growth counties consist of counties that experienced population growth rates below the 25th percentile between 1990 and 2004. High population growth counties consist of those that experienced growth above the 75th percentile. Community institutions include insured banks and thrifts with assets less than $1 billion excluding credit card and other specialty banks as of September 30, 2005.
To extend their geographic reach, more banks in the Region have branched into other states or are offering electronic banking products. Insured institutions also are reporting upticks in investment sales and trust activity, product areas of interest to an aging population. In addition, some institutions, particularly in the larger metro areas, have expanded outreach and marketing efforts to target the growing immigrant population.

**Dallas Region—Southwest**

*Concentrations of aging baby boomers and elderly with significant wealth present opportunities for local banking institutions.*

Three key demographic trends are emerging in the Southwest United States: a slowing in domestic migration from other areas of the country, rapid growth in the number of baby boomer retirees and preretirees, and continued rapid growth in the Hispanic population. Between 2000 and 2004, Hispanics represented nearly two-thirds of the Region’s population growth, increasing at a rate two-and-a-half times that of non-Hispanics. In addition, robust economic and job growth during the 1990s, particularly in Colorado and Texas, contributed to a substantial net domestic migration from California, the Midwest, and the Northeast. During the past five years, this relocation of population slowed and, in some states, turned negative largely as a result of the economic downturn in the Southwest. Looking forward, however, because of a strong economic outlook, each of the Region’s states is projected to rank among the top third among the 50 states in employment growth through 2009, which should result in a resumption of domestic in-migration. And finally, U.S. Census Bureau data project that between 2000 and 2030 the Region’s elderly population will grow 136 percent, compared with 48 percent for the Region’s overall population.

Banks and thrifts are expected to target aging baby boomers and the elderly with significant wealth accumulation. *Environmental System Research Institute* (ESRI), an information management firm that has developed a methodology for segmenting population groups, has identified two such affluent groups.20 *Prosperous Empty Nesters* typically are married couples with no children living at home, often age 55 years or older, well educated, and with a median income of more than $64,000. *Silver and Gold* persons are among the nation’s wealthiest seniors, having a median age of 58 years, retired from professional occupations, and owning a home with a median value of $276,000. Although almost every county in the nation is home to individuals in these groups, the Dallas Region has many counties with concentrations that are more than double the U.S. average (see Map 3).


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**Map 3**

*Favorable Amenities and Lower Living Costs Are Attracting Affluent Retirees and Baby Boomers to the Southwest*

Note: These counties have twice the national average of Prosperous Empty Nesters and Silver and Gold, designated by ESRI as representing affluent boomers and retirees. Source: ESRI.

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10 Source: Community Tapestry Segments as defined by ESRI Business Information Solutions.
11 Location quotients were used to establish county concentrations.
Banking on the Baby Boomers

These two elderly segments of the population increasingly will influence labor and housing markets, expenditures for health care and travel, and demand for financial services. Financial institutions are expected to develop and market products for these individuals because of their significant assets. Current product offerings include reverse mortgages and annuities, investment management, and trust and estate planning services.

Dallas Region—Mid-South

Affluent Mid-South suburbs have attracted baby boomers, and insured financial institutions have followed.

The Mid-South continues to be characterized by modest population growth, depopulation of the Mississippi Delta area, and a growing concentration of baby boomers in metropolitan areas. Overall population growth in the area has trailed the nation during the past 40 years. Since 1962, when the first baby boomers entered the workforce, the total population of the Mid-South grew 46 percent, compared with 60 percent for the nation. During the same period, nearly all counties in the Mississippi Delta declined in population as residents, including baby boomers, left the area in search of jobs and amenities in metropolitan areas, such as Memphis, Little Rock, and Jackson. Approximately 66 percent of the area’s 4.2 million baby boomers now live in the Mid-South’s metropolitan areas.

A few smaller Mid-South communities also are drawing these individuals as they retire. The baby boomer population of these “retirement havens,” including Hot Springs, Arkansas, and Crossville, Tennessee, has grown in recent decades. A few other areas are now beginning to attract aging baby boomers, including communities near the Smokey Mountains, the Mississippi Gulf Coast, and college towns, such as Oxford, Mississippi. These communities share a number of desirable factors: a relatively low cost of living, affordable housing, favorable climate, cultural opportunities, and other amenities.

