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Session 10 Seminar
Addressing the Financial Risks from Retirement Systems Seminar: Putting Retirement System Risk into Context

Track: Pension

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Panelists: JAMES C. HICKMAN
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Summary: Before ERISA and Statement of Financial Accounting Standards (SFAS) 87, various provincial legislation and Canadian Institute of Chartered Accountants (CICA) 3461, there was little financial regulation of defined-benefit (DB) pension plans. An actuary's advice to clients on funding and other aspects of plan financing was based on the costs and risks inherent in the plans themselves. With the passage of ERISA and parallel legislation in Canada, plan funding, in most cases, became a matter of meeting minimum funding standards without exceeding tax-deductible limits. The advent of SFAS 87 and CICA 3461 set similar but different standards for reporting pension-plan liability and expense on the company books.

Over the last 30 years, the inherent risks that plan sponsors face from their pension plans have changed. Thirty years ago, DB plans were relatively small in relationship to the plan sponsor's core business of sponsoring government's infrastructure. A graying baby boom population, increased longevity and contraction of old-line industries have combined to increase the cost and financial risk engendered by pension plans. Once small fringe benefits, retirement plans have grown to become substantial financial commitments with accompanying risks. Many plan sponsors have reacted by terminating or freezing plans and moving to defined-contribution (DC) plans. In the meantime, the tight regulatory environment for private plans has led sponsors to lose sight of these changes in the bustle of compliance with myriad complex and obscure rules.

Actuaries must help plan sponsors get back to the basics: the costs and risks inherent in DB and DC plans before the accumulated overlay of regulation. From this perspective, it is possible to address more cogently some fundamental

questions about DB and DC plans: Is eliminating DB plans the only possible solution? Are DC plans the answer? What can actuaries do to help corporate plan sponsors manage the risk of both of these types of pension plans? How can these risks be balanced to manage needs of sponsors, shareholders, plan participants, taxpayers and guaranty agencies? And what happens to a society in which DB plans disappear? Do DB plans still provide other benefits to plan sponsors and overall society to make them worth the risk?

Addressing the Financial Risks from Retirement Systems seminar is designed to help actuaries better measure, discuss, manage and mitigate risks that pension plans bring to their sponsoring organizations.

The session provides context for issues of retirement risk. One examination will be historical—how things have changed since funding rules and accounting rules were set in the 1970s and 1980s. We will focus on the risks to the plan sponsor and consider complimentary and competing risks faced by employees, shareholders, management fiduciaries and guaranty agencies. This session sets the stage for issues and ideas to be discussed throughout the seminar.

MS. ANNA M. RAPPAPORT: We're going to have a series of related sessions on risk and will provide a broad context and overview. I've been a pension actuary for many years. I am past-president of the SOA, and I currently chair the Committee on Post-Retirement Needs and Risks. I want to ask my panelists to introduce themselves.

MS. PHYLLIS BORZI: I was the benefits counsel for the House Labor Committee in the U.S. House of Representatives for 16 years and worked on many bills. I worked on all of the amendments to ERISA up through 1995. It's hard for me to believe that I've been in the private sector for 10 years. Now, I split my time. I'm a practicing lawyer at O'Donahue & O'Donahue, which is a Washington, D.C., law firm. I represent primarily multi-employer plans, collectively bargained plans. I'm also a research professor of health policy in the School of Public Health at George Washington University Medical Center. I continue to work in the pension area, but primarily have been doing health for the past few years.

MR. JAMES C. HICKMAN: Much of my background will be built in naturally to what I say. I'm an emeritus professor and dean at the University of Wisconsin, Madison. I've been a Fellow of the SOA since 1958.

MS. RAPPAPORT: This will be an interactive discussion with a series of questions. The panel members will interact with each other. Let's start with the first question. Mr. Hickman, why is historical context so important?

MR. HICKMAN: No. 1, the study of history is important. No. 2, the problem of income for the elderly always has been with us, and there are lessons to be learned from the past. No. 3, retirement systems are part of a general culture. They are not divorced from that culture. To understand what is happening now and what has happened in the past, you need the big picture.

Proposition No. 1: History is important. Whenever you can't think of anything to say yourself, turn to the masters. There is no greater master than Abraham Lincoln. Lincoln said, "If we would first know where we are and whither we are tending, we could better judge what to do and how to do it." He stated that at the Republican State Convention in Illinois in 1858. That is good advice. Also, from the Spanish-American philosopher who served for some time at Harvard, Georges Santayana, "Those who would not remember the past are condemned to relive it." Those of you who read history may have seen that in the foreword of the book, *The Rise and Fall of the Third Reich*.

History is important. I don't believe that I will need to develop much more on that. I would like, however, to say one other thing that gives me, I hope, competence here. About 30 years ago, we had a vice president of the United States named Spiro Agnew. I never thought very much of him, especially when it became public that he cheated on his income tax and my opinion of him dropped still further. Nonetheless, you shouldn't necessarily forget everything that a guy says or does. One time, Spiro Agnew said that anyone who speaks in public should make a clear statement of their competence to address the issue at hand. My competence to address history and retirement is the fact that I became a Fellow in 1958, which is a long time ago, and I do get a pension, thank goodness.

