

January 2009, Issue No. 69

IN THIS ISSUE

Contest Results—Renaming
Our Newsletter!

Chairperson's Corner

Retirement 20/20: A Brief
History and an Update

We Want You!

Selecting Mortality Tables: A
Credibility Approach

What is the Cost of a
Pension Plan?

Become an ERM Expert

Return to Email Version

LINKS



Pension Section
Council



20 / 20 Web site



Contact the Editor

RETIREMENT 20/20: A BRIEF HISTORY AND AN UPDATE

Andrew Peterson, FSA

I have been in my role as Staff Fellow, Retirement Systems for the SOA since April of 2008. I like to think of myself as being fairly well-informed and up to date on issues affecting actuaries practicing in the retirement arena. Before joining the SOA, I typically read or at least skimmed most of the pension-related publications from the SOA and other actuarial organizations. I knew that there was this ongoing initiative called *Retirement 20/20*, but I would have been hard-pressed to provide more than a vague description of how the initiative is an attempt to reinvent the retirement system. Based on my anecdotal evidence in talking with friends and colleagues in the profession, I think that my level of understanding was fairly typical.

However, since joining the SOA I've found myself immersed in this initiative. I've found it to be an interesting project but somewhat daunting in its objectives. The primary purpose of this article is to provide a summary of our recent *Retirement 20/20* conference (held in November 2008 in Washington, DC). But to begin, I want to offer some background on how we got to 2008. Let's call it, "*Retirement 20/20* for Dummies."

A Brief History...

Actuaries have been consulting to retirement plan sponsors about significant demographic and economic issues for a number of years. However, often this work involves solving problems "tree by tree" rather than looking at "the forest" as a whole. It was this desire to take a step back and look at the macro picture that led the Pension Section to start the *Retirement 20/20* initiative late in 2005. The fundamental goal of *Retirement 20/20* is to help create a better retirement system.

The discussions that led to the *Retirement 20/20* initiative started as a reaction to the decline of the traditional defined benefit pension plan and moved quickly to the acknowledged shortcomings of our North American retirement systems, in both the defined benefit and defined contribution arenas—shortcomings which have been further accentuated during the current financial crisis. *Retirement 20/20* seeks to find retirement solutions that will meet the economic and demographic needs of the 21st century in North America.

Some have asked where the 20/20 name came from, thinking that it's perhaps referring to a goal of having a new retirement system in place by the year 2020. This is not the case! Instead, the 20/20 title is a reference to perfect 20/20 vision and our desire to bring improved clarity to an uncertain retirement future. Stepping back and looking at the problem with 20/20 vision will allow us to design solutions to directly meet current and

future needs.

The goal of creating a better retirement system is ambitious (and some would even say audacious), but we believe that as actuaries who deal with retirement plans every day we are uniquely positioned to lead this discussion. That being said, the strength of this initiative to date has been the involvement of a wide variety of non-actuary retirement professionals from policy experts, to academics, to economists and others. This diverse group has worked with us enthusiastically as we seek to develop the principles and new ideas required for a sustainable retirement system in the 21st century. We are developing ideas that we hope will transcend political biases and ultimately lead to fruitful discussions about improving the retirement system in North America.

The initiative didn't start by looking at specific designs or risk-sharing ideas, but rather with the development of core principles. The process has purposefully avoided the temptation to jump to solutions before laying the appropriate groundwork. Initial discussions in 2006 focused on identifying the key stakeholders and objectives for successful and sustainable retirement systems. In 2007, we focused on the skills of the various stakeholders and how best to align their roles with their skills. In 2008, we began to drill down to understand and evaluate some of the specific mechanisms that have been considered or implemented and that may serve to achieve some of the key objectives identified in 2006 as critical to a sustainable new retirement system.

The 2008 *Retirement 20/20* conference invited experts from North America and beyond (the Netherlands and Spain, to be exact) to present their ideas, their research, and their experiences through papers and panel discussions. Considerable time was also spent over the course of 2008 developing a benchmarking tool which we call the Measurement Framework (described in the May 2008 *Pension Section News* at <http://newsletters.soa.org/soap/issues/2008-06-02/2.html>).

2006 and 2007 Conferences

The 2006 conference was a discussion of needs, risks, and roles related to the following stakeholders: society, individuals, markets, and employers.

The six key themes that came out of the 2006 conference were:

1. Systems should align stakeholders' roles with their skills;
2. Systems should be designed to self-adjust;
3. Systems should consider new norms for work and retirement and the role of the normative retirement age;
4. Systems should be better aligned with markets;
5. Systems should clarify the role of the employer; and
6. Retirement systems will not succeed without improvements in the health and long-term care systems. (*Note that this last theme has purposefully been excluded from subsequent discussions due to its complexity and scope.*)

The seed for the topic of the 2007 conference was found in the first theme from 2006: aligning roles with skills. We set out to identify optimal roles for our various stakeholders. Proper role definition is critical to the system's success. The correct role is one that uses each stakeholder's knowledge and talents optimally. For example, market experts would work in the markets, and employers could focus on their core business. Defining stakeholder roles is a necessary step that must be completed before beginning to design the features of the new retirement system.

The 2007 conference focused on three of the stakeholder groups: society, markets, and employers. Individuals, while very important, were not discussed explicitly. However, they were often referenced in the discussions. Based on the consensus of conference participants, the key roles identified for these stakeholders were as follows:

- Society provides structure to the retirement system through:
 - Helping individuals make the right decisions,
 - Setting some guidelines about what ought to happen, and
 - Providing consumer protection.
- Markets provide structure to support the retirement system by:
 - Facilitating and allowing for groups to approach the markets,
 - Providing proper incentives for agents (who can facilitate the use of groups),
 - Providing standardization among products offered, and
 - Encouraging innovation in hedging and pooling instruments.
- Employers provide structure to the retirement system through:
 - Playing a role as a facilitator of individual savings,
 - Serving as an unbiased educator and trusted advisor, and
 - Participating in various elective employer roles as purchasing agent, distributor of income and guarantor.

