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How Should Retirement Policy Be Reformed? Don’t Speak All Together, Please

Reinventing the Retirement Paradigm: Wharton Conference focuses on Retirement Policy and Changing Retirement Policy

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Retirement Policy Reform

Changing demographics, the high cost of pension benefits and workers’ continued failure to save enough for old age are all driving changes in the nation’s retirement prospects, according to speakers at a recent Wharton Impact Conference titled, “Reinventing the Retirement Paradigm.”

“The median American household needs to save at least 15 percent per year more than it is doing now to reach a reasonable retirement target,” said Olivia Mitchell, executive director of The Pension Research Council at Wharton and a co-sponsor of the conference. “However, the majority of Americans do not recognize the shortfall nor make amends.” Meanwhile, Mitchell added, retirement is being reformulated, with more people working after 55 than in the past—a natural reaction to longer, healthier life spans.

In the policy arena, changes in international accounting rules will have an impact on pension plans even as government pension systems around the world are being forced to reduce benefit promises and encourage delayed retirement, said Mitchell. She co-hosted the two-day conference with Robert L. Clark, professor of business management and economics at North Carolina State University.

The Tail Wagging the Dog

The conference, which drew 130 experts from government, academia and the private sector, opened with broad ideas about retirement policy reform. James Klein, president of the American Benefits Council, a group representing major employers and designers of benefit programs for plan sponsors, emphasized that the pension system must revolve around trust. “The greatest achievement of our retirement system is that millions of people and thousands of plan sponsors give vast sums of money to third parties, confident [the money] will be prudently managed and will grow and provide benefits decades into the future,” he said. “That confidence is not based on naïveté but rather on faith in the regulatory structure we have [where] we know people will be held accountable.”

Klein said that trust has eroded somewhat, in part, because of complex pension laws designed to protect workers but that some plan sponsors believe have been irregularly enforced. He suggested a tradeoff in which regulators give plan sponsors more flexibility in how plans are designed and run; in exchange, the regulated community would accept harsher penalties for violating rules. Klein also proposed a negotiated system of rule-making. Now, he said, regulators take input on regulations and then come back with a final set of rules, with no room for back-and-forth trade-offs. Under a negotiated system, “the substantive results might be better, but even if not, the parties would have greater faith in the system knowing they were more involved in the process.”

Finally, pension policy should strike a better balance of tax and labor policy against the goals of revenue creation and retirement security. “For too long we have had the tax policy tail wagging the retirement policy dog,” said Klein, adding that “the real conflict up to now is the tension between tax legislation enacted for revenue purposes as opposed to tax legislation enacted for retirement security purposes.”

110 Pension Plan Choices

Pamela Perun, an independent consultant on retirement income policy issues, presented a paper titled, “Reality Testing for Pension Reform,” co-authored with C. Eugene Steuerle of The Urban Institute. She began with a quote from humorist Dave Barry who said that he could not figure out a statement about his pension benefits “no matter how many beers I drink.” Noted Perun: “We do have a problem with complexity.” She pointed to differences within types of plans as well as between plans, and then showed a chart listing 110 individual private pension plan types that will be available by 2006.

Perun discussed two current reform proposals, the Pension Preservation and Savings Expansion Act (PPSEA) and Bush administration proposals, which rely on lifetime savings accounts (LSAs) and retirement savings accounts (RSAs). She said the PPSEA tinkers with just about every aspect of pension law and increases complexity but is likely to pass in some form. The Bush proposals are simpler, but have been criticized as favoring wealthier savers. "Neither proposal is satisfactory," said Perun, who argued for an alternative that favors adding incentives for a simple defined contribution plan for employee savings, and uniform social security treatment along with a savings tool for low-wage workers. "We don't need more innovative savings tools. We just need one that works," said Perun. "The true reality test for pension reform is how well does it increase retirement plan assets of middle, moderate and low-income families and how much does it cost?"

