The Future of Pensions

By David Blitzstein

I have to admit that I accepted your invitation for selfish reasons. I'm hoping to use my time here as a catharsis. The dictionary defines catharsis as the purifying of emotions or the relieving of emotional tensions. Originally, the term catharsis was applied by Aristotle to the purging of pity or terror by viewing a tragedy.

Our tragedy is the unraveling of the defined benefit pension system. For the past five years my union has expended great energies in an attempt to shore up our multiemployer and single employer pension plans from a tidal wave of traumatic financial and economic events that threatens to destroy them. Over one million active workers and 300,000 retirees are caught up in this tragedy. What the UFCW is experiencing is a microcosm of what is happening to the defined benefit retirement system nationwide.

The UFCW's pension problem amounts to a $10 billion unfunded liability in a $30 billion system spread over 70 multiemployer plans. These are mature plans where the active to inactive support ratio is 1:1, and most of the plans are beset with net negative cash flow that is growing. This negative cash flow compounds an already difficult low return capital markets environment. As this audience knows better than most, the probability of investing our way out of this funding dilemma is very low.

The UFCW and the unionized supermarket industry have not stood by passively as the pension crisis developed. Labor and management reached an understanding around the pension problem pretty rapidly and initiated negotiated remedies by 2003 and 2004. The understanding was based on principles of shared responsibility and shared pain by the stakeholders. This translated into substantial benefit reductions going forward and significant increases in employer contributions. The typical benefit reductions formula included decreases in early retirement subsidies, decreases in flat benefit rates, and the creation of lower benefit tiers for new hires, with all the ramifications for inter-generational conflicts among young and more senior workers and retirees.

A key component of these pension agreements included actuarial relief available in ERISA, specifically Section 412 (e) extension of amortizations. These pension funding agreements also contain restrictions on future benefit improvements based on funding targets, with additional contribution increases and benefit reductions triggered in the future based on projected minimum funding deficiency. The second stage of action by the UFCW and the unionized supermarkets was a legislative campaign that proposed a very pragmatic pension funding reform regime along with a broad coalition of unions and employers including Kroger, Safeway and UPS.

The problem is that these actions were not enough. The regulators, specifically the IRS, have failed to recognize the good faith efforts of labor and management, and have refused to grant the actuarial relief anticipated by ERISA. As a result, many of the pension deals that we crafted in retail food industry may unravel or require renegotiation, which can only mean more economic pain for the stakeholders. Congress is still grappling with pension funding reform legislation, and the odds are not in our favor that legislation will be passed this year. Even if the legislation is passed, many plans will find themselves in reorganization status. In effect, this means workers covered by these plans can expect no benefit improvements for a generation.

If the multiemployer pension system has deep problems, the single employer system is hopeless. The single employer legislation under consideration in Congress and the anticipated changes in the FASB pension accounting rules this year will drive employers to freeze and terminate plans at a pace similar to what occurred in the UK most recently.

So as the tragedy unfolds, we have to commit ourselves to preparing an honest and accurate post-mortem on the defined benefit system as we knew it, determine what went wrong, and learn from our mistakes, so we can rebuild a retirement system that serves society and revitalizes the faith of all the retirement stakeholders.

Lessons Learned

One lesson learned is that the current defined benefit pension system is deeply flawed. The ERISA funding regime is inherently unworkable and intellectually dishonest. It’s been tested under fire and it failed miserably. We set the price of benefits too low, and made promises to workers that we can’t keep. Then we compounded the problem by adopting investment strategies that were overly risky and produced return volatility that was unsustainable in the short term for employers. Many of us bought into a dangerous and lethal fantasy that an economic “free lunch” existed for pension plans. We embraced prolonged contribution holidays and larger allocations to stocks contrary to the lessons of diversification and financial economics. Reality came knocking on the door in March 2000.

