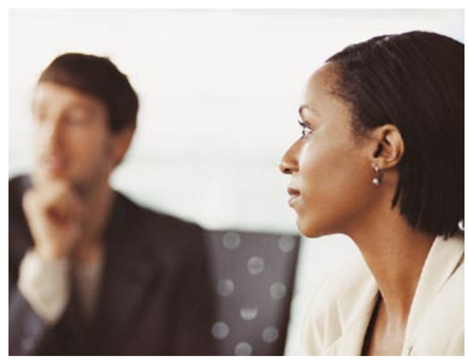
Society of Actuaries



Retirement 20/20

Conference Report

Building the Foundations for New Retirement Systems

September 28–29, 2006

Actuaries

Risk is Opportunity.sm

© Copyright 2007 Society of Actuaries. All Rights Reserved.

Conference Report

Building the Foundations for New Retirement Systems

September 28–29, 2006

Table of Contents

Introduction

On September 28–29, 2006, the Society of Actuaries Pension Section Council held a kick-off conference for its *Retirement 20/20* project, titled "Building the Foundations for New Retirement Systems."

Retirement 20/20 is an initiative of the Pension Section Council. The initiative began in late 2005 in reaction to the decline in defined benefit plans. Its purpose is to design a new system from the ground up. While defined contribution plans are an alternative to defined benefit plans, we believe that existing traditional plans (both defined benefit and defined contribution) are not ideal answers; and we believe there is a better way. *Retirement 20/20* seeks to find solutions that meet the economic and demographic needs for the 21st century in North America. While we ultimately will deal with specific design ideas/risk sharing models and transition issues, that is not where we are starting. The first part of the process, including the September conference, focuses on fundamentals.

The purpose of the Conference was to elucidate core ideas, rather than develop specific proposals for change or ideal plan designs. It sought to examine the stakeholders in the system, what the system must accomplish to meet their needs, what risks these stakeholders can take on and what role they can play in the system. It sought to determine what the system needed to accomplish, unconstrained by the structure of the existing retirement system and its regulatory structures. This report identifies key ideas that came out of the conference. The Pension Section Council will follow up and test the validity of these ideas.

Transition is not easy

At this stage, *Retirement 20/20* is focusing on what we need new retirement systems to do. We realize that this focus leaves a big piece of the puzzle out of the picture, namely: how do we get from where we are today to where we need to be?

We know that transition issues are not inconsequential and could derail the success of any new retirement systems. However, at this stage we also believe we need a better picture of where we are going—what the new system might look like—before we can determine what might need to be done to get us there.

Building the Foundations for New Retirement Systems

The September conference brought together a diverse group of about 60 individuals with expertise in retirement issues, including actuaries, attorneys, economists, employers and public policy professionals. The focus was on *what could be*, on principles rather than specific solutions, on what we need to achieve, not how to achieve it. This conference included attendees from the United States and Canada.

The conference was structured to consider three fundamental questions for each of the four basic stakeholder groups (society, individuals, markets and employers, discussed below). Panels for each stakeholder group considered the following three questions:

- Who has what **needs**?
- Who bears what **risks**?
- Who should or could play what **roles**?

To be sustainable, any retirement system must meet the core needs of all stakeholders (sometimes referred to as the "what's in it for me?" test). Stakeholders will have conflicting needs, so another principle of any retirement system should be that it doesn't violate the core needs of any stakeholder group. The conference used panelists representing various stakeholders to identify these tensions. Audience discussion also contributed to the understanding of needs, risks and roles.

The conference focused on **needs, risks** and **roles** for these four stakeholders:

- **Society:** By society, we mean society as a whole (all taxpayers/citizens). This includes both current and future generations since there are intergenerational cost and risk-bearing issues.
  - In this framework, governments (politicians) are agents of taxpayers/citizens.
  - A social insurance system (e.g. Social Security, C/QPP) is a way to address the needs of society. As such, the current role of any social insurance system was not discussed, but rather what society needed the system in total to achieve. From that, future steps can discuss what the role of social insurance should be.

- **Individuals:** Individuals are the ultimate users of retirement income. They have the need to prepare for retirement and spend income during their retirement years. They face the risks of retirement and need to find ways to pool or hedge those risks.