Rep. Earl Pomeroy, a Democrat from North Dakota, told the conference that Congress tends to think in two-year bursts, which is a problem when it comes to legislating pension reform. "This mismatch in long-term liabilities and short-term fiscal planning has never been starker in any period in our history," he noted. "Our children will pay the price."

Keith P. Ambachtsheer, president and founder of KPA Advisory Service of Toronto, suggested that pension funds could be better managed. He examined Cost Effectiveness Measurement's database on 256 pension funds for 10 years prior to 2002 and found little variance in terms of asset mix among the different portfolios. The old view, which favored a 60-40 or 70-30 asset mix between equities and bonds, worked well in the 1980s and 1990s when equities performed better than bonds. But economic upheaval in 2000 through 2002 showed the standard asset mix left defined pension plans vulnerable. In the old paradigm, Ambachtsheer said, plan managers took a great deal of long-horizon risk but little short-term risk. "If you really think you're good at short-horizon risky strategies, why only do a little bit of it?" he asked. He suggested a new paradigm based on what he called defensible investment beliefs, including the notion of a varying equity risk premium. He also said there is a need to restate investment policy in terms of the balance sheet, not just assets, and the risk tolerance of stakeholders.

$2.1 Trillion in Public Pension Assets

Gary Anderson, executive director of the Texas Municipal Retirement System, and Keith Brainard, research director for the National Association of State Retirement Administrators, argued that public pension funds play a significant role in retirement income security. Defined benefit plans are the primary retirement benefit for about 90 percent of public employees, said Anderson, adding that about 10 percent of the U.S. workforce is employed by state and local governments.

The public plans do offer flexibility, including short vesting periods, the opportunity to buy service credits, return-to-work opportunities and lump-sum early retirement options. Anderson noted that governments act not only as employers, but also as policy makers, and consequently need to set a good example in operating their own pension plans. "These people are secure and not dependent on government programs in their retirement years. I think that's a good example to set. Public sector plans have not gotten the recognition we deserve for the innovations we've made and the impact on the retirement status of our country." According to Brainard, more than $2.1 trillion in public pension assets are an important source of liquidity and stability for financial markets. "Public pension assets serve as an important source of entrepreneurial capital funding because of their long-term horizon. They create economic stimulus for generating and distributing investment returns greater than what individual investors would accrue in defined contribution plans."

Approximately $40 billion in public pension assets are invested in venture capital, he added. Using studies that indicate public defined benefit plans returned more than 10 percent from 1983 to 2002, while defined contribution plans returned 6.5 percent, he extrapolated that the difference amounted to $203 billion in added assets for the U.S. economy in 2002.

Ronald Albahary, chief investment officer of Merrill Lynch's Retirement Group, wondered how the numbers on public pension funds would look if the analysis had been done in 1966-1983, instead of what he called "the golden age of equities." With rising health care costs, Albahary said, the standard advice that retirees need to save enough to provide 70 to 80 percent of their working income to maintain their standard of living after retirement could be faulty. He, like others, is concerned about the mismatch between the asset and liability side of the balance sheet, pointing out that hedge funds have not been embraced among private pension fund managers even though they have been used by foundations and endowments.

Joseph Miskel, vice president of retirement advisory solutions at Merrill Lynch, said he, too, believes an asset-centric management strategy can create problems for private pension plans. "I think we fall short in implementing strategies that focus more on the performance of the liabilities." According to Miskel, hedge funds should be used along with other alternatives, including collars, matched futures accounts and alternatives to fixed income investment called equity participation notes. He warned that companies need to take better stock of the effect of pension plans on their corporate finances. "Without the corporation there is no pension. What if a corporation continually

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pours cash into the pension fund and creates a credit risk for the plan or for plan participants?"