My next assignment is to support the proposition that the question and organization of old-age income always has been with us. You will find hints of it in the scriptures. Remember Thomas Paine? He was George Washington's propaganda minister. After the American Revolution, he went to England, where, in 1791, he wrote a famous monograph called *The Rights of Man*, defending the French Revolution. What you may not know is that the last chapter of *The Rights of Man* is, to the best of my knowledge, the first proposal for a social-insurance system, along with a cost estimate. And for those of you who are even younger than I, I think that Paine's words may distress you. He divides age into two classes. First, there is the approach of old age, beginning at 50. Secondly, old age commencing at 60. At 50, though the mental facilities of man are in full vigor and his judgment is better than at any preceding date, the bodily powers are on the decline. He cannot bear the same quality of fatigue as in an earlier period. He begins to earn less and is less capable of enduring the wind and weather. In those retired employments for which much sight is required, he feels like an old horse beginning to turn adrift. Paine goes beyond that and actually proposes a benefit system. It was a pay-as-you-go current-cost system.

My first proposition is that the study of history is important. The second proposition is that old-age income issues always have been with us. My third proposition is that retirement systems depend upon the values culture on which they are based. As we look back, there are certain turning points, which we will discuss in part later. As we transited from an agricultural to industrial system, there were fundamental changes in how we took care of old-age income. Are we in another one of those great transition points today?

MS. RAPPAPORT: As we go through this exploration, it is important to keep in mind that there are different stakeholders. We might be representing different stakeholders at different times, but, often, we're representing primarily one stakeholder. For many of us, it's the plan sponsor. But, in addition to this plan sponsor (the corporation), employees are major stakeholders, and we should never forget them. The shareholders of our companies are stakeholders, which may be the same as management, but not always entirely. The policy community is a stakeholder of ours. The public at-large includes stakeholders.

One of the propositions that I think that some of us in the United States have failed to remember, but is so critical, is that having an organized retirement system is extremely important to society. If we don't have one, there will be consequences to society. I would like for all of us to focus on that as we think about the community. Deviations from systems can have big impacts on all of us.

MR. HICKMAN: It is the study of risk that holds us together as actuaries. Without it, we would not be. Because I like to study history, I'd like to quote Harold Cramer, the great Swedish probabilist, statistician and actuary of the 20th century. Cramer said, “The object of the theory of risk is to provide an analysis of fluctuations in a business and to discuss various means of protecting against their inconvenient effects.” You, in pensions, are aware of deviations of expected results and of their inconvenient and perhaps disastrous consequences. That makes you an actuary. And the study of those, developing a theory, a way of studying those deviations, is what we are all about.

There is a taxonomy in enterprise-risk management—including hazard risk, financial risk, operational risk and strategic risk. We primarily will talk about strategic risk, deviations from expected results. Although, certainly, you are acquainted with hazard risk, those external economic or social events that may change the environment in which you operate.

MS. RAPPAPORT: We want to move ahead in our exploration of history and talk about the roots of formal systems for retirement and how they shift and distribute risk taking between individuals and families.

MR. HICKMAN: One of the great shifts that is commemorated, both in literature and history, is that the world became industrialized. Let's go back even further. In the feudal age, old-age retirement income was bound up with a series of allegiances and traditions that involved the peasants, the nobles and the church. It was a great, encompassing system. The Renaissance was a period of individualism. If you could read Shakespeare, there were what were called “maintenance agreements.” One generation would make an agreement with the next to transfer power or property in return for maintenance. (King Lear is an example of when it didn't work.) By the way, they were indexed, because most of those agreements (and they were legal documents) called for benefits in forms of so much wheat or wool, etc. There was no money. Out of that grew the agricultural society that dominated Europe and the United States. In the middle of the 19th century came the Industrial Revolution. It was a profound movement. Those of you who read Dickens are aware of the degradation and poverty that was characteristic in the United States and the United Kingdom at that time.

Out of that period came political reformers, such as Karl Marx and Friedrich Engels. But there also came the great industrial giants, the great labor unions and the shift of retirement responsibility from individuals and families, largely, to government and to employers, which, judging from history, would have been a strange shift. Of course, it had profound impacts and in many ways was the beginning of the world in which most of us have spent our lives.

MS. RAPPAPORT: We'd like to focus on some of the major events affecting retirement-risk allocations and think about this in a longer-term perspective in our careers.

MS. BORZI: I'd like to set the stage. You can't think about retirement and retirement security with a narrow focus. You have to think more broadly, because it's clear that when we talk about retirement-income security, the old, proverbial, three-legged stool should have many more legs to it than just three. Obviously, Social Security and employer-sponsored pensions and savings are the three that people mostly talk about. In today's world, you have to add income, because many people will rely on supplemental income through retirement. And you certainly have to talk about health care. In putting together the milestones, you'll see that there's a mix of these various components.

You could start way back in the 1920s with the Revenue Act. For most of us, the biggest formal step forward that we're aware of, in terms of retirement security, was the creation of Social Security. That was followed closely after World War II with the wage and price controls that gave rise to the growth of pension plans. Because, of course, the problem was that you couldn't increase wages. People had to figure out another way to compensate employees, so benefits really began to explode in that context.

Then we had the creation of the second great pillar of the social-insurance system, which was Medicare and Medicaid, created in the same law in the 1960s. Then, we moved forward to the creation of ERISA. ERISA was a natural outcome of these other approaches to retirement security, the others focusing on retirement generally. The private-sector employer-sponsored plans began to focus on benefits for actives in the context of wage and price controls. We had the establishment of the Pension Benefit Guaranty Corporation (PBGC), which I'll talk about later on.