- **Markets:** Markets have two roles. They are the place where retirement assets are both accumulated and decumulated. They also have the ability to hedge risks.
- **Employers:** Employers (and the shareholders they represent) employ individuals and need to attract, retain, motivate and retire these individuals. Today, employers have a significant role in the retirement system in the United States and Canada.

Conference participants spent the last afternoon looking at four key attributes of any retirement system. Using what they understand about needs, risks and roles for the four stakeholders, they considered the following

- Retirement age/retirement process,
- Social balance,
- Voluntary vs. mandatory systems and
- Role or risk pooling.

There were two keynote speakers, Bradley Belt and Dallas Salisbury, whose views are incorporated into the discussion of needs, risks and roles presented in the main report.

Throughout the two-day meeting we polled the audience on key issues. An addendum to this report (forthcoming) will show highlights of these questions.

Headlines

During the conference, there were six themes that emerged from the discussions. These themes do not necessarily touch specifically on needs, risks and roles but they illuminate some principles we need to address in the development of new retirement systems.

The six themes are:

- Systems should align stakeholders' roles with their skills;
- Systems should be designed to self-adjust;
- Systems should consider new norms for work and retirement and the role of the normative retirement age;
- Systems should be better aligned with markets;
- Systems should clarify the role of the employer; and
- Retirement systems will not succeed without improvements in the health and long-term care systems.

Systems should align stakeholders' roles with their skills

As participants discussed in depth what role different stakeholders could play in the system, one theme quickly emerged: align each stakeholders' skill set with their roles, and specifically with realistic expectations about those roles. Participants cited several examples where it does not currently happen:

- It's not realistic to expect individuals to be experts in retirement planning, particularly investments. One participant cited 13 years of research on the knowledge of individuals as investors and provided several salient conclusions, that "first …the focus on educating participants is an admirable goal, but it hasn't been working. Second, as structured currently, defined contribution plans are not working well for many participants … Third, on paper, 401(k) plans and defined contribution plans provide the right incentives, the right investments, the right educational tools and in many cases, even investment assistance and advice, but in reality human nature gets in the way." Conference participants questioned whether individuals would ever be skilled investors, due to lack of knowledge but also inclination.

  Other participants cited the work of behavioral economists, who've both noted difficulties individuals have with retirement planning and have helped sponsors of retirement savings plans make those plans work better (e.g., auto-enrollment, "auto-pilot" investments) . One participant noted that we need to decide what level of financial education is appropriate: "Do we expect people to be able to drive the car, or do they have to know how to fix it in order to drive it?" Historically, the defined contribution system has expected participants to not only drive the car, but to be able to fix it (choose the investment policy) and create the map to know where to drive it (set a level of contributions to provide adequate retirement income). Is such expert knowledge required or legitimately expected? Or can we design systems that work in spite of participants' inertia and lack of knowledge?

Another level of this discussion is how much individuals are able to prepare for and handle the risks of retirement given their circumstances. Participants noted that women often have additional difficulty saving for retirement (many women spend time out of the labor force) and are more exposed to longevity risk and the death of a spouse.

- During the conference, the role of the employer in the retirement system was discussed. Participants considered whether the employer has the right skill set to operate pension plans, with their complex legal and financial attributes. Employers exist to create value in their core businesses; do the sponsorship and operation of pension plans enhance this value or detract from it?

  Litigation risk with regard to the management of any retirement benefit plan was also discussed. Employer representatives repeatedly echoed comments that the threat of litigation is a significant concern in the operation of retirement plans. One participant noted that it is the mere threat of a lawsuit which is potentially damaging, particularly for large employers.

  Other participants brought up the shorter lifespan of corporations relative to traditional defined benefit pension plans. Is it rational for employers to sponsor retirement plans and operate them in a way that creates residual liabilities long after they are gone?