Douglas Fore, principal research fellow at the TIAA-CREF Institute, told the conference that important new pension accounting rules have been formulated in Europe and are being imposed on U.S. companies as the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) seek convergence. "Pension accounting in the United States has widely been recognized as one of the most backward areas of all accounting and is in dire need of reform. Everybody knows we got ourselves in a terrible mess the last few years. The accounting rules are part of this," said Fore. The old accounting rules allowed companies to smooth out rate-of-return assumptions over time, creating a strong pro-equity bias, he noted. "In the '90s, this didn't matter at all; the stock market did the heavy lifting for everybody. But when the tide turned in March 2000 things [changed] dramatically." The prior smoothing had made the situation even worse, he said. At the end of 1999, defined benefit plans of the S&P 500 firms were overfunded by $350 billion. Four years later, the same pension plans were underfunded by the same amount.

Fore also commented on the FASB's revisions of FAS 132, noting, "What was very opaque is much clearer." British authorities, in the development of FRS 17, went through a similar change, but they did it at a time when companies were reeling from the 2000 stock slump, leading many companies to back off from defined benefit plans. "In essence defined benefit plans have been frozen to new entrants in the U.K.," said Fore. "They have been substituted for defined contribution plans." The scandals at Enron and other U.S. firms, he added, have led to an international attack on U.S. Generally Accepted Accounting Principles (GAAP), which have already led to changes in accounting for stock options and will likely change insurance accounting rules.

Pet Insurance Over Financial Planning

In the wake of all these changes—and the continued lack of a savings cushion for the bulge of retiring baby boomers, William J. Arnone, a partner in Ernst & Young's human capital practice, suggested it is now time to remove the word baby from the phrase "baby boomer." "We have not learned the lessons," he said. "Someone's going to pay the price for our acting in less than an adult manner." Arnone, who runs investor education programs for employers, said companies began offering financial literacy programs in the early 1980s as they encouraged workers to take early retirement. "The rationale was that if these older employees did the calculations, they would conclude they were better off (taking early retirement). I think we're going to have a resurgence, only now they are going to conclude, 'I cannot retire as soon as I thought I could.'" No more than 20 percent of large employers initiated financial education programs, added Arnone. His own firm used to offer financial planning in its flexible benefits program, but many other choices, including pet insurance, were more popular.

Among investors who manage their own retirement accounts, some of the common problems include: questionable asset allocation, failure to rebalance periodically and an overconcentration in employer stock. Approximately 20 percent of defined contribution participants have outstanding loans and many cash out at time of termination. "The latest, biggest, hottest thing now is professionally managed 401(k) plans," he said.

Martha Priddy Patterson, a director at Deloitte Consulting, said she is concerned about the possibility that the accounting changes will lead to a decline in defined benefit plans in the United States. "There have been so many pressures on defined benefit plans that I am opposed to anything else that will, in any way, adversely affect them," said Patterson. Tax rules inhibit funding defined-benefit plans, she added. "It's increasingly hard to stuff money in the plan when you have a boom year to ride out the bust years." Patterson also said the phrase "pension surplus" on balance sheets is confusing. "A lot of people I thought of as sophisticated don't understand that the big number there on the financials doesn't mean the employer can do anything with it [the employer] wants," she said. Patterson is also concerned that a rise in interest rates will lead to a termination of defined-benefit plans. She pointed out that even if companies provide financial education, by the time employees are in the workforce, it's too late. "It should be cradle to grave." Another reason she said employers may be reluctant to provide financial education is that they are concerned about liability and privacy issues.

One more problem that hasn't been addressed is "when the boomers retire with their 401(k) lump sum—more money than they have ever seen in their lives—the financial thieves will be knocking themselves down to separate those individuals from their money," said Patterson, who urged states to form financial-fraud task forces to combat the problem now. Arnone, however, suggested the money those thieves would seek may not amount to much: The average 401(k) balance for workers over age 55 is just above $70,000 and the median is $30,000. "The lump sums are not there."

Anna Rappaport, of Mercer Human Resource Consulting, is concerned that given too much choice, workers choose not to save. "I want us to remember there are situations where defined benefit plans are an efficient option. "Many people are covered by them and, despite their decline, I'd like to see us try to make them work better rather than giving up and leaving it to the individual. I think that will produce a much better retirement future."