If you look at the current system of employer-sponsored pension plans, the Revenue Act of 1978, and the creation of the 401(k)s, it's really hard to imagine that they were only created in 1978. It seems as though they've been around forever. In a speech that I recently gave at the Pension Research Council, I pointed out, somewhat ironically, that the only section of the Internal Revenue Code that ordinary Americans know is 401(k). They may not know that it's a section of the code, but it's certainly a section that they know. It's probably the only part of the tax code that anybody ever cites with approval. It's hard to believe that 401(k)s came into the law in 1978. Since then, Congress has created a variety of other tools for retirement-income savings, some group tools, some, in more recent years, focusing on individual tools. I think, in terms of a 401(k) evolution, it's quite important to think about what a transformation we've seen in the benefits area with respect to 401(k)s.

I will use some Employee Benefit Research Institute (EBRI) numbers. I thought it was interesting to look at a recent EBRI report that focused on the number of individuals enrolled in employer-sponsored plans, as a percentage of how many are in DB plans, how many are in DC plans and how many are in both. In 1992, 40 percent of all those covered under employer-sponsored plans were in DB plans only. In 2001 that number had dropped to 19.5 percent, a huge drop. In 1992, 37.5 percent of people enrolled in employer plans were in DC plans only. And 57.7 percent of all covered individuals now are in DC-only plans—again, that is a huge shift.

I'm one of those people who thinks that neither DB nor DC is the silver bullet for retirement, because people need different kinds of benefits as they go through their careers. I used to say, when I worked on Capitol Hill, if I ever had a vote, this is what I'd vote for: everybody is covered under both types of plans. But, interestingly enough, the number of people who have been covered under both types of plans has stayed perfectly constant at 22 percent for that decade, 1992 to 2001. I think that's important. In terms of DC plans, more than 75 percent of them are 401(k) plans. And more than 80 percent of those 401(k) plans are self-directed plans. That has a series of very important implications with respect to risk allocation, which we will talk about.

Other milestones include the rise in technology that enabled the 401(k) record keepers to give people daily valuations and allow them to take control of their investments. We can't overlook what our colleagues in the accounting industry have done—the Financial Accounting Standards Board (FASB) 86, 87 and the ever-popular 106 (post-employment retirement benefits). I, personally, think that the rise in the number of DB plans that now are offering lump-sum distributions is a troubling development, but reasonable people can differ. That's an important trend that one must be aware of.

On the medical side, it's undisputed that medical advances, increases in technology, increases in longevity, all of those important advances (which from the point of view of society and individuals is probably a good thing) have a dramatic impact on the way that all of our systems operate—whether they be the public programs (Social Security and Medicare) or the private programs. They put greater pressure, financially, on these systems to perform for a greater period of time.

Finally, there is a "tsunami-type" move from the notion that group arrangements are the way to go as the most efficient and effective way to enable people to have savings in retirement or to have adequate retirement income in retirement, to this shift toward individual approaches to savings at the expense of the group—not generally supplemental to the group, as most of us in the early years thought that it was going to be. One can hardly read the newspapers today without the growing realization on the part of the American people that major household-name companies could cancel their benefits, whether they be retiree health benefits or, in the case of the most splashy cancellation, the United Airlines case, the pension benefits. The retirement deal that workers and retirees thought that they had with their employers legally could be thrown away completely.

MR. HICKMAN: As a resident old-timer, I'd like to make two points. No. 1, I'd like to take you back to August 14, 1935, when Franklin Delano Roosevelt signed Social Security. I may be the only one in the room who can remember with some vivid recollection what the Great Depression was like. In my hometown, there were five banks at the beginning of the Great Depression. There was one at the end. One-third of the banks in America closed. Unemployment was up to 25 to 30 percent. It's around 5 and 6 percent now. It was a remarkable and terrible time.

This is another indication of how society changed. Do you remember the first female member of a U.S. Cabinet: Frances Perkins? Today, of course, female participation in all of business, including the Cabinet of the United States, is quite common. Ms. Perkins was the chairman of the Committee on Economic Security that developed the enormous Social Security Act called the "Big Bill." Although she started life as a romance writer, she became a social worker and was not well known for her devotion to fashion. (In fact, one of her critics said that her dresses looked like they had been designed by the Bureau of Standards.)

The second point that I'd like to come to is, in the 1930s, many of us thought that United States Steel, General Motors, Pennsylvania Railroad, etc., were the eternal institutions of mankind, like the British monarchy and the Catholic Church. They proved not to be that solid. And there is movement toward more individual benefits. Many of you have studied portfolio theory, in which you talk about investments and both the mean return and the variability of the return. What may be happening is that, in order to achieve economic growth (which we have had, basically), we are returning to a much more entrepreneurial, churning aggregate of firms, rather than some of these industrial giants with the, perhaps, unfortunate consequence that although mean income is going up, the variance also has gone up.

There may be some great economic principle that, just as an investment allocation, there is a tradeoff between mean and variability. And by choosing a mean, we have to have, as one economist said, “the creative destruction of capitalism.” That creates greater variability. Are we at another one of those great turning points? Are we moving into the area in which we, in order to get a higher mean, are willing to tolerate more individual variability?

