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Changing Frameworks for Retirement Security

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Changing Frameworks for Retirement Security

Abstract

In 1963, the termination of the Studebaker Corporation's pension plan wiped out or significantly reduced the pensions of thousands of the automaker's employees and retirees. In response, Congress passed the 1974 Employee Retirement Income Security Act (ERISA), a monumental and revolutionary piece of legislation crafted to address corporate pension underfunding and set new rules regarding defined benefit (DB) and other retirement plans. ERISA also established the Pension Benefit Guaranty Corporation as a government-run insurer to serve as a backdrop to U.S. corporate pensions. Despite the bill's far-ranging scope, in the years since its passage it has become evident that ERISA failed to achieve all of its intended objectives. The corporate pension scene today is in turmoil, and most private employers have terminated or frozen their traditional DB plans. In their place, employers are increasingly substituting defined contribution (DC) retirement saving plans, which pose a new set of responsibilities on employees and their firms. This volume investigates how and why traditional approaches to pension risk management have failed, and we also explore the new mechanisms required to strengthen retirement security for the future

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Reimagining Pensions

The Next 40 Years

EDITED BY

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Chapter 1

Introduction: Changing Frameworks for Retirement Security

Olivia S. Mitchell

The passage of the Employee Retirement Income Security Act (ERISA) of 1974 in the United States was spurred by the 1963 termination of the Studebaker Corporation's automaker's pension plan. That development wiped out or significantly reduced the pensions of thousands of Studebaker employees and retirees. In response, Congress undertook the crafting of this monumental and revolutionary legislation to address corporate pension underfunding and set new rules regarding defined benefit (DB) and other retirement plans. Additionally, ERISA established the Pension Benefit Guaranty Corporation (PBGC) as government-run insurer, to serve as a backdrop to US corporate pensions.

Despite the bill's far-ranging scope, in the years since its passage it has become evident that ERISA failed to achieve many of its intended objectives. The corporate pension scene today is in turmoil, and most private employers have terminated or frozen their traditional defined benefit plans. In their place, employers are increasingly substituting defined contribution (DC) retirement saving plans, which pose a new set of responsibilities on employees and their firms. In this volume we investigate how and why traditional approaches to pension risk management have failed, and we also explore new mechanisms that can help strengthen retirement security for the future.

Assessing the Retirement System: Adequacy, Efficiency, and Stability

There has been much energetic debate over the question of how well Americans prepare for retirement. In the first section of this volume, several authors offer their perspectives on the strengths and weaknesses of the current retirement system. One approach, by Alicia Munnell, Matthew Rutledge, and Anthony Webb, uses the National Retirement Risk Index

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(NRRI). The authors apply this measure to a variety of datasets and conclude that more than half of working-age households in the US are at risk of failing to maintain their pre-retirement standard of living in retirement. Yet other analysts have arrived at less dire conclusions, and some even propose that the majority of older workers have accumulated an optimal level of retirement wealth. In order to evaluate what, if any, policies might be useful in strengthening retirement security, it is helpful to establish the sources of this dissonance.

Munnell and co-authors seek to reconcile the conflicting evidence by updating their NRRI projections and simulating how their results differ under different assumptions regarding preferences and drawdown strategies. For instance, they show that their findings are sensitive to assumed changes in household consumption before and after children leave home. On the one hand, adjusting their NRRI metric to allow for the presence and then the departure of children in the household yields results similar to those from the more sanguine analysts. On the other hand, there is some evidence that households do cut back spending as they age; further, households with insufficient resources also cut back their post-retirement consumption to a greater degree than households having sufficient retirement resources, by their computations.

Jack VanDerhei approaches the question of whether Baby Boomers and Gen Xers will have enough money saved for retirement from a different perspective. Here the author asks whether Americans will have enough assets to replicate 100 percent of their pre-retirement expenses, along with two lower thresholds. His Retirement Readiness Ratings show that 57–9 percent of older households will not fall short of money in retirement using the 100 percent criterion, taking into account both long-term care and home health costs. Additionally, people eligible to contribute to a DC pension are likely to be better off, compared to those ineligible.