Fore pointed out that many employers, if they could, would try to get out of their defined benefit plans. "There are winners and losers with these plans. Younger workers subsidize older workers who do stay. It is a multigenerational commitment. On the other hand, well-run defined-benefit plans, year after year, can contribute to the firm's bottom line. GE has done that. They would not get out. They understand how to do it."

The implications of retirement funding can extend well beyond retirees' own portfolios, Rappaport added. "What will happen to the economy when the boomers stop spending money because they're afraid of outliving their defined contribution plan? We're in a heap of trouble in this country."

Redefining Retirement in the 21st Century

The demographics of today's workforce, employee expectations about retirement and the types of retirement options offered are all in a state of flux, making retirement policy a moving target for those charged with researching and administering pension plans. That was a second major theme of the "Reinventing the Retirement Paradigm" conference.

One Option: "Phased Retirement"

According to Patrick Purcell, an economist with the Congressional Research Service of the Library of Congress, 27 percent of the population will be over 65 by 2035 compared to 17 percent now. Growth in the population aged 20-54 will accelerate briefly, then fall sharply, which will have implications for employers trying to fill jobs. Among men, 90 percent between the ages of 20 to 54 are employed but it drops to 68 percent for men aged 55 to 64. For women aged 20 to 54, 75 percent are working, but after age 55 employment drops to 55 percent.

Overall, pension coverage has remained at 50 percent for more than 40 years, but there has been a substantial shift from defined benefit plans, which provide guaranteed lifetime benefits to employees, to defined contribution plans such as 401(k)s, which provide savings incentives but leave their management up to employees. In 2001, only one in five workers in the private sector was in a defined benefit plan, although Purcell said defined benefit plans tend to get more attention because they are offered at larger, more visible firms. Many defined benefit plans subsidize early retirement, while defined contribution plans are generally age-neutral. "That's a vestige of another time when we needed to move older workers out," Purcell said.

He discussed the idea of "phased retirement," in which older workers continue with their employers on a part-time basis. To make that work financially, many workers need to unlock some early retirement benefits. That, however, is problematic; defined-benefit plans often require an employee to stop working before receiving benefits. Meanwhile, legislation has been introduced that would allow phased retirement plans, but it has not generated much interest, Purcell said, asking the question: "Should tax subsidies that have been created to promote pensions be extended to include people who have not yet retired? Do we really want to make that fundamental change?" He expects that strong workforce participation levels among those aged 55 to 64 will continue, with health insurance coverage being a major driver.

Katharine G. Abraham, professor of survey methodology at the University of Maryland, suggested that changing workforce demographics have made companies more interested in employing older people. "Employers are concerned about the ability to recruit workers," said Abraham, adding that policy makers are worried about "the solvency of Medicare and the Social Security system." She also noted that while many employees say they would like to continue to work beyond retirement age, few actually end up doing so.

Looming Labor Shortages

According to research by Abraham and Susan Houseman, senior economist at the W. E. Upjohn Institute for Employment Research, only a quarter of older workers surveyed said they planned to stop working entirely at retirement age. Of the rest, 18 percent said they planned to work fewer hours, 5 percent said they wanted to change jobs and the rest said they did not have plans. When interviewed two years later, two-thirds of the people who planned to stop work actually did so, but most of those who planned to work fewer hours had not followed through. Abraham said the disconnect may have to do with the employment that is available. "Most of them are doing exactly what they were doing before or stopped working altogether."

Houseman noted that perhaps those who reduced their hours were working more than 40 hours to begin with, so the reduction in hours did not reduce their salary. Other workers had been working two jobs and cut one out. "They are not fundamentally renegotiating their employment," she said.