Interesting distinctions among populations are now emerging in the Mid-South’s metropolitan areas. Drilling down to the county level, our analysts found the demographic characteristics of suburban county households generally include higher income and rates of home ownership, more years of education, and a higher ratio of married couples to single individuals. Our analysis identifies 20 “affluent” counties that are home to significant numbers of residents who share these traits (see Table 2, next page); these affluent counties are primarily suburban counties that have attracted an influx of relatively high-earning baby boomers from the urban core. As a result, these counties have experienced strong population growth. The Mid-South’s median county population growth between 1995 and 2003 fell below 5 percent; however, median growth for affluent counties was 18 percent, including a disproportionate number of baby boomers.

Insured financial institutions have followed baby boomers into these affluent counties. Although the number of banking institutions fell 28 percent across the country between 1995 and 2005, and Mid-South totals dropped 24 percent, the number of banks and thrifts in these affluent counties increased 42 percent. Branching activity also has been very strong in these counties; the number of branches increased 36 percent between 1995 and 2005, more than double the average of the entire Mid-South area.

Kansas City Region

Large concentrations of elderly in depopulating, rural counties will increase as baby boomers retire, placing additional stress on financial institutions’ sources of funding.

Since 1970, a majority of the Region’s 618 counties have lost population. As farm technology has continued to improve, fewer farmers are required to work on farms. As a result, displaced farmers and residents of small towns that support farms have migrated to less agriculturally intensive areas in search of better employment and educational opportunities.

15 Most recent county-level data available.
16 FDIC’s Summary of Deposits database.
17 Walser and Anderlik, p. 70.
## Table 2

### Significant Numbers of Baby Boomers Now Live in Relatively Affluent Mid-South Counties

<table>
<thead>
<tr>
<th>County/Parish Name</th>
<th>State</th>
<th>Metropolitan Statistical Area</th>
<th>Total Boomers¹</th>
<th>Boomers’ Share of Total¹</th>
<th>Per Capita Income²</th>
<th>Poverty Rate²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pulaski AR</td>
<td>Little Rock</td>
<td>108,534</td>
<td>30.0%</td>
<td>$33,620</td>
<td>14.0%</td>
<td></td>
</tr>
<tr>
<td>Saline AR</td>
<td>Little Rock</td>
<td>25,217</td>
<td>30.2%</td>
<td>26,004</td>
<td>9.2%</td>
<td></td>
</tr>
<tr>
<td>Ascension LA</td>
<td>Baton Rouge</td>
<td>23,063</td>
<td>30.1%</td>
<td>26,441</td>
<td>10.4%</td>
<td></td>
</tr>
<tr>
<td>St. Charles LA</td>
<td>New Orleans</td>
<td>15,580</td>
<td>32.4%</td>
<td>26,470</td>
<td>11.6%</td>
<td></td>
</tr>
<tr>
<td>St. Tammany LA</td>
<td>New Orleans</td>
<td>63,815</td>
<td>33.4%</td>
<td>31,639</td>
<td>10.4%</td>
<td></td>
</tr>
<tr>
<td>De Soto MS</td>
<td>Memphis</td>
<td>32,126</td>
<td>30.0%</td>
<td>28,713</td>
<td>8.2%</td>
<td></td>
</tr>
<tr>
<td>Madison MS</td>
<td>Jackson</td>
<td>22,930</td>
<td>30.7%</td>
<td>36,451</td>
<td>12.5%</td>
<td></td>
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<tr>
<td>Rankin MS</td>
<td>Jackson</td>
<td>35,805</td>
<td>31.0%</td>
<td>27,729</td>
<td>10.3%</td>
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<tr>
<td>Anderson TN</td>
<td>Knoxville</td>
<td>21,497</td>
<td>30.1%</td>
<td>27,668</td>
<td>12.9%</td>
<td></td>
</tr>
<tr>
<td>Blount TN</td>
<td>Knoxville</td>
<td>32,482</td>
<td>30.7%</td>
<td>26,253</td>
<td>10.3%</td>
<td></td>
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<tr>
<td>Cheatham TN</td>
<td>Nashville</td>
<td>12,008</td>
<td>33.4%</td>
<td>26,888</td>
<td>8.9%</td>
<td></td>
</tr>
<tr>
<td>Hamilton TN</td>
<td>Chattanooga</td>
<td>93,042</td>
<td>30.2%</td>
<td>32,365</td>
<td>12.9%</td>
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<tr>
<td>Knox TN</td>
<td>Knoxville</td>
<td>114,642</td>
<td>30.0%</td>
<td>30,901</td>
<td>12.3%</td>
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<tr>
<td>Maury TN</td>
<td>Nashville</td>
<td>21,792</td>
<td>31.4%</td>
<td>28,810</td>
<td>11.3%</td>
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<tr>
<td>Robertson TN</td>
<td>Nashville</td>
<td>16,887</td>
<td>31.0%</td>
<td>26,958</td>
<td>9.5%</td>
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<tr>
<td>Sevier TN</td>
<td>Knoxville</td>
<td>22,190</td>
<td>31.2%</td>
<td>25,822</td>
<td>13.0%</td>
<td></td>
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<tr>
<td>Sullivan TN</td>
<td>Johnson City-Kingsport-Bristol</td>
<td>46,191</td>
<td>30.2%</td>
<td>27,232</td>
<td>12.7%</td>
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<tr>
<td>Sumner TN</td>
<td>Nashville</td>
<td>41,173</td>
<td>31.6%</td>
<td>28,544</td>
<td>9.3%</td>
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<tr>
<td>Williamson TN</td>
<td>Nashville</td>
<td>45,778</td>
<td>36.1%</td>
<td>42,694</td>
<td>4.8%</td>
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<tr>
<td>Wilson TN</td>
<td>Nashville</td>
<td>29,245</td>
<td>32.9%</td>
<td>31,376</td>
<td>7.9%</td>
<td></td>
</tr>
</tbody>
</table>

