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RETIREMENT AGE ISSUES, TRENDS AND ASSUMPTIONS

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For large and small pension plans, a discussion of current practice and expectations relating to retirement ages will be covered.

1. Trends in experience, especially as they may be influenced by:
    a. Changes in Social Security
    b. Government regulation, such as Age Discrimination in Employment Act
    c. Early retirement incentives, such as bonuses or subsidized early retirement factors
    d. Cost-of-living supplements to retirees

2. Plan design for early and postponed retirement

3. Effects of deferred retirement on actuarial costs

4. Trends in actuarial assumptions

MR. EDWARD I. FARB: Good Morning, I am Ed Farb of Buck Consultants in New York. Welcome to Open Forum 5, Retirement Age Issues, Trends and Assumptions.

In keeping with the format of an Open Forum, the speakers will present their remarks, and the floor will be opened for audience questions and comments.

Our panel this morning consists of Stephen Goss of the Social Security Administration, John Hickey of Kwasha Lipton, and Tom Malloy of Connecticut General.

We will begin the presentation with Steve Goss, who will discuss some of the current issues affecting Social Security.

MR. STEPHEN C. GOSS: Thank you, Ed. The statutory normal retirement age for Social Security has remained unchanged at 65 since 1935. Early retirement provisions were enacted later, but no major change in eligibility age has occurred since 1961 when reduced, early retirement benefits were made available to men as well as to women. I would like to talk today about two related topics. These are, retirement experience under Social Security over the past decade, and prospects for the future, including our expectations about future retirement experience under the current program, as well as possible legislative changes that are now being considered.

Unfortunately, the concept of average retirement age is not really applicable to Social Security experience. Many persons receive benefits intermittently because of the earnings test. We consider them to be retired only when they are receiving monthly benefits. For this reason, we generally use retirement prevalence rates rather than incidence rates.

Table 1

Retirement Prevalence Rates:
Percentage of Eligible Workers Who Were Receiving
Social Security Retirement Benefits in January

Year	Age 62-64		Age 65-69	
	Male	Female	Male	Female
1970	24%	40%	77%	80%
1971	26	41	78	80
1972	28	43	79	80
1973	30	44	81	82
1974	32	47	84	85
1975	33	48	85	85
1976	35	48	87	85
1977	35	48	88	86
1978	36	49	89	86
1979	35	48	90	87
1980	37	49	89	87
1981 p	39	50	90	88
1982 p	40	50	91	89
Projected Ultimate	42	54	93	93

p = Preliminary

Source: Office of the Acutary
April 1982

Table 1 shows that early retirement under Social Security increased since 1970, from 24 percent of eligible males under age 65 to about 40 percent currently. For eligible females under age 65, the rate increased from 40 percent to 50 percent. By the time they reach age 65, at current rates, close to two-thirds of eligible persons will have received some early retirement benefits. This experience is even more impressive when we consider that an additional 15 percent of eligible persons do not retire early because they receive either disability or survivor benefits up to age 65.

At ages 65 through 69, retirement prevalence rates have increased from about 80 percent in 1970 to about 90 percent currently for both men and women. For men, this data allows us to see the extent of benefit withholding due to the earnings test. For women, however, roughly half of those not receiving retirement benefits at ages 65 through 69 receive a widow benefit instead.

We are currently projecting retirement prevalence rates to stabilize at levels only slightly above the current levels. Many of the factors which have contributed to retirement rate increases in the past will probably continue in the future. Among these are the increased coverage by private pensions and the changing mix of the job market. However, certain factors closely related to Social Security retirement rates will soon begin stabilizing or even reversing direction.

Table 2

Benefit Replacement Rates * for Steady Workers
With Average Earnings in Each Year

Year	At Age 62, Average During Prior 3 Years	At Age 65, Average During Prior 5 Years
1970	30%	31%
1971	31	32
1972	33	33
1973	35	34
1974	37	36
1975	40	38
1976	40	39
1977	42	41
1978	43	42
1979	44	44
1980	45	45
1981	45	47
1982	45	49
Projected Ultimate	43	42

* Benefit replacement rate is defined here as the ratio of the average primary insurance amount for the first 12 months of entitlement to the average level of monthly earnings for the 12 months prior to entitlement.

Source: Office of the Actuary
April 1982

From Table 2, we see how the level of Social Security benefits has risen relative to earnings since 1970 due to a combination of ad-hoc increases and the excessive indexing provided in the 1972 Amendments. Increases of this magnitude have a significant impact on the decision of whether to retire or to continue working. The effect of the 1977 Amendments, though, will reverse this trend and stabilize benefit replacement rates substantially below recent levels.

Another factor that has influenced retirement rate trends since 1970 is the Social Security earnings test. Starting in 1973, the withholding rate was changed from one dollar for each dollar of earnings to one dollar for every two dollars of earnings. In addition, the amount of earnings exempt from the test has risen faster than wages since 1970, especially for beneficiaries over age 65. After 1982, these exempt amounts are scheduled to increase automatically at the same rate as average wages.

Overall,then, the forces influencing Social Security retirement rates are expected to be in better balance and are likely to result in a more stable retirement age pattern in the future.

The retirement rate experience and projections I have discussed up to this point relate to a Social Security program with changes in benefit levels but with a steady, unchanging age structure. However, the large deficits projected for after the turn of the century may prompt significant changes in the age structure of the program.