  However, other participants noted that people do better saving for retirement when

> *[W]hy would any reasonable person think that people not trained in investments would be able to make these decisions in any sensible way? … I've been teaching investments for 35 years, so to me it's second nature. But let's take an area like medicine … Now I consider myself a reasonably well informed consumer of medical services, but I wouldn't dream of diagnosing my own illnesses …even if my doctor said 'You know performing minor surgery is really not such a big deal. I can give you the equipment and a brochure and you can take care of it on your own.' Well you laugh, [but] that's what we're doing now with 401(k) plans.*
>
> —CONFERENCE PARTICIPANT

their employer is involved. One participant quoted an EBRI statistic that over 77 percent of people making between $30,000 and $50,000 save in an employer defined contribution plan if one is offered. But, if no plan is offered, in that same income group, only 5 percent of people save. Others noted that individuals trust their employers and want them to continue to play a role the system. Most participants agreed that individuals do better if an employer has a role in the retirement system. The question was how to best align the skills and needs of the employer with the role, and to provide roles and opportunities that met the different needs of employers.

Going Forward

Aligning stakeholders' roles with their skills requires a fundamental reexamination of existing structures. Just because it has been done this way does not mean it is the best way to do it. But this represents changes to the system, which should be discussed openly by all stakeholders involved.

What can we reasonably expect from stakeholders without a great deal of knowledge and training? While it is always easy to say "should" (individuals should take more responsibility for retirement, employers should see the value in sponsoring a retirement plan) maybe we ought to be realistic about what can be done and about the consequences of various courses of action.

Systems should be designed to self-adjust

Any system that is to survive should be self-adjusting. Quite simply, the system should be built to be flexible to adapt to changing conditions. For example, increased longevity and the evolution of global competition have changed what we need from a retirement system. This has put pressure on today's system and is part of what is causing it to falter. If today's system had self-adjusted, then it might be as sustainable as it was 30 years ago.

Participants discussed three things in particular around the issue of system self-adjustment:

- Systems should be self-adjusting based on our evolving ideas on how we use human capital. Retirement systems should adjust as we work (and retire). If we are working longer, or having several careers, then we should have systems—retirement and others—that support these new ideas about work and life. Today's traditional pension plan assumes retirement is an event: one day you are working, the next day you are not. Tomorrow, we may need people to move between periods of work, study and leisure at different stages of their lives. Going forward, we need retirement plans that permit more flexibility in how and when benefits are paid, and that can adjust as conditions for workers change as well.

> "*There's no reason actuarially why we can't build in some caveat in the design of plans [public or private] that [says], look if [costs get] way over here, then automatically two or three things happen … Seems to me that we might be able to constrain the risk (the risk being variance) by having some of these default options that, if we get into bad times, [adjustments] automatically occur.*"
>
> —CONFERENCE PARTICIPANT

- Systems should self-adjust based on how long we are living. One example where systems do not adjust is retirement age. The typical private sector plan retirement age—65—was set by the Committee on Economic Security in 1935 and considered actuarial estimates of life expectancy in 1935. Today, despite increased life expectancy, we still use it because it is enshrined in statute. As we live longer, this combination of a fixed retirement age with increased longevity has increased the cost of defined benefit pension plans over and above that of inflation. A simple self-adjustment to retirement age would keep the cost of the system affordable but would also keep the promises in line with those made to prior generations.

- Family structures are also changing, which may change the informal support that can be provided by family members at retirement. One panelist cited fewer marriages, more single parent households and lower birth rates (particularly in

Canada). As family structures change, retirement systems, which have historically assumed some informal or formal role for the family in retirement, may have to adjust to reflect changing family dynamics.

- One aspect of risk in any system is variance: how much do the results vary from the "norm" or "expected" value. Systems should limit risk by constraining variance within the system. If conditions arise such that the costs of a system start to rise above certain tolerance levels, benefits are adjusted so that all parties—payers and payees—share in the burden. One example of this is Canada's CPP plan. In this plan, if costs rise above a certain level, contributions increase but benefits are also constrained, by limiting the amount of inflationary increase beneficiaries receive. In this way, the variance in the cost of the system is limited and shared by all parties.

Making the system work better for politicians

Ideas such as self-adjusting systems and aligning skills with roles could help improve the efficiency of our political process. Why? Taxpayers entrust politicians with designing and managing our retirement system. If the system is designed in ways that politicians' success is aligned with (and not against) public interest, both politicians and the system can do a better job.

Going Forward

Self-adjustment will often shift risk from one stakeholder to another. When we look at this idea, we must consider the following:

- What parts of the system should self-adjust (e.g., social insurance, private plans)?
- What characteristics should be considered for self-adjusting (e.g., retirement age, benefit levels)?
- How much should risk be shifted, and how much should any change in the risk be shared between stakeholders in the system?
- How do these adjustments change the needs, risks and roles of the various stakeholders? In particular, if significant risk is shifted to individuals, how does this affect their needs at retirement? Does this increase the aggregate level of retirement assets needed to achieve the same level of risk protection?

