How Debt Affects Retirement

By Kerry Pechter *Fri, May 10, 2019*

"Remaking Retirement? Debt in an Aging Economy," was the theme of the 65th annual symposium of the Wharton School's Pension Research Council, held last week in Philadelphia. (Photo: Kitchen and retirement makeovers sometimes occur in tandem.)

A mid-life kitchen crisis can mess up your retirement plans.

A suburban couple, ages 55 and 50, had 10 years left on their mortgage and a 1970s kitchen with avocado appliances and brown cabinets. With a $50,000 cash-out refinance, they removed a wall, added a stainless steel stove and fridge, and created a beautiful open-plan living/cooking space.

There was a small problem, however. Their new 15-year mortgage threatened to push back the husband's retirement date—and Social Security claiming date—by five years. In theory, he could pay off their mortgage early and still stop working at age 65, but the couple's savings would shrink.

This anecdote is admittedly, well, anecdotal. But it's indicative of a trend—one strong enough to be documented by economists Barbara A. Butrica of the Urban Institute and Nadia S. Karamcheva of the Congressional Budget Office, in a new paper, "Is Rising Household Debt Affecting Retirement Decisions."

They aren't the only ones tracking the effect of debt on retirement. Their paper was one of several presented in Philadelphia last week at the 65th annual symposium of the Pension Research Council, which is part of the Wharton School. This year's conference theme was "Remaking Retirement? Debt in an Aging Economy."

Americans are approaching and entering retirement with unprecedented debt. For the poorest retirees, bills can spoil retirement entirely. For the wealthy, it's often harmless–a reflection less of hardship than of leveraged assets. For those in the middle, like the couple with the kitchen, it's a problem that needs careful handling. Advisors who specialize in retirement planning should take note.

A wrinkled rainbow

Franco Modigliani's **lifecycle theory** of personal finance suggests that people lever up for homes and education in impecunious early adulthood and amortize their debt as they earn more: thus “smoothing” their consumption. But with older Americans refinancing mortgages, taking on college loans or buying new cars, the lifecycle arc looks less and less like a rainbow and there’s as much debt as gold at the end.

“On average, households continue to make payments for mortgages, auto loans, credit card debt, and even student loans well into their 60s, 70s, and beyond,” wrote Anne Lester of JP Morgan, who presented her team’s analysis of the debt payments of 5.1 million JP Morgan banking customers. “This suggests that the conventional view of enjoying retirement largely debt free after paying off a mortgage and driving the same paid-for car appears outdated for many.”

Older Americans still carry less debt than their younger counterparts, but their debt loads are trending up. There’s been “an 87% increase in the real consumer debt held by Americans ages 55 to 80 between 2003 and 2017,” according to economists from Stony Brook University and the Federal Reserve Bank of New York, in their paper, “The Graying of American Debt.” Meanwhile, debt for those ages 35-54 rose only 6%. For those below age 35, debt growth was flat.

The same proportion of households ages 55 to 64 carries debt as did 25 years ago (about 75%), but their median debt load ($31,000 in 2016) was more than double the median in 1995 [adjusted for inflation],” according to “The Risk of Financial Distress in Retirement: A Cohort Analysis,” by economists at the Social Security Administration, the Treasury Department and Harvard.

Most of the increase comes from mortgages and home equity loans, but credit card debt and student loans also increased over the period, they said. The share of older households with credit card debt has increased to 42% from 31% since 1995; the median credit card balance has doubled, to $2,800 from $1,400. The share of older households paying off student loans—either for children, grandchildren or themselves—rose to 10% from 3%, and the median amount owed rose to $18,000 from $5,400 (in 2016 dollars).

Along with per capita debt, aggregate debt among older people is growing in part because the elderly demographic is growing. The baby boom “elephant” is moving through the “python” of history. Low interest rates, the abundant and ubiquitous availability of credit, the federal bankruptcy reform of 2005 (which made it harder to discharge debts), the wealth effects of the housing and equity markets, and the concentration of wealth have all shaped recent trends in debt holding.