Let's consider these projected OASDI deficits for a moment. The 75 year average deficit is projected at about 1.8 percent of taxable payroll under intermediate (Alternative II-B) assumptions. Annual deficits in the long range are projected to begin in the year 2014, after the baby boom has begun reaching old age. But these annual deficits will remain over 4 percent of payroll past the year 2055, when the baby boomers will be little more than a memory. A major reason for this is, of course, the projected increase in life expectancy. That is why increasing the normal retirement age is being discussed as the most direct, if not the most acceptable, solution.

Increasing the normal retirement age from 65 to 68 would eliminate almost half of the OASDI deficit projected for the year 2055. Specific proposals that would accomplish this have been recommended recently by the National Commission on Social Security, the President's Commission on Pension Policy, and are included in Bills introduced by Representative Pickle and Senator Chiles.

Other possible changes would involve modification of early retirement reduction factors and/or the delayed retirement credit in order to encourage later retirement. Increased reduction for early retirement, as was proposed last year by the Administration, would result in deferred retirement by many persons and in substantially lower lifetime benefits for those who do not defer. Long-range savings would be significant but not nearly as large as would result from raising normal retirement age to 68. Increasing the delayed retirement credit above the 3 percent level would also encourage later retirement but would, in net, increase the cost of the Social Security program.

In conclusion, current Social Security provisions can be expected to slow and eventually stabilize the historic trend toward earlier retirement. Furthermore, because of increases in life expectancy and the resulting long-range Social Security deficits, we are going to see many more proposals intended to encourage later retirement. Eventually one or more of these proposals will almost certainly be adopted.

MR. FARB: Thank you, Steve. John Hickey is next. John indicated that he is going to cover three areas in his talk. The first will be some general observations on retirement issues as viewed from his firm, Kwasha Lipton. John will then discuss the impact of retiree welfare plan design on cost and experience. Finally, he will review the impact of present and potential government regulations on retiree welfare plans.

MR. JOHN C. HICKEY: Thank you, Ed. Before I get into the meat of my talk, I think it might be useful for the participants if I told you a little bit more about my firm and my role at that firm so that you can judge my biases and the basis for my conclusions. Kwasha Lipton is an employee benefits and consulting actuarial firm specializing in medium to large size corporate clients. Since the view that we take is based upon how any given issue impacts our clients, we are going to be talking from the perspective of generally large corporate entities.

The primary reason why I am on this panel is the affinity my 11 year old daughter has for Space Mountain, and this is a good way to get her here. But, more than that, I work with a large number of our clients that ERISA calls welfare plans but we call group benefits plans. Happily, getting ready for this meeting, I took a survey with five or six of my partners who work in the pension plan area, and I do have their conclusions and thoughts to share with you this morning.

At the outset, I think it is important to keep in mind, at the expense of boring you with a bit of detail, that we have to differentiate between large plans and small plans when we are talking about retirement assumptions and tracking of experience. It is the old cliche, but when you talk about large plans, you have to reflect that plan's own experience and the plan design that is involved there. When you are working with smaller plans, plan design has an impact, but obviously, you have to base your experience on more general trends than what is happening at that given client.

Historically, I am told by my partners in the pension area, that way back, pre-ERISA, when they first took a hard look at retirement assumptions (or at least, being younger guys, the first time in their experience), they noted that there was a great trend toward early retirement supplements, particularly among the large bargaining plans. It was a trying time for them because it was very difficult to predict exactly what the impact of these early retirement supplements was going to be in filling the gap from the time retirement occurred until Social Security started. But, they muddled through, and they made some assumptions which, right now, we are in the process of reviewing to see how accurate they were. It appears they came out pretty well. There has been some movement toward changing those assumptions recently, but there is no one trend that is consistent from one client to the next with respect to early retirement supplements, whether people are taking advantage of them or postponing them.

There definitely is a trend for the first time toward assuming that people do work past age 65. My sampling techniques were not the greatest in the world, but it seems as though about 10 percent of our plans assume at least some employment past age 65. The remainder still have everybody going out at 65.

I mentioned before that people have taken a look at the assumptions and are reviewing them. Unfortunately, those of you that are in the consulting business with us know that there is currently a great deal of attention being focused on interest rate assumptions which have a much larger impact. Tinkering with the retirement age is not receiving as much attention. Depending on the plan design, if there are accruals involved past 65, the funded status of the plan and how you are going to amortize experience gains and losses, retirement assumptions just do not have that much impact on the cost of the plan.

One thing that might happen to impact retirement ages in the future is whether or not we are going to see any real growth in some sort of indexing for pension plans. I think that it is generally accepted that the one barrier to people retiring, either early or when they get to be 65, is the fear of inflation. How real it is, we do not know, but as long as the perception exists that the employee is retiring on a fixed income, that inflation is going to continue, and that the private plan is not going to protect against inflation, there has to be a very strong motivation to stay on past age 65. Not only until 65, but past 65.

From my own experiences, I doubt whether we are going to see any real rush to add indexing in pension plans. Most large companies are having enough problems wrestling with the liabilities they have on the books now. Start introducing something like that, and it is really opening another Pandora's Box.

Just as a little bit of a sidelight, there is a great deal of activity in capital accumulation plans which most companies are trying to structure to deal with the problem of supplementing the defined benefit plan.

I do not think you are going to see a great deal of activity in the defined benefit area. For that reason, I do not think you are going to see a change in the assumptions that are used in their funding.