The tragedy that has unfolded was predicted by a handful of astute observers. Zvi Bodie, professor of finance at Boston University, was hired by the Department of Labor to analyze the financial health of defined benefit pension plans in 1990. His report warned:

> “The possible doomsday scenario for the defined benefit pension system would be an event such as a sharp and prolonged drop in stock prices that causes a sharp decline in the market value of pension asset portfolios. Underfunding becomes much more prevalent. Several major defaults of underfunded pension plans lead the PBGC to significantly raise premiums on the remaining plans in the system. Expectations of even higher premiums in the future lead sponsors of the well funded plans to terminate their defined benefit plans to avoid the PBGC tax.... Ultimately, the United States could be left only with bankrupt defined benefit plans with the benefits financed directly by taxpayers.”

Labor and management in the 1990's fooled themselves into believing that their decisions to improve benefits came with no price tag. This built an underlying economic moral hazard into the system. I don’t buy the proposition that this moral hazard was premeditated by labor and management. I believe the outcomes were driven more by bad science and a breakdown of intellectual discipline by public policy makers and professional advisors. Maybe the roots of the defined benefit problem go back to the passage of ERISA and the jumble of amendments added on since 1974.

ERISA failed to clearly define the risk sharing "deal" that pension plans represent. Canadian pension strategist, Keith Ambachtsheer, who has focused much needed attention on the pension risk sharing deal, reminds us what game theorist, John Nash, taught us years ago that such complex yet misunderstood contracts will eventually deteriorate into adversarial win-lose games. Thus the myth that defined benefit plans socialize investment risk has been laid bare in the past decade by a wave of plan terminations in the steel and airline industries. Chapter 11 bankruptcies has become a very effective means to break and rewrite pension deals between a host of pension stakeholders - retirees, older workers, younger workers, corporate management, corporate boards, unions, bond holders, shareholders, and the PBGC. Pension regulators, securities regulators, credit agencies, actuaries, accountants, and the courts all play supporting roles in this renegotiation process.

In attempting to better understand why ERISA failed to properly define the pension deal clearly, I returned to some writings of my old and departed friend, Michael Gordon, one of the drafters and historians of that law. In a chapter titled, "The Social Policy Origins of ERISA", Gordon informed us that "ERISA was not connected to some grand overarching vision of structural reform that would facilitate the adoption of private benefit arrangements to the needs and expectations of an emerging post-industrial period"... but, "concentrated instead on flushing out and correcting major historic flaws in private plans", like vesting rights and termination rules and insurance.

As a result, Congress and the private pension system failed to anticipate the dynamic and ever changing structure of a capitalist economy. The "creative destruction" of the system identified by economist Joseph Schumpeter became the Achilles' heel of the private pension system. The relatively short lives of corporations contradicts their role as pension sponsors. Just consider the survivorship numbers for the S&P 500. How many names remain that were on the list 30 years ago? Complementing the trend of creative destruction is the wave of mergers and acquisitions experienced by America in the past fifty years and the instability they create for pension plans. Finally the restructuring of Corporate America has had a major impact on labor markets and the behavior of workers, including the weakening of the labor movement, which played a key role in creating the private pension system in the first place.

This raises another important Ambachtsheer theme - principal/agency issues. Adolph Berle and Gardiner Means set out the principal-agent problem in their classic book, <u>The Modern Corporation and Private Property</u>, where they identified the tensions between management and shareholders, and the potential for conflicts of interest. Further to this point, Gordon describes how ERISA allows settlor/employer conduct to override proper fiduciary conduct. Single employer pension plans exemplify classic agency-principal behavior. Trustees of single employer plans more often than not make funding decisions in the best interest of the corporation, not the plan participants.

We can conclude that ERISA was limited as a retirement policy tool by its backward looking perspective. Congress's current pension reform efforts repeat the same pattern of backward looking policy behavior, applying stopgap legislative remedies. Maybe this is the heart of the pension policy problem in the United States. I'll take it a step further - in my opinion, there is no retirement policy in this country. The concept of the "three-legged stool" is not national policy because it doesn't exist - 50% of the working population doesn't participate in a private pension plan and savings rates are at historically low levels. Again Gordon informed us that what was missing in the policy equation during the passage of ERISA was no "...attempt to forge a political consensus with respect to a specific national target of retirement income adequacy". This key starting point got lost in all retirement policy discussions since the 1981 President's Commission on Pension Policy Report.

