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Comments on

"The SERIOUS System: A New Model for Retirement Income Success"

by Cynthia J. Levering

1. Overview

Ken Beckman's "Successful Employee Retirement Income Outcomes in the U.S. (SERIOUS)" creates a comprehensive Tier II system using deferred annuities to create secure retirement. It is a plan in which more workers should end up with Tier II benefits than today after participating in a voluntary, less risky system that is expected to be less costly to employers. The system is a comprehensive design using existing products and structures that meets most stakeholder needs. While some market and governance issues would need to be addressed, they are likely not insurmountable. It is designed to be simple and easy for employees to understand.

Beckman admits many of the features of his system have been around for a while and some have already been implemented. What he feels he has done is to bring the components together to create a comprehensive system that better meets the needs of all stakeholders. A few issues are either not 100 percent clear or need to be resolved, including the time and costs to transition to this new system, which will require legislative action.

2. Key Elements of the System

The system's strengths are in auto-enrollment, flexibility of contribution levels (for employers and employees), use of deferred annuities to provide longevity and inflation protection, and centralized plan sponsors. The employers' role is generally limited to collecting and transmitting contributions to the sponsor of the employee's choice, which relieves the employer of establishing and maintaining a plan. Their job will be to make sure contributions (employee and employer, if provided) are transmitted to a central clearing house that handles all administrative services (e.g., processing contributions, disbursing benefits). This change could have two positive outcomes:

(1) Employers without existing plans, especially small employers (and even self-employed individuals), might be willing to start contributing on behalf of their employees, and

(2) Employers with existing plans might contribute more to the new system once they no longer face the same costs of sponsoring their own plans. (Existing plans could coexist with SERIOUS, so costs for the present system would not necessarily drop to zero.)

While the benefits aren't portable, a centralized administration system would provide information on all benefits accumulated to date to help employees track their progress in accumulating retirement income. The system permits some lump-sum payments, while keeping the primary focus on annuity income at retirement, including novel ideas for supporting the costs of long-term care. Details about the oversight and governance would need to be determined, and there could be a long ramp-up time (and high cost) to get plan sponsors established.

The SERIOUS system is actually quite simple and should be easy for employees to understand—always a good thing. Investment and asset allocation decisions will be taken over by independent plan sponsors. Employers will be relieved of the burden of establishing and maintaining retirement plans.

SERIOUS is a voluntary system, which is a plus because a mandatory Tier II system does not seem politically feasible in the United States at the present time. However, voluntary systems mean some people will remain unprotected. Automatic enrollment is designed to increase participation. Workers can opt out, but they will be automatically reenrolled every year, another feature that should increase participation.

Tax deductible contributions and a tiered bonus tax incentive are designed to encourage employer participation. To qualify for the tiered bonus tax incentive, employers must make a minimum contribution of 1.5 percent of a capped salary for all employees, even those who do not contribute on their own. This ensures all employees will end up with something in the way of SERIOUS benefits. It might not be much, but perhaps some workers who see the modest accumulations will realize they need more and will begin to augment them with their own contributions.

Employees will have a minimum of decisions to make—selecting a plan sponsor and a contribution percentage. Some may look unfavorably upon this limited involvement, but it is probably the best approach for most workers given the lack of financial literacy in the general population. Those who want to manage their own investments can do so with Tier III individual accounts.

3. Pros

- Initial and annual auto-enrollment encourages broad labor force participation.

- No contributions are required of employees or employers—individuals set their own levels. In addition, the contribution rate will increase automatically each year (auto-escalation), meaning greater savings build up as earnings (presumably) increase with tenure.

- Limited lumpsums from employee contributions could be made available. This might encourage more participation from workers who do not want to see all their money tied up in an annuity but who want to hedge their longevity risks. However, lifetime income rather than the accumulation of assets will be the main focus.

- Mandated annuity purchases at the time the contribution is made and post-retirement inflation indexation would protect against longevity risk as well as enhance robustness and sustainability.

- Post-retirement income levels are reasonably predictable, with the degree of predictability increasing throughout the contribution period.

- Supplemental annuity payments will be available in the event long-term care is needed. This is another feature that might make annuitization more attractive to workers who like the idea of some guarantee but do not want all their money tied up in case of an emergency.

- Investment decisions reside with the plan sponsor so there is no need for individual investment skills.