The other thing that might come about, and I do think you are liable to see some activity here, is the further liberalization and the practice of accruing benefits past age 65. We will talk a little bit about ADEA later, but right now the Age Discrimination Employment Act does not mandate that defined benefit plans accrue benefits past age 65. Nevertheless, a lot of companies are taking another look at that and being more liberal than the law allows them to be and, in fact, are moving in the direction of accruing pensions past age 65. That could have some impact on the likelihood of people staying on or not.

Moving on to the group benefit or welfare plan area, there are primarily two important benefits that are provided to all the older, active work force and to retirees which may impact retirement age assumptions and actual experience.

The first is life insurance. I think common sense and a lot of survey material would indicate that what you do in either the death benefit or the life insurance area for older employees or retirees is not really going to have any impact on a person's decision to retire or not. The health

coverages that are provided, however, are financially important enough and perceived by employees to be important enough that they may impact what employees will do with respect to early retirement.

There are really four different areas that come into play under health plans. One is how do large companies treat their early retirees? The general practice, I guess, by default, if it is not given the proper attention, is to just give early retirees the same plan as the actives. But you have to address a couple of issues: are we going to ask our early retirees to contribute if the active plan involves employee contributions, and if so, are we going to deduct it from pensions, or how else are we going to go about it? Are we going to continue to cover the dependents of retirees in the same way that we do our active employees? Are we going to cover retirees' children? Are we going to cover the spouse? Are we going to cover the spouse in the case of remarriage? Are we going to cover, in the case of a remarriage, spouses' children who are acquired through the remarriage? These things can have a real impact on a retiree when he is considering going out or not. The health coverage is worth a great deal to people, and they do want to know about it at the time they are retiring.

The second major area in health coverages which can impact a person's decision to retire is: for the retirees that are eligible for Medicare, how are we going to go about integrating with Medicare? You would be surprised at how much detail some of these older people know. The people that are going through pre-retirement counseling, or have just retired, know a great deal more about their health coverage and Medicare than the younger, active people who do not pay any attention until they get sick and send in a bill for reimbursement. Whatever reimbursement comes back, they may argue about, but, depending on their level of sophistication, probably will not. On the other hand, the retirees are very concerned.

There are three ways to handle the integration with Medicare. You can fill in Medicare deductibles, and co-payments would be the gap. This is probably the cheapest type of coverage, and people do not often feel safe when that is the approach that is taken. The most prevalent approach is to have a Medicare carve out. You have the active plan continue to retirees, and you carve out Medicare. That is, you give them the same total benefits as an active employee would get, and you reduce by the benefits from Medicare. Finally, there are still some companies out there that do a coordination of benefits with Medicare. In most instances, this means that retirees get 100 percent of their medical expenses reimbursed. Obviously, there is not going to be a barrier to retiring if that is the type of plan that is in force. I do not know if it makes sound plan design from the company's point of view, but the retirees love it when you have a COB provision.

Another very important issue in the health care area for those over age 65 is who is going to pay the Medicare Part B premium. ADEA has mandated that for employees over age 65 who stay active, the Part B premium generally has to be paid, depending on the contributory nature of the plan. Most

companies do not pay the Part B premium for retirees that are over age 65. This Part B premium can be viewed just as another little pension supplement. It is worth a certain amount, is automatically indexed and is not as important as some of the other issues that we have discussed.

The fourth important issue is how do we treat a retiree's survivors. We read a lot about the changing work force, two working spouses and the like. But a lot of people who are now of retirement age or who are already retired, were the employees that the traditional plan design, based on a non-working spouse, was geared for. A lot of these people have worked and supported a spouse, have been married to the same individual for 30 or 40 years, and are very concerned about that individual's welfare. A big part of that concern revolves around health care coverage that will be provided should the spouse survive the employee. A lot of plans are very generous in this regard. They give lifetime coverage to a spouse and that makes retirement more comfortable and more accessible to a lot of employees.

That ends my remarks on general welfare design. I have tried to overview some of the important issues to keep in mind when deciding what you do for your retirees in terms of health care. I will now make a few comments on legislative changes that have recently taken place and will speculate a little bit more on what might take place in the future.

First, of course, is age discrimination -- ADEA. Just as a quick review, ADEA does not affect retirees. ADEA only tells employers what they have to do for their active work force who are in the protected age group, which is now 40-70. It is funny how few of my clients realize this when we start talking about the subject. They get confused and think there are certain things they have to do for retirees. As you know, however, once a person retires, from a legislative point of view, you do nothave to do anything for him. From an employee relations point of view, though, it probably does not make sense. In any event, with ADEA, we are only talking about what we have to do for active people.

In its present form, ADEA has little impact on design in either the pension area or the welfare area, because what was mandated was, with few exceptions, pretty much the general practice. There was some tinkering that had to be done maybe with life insurance schedules to get the reductions to look better,and you had to pay the Part B premium, which probably was not good. Aside from these, there probably wasnot much that ADEA did that would affect plans for older employees or for retirees. That may change.

The primary thing that may change in response to ADEA is the mandating of pension plan accruals when somebody is over 65. If that happens, you are liable to see people stay on a little bit longer than they otherwise would.

The last point I would like to cover before turning the program back over to Ed is the potential changes in Medicare, where people that are actively working would not be eligible for Medicare. In other words, the employer's

plan would have to pick up the full cost of health care coverage, it could no longer integrate with Medicare. This would not affect the employee's perspective, he is getting the same benefits; it is just a matter of which pocket he is getting it out of: the government's or his employer's.