MS. RAPPAPORT: When we describe the environment, we also describe globalization and offshore jobs. Globalization is very much a part of the environment today. One of the key things about globalization is that, if we exclude some of the health care companies, most of the big companies that were American companies, some years ago, now have customers overseas, operations overseas, owners overseas, or all of those. The labor market is increasingly a global labor market. Ms. Borzi talked about the collapse of “The Deal.” The competitive environment has changed so much that what customers are willing and expected to support today often is not that old deal.

I'd like to move us into a quick visit to demographic issues, because they're very much part of the landscape. On the other hand, while we thought that many of you hadn't thought about some of this history recently, most of us probably have dealt with the demographic issues every day. We're continuing to live longer than we did before, and to be healthy longer. There's good evidence about that. The number of older people at different years is a function also of births.

We all have heard about how the baby boom is just getting to retirement ages. Mr. Hickman talked about the role of women. One of my big issues is retirement security for women. Women live longer than men; we all know that. And while they have entered the labor force and there are many more of us in the room than there would have been 50 years ago, women still have very different life histories than men. If we look at the people who are reaching Social-Security age today (and this'll be true for a long time in the future), in studying their histories, we find that they have fewer years of covered employment, on average. This isn't going to change. They have lower earnings histories, because they have different employment histories. So they have different results.

If we had decided to show you a graphic, the graphic that I would have picked would be one that shows the number of people at older ages split by age group and by sex. If we look at the over-75 group, there are many more women than men. And of those women, many of them are widows. Many of them are alone. So many women will spend their last years alone either as widows, single women or divorced. We need to pay attention to how the systems will work for them and what their spousal rights are. This is a Social-Security issue, a private issue.

I want to mention one more demographic trend: fertility rates. In the United States, we're around two. Canada is a bit lower than that. Germany, Japan, Spain and Italy are in the 1, 1.2 range. That is well below replacement. In the Social

Security technical panel that I served on, one of our big questions was: Will the United States become like Europe? Our group decided that it wouldn't, that the fertility rates were likely to stay where they are. But in terms of thinking about these financial-security systems and their long-term future, this combination of increasing life spans and the fertility pictures is critical.

MR. HICKMAN: Kenneth Boulding was a great economist. He was a Quaker. Unfortunately, he had a serious speech impediment. But he was a very perceptive observer of the passing parade. Boulding said some years ago that the two things that frightened him the most in the sense that they would destroy society were: No. 1, all-out nuclear war and, No. 2, having the life expectancy jump to 150. If you blow everything up, your society is gone. Having life expectancy jump to 150—think of how much of life is tailored to the passing of the generations, how we organize education, how we organize leadership, how we organize the passing of property. Suddenly, to have that change would have a big impact on society. Watch demographics. They are changing. We aren't quite sure if there's an upper bound on that life expectancy yet, but it is having a big impact on what was the normal progression of society. The fact of delayed marriages and delayed childbearing of the current generation compared to my generation is one example of that fundamental social change. I don't think that Boulding—who, by the way, passed away in 1994—needs to fear a sudden dramatic jump of life expectancy to 150, but it does grab your attention.

MS. BORZI: I usually watch "The Today Show." Some days it's frightening to see how many people over the age of 100 Willard Scott congratulates.

MS. RAPPAPORT: I would like to mention that the SOA, together with about 20 other organizations, held a symposium recently on living to 100 and beyond. I believe that they'll be continued in a series. It pulled researchers from a number of countries into the issue of old-age mortality, trying to understand both what's happening with mortality and the challenges involved in studying it and collecting the data. One of the problems, when you try to figure out how many people are actually living to very old ages, is that it isn't easy to count them or to confirm how old they really are.

MS. BORZI: Let me, in a nutshell, talk about the role of organized labor. Most people credit organized labor as the muscle behind the movement toward employer-sponsored plans. As I mentioned before, with the wage and price controls that came into existence after World War II, people were struggling for ways to compensate employees without actually giving them pay. So the notion of providing benefits in lieu of pay for actives was very attractive. It wasn't just in the private sector. We see, currently, the state and local governments doing the same thing. We also see state and local governments retrenching, as taxpayers begin to realize how expensive these promises are. We see this phenomenon in the private sector.

The labor unions, particularly in the steel and auto industry, were really the force behind the creation of the PBGC, initially, and Title IV, when ERISA was passed. I think that everybody who knows the ERISA story knows the story of Studebaker. The thing that people don't know about Studebaker is that the people didn't get nothing. They got something. They got probably, roughly, what the United Air Lines, Inc., pilots, machinists and flight attendants are going to get, which is about half of the benefits that they've earned. The Studebaker situation really highlighted the lack of a safety net in the private sector. So the unions played an important role.

It's clear that despite the dramatic reduction in the number of the unionized workforces (just 12.7 percent of the population is unionized), the commitment in the unionized sector to DB plans and to employer-sponsored plans, generally, is there. Labor saw this and continues to see this as a risk-sharing proposition on the part of the employees through deferred compensation, because that's what this really is. Active workers are willing to forego wages in return for benefits in retirement. I think that that probably explains the reason that so many workers (whether they're unionized or not) feel disappointed, betrayed and sold out by the current set of situations. In the DB plan, the tradeoff was rather clear. Deferred wages were what the employees gave up. In return, employers bore the investment risk for providing the benefits.

