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Envisioning pensions in the 21st century

Three noted actuaries who practice in the retirement systems area look into their "crystal balls" to see what might be in store for pensions as we enter the next century. Two — Anna Rappaport and Don Grubbs — give their views on private pensions, and Norman Jones focuses on public pensions.

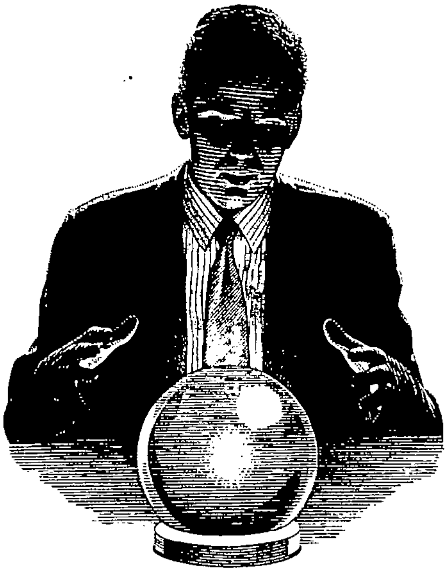
Anna Rappaport

The elderly in the United States are better off financially today than in the past, largely because of pensions and Social Security. Men age 65 and over had a median income (in 1992 dollars) of $14,789 in 1991, up from $5,542 in 1947. For women, the corresponding figures are $8,436 and $3,194. Fewer are in poverty now, although many more women than men are in poverty or near poverty.

The following trends are important in considering the outlook for private pensions:

1) **Employment growth** — Growth is largely with smaller employers and new companies, some of which may be the result of pieces of other companies sold to new ventures.

2) **Decline of DB plans** — DB plans have declined in popularity, although companies with more than 1,000 employees continue to use them about as much as before. Many medium-sized companies have moved to defined contribution (DC) plans as their primary retirement vehicles. Most very small companies have terminated their DB plans, and when they offer retirement plans, it's much more likely to be DC plans.



3) **Asset growth** — DC assets, in which part or all of the money comes from employee contributions, have grown markedly, with companies improving their matches.

4) **Funding** — The favorable investment returns of the last 15 years (in combination with legislative action from Congress) have had very different effects on the two plans' funding. Many DB plans became fully funded, and no contributions were required (or permitted on a tax-deductible basis) so that asset growth slowed. Now, many plans require or are about to require contributions again. DC plan assets grew more rapidly than expected, and employees were encouraged to save more money as perceptions of benefits changed from entitlement to compensation.

5) **Health benefits** — Retiree health benefits are offered much more frequently by larger companies than smaller ones, and cost sharing has increased markedly. For employees under age 65, lack of health coverage is a barrier to retirement, with very few options to purchase coverage.

6) **Change in environment** — Many organizations have been through reengineering, downsizing, and restructuring, with large layoffs.

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Even the "most stable" traditional large companies no longer offer an opportunity of lifetime employment to the same extent.

Organizations are reevaluating the traditional retirement programs and the messages they give. Many are considering new designs that provide payment in a lump sum and look like a DC plan (e.g., a cash balance plan).

Cost pressures have forced companies to look critically at spending in all areas. Plans that had been fully funded and now are faced with staggering contributions are reevaluating their position.

7) **Regulation** — Expanded regulations have placed an enormous burden on retirement plan sponsors. As a result, many plan sponsors are viewing DC plans as a viable alternative.

Implications for private pensions

We are faced with the consequences of the aging of the baby boomers and the strain on government programs that the shifting age structure will cause. It appears inevitable that the growth in Social Security and Medicare spending will have to be moderated, reducing benefit amounts or eligibility, or both.

In the 21st century, the need for private pensions will be greater than ever. However, public policy has been hostile to private pensions. If these policies are not reexamined and made more friendly, the role of private pensions could decline markedly, causing intergenerational discrepancies in post-retirement standards of living.

Organizations will continue to shift responsibility to employees, and many will be ill-prepared to deal with it. Those employees who don't save will be forced to work longer, live with other family members, or accept a major reduction in living standard at retirement.

DB plans will continue to be the preferred method of providing a base layer of benefits. They will diversify with increased use of new designs, such as cash balance plans. Benefit levels will be more modest than in the past, especially at early retirement ages.

Supplemental DC plans will continue to grow with diversity in investment options and investment education. The results will be far better for those with more financial sophistication.

We will need to readjust expectations about retirement ages to balance resources and needs. New work patterns will be needed to accommodate the other workers who are delaying retirement.