However, it may change an employer's attitude about wanting to keep people on past age 65. While we all recognize that the law does not allow termination of employment on account of age, I think the employer's attitude is very important. If they want to structure the plan with employment practices that get people out early, they can do it. If eligibility for Medicare is denied to active employees, it is going to become a lot more expensive than it is now to keep people on past age 65. There might be some incentive for employers to structure their other plans to encourage people to retire. It is not as though it is going to cost them a great deal more than it costs for a guy age 60. It is going to cost them the same. The point is that now it costs a lot less to keep a person on past age 65 because Medicare is paying a big part of the health care bill.

That concludes my prepared remarks.

MR. FARB: Thank you, John.

Tom Malloy is going to cover a variety of areas: from plan design to reviewing the retirement decision that people have to make to the setting of retirement assumptions. Tom will also spend some time on the issue of preserving the purchasing power of retirees.

MR. THOMAS M. MALLOY: Thanks, Ed. I do not know about the rest of you, but I had a very difficult time convincing my staff that I had to leave the office to go to Fantasyland. After a few days in the Magic Kingdom, I knew why I came down. They do things much better here.

I would like to spend a little bit of time directed towards what problems are ahead of us rather than what is behind us. Most of these remarks are going to be my own personal speculation, but I thought they would be a way to stimulate some response from the group, because when I finish, Ed is going to turn the meeting over to you.

If there is any trend in retirement assumptions, it can be summarized by saying - "it is changing". This is an area where plan sponsors might be better served if the actuary anticipates change in experience rather than responds to it after an established pattern can be recognized. We should expect higher utilization of early retirement when a subsidy is introduced. There is no need to "wait and see what happens". Let's remember a bit of human nature that is often lost track of in pension work. It is one of those "conservative insurance company rules". Given a free and unrestricted choice of alternate courses of action, people will select a course perceived to be most favorable to their own interests.

An underwriter labels this as anti-selection. The retirement decision is probably the biggest single opportunity of one's life to act in an anti-selective fashion. A large plan will have hundreds of "one-on-one" games, participant versus "the plan", being played out every day, and I have seen nothing to suggest that, even in what we might view as an uninformed judgment, participants are not making correct choices for themselves in the majority of cases.

People retire when they can afford to retire - more properly stated - people take down their retirement benefits when they judge it to be in their financial interest to do so. The potential for this phenomenon to affect the actuary's retirement assumptions should not be underestimated. For example: a large plan has a moderately subsidized early retirement program, maybe one-half of what a good actuarial equivalent would have been in 1970. An examination of retirement activity indicates that a single point estimate of age 60 or 61 would represent overall experience. As a matter of fact, virtually all vested terminees have taken their benefit down before age 57, while in-service retirements are bimodal - concentrated almost entirely at 62 and 65. Recognizing the difference between retirement from active service versus retirement from vested term status makes a difference in plan costs.

Another plan has unreduced benefits available at age 62 and substantial subsidies at earlier ages. Examination of the participants' data indicates that while the group as a whole has an entry age of 30, virtually all participants working beyond age 60 have less than 20 years of service. Should the retirement assumption incorporate entry age as one of its dimensions?

These are real, live situations. I would be interested in hearing what others have encountered in this area.

It is useful for the pension actuary to step back from his day-to-day work and explore the forces that play on an individual's decision to retire. I have already noted affordability as a prime consideration. What affects affordability? What other considerations come into play? These forces, whatever they are, will drive what we will eventually acknowledge to be trends and adopt as assumptions.

"Affordability", to the participant, is a very subjective issue. At the personal level, one will consider the employer's plan, Social Security, personal wealth and alternative subsequent employment. In addition, the retirement decision will be colored by character of present work, one's ability to perform (satisfaction with one's results), social pressures (peers and employer) and a basic need to be active and busy.

The employer has an interest in the retirement decision, and his needs provide signals that affect the individual's decision -

- productivity of a worker
  - the need to retain skills/experience in the work force
  - the prospect of technological displacement

° a need for continuity of staff
  - advancement of younger staff
  - recruitment versus retention

While trying to solve these "business needs" questions, some sponsors are going to be swept along by a "me too" syndrome, mimicking the decisions of other organizations. Others will give little thought to long-term consequences of using plan provisions to solve short-term problems.

By 1982, many larger plans have matured. They are past the point of delivering a benefit that would meet tests of basic, bare bones adequacy. In these situations, continued casual attention to how his employees "use" the plan will lead to trouble.

National needs and policy (or its lack) will have an influence on the participant's sense of affordability.

° Social Security
  - benefit levels
  - age of access

° Social attitudes and economic trends
  - demographics
  - maintenance of an adequate labor supply
  - quality of life
  - inflation

All of this will impact on the individual participant's measure of affordability and thus his retirement decision.

Pension actuaries in 1982 have the prospect of seeing virtually every factor affecting the retirement decision change dramatically sometime in the next ten years. I look for some of this change to impact on whatever retirement patterns we have at present. Many plan sponsors will benefit from their actuary's effort to understand and even anticipate change in this area.

