Retirement 20/20

CONFERENCE REPORT



Resolving Stakeholder Tensions: Aligning Roles with Skills

A Retirement 20/20 Conference

Sept. 24–25, 2007

Actuaries

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Resolving Stakeholder Tensions: Aligning Roles with Skills

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Introduction

Retirement 20/20, an initiative sponsored by the Society of Actuaries' Pension Section, aims to bring together experts interested in and impacted by retirement issues in order to design a new retirement system from the ground up. In reaction to the shortcomings of both traditional defined benefit plans and defined contribution plans, Retirement 20/20 seeks to find solutions that meet the economic and demographic needs for the 21st century.

On Sept. 24–25, 2007, the Society of Actuaries held its second annual *Retirement 20/20* conference. The 2007 Conference focused on the alignment of roles and skills for different stakeholders. The conference attendees worked on defining stakeholder roles that work together while minimizing competing priorities between stakeholders. In the end all roles need to be assigned; to the extent one role is removed from one stakeholder, it needs to be transferred to another (i.e., interlocking roles).

Background on *Retirement 20/20* and the First (2006) Conference

The initiative began in late 2005 with the purpose of designing a new retirement system based on the belief that neither defined contribution nor defined benefit plans are the ideal answer, and a better way can be found. The initiative did not start by looking at specific designs or risk sharing ideas, but rather started with the idea of developing core principles.

The 2006 Conference[1] was a discussion of needs, risks and roles for the following stakeholders:

- **Society**. By society, we mean society as a whole (all taxpayers/citizens). This includes both current and future generations since there are intergenerational costs and risk-bearing issues.

- **Individuals**. Individuals are the ultimate users of retirement income and have the need to prepare for retirement and then manage retirement income while negotiating various risks.

- **Markets**. Markets have the dual roles of retirement asset accumulation and de-accumulation and also provide hedging opportunities.

- **Employers**. Employers hire individuals and need to attract, retain, motivate and retire individuals.

The six themes that came out of the 2006 Conference were:

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

The seed for the 2007 Conference was found in the first theme of aligning roles with skills. Participants at the 2006 Conference discussed the fact that individuals aren't the best suited for retirement planning or deciding how to invest retirement assets, and an employer's goal in business usually isn't to operate a pension plan. This misalignment of roles with skills creates problems in today's retirement system. Therefore, the proper alignment of stakeholder skills with roles is critical to the success of any new retirement system.

Headlines

Executive Summary

For 2007, we set out to determine the optimal roles for our various stakeholders. Proper role definition is critical for the system's success. The correct role would be one that uses each stakeholder's knowledge and talents optimally. For example, market experts would work in the markets, and employers could focus on their core business. Defining the stakeholder roles is also necessary before beginning to design the features of the new retirement system.

For 2007, we focused on role definition. Particularly:

- Which stakeholder is best suited to take on what role?
- How do you allocate roles based on stakeholder skills?
- How do these role assignments affect other stakeholders?

The stakeholders discussed in 2007 were society, markets and employers. Based on the consensus development of conference participants, the key roles identified for these stakeholders were as follows:

1) Society provides structure to the retirement system through:

- Helping individuals make the right decisions,
- Setting some guidelines about what **ought** to happen, and
- Providing consumer protection.

Specific goals that society should work toward include:

- Encourage **lifetime income** (annuitization), at least through a basic social insurance component,
- Help individuals in the **accumulation** of retirement wealth, and
- Provide **oversight** to the system through appropriate levels of rules and regulations.

2) Markets provide structure to support the retirement system by:

- Facilitating and allowing for **groups** to approach the markets,
- Providing proper **incentives** for agents (who can facilitate the use of groups),
- Providing **standardization** among products offered, and
- Encouraging **innovation** in hedging and pooling instruments.

3) Employer provides structure to the retirement system through:

- Playing a role as a **facilitator** of individual savings,
- Serving as an unbiased **educator and trusted advisor**, and
- Participating in various **elective employer roles** of purchasing agent, distributor of income and guarantor.

Conference Overview

Roles were considered for three of our stakeholders:

- **Society.** Society in this case is society at large: all citizens and particularly all taxpayers who have to pay the cost of any retirement system designed. In this case, government (including politicians) acts as an agent or representative of taxpayers/society. Taxpayers include current taxpayers and future taxpayers, those who may end up paying for unfunded mandates.

  Society as a whole is often concerned with issues of intergenerational balance (more money spent on retirees means less money to spend on children and infrastructure) and the redistribution of wealth (social insurance systems, such as U.S. Social Security and the Canada Pension Plan/Quebec Pension Plan (CPP/QPP) often pay progressive benefits, where wealthier taxpayers receive less money relative to their earnings or contributions than less wealthy taxpayers).

- **Markets.** Capital markets are where the accumulation and de-accumulation of wealth take place. For purposes of our discussion, markets include financial intermediaries (e.g., insurers and mutual funds) who take the raw product of the capital markets and turn it into solutions for individuals and groups. Markets are a key to the success of the new retirement system. They can reduce the cost of retirement risks by providing the proper hedges (e.g., longevity bonds).

- **Employers.** Employers play a key role in today's retirement system, as the sponsors of defined benefit and defined contribution plans in both the United States and Canada. Employers also have motivations that may drive them to want to sponsor retirement plans—as a tool to help attract, retain, motivate and eventually retire their workforce. The employer discussion tended to focus on private (rather than public) sector employers; in some cases the employer discussion considered differences between the two employers.

What happened to individuals?

Keen observers will note that we identified four stakeholder groups at our 2006 Conference—individuals, employers, markets and society—but the 2007 Conference only focused on three of those. The individual as stakeholder was excluded from the 2007 Conference. What happened? Mostly driven by logistical considerations, we focused on the other three stakeholders. However, even though individuals were not highlighted by a separate panel discussion, they were always part of the conference discussions. The discussions focused on what roles the other stakeholders needed to play to best support individuals.

The conference was organized into three panels. Each panel began with expert speakers, chosen to present diverse views of the issue, who introduced the topic. After the panel introduction, the participants broke into working groups to discuss the issue in more depth. A spokesperson then reported the consensus (or lack thereof) of his group back to the full conference. At the end of the two days, conference participants were given the opportunity to vote for their favorite themes (those that they felt were the most important) from all of those that emerged out of the discussions.

Role of Society

Malcolm Hamilton (Mercer) and Virginia Reno (National Academy of Social Insurance) presented an overview of how and how well the social insurance systems are working in Canada and the United States, began discussion of the proper role of society in providing retirement security, and debated the role society should take with respect to retirement savings. Conference participants then considered these questions, as well as whether society should protect people if they are forced to retire before they plan to and whether society should encourage individuals to work longer.

The primary conclusion of conference participants was that the role of society is to provide structure to the retirement system. This comes about primarily through three main functions:

- Help individuals make the right decisions,
- Set some guidelines about what ought to happen, and
- Provide consumer protection.

One goal of society with regards to the retirement system is that it wants to ensure that today's workers save enough that they aren't a burden on tomorrow's taxpayers. Society, when focusing on the roles of helping individuals make the right decisions and setting guidelines about what ought to happen, could achieve this particular goal by doing the following:

> *"There's an awful lot of work that needs to be done to find ways to alleviate poverty without shifting burdens to future generations [and] without undermining the incentive to save for people with average incomes. To me that's the challenge. Canada's done an OK job, but there's certainly room to do these things better."*
>
> *—CONFERENCE PARTICIPANT*

- **Encourage lifetime income (annuitization).** First, conference participants felt the basic social insurance benefits ought to be structured as lifetime income, and they should maintain their progressive element. Participants discussed whether flat-dollar benefits were better; flat dollar benefits introduce negative incentives for individual behavior and the surrounding bureaucracy around means-testing was thought to outweigh any potential savings. Secondly, as a rule, society should mandate or encourage the annuitization of retirement savings. It could do this by mandating or encouraging the annuitization of a portion of savings (e.g., up to a dollar level or percentage of pay). Note that this could be done through tax mechanisms; annuitization could be tax-favored while not annuitizing could carry tax penalties.

- **Accumulation of retirement wealth.** Conference participants felt that society should take an active role in helping individuals accumulate funds for retirement. This could be done in several ways. One way would be for society (the government) to mandate a minimum level of savings and encourage more savings (e.g., through tax policy). Another way this could be achieved would be to set up a mandatory second-tier program that would exist in addition to the social insurance system (Social Security in the United States, CPP/QPP in Canada). This second-tier system might be thought of as a mandatory pension plan out of which employers or individuals could elect to opt. This idea was revisited and developed more fully in the role of the employer discussions.