Delayed retirements

Not surprisingly, debt forces people to postpone retirement and/or postpone claiming Social Security. “Individuals who have more debt than financial assets are more likely to be working and less likely to be retired than individuals who have enough financial assets to cover their debt, and individuals with no debt are least likely to work and most likely to be retired,” wrote Butrica and Karamcheva.

Mortgage debt appears to delay retirement, while credit card debt tends to hasten claiming Social Security. “Compared to households with no debt, those with a medium degree of indebtedness (households whose financial assets cover their debt) are more likely to delay claiming their benefits, while households with a high degree of indebtedness (households whose financial assets don’t cover their debt) might be more likely to claim early,” they wrote.

Although secured debt (i.e., mortgage) levels tend to be much higher in dollar value than unsecured debt (i.e., credit cards), credit card debt affects retirement decisions more. “A $10,000 increase in credit card debt for a person with the median amount of credit card debt increases the likelihood of working by 9.4 percentage points, reduces the probability of receiving Social Security benefits by 9.1 percentage points, and reduces the likelihood of being retired by 11.0 percentage points,” according to Butrica and Karamcheva.

Because of debt, the “incidence of hardship” is currently projected to be about 50% higher for retirees born in the mid-1950s compared with people born in the mid-1930s, according to the paper, “The Risk of Financial Hardship in Retirement: A Cohort Analysis,” by Jason Brown of the Social Security Administration, Karen Dynan of Harvard, and Theodore Figinski of the Treasury Department.

In addition to suffering, this will create pressure on government services. “A material share of the individuals approaching retirement age in the mid-2010s are likely to face hardship in their late 70s and early 80s… One in ten are predicted to be on food stamps, one in eight are predicted to be in poverty, one in six are predicted to be on Medicaid, and one in four will have annuitized wealth that is below 1.5 times the poverty line for their household,” they wrote.

If nothing else, high debt loads make retirees more financially fragile and less able to absorb the shocks that they will inevitably experience with age. Butrica and Karamcheva cited data showing that “three-quarters of adults ages 51 to 61 and more than two-thirds of those age 70 and older experience a negative event over a nine- or 10-year period and simultaneously a large decline in wealth.”

Worse for some than others

Debt in retirement tends to be a burden to the extent that it outweighs assets. Wealthy retirees have more capacity for debt and carry more of it, but they wear it relatively lightly because they own substantial amounts of assets—some of which they financed with debt.

“Having debt in late middle-age may, on average, be associated with households who are in a relatively secure position at this stage given that access to credit rises with income and that much household debt finances assets that yield material positive returns over the longer run,” according to Brown, Dynan and Figinski.

For the mass-affluent retiree with little or no mortgage debt, ample savings and income from pensions or Social Security, debt service tends to be manageable. For the poor, debt becomes a source of hardship. Americans of color continue to have much lower levels of assets, on average, than white Americans. The differential is somewhat startling.

“The ratio of the wealth of the median White household to the median Black household and the median Hispanic household has fluctuated between 5 to 1 and 10 to 1 for over 20 years,” according to those three authors.

Lack of assets will force the poorest retirees to use unsecured debt, often at high interest rates. “We find that those with short-term uncollateralized debt as well as those still holding student loans for their education tend to be those most subject to financial distress,” according to the organizers of the conference, Annamaria Lusardi, an economist and professor at George Washington University and Olivia S. Mitchell, PhD, director of the Pension Research Council, in their paper, “Financial Vulnerability in Later Life and its Implications for Retirement Well-being.”

“Women, the low-income, and African Americans tend to be those most vulnerable due to debt at older ages,” they wrote. Having to postpone retirement by a few years to accommodate an investment in a modern kitchen is not the worst problem one can have.

(Editor’s note: The conference papers are not yet available for broad distribution.)