Why is this the case? One reason for the lack of policy debate and coordination may be the fragmentation of pension and retirement regulatory and legislative authority among so many agencies and Congressional committees. There is no cabinet position for pensions. In contrast, every other developed nation has a centralized regulatory power and a minister for retirement policy. Just compare our dysfunctional model to the Netherlands, where the Dutch are busy re-inventing their defined benefit pension system based on modern finance principles.

Other countries also use commissions more effectively to study retirement issues and make broad recommendations to their governments for new legislation. Most recently I had the opportunity to hear Lord Turner, the chairman of Merrill Lynch in the UK, present his commission report on comprehensive reform of the UK retirement system. I was impressed by Lord Turner's grasp of pension economics and the quality of his analysis which surprisingly avoided politics and ideological agendas.

My thoughts on the future of the U.S. retirement system are based on two practical issues. First, how do we secure the legacy benefit liabilities of the current system in an effort to keep benefit promises and sort out the financial obligations among the various stakeholders? Second, what kind of retirement system can we build that avoids the pitfalls of the current system, and instead has more symmetrical risk sharing, making it fairer and financially sustainable?

Finding a fix for the current black hole of unfunded pension liabilities is a critical first stage to rebuilding a viable retirement system. The past service legacy costs of these under-funded plans has to be secured and de-politicized. If this can be accomplished, it would relieve the immediate financial crisis, and allow the stakeholders the freedom to negotiate a new pension model for the future based on a new set of risk sharing rules.

A solution does not have to be a taxpayer bail-out, but the government needs to play a financial leadership role. I would suggest we consider a mix of public and private capital market financial engineering schemes. For example, Jeremy Gold has proposed an idea that securitizes unfunded liabilities of defined benefit plans in the capital markets through the PBGC. Under the Gold strategy, the sponsoring company would issue private placement bonds or tradable bonds to the PBGC, and the plan would receive bonds issued by the PBGC, each in an amount equal to the initial unfunded actuarial liability. The price of these bonds would be adjusted for a company's credit rating. This financial engineering approach offers transparency and fully funds all plans over a transition period.

Richard Berner and Michael Peskin from Morgan Stanley have proposed a similar defeasance strategy for pension legacy costs in which sponsoring companies and the PBGC would swap "amortizing promissory notes". And a third idea from Bernard Dumas of INSEAD and Andrew Smithers of Smithers & Company proposes a market for trading pension claims in the form of collateralized pension claim obligations (CPCOs), similar to collateralized debt obligations (CDOs). These ideas require an accommodating legal and tax environment that only government can ensure if these strategies are expected to succeed.

What should we be looking at?

Once we secure the past legacy costs of the current defined benefit system, we can begin to formulate a viable private retirement system for the future. I'll concentrate on four main topics, all of which are linked and must be integrated in order to succeed:

- First, a new risk sharing deal that corrects the current destructive asymmetry, reflecting the mismatch between risk and reward among stakeholders in the DB system.

- Second, a retirement delivery system that corrects the agent/principal problems in the current system.

- Third, benefit design.

- And fourth, ideas on how to increase the savings of low and moderate income workers.

Correct the current destructive asymmetry

Redefining pension contracts among stakeholders is a critical subject that has been generally ignored in most policy circles. In Canada, the mismatch between stakeholder risk and reward, defined as asymmetry, and the issues of who owns a pension surplus or a pension deficit, has been highlighted by the Association of Canadian Pension Management in the national debate over the future of the retirement system. In fact, the ACPM has taken the position that resolving the asymmetry issue would lead to better funding and even growth of the DB system.