- **Oversight.** Society has a responsibility to set the rules and regulations and to provide oversight to the system. This occurs in several ways. First, society provides basic oversight for consumer protection. Secondly, it encourages some degree of standardization to allow consumer comparability. Finally, in providing oversight, the government also needs to "get out of the way" to allow and encourage evolution. The example noted most often was removing barriers to phased retirement and later retirement that could help encourage new patterns of work and retirement in an individual's later life.

Two final observations that arose from the role of society discussion were:

- **Participants felt strongly that society should not set any direction regarding retirement age**. Some people have argued that society ought to be encouraging later retirement, particularly for knowledge workers, as this will help to avert the retirement crisis by keeping people in the workforce longer (paying taxes into the social insurance system without yet collecting benefits). Conference participants felt that society should neither encourage nor discourage earlier or later retirement.

- **Participants felt that society should have an actual retirement policy, not just a tax policy.** Tax policy is certainly one way to influence the behavior of individuals, but conference participants noted again and again the need for oversight, standardization of products and education of participants—three potential goals of society that are unrelated to tax policy.

Role of Markets

Keith Ambachtsheer (KPA Advisory Services) and Zvi Bodie (University of Boston) discussed the imbalance between the markets (and the very sophisticated individuals who work there), and the individuals who need the markets to help them manage their retirement risks. This is partly due to a lack of symmetric information (market makers and financial intermediaries have more information than users of the market, particularly unsophisticated users such as individuals). Panelists considered whether you fix that asymmetry by using buying cooperatives (unsophisticated individuals band together to hire an agent who understands the markets), or by offering guarantees (consumers don't have to understand how the car is put together because it comes with a manufacturer's warranty). In identifying a solution, one must consider that buying collectives may not achieve what is desired if their agents don't have the proper incentives.

> *Behavioral finance certainly emphasizes [that] you want to offer few choices. If you give too many, you muddy the waters. Toyota only offered three good cars in the 70s, meaning they only offered three cars, as opposed to GM [which] had lots of bad cars, but you could get lots of variety in those bad cars.*
>
> *—CONFERENCE PARTICIPANT*

The animation of the panelists spilled out into the working groups, where participants considered how the markets can best be used to hedge retirement risks. They considered whether the information asymmetry that the panelists discussed could be better handled by focusing on variety or standardization (particularly of products), whether we should focus on designing better solutions for individuals or encouraging increased formation of groups, and how to get all of this done.

Participants concluded that it is very important, when we think about the retirement system, to consider how we use the markets. Structure became a recurring theme, because it was felt that additional structure would help the markets work better. Participants saw this structure represented in the following four characteristics of a new retirement system:

- **Groups.** Markets work best when groups approach the markets. One participant quoted a study where groups (in the form of institutional pension funds) performed at least 200 basis points better than individuals (in the form of mutual funds) when all other factors were controlled for (the difference was largely, but not completely, attributable to fees). Conference participants felt that large groups were best, that groups could be either for-profit or not-for-profit, and that competition among groups was essential. A for-profit/not-for-profit model could mean that you could have government agencies, as well as insurers and other financial institutions, establish groups that individuals or employers could elect to join. Competition is necessary to ensure that participants experience the best outcomes (groups that have to compete would be more efficient than groups that do not compete).

- **Incentives.** Agents help groups (and individuals) use the markets better, but agents need proper incentives. Agents in this case can include agents working with a large group (such as investment managers, actuaries and administrators) and agents working with individuals on their retirement plans (such as financial planners). One conference participant who works for a public pension plan described the principles they use to run their fund: run it like a business; don't do in-house what they can purchase cheaply; reward employees competitively to maintain talent. The discussion on how to give agents the right incentives to work on behalf of individuals included disclosure of costs/fees of products (both as a dollar amount and a percentage) and a better alignment of agents' compensation with the group members' interests (for example, agents' bonuses increase when group members' benefits increase).

- **Standardization.** Conference participants discussed whether market innovation or standardization was necessary, and came to the conclusion that a degree of market standardization was important going forward. Markets need to offer standardized products so consumers can comparison shop. Today, while specialized features on products such as annuities can be very helpful, it's difficult, if not impossible, for most consumers to determine if the special features add value. The analogy was made to U.S. Medicare Supplement plans, which are standardized into 12 basic designs (made a bit more complicated by the introduction of Part D) to allow price comparison by seniors. One advantage of standardization in the retirement system context would be that middle income consumers who had a relatively small amount to annuitize (say $50,000 to $100,000) would be able to get more for their accumulations, given that standardized products should improve comparability, increase competition and drive down prices. For these consumers, an additional $10 of monthly benefit in the long term would come at a lower price than at present, all other things being equal.

  Conference participants discussed whether there should be standardized products (e.g., standard form for a life annuity with a 10-year guarantee period) or standardized features (e.g., guarantee period option works the same on all annuity forms). Participants clearly felt that standardized products were necessary because standardized features did not clear up enough of the confusion. However, the development of standardized products would not mean that insurers and others could not offer products that were not standardized.

- **Innovation.** We need to encourage market innovation, particularly in the development of instruments that can hedge retirement risks. Markets have more ways to hedge financial risks. However, retirement risks are somewhat different from most financial market risks. Pension plans and annuities have long tails on their obligations. In the United States today, the supply of long bonds is far outstripped by the potential demand (from pension plans and insurers), and what long bonds do exist don't match the duration of pension plans and insurer obligations. In addition, systematic longevity risk (the risk that a cohort of individuals will outlive expectations for that cohort) is not a risk that markets can currently hedge. This can make annuitization, in particular, very expensive. Markets must be encouraged to develop the instruments to meet the needs of tomorrow's retirement system so we can bring the complex future into focus.

One thing was clear from the markets panel discussions: markets need to work better. To some extent, this may happen by changing how we use the markets (using groups and agents), but we also need to make the market work better for the retirement system (some standardization and more innovation). Defined benefit plans sponsored by employers arose in an era before many of today's hedging vehicles were developed. We ought to be able to both better use what the markets are doing today, and also demand more from the markets, as we design better retirement systems.

Role of the Employer

Rounding out the two-day conference was a panel that explored the role of employers in the retirement system. Panelists Elaine Noel-Bentley (Alberta Local Authorities Pension Plan trustee) and Robert Patrician (Communication Workers of America) worked through what role, if any, the employer should have in a retirement system. Their discussion covered points such as whether the employer ought to have a role, whether that role should be mandatory or voluntary, whether the employer role should be to put aside money for employees (capital financing), to provide payroll deductions to the employee's fund of choice (facilitate savings), to act as a trusted agent to determine the best accumulation and de-accumulation vehicles, and whether the employer should ever be the guarantor of the retirement promise (as they are today in defined benefit plans). And finally, critically, if not the employer, who?

The working groups debated these questions at length and agreed that employers ought to have a role in a retirement system, but that role could look very different from the role they play today. Today, their role in the retirement system is really based on a binary choice: they sponsor a plan (defined benefit or defined contribution) or they don't. There are some circumstances where they can offer access to a plan (e.g., universities and TIAA-CREF) and some circumstances where they participate in industry-wide plans (e.g., multi-employer plans), but these are limited.

When thinking about the role of the employer, the working groups developed the following possibilities:

- **Facilitator.** Participants felt that employers should continue to play the role they do well today in terms of facilitating employee savings. Payroll deductions are a powerful tool to help employees prepare painlessly for retirement.

> *"I think we have to challenge ourselves. What is so fundamentally sacrosanct [with] the employer being the entity that sponsors the pension plan? In the United States, that's a creation of wage price controls of World War II."*
>
> —CONFERENCE PARTICIPANT

- **Educator and trusted advisor.** The working groups also focused on the role of the employer as educator and trusted advisor. We know that employees trust their employer to give them unbiased information about retirement accumulations. In addition, the employer can truly be an unbiased agent—the employer realizes no monetary gain from the choice the employee makes, and in fact may be biased to ensure that the employee plans well, which would assist the employer in easing the employee out of employment were this to become necessary or desirable later on.

- **Elective employer roles.** Other possible employer roles include purchasing agent, distributor of income and guarantor. As a purchasing agent, the employer might select groups for employees to participate in or investment funds that meet specific retirement targets and provide superior performance at a reasonable fee level. Many employers play the purchasing agent role today with defined contribution plans and other employee benefits. As a distributor of income, the employer would help employees to structure the transition from accumulation of wealth to creation of lifetime income. Employers wouldn't necessarily guarantee the lifetime income, but they would help structure the choices, such as by setting up preferred arrangements with insurers and other third parties. Finally, the employer could act as guarantor, a role it has played historically in defined benefit plans, whereby the owners of the business (taxpayers for public plans) guarantee some or all of the retirement risks faced by employees. One way this might differ from the traditional defined benefit sponsor role would be that

> *"Employers are where it all starts. That's where your compensation comes from, so they are always going to have a role in this. You can't just say, "well, you have nothing to do with it," unless you're going to just go with [a] totally general revenue-financed type of program."*
>
> —CONFERENCE PARTICIPANT

> the employer might choose to guarantee part of the risk (e.g., longevity risk) but might pass other risks back to the employee, or hedge them in the markets.