In her work on a closely related topic, Julia Coronado examines the employment situation of the Baby Boom generation in the wake of the Great Recession of 2008–10. She notes that more than half of all workers retiring since the Great Recession reported that they retired earlier than planned, citing economic rather than health considerations. The younger end of that generation, and men in particular, were most likely to report disruptions in their work lives. Interestingly, while the Social Security ‘full’ retirement age is rising, peoples’ actual behavior is going in the direction of earlier retirement. Coronado concludes that much of this is unintended retirement, and she suggests that this implies that future retirees will not be as well off as previous retirees.

To round out the assessment of America’s retirement system, Gene Steuerle, Pamela Perun, and Benjamin Harris point out that the so-called ‘entitlement’ programs, Social Security and Medicare, face deep financial

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problems. The authors recommend that entitlement reforms take advantage of the additional resources provided by economic growth, along with growth in both the demand for and supply of older workers. To this end, they outline reforms aimed at three goals: better orientation of public sector retirement resources to needier and older populations; removal of obstacles to increased employment of older workers; and private-pension reform that provides the long-sought second tier of support in older ages. In particular, economic growth has provided households with significant increases in GDP per household, of \$141,000 in 2014, projected to rise to \$168,000 in 2024. Moreover, demand for older workers is likely to rise as population trends result in fewer younger workers, but they add that, right now, wealthier individuals actually account for the majority of the working elderly. Since Social Security benefits are progressive, they tend to be more valuable to the older, poorer population. As a result, the authors argue that changes in the benefit formulas will be necessary to keep from discouraging older people from working.

New Approaches to Retirement Risk Sharing

The middle section of this volume takes up alternative pension models, and these chapters do much to enlighten the discussion of reform proposals. In their chapter, Anna M. Rappaport and Andrew Peterson discuss the fact that pension plan designs have very different risk allocations depending on their design. Some models place virtually all risks on the plan sponsor, while others place the risk on covered workers and retirees. The writers suggest that policy changes will be needed to underpin new plan designs that do a better job of risk sharing. The most salient concerns are investment risk, interest rate risk, inflation risk, and longevity risk. Potential new models could involve moving to DC plans, paying retirees lump sums, indexing retirement ages, adjusting benefits for longer life spans, selecting assumptions for DB plan valuation that build in more mortality improvement, and using financial instruments to manage this risk. Even in DC plans, there can still be plan sponsor risk: for instance, there is fiduciary risk as well as workforce management risk that may arise if employees are unable to afford to retire.

An interesting case study of a private sector union is reviewed by David S. Blitzstein who demonstrates how labor unions can renegotiate the pension contract. In his chapter, he describes how one union responded proactively by developing a hybrid pension plan that sought to align stakeholders through equitable risk sharing. The new model was called a Variable Defined Benefit Plan (later referred to as the Adjustable Pension Plan or APP). It was structured like a DB plan, in that retirement and longevity risks

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were pooled, and all assets were pooled and managed professionally. But in contrast to a DB plan, the new model shares investment performance between the employer and plan participants. Specifically, the Variable Plan benefit is the greater of two benefits calculated each year: either a ‘floor’ defined benefit (a flat benefit accrual or salary-based career average formula), and a ‘variable’ benefit that fluctuates depending on actual investment performance. Moreover, the annual benefit accrual can never be lower than the floor benefit. Numerous other unions have expressed interest in this model as well.

Donald Fuerst also favors a variable annuity plan that will provide participants with lifetime income without exposing them to the risk of running out of money at advanced ages. In exchange for this income guarantee, participants accept the risk and rewards that actual investment returns provide. Moreover, a variable annuity plan offers the employer cost stability and predictability, similar to a DC plan, but the sponsor accepts longevity risk. His model, termed the Retirement Shares Plan, enhances the typical variable annuity plan by allowing participants to elect more stable benefits. That is, benefits are adjusted every year to reflect invest gains and losses, and the plan is relatively indifferent to discount rates. There is still debate about how aggressively to invest, between younger and older participants, which he argues can be dealt with using a limited set of portfolio alternatives.