### Notes:

1. U.S. Census Bureau, Based on 2000 Census data.

Because rural-to-urban migrants tend to be younger people, declining counties—those that lost population between the 1970 and 2000 Censuses—typically have fewer young people and large elderly populations (see Chart 2, next page). Note the relatively small proportion of the population ages 20 to 34 and the large number of elderly people. In this example, almost 20 percent of the population is older than 65, compared with 12.4 percent for the nation as a whole.

The population of a majority of the Region’s counties is characterized by a high share of elderly individuals. Our analysis ranked the nation’s counties by the proportion of the elderly population and divided the counties into quartiles. The data show a majority of the Region’s counties fall in the oldest quartile (see Map 4, next page). Of the Region’s 342 counties in this quartile, 285 are rural counties with declining populations. This phenomenon likely will worsen as baby boomers in these areas begin to join the ranks of the elderly in coming years.

Counties with declining populations and large elderly populations face significant challenges related to the composition of the labor force. Declining counties in general already have smaller-than-average labor forces, making it difficult to attract the significant employers needed to reverse population outflows. This unfavorable situation is exacerbated when a small community has a high proportion of elderly who typically lack the education and skills needed to attract employers.

The concentration of elderly people in declining counties is also a concern for insured financial institutions. Banks in these areas find it difficult to maintain and grow deposits. Between 1994 and 2004, deposits in
declining county bank and thrift branches grew 24.4 percent; the figures were 74.5 percent and 58.7 percent for deposits in branches in metropolitan counties and growing rural counties, respectively. This situation is more serious in those cases where banks rely on the elderly for funding. Many rural bankers have a similar story to tell: an elderly depositor with significant deposits passes away, and that person’s funds are withdrawn within days by heirs who have moved to metropolitan areas. These deposits, used to make loans or other investments, are difficult to replace. The large elderly population in much of the Region suggests this problem will intensify in coming years.

New York Region—Mid-Atlantic

Housing affordability has shifted population in the Mid-Atlantic to the suburbs and exurbs.

Growth in total population and baby boomer cohorts in the Mid-Atlantic region has trailed the U.S. average since 1990 and, for the most part, reflects out-migration to lower-cost areas of the country. Affordability also has contributed to migration patterns within the Mid-Atlantic from larger cities to suburbs and newly formed exurbs.

18 Bank and Thrift Call Reports, all insured institutions. Rates shown are median rates for each group of institutions. Growth rates are merger-adjusted.
19 Walser and Anderlik, p. 84
20 Source: U.S. Census Bureau. This analysis tracks population growth between 1990 and 2003.
Overall population growth in the Mid-Atlantic states has been about 8 percent since 1990, but growth has been much stronger in rings of suburban and exurban counties surrounding major cities along the New York–Washington, D.C., corridor (see Map 5). Around the New York City metropolitan area, particularly in Orange and Putnam counties and in neighboring Pike and Monroe counties in Pennsylvania, population has expanded more than 55 percent since 1990. In addition, population growth along the Baltimore-Washington corridor ranged between 20 and 60 percent. The extension of suburban boundaries also has occurred around the Philadelphia metropolitan area, including suburbs in New Jersey.