Ironically, by opening up a debate on the appropriate role of the employer, we can consider mandating second-tier coverage[2] as one feature of the new retirement system. Second-tier coverage in the United States and Canada has been, to date, employer-sponsored pension plans. One criticism of the current private employer retirement system is that it has never covered the majority of workers. Small employers in particular are unable to play a role, because the cost and risk of sponsoring a pension plan are simply too much for them to bear.

If there were plan sponsors other than employers, and if the employer's role could be simply to ensure that a payroll deduction makes it from the employer to the plan of choice, then you could mandate participation in the system. We already mandate participation in the social insurance system (with some exceptions) and the employer's role in its financing and administration (to remit contributions on behalf of itself and its employees). There could be opt-out options for employers (permitting an employer to sponsor its own plan) and/or for employees (permitting employees to elect to contribute to a plan of their choice).

Role of Society

Panel Discussion

The opening panel discussion featured Malcolm Hamilton (Mercer) and Virginia Reno (National Academy of Social Insurance). Hamilton and Reno presented on the Canadian and U.S. social insurance systems, respectively, to give the audience two different perspectives on the role of society in retirement income. The panelists' presentation was structured as a response to four questions.

The first question has to do with **the success of the current social insurance system, namely, evidence that the system is (or is not) failing**. Hamilton opened the panel discussion by noting that, in Canada, the system does not appear to be failing and is stronger now than in the past. This considers both the financial welfare of Canadian retirees and the current and projected contribution rates of Canadian taxpayers. Canadian retirees are at a low risk of poverty (which is society's main concern), mainly due to relatively generous social insurance benefits. The Canadian social insurance benefit varies little by income, and the system redistributes wealth to eliminate poverty. Canadian retirees at the middle to upper income levels continue to save and give away income. One issue in Canada is that its large first-tier flat dollar benefit is income tested, which creates disincentives to save, particularly for those in the bottom income tier.

The CPP/QPP has done much in the past 10 years to improve its sustainability by increasing the contribution rate, so that its surplus is now around CN$130 billion and is projected to rise to CN$300 billion in another 10 years. Government debt has also dropped; the Canadian debt (as a proportion of GDP) has fallen from 70 percent in the mid-1990s to 25 percent today, and it is still falling. The drop in public debt has led to 5 percent of GDP savings in interest spending, which is equivalent to what the government spends on retirees.

In the United States, the system is not terribly generous, but benefits are seen as adequate. While the average Social Security replacement rate is now 39 percent, by 2030 this average will drop to 29 percent as Social Security retirement ages increase, Medicare taxes increase, and Social Security benefits become more taxable.

The second question focused on **the role of society in retirement income/security, particularly the role of social insurance**. One role of society, and social insurance, is to alleviate poverty in old age. That sounds simple, but poverty is difficult to define (the definition of the poverty level can be politically manipulated), and money spent on seniors is money not spent on children and other social needs. Overall, the Canadian model focuses more on poverty alleviation than the U.S. Social Security model.

Canada has also tried to decrease the degree of cost shifting between generations by increasing taxes on current workers (to build a larger CPP/QPP surplus to be used in their retirement). Canada uses income testing to direct the dollars to the poorest, which can be problematic. It's hard to convince people in the bottom third of the income distribution to save for retirement in tax-preferred vehicles, when their savings will be used dollar for dollar to offset government benefits. It was suggested that a more efficient alternative to income testing would be to rely directly on income taxes to redistribute funds without creating disincentives to save.

In the United States, many more seniors are poor than in Canada. By one measure, one in four U.S. seniors lives in poverty. Reno shared several statistics showing that the United States, in comparison to other nations, has relatively low social insurance benefits, but seniors rely on them for a large part of their income. In an OECD study[3] of its 30 member nations, the United States ranks near the bottom for replacement rates (27th for low-income earners, 26th for average earners, and 21st for high earners). A study by the Social Security Administration[4] showed that, for married and unmarried individuals age 65 and older, Social Security represented 83 percent of the income for those in the bottom two quintiles (earnings under $16,350). For the middle income group, social security is two-thirds of their income, and for the second to highest group (earning $25,590 to $44,130), Social Security still represents almost half of their income. Social Security drops to under 20 percent of earnings only for those making more than $44,130; for these individuals, earnings from employment are the largest source of their income (40 percent).

The third question was, **if you step outside of the realm of social insurance (society's direct role), what other roles should society play?** Both panelists agreed that the government needs to create an environment that is more even and mutually beneficial to individuals and providers. The panelists offered a few ideas, including:

- Ensure that there are safe places for people to put retirement savings
- Prevent fraud
- Prevent deceptive selling practices
- Promote transparency (particularly of fees and risk), and
- Promote financial literacy (e.g., how consumer debt and fees on savings vehicles can eat into retirement savings).

The panelists discussed the benefits of tax incentives to help people save. Hamilton argued that a 50 percent marginal rate on the highest income bracket in Canada acts as a deterrent to anyone saving outside of a tax-favored vehicle (with the double taxation of corporate profits as another barrier[5]). Reno discussed whether tax credits would be better than tax deductions (it's a better incentive for lower income earners to give them a 30 percent credit on their taxes rather than an income deduction). But both panelists agreed that the first priority of government is not to get people to save—the government has a larger social welfare function, partly represented by its role in social insurance.

As part of financial education, the government can take a role in explaining the trade-offs of beginning social insurance benefits earlier rather than later. Social insurance provides income and longevity protection, and people need to consider these insurance protections, rather than "what if I die early and don't get my money back."

Finally, the fourth question was **whether the government should take any role in changing work patterns (encouraging people to work longer and retire later)**. The panelists and conference participants agreed that there is no role for government (or many employers) to encourage (or discourage) people to retire later. Systems should be largely neutral, although neutrality needs to be defined. First, retirement should be an individual decision, and benefits should be adjusted in an actuarially neutral manner. Secondly, r etirement systems that define an income stream (e.g., social insurance and defined benefit plans) are very difficult to change once provisions are set to encourage retirement at a particular age. Many employers in the United States and Canada added early retirement provisions in the 1980s and 1990s, which now don't seem to meet their needs of retaining skilled older workers longer. Now those systems encourage early retirement when employers want skilled workers to stay. Finally, healthy life expectancy—the period over which one can work or be expected to work—isn't necessarily rising as fast as life expectancy. If you shift systems to change retirement age to correlate with life expectancy, the new system may not meet the ability of individuals to work.

> *It seems to me that it's folly for government and for employers as well to be adopting plans that create long-term incentives for people to retire early [or] … to work until a very old age … If you can't foresee 10 and 15 years in advance what the labor force conditions are going to be like, if you don't know 10 and 15 years in advance whether you're going to be wanting to encourage employees to leave or to stay, then you're probably best to design retirement programs neutrally and then use cash incentives if at a particular time you want people to leave or you want them to stay.*
>
> *—CONFERENCE PARTICIPANT*

One reason for society to be cautious about stepping into this debate is that changing retirement ages can, politically, be seen as a cover for decreasing social insurance benefits (later retirement ages decrease the period over which benefits are paid, decreasing their cost; also, participants spend more time in the system paying taxes than receiving benefits). It's particularly challenging for people at the bottom part of the income distribution, who may be in physically demanding jobs, who may not have the same level of education, and who may not be able to find an employer who wants to employ them for 50-plus years after they leave high school.

Many argue that retirement should be seen as a gradual process of leaving the labor force. This works well for knowledge workers, but it may not be an option for all workers. In some cases, it may not benefit society to have workers continue to work past traditional retirement ages in certain roles. We do not have well developed ideas of skill and career transformation at older ages, which the government, in conjunction with employment markets, could help define.

Working Groups

Conference participants broke into four working groups to continue the discussion of society's role and looked at the following questions:

- What is the role of a social safety net?
- What is the role of society in protecting against premature retirement risk (retiring before one expects to and is financially able to retire)?
- What is the role of society in encouraging people to work longer?

Social Safety Net

One group's definition of the social safety net was that it should be: (1) substantial, (2) universal, (3) indexed, (4) relatively simple (as simple as it can be), (5) retirement age neutral, (6) able to generate a confidence level that it will last over many generations and (7) individual focused and not family focused.