The research also indicated that those with pension plans were more likely to plan to retire; within that group, workers with a defined benefit plan were more likely to quit than those with a defined contribution plan. "Becoming eligible to receive a defined benefit greatly increases the probability of retirement," said Houseman, adding that health insurance is also a factor. Those covered by a plan or through their spouse's employer were more likely to reduce hours, and those with medical plans covering them in retirement were more likely to stop working.

The self-employed were more likely than other workers to continue working and less likely to stop altogether, although Houseman said that could be because self-em-

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There are winners and losers with these plans. Younger workers subsidize older workers who do stay. It is a multigenerational commitment.

ployment comes with inherent flexibility. Other factors that can influence retirement plans include a change in health status or assets, such as job loss and/or the decline in 401(k) portfolios.

Research also indicates that workers do not understand their finances or don't incorporate them into retirement planning until they are right up against the decision point, according to Houseman. She suggested that the gap between people who would like to continue to work, but work less in retirement, and those who actually do may indicate a need for new policies to help older workers transition to full retirement. "We already have programs to assist older workers who are unemployed or dislocated. There may be broader need for this kind of policy."

Rappaport noted that many companies have dropped prohibitions against rehiring retirees to fill gaps in their labor force. "The action is heavily around the rehiring of retirees. There is a lot of that happening out in the private sector."

She said that as the first wave of baby boomers begins to take early retirement, certain industries—like aerospace, utilities and health care—are already facing severe labor shortages. "Phased retirement is important to workers and employers," said Rappaport, "and in the case of aerospace, to the national security of this country."

She advised employers to analyze the demographic makeup of their workforce and find out where they have gaps developing. Individuals, too, should evaluate their resources, financial options and skills. "People work after retirement for very different reasons. There is a significant number of people who do it out of economic need, whether for health care or for money … We're in a situation where our policy actions can give people the opportunity to create their own future."

Impact of Baby Boomers

In a panel on "Managing the Retirement Promise," Janemarie Mulvey, assistant director of the Research Information Center at Watson Wyatt Worldwide, discussed strategies to retain older workers that balance the promise of retirement income with changing workforce demographics.

She pointed out that the Employee Retirement Income Security Act (ERISA) guarantees pension benefits that are already accrued, but does not require employers to continue to provide pension benefits in the future. Employers offer pensions voluntarily to minimize turnover and receive certain tax benefits, she noted, but also pointed out that pensions are growing increasingly more costly to administer, with costs tripling since 1981. As a result, she said, 64 percent of companies with fewer than 1,000 workers dropped defined benefit plans between 1990 and 2002. For companies larger than that, 11 percent dropped their defined benefit plans.

Mulvey also noted that 21 percent of defined benefit participants are in hybrid plans that combine elements of defined-benefit and defined-contribution plans and that cater to a more mobile workforce. However, she said, many employers are not able to offer such plans because of regulatory constraints. A common criticism of hybrid plans is that they are a way for employers to cut employee benefits, but Watson Wyatt data indicate hybrid plans add costs to employers and protect older workers.

By 2020 all baby boomers will be over age 55, with strong implications for the labor markets, Mulvey said, adding that by 2010 the United States will experience a 6.6 percent shortfall of workers which will grow to 13 percent in 2020. Meanwhile, many retirement plans encourage workers to leave before age 65. A study of data gathered from 50 large employers showed that women over age 55 with early retirement plans retired a year earlier than other female workers, while men with those plans left eight months earlier. If a company offers medical benefits for early retirees, the numbers increase, with women retiring two years earlier and men 1.5 years sooner. In companies with more restrictive medical plans, such as caps on service, there is a smaller effect, said Mulvey.

Still, even with a labor shortage looming, employers are reluctant to change their incentive plans, particularly for those closest to retirement. Rather than cut early retirement benefits, Mulvey suggested that employers consider two incentives—elder care programs to help assist with the care of older relatives, and phased retirement programs that allow older workers to cut back on their hours without losing benefits. Of those surveyed, 25 percent of the women who retired early were responsible for caring for an older relative, she noted. "These are the softer side of benefits, but they matter and they're not too costly to implement." While men seemed less responsive to phased retirement programs, Mulvey said many men are retiring early and returning to their employers on a contract basis.