- Employers are relieved of the burden of sponsoring and administering plans and there would be no fiduciary, business or regulatory risk for employers, although employers would have to auto-enroll all their employees each year.

- Employers can still attract and retain employees by setting a more generous employer contribution level with a related vesting schedule.

- The large size of the resulting plans could assist in achieving strong governance practices and reducing moral hazard, especially since third party plan sponsors would be independent of any employer or employee group. Large plans providing centralized administration and oversight also promote economies of scale and should result in lower administrative costs and greater efficiency.

- A system-wide insurance fund would reimburse impacted investors up to certain limits if a plan sponsor could not meet obligations.

- Risk would be borne by individuals but it is designed to be hedged which should encourage markets to develop new hedging instruments.

- The plans will presumably be able to handle extreme events but plan sponsors will have to have a system of risk management and establish a level of capital to deal with risks taken.

4. Cons

- While both employers and employees prefer voluntary contributions, this poses a risk that sufficient retirement income won't be provided.

- Attainment of a reasonable level of benefit would be dependent on a contribution level of at least 6 percent of pay over the employee's working lifetime.

- Standardized benefits may not be responsive to family needs.

- Allowing annuitization beginning at age 60 could send a signal that this is an appropriate retirement age. In addition, no early retirement subsides are provided.

- Members choose their plan sponsor which requires some level of knowledge and expertise and will depend on the quality of the communication provided.

- The long-term care benefit may not be sufficient.

- There is no effective enforcement mechanism for capital/insurance requirements—it is unclear whether trust or insurance law would govern.

- The large nature of the resulting plans could lead to concentration of decision-making authority and impact the strength of governance, such as politically oriented board appointments.

- Since adjustment is limited to future contributions, where rates will be very visible and participants have full latitude to choose a plan sponsor, a sponsor could potentially spiral downward very quickly.

- It is not clear costs will be transparent.

- The funding of the clearinghouse and plan sponsor market oversight is unclear and ensuring appropriate reserves from the outset may take some time.

- It would seem to take a while to get the plan sponsors up and running. It is possible existing companies could spin these off fairly quickly, but it may require a great deal of regulatory change.

- A significant amount of infrastructure must be set up before implementation, including such things as centralized administrators, oversight boards, competitive markets for long-deferred annuities, and special statutes.

5. Questions for the Author

- Will lower-paid employees be able to participate, even at a modest level?

- Who monitors or regulates the information provided to individuals? Would employees be given enough standardized information to be able to compare the various plan sponsors?

- Will competition for participants drive up advertising/administration costs?

- Are the assumptions used to produce a 40 percent replacement rate reasonable?

- How sensitive are the benefits to modest changes in assumptions?

- Do these plans function as insurers or trusts?

- How will the clearinghouse be funded?

- What safeguards could be used to prevent large plan sponsors from abusing their authority?

- Since existing plans could coexist with SERIOUS, how would the transition from the current system be encouraged or incentivized besides using tax incentives?

- What could be done to minimize the cost of the system and feasibility of providing guarantees?

- What happens if plan sponsors take on excessive risks?

- Since the underlying investments are more geared to fixed income than equity, what impact will this have on the capital markets?

- Could a similar system work in the Canadian context?

6. Conclusion

The main strengths of the SERIOUS system are in its simplicity, auto-enrollment, flexibility of contribution levels (for both employers and employees), use of deferred annuities to provide longevity and inflation protection, and centralized plan sponsors. The employer's role is limited to collecting and transmitting contributions to the sponsor of the employee's choice which may appeal to employers of all sizes. The benefits aren't necessarily portable but a centralized administration system will communicate all benefits earned to date to help employees track progress in accumulating retirement income. The system permits some lump-sum payments, while keeping the primary focus on annuity income at retirement, including novel ideas for supporting the costs of long-term care. Details about the oversight and governance would need to be determined and there could be a long ramp-up time to get plan sponsors established. The cost of the system and feasibility of providing these guarantees could also be greater than the author anticipated. However, the system is a comprehensive design that meets many stakeholder needs; market and governance issues would need to be addressed but are likely not insurmountable. Most importantly, if the assumptions the author used in his projections hold out, employees should, with SERIOUS, be able to provide themselves with a reasonable income to supplement Social Security.

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