Age discrimination could become a much greater factor in employment management. It is much more difficult for older persons to get jobs, and they are often discriminated against in the workplace. Failure to provide them access to financial security will encourage the escalation of age discrimination litigation and build pressure for tightening the laws.

Retirees will be a significant political force as they lobby for mandated access to health care and reform.

Anna Rappaport is a managing director at William M. Mercer, Inc., in Chicago and a member of the SOA Board of Governors.

Donald S. Grubbs, Jr.

In the 1890s, no one could have foreseen the major changes that have occurred in pensions in the 20th century, and I cannot predict what will happen in the 21st century any better. However, some of the key issues facing pension programs in the next century are clear. Private pension plans face three major problems:

1) **Regulation** — The continual increase in regulatory complexity and burdens forces more dollars to be spent on administrative expense and professional fees that would be better spent on providing benefits. These burdens discourage smaller employers from maintaining DB plans or any plan.

Actuaries often have contributed to this increasing complexity, advocating more complex rules for all plans in their efforts to meet objectives of certain clients. Some of us have worked vigorously to simplify the requirements, but the rules have become more complex. I see no reason to hope this complexity will not continue to grow in the next century.

2) **Coverage** — Every worker needs a pension to supplement Social Security, but only half of all private-sector workers are participants in a plan, and growth of coverage has stagnated.

I expect no growth in pension coverage in the next century without congressional action. I have advocated legislation requiring every employer to provide every employee with a minimum pension, either by an employer plan or by contributing to a second layer of Social Security for the employee. Eventually, Congress will recognize this is the only way to solve the coverage problem.

3) **Inflation** — If inflation averages 5% per year, the purchasing power of a fixed pension is cut in half in 14 years and cut to one-quarter in 28 years. Many pension plans make no post-retirement adjustments. Workers who receive a lump sum generally are unable to convert it into an income that continues for life and keeps pace with inflation. Various solutions have been proposed, but it is difficult to foresee a widespread solution to this problem being adopted.

What actuaries can do

Actuaries can contribute to solving the problems by helping the public understand the future consequences of alternative courses of action. Actuaries should put the public interest first, even if it conflicts with the interests of their employers and clients.

Donald S. Grubbs, Jr., is the former president of Grubbs and Company, Silver Springs, Maryland, and the former director of the actuarial division of the Internal Revenue Service.

Norman L. Jones

My comments are limited to three topics in my primary area of activity, which is state and local government pension plans:

1) **Benefit design** — Most public

sector retirement plans are traditional DB programs. Many public employees may also participate in Internal Revenue Code (IRC) Section 457 deferred compensation plans, nearly all of which are funded solely by employee contributions. (A few public entities also sponsor 401(k) plans comparable to those in the private sector.) Changes likely in traditional benefit structures include:

- **More DC plans.** Although a massive shift like that experienced in the private sector is unlikely, a move to a DC plan often is perceived as being more politically feasible than creating a new, lower-tiered DB plan. Expect to see a moderate increase in activity in this area.
- **Hybrid plans.** Many of the attractive DC plan features (employee investment choices, enhanced portability, sharing investment gains, more optional benefit choices at retirement, more valuable vested benefits) can be added to an existing DB plan. One example is a money purchase minimum benefit based on some multiple of the participants's account balance. Participants also have the option to direct the investment of their account. The favorable attributes of the traditional DB plan (base level of assured retirement income, ability to add past service benefits, early retirement incentives) are preserved in a hybrid plan. Expect to see much more activity in this area.
- **Temporary retirement incentives.** Window programs have been used widely in the private sector as companies downsize or reorganize. As the methods of delivering public services change over the coming decades, well-designed temporary retirement incentive schemes can facilitate transitions in the public labor force.

None of these features are new, but each will see increased interest in coming years. Actuaries have an opportunity to play a major role in the design, implementation, and sound financing of new benefit structures as they emerge.

2) Trust funds — Contrary to widespread perceptions, public retirement plans are generally well funded. However, most have not reached maturity, and their assets will grow in real

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We need to impact emerging social policy

by George B. Swick

In my opinion, the actuarial profession has not been effective in impacting emerging social policy. In making this observation, I speak as one of a group of experienced pension actuaries who tried and largely failed to influence the direction of the Employee Retirement Income Security Act of 1974 (ERISA) particularly with respect to Title IV. Nevertheless, I believe we should continue to move forward with ideas for developing future improvements in policies relating to benefit improvements.