I believe we are going to see some rather dramatic departures from the current retirement provisions of a typical defined benefit plan.

a) One of our challenges is whether private plans will continue to parallel Social Security, providing supplemental income at pretty much the same age that the federal benefits may be taken down; or, is it more likely that private plans in the future will be found complementing Social Security, providing substantive income where there is a retirement need that is not met by the federal program.

b) The more frequent presence of employee savings programs will affect plan design. An employer can more confidently assign certain retirement needs to the employees' responsibility when it is known that the employee has the resources. There is already work being done in dealing with cost-of-living protection in this fashion. Whether it is formally integrated in the actual plan provision or only taken into consideration as plan objectives are set - employee savings, when they are known to exist, are going to influence plan design far more in the future than in the past.

c) The phrases early and postponed retirement will persist as long as a normal retirement age is needed to peg certain design features down. However, plan design will more frequently be considering a retirement period, or window; that is, an employee with 35 years of service will have full benefits available any time from age 60 through 70, and benefits are not going to be any different whenever he takes it down. He and the employer will agree when it is time to retire, based on facts and circumstances surrounding the job. The retirement benefit will be neither an incentive or disincentive to either retire or continue to work.

d) I expect plan design to become more involved with partial retirements - whether it involves a participant working full time, but with less responsibility and lower direct compensation; part-time, but throughout the year; or full time for a portion of the year.

To some extent, breakthroughs in partial retirement area may release the cost pressure building up as a result of current early retirement practices. I am absolutely convinced that system-wide, unintended "windfall" benefits are being paid out in the form of generously subsidized early retirement benefits to employees who continue to be full time participants in the work force. I would not speculate on the current prevalence of this phenomenon or its importance at the present time. I do feel that it is one of those "little" distortions that creep into a program. Left unattended, it will go out of control. The cost effectiveness to the sponsoring enterprize of early retirement provisions should come under far greater scrutiny in future years.

At the present time, both employers and participants are honestly worried over inflation's capacity to virtually destroy the basic goal of the retirement plan.

Most corporate-sponsored plans respond to the erosion of a retiree's purchasing power with ad hoc, one-time adjustments. A few companies have structured programs that provide some level of ongoing protection.

The biggest fault of even a well-run ad hoc program is that those participants most concerned about inflation are aware that the company is being quite careful in making no long-term commitments. This can be a source of anxiety. "What kind of risk is involved if my employer shies away from it"?

Employers, while sympathetic to the participants' concern, do shy away from the large increases in plan expense that a permanent COLA is perceived to involve. There are ways an employer can make a permanent commitment without involving as great a risk in future plan expense as might be feared.

Inflation is an undeniable threat to the continuing real value of any fixed dollar income stream. Full protection from inflation is expensive and may be inflationary itself.

Let's look at ways cost/risk trade-offs are managed in other areas of our business.

We are all familiar with the power of a "deductible" in solving auto insurance cost problems. For the same premium dollars, a higher deductible will deliver more protection at a time when it is really needed.

A deductible feature preserves claim dollars for use when the level of claim is most intense, when the risk of loss or ruin is most severe. First dollar coverage with no limits is expensive. Why is it not reasonable to apply this same theory to inflation protection? Which would you rather have? An increase in your annuity that matches the first 3 percent of CPI, or an increase in your annuity which is indexed to the CPI in excess of 3 percent?

A second concept, common in health insurance, is one of coinsurance. The employer might be willing to share the risk, particularly if it is already controlled with a deductible. Today, in most plans, the employee is carrying the whole risk.

The two concepts, once combined, provide a basis for the sponsor to offer a program where his exposure to future added expense can be fine-tuned to his risk tolerance (or his pocketbook), concentrating a greater portion of the committed resources to periods when it is needed most by the participant.

Consider the typical structure of a plan that does provide some inflation protection today. It is likely to be a match of 50 percent or two-thirds of CPI, but not more than 3 percent in any one year. As a practical matter, if you were about to retire, would not 50 percent of the CPI in excess of 3 percent be more comforting?

In this form, the coinsurance factor and the deductible threshold can be manipulated to contain the employer's exposure to future costs. 30 percent of CPI in excess of 6 percent would be more protection than most retirees have now.

Do not forget that, at the present time at least, the majority of retirees get as much as 50 percent or 60 percent of their total retirement income from Social Security, which is fully indexed to CPI with no coinsurance and no deductible. The ravages of first dollar, fully indexing of Social Security is certainly one of the reasons private sponsors are avoiding commitments in this area.

There is another dimension to inflation protection, the surface of which is just being scratched. Many participants today have resources from thrift and profit sharing plans that they would be willing to apply to the inflation protection problem, but there is little or no structure to assist them in doing so. Why shouldn't the employer, through the defined benefit plan, accept a voluntary transfer of employee money so as to facilitate the employee protecting himself? This approach has the added advantage of allowing the participant to set things like a deductible and coinsurance factors at a level with which he or she is personally comfortable. The risk-sensitive soul may apply enough assets to establish a very low deductible and little coinsurance. The risk-taker may not utilize the facility at all.

The option of the participant applying funds accumulated in a companion defined contribution plan may be supplemented by a formal retirement option which permits the direct restructuring of the defined benefit payments.

Let's discuss a practical example. What about a defined benefit plan that offered to:

1) index annuities by 50 percent of the CPI in excess of 6 percent,

2) permit the 6 percent deductible limit be reduced by 1 percent for either:
   a) a reduction of 2 percent in the otherwise payable annuity
   b) the application of a certain dollar amount of participant resources

3) permit the participants to purchase additional units of coverage in excess of the basic 50 percent level

Let it be understood that this is an example designed to stimulate discussion. Do not test any implied cost-relationships too strenuously.