As we move to a system of DC plans largely replacing DB plans, workers and retirees see that they're still giving up wages. They're still bearing that risk, the financial risk, as active workers, for not getting the wages that they normally would get but for the deferral of their wages. But they, too, bear the risk in the DC arena. While some of them think that it's a wonderful idea, because they believe that they're smarter investors than their companies ever were, that perception may not be reality when you actually look at the numbers. I think that's important. They saw the employer-sponsored system as a system of shared risks and rewards.

The other point that I want to make in terms of the rise of the union sector refers to the kinds of plans that I represent. The multi-employer plan was a big part of the collective-bargaining segment. And now, given the reduction in the single-employer collective-bargaining plan, it continues to be a very important part of the system. It offers the opportunity for smaller employers who are signatory to a collective-bargaining agreement to band together and offer affordable insurance. I wrote an article that was published in the *University of Michigan Law Review*. I wrote that I saw, as the policy of the future, a series of regional multi-employer-like plans, not collective-bargaining, but plans in which small employers can contribute and individuals can contribute.

MS. RAPPAPORT: As we pull these strings together, some of them play out very differently in different countries. The role of organized labor is much greater in many European countries.

MR. HICKMAN: All of you can remember when one-third of the American labor force was organized. Now, it is roughly one-eighth. That's a big change. In the 1930s, I was in grade school. And even on the playground, you could grab any kid and ask them who the president of United Auto Workers was. Chances are, he could tell you that it was Walter Reuther. You could grab a kid and ask him who the president of United Steelworkers of America was. And he could probably tell you that it was John J. Murphy. And if you asked a child who the president of United Mine Workers of America was, everybody knew John L. Lewis. I'd be willing to bet that if I asked you who the president of American Federation of Labor-Congress of Industrial Organizations is today, I would not get a 100 percent response.

MS. BORZI: I work in the unionized sector, and I can't even identify the names of the major unions. I can name our clients; other unions, I can't.

MR. HICKMAN: The big point is that the political power of organized labor is a fraction of what it was in the 1930s, 1940s and 1950s. Whether that is simply a result of poor organization on their part or whether it's part of this new, dynamic, churning, labor-industrial environment, I'm not sure that I'm smart enough to tell you. But there's no question that those giants that marched the earth in earlier decades are not quite as large anymore.

MS. RAPPAPORT: If we think about organized labor as having been a major representative of the participant and that role having declined greatly, the increasing variance, and the distribution of wealth, one of our big questions is: Who will be the representative of the participant and the individual going forward? As I mentioned before, I worry about this with regard to the women who earned their rights to benefits, often, because of attachment to a family that they're no longer attached to when they need to collect the benefits.

We want to move on now to the role of the government.

MR. HICKMAN: We, blessedly, live in a republic in which the role of government ultimately is determined by us. It is conventional wisdom that by proper lobbying and advertising, and so on, a minority can influence government. They can, but the ultimate reality is that government represents the people, and what is driving the people ultimately will drive government. For example, one can speculate on what some of the governmental issues might be. Obviously, a drive toward DC rather than DB plans will create an economic downturn. Inevitably, the question of a deposit-insurance corporation for DC plans arises. Does Uncle Sam or another government have a responsibility, as we decided during the depression on bank deposits? Will the same pressure come up with respect to pension accumulations? Chances are, it will.

The overriding question for government, in my view, will be health care. In my retirement years, I give talks to Kiwanis clubs and high-school groups about some of these issues. I must say that I am optimistic that democracy is working, at least in rural Wisconsin on Social Security. I get good questions. Most people understand what the issues are. I am not so optimistic about health care. That political discussion is not going on. The dominant fiscal, social and political issue of the next few years will be the idle position that health care has taken in values. It formerly was seen as an ultimate good. How can we start a political discussion about not only the role of government in health care, but the role of health care in our sense of values? Luckily, we live in a democracy. We can influence what the government does. You can extrapolate from the trends as to what those inevitable issues are. Overriding them all is the value attached to health care and the division of responsibility for it.

MS. RAPPAPORT: I want to point out that there is a significant segment of the population for whom, whatever the government provides, that is all they get. For 40 percent of older women alone in the United States, basically, they get all of their money from government programs. For about one-third of the population over 65, men and women, again, money from government programs is all that they get. I recently was astounded to see a statistic that says that between 10 and 20 percent of the U.S. population is “unbanked.” They don't have any kind of bank or credit-union accounts. For many of those people, the safety-net programs provide their entire source of income. I think that it's critical for us to remember this as we think about various-legged stools. There's a large part of the population for whom the government leg provides their entire source of income. And in terms of our being out there in the public, the government role in some of these programs is a critical issue today. It's been moved from being a background issue to a forefront issue. We need to think about how that will affect the benefit delivery of various subsets of the population.

MS. BORZI: As the two of you were talking, I was thinking back to when I was very young in my first days of working on Capitol Hill. I was asked to write a speech for the then-chairman of the committee. Having worked for him for only two weeks, it wasn't like I had some deep understanding of his views. The topic was: What's the role of the government? I remember that I wrote that the role of government was to take care of those people who simply could not take care of themselves. But there was an equally important role of government to create structures and mechanisms to avoid having that group be very large. We must recognize that there were people in that first group for whom you can’t create do-it-yourself structures and assume that they would be able to take care of themselves.