Some random thoughts which have occurred to me in recent years are as follows:

- In our new world and high tech economy, the means of providing retirement income, especially for short-term employment, is in need of serious thought. Long-term employment is probably a relic of the past, and we have little choice but to rely on defined contribution (DC) plans, both qualified and non-qualified.
- One important input into the equation might well result from major research into the British experiment with personal pension alternatives to both governmental and private pension schemes.
- The Social Security retirement age for unreduced benefits might be well served by adding an automatic adjustment (up or down) based upon a specific constant life expectancy as determined by life tables constructed for the entire population following each ten-year census.
- The Medicare commencement age should track the Primary Social Security age, if nothing else. Going much further, however, my own experience under Medicare has led me to speculate that Medicare might well form a desirable basic health care system for the entire population. It would:

1) Eliminate Medicaid and all other governmental health programs
2) Establish governmental Medigap coverage for those under "x" times the poverty level
3) Permit tax deductible Medigap coverage for deductibles and co-insurance but permit non-deductible coverage at any level
4) Maintain Medicare cost controls on hospitals and doctor fees
5) Significantly reduce administrative costs
6) Retain the competitive value of HMOs and PPOs, networks that will survive only if providers are able to turn a profit

Long-term care represents another area where significant actuarial expertise is required. However, it cannot be dominated by insurance companies. The investment return during the reserve build-up period would be unacceptable, similar to the old group annuities. This should be a joint project of group underwriting and 401(k) investment vehicles.

George B. Swick, a former member of the Actuarial Standards Board, is the retired chairman and CEO of Buck Consultants, Inc.

THE COMPLETE ACTUARY

Field trips lead spring meeting attendees off-site

by Charles R. Haskins

You are on a team that has to research and develop a plan to expand product lines into countries outside North America. Where do you start? Answer: Pre-register for one of the spring SOA meetings and sign up for the all-afternoon field trips studying "Effective Business Relations Across the Border," with speaker Cynthia Barnum from the Globalization Consulting Services.

In New Orleans, the field trip is to the World Trade Center on Friday, April 7, with a focus on Mexico and Latin America. In New York, the date is Tuesday, May 23, and the focus is Europe, and the location is the United Nations. The session at Vancouver is Tuesday, June 27, and focuses on markets in Asia.

The beginning session will identify the issues that need to be addressed in doing business internationally, the resources available, and how to decide which country to target as a business opportunity. In the second session, two breakout groups will build a business plan.

The sessions are jointly sponsored by the International Section and the Committee on Management and Personal Development. Advance registration is required, and the fee for the field trip and lunch cannot be refunded.

Also at all three spring meetings is a personal development session titled, "Removing the Blinders," focusing on achieving your career goals, with speaker Dr. Vic Heckler, a management psychologist. Advance registration is also required for this session. Check your registration information for date and times.

The Committee on Management and Personal Development promotes management and business skill development for members, using a variety of channels. Its theme for 1995 is "Positioning Yourself for Management and Leadership in the Year 2000." If you would like to be a part of this committee, contact Chairman Charles R. Haskins; phone: 302/672-5047; fax: 302/672-5163.

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dollar terms for two or three more decades. Most are expected to mature around the time the baby boomers retire. The resulting large pool of assets, combined with the surge of retirements beginning a few years from now, have three important implications:

- Larger pools of money are larger targets. Pressures to reduce funding commitments and to influence the use of the trust funds are likely to grow as governmental budgets get tighter.
- Liquidity needs will rise dramatically as boomers retire. Actuaries can and should play an increasing role through the use of forecasting tools to assist sponsors and trustees in asset planning.
- A retirement funding paradox is that, as well-funded plans approach maturity, maintaining stable contribution rates (the primary objective of most public sector plans) becomes increasingly difficult. Small market fluctuations have a magnified effect on the funded status of plans and year-to-year contribution requirements, even with the most sophisticated smoothing devices. Actuaries are challenged to fully understand the financing mechanisms and to work with plan sponsors in finding funding arrangements that will minimize volatility and maximize intergenerational equity.

3) Member services — As the working population continues to age and as the ratio of active participants to retirees continues to decline, the demand for member services in the retirement area will increase. Development of hybrid plans and expansion of DC plans will compound the demand. Fortunately, plan sponsors have better tools at their disposal than ever before. Creative actuaries and benefit consultants can play a key role in improved communication and financial planning assistance for plan participants.

Believing that we really can predict the future is an occupational risk for actuaries. Adding refinements to our already elaborate models will not eliminate uncertainty. We sometimes forget that the best we can achieve is to design financial programs that are flexible enough to accommodate rapidly changing economic, demographic, social, and political environments.

Norman L. Jones is president of Gabriel Roeder Smith & Co., Southfield, Michigan.