Affordability and lifestyle are key factors driving Mid-Atlantic population trends, as homes are generally less expensive further from major cities. However, growing demand for housing has pushed home appreciation rates in many Mid-Atlantic suburbs and exurbs to approximate those of major cities. During 2005, home appreciation reached cyclical highs that exceeded 20 percent in some Maryland and New Jersey suburbs, a consequence of spillover demand from the neighboring larger metropolitan areas.22 However, because the recent increase in home prices started from much lower levels, homes remain relatively affordable in most Mid-Atlantic suburbs, which should continue to encourage out-migration from urban areas.

Mid-Atlantic counties with higher rates of population growth also generally have experienced increases in job growth and bank branching activity. A majority of the counties that ranked in the top quartile for population growth between 1990 and 2003 also ranked in the top quartile for job growth. Stronger population growth has spurred demand for construction of local infrastructure—such as roads, sewers, and schools—and has supported new business formation, which collectively fosters an expanding economic base and demand for banking services. The number of bank branches has increased almost 9 percent in counties in the top quartile of population growth, compared with a 2 percent decline in counties in the bottom quartile. Loan growth also has been stronger among insured institutions in fast-growing counties.

While the percentage increase in the baby boomer population in the Mid-Atlantic has slightly lagged the national, demand for vacation and retirement homes by this cohort has driven population growth along the New Jersey, Delaware, and Maryland shorelines. Baby boomers in these areas represented one-fourth of the population gain since 1990—an average increase of 34 percent, four times the national average. Demand for second homes also has contributed to significant growth in the baby boomer population in Pennsylvania’s Pocono resort area and the Delaware Valley.

Recent studies also suggest a reversal of migration trends for some of the area’s aging baby boomers. Traditionally, baby boomers have migrated away from the big cities; however, data show that some “empty nesters”—those whose children are grown and out of the house—are returning to the larger cities to take advantage of amenities, such as restaurants, entertainment, and cultural events.22 The return of empty nesters and foreign immigration has offset, at least in part, domestic out-migration in some of the larger urban cities along the East Coast.

New York Region—New England

Net out-migration and aging baby boomers challenge future economic growth.

In all six New England states, baby boomers make up a larger share of the total population than the national average. This is due in part to out-migration of younger individuals and some in-migration of baby boomers and retirees to the Region’s vacation areas. These shifts in population, in addition to the fact that a significant share of elderly already live in the area, have contributed to a relatively high median age, making New England the oldest of the Census Bureau’s nine divisions. Census Bureau projections show New England will remain at the forefront of this country’s “age wave” as the Region will be characterized by the highest median age from 2004 through 2030.23 As a result, economic and banking implications associated with aging baby boomers could be magnified in New England.

While the aging of the baby boomer generation is a long-term concern, out-migration and slow natural popu-

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loration growth in New England are key demographic trends expected to affect businesses and governments in the near term. As expected from the population’s age distribution, New England has the slowest rate of natural increase. More troubling is the net out-migration attributable, at least in part, to lagging rates of job creation since the 2001 recession in the two most populous states, Massachusetts and Connecticut.

Shifts in population exhibit a sharp north/south divide. From 2002 through 2005, domestic population outflows occurred in the three southernmost states: Connecticut, Massachusetts, and Rhode Island. Moreover, Massachusetts and Rhode Island lost total population between 2004 and 2005, and Massachusetts is the only state in the nation to lose population for two consecutive years. However, New Hampshire and Maine to the north enjoyed net inflows rivaling the best in the nation during that time. All three southern states are considered “mature” economies with significant concentrations of traditional industries, such as finance and insurance and production of consumer goods. Although Massachusetts boasts a vibrant technology economy, the state has not created enough jobs to offset attrition in the more traditional sectors. Conversely, the New Hampshire economy, consistent with the state’s strong population growth, continues to expand.

The most significant demographic challenge for New England stems from the slow expansion of the working-age population, the age group most important for the economy’s health. Domestic migration by age shows clear patterns of working-age cohorts leaving New England and relocating south and west because of milder weather, less expensive housing, and shorter commutes. Census data suggest these trends will continue (see Chart 3), and estimates of slow growth in the 22-to-65-year-old cohort suggest a considerable headwind facing the New England economy. This age segment represents a significant share of an area’s workforce and encompasses most entrepreneurs. When these individuals relocate, an economy’s vitality often moves with them.

San Francisco Region

*Strong population growth is expected to continue in much of the Region.*

States in the San Francisco Region added about 9 million new residents during the 1990s and generally reported more rapid population growth than the rest of the nation. Census data indicate this growth will continue, albeit at a somewhat slower rate, through 2010 (see Chart 4), and that gains in population should occur among baby boomers and foreign immigrants.