Ambachtsheer and others have observed that DB pension contracts unfairly favor current generations at the expense of future generations. Moreover, our recent experience, suggests that course-correction mechanisms either do not exist or are not vigorous enough to maintain DB sustainability during periods of adverse investment and demographic experience. Again relying on Ambachtsheer, we can envision the following inter-generational negotiation, based on a new set of rules:

- All pension stakeholders including future generations of workers must have knowledgeable bargaining representatives.

- The stakeholders must agree to the following long-term expectations: the economy's wealth creating potential; the term structure of risk-free investment returns; the long-term cost of risk capital which equates to the risk premium; and, the inter-generational variance around these long-term expectations.

- Based on the above agreements, the income replacement equivalent pension benefit, and the potential inter-generational pension variance based on surplus and shortfall risk scenarios would be calculated.

- These negotiations will determine investment risk and contribution levels necessary to pay agreed-to benefits. If the current generation imposes investment risk on future generations, these future generations should receive fair compensation for undertaking this burden.

This model is based on sound finance principles, but it also demands a societal partnership arrangement that is inclusive of all pension stakeholders. In the United States we pride ourselves on our democratic values, but those values do not always cross-over well into the economic life of this country. However, the examples of the Netherlands and Australia should encourage us to try a new approach to retirement policy.

Correct the agency/principal problem

To facilitate the new pension deal, we need to minimize agency costs by creating what Ambachtsheer refers to as “single-purpose pension co-ops”. TIAA-CREF, superannuation funds in Australia, big industry funds in the Netherlands like ABP and PGGM, and large multi-employer plans in the U.S. and Canada are examples of the “single purpose pension co-op”. In response to the recent recommendations of the UK Turner Commission to establish a National Pension Savings Scheme, the National Association of Pension Funds offered the idea of “Super Trusts”, which would group the savings of different industries. These plans minimize the potential for conflict of interest and build on economies of scale. These single purpose pension co-ops could also become attractive platforms to compliment a universal coverage system based on some level of compulsory contributions by employees and employers.

The single purpose pension co-op arrangement also opens up the opportunity to foster stronger governance and organizational design for pensions. Research has found an excess return gap of 1% per annum between well and poorly governed pension plans. Research from Cost Effectiveness Measurement has determined that the economies of scale premium for a pension plan is 20 basis points for every ten-fold increase in assets. This means that a large pension plan could afford to hire qualified staff, allowing boards of trustees to delegate development and implementation of fund strategy. Good governance practices would be further enhanced by expanding the training and professional certification of trustees, and eventually converting trustees into full-time professional positions.

Rethink benefit design

Benefit design has to be rethought in light of the rules of the new pension deal. This requires a leap beyond simple debates over DB vs. DC. Our starting point has to accept the fact that effective retirement programs are expensive, in the range of 15-20% of payroll. Therefore, a mixed DB/DC approach may be most appropriate. For example, the DB piece could look like the Mercer “retirement shares” model which cures much of the risk sharing asymmetry by pricing benefits properly without a risk premium, and eliminates the contractual problem of who owns the deficit or surplus with pre-determined rules that re-balance costs and benefits annually. In this design, workers are protected from longevity risk but share investment and interest rate risk. This means workers own the deficits as well as the surpluses of the plan. We can agree or disagree with this risk sharing formula, but at least it offers a workable starting point.

This hybrid DB design requires a defined contribution component if we expect to meet our retirement income adequacy goals. This is especially necessary considering the more conservative and more expensive DB design inherent in the Mercer shares model. The DC design I envision would be integrated as a wrap-around to the new DB plan to be managed in the same single purpose pension co-op. This concept is not dissimilar to the "retirement account pension plan" (RAPP) envisioned by Bob Paul of the Segal Company over a decade ago, or the DB-K Plus plan formulated by the American Academy of Actuaries in 2003. These complimentary DC programs would be structured so that workers make decisions about the level of retirement benefit they will earn per dollar of savings. The DC component would be invested professionally by the Plan with the sole objective of meeting the realistic benefit goals set by the worker, assuming the bulk of the benefits would be paid in annuity form.