A different approach to hybrid retirement plans would combine the best features of DB and DC plans according to the chapter by Benjamin Goodman and David P. Richardson. In their view, the TIAA-CREF system which began in 1918 and now covers millions of workers in the nonprofit sector, provides a useful example of how to incorporate features of hybrid co-operative design into a retirement plan. The Teachers Insurance and Annuity Association (TIAA) offers a contributory guaranteed fixed annuity plan, where participants have the right but not the obligation to annuitize assets, while the College Retirement Equity Fund (CREF) was the first commercially available variable annuity sold in the US. The plan is a co-operative structure, ‘owned’ by participants, and it features population and cohort risk pooling, while assets are fully portable within the system.

Echoing the theme that intelligent risk sharing between employers and individuals can greatly improve retirement outcomes Richard C. Shea, Robert S. Newman, and Jonathan P. Goldberg describe the Portfolio Pension Plan (PPP) model. This approach adapts a DB plan design to rebalance the allocation of risks to employers and individuals. In particular, it is modeled on a cash balance design in which the employee’s account balance is adjusted based on investment returns and his portfolio is adjusted over time in line with his changing circumstances. Rather than credit a single rate for all participants, each individual’s account balance in a PPP is adjusted based on the return to his individually tailored retirement investment

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portfolio. Several of the design features central to this plan have been incorporated into legislative proposals and regulations.

Turning to the regulatory environment in which new plans can be structured, John M. Vine believes that employers have migrated away from traditional DB plans because DC and some hybrid plans have proven more compatible with their own interests and those of their employees. Moreover, ERISA and other regulations have been intended to safeguard participants in existing plans, but they have failed to encourage the establishment of new plans covered under the regulation. Indeed, one result of ERISA's strictures is that states and the federal government are now proposing so-called 'Simple Choice' plans, which would avoid ERISA's regulatory framework by virtue of being entirely employee-financed.

Pension Reform: Lessons from Abroad

The final section of this volume offers a number of insights into new pension models being developed outside the US. The Netherlands has been a particularly fertile source of new ideas, including the 'Defined Ambition' (DA) plans proposed by Lans Bovenberg, Roel Mehlkopf, and Theo Nijman. Despite the fact that plan participants had believed that the old-style Dutch DB plans were safe, in fact 'guaranteed' promises could not be kept post-financial crisis. The authors favor DA plans as they allow firms to continue providing a distributional platform for pension saving, while reducing plan sponsor risk-bearing compared to the traditional DB environment. This, the authors contend, addresses behavioral and agency issues as well as imperfections of insurance and financial markets.

In a DA plan, pension entitlements would be stipulated as deferred annuities, and participants must share the capital market risk via a joint liability pool. The chapter focuses on workplace-based pension schemes that can provide lifetime income streams during retirement. All Dutch workers would be automatically enrolled in these plans, thereby reducing marketing and other transaction costs, and protecting individuals against myopia and other behavioral biases. The conversion of existing DB rights into DA rights will be complicated by the fact that, under traditional DB plans, individual property rights were not objectively valued. That is, these contracts were incomplete so it was unclear who bore which risks. Moreover, these risks were not well communicated to plan participants. The authors suggest that DC plans in the US could better manage risk for participants if investments could be more 'liability-driven'. In other words, retirement income needs would be identified as in the DA setting, and the target income streams would be used to construct investment portfolios.