Affordability and quality of life attract many baby boomers to states in the West—both those groups of individuals who choose to “age in place” during retirement and those moving from other parts of the country. Cost of living affects relocation decisions at any age, but may be particularly important to baby boomers transitioning from their prime earning years to fixed incomes. Four Western states rank favorably for housing affordability: Wyoming, Idaho, Montana, and

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**Chart 3**

**New England Expected to See Sluggish Growth of Working-Age Population**

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>NH</td>
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<td>CT</td>
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</tr>
<tr>
<td>MA</td>
<td>2.0</td>
</tr>
</tbody>
</table>

*Source: U.S. Census Bureau.*

**Chart 4**

**Nevada and Arizona Are Expected to Continue to Lead the Region’s Growth Through 2010**

<table>
<thead>
<tr>
<th>State</th>
<th>Population Change (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NV</td>
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</tr>
<tr>
<td>AZ</td>
<td>6.0</td>
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<tr>
<td>UT</td>
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<tr>
<td>ID</td>
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<tr>
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<td>3.0</td>
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<td>OR</td>
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<tr>
<td>CA</td>
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<tr>
<td>AK</td>
<td>0.5</td>
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<tr>
<td>MT</td>
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<tr>
<td>WY</td>
<td>0.0</td>
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<tr>
<td>HI</td>
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</tr>
<tr>
<td>US</td>
<td>0.0</td>
</tr>
</tbody>
</table>

*Forecast data from the U.S. Census Bureau.*

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Utah. Also, relatively affordable housing in Oregon and Arizona has attracted baby boomers from California, where home prices are higher. Several states in the Region also are attractive because of retiree-friendly tax structures. While many retiree benefits and pension income is exempt from state taxes, residents enjoy another advantage in Alaska, Nevada, Washington, and Wyoming, where they do not pay income tax.

The availability of health care, transportation, and recreation are also key considerations for individuals considering moving to a new area. In particular, nearly one-third of the nation’s nonmetropolitan, recreation-based counties are located in the West (see Map 6). Many recreational counties in the West, including Prescott, Arizona; St. George, Utah; Bend, Oregon; and Coeur d’Alene, Idaho, already have become retirement hubs and experienced significant in-migration.

Immigration of younger job-seeking individuals also played a key role in the West’s robust population growth. During 2004, California ranked first in the number of immigrants in the nation, with 27 percent of its residents born outside the United States. Furthermore, the California foreign-born population expanded 37 percent during the 1990s, far outpacing the growth of domestic-born residents (7 percent). Prospectively, immigration may increase in importance as California continues to lose baby boomers to other states. In addition, the number of foreign-born residents at least doubled in Nevada, Utah, Arizona, Idaho, and Oregon between 1990 and 2000.

Conclusion

Drilling down to the regional level adds insight into how national demographic trends may manifest themselves in local communities. The demographic trends highlighted in this article present challenges and opportunities for regional economies and the local banking sector. Understanding the factors driving these trends will help insured institutions anticipate their customers’ changing financial needs and develop financial products and services that will meet those needs.
How Aging Baby Boomers Are Changing the Financial Marketplace

As the baby boom generation moves toward retirement, the financial needs and preferences of its members likely will change considerably as their lifestyles change. Key social and demographic trends will shape the retirement years and have implications for how insured institutions can attract and retain these customers. For example, older individuals generally want to move assets into safer, more conservative investments to protect the wealth they have accumulated. In addition, an ongoing shift from traditional defined benefit to defined contribution pension plans presents challenges to aging baby boomers, as they now must accept more responsibility for their own retirement planning. Retirees with substantial equity in their homes may have questions about how to use that equity to help fund their retirement. And finally, baby boomers can expect to live longer than past generations, and they must consider the effect higher health care costs may have on their retirement security. This article focuses on understanding the opportunities these trends may present and how FDIC-insured institutions may offer financial products and services that can help meet the needs of aging baby boomers.

As Baby Boomers Approach Retirement, Their Preference for Lower Risk Financial Products Is Expected to Grow

Studies show that as baby boomers age, their investment strategies tend to become more conservative. For example, older individuals tend to shift out of the stock market about the time they begin receiving annuities or withdrawing some of their financial assets. The results of a recent survey of baby boomers indicate that respondents shifted some portion of their retirement savings from relatively riskier assets, such as accounts invested in stocks and real estate, into safer ones, such as savings accounts. Forty-two percent said they had put money into regular savings in 1998; by 2003, this number had increased to 50 percent. The shift for older respondents (ages 53 to 57) was slightly higher—an additional 12 percent of them had put money into regular savings by 2003. During the same period, older respondents’ contributions to individual retirement accounts (IRAs), 401(k) plans, and other retirement savings accounts, often invested in equities, dropped 6 percent. Certificate of deposit (CD) data show similar results: older people are more likely to hold CDs than younger people, and the median value of their CD holdings exceeds that of younger people (see Chart 1).