All of the foregoing is said to make one or two points. There is room for creative plan design to deliver more inflation protection on a permanent basis than is now the norm. If anyone begins experimenting in this area, however, bear one fact in mind - some level of employer-provided subsidy will be a necessary ingredient in any scheme that requires the application of participant resources, whether it is savings plan proceeds or a reduction in normal benefits. Do not fight human nature on this point.

An employee-pay-all inflation option offers the participant nothing more that he presently has. I would be very surprised to see any substantial continued participation in programs that do not involve some commitments of employer funds.

That is a little potpourri of topics, my own thoughts, looking forward rather than backwards. At this point, Ed is going to see how much action he can get out of you people.

MR. FARB: I just have a couple of comments based on what the panel has presented here. In discussing this subject before coming here this morning, the comment was made that the selection of retirement assumptions for earlier or postponed retirement is extremely difficult because of many of the outside forces. One of the forces coming up in the future relates back to the three-legged stool of providing retirement income from Social Security, the employer, and employee savings. Well, in the 1970's, employee savings were zero because of high inflation. But, the recent tax acts are bringing back the three-legged stool. IRA's are now available to everyone. Thrift plans started in the early 70's in a lot of companies are becoming more mature, and now, thanks to the tax incentives, many companies will be establishing 401(k) plans, the cash or deferred plans, in 1982/1983. Some of this savings will have to mature, but these plans will also start impacting retirement and providing a lot of employee savings. I agree with Tom the key to retirement is the economics of the issue. Would anyone like to ask any questions of the panel?

MR. SHELDON WISHNICK: I have a question for Tom. It seems to me that retirees would be most concerned about the runaway type of inflation we have had in recent years. Under those conditions, under any approach you have, the employers will probably be paying the same amount whether they are covering the first 3 percent of inflation or some portion of the excess. I doubt that any employer is willing to pay more than a 4 percent, 5 percent, or 6 percent adjustment, and no matter how you structure the program, the retiree would still be collecting the same piece from the employer whether you call it coverage of the first portion of inflation or some excess form of coverage. Do you see employers being willing to cover more of the burden if it is structured with a deductible approach rather than with first dollar approach?

MR. MALLOY: A significant effort is going to be involved for the actuary in explaining to the employer what is actually going on. Right now, many employers, particularly those with large plans having matured retired groups, are either financing their ad hoc increases or financing part of their current costs with the excess investment returns for retired life reserves that are built up in the plan.

You can demonstrate to an employer that he can finance a deductible program at 6 percent. If the current actuarial valuation assumption is 6 percent, he can finance a 6 percent deductible COLA by locking off his funds even, and putting them into short term obligations. 1970 to 1980 provided almost a direct correlation between average annual short term rates (3-6 month governments) and the CPI, measured on an annual basis. There need not be any risk beyond the investment strategy of keeping funds attributable to retirees in short term obligations and then distributing the excess interest to finance the deductible. There is no cost to the employer if that deductible is set at the assumption he is using to value those reserves. Now, that does not mean it is a free lunch. What the employer is giving up is the excess interest on those retired reserves that he is currently gaining. What he is also giving up, if he wants to do it and has a well run plan with positive cash flows, is the investment opportunity of putting those funds into something that might return more than short-term obligations, although there is a risk element and, in some years, returns could be less.

MR. JAMES A. BEIRNE: I work for the New York City Employees' Retirement Systems. I would like to compare my experience with public plans versus your experience with private plans. The first thing I would like to ask the panel is: there used to be a concept that actuarial gains from interest accrued to the benefit of the employer to reduce his contributions, but in public plans, I notice a new trend. Because of inflation, many public plans are experiencing actuarial gains from interest. Union representatives on the boards of trustees then come in and say these gains should accrue to the retirees since basically it is the assets supporting the retirees that are earning these excess interest earnings. The next step is to say: let's use those excess interest earnings, not to reduce employer cost, but to provide the cost-of-living supplementation. This is happening in public plans. Is this also happening in private plans?

MR. FARB: I do not think the employees have representation enough to influence that fact. In many of the plans the excess interest earnings are used to offset salary losses that have occurred because of the impact of high inflation. I have been involved with a couple of corporations where we have tried to set a policy of level expense, anticipating excess interest to pay for future ad hoc cost-of-living increases. Thus, we were using it to pre-fund ad hoc cost-of-living increases. In the only situation of this kind that I have been involved, the client has indicated to me that after two or three years of this policy; maybe they are not going to pay a COL increase for another two or three years. My question to them was why have the policy then? They need the money now. Does anybody else have a comment on that?

MR. HICKEY: Yes, with respect to large employers who have single employer, collectively bargained plans, the usual practice there is to just negotiate benefits. Any interest gains that accrued were used to reduce the cost of the plan, depending on how they are amortized.

These gains can also impact the cost of various changes to the plan. There can be indirect pressure from the union side for more liberal benefits because the cost parameters have been changed by the gains that have accrued.