Another group came up with a classification for the role of government that considered the various roles the government could play:

- Enable (don't impede with regulations) and encourage,
- Incent (tax or reduce taxes for positive behavior),
- Mandate, but don't impede (regulate what should and should not happen), and
- Provide.

Several key concepts came out of the discussion that considered these various roles for government. Participants did not discuss the incent option (as the focus of the conference was not to develop tax policy recommendations), and one criticism of current retirement policy, particularly in the United States, is that it is based on tax policy, rather than on retirement policy.

Enable and encourage:

- Provide a more fluid space in which new definitions of work and retirement can be forged. The 20th century retirement model treats work and retirement as binary states—one is either working or retired. Part of the challenge for the government is not to create a system that artificially governs the decisions people make about work and retirement.
- Provide education for retirees, both financial education and education on the retirement process. People need to be well-prepared to be able to retire successfully.
- Eliminate laws in the United States that interfere with or impede phased retirement.
- Set retirement policy that is not driven by tax policy but instead by the needs of beneficiaries (and taxpayers).
- Define fairness and adequacy—fairness to participants and fairness in the structure of the rules.

Mandate:

- Government needs to provide secure retirement contracts. Part of this is the oversight role. Individuals need to be protected against predatory practices; fees and risks need to be transparent and well-defined.
- The role of society is to help create institutions (groups) that can hire experts who can use markets more efficiently (this was echoed in the markets discussion). But, government involvement carries risk as well, as the cost of the government providing the oversight might be higher than the cost of the private agencies providing the oversight.

Provide:

- Set floor benefits. Other groups echoed this obligation to provide a basic level of income.

Protecting Against Pre-retirement Risk and Policy Retirement Ages

Regarding pre-retirement risk, many groups discussed it but most believed it was not the government's responsibility to handle this. As with encouraging later retirement, they believed society ought to be neutral regarding retirement before one is able. However, there were two roles discussed:

- There is a role for society in addressing the misalignment between the market needs, skill sets of individuals and labor and job expectations. Today the educational system assumes a period of training early in one's lifetime that basically carries individuals throughout adulthood. Consideration should be given to periods where training is provided at later ages (e.g., free retraining at age 50 to do something else). Society's role here is merely to ensure that everyone has access to retraining and the flexibility for individuals to be able to take advantage of it.

- If people are going to be living longer, not everyone will have a longer healthy life expectancy. For some individuals, continued work will not be productive. In this case, disability and other supplemental income benefits might have to be redefined. Can we provide additional income to people who may not be fully disabled but for whom full-time work is no longer possible? Work and disability, particularly as individuals get older, would not be seen as binary (exclusive) states; people may experience disability by degrees and need income assistance as they become less able to work full-time.

There was a lively discussion of the role of tax policy and how the government should ensure that the redistribution of wealth goes to those individuals who most need it. Many participants disliked means testing, because it creates perverse incentives. There is a tension between the role of society to get out of the way—and to encourage other stakeholders to take responsibility—and where society might best serve all its members by being the agent of choice:

> When we want as a society to put resources in the hands of those who wouldn't get it in the completely free market economy, we …have a choice. We do tax—we can just put that money where we want it. I think in fact that encourage, enable, mandate is often the most expensive way to achieve a purpose which would be cheaper to achieve if we had some [direct] agreement … To incent somebody to give away money; we spend far more than if we simply took the money and gave it away. So we shouldn't perhaps be caught up in our own free choice myths; for those few things …where we want to do something that's non-economic we ought to do it directly because the cost of doing trying to do it [indirectly] is well beyond the economic cost. *(Conference participant)*

Finally, as we consider how best for society to play its role, we need to consider not only how income is redistributed, but also how wealth is redistributed. The baby boom generation has accumulated an enormous amount of wealth, which we may or may not want to see transferred to individuals privately, particularly if that private transfer has certain economic costs.

Society's Role: Conference Consensus

On the final day, participants looked back and defined the headlines for the role they felt society ought to play. The key society themes selected by conference participants were:

- **Society should mandate that individuals annuitize some portion of savings/ Society should encourage annuitization (e.g., tax favor).** Conference participants put greater value on longevity insurance over wealth accumulation that could be passed onto future generations. Conference participants recognized the important social benefit that annuities provide by ensuring that individuals who live a long life do not run out of money. A vote for a mandate or tax favor for annuitization was an acknowledgement by conference participants that the cost to the society for the mandate or tax favor outweighs the risk; society (and in this case future generations of taxpayers) would be at risk to provide support for those who used their retirement funds unwisely, or simply lived longer than expected. Note that conference participants rejected headlines that suggested that society did not need to intervene to encourage annuitization.[6]

  Conference participants were deliberate in their choice of the phrase "some annuitization." This was recognition that above some level that meets basic needs society has no interest in forcing annuitization and that some needs such as health care may not be uniform and might be best handled with access to lump sums. There was no decision made as to what level of required annuitization would be optimal. There was discussion that requiring some annuitization or providing tax-favored annuitization should help create a more robust annuity market, which should drive down the cost.

- **Society should provide lifetime income, not lump sum.** This headline refers primarily to the income that society provides (e.g., social insurance). While individuals desire lump sums and have some valid reasons (e.g., unexpected health expenses), society needs to try to ensure lifetime income protection to protect citizens and future generations from the cost of paying for retirement savings spent unwisely. As noted above, conference participants recognized a need for annuitization, and this election clearly is consistent with other elections made noting the importance of ensuring that individuals do not outlive their assets. This protects future generations from having to make additional payments.

Conference participants were asked several other questions about the form of social insurance. There were no strong trends, but in general they thought that social insurance benefits should be inflation protected, and that they should be based on the individual's earnings rather than the family's earnings, although they should include survivor benefits. These are minor points and did not receive the same level of support as the basic concept that benefits should be paid as lifetime income.

- **Universal social insurance benefits should be work history related and progressive.** Participants were asked to choose between a social insurance benefit that was work history related and progressive (redistributes more income, proportionately, to lowest paid), work history related but not progressive (redistributes income directly proportionate to earnings) or a minimum dollar amount. Participants chose the work history related, progressive benefit over the other options. This may partially reflect what participants know,[7] but it also reflects the discussions at the conference about the problems with means testing minimum dollar benefits.
- **Social policy should be neutral regarding retirement age.** As noted earlier in this section, participants discussed at length that society should not encourage (or discourage) retiring at any particular age. Many reasons were given, including the fact that not all individuals in all jobs can work longer, the question of whether the healthy working lifetime is increasing as rapidly as the lifespan, and policy changes that encourage retirement at one age or another are very costly and difficult to undo, so it's possibly best not to set any policy. Conference participants chose this headline over others that suggested that society should be "directive regarding retirement age."
- **Society should mandate some savings (but only at a low level) and encourage higher levels of savings.** The final headline chosen was regarding savings. We discussed the role of the government to enable, encourage, incent, mandate/impede and/or provide. The compromise is to mandate some low level of savings to minimize the future poverty levels at older ages. Once this level is met, savings would just be encouraged. This was chosen over statements to simply encourage savings or to mandate savings. This could be done through a mandatory second-tier plan (which employers or other groups could opt out of); this option is discussed more in the role of the employer.

Other headlines around the formation of groups will be discussed in the role of the markets.

Role of Markets

Panel Discussion

In this discussion, markets include both capital markets (arbitrator of economic discipline) and profit-seeking enterprises (which use capital markets to deliver services and products). The discussion was opened by panelists Keith Ambachtsheer (KPA Advisory Services) and Zvi Bodie (Boston University).

The markets panel commenced with the question **of whether markets should focus on variety or standardization.** This question has emerged as the retirement system evolves, from one where individuals might have had a defined benefit plan (where your benefit is set by your employer and you have few options in payout at retirement) to one where individuals may have a defined contribution plan, which simply is a vehicle to accumulate savings. Some argue that defined contribution plans are an improvement because they offer participants options (how much risk they take as they invest their money and an endless series of options as to how they take that money when they retire). However, this is contrasted with the observation that individuals often don't make smart choices.

The panelists defined the critical issue as **symmetry of information.** If all participants in the markets—both the financial firms that offer products and investment options and individuals who must select those options—have symmetric information, then you get a properly functioning market where individuals are able to choose among a variety of products to optimize their outcomes at the lowest possible cost. The retirement market has asymmetric information. Market innovation has allowed for much more sophisticated financial products that can protect individuals against certain retirement risks. But these sophisticated products involve trade-offs in terms of risks and rewards, and therefore are not easily understood by individuals making purchasing decisions. At the 2006 Conference, one participant compared asking individuals to make sophisticated investment decisions to a doctor encouraging a patient to diagnose his own illness or perform minor surgery.