These trends may present opportunities for insured institutions. The ability to offer a range of investment products and services may enable banks to help these individuals hedge against the risk that inflation could deplete the value of their assets. Inflation-linked CDs may be particularly attractive to baby boomers because of the enactment of legislation raising deposit

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2 Baby Boomers Envision Retirement II, prepared for AARP by Roper ASW, May 2004. The 1998 respondents were between ages 33 and 52, and the 2003 respondents were between ages 38 and 57. Riskier assets are defined here as assets with greater return volatility than short-term, highly liquid, relatively low-risk debt instruments such as Treasury bills. http://assets.aarp.org/rgcenter/econ/boomers-envision.pdf.
insurance coverage of certain retirement accounts to $250,000.\(^5\)

Inflation reduces the purchasing power of fixed payment streams flowing from ordinary bonds and annuities.\(^6\) However, bonds and annuity products that feature payment streams that adjust for price increases can help mitigate the effects of inflation.\(^7\) Therefore, financial products that may be appropriate for baby boomers concerned about preserving their accumulated wealth include U.S. Treasury inflation-linked bonds (TIPS), TIPS mutual funds, inflation-linked U.S. savings bonds (I-bonds), or immediate life-escalating annuities (see text box at right for an explanation of immediate life escalating annuities).\(^8\)

### Pension Plan Changes May Create Demand for Financial Planning Services

The trend away from traditional defined benefit pension plans to defined contribution plans is tending to shift responsibility for retirement planning from employers to employees (see “The Shift Away from Defined Benefit Plans,” page 10). However, research shows that a significant number of households nearing retirement have done little or no retirement planning.\(^9\) Fewer than half (41 percent) of the respondents to the Vanguard study indicated that they have an asset accumulation goal, and one-quarter did not have an income goal for their “current” standard of living or a “minimally acceptable” standard of living during retirement.\(^10\) Almost 25 percent of the respondents to the AARP

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\(^5\) For more information on one example of an inflation-linked CD offered by LaSalle Bank, see www.lasallecdips.com. Deposits (including CDs) are FDIC-insured. Legislation signed on February 8, 2006, will increase the $100,000 insurance limit to $250,000 for certain retirement accounts. This higher limit could attract nearly $30 billion of new deposits in IRA/Keogh accounts at FDIC-insured institutions. January 31, 2006, update to a revised FDIC September 7, 2001, memorandum, “Potential Effects of Certain Cover Limit Changes on FDIC Insurance Funds Reserves.”


\(^7\) Banks that offer inflation-linked products can purchase and hold Treasury inflation-linked bonds in their own investment portfolios to hedge the inflation risk.

\(^8\) U.S. Treasury inflation-linked bonds are called TIPS—Treasury Inflation Protection Securities. Banks, brokers and other investors purchase TIPS for their customers through the U.S. Treasury’s Commercial Book-Entry System. Inflation-linked CDs feature less duration risk than TIPS, but higher before-tax interest rates than I-bonds.

\(^9\) Lusardi, Annamaria. December 2003. Planning and Saving for Retirement. Dartmouth College. The 4,489 respondents who were asked how much they thought about retirement were approximately 51–61 years of age when interviewed. www.dartmouth.edu/~alusardi/ lusardi_pdf.pdf.

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### Immediate Life Escalating Annuities: One Strategy to Protect Retirement Income

A study conducted by the Vanguard Center for Retirement Research (Vanguard study) found that slightly fewer than half the respondents have given “a great deal of thought” to whether their income would keep pace with the rising cost of living during retirement.\(^9\) A product that may help allay retirees’ concerns about inflation risk is an immediate life annuity with escalating payments. Currently, most immediate life annuities pay fixed amounts for the rest of the purchaser’s life. Some financial institutions recently have introduced immediate life escalating annuities featuring payment streams that adjust over time, either by a fixed percentage or an inflation-linked adjustment.