MR. BEIRNE: I would like to discuss another trend that I see with public pension plans, and I would like to know if it is true with private pension plans. Let me discuss option factors. The particular public plans that I work for have option factors which provide actuarial gains to the plan. In other words, these factors were written into the plan at old interest rates so it is expensive for the employees to elect options like 100 percent J&S or 50 percent J&S. But this still being the case, we have a lot of people who elect the options. Of course, we find out that the people who elect the options are those who get the bigger benefits to begin with. We find out that service retirees elect the options more frequently than the disability retirees. We find out the older employees elect the options, as opposed to the younger employees. As you know, in public service, the uniformed people like police and firemen have relatively early retirement ages and usually do not elect options. We also find that males elect options as opposed to females. Do these trends also hold for private plans?

MR. FARB: Let me ask you a question. Why don't the factors get changed when the funding interest rate is changed?

MR. BEIRNE: In the particular public plans I work for, they are providing very liberal benefits and do not want to liberalize them anymore at this point. Maybe in 1984 we will have to liberalize them. Is there a belief in private industry that you have to have actuarial equivalence?

MR. FARB: Yes, we try and maintain actuarial equivalence which would mean changing the factors, especially as the interest rates are rising. If you do not change the factors, the joint and survivor factors will cause gains to the fund. Years ago, a lot of private plans went for flat early retirement factors to improve communications by having people better understand the adjustments being made. But, as the interest rates go up,

those factors are providing somewhat of a subsidy. It is interesting to note, but I would say that most factors in private plans would move as the interest rate goes up, unless possibly they were negotiated and you did not want to go back to the union. Do you have a further comment?

MR. MALLOY: No, I would just make the point that to the extent that I have probed it in the plans I run myself, many of the phenomena you described do occur. The individual with the higher level of income is more likely to elect an optional form of annuity. I think the facts of the matter are that the male is more likely to use the option and the female is somewhat tied into that same issue. Most plans today, because of history, will have the higher annuity level going to the males.

I think that phenomenon and the others you have touched on are basically individual economic decisions. If you get a larger annuity, you are more inclined to see the advantage in an optional form because you have the resources to finance it through an option. If you do not have a large annuity, then you are going to take care of short term problems first and draw down as much as you can as quickly as you can.

Public employees eligible for early retirement, particularly the uniformed services, are not unlike the early retirements I see. Many early retirements, particularly when they are taken before Social Security is accessible, are retirements from a corporation or a particular employment situation and are not retirements from the work force. These employees go into alternate or secondary employment, and the option factor, the protection provided by an optional form, is not an active consideration.

MR. BEIRNE: One last item I would like to touch on. You mention early retirement incentives such as bonuses. Have any of the panel had experiences where a corporation has been able to induce large numbers of people to retire and found it was economically possible by giving bonuses?

MR. HICKEY: I can think of two of our large corporate clients who have instituted what is called an "early retirement window". If an early retirement takes place within a specified period of a year and a half to two years, there are special supplements or bonuses which are paid either from the qualified plan or in a program apart from the qualified plan. It has proven to be successful and has generated a lot of activity. They have accomplished the goal of getting a large block of employees to retire.

MR. MALLOY: This is an area where any employer, public or private, ought to be concerned about merely mimicking or matching what somebody else did because it was good for them. I have been involved in the actual design, pricing and implementation of at least two of these. The considerations involve the total overall benefits inuring to the employer. The employer looks at it, or should look at it, as the total cost of the transaction.

I was involved with a private corporation that is in the service industry, that stimulated additional retirement for people ages 60 to 65. This corporation was wrestling with its own demographic profile. They had a disproportionate number of middle management in age 55 to 60 range. They

wanted a certain percentage of these out of the organization to free up the lines of advancement for its younger professional staff. They had a business purpose being served by doing this and actually went through the numbers as to the additional cost of the early retirement subsidy versus the differentials in compensation that would be worked through the organization as the higher-paid person retired and was replaced by somebody that would not get to that pay range for three, four, or five years.

I think there has to be a business purpose served beyond the mechanics of the pension plan, and you better draw the employer in to make his own evaluation of business purpose and cost effectiveness.

As another example, the same kind of program was used in our own company on an informal basis outside the plan in the early 1960's. This was a case of technological displacement. As they moved on to large high-speed computers, the insurance industry in the early 1960's had a lot of older clerks with no place to go. They were replaced by the computer. Out of a sense of obligation to the individuals and to the economics, it was best all around to provide some sort of additional early retirement supplementation to move those people out. It was certainly less expensive than the corporation trying to enter into some type of retraining program.

MR. FARB: I can give you an example of a company in which the program was too rich and too many people went out. The company provided a full benefit after age 55 (there may have been a ten-year service requirement). A $500 monthly supplement was provided payable not just to age 62, but to age 65. The individual at 62 was in the position of getting $500 a month from the company plus $500 or $600 a month from Social Secuirty plus his pension. There were a lot of long service employees and too many people left. They lost a lot of skilled people.

MR. MALLOY: It can be overdone and that is why it takes a lot of hard work to put a program together. I have watched two companies in the same industry trying to achieve the same thing. One achieved its goals in terms of the percentage they wanted to move out. The other company provided a subsidy of something like double the first. They overreacted, and too many people left.

Do not forget, particularly in the early retirement area, if you are trying to stimulate people to leave, the good ones are the ones who are going to take the opportunity. They do so for all sorts of reasons, including their own self-confidence of getting a second job.

MR. GOSS: In Social Security last year we had a fairly effective, although I think unintended, occurrence when the Administration announced its intention to pursue a policy that would lower the 80 percent benefit payable at 62, dropping it to perhaps 55 percent. At that time, filings for retirement benefits approximately doubled for a short period of time.