MR. HICKMAN: I'd like to stress the almost-cosmic importance of Social Security as an institution of society and an element of stability. It was the climax achievement of the Roosevelt administration. If I ask you what the CCC is (and not care, custody and control), many of you would answer Civilian Conservation Corps. If I ask you what the AAA was (and not the American Academy of Actuaries, the American Accounting Association or asset-adequacy analysis), at least some would tell me the Agricultural Adjustment Act. But I'd be willing to bet you that if I asked you what the NRA was (and not the National Rifle Association or normal retirement age), you would not know. It is, by the way, the National Recovery Administration, the “Blue Buzzard” or the “Blue Eagle,” depending upon whether your family was Republican or Democrat. For 70 years, that act has survived.

It is as long from the surrender of Lee to Grant in 1865, from the enactment of Social Security to today. That gives you an idea that roughly half of the time since the American Civil War was characterized by the Social Security Act. It has been politically powerful, the third rail. And it has been successful by at least its stated goals. It has been an enormous pillar of stability in a government that's changed quite a bit. The issue in the future is its adaptation to “the new realities.” And I must say that I believe in a democracy, a republican form of government, and I don't like to have sharp divisions between races or genders. I don't want to create a sharp division between the elderly and the working population. That is one of the reasons that I am a fan of raising retirement ages, partial retirements, etc. I don't want the economic benefits of any group—be they racial, gender or age — to be sharply divided. That's not the way to have a democracy.

MS. RAPPAPORT: You just brought to mind another critical issue that we haven't mentioned so far, which is the change in the way that people are retiring. More people are retiring gradually. Maybe it's not as much of a change, maybe we just have more data about it, but many people are “retired” but still do some work. The question is how to build systems that accommodate various patterns of work for people as they begin to not want or not be able to work, or employers do not want them to work at the same level as previously.

I want to come back to one other point about the government role. Many of the meetings at this convention discuss Medicare, which has this major change taking place. This major ideological difference surrounding Medicare involves not just the changes that already have been adopted. Should it be a private-sector program versus one that's government run? The extent to which there'll be private sector involvement, there are huge questions about that. I think that they're parallel questions to those regarding Social Security. In a way, they're parallel questions to the questions about DB plans. The whole question about ownership society versus collective action gets us to the issue of role of the employer.

MS. BORZI: I think that, going forward, the jury is still out as to what the role of the employer might be in the provision of benefits. I mentioned this ownership society. If you look at recent trends, there seems to be a disfavoring of group arrangements in favor of individual arrangements. But it’s also perfectly clear that, given the strength of the current system, most people, regardless of what we do in the future, are going to get their benefits through the employer-sponsored system, one way or the other, whatever government programs that they are getting—Social Security or Medicare.

To bring this discussion back to the risk component that we started with, most experts categorize risks for retirement into four categories: the accumulation phase, the investment phase, risk in retirement (that's when you will retire), and the post-distribution management-asset concept (how you will manage not to outlive your assets in retirement). This brings us back to the demographic issues. Regardless of what kind of role employers play in the future, those latter two risks always will be present. There always will be the retirement risk; most people assume that they will work until normal retirement age. And yet, most people don't work until normal retirement age because of factors well beyond their control. Those factors might include their own medical condition or the medical condition of their family members, which causes them to have to leave the workforce before they had planned to. Or there could be corporate factors: globalization, mergers and acquisitions and corporate restructuring can cause people to lose their jobs before they reach retirement age.

Retirement-age issues and the question of post-distribution risk will be present no matter what you have, but particularly in a system that we now see, which is more DC- than DB-oriented. In a system of DB plans, people have more opportunity to take lump sums. Annuitization (which is a very important option that people have to deal with these risks) is playing a smaller role, unfortunately. That will be a problem in the future. I just want to point out that, while I still believe that employers will have important roles in the future, I see employers (even under the individual-ownership society approach) as being involved in the process, perhaps not as subsidizers, perhaps not as drivers of the choice, but as facilitators. There's no question that individuals need financial and administrative intermediaries to deal with the system, whether it's on the health side or on the investment side, the pension side.

MR. HICKMAN: I simply want to say that in a great, broad country like this, we never do anything that's completely ideologically pure. It's always a compromise. And although they're quite correct that the tendency has been to reduce the role of employers, those employers aren't nearly as stable as they used to be. They're always merging and going overseas. They aren't the pillars of society that they were some years ago, but the role of employers always will exist. They furnish an important role. That role may be changing, but in certain industries and in certain places, there still will be an important role for employers. While this session is devoted to pensions, health care is the big issue—not only fiscally, but in terms of the responsibility of the employers and the efficiency of the employers doing it. That will be an issue that will occupy us as professionals and as citizens for some time.

MS. RAPPAPORT: If we want to know, statistically, about the wealth of older Americans, there's something called "The Health in Retirement Study," which is a big, federally funded longitudinal study. There is data about that. But if we think about the wealth of Americans and exclude the people who happen to inherit a bunch of money and exclude the money that people have made on their houses, for most Americans, their wealth beyond government programs somehow comes from their employment relationship. It might be their pension. For many people, it's the

401(k) plan and the pension. It might also have been stock options. It might have been some other kind of employer wealth-building program. If you look at the record and separate out things that are employment-related, versus what people saved on their own, the role of the employer has been huge. And I don't see that changing. I don't see Americans being good savers.