Certain types of these innovative annuity products may be appropriate for specific financial situations, for example, a graded payment immediate life escalating annuity with payments that increase a fixed percentage (3 or 5 percent) each year as a way to offset rising prices, or an inflation-linked immediate life escalating annuity with payments that adjust each year for changes in inflation.\(^8\)

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\(^9\) As noted in the Vanguard study, a target goal for asset accumulation is the dollar amount in financial assets a person plans to accumulate by retirement age to augment income flows from Social Security and traditional defined benefit pension plans.

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Banking on the Baby Boomers

Some baby boomers will receive retirement income from both Social Security and traditional defined benefit pension plans; however, many may not know how much they can expect to receive from these sources and may need help choosing appropriate investment vehicles to augment that cash flow. In addition, a key issue for many baby boomers, as they look forward to living longer, will be determining an appropriate withdrawal strategy of retirement savings that ensures they will not outlive their financial assets. Penalties for early withdrawals, minimum required distribution requirements, and estate planning issues also must be considered.

These questions are further complicated by the fact that baby boomers’ retirement assets are taxed at different rates. For example, some retirement accounts, such as traditional IRAs, are taxed at ordinary marginal tax rates when withdrawn, while other assets are taxed at capital gains or qualified dividend rates. Social Security is either tax-free or taxed at a preferential marginal tax rate, and Roth IRA withdrawals are tax-free.

Obtaining wealth management and financial and tax planning services, therefore, is critical to aging baby boomers. A newsletter for independent banks, Banc Investment Daily, recently reported that banks are beginning to develop long-term strategies as a means of attracting the $200 billion per year that soon will rollover from 401(k) plans when baby boomers retire. In fact, Wachovia Corp. recently hired 15 consultants to provide education, marketing, and sales support for its retirement planning services, therefore, is critical to aging baby boomers.

In fact, Wachovia Corp. recently hired 15 consultants to provide education, marketing, and sales support for its retirement planning services, therefore, is critical to aging baby boomers.

Customers

approaching retirement increasingly will need rollover products and services; this strategy helped the brokerage house TD Waterhouse significantly increase its rollover deposits.

Some Baby Boomers May Need to Tap Equity in Their Homes to Fund Retirement

For many older Americans, the value of their home is their most significant financial asset. Many baby boomers may have inadequate savings to fund their retirement years, but may hold significant illiquid equity in their homes. In fact, households headed by individuals 45 to 54 are more likely to own a home than to have a retirement account (77 percent compared with 58 percent). As Chart 2 indicates, home-secured debt diminishes for ages above 35 to 44 (the age cohort that includes the youngest baby boomers). Although aging baby boomers may no longer need a traditional mortgage, some are candidates for other forms of mortgage products. Statistics show that tapping the equity in real estate is becoming an increasingly attractive source of income to fund retirement. For example, retirees who face unexpected expenses

11 See note 2.
12 In 2005, real lifetime benefits for an average-income couple from Social Security were $439,000. Data are from testimony of C. Eugene Steuerle, The Urban Institute, before the Subcommittee on Social Security of the House Committee on Ways and Means on June 14, 2005, http://waysandmeans.house.gov/hearings.asp?formmode=printfriendly&id=2774.
13 These issues are complex. For example, federal tax regulations vary regarding distributions for an IRA in the retiree’s own name or one that is inherited. Refer to the Internal Revenue Service website at www.irs.gov.
19 See “Are Baby Boomers Financially Prepared for Retirement?” in this issue, for more information on sources of retirement income.
20 See note 3, pp. 13 and 22.
21 See note 3, p. 29.
(such as medical or home improvement bills) may apply for a home equity loan or a home equity line of credit that may have generally low closing costs and may be appropriate for short-term financial needs. Home equity conversion plans represent another way retirees can supplement their income (see text box). Although terms vary, in general, these plans allow homeowners to remain in their home while turning the equity into an income stream during retirement. The income stream is repaid when the home is sold.

Dealing with the Rising Cost of Health Care

As baby boomers age, they must consider how rising health care costs could affect their retirement security. About half the personal bankruptcy filers interviewed for an article in *Health Affairs* cited medical expenses as contributing to their decision to declare bankruptcy. Furthermore, some aging baby boomers are unclear about the level of protection their health insurance provides. For example, AARP statistics show that 30 percent of baby boomers mistakenly believe Medicare covers long-term nursing home care. Others may overestimate the cost of long-term care insurance policies and decide against purchasing them. Although baby boomer income and wealth, on average, are higher than those of previous generations, the distribution is skewed toward higher income brackets. Baby boomers in higher income brackets may have the financial resources to cushion against rising health care costs; however, others in lower and middle income brackets may find it difficult to budget for unexpected health care expenses.