MR. ROBERT J. MYERS: To supplement what Steve said, which is quite true, people did rush in and file. In fact, many filed and did not really need to, because the proposal was not going to be effective except for people who reach age 62 after 1981. A lot of people thought it was going to be effective in 1982 regardless of their age when they retired.

On another point, in discussing the automatic COLA increases under private pension plans, it has been discussed that one approach is to use the excess interest over the valuation rate of, say, 6 percent. I wonder why the valuation interest rate should not be a lower rate, such as a real rate of return like 2 percent or 3 percent. I realize that this makes a higher cost to a pension plan, but perhaps the sponsor of the plan should realize that the costs of the plan are really higher than they seem when you take an interest rate of 6 percent. To look at it another way, if you use a valuation interest rate of 6 percent, you are saying the employee is really paying the whole cost of the first 3 percent or 4 percent of inflation. Perhaps you ought to give the employees an option to take an actuarial equivalent pension on an increasing basis of 3 percent or 4 percent per year. Of course, it looks like a pretty sharp cut in the initial benefits, but at least they would have a chance to remain equal with inflation.

When you come to defined contribution plans like, say, TIAA/CREF or some church denominational plans that are on this basis, all of the excess interest is always given to the participants, who have a better chance of remaining equal or not falling too far behind the cost of living.

Just one other point, if the retirement age for full benefits under Social Security is raised, as to which, as Steve Goss has pointed out, there have been a number of proposals, it seems to me that there is a certain responsibility that rests on management to likewise raise the age for private pension plans. The arguments for moving up the age are not so much to pull down the cost of the Social Security program. That is rather a sort of "cart before the horse" point. The age would be raised because people are living longer and that in turn increases the costs and produces the actuarial imbalance. It seems to me that it would be very unfair if private pension plans just filled in the gap so that the proportion of the population that has private pension plans, generally the better-paid portion of the population, would have the gap filled in by the private pension plan and that lower-income people would have to work to an older age.

MR. MALLOY: I agree, particularly with your last remarks. I view this as a continuing problem, not really a problem, but a tension, between what I would call macro-and micro-policy.

Macro-policy (national level) involves the retention of the older work group and the stimulation of their continued employment. This is something that ought to be happening not only for their own well being, as you can get many people to comment on, but because retirement should be later if people are vital and capable of productive work.

Social Security with its earnings test actually is, as Steve commented, a measure of prevalence of retirement, providing benefits when somebody withdraws from the work force. The private plan at this time is constrained from doing that. You cannot suspend benefits unless the individual returns to you. So private pension plan sponsors, rightly or wrongly, although influenced by national policy needs, are going to be far more stimulated by their own business needs for a long time to come. That is something that bears discussion, but it is going to take a long time for a private plan sponsor to get beyond the short-term business interest that he is serving. Using the pension plan to manipulate the demographic profile of his own work force with things such as special bonus programs, etc., I am inclined to agree with you, Bob, that the private plan ought to move along. I have difficulty seeing it happen too soon or too rapidly.

MR. FARB: I would also agree. I had one very large company just recently adopt a further liberalization of an early retirement provision, moving it from a full benefit age 62 down to age 60. In light of the fact that very few people are taking it now, the company just hopes that because it is there, people will take it. The basic reason being they are trying to provide openings for younger people by encouraging older people to retire.

MR. K. ERIC FREDEN: Along the lines of what you just talked about, I have a client that has been gradually liberalizing their early retirement reduction factors. They are down to only a 2 percent reduction between 65 and 62 and are talking about eliminating it completely. But, it is also a plan based on final 3-year average earnings, and it is a pretty high-paid group. I am trying to anticipate what kind of an impact, if any, this is going to have. Will people still want to work beyond 62, even though there is no early retirement reduction in this plan? I was wondering if anyone else had run into this kind of situation. The group is relatively young, and there have been very few retirements up to this point on which to base an experience analysis.

MR. MALLOY: I have a sample of one or two plans with good, subsidized early retirement, something close to unreduced benefits at 62 for the 1976 to 1978 period where there was availability of second employment, unemployment was not as high and inflation was not like it has been in the last couple of years. My current feel from the plans that I work with, unreduced at 62 will generate something on the order of 30 percent, 40 percent, 50 percent early retirement utilization. Somewhere in that range, with the availability of second employment and things like that fine tuning the percentage. There is another point, you have to look at what experience you are getting now, because another element in that early retirement decision that we are not going to be able to influence a great deal is back-door peer pressure. If people are taking early retirement now and a subsidy comes along, it is going to stimulate the phenomena and you have workers, particularly in a large corporation, who make some of their retirement decision based on what Joe did last year. He has worked with the guy for 30 years and Joe went out at 62. He thinks to himself: Joe was kind of smart, and I am going to do it too. Well, it may be a poor evaluation of his individual situation, but suddenly it is the thing to do and it becomes part of the corporate culture.

MR. FARB: I would say also that below age 62 some of the statistics I have seen on some of our companies indicate that you have to look at: 1) is it a decent plan and 2) what length of service do the potential retirees have? The longer service people will show a trend. They will take early retirement only because they have the higher benefits. The shorter service people will not take it unless it is the type of company where people have come from other companies and are just putting in their last ten years there. But, generally, it would be the people with 25 or 30 years of experience who would tend to take it. Other than that they may not take it unless the economy changes a little further down the road.