Comparing Pension Benefits

Workforce issues could have broader economic implications, according to Steven A. Nyce, senior retirement research associate with the Research and Information Center of Watson Wyatt Worldwide. "If we do not find enough workers and if productivity is not high enough, it's likely companies will not be able to meet the consumption in society and the result will be higher inflation … For decades on end we have enjoyed prosperous growth," he said. "What's going on in outsourcing is some of the reaction to the labor shortage and it might mitigate some of the inflation down the road."

David McCarthy, a researcher and faculty member at Imperial College in London, studied the portfolio value of pension plan types. He said there are three economic perspectives at play in determining occupational pension type: labor market conditions, portfolio theory and corporate finance, which is most relevant for defined benefit plans. Laws and taxes also play a role, but they add so much complexity he left them out of the model. "The optimal pension choice is influenced by all three areas," said McCarthy. "Companies need to take both the labor-market effects and the employee-portfolio effects into account when designing compensation strategies." For many people in the United States and other countries, their pension is an extremely important asset, up to 40 percent to 60 percent of their total assets, he added.

Economists have developed life-cycle models that indicate defined benefit plans are less desirable for younger workers than for older employees. McCarthy compared pension benefits to being paid in movie tickets. He said he usually goes to two movies a month, so the first two tickets would be worthwhile. The third ticket, and those paid to him after that would have less value. The same would be true of pension benefits; at a certain point they become less meaningful.

But where is that point? McCarthy developed a model to measure the effects of various pension plans, although he cautioned that his work does not take into account two large sources of pension risk in defined-benefit plans – early separation and employer insolvency. "Results indicate that even for the most generous DB (defined benefit) pensions offered to younger workers, required productivity increases are small from the point of view of lifetime income, but large relative to the value of the pension. However, for older workers and less generous DB pensions, the required productivity increases are small relative to both the cost of the pension and lifetime income," McCarthy's paper states.

Donald Elbaum, director of actuarial studies in the treasurer's office of Ford Motor Co., said the idea of reducing early retirement subsidies is gaining ground in national pension plans around the world and in private schemes. The changes have been driven largely by cost as retirees live longer. "In the United States there are some regulatory obstacles that could present themselves in trying to reduce early retirement benefits already accrued. To some degree your hands are tied." To change the packages for future employees would require that companies strike a balance between flexibility and the ability to select certain employees for the benefits without violating nondiscrimination rules.

Elbaum also said researchers may want to consider how the current boom in offshore employment may impact the economy and pensions, and he pointed out that the tightening of the labor pool will first manifest itself among younger workers. "When someone retires at Ford we don't replace them with someone coming in the door. In some sense, the first battleground will be trying to find strategies for retention of employees in the early years when turnover is high."

According to Elbaum, defined benefit plans are not highly valued by younger workers. He said Ford took that into account when it closed its 50-plus early retirement program to new employees, replacing those benefits with a cash plan. Structuring employment to allow more part-time work might keep some people in the workforce, he said, but it might also provide incentives for people who would have worked full-time to cut back.

Mulvey suggested that employers who have been intent on reducing costs and cutting workers during the past years of slow economic growth need to look ahead and plan for a different future. "We try to know what's down the road," added Elbaum. "At the same time, it's hard to keep a bench workforce in waiting. We're measured against our competitors. We have to make sure we are staffed appropriately."

And if workers are not available in the United States, Ford has options overseas. "As a global company we do have alternate locations available," he said. "That's not to say this is our strategy, but it's something we grapple with."

An overview of the conference, with PowerPoint presentations, is available on the Pension Research Council's Web site at *http://rider.wharton.upenn.edu/~prc/04conf. html.* To learn more about the Pension Research Council, visit their Web site at *http://prc.wharton.upenn.edu/prc/ prc.html.*

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