Next, we will talk about things we've missed. The SOA, together with the Life Insurance and Marketing Research Association (LIMRA) and Mathew Greenwald, recently completed a paper on misperceptions, pulling together research about what people don't know about saving for retirement on their own. This is critically important in thinking about future roles. As we talk about ownership society and people saving on their own, we now have increasing evidence that people don't have the knowledge, the skills or the interest. And that gets us to the next set of evidence. The misperceptions paper is on the SOA Web site. We also are going to do a Capitol Hill briefing for Congressional staff on the misperceptions paper. The Profit Sharing/401(k) Council of America represents many employers. Recently, the lead article in its publication *Defined Contribution Insights* was about the misperceptions paper and implications for employers.

If you turn the misperceptions paper upside down, it tells you that the programs that work without people having to take individual action are critically important. I want to mention that I am involved in a project with the Profit Sharing/401(k) Council on the value of the employer. If anybody has evidence to contribute or information or ideas about how to document the value that the employer is bringing to the system at this juncture, that is critical. I think that the value of the employer and doing something to get better policy support for the employer are critically important. One of those studies found that about four in 10 people end up retiring before they thought they would.

There's a whole new set of scientific evidence in the last few years that has been packaged up into something called "behavioral economics." If you want to summarize it easily, the old way of thinking about it is that individuals are rational economists. Behavioral economics and behavioral finance tells us that individuals are not rational economists (which many of us knew all along). Some of the studies divide people by segments, according to how you could expect them to behave if they are responsible for their own planning. There are many people for whom it doesn't matter how much education you give them. They don't want to do it and are not going to be bothered. There are some people who are not going to be good planners. That's another set of information to factor in.

There's a set of evidence regarding 401(k) plans that has found that whatever the default is, there is a large group of people who will choose it. From the day that they come into the program to the day that they leave, they will be in the default option. This raises the issue that it's important to have good default options and some safe harbors for them. That's one of the recommendations that the SOA is going to make to Congress, besides reinforcing the importance of DB plans.

As we think about the role of the employer, I, for one, see no change. They may not offer a pension plan, it might be a different form of compensation, but, for people that have long-term jobs, what the employer will do will be critical to wealth building.

Another issue relative to the role of the employer that we haven't talked about is long-term versus short-term employment. There's been a huge amount of rhetoric about radical changes in patterns of employment. If you look at the Department of Labor data and some of the stuff that EBRI does with the data, there have been changes in the duration of employment. Durations of employment have shortened, but not nearly to the radical degree that the rhetoric would say. In fact, they probably always were shorter than people thought, and they haven't changed nearly as much. But in spite of all of the change, there is a big value to businesses in having stability of employment. If you have businesses with big customers, there's a value in having continuity of customer relationships. You can expect that companies will continue to focus on that issue, and it's likely that we won't see the patterns of the past.

FROM THE FLOOR: You brought up history. I want to talk about the role of the government. Some people are frightened when the government arrives to help them. You mentioned Studebaker, which happened in 1964. ERISA was adopted in 1974. There was a 10-year gap. Really, the only plan termination that people talk about as justification for ERISA is Studebaker, one lonely instance of a fairly small company. Since then, we've had a lot of plan terminations. My question is: Has the institution of the PBGC actually increased the probability of plan termination, rather than provided a preventive measure?

MS. RAPPAPORT: One of the issues that people raise with individual accounts and Social Security is: If they go bad, at what point will the government be called on to make up the losses? Mr. Hickman raised the issue of FDIC. Government guarantees are an issue. No matter how the system works, it really won't go away. In the United Kingdom where they cut the benefits in Social Security, more people ended up on welfare.

MS. BORZI: A paper that I recently wrote brings home what we often overlook, which is how much money people are accumulating and how much people need for retirement. People don't know what they need for retirement. They don't have ways for estimating it. There are many online calculators, but those give averages. It's very difficult for people to estimate how much they will need for retirement and how long they're going to live in retirement as a way to estimate that. Using EBRI statistics, the average account balance in a 401(k) plan at the end of 2004 was $76,809. Now, mind you, 401(k) plans have been in existence since 1978, so we're talking about close to three decades. They're not completely mature, obviously. How many of you believe that, given inflation, etc., you would be able to live your retirement years on that? If you think that we're going to be able to rely on individual savings in the future, this gives you a peek at the individual-savings phenomenon. This money comes from structured savings in employer-sponsored plans, in which we have payroll deductions and employer matches to encourage people to participate.

MR. HICKMAN: On the question of what we might have missed up until now, clearly, I have lived much of my life in a world of ideas, and I want to give a boost to the impact of ideas. The technological advance in health care is everything. I resent people who talk about health care inflation. You have a hard time talking of the value of health care, because of quality changes. Technology and ideas drive things. In the pension area, you have lived through an era in which technology has affected your operations profoundly. Many of us grew up before the computer era, which changed the way that you work. The degree of sophistication that you have built into your valuations is enormous compared to what it was even 10 years ago.