Systems should consider new norms for work and retirement and the role of the normative retirement age

Conference participants continually discussed issues of work and retirement, particularly retirement age. Retirement age in this context was both full retirement age—the age at which full benefits are payable (currently 65 for most private plans and gradually increasing to 67 for U.S. Social Security) —and earliest eligibility age (varies, but often age 55 for private plans and currently age 62 for U.S. Social Security). Studies have shown that both the full retirement age and the early retirement age affect people's decisions to retire.

[T]he need is clear. Many people are going to work longer, if they can. The risk is that workers won't be able to work longer due to ill health or disability or because employers won't want them or because the closer they get to retirement, the better retirement is going to look…. What is the appropriate role of the various stakeholders (government, society, employers and workers) in extending work life and ensuring appropriate opportunities are available … and in discouraging the early [commencement] of pension benefits?

—CONFERENCE PARTICIPANT

On one side, participants argued that there was no need for a retirement age—the system can be set up to adjust benefits to be actuarially equitable at whatever age participants choose to retire. As the retirement experience may vary based on needs—later retirement for knowledge workers, earlier retirement for physical laborers—not having a set retirement age may more easily meet this need. However, other participants pointed out that retirement ages send signals to individuals as to what age is appropriate for retirement. If we, as a society, want to encourage longer work, then increasing retirement ages is an important tool to drive behavior change. In particular, early retirement age may act more as a "target" for individuals, much more so than the age at which full benefits are payable.

I'm a big believer in neutrality … when I hear people say 'well, we shouldn't encourage early retirement' I agree with that. But, when I start hearing we should encourage people to work longer, that will very quickly morph into we should punish people who retire at the age they wanted to retire and that's not the job of the system to do.

—CONFERENCE PARTICIPANT

The role of work at older ages was discussed from many different points of view. From the individuals' point of view, the discussion centered on how much longer society can expect, on average, individuals to work or to wait to collect benefits. We already know that many people are not able to work longer, due to the type of job, disability or family needs (e.g., caring for partner/parent). However, participants agreed that if you push out retirement, we have to extend eligibility ages for and provisions for disability income in light of this changing environment. Other questions that were raised include, from the employers' point of view, do you want to have an older workforce? What sort of challenges does that bring? Are there any special challenges in managing an older workforce with or without retirement plans? In this new process, would retirement plans play a more important role (to manage out those workers who cannot work but retain those who can) or do they become a hindrance (use severance packages and individual contracts to choose who you retire and who you retain)? How do you make sure the system supports those who want to work longer without penalizing those who cannot?

Going Forward

The changing nature of retirement—from an event to a process—is being driven by increases in lifespan, preferences and expectations and is in turn driving many changes we see today in the retirement system. Understanding how this is evolving, including where new social norms are headed, is critical to establish a successful new retirement system.

Not everyone will be able to work longer. We need to look carefully at what the different needs for retirement will be based on different individual characteristics. Stakeholder roles may need to change to support those different norms. For example, employers may be more involved in helping those physically no longer able to work after retirement, whereas society may encourage as many people as possible to work longer.

Systems should be better aligned with markets

Several participants felt strongly that the system should look to markets to pool and hedge risks, and not leave those risks to the employer, the employers' shareholders or the employees. Today's system is a seesaw—most risk either lies with the employer (and its shareholders, in a traditional DB plan) or with the individual employee (in a DC plan). It is probably too unsophisticated of a way to deal with risk, although defined benefit plans do pool certain risks well (e.g., longevity risk for annuities). Several participants also argued that employers should not be bearing risks that do not add to shareholder value, and that if employers make promises, they should properly price the commitments they are making.