The debate between the panelists focused not on whether standardization is a good idea (the conference participants picked up this idea in the breakout groups), but on what other solutions there were to correct for market information asymmetry.

At the International Centre for Pension Management, Ambachtsheer noted that they've recently measured the cost of this information asymmetry by comparing investment mandates between mutual funds and pension funds. Mutual funds are retail products, sold directly to individuals (no sophisticated agent buying the product), while pension funds are a wholesale product, with a sophisticated agent acting on behalf of the individuals whose benefits will eventually be paid from the fund. They noted that one study shows there was a 2 percent (United States) to 2.75 percent (Canada) differential in returns in favor of the wholesale (pension) over the retail. Fees accounted for part of that difference, but not always. A 2 percent differential in return over 40 years can lower the ending value of a fund by 33 percent.

> Everybody in this room can do the math on a 2 percent per year haircut out of returns over a 40-year accumulation period. It's night and day. If we don't figure out how to get rid of the 2 percent haircut, we're all just wasting our time. This is a fundamental question about markets that we have a situation here where the normal Adam Smith kind of market doesn't work. And the question is: What do you do in that kind of situation? The answer—and we've heard it a number of times already—is you have to create buying power on the buy side of the equation. In other words, you have to create mechanisms that level the informational playing field. And then the question becomes, well, what do the buy side institutions look like that can create the level field in a market for pricing annuities … pricing investment management [or] … pricing advice that acts in the best interest of the participants. … [T]hat's the fundamental question. — *Keith Ambachtsheer*

The debate focused on two potential solutions to the 2 percent haircut problem. First, you can look at **banding people into groups—the cooperative effect**. The information asymmetry on the buy side of the equation is evened out by creating a group large enough to hire sophisticated investment advisors. These do exist outside of North America, but not in a pure form within the United States and Canada. Part of the reason that they don't exist here is cultural; we assume markets will work toward the best solution if left to solve their own problems. The closest examples are TIAA-CREF and Vanguard (where the mutual fund clients own the company). The disadvantage of cooperative groups is that they only work as well as the agents who manage them, and this means the incentives for agents have to be set up properly.

The panelists were asked how to **create better agents**. Possibilities discussed included creating common products (that allow transparent price comparison) and benchmarking (standardized measures). Risk adjusted comparisons are problematic because it's difficult for consumers to understand what risk adjusted costs mean. Finally, we need to improve professional standards and ethics so that smart consumers can evaluate experts and protect themselves against incompetence.

Another solution would be to **create consumer guarantees** to compensate for information asymmetry. Consumers regularly buy expensive items with a guarantee (e.g., autos and home appliances). Investment products are sold without guarantees, because many portions of the industry have individuals and regulators who believe risky investments are safe if you have a long enough time horizon for investment. Guaranteed products can help—and there are products out there with guarantees (e.g., traditional annuities), but the degree of information asymmetry goes beyond investment vehicles. Participants are unsure of how to handle the entire retirement process (accumulating funds for retirement and de-accumulating them in retirement). Also, it takes a fair degree of knowledge to understand financial guarantees. We've seen, through behavioral finance, that people not only do not make smart choices, but they'd rather not have to make that choice in addition to all their other daily decisions.

We also have a product with guarantees—deferred annuities—but we know that product doesn't work well, particularly for young individuals who are both willing and able to take on more risk given their higher human capital. So how do you balance out the guarantee with the desire to make sure that a lifecycle view of the individual is taken into consideration in their preparation for and eventual move into retirement? Mutual funds sell lifecycle accounts and target date funds, but these aren't based on any standards or guarantees; they're simply a way of describing a shifting investment policy over time. This gets back to the argument that the only way to get properly motivated pricing and transparency is through institutions.

> *"We talk about [this question of how to use markets] like we live in a little vacuum in our own little world. There's a whole question … [of] how does this system connect to the rest of the economy? How does it affect capitalism? To me those are profound questions.*
>
> *What you get with intelligent, properly motivated expert investors is they the drive some of the agency costs out of capitalism. We need to take a holistic view that the best-placed organizations to do that kind of work are these long-horizon investors that not only do annuities but also do the active wealth creation part of investing. Its pension funds who have created infra-structure investing … [which] is a marvelous match for inflation related long horizon liabilities … This is part of the dynamic wealth creation world that I think we are capable of creating …"*
>
> *—CONFERENCE PARTICIPANT*

The panelists then turned to how to get to this next stage—**do we need to intervene in the markets?** How you answer this is partly based on cultural expectations. In

North America, and the United States in particular, people aren't interested in having the government create solutions because the government is not seen as creating innovative or effective solutions. The point is not necessarily to have the government actually creating the solutions, but to have the government spur the creation of organizations (for-profit or not-for-profit) that can accomplish the mission. The government can also create structure (e.g., regulatory environment) in which these organizations operate to ensure a level playing field and consumer protections.

The panelists also debated whether competition among these organizations would be helpful. It was noted that TIAA-CREF had a virtual monopoly among educational institutions until the 1980s, at which point other institutions started to compete for the university business. Competition helped TIAA-CREF improve its offerings. The point is to encourage accountability; accountability is required whether or not provided by a for-profit or non-profit organization. The best way to ensure that organizations provide value is to make them accountable.

Finally, as we closed the discussion, one participant commented on the bifurcation that has existed to date with the defined benefit (full guarantee) and defined contribution (no guarantee) system. The participant noted that insurance products have moved out of full guarantees, because they are very expensive, into products that have risk-sharing mechanisms. The question was left as to how to get the information into the contract in a way that participants understand their risk exposure. Participants commented that they could find literature to help them understand how to price these options, but there is little information akin to what we've learned from behavioral economics that helps us understand the best way to communicate those options to individuals. Risk-sharing mechanisms can help reduce cost, but if participants cannot understand where they are taking risk and what the consequences are, designers of financial products are limited in their ability to use them. This difficulty also faces new group mechanisms that were discussed; if it's not fully guaranteed, participants need to understand what the group is doing and what risk they still bear.

Working Groups

Conference participants broke into working groups to continue the discussion of markets' role and looked at the following questions:

- Should markets focus on variety or standardization?
- Should markets design solutions primarily for individuals or groups?
- Do we need to intervene to create the best retirement markets?

Variety or Standardization

On the issue of variety versus standardization, the breakout groups thought **a degree of standardization would improve the functioning of markets.** First, the breakout groups almost universally agreed that we have a great deal of variety in the marketplace today, and we've seen that individuals haven't coped well with that variety. We know from behavioral finance that individuals do better if they are given only a few choices. Introducing standardization would provide that balance and help individuals make better decisions. Conference participants felt some standardization would improve transparency and comparability. For example, there could be standardized disclosures on fees and costs, much like credit card companies show a standardized disclosure of the annual percentage rate and banks show standardized information on mortgage terms. Disclosure on fees would not only help individuals, but would help employers and others who select providers in a group setting.

Ideas as to what would need to be standardized and how that would happen varied widely. Do you standardize in the accumulation phase, de-accumulation phase, or both? Some participants argued that it was most important to standardize in the accumulation phase, where individuals' risk tolerance varies widely, and where you have a great deal of variation particularly in savings vehicles (e.g., mutual funds). In the de-accumulation phase, it could be that certain financial products had to meet a standard description so individuals could compare the cost of products on an apples to apples basis. How you approach standardization may also depend on what role there is for groups in the system, which is discussed later.

How much standardization and where there is more standardization or more variety may also depend on how the rest of the system is configured. For example, variety in the insurance product market, which is where we are today, could be beneficial if most individuals have benefits from both social insurance and annuities through employer-sponsored defined benefit plans. In other words, the larger the safety net, the greater degree of market variety may be supportable, and the less need for standardization may exist.

Individuals or Groups

Overall, conference participants felt there was a **need for groups in the system.** Groups covered several issues. First, the introduction of a limited set of options (standardized products or benefit forms) works best in a group situation. This doesn't mean these products couldn't also be sold through the individual market—in fact it may be best to pull standardized products from the individual market to provide in a group setting. This helps to hold down the cost of benefits for the group and facilitates administration. Reducing the number of options also improves individual decision making. In most cases, individuals don't want to make these decisions; one participant reported viewing focus groups of teachers, a very well-educated group, repeatedly stating that they don't want to make these decisions. If they do want to make some choices, behavioral finance shows that they make the best choices when there are a limited number of highly differentiated options. Groups also provide high value to individuals with lower incomes. High net worth individuals can purchase advice, which improves the information asymmetry. Individuals with low incomes can only afford the advice if it is through a group setting (where the advice is used to set up an efficient benefit).

