SOCIETY OF ACTUARIES

**Testimony for the ERISA Advisory Council**
**Approaches for Retirement Security in the US**
**21 July 2009**

Good afternoon. My name is Emily Kessler. I am a Senior Fellow with the Society of Actuaries. I am a Fellow of the Society of Actuaries, an Enrolled Actuary, a Member of the American Academy of Actuaries and a Fellow of the Conference of Consulting Actuaries. Prior to joining the SOA in 2003, I was a consulting actuary with Towers Perrin for 14 years, in the United States and Europe. The Society of Actuaries (SOA) is a not-for-profit research and education association with 20,000 members, primarily in the United States and Canada. The SOA Pension Section has sponsored the *Retirement 20/20* project over the past three years to systematically explore new models for retirement systems that go beyond today's defined benefit and defined contribution system. My testimony will focus on the lessons learned in that project. The views today expressed are my own and are not those of the Society of Actuaries, its employees, members or volunteer leadership.

## Background

*Retirement 20/20* is a multi-disciplinary project to explore how best to design retirement systems to meet the 21st century needs. Through a series of three conferences and working committees we have brought together actuaries, attorneys, economists, employers, union leadership, policy experts and others with an interest in retirement security in the United States and Canada. We have focused on how best to design the system from the ground up, starting with a definition of the needs, risks and roles for stakeholders in the system. We have also built on ideas raised in through the project on key aspects that should be incorporated into retirement systems, such as self-adjusting mechanisms, new norms for work and retirement, signals, default distributions, and alignment markets and need for new market hedging instruments.

The *Retirement 20/20* project was born out of a belief that today's tier II retirement system can better meet the needs of stakeholders. Stakeholders are defined as individuals (who are retiring), society (future taxpayers), employers and markets (capital markets and intermediaries). We have specifically focused on the tier II system: what is today employer sponsored defined benefit (DB) and defined contribution (DC) plans designed to act in combination with Social Security (tier I) and private savings (tier III) to provide secure income in retirement. We have specifically considered whether we need models for retirement security in addition to DB and DC. We have not considered the role of the health or long-term care systems, although we have acknowledged that it will be difficult to design efficient retirement income systems without addressing the problems of these systems.

This testimony draws from some of the lessons learned in *Retirement 20/20* that are relevant to the topic the Advisory Council is addressing today. For more information and overview of all the *Retirement 20/20* work, please see http://retirement2020.soa.org.

## Principles

Necessity for a degree of insurance. One principle we've drawn out of *Retirement 20/20* is that society (future taxpayers) and individuals do better with a degree of insurance. Insurance



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(such as annuitization or traditional pensions) takes advantage of the pooling of risk, particularly longevity risk, to ensure that individuals do not outlive their assets.

Investment based systems can produce a wide distribution of results – some people will save a lot and invest wisely, while others will either not save enough or make poor investment decisions. Even if you standardize rates of savings and investments, they may retire before they expect due to ill health (with fewer assets than planned) or experience bad luck in the capital markets (such as the recent declines). Those folks who do poorly may turn to society (the government) for additional assistance. The government will then be faced with increasing taxation of workers, and may have to consider raising taxes on the retirement assets of those retirees who were wiser and/or more fortunate.

A second concern with an investment based system is that people see their retirement assets as personal wealth to be bequeathed to children. But preservation of wealth does not allow individuals to take advantage of risk pooling mechanisms – primarily annuitization – that will derive the most income from that wealth. The assets of those who die early leak to their children, and the assets of those who live long will be insufficient to support their long lifespan, potentially leading to additional taxation of future generations.

<u>Rethink the role of the employer.</u> *Retirement 20/20* participants have discussed the necessity for more choice for the employer. Today we have a voluntary benefit system where the primary onus of retirement income provision rests with the employer to sponsor a plan (and take all the inherent risks and responsibilities thereof). Today many employers are choosing to sponsor DC over DB plans, which is partly due to concerns with the cost of DB plans, the variability in contribution levels, and the complex funding, accounting and statutory (administrative and legal) requirements. DC plans have much simpler statutory requirements, the employer has complete discretion in any year whether to fund or not fund the plan, and the plans place no balance sheet liability to the employers.