> *"[Market] discipline [is] a necessary, but not sufficient, condition for a successful retirement system. Number one, policy makers should stop "improving" on market pricing. Two, we need more complete markets including mortality and inflation securities. And three, while waiting for more complete markets, plan designers and regulators should make and price benefits more in line with the securities that are already available."*
>
> —CONFERENCE PARTICIPANT

The principal focus of the discussion was that any new retirement plan designs should work with the markets and utilize the ability of the markets to effectively pool and hedge risks. The arguments made by several conference participants were that capital markets offer efficient pricing and risk bearing and therefore should be utilized as much as possible. Any system that does not use market mechanisms and does not work within market frameworks (e.g., transparent costs) may not be accepted by the markets and may fail. Participants also discussed the value of having groups approach the market rather than having individuals make their own market contracts.

However, it was noted that today's markets are not complete. Markets do not hedge all the risks they can hedge, and there may be some risks for which the cost of the market hedge may be beyond what individuals are able to pay. Markets also cannot provide the kind of hedging instruments needed to construct products or plans to protect individuals. The example of longevity bonds was discussed. Longevity bonds are issued to hedge systematic longevity risk (the risk that the average person lives longer than expected). To date, several firms have attempted to issue bonds but with little interest in the market to purchase them. The

> *"I would certainly urge caution in putting too much faith in either the markets or the public sector … history is replete with examples of markets overshooting and governments overreacting. [H]aving said that, I do believe that prudently regulated markets are better than wholly unregulated markets. It's a calibration that's very difficult to achieve."*
>
> —CONFERENCE PARTICIPANT

incompleteness of the model for inflation-linked bonds in the United States was also discussed (the TIPS market).

Going Forward

Other than through insurers, most of the market focus has been on short-term financial risks. Retirement systems present longer risks than most risks the market pools or hedges. This would argue for new market instruments to better meet retirement risks. Markets may not be able to hedge all risks, or may be only able to hedge them at a price individuals cannot afford.

What can the markets do well, what are the markets currently unable to do (but may be able to do in the future) and what are markets simply unable to accommodate? Where markets cannot hedge risks, should they be borne by individuals? Should they be shared with other generations? When is transferring risk from one stakeholder to another appropriate?

Systems should clarify the role of the employer

Employer plans have been a key source of retirement income after social insurance for many U.S. and Canadian citizens. However, changes in the regulatory environment, both for taxation and accounting, have caused many employers to question whether they can continue to provide traditional defined benefit plans. Today, the only alternative for employers wishing to sponsor a plan is a defined contribution plan. Participants discussed at length what role the employer should have in the retirement system. Many participants were open to thinking of employer solutions outside of the defined benefit and defined contribution paradigm.

Participants discussed several principles regarding the role of the employer:

- What role do retirement plans serve for employers? There was an acknowledgement that retention and orderly retirement of employees was a key goal of plans. Most employers noted, however, that in terms of attraction of employees, younger employees only consider whether the employer has a retirement plan or not, and not what the plan looked like or what level of benefits were provided.
- Retirement plans must meet corporate goals. Participants noted that there has to be a reason why employers sponsor retirement plans, other than tradition. If retirement plans do not meet corporate goals, then the employers' role should be different (e.g., facilitate entry into plan run by a third-party). Similarly, the ability of retirement plans to assist in the attraction, retention and retirement of employees must not conflict with the employer's core business.
- Companies exist in a global economy. Many countries do not have employer--sponsored retirement (or, for the United States, health care) plans. It is difficult to justify the cost of plans for many employers given global competition.
- One goal of retirement systems might be the redistribution of income, from more to less wealthy individuals. But does it make sense for employers to redistribute wealth? Employers' goals may work against this social goal, such as rewarding the most productive workers. If employers are part of a retirement system, how much can you expect them to support the social goals of retirement systems as well?

> "*[W]hy do we feel this compulsive urge to jump in the middle of [employees'] retirement plan when we don't feel it anywhere else?... [U]ntil we can give answers to what is in it for the corporation, I think what you're going to hear from [outside] directors over and over is we don't want to be the deep-pocketed player in the game. We want to be an interested bystander.*"
>
> —CONFERENCE PARTICIPANT

- Statutory frameworks for both funding and accounting must align with employer cost frameworks. One point discussed is whether the pricing of traditional defined benefit plans under the current accounting system overstates costs for younger workers and understates costs for older workers. This framework may be discouraging traditional defined benefit plans because the employer's cost does not equal the employee's perceived value. This is simply one example of how the cost of the system, as set by funding and accounting bodies, should align with the employers' view of the costs; if they do not, then employers may not be inclined to sponsor plans.