Participants felt size mattered. **Groups should be large**. Larger groups have an opportunity to purchase more sophisticated advice, and more sophisticated market instruments, creating information symmetry. Historically groups have been organized around the employer, but there's no reason why groups couldn't be organized in other ways (e.g., unions, profession, geography). Participants believed for-profit and not-for-profit groups could exist simultaneously (e.g., postal system and courier services). A key aspect was competition among groups, to encourage innovation and increase efficiency. Finally, transparency was key. Costs, fees and even salaries for key staff working for groups ought to be transparent; another participant noted that it was important to have strong regulation and oversight, to prevent embezzlement and abuse.

While groups have intuitive appeal, they aren't perfect. Do we need to include opt-out provisions? What would they be? Opt-out provisions add cost; the more you allow people to opt out, the higher the cost. For example, allowing individuals to take single sums at retirement increases the cost to the rest of the group (those individuals choosing single sums likely know something about their life expectancy—that it's likely shorter than average—increasing the annuity cost to the individuals left in the fund). In insurance, opt-out provisions have charges associated with them, but charges add complexity.

Intervention

The question of whether we intervene in markets covered the issue of whether the markets can develop solutions, left to their own accord, or if someone (likely government) needs to step in to encourage markets to provide the instruments needed to hedge retirement risks. In general, there was a feeling that **some sort of intervention might be helpful**, but participants did not have a clear idea who would intervene, and what they would do.

On one level, participants argued that the market for securities used to hedge these long-term risks was clearly not mature. We've seen a great development in market instruments for short-term risks, which is what most market participants need to hedge, but there are very few business applications other than pensions and annuities that have the need for long bonds, long inflation-linked bonds and longevity bonds. Because the market is not mature, these instruments are not efficiently priced, which means that market innovators don't have the right tools at the right costs to build the hedging and pooling instruments.

Market intervention could also include asking product providers to provide standard products, encouraging competition, encouraging the formation of groups or incentivizing individuals to buy certain products to improve the market for them.

Markets' Role: Conference Consensus

On the final day, participants looked back and defined the headlines for the role they felt markets ought to play. The key market themes selected by conference participants were:

- **Agents' compensation should be aligned with interest of plan members.** Agents in this case include service providers acting on behalf of individuals (e.g., financial planners, insurance agents and product sales people) but also individuals employed by groups to make decisions on behalf of the group. We discussed earlier that the formation of the group is a way to allow group members to offset information asymmetry, but only if the agents—the individuals with the knowledge hired on behalf of the group—act in the group's best interest and not the agents'. This can be done through regulations and oversight structure, but the best way is if the agents' compensation aligns with the interests of individuals—be they individuals purchasing financial advice or members of a group relying on the group to deliver retirement benefits at the lowest possible cost.
- **Markets must disclose costs/fees (as both a dollar amount and as a percentage).** Fee disclosure is important particularly where product differentiation is high. Fee disclosure in and of itself may not be sufficient; for example, conference participants rejected the headline "Disclosure of agents' compensation is sufficient" for the stronger statement that agents' compensation needed to be aligned with individuals' interests. There was discussion as to whether the professionals working in the retirement field ought to collaborate to set fee disclosure standards. The belief was it would help not only individuals but also employers and others who might be selecting among groups.

- **Group formation should not be discouraged.** Conference participants didn't want to get more specific than this, because they felt they would be making a statement about the particular kind of group (e.g., for-profit or not-for-profit, or based on trades, employer, geography). Also, they felt that it would be best if groups could form on their own—without specific encouragement by, say, the government or another body. Initially, they felt that many sorts of groups should be encouraged, and then the marketplace would determine which groups were most efficient. In addition, they felt that **size matters (larger groups are encouraged)**. This goes back to the arguments that larger groups have the best chance of hiring the best agents who, properly incentivized, can create the best outcome for individuals.

- **Encourage innovation of hedging and pooling instruments in the secondary markets.** To be able to deliver retirement benefits at the lowest possible cost, we want to encourage market innovators to develop the best instruments to hedge and pool retirement risk. This builds products for individuals, or group structures, that efficiently use the markets' raw materials (e.g., long bonds, inflation bonds and longevity bonds) in ways that meet the needs of individuals. As noted earlier, the key to getting this done is to improve bond pricing and other inputs needed to create these instruments.

- **Markets must offer some standardized products**. Standardization produces products and other instruments (e.g., group plans) that can be compared, which allows individuals to make well-reasoned choices. Conference participants were also asked to consider a statement about whether we needed standardization at all, or whether products simply needed to have standardized features[8]; they strongly favored the stronger statement that standardization had to happen at the product level over these other two statements. Standardization at the product level helps groups operate efficiently because it improves the efficiency of choice (as the agent for the group, I can make arrangements to purchase the most cost efficient high quality deferred annuity for my group's participants) and at the lowest cost (as the agent for the group, if several firms offer the same standardized product, I can negotiate the best possible deal for my group members, rather than trying to price compare products with different features).

Role of Employer

Panel Discussion

Bob Patrician (Communication Workers of America) and Elaine Noel-Bentley (Alberta Local Authorities Pension Plan trustee) framed their discussion around the following questions:

- Should employers be required or encouraged to participate in a retirement system?
- What role, if any, should employers have in a retirement system?
- If employers are not taking a role in being sure employees have a lifetime income, on whom will this role fall?

Discussions about whether employers play a role in providing retirement income can get confused because provision of income can be thought of in several ways. First, there is the provision of capital to be spent in retirement. Panelists generally agreed that employers had an important role to provide capital. The employer has the ability to take a portion of wages and defer that payment for retirement. Whether we set a specific required level of capital contribution was not discussed.[9] A second way that employers provide income is to sponsor the arrangement that turns that capital into retirement income (e.g., defined benefit or defined contribution plans). Not every employer can sponsor a retirement income plan.

The role of employer sponsorship becomes key in the debate. In the United States and Canada, most plans are sponsored by single employers (private or public). This is somewhat due to historical accident. One conference participant noted that, when the corporate pension system was in its infancy, GM President Walter Ruther had to decide whether the corporation or the union was to be the sponsor of the pension system. The ideal at that time was that the accumulated savings was to be used to help fight communism. What would have happened if the union and not the corporation had sponsored the plan? Patrician and another conference participant began a lively discussion about the role of the corporation in providing benefits, and why it doesn't make sense for the corporation to have that starring role in sponsoring retirement systems. The context of the discussion was the traditional defined benefit pension plan, but the analysis can apply to new retirement models as well:

> Patrician: [I]t would have been much more interesting to have had a system where every pension plan in the country was a collectively bargained pension plan in a Taft-Hartley environment … [W]e would have had a different kind of business running the pension business at that point. I think right now we'd be in a different situation because the liability would be all about the pension

instead of tied to the accounting for the pension in the context of accounting for the business … When I hear someone say that 'pensions are not our primary line of business'—well, of course not—if that's a problem, if your product is not pensions, what are you doing in that business? It's very hard to refute that, particularly when now problems funding pensions go directly to [reduce] profit … [We're moving to make things more transparent which] is a great idea but the problem is … we've gotten to the historical limits of the decisions that got made right there [(by Walter Ruther)] which were very short-term decisions …

Conference participant: I just want to pick up on the issue of why these large powerful, sophisticated corporations can manage business risk but not pension risk. It's not that they can't manage pension risk; it's that they're paid to manage business risk. They don't do it for free; it's not a public service. They do it to make money. They've not been paid to take on pension risk. What they were told consistently is that there is little or no pension risk. And what the accountants are doing …is forcing the issue by making it transparent to the owners of corporations, the shareholders, that there is a large non-negligible, expensive pension risk. The corporations when they get their heads around how to price that, and they ask the question 'If we reduce employee compensation by enough to adequately compensate shareholders for the risk being run here, would the employees actually want these plans or not,' they strongly suspect … the answer is no …

Patrician: That's exactly what's happening … I think there are those who would say 'woe is us and let's not let that analysis get out.' But, I don't understand why we can't realistically say we have risk; we have needs; we have to fund those needs. We have needs for retirement income; we have needs for health care. Fifteen years ago when American corporations had to recognize retiree health care liabilities, people said, 'Where [did] that come from?' Well, the fact that you got old and you got health care, that's where it came from. Why [wasn't] that something that was reasonable to expect? I think it's an unfortunate result of the perverse way that we provide those benefits in [the United States].

Regarding the role of sponsorship, Noel-Bentley raised several concerns with employer sponsorship of retirement income plans. First, employers don't stay in business forever—for future enterprises to be created, past enterprises must die. Pension obligations can last beyond the lifetime of the company. Should the employer be taking on an obligation that might outlive the core business?[10] Secondly, many employees do not stay with one employer for their entire working lifetime. And if the system is voluntary, many employees may not be with an employer who sponsors a pension plan for much of their career. Finally, employers have different abilities to sponsor a plan. Requiring all employers to sponsor a plan puts a large burden on small business, and increases the cost of business start-up. Employers in certain industries may be competing globally with companies in countries without pensions or where more benefits are provided through social insurance. Companies with highly volatile profits may not be able to make the sustained contributions to pension benefits that some designs require.