Home Equity Conversion Plans

A traditional reverse mortgage is the most common form of home equity conversion (HEC) plan. An individual borrows against the equity in his or her home, and the loan is paid off when the borrower moves or dies. (The borrower or the heir(s) receive any remaining equity value.) A reverse annuity mortgage is another form of HEC, in which the reverse mortgage proceeds are used to purchase an annuity that provides monthly income for life, even if the borrower is no longer living in the home. A third type of HEC is a home sale plan. An investor (which could be a bank) purchases a home at a discount and the owner remains in the house and receives the sale proceeds in a stream of lifetime payments.

The volume of federally insured reverse mortgages more than doubled during the year ending September 30, 2004, according to statistics provided by the National Reverse Mortgage Lenders Association. Loan volume at Financial Freedom, the nation’s leading reverse mortgage servicer, expanded 44 percent during this time. Receiving counseling about Medicare and the availability and costs of long-term care insurance, therefore, can help aging baby boomers make key decisions about health insurance products as they near retirement. Choosing a long-term care product is a complex decision that must weigh many variables, including age, current health, family medical history, income, and wealth. For example, some younger middle-income baby boomers may benefit from purchasing long-term care insurance. Baby boomers entering retirement may consider an immediate life annuity bundled with long-term care insurance. “Bundling” helps a bank offer products and services more affordably because the risks of each product to the bank are offsetting. For example, if a customer is a relatively high risk to the bank in terms of long-term care insurance (because of poor health)...

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23 See note 2.

24 “Baby Boomers Get an ‘F’ in Planning for Old Age.” *SeniorJournal.com*, July 2, 2001. www.seniorjournal.com/NEWS/Retirement/07-02-1BoomerF.htm. A study conducted by the Center for Aging Research and Education and sponsored by the GE Center for Financial Learning found that 75 percent of the respondents had no idea how much long-term care policies cost, with most overestimating the cost of long-term care insurance premiums by more than 300 percent.

25 For example, the U.S. Census Bureau Historical Income Tables show the mean inflation-adjusted household income for households with the highest incomes (top 20 percent) had a mean increase of 50 percent between 1980 and 2004. The next 20 percent had a mean increase of 24 percent, while income for the remaining 60 percent of households grew only 13 percent.

Banking on the Baby Boomers

health), this individual likely would be lower risk in terms of an immediate annuity (poor health may suggest shorter longevity).

Retirement Challenges May Create Opportunities for Banks

Banks and thrifts that design and market products and services that respond to the changing financial needs of aging baby boomers may be well positioned to attract and retain these customers. In addition, these institutions have the opportunity to benefit from increasing levels of fee income. Overall, noninterest income is becoming more important as a source of revenue growth for banks of all sizes, as net interest margins continue to tighten in an increasingly competitive marketplace. Although larger banks (with assets greater than $1 billion) consistently have received a greater share of revenue from fee income sources, Chart 3 shows the increasing importance of noninterest income to smaller institutions (with assets less than $1 billion).

Larger institutions historically have offered product lines not readily available to smaller institutions, such as investment banking services and capital markets products. However, recent advances in technology and affiliations with other financial institutions are helping to bridge that gap. Increasingly, smaller community banks may find opportunities for growing fee income through the sale of wealth management products and financial planning services, as well as fees associated with electronic banking services. As baby boomers age toward retirement and their investment strategies become more conservative, banks of all sizes may be able to benefit by offering products and services that meet their financial needs.

Heather Gratton
Senior Financial Analyst

Chart 3
Levels of Noninterest Income Have Been Trending Upward for All Insured Institutions

Banks Seek to Attract and Retain Baby Boomer Customers

Some banks now are offering memberships in senior social clubs that offer travel tours, prescription drug and hotel discounts, as well as discounts on traditional banking services.\(^a\) Bank social clubs have expanded across the country, and the National Association of Bank Club Organizations’ (NABOR) membership currently includes approximately 2,200 small community banks that have between 1,000 and 2,000 accounts each.\(^b\)

The Pew Internet Project reports that about 50 percent of older baby boomers and 40 percent of younger baby boomers have banked online.\(^c\) As a result, Internet banking may be a particularly good fit for aging baby boomers who travel extensively or relocate during retirement, but want to retain a relationship with a particular financial institution that does not have branches in the area.

\(^b\) Ibid. NABOR is a nonprofit organization headquartered in Minneapolis, Minnesota, that provides education, benefit programs, and professional networking opportunities for banks. Membership information is current as of February 23, 2006.
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