Going Forward

We need to rethink the possible roles of the employer in the system. Conference participants noted studies that have shown that employees trust information received from their employer more than information received from other sources. And employers note the role of retirement systems in helping them to retain and retire employees. The group pooling and purchasing that have taken place through employer systems are valuable, but could those be accomplished by other means? Could the employer role simply be to act as a conduit to retirement plans, not as the sponsor of the plan?

The role of work and retirement ages was discussed earlier. Work at older ages will not become the rule rather than the exception unless it is embraced by employers. Keeping workers in the job market requires workers and employers to understand the benefits of work at older ages. It also requires the system to permit employers to differentiate between those workers who are able to work longer and those who cannot.

Retirement systems will not succeed without improvements in the health and long-term care systems

Finally, conference participants felt strongly that any retirement system redesign will fail unless changes are also made to the health care (particularly in the United States) and long-term care systems. Several participants noted the ballooning deficits for Medicare (health care) and Medicaid (health and long-term care) noting that there would likely be cutbacks in those programs going forward. In addition, most private employers in the United States no longer offer health care benefits to retirees (particularly future retirees) and many in the room predicted health care benefits for government retirees would soon disappear in the United States with the introduction of new accounting standards for those benefits.

Will Retirement 20/20 tackle issues in the health care and long-term care systems?

The Retirement 20/20 project is focused on finding solutions for retirement income. There are no plans to consider necessary revisions to the health care and long-term care systems. Health care affects everyone—children, workers and retirees—and would need to be considered for society as a whole, not just from the point of view of retirees. Long-term care is a complex system in and of itself with issues that go beyond those facing retirement income. Both of these are significant projects which deserve their own dedicated experts working on them. Retirement 20/20 does not have the resources, or the experts, to devote to these issues.

The Pension Section Council will encourage others to take on the challenge of addressing health care and long-term care. We will communicate broadly that changes to the retirement system cannot succeed without also addressing these other vital components of retirement protection.

Several concerns were raised that we can create the most perfect retirement systems in the world but it will not work if the health care and long-term care systems are not aligned as well to meet it. Participants cited recent studies showing that individuals will not annuitize their income—protecting them from outliving their assets—because they are concerned about needing large sums to cover medical costs.

In addition, the instability and rapidly rising costs of health care are decreasing future retirement benefits. Employers noted that they have limited budgets to spend on employee benefits, and as health care costs continue to escalate, they are often cutting the retirement benefits to be able to continue to pay for health care for current employees.

Report on the Conference

Society's Needs, Risks and Roles

In discussing the needs, risks and roles for society, participants honed in on four key issues: society must ensure that the retirement system is adequate, affordable, sustainable and robust. Conference participants may have differed on exactly how one would achieve any of those objectives, but several themes about the roles of employers, individuals and markets that were to be repeated throughout the conference came through in the initial discussions of society's role. Note that in this case the retirement system is not simply social insurance (Social Security or OAS/C/QPP) but all sources of retirement income.

Society's risks fall along two lines, economic and political. Economic stability has many characteristics, including efficient allocation of economic resources. Society also faces risk when other stakeholders fail. Examples of this include individuals who fail to save adequately for retirement and employer-sponsored plans that ultimately become bankrupt.

Society's role is to ensure economic success and political stability, which aligns with its two greatest risks. Society also sets up the regulatory structure to ensure that all stakeholders understand how the system operates, but to build trust in the system and to minimize the risk that other stakeholders may fail. Finally, discussion throughout the conference returned to the need for society to address imperfections in the system. Some of these imperfections were failings of other stakeholders, for example, individuals to adequately prepare for retirement and markets to provide vehicles for the pooling and hedging of risk. Other imperfections related to social imbalance (the redistribution of wealth) or to protect against the moral hazard of poverty at old age.

As we started the discussion of society, tensions quickly arose between what society may need, and what other stakeholders may be able to accomplish.

Society's Needs

Adequate

Adequacy ensures that the most vulnerable members of society are protected by providing a minimum benefit above poverty level. This might be accomplished by promoting redistribution of wealth from wealthier to less wealthy citizens. There was significant discussion as to whether an employer-based system could or should do that (could you ask employers to redistribute wealth when their goal was to compensate employees?).