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In a discussion of Switzerland's pension system, Monika Bütler describes that country's three-pillar system and considers some of the challenges the system faces in the context of a rapidly aging society. A first pillar is a pay-as-you-go system that seeks to provide a subsistence level of income to all retired residents. A second pillar is an employer-based, fully funded occupational pension scheme, mandatory for all employees whose annual income exceeds a certain threshold. Means-tested supplemental benefits may be claimed if total income does not cover basic needs in old age. A voluntary third pillar, which is an individual tax-deductible savings account for retirement, completes the model. The first two pillars yield a gross replacement rate of about 60 percent, and a net replacement rate of 70–80 percent. Switzerland does have a high elderly labor force participation rate, but early retirement is permitted at ages 62 and 63, respectively, with a benefit reduction of 6.8 percent per year early. Future challenges for the Swiss retirement model include funding and long-term care financing, just as in the US.

In an interesting comparison of the Australian and US economies and demographics, Rafal Chomik and John Piggott evaluate how Australia's retirement income structure performs in terms of economic efficiency and efficacy in delivering old-age support. Australia's retirement income system is comprised by a flat-rate, non-contributory, affluence-tested age pension; this first pillar operates as a non-contributory transfer potentially available to all residents. A second pillar is a national mandatory defined contribution plan to which firms must contribute 9.25 percent (moving to 12 percent) of wages on behalf of their employees. Access to the second-pillar funds is available tax-free at age 60. There is also a third pillar made up of voluntary retirement saving. This structure has resulted in low poverty rates for people age 65+, and private pension coverage is also higher in Australia than in other developed nations. In addition, marginal tax rates are also higher. The authors suggest that more means-testing might be a path that the United States could pursue.

Singapore, like Australia, also has a national mandatory defined contribution retirement saving system. In his chapter, Benedict Koh describes how the Central Provident Fund (CPF) has functioned over the past half-century, along with its success in achieving nearly universal home ownership, health care coverage, and financial protection. Nevertheless, many people have inadequate retirement assets due to high transaction costs, lack of financial literacy, and inertia. Additionally, CPF participants may withdraw money to purchase homes, service mortgage payments, and finance premiums for insurance protection or children's tertiary education. People may also invest in a permitted list of financial products, but few have taken advantage of the

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large menu of investment instruments on offer to grow their retirement savings, instead leaving the monies in their CPF accounts where they earned a safe but low interest rate. Since 2013, it has also been mandatory for all CPF members to invest their RA savings in deferred life annuities that provide them with an income stream until their deaths.

Focusing on retirement saving adequacy, Koh explains that the CPF Board established the Minimum Sum Scheme with the goal of requiring members to retain a minimum level of savings for old age. From July 2013 onwards, members must set aside S\$148,000 in their Retirement Account upon reaching age 55, which is believed sufficient to support a subsistence level of living. Nevertheless, many members lack sufficient cash savings, and currently fewer than half of those turning age 55 meet the Minimum Sum Scheme requirement. Some possible reforms could involve raising older persons' contribution rates, ways to help monetize peoples' homes, increasing investment returns, and extending retirement ages. Koh also discusses the positive effect of introducing new low-cost default portfolios such as target-date funds. In this sense, the Singaporean system has adopted elements of the US defined contribution model.

Conclusion

Forty years ago, many observers hailed ERISA and its amendments as absolutely instrumental for strengthening private sector employer pensions in America. And by some criteria, there is much to be proud of. In 1974, for instance, when ERISA was passed, the total assets of private pension plans amounted to \$164 billion (Sirkin 1994). Now US private pension assets have grown to almost \$25 trillion (ICI 2015), despite having passed through one of the toughest market downturns in history. Unfortunately, with hindsight, Steve Sass was prescient when he argued that 'ERISA neither solidified nor undermined the nation's private pension institution; it merely marked its high-water level' (1997: 229). Traditional DB pensions were the creation of big labor, big business, and big government. Today, employees and plan sponsors have a very different perspective on risk management, the workplace, and capital markets, compared to 40 years ago.

In the twenty-first century, we have a much clearer view of the common risks facing the world's retirement systems; these include rising but uncertain longevity, probably lower investment yields, and rising health care costs. This volume will generate discussion for years to come, on how to craft a pension system for workers, retirees, and plan sponsors of the future.

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