Increase low and moderate income worker savings

Finally, the retirement needs of low and moderate income workers require special attention. This group is most at risk to coverage gaps and retirement benefit inadequacy. We all know that raising contribution limits on IRAs and 401(k)s is not the answer for these workers. We need to promote creative ways to leverage the limited savings potential for this population.

I have two recommendations that target this group. First, as part of Social Security reform we need to restructure the payroll tax by exempting the first $10,000 of salaried income for those workers under an inflation adjusted income threshold, and re-directing those contributions into our private single purpose pension co-op. The lost income to Social Security will be made up by raising the payroll cap, or with special taxes on pollution or foreign oil as suggested by conservative thinker Irwin Stelzer.

Second, we can leverage the savings power of Federal income tax refunds by fostering the idea of refund splitting. In 2001, low and moderate income workers received $78 billion in total Federal refund payments, including the Earned Income tax Credit (EITC), child tax credits, and other refundable credits from over withholding. This amounts to an average value of $1,546 per family. In one refund splitting experiment in Tulsa, Oklahoma, called “refund to assets” (R2A), participants contributed $606 or 47% of their refunds to savings accounts. This refund splitting scheme could be further complemented by an expansion of the 2001 Savers Credit as suggested by J Mark Iwry, by eliminating and modifying asset rules that affect program eligibility. This integrated model aimed at leveraging the savings potential of low and moderate wage workers could provide powerful momentum to building additional retirement savings.

So What Can We Do Now

My views on retirement policy are obviously a product of my experience as a union representative over the last 28 years. My work with the United Mine Workers and the history of that mythical organization with its special role in establishing multi-employer pension and health trusts greatly influenced my thinking about retirement. Sometimes I think back to the words of John L. Lewis when he was campaigning for the retirement funds in 1946:

> “The United Mine Workers of America has assumed the position over the years that the cost of caring for human equity in the coal industry is inherently as valid as the cost of replacement of mining machinery, or the cost of paying taxes, or the cost of paying interest indebtedness, or any other factor incident to the production of a ton of coal for consumers’ bins..... (The agreement establishing the fund) recognized in principle the fact that the industry owed an obligation to those employees, and the coal miners could no longer be used up, crippled beyond repair and turned out to live or die subject to the charity of the community or the minimum contributions of the state.”

These are not just empty words from a bygone era. The need for retirement benefits is as critical as it was 60 years ago when Lewis wrote these words. The social contract of the post WWII era has most definitely unraveled. There is no going back. We in the United States, as the wealthiest nation in the world, will be judged on how we reconstruct our retirement system. We can import intelligent ideas from abroad as part of the pension reform effort, but ultimately our unique economic and political culture will drive us toward a mixed private/public solution. This mixed system along with a strong dose of financial engineering will provide the answer.

Maybe the 1981 President's Commission on Pension Policy Report provides a guidepost for the future. Twenty-five years later its still offers a vision and a framework for unfinished business of creating a universal and financially sustainable system. The hallmarks of the 1981 Commission were:

- It was based on retirement income replacement goals.

- It promoted a 3% of payroll contribution supplement called Minimum Universal Pension System (MUPS) to be administered as an add-on to existing private plans, or where employers could opt to a independent central fund run by the government.

- It raised concerns 25 years ago about the costs of early retirement benefits, and suggesting that private plans link their normal retirement age to Social Security.

- It called for equalizing the tax treatment for all contributions and benefits, and phasing out the Social Security earnings test.

- It emphasized the creation of incentives for older employees to work beyond normal retirement age.

- It called for inflation protection for retirees.

- And, it determined that retirement policy would fail without the consolidation of pension regulatory and legislative authority.

The 1981 Commission had great foresight. Only if someone had bothered to listen and act. Public policy moves in long cycles. Historically, the moment is timely to begin the great effort necessary to rewrite the retirement social contract in America.