*Retirement 20/20* participants believe the role of the employer should be opened up to give the employer more choice. The employer could elect to take a role in educating employees, collecting employee payroll contributions to be contributed to the plan of the employee's choice, selecting a plan sponsored by the employer to which the employee and employer's contributions are made as well as (or instead of) the traditional roles of sponsoring and contributing toward an employer sponsored plan. By limiting the tier II retirement system to employer sponsored plans, we are limiting the access of individuals to those plans (they must work for an employer who is able to sponsor them) and we are also hampering benefit portability by tying benefits to the place of employment.

Several examples of non-employer sponsored plans exist. In the United States, TIAA-CREF serves as the retirement plan for universities and select non-for-profit employers (including the SOA). Employers make contributions and direct employee contributions to TIAA-CREF. Participants can purchase a traditional variable annuity (through TIAA) which pays out benefits for a lifetime (there are guaranteed minimum rates, with some potential to experience upside gains). This benefit provides the necessary insurance protection, and TIAA acts essentially as a non-for-profit mutual insurer. The employer is neither a sponsor nor a financial guarantor. And, as long as the participant is employed by an employer who participates in TIAA-CREF, the benefit is perfectly portable. In the Netherlands, there are career pay benefit plans (and defined contribution schemes) that operate industry wide. These independent funds guarantee career pay benefits with pre-and post-retirement inflation indexation conditional on fund performance. Some of the largest funds now take contributions from other smaller employers.

<u>Use markets wisely.</u> Markets are not a true stakeholder within the retirement system, but are the place where savings and de-accumulation is done; proper use of the markets is vital to a well-functioning retirement system. *Retirement 20/20* participants have made several observations about markets and their best use.

Markets need structure to work best. Markets work best when individuals approach the markets in groups. Groups can take advantage of specialized investments not open to individuals, employ sophisticated advisors and, with the advantages of size, minimize the cost of transactions and administration. Second, we can improve how individuals can work with the market if we can provide a degree of standardization so individuals can compare products offered. This is particularly important for individuals making annuity purchases; for example, it would be helpful to consider having several basic annuities which would be the same across all product providers so individuals can make comparisons on price and quality of provider. Finally, agents – those professionals working in the markets on behalf or plans or individuals – need to be properly incentivized.

However, we want to encourage market innovation. As will be noted below, choice encourages innovation, and we want the markets to continuously innovate.

Finally, as we've considered how we best use markets going forward, we've recognized that the capital markets may not be providing all the hedging tools that retirement plans would need to hedge retirement risks. This is particularly important if we are going to provide insurance benefits in plans which do not have an employer or other government guarantee. One example is longevity bonds which would offset the systematic longevity risk (the extent that a cohort does or does not exceed the cohort's expected lifespan). Today insurers can only charge annuitants for the potential negative costs of systematic longevity risk (a cohort living longer than expected). In theory this could be hedged in the capital markets. *Retirement 20/20* participants have discussed this issue at several conferences and concluded that the marketplace will not create the proper hedging instruments without institutional demand. In other words, we may have to stimulate more institutional demand for insurance products, and their associated hedging instruments, for the markets to appropriately respond.

<u>Choice, defaults and signals.</u> When we think about retirement system, the role of choice has to be carefully considered, including

- How much choice is included in the system? How much is default?
- How do you frame the choices you're asking stakeholders to make?

- What is the role of signals?
- Do you encourage or discourage certain choices?
- Who pays when bad choices are made?

When you look at insurance, choice increases cost. Choice allows individuals to choose to opt in or opt out to ones own advantage; choice also adds administrative costs. Actuarially, pooling individuals with no opt-out option maximizes the benefits of pooling, and giving everyone the same benefit minimizes administrative costs. But, not providing any choice doesn't allow individuals to customize for their situation. *Retirement 20/20* participants have considered how the system stakeholders view choice and who benefits from choice (and who pays when poor choices are made).