We do know that employers are in a position to assist employees in preparing for retirement. They have a trusted relationship with the employee, and, as noted before, their ability to automatically defer income on behalf of the employee makes the workplace an efficient place to gather retirement capital.

There may be employers who wish to have an employer-sponsored plan. They may have workforce needs that require specific benefits not provided by a generic plan (e.g., physical jobs requiring early retirement). They may have attraction and retention issues that are served by having their own branded retirement arrangement, to encourage employee loyalty, particularly among older employees.

One negative consequence of employer-sponsored plans is that when plan features and benefits need to be adjusted, this becomes tied into the employment relationship. For example, provisions to encourage early retirement were put into retirement plans by employers to move the Depression babies out of the work force to make way for the baby boom generation. But now that those same employers want to retain baby boom workers, these provisions have become an expensive barrier to encouraging workers to work longer. They've become a benefit right that workers don't want to lose, yet they no longer fit the needs of the employer. You now have a hostile relationship between employers with a benefit feature they don't want and employees with a benefit right they don't want to lose.

If employers aren't going to be the primary providers of retirement income, then who will be? The question is really one of securitization: who ensures that there are healthy, functioning plans that secure a strong retirement for individuals? Patrician noted that if the employer role is really to provide capital, then you could move the provision of retirement income to structures based on profession, industry and/or region that could provide these benefits. Governance could be partly driven by the employers but in concert with individuals and society (local government). This would ensure the entire burden did not fall on employers, but also guarantee that individuals could have access to a retirement plan, even if their employer didn't choose to sponsor one. Noel-Bentley commented that it would be important that any governance role that employers play be voluntary. In addition, in that sort of a system where the second leg was based on these cooperative structures, she could also see it being done through the social insurance system. Employers could elect to sponsor a plan that was part of that second leg, but their election would be voluntary. Employees would have access to those benefits—employers would provide that access and provide the capital to fund it—but it wouldn't have to be through a plan owned by the employer.

Another advantage of moving the employer out of the role as sponsor is it allows others to take on that role. The role of plan sponsorship could fall to a combination of employers, employees and other citizens. Employers might retain some responsibility, but they wouldn't have the sole responsibility.

In considering whether employers should be required or encouraged to participate in the retirement system, both panelists agreed the answer is "yes," although their answer varied based on the definition of required. The panelists agreed that employers were required to provide access to a plan, but if the question shifted to sponsorship, with the attendant risks, it wasn't clear that employers could be required to take on the risk of a retirement plan. The question becomes what participation options employers have, and to what degree you have other mechanisms in place if the employer does not wish to take a large role in providing retirement benefits. The challenge is to find the right vehicles to ensure that the accrual of capital continues to happen, in vehicles that are sustainable over time. In the breakout groups, conference participants further developed these ideas about how the role of the employer could be structured.

On a final note, conference participants discussed why the employer remained at the heart of the retirement system; many felt it was related, in the United States, to ideology. In the United States, a group other than the employer sponsoring a retirement plan would likely be seen as socialistic (GM sponsored their pension plans to fight communism).

Working Groups

Working groups considered the following questions:

- Should employers have a role in capital growth in preparing for retirement?
- Should employers have a role in capital disbursement in retirement?
- If the employer doesn't have a role in the system, who does?

The working groups focused mostly on what role the employer could take. One group characterized it as the employer could do nothing, provide access to a plan (but no money), provide access and money or provide a guarantee. Several people were uncomfortable with the "do nothing" role—many felt the employer should act as a facilitator because we know employees value their employer's advice. If they simply provided access to a savings plan, they may want to ensure that participants are making strong distribution choices. There was significant discussion about the role of employers in educating and guiding employees, particularly with regards to distribution options. Particularly if the employer were acting as a conduit, it could ensure that employees had access to institutional pricing. Another group wondered if the employer might take different roles in the accumulation versus de-accumulation phase.

Some of the groups acknowledged that the role of employer in retirement is fundamental. Many employers may still want to use benefits—including retirement benefits—as a compensation tool, and as a tool to distinguish themselves from other employers. Employers control employees' compensation, and there will be employers who choose to put part of that compensation into their own retirement plan.
When talking about the roles of others, some were concerned that if an employer weren't the sponsor of a plan, would there be a need for a third party to back the risks in the pool? Many felt that any intermediary who put together one of these pools must be credible—there was no consensus if this was a for-profit or not-for-profit intermediary. The pool though would have to be diverse enough so that any industry shocks wouldn't affect it.

Employer's Role: Conference Consensus

The conference participants chose key themes which outline and elaborate the role of the employer. Key is the notion that the employer has a role in educating employees, and employers should have a role in sponsoring a plan if they want to, but otherwise the employer's role is really to act as a conduit to facilitate savings and growth.

- **Employers should facilitate savings/capital growth (act as a conduit).** This was viewed as important for a variety of reasons. Keeping the employer involved is the starting place—many employers will elect to defer compensation into retirement plans, but it's also easiest for employees to electively defer additional compensation through the workplace.

- **A mandatory umbrella second-tier plan should exist out of which employers or employees may elect to opt.** If the employer is no longer the only sponsor of a second-tier plan, then participants believed we could have a second-tier plan that existed outside of employers. This way, the employer could elect to opt out of this plan, if the employer wanted its own plan. This could improve the retirement system, by providing second-tier coverage to more individuals; under the voluntary system, not all employers have chosen to provide plans, so not all individuals have had access to second-tier coverage. This greatly improves the coverage for small businesses as well, who often find the cost and risk of plan sponsorship—defined benefit or defined contribution—to be too great.

- **If not the employer, the third party could be private or governmental.** Any second-tier plan that was not employer-sponsored would have to be sponsored by another group. The conference participants had no preference for whether this was a private or government-sponsored plan. This is similar to their thoughts about group formation (under markets)—groups could occur in a for-profit or not-for-profit environment.

- **Employers have a role in educating and influencing employees in savings and distribution (trusted advisor role).** Even if the employer accepts no investment or financial risk, there is considerable value to having the employer provide unbiased education and information to employees.

- **Employers should act as a purchasing agent** and **Employers should facilitate disbursements (lifetime income).** These last two themes were chosen slightly less frequently than the other four, but give direction to what roles are critical for employers to play. Clearly, as purchasing agent, employers can sort through marketplace alternatives for investing or distribution options, and often arrange for those at institutional pricing. If the employer facilitates disbursements, this could increase the likelihood that employees have access to efficiently priced lifetime income options that are attractive and protect society.

End Notes

[1] A copy of the 2006 Conference report can be found at *www.retirement2020.soa.org*.

[2] First tier coverage is social insurance. Second tier coverage is in addition to social insurance, e.g. defined benefit pension plans. Second tier coverage typically defers income and pools risk, while first tier coverage may also redistribute income (between generations and within generations).

[3] Organisation for Economic Co-operation and Development (OECD). 2005a. *Pensions at a Glance: Public Policies across OECD Countries* and 2005b " Solving the Pension Puzzle," *OECD Policy Brief* (March), as quoted in National Academy of Social Insurance, *Social Security Brief: Social Security Income and Retirement Adequacy*, May 2007. In the same OECD study, Canada ranks 15th for low earners, 22nd for average earners and 27th for high earners, showing the effect of income testing and flat dollar benefits.

[4] U.S. Social Security Administration, 2006, *Income of the Population 55 or Older, 2004*,as quoted in National Academy of Social Insurance, *Social Security Brief: Social Security Income and Retirement Adequacy*, May 2007.

[5] Corporations pay taxes on earnings before they're paid as dividends, and then individuals pay tax again on those dividends once received.

[6] Conference participants rejected the statement "No intervention is necessary (annuitization)—the market will correct."

[7] Most of the conference participants were from the United States, which has a work history related, progressive social insurance benefit.

[8] Conference participants rejected the statements "Markets must offer some products with standardized features" and "No standardization of market offerings is required."

[9] While the panelists did not discuss this aspect, requiring the employers to provide capital is equivalent to a tax. The advantage of allowing employers to set the level of capital is it can vary by employers' competitive situations, it reduces cost of start-ups, and it allows the employer to directly determine compensation (retirement contributions are a form of deferred compensation). The disadvantages are centered on the functioning of the retirement system (predictability of future income for society and individuals). Society would have to make the determination of trade-offs.