The absence of the world of ideas in the impact on financial economics is upon you because of a revolution, mainly between 1950 and 1960, in a series of remarkable advances that have not been incorporated into employee benefits totally. Most of the results would not surprise you. They center on the idea that there is such a thing as risk, that there is variability. We do not live in a uniformly lovely world. Things do change. And one of the premises of modern financial economics is that there is a risk premium, and one must recognize it as a risk premium to take care of fluctuations. It is not “profit.” These ideas have had a big impact on the world in which you live. They will continue to have an impact. If I could tell you what those ideas would be, I probably would get a Nobel prize. I cannot, but be sure that you recognize the power of ideas.

MS. RAPPAPORT: We mentioned some of the major laws. We didn’t talk about the interaction of all of these laws and how that has created extreme complexity. We didn’t talk about the crisis of instability in the last couple of years. Adding to this broad-brush long-term view, there’s a short-term view of tremendous instability and complexity. We didn’t talk about the issue of litigation. Litigation is a major issue for health care. It’s a major issue for employers, in all sorts of employment relationships. In pensions, as we think about the aging society, the question is: What do these age-discrimination regulation rules really mean? At the end of the day, how much do they help people, versus how much do they stifle innovation? Those are more parts of our picture.

We mentioned the importance of lifetime income. One of the things that have been a puzzle to us in the research that my committee has been doing is that people say that they value lifetime income, but we know that they choose lump sums. When you put this together with the size of the accumulations that people have, it is very frightening when we think about the older ages and what happens in a world in which people are living from those lump sums. If you exclude the top 10 percent who have enough money, what will happen to people? Lifetime income is a really important issue. I see us as having moved away from lifetime income. If we think of ourselves as people who are trying to drive the future, versus people who are living with what's going to happen, focusing on the importance of long life and lifetime income would be extremely important.

We touched on the issue of financial literacy and education. This is a huge failure. The failure isn't really at the level of people not understanding how to do retirement planning. The failure is at a much more basic level. Much of the American population can't do percents. They can't do simple arithmetic. If they can't calculate a percent, how in the world would they ever understand compound interest? The whole tool set is lacking. This goes back to our young people and the schools. There's a conflict, from my perspective, with regard to the issue of education. It's really important to have better mathematic skills and financial literacy in the population. At the same time, I would be horrified if anybody thought that we could solve the problems that exist today with regard to the retirement security of today's adults by education. On the one hand, we need to do more education; we need a more financially literate public. But based on where we're starting and where the population is, that is not going to solve the problem.

MS. BORZI: There's a wonderful paper that the American Association of Retired Persons Public Policy Institute published on decision making in health care. The financial literacy question is critical. But we have an equally big education gap or understanding gap in the health care arena. This study examined the current system. Forget these consumer-driven health care plans. They went through the types of decisions that individuals have to make currently in deciding who their primary-care physician will be, who their providers are and what hospital to go to. It's a fascinating paper that highlights how inadequate those decision-making skills are.

MS. RAPPAPORT: I want to make a couple of predictions. I think that it's inevitable that we're going to work longer, and we need to come to grips with the retirement-age issue. That's one of the big pieces in the Social-Security puzzle, as well as the employer puzzle. I would like to encourage all of you to be active in that. It is inevitable that the individual is going to have more responsibility, and that's going to lead to a bad result for many people. I'm sorry to say that. I think it's up to us to try to create a better result. It's very critical that we have systems that work, regardless of individual action. I feel a tremendous amount of uncertainty as to what form those systems are going to take and how extensive they're going to be. I think that the family continues to be extremely important. But for many Americans, there simply won't be families available. We talked about health care. I think that it's inevitable that we will have new definitions of limits.

We wanted to close with advice for the actuarial profession, as well as what we see for the future.

MR. HICKMAN: The advice is eternal advice. Be adaptable. It is possible that your great-grandparents worked out their lifetime with skills that they acquired before they were 24 or 25. The existence of names like Baker, Miller, Wheelwright and so on, indicate how stable those work patterns were. You have not, and you had to reeducate yourselves at least once, and maybe twice. And you ain't seen nothin' yet. The rate of technological and social change is such that your survival as an individual and the survival of our profession depend upon not only the development and leadership in creating new ideas, but in disseminating them. Keep studying.

MS. BORZI: It's very important for people to follow the trends. It becomes very easy for us, as we get bogged down in our day-to-day existence, to not step back and look at where we're going. The proper source of the quote is the Cheshire cat in *Alice in Wonderland*, "If you don't know where you're going, any road will take you there." Keep abreast of what's going on. Stay informed. Be flexible, be responsive, be thoughtful.

I'd like to quote that curbstone philosopher, Mork from Ork. Some of you may remember "Mork & Mindy," Robin Williams' first breakthrough comedy hit TV series. You may recall the way that the series ended each week. Mork would communicate with the great power from the other planet that sent him to earth. He always had some very pithy and sometimes very touching advice or commentary on the human condition. In this particular episode, Mindy's grandmother was depressed, and they couldn't figure out what was wrong with her. It turned out that all of her friends were dying. And she was feeling a great sense of her own mortality. They did everything that they could to cheer her up and eventually she was mildly cheerful. At the end of the program, Mork, in speaking to his greater power, said, "You know, these earthlings are very curious creatures. They value all sorts of old things, old cars, old coins, old clothes, old houses, but they don't seem to value old people." As we move forward in these endeavors that we're all compatriots in, we can't lose sight of the ultimate end-users of these products. When we work through these structures, we have to think about what we're recommending in what we do and how they affect the old people.