While choice can be good – choice drives market innovation – too much unstructured choice, within retirement, can lead to poor outcomes. Individuals don't understand the risks of retirement, have a short planning horizon and face many psychological barriers in planning for retirement (e.g. money not saved today can go towards immediate consumption and preparing for retirement is preparing for the end of one's life). And as we noted earlier, when individuals' choice leads to poor outcomes, society (future taxpayers) can pay the price. Strong defaults can help, and there are opportunities for tax policy and other means to steer individuals to choices that provide the best outcome both for the individual and for society.

Signals can help individuals prepare because they act to guide individual choices. But they can also encourage behavior that may not be optimal for the retirement system. Early retirement ages can give individuals permission to retire while normal retirement ages send a strong signal that one ought to be retired by this point. By focusing preparation for retirement on the accumulation of assets, we signal to individuals that the investment wealth is the most important aspect (and deemphasize the importance of deriving a guaranteed lifetime income stream).

<u>Consider innovations outside the single-employer system, and outside the United States.</u>
*Retirement 20/20* has been focusing on what possibilities exist outside the corporate sponsored DB and DC system. As such we've considered innovations in non-corporate sponsored plans both inside and outside of the United States. TIAA-CREF has been noted; some church plans also contain innovative features. The Dutch collective DB system is one of the most innovative retirement plan designs. The Ontario Teachers Pension Plan, a public retirement plan, is considered one of the strongest plans in Canada. *Retirement 20/20* has examined the Dutch collective DB system, a church plan, and the Ontario Teachers Pension Plan. We've discovered that these systems share some common attributes which should be considered as we design new retirement systems, including strong governance, alignment of roles with skills, presence of self-adjusting mechanisms, a degree of independence from than the employer, strong solidarity among members, use of groups, and disclosure at nearly default-free discount rates. Self-adjusting mechanisms are particularly interesting because they can share risk among plan participants.

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**Conclusions**

The *Retirement 20/20* project started three years ago because we believed there was a way to design tier II retirement systems that went beyond the current DB and DC system. Today, we still believe that there are opportunities to improve the retirement system if we are willing to move beyond the regulatory constraints that currently exist. As *Retirement 20/20* has systematically considered what retirement features provide the best outcomes for the most number of participants, a number of themes have emerged:

- A degree of insurance is necessary for the retirement system to do the best job at delivering the most income to the most people at the lowest total cost. It is particularly effective at meeting the needs and risks of individuals who retire and society (future taxpayers). It is difficult to deliver this benefit with DC plans, largely because of the nature of the individual account and its association with individual property. Insurance is a sharing of risk and risk protection. Annuitization out of a DC plan cannot provide the same benefits as efficiently or inexpensively (there are timing risks around annuitization, and voluntary annuitization is emore costly than group annuitization).

- Opening up the role of employers within the tier II retirement system is critical. Many efforts have been made to increase sponsorship of DB and DC plans by employer. Maybe we should also consider providing opportunities for employers to provide access to the system without having to be plan sponsors. Opening up the role of the employer and offering new ways for plans to be established and sponsored could open up possibilities not currently envisioned.

- The efficient working of the retirement system requires using markets wisely. Markets function best when well-trained, properly incentivized professionals work on behalf of well-organized groups. Individuals don't do well when they access markets directly; some standardized products could help individuals make better choices (e.g. standard definition of annuities and lifecycle funds).

- The role of choice, defaults and signals has to be considered carefully. Today we encourage early retirement, discourage annuitization and do not do enough to help individuals prepare well for retirement.

Retirement innovation is possible. One of the premises of *Retirement 20/20* is that if it were possible to fix the DB/DC system easily, we would have done so already, which is why we started the process of looking beyond the DB/DC system. Today the *Retirement 20/20* project is focused on collecting new ideas for tier II systems, through our call for models. The call for models is asking for proposals for new tier II designs that would work in the United States or Canada. Our target is to present the best of these models to the public in early 2010.

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For more information on the call for models, to read the 2006, 2007 or 2008 (forthcoming) *Retirement 20/20* conference reports or to read the summary paper written for the Pension Research Council conference (April 2009), please visit http://retirement2020.soa.org.