[10] Other arguments have been made that employers should not be taking on any obligation that is outside their core business. If my core business is manufacturing widgets, how does it benefit my shareholders to operate a captive annuity block of business (defined benefit pension plan)? If operating that plan adds value to my business, e.g., competitive advantage, there could be some benefit.

[11] When the handout was sent to participants before the conference, the third question originally read "If the employer is not to take an active role in a new retirement system, then on whom does the burden fall?" Panelists modified the question to read as stated above before the conference began.

Appendices

Conference Overview Handout for Society/ Individual Panel

Last year's Retirement 20/20 symposium highlighted some of the tensions between individuals and society as a whole.

> The debate about the role individuals should play in the system somewhat ties back to the level of risk they have and are able to bear. The other facets of the role have to do with how well individuals are, in general, able to handle the process of accumulation and de-accumulation of wealth. In other words, how much should retirement vehicles operate without individual action (or intelligent individual action) and how much should they operate automatically.
> *(Retirement 20/20 report, 2006)*

Since fewer individuals are covered by a pension plan, most will rely on a "two-legged" stool for retirement.

In considering how this two-legged stool will work, one challenge is to think about the role of society and the role of the individual as the two key legs of the system. Most of the discussion will be framed as the role of society, but the role of the individual is partly defined based on the role of the society. As a first step, the panel discussion will consider the strengths of the current U.S. and Canadian systems, and the key challenges to these systems. Sometimes it seems like all we hear about is the potential for catastrophe. Twenty to 30 years ago, conventional wisdom was that there would be problems with the baby boom generation, yet those problems haven't materialized yet. This may be due to the increase in home equity that replaced boomers savings. Conversely, there is evidence that individuals are not saving and are using their home equity for other purposes.

Society needs to be confident that individual circumstances are fully understood before imposing requirements. Institutions (and actuaries) often believe that they know better than individuals. It isn't easy to prescribe sensible strategies that apply to everyone. Given this background, what is the proper (or ideal) role of government programs for retirement security (in Canada or the United States)? Specifically, what role do we envision for social insurance and for means-tested assistance? Government-sponsored retirement programs were generally designed to alleviate poverty. Government may have a larger role in social insurance and fraud prevention but a smaller role with respect to encouraging savings with tax subsidies.

The Canadian System takes care of the low income (lower quartile of population), so this group doesn't need savings. As designed, it meets the goal as far as eliminating poverty among the elderly. Yet, it is also designed to discourage savings since the more a person saves, the smaller benefit from the government is paid. The U.S. system covers individuals with lower incomes to a lesser extent, but does not discourage savings.

In the United States, replacement rates are declining. However, are the traditional replacement ratios the appropriate measure to use to assess social insurance adequacy? How do we take into account a particular individual's retirement income needs? For example, people who are well off are those who are married. Other populations, such as divorced individuals, do worse. How do we reflect these situations in replacement ratios? What other measures would be appropriate?

What is a proper or desirable role for government with respect to supplementary retirement savings (in Canada or the United States)? Is there an appropriate role for governmental mandated savings? Is there a role for subsidies, or tax breaks? Should government restrict the use of savings for purposes other than retirement?

Programs that are designed to encourage savings with mandatory employee contributions and some form of a match may actually force younger people with lower incomes into a suboptimal savings plan. Government programs in each country should be designed to optimize retirement income while minimizing moral hazard. What do we envision (in Canada or the United States) with regard to encouraging (or requiring) people to work longer and retire later?

Finally, what do we see as the fundamental trade-offs with respect to social insurance, employer pensions and tax-favored savings? There is a study that was done looking at people retiring over the last 100 years or so which showed that affordability was more of a driver than preference. Canada had commissioned a survey of seniors that looked at those seniors who had no work/active leisure time (versus those that did) to see if those who worked/had active leisure time were happier than those who did not. In general, those individuals who were not working appeared happier. The study determined that the only measurable impact was an individual's health. The one thing that people missed from work was interaction with their colleagues.

Conference Overview Handout for Markets Panel

Retirement plans and markets are inextricably linked (note: in this context markets include the capital markets and financial intermediaries such as mutual funds and insurance companies). The evolution of markets has put pressure on the retirement system to evolve, and society's and individuals' changing needs regarding retirement are putting pressure on the capital markets to evolve In the midst of this evolution, we need to reconsider what role we want markets to play within the retirement system. Markets' primary role within the retirement system is to provide vehicles for hedging (mitigating) or pooling (spreading) retirement risk. If markets are successful in playing their role, the cost of retirement is reduced for individuals and society, since risk would be born by those most able to hold it. Are markets doing the best they can today to reduce both the risk and cost of retirement? Are markets set up in a way to best reduce the long-term costs of retirement?

This discussion will focus on how to make the best use of the markets in pooling and hedging retirement risk. Panelists will consider, first, if markets already produce the necessary instruments to most effectively mitigate retirement risk or whether there are market instruments (e.g., longevity bonds) that need to be introduced to best optimize markets' performance.

The role of financial intermediaries is to design products and systems to deliver the benefits of markets to individuals (and society). As intermediaries compete, they are able to offer services in a more cost-effective manner, with more sophisticated designs that better meet the needs of individuals. The result should be a healthy marriage between individuals' needs and markets' capabilities. However, we know that we haven't yet achieved that goal, and some question whether, with regards to retirement income, this market optimization can be achieved. The retirement system is characterized by a lack of understanding of the issues among key stakeholders (particularly individuals but sometimes also retirement professionals). Behavioral economists argue that the nature of retirement planning is such that, even with education, participants are unlikely to change their behavior. This leaves us with several questions to answer:

- Do all market participants have symmetric information? Do individuals know enough to decide among competing products or do too many options create confusion and lead to a lack of decision? How well do agents work to make these decisions (either agents who act on behalf of an individual—e.g., financial planners—or on behalf of a group—e.g., defined benefit pension plan)?

- Can markets price effectively for individuals (e.g., price annuities effectively for differences in personal life expectancy)? What role would groups provide in overcoming this obstacle?

- Finally, given the lack of understanding of individuals and the social importance of low-cost, efficient retirement systems, is market variety a worthwhile goal? Or should markets focus on several preset solutions that can be widely understood and explained to beneficiaries where financial institutions can focus on providing basic benefits at the lowest cost (e.g., standardization of Medicare Supplement plans)?

And finally, to the extent that the markets aren't moving in the direction we need them to move today, do we need an outside stimulus to get markets working more efficiently on behalf of individuals? What interventions might be necessary? Are they simply to correct lack of information or lack of transparency, or do we need to develop other market instruments to handle retirement risks? Any intervention must be carefully considered, as market interventions often fail.

Conference Overview Handout for Employer Panel

The PBGC's 2006 annual report indicates it had an $18 billion deficit for defined benefit pension plans that it had taken over from employers who were unable to fulfill their funding obligations to the plans. And, while more than 12,000 single employer defined benefit plans remain in the United States, employers have increasingly moved to a program platform that places all of the risk for retirement security on their workers. Workers' desire and need for income security in retirement appears to have been at odds with employers' ability to consistently deliver retirement income to their former employees and/or employer willingness to live with the volatility and uncertainty of defined benefit plans. In this session, we will explore what role in a new retirement system employers are able—and willing—to play.

The first question to consider is whether employers should be required or encouraged to participate in a retirement system. Why might employers want to have a role in the system? Why might society wish employer involvement? Is there an overarching societal good that comes from employers taking on a role that goes beyond merely providing capital, and is that societal good sufficient to offset the harm that comes when an employer is unable to meet its commitments? Are those reasons sufficient to provide tax or other financial considerations to employers in order to encourage employer participation? Should those considerations differ in any way—and if so, how—from considerations provided to individuals for their own participation?

The second question is what role, if any, should employers have in a retirement system? Is the role confined to provision of capital as individuals perform services for the employer? Or should the employer have an active role in securing retirement income for its employees? Are employers capable of fulfilling the long-term commitment required to secure retirement income for their employees? Does this capability vary by type of employer (size, public/private, profit/not-for-profit, etc.) and how? Should employers have discretion in the amount of capital and/or the form of program they provide—and why? How much latitude should employers have to tailor solutions to their particular needs? Should employers be allowed to implement short-term labor solutions via retirement programs without making longer term promises?

And finally, if employers are not taking a role in being sure employees have a lifetime income, on whom will this role fall?[11]

Conference Participants

Speakers

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Elaine Noel-Bentley – Trustee, Alberta Local Authorities Pension Plan

Robert Patrician – Communication Workers of America

Virginia Reno – National Academy of Social Insurance

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Attendees

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Attendees (Continued)

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Douglas Love – Ryan Labs

Thomas Lowman – Bolton Partners Inc

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