The full 2006 and 2007 conference reports can be found at www.retirement2020.soa.org.

The 2008 Conference

As mentioned above, we shifted our focus in 2008 to drill down into some of the key objectives or features identified back in 2006 as important for a new retirement system. Our most recent conference, *Defining the Characteristics of the 21st Century Retirement System*, was held in November and covered the following major themes:

- Changing signals,
- Default distribution options,
- Self-adjusting mechanisms, and
- Market hedging opportunities.

An additional theme permeated many of the sessions, as there was considerable discussion from both panelists and attendees about behavioral finance and how the participant decision-making process impacts retirement planning, related choices, and eventual outcomes. Plan member behavior was the topic of our luncheon speaker, Brigitte Madrian, a Harvard professor and economist who has done significant research in this area.

As was the case in 2006 and 2007, the 2008 panelists represented a wide variety of disciplines. There were actuaries, economists, academics, investment advisors, and policy experts. These individuals represented

public and private sector employers, as well as government. We were delighted by the international flavor provided through presentations on the Swedish social insurance system, the Dutch collective industry-based plans (explained to us by a Dutch expert), and a behavioral finance experiment (presented by a Spanish academic). Both Canada and the United States were well represented amongst the less exotic panelists. This diversity of both professions and cultures once again proved to be a valuable aspect of the meeting.

Changing Signals

“Signaling” within retirement plans refers to design elements or other factors that direct participants’ behavior. These signals can be specific plan features or external factors such as policy statements or even cultural norms. For example, an early retirement age or an announcement about a new benefit provision can send signals (sometimes unintended) to participants that they should retire at a specific age or take a specific action. At the conference, the discussion of signals focused on the signals that currently exist and how they might be changed to influence participant behavior in a manner that would make a new retirement system work effectively over the long term. There was also discussion of what new signals one might want to imbed, or avoid, in a future system. Much of the dialogue focused on the signals that impact retirement age and people’s expectations with respect to what retirement is, or should be, like.

Presentations and follow-up discussions highlighted points such as:

- In a sustainable retirement system, retirement ages need to increase with increases in longevity. The signals imbedded in social insurance plans, the tax code, and employer- or industry-sponsored tier two plans should communicate this.
- Cultural expectations need to change to promote life-long learning and maximizing productivity in the workforce versus maximizing time spent in retirement leisure. This includes behavioral changes on the part of workers, the employers who need to employ older workers, and the governments that create policies and regulations.
- Expectations about the retirement period are often misleading. The focus in the media is often on leisure and relaxation (e.g., golf and cruises) rather than income security or age-related risks (such as the death of a spouse or a long-term illness).
- These expectations, coupled with the inherent difficulties most individuals have in making decisions related to long-term and uncertain outcomes, can result in suboptimal decision-making. Most retired individuals don’t buy annuities. They may retire before their retirement savings are sufficient for an adequate lifetime retirement income. They may spend too much of their savings in the initial retirement years, without an appreciation of their own life expectancy or the potential cost of care in their advanced years. Or, they may spend too little.
- Options within a plan need to be framed well, with good defaults that facilitate the action that people want or know they need to take. Choices must be presented in a simple, straightforward manner so as not to overwhelm and create “decision paralysis.”
- Much more needs to be done to improve the financial literacy and analytic skills of the general public, although even when financially literate, people often make decisions on an emotional basis.
- Encouraging follow-through even on an important matter can be a challenge due to the overwhelming power of inertia, as proven by research in behavioral economics.
- Due to the above two issues, signals may not always work as intended or expected. For example, the existence of generous

early retirement provisions signals that early retirement is acceptable and perhaps even desirable and this signal can be stronger than the signal given to the same plan participants by stating a normal retirement age.

- The terminology we use may need to change to match the signals we want to send. For example, “normal retirement age” implies an expectation that everyone should retire at one specific age. Unless this is what we want, perhaps we shouldn’t use the term.

Default Distribution Options

The default distribution options are important signals imbedded in retirement plans. Much of the discussion around this topic centered on annuitizing retirement assets: why it should or shouldn’t be done, why it doesn’t happen more, and what can be done to encourage it. As at the 2007 conference, there was general consensus that at least a certain level of annuitization is valuable and should be encouraged or mandated (this latter point was a subject of significant debate) to help individuals avoid outliving their retirement assets. Of course, whether or not people annuitize is often a function of the signals they get (both internal and external to the plan). Ideas and signals for encouraging more annuitization include:

- Develop government incentives, such as favorable tax policies, that encourage use of annuities,
- Create better and more portable annuity options in DC plans with retirement savings objectives,
- Frame the annuity decision differently and make annuitization the default option,
- Focus on the long-term nature of retirement and on longevity risk when offering retirement-related education,
- Encourage the development of better alternative annuity products and strategies (e.g., annuitization in stages, different refund options for perceived “premature” death, etc.).

Self-adjusting Mechanisms

The importance of self-adjusting mechanisms in retirement plans was another key theme of the 2006 conference. These are plan features that adjust “automatically” in response to changes in economic and/or demographic conditions that cause financial imbalance. Examples of self-adjusting mechanisms are social insurance systems that adjust retirement benefits based on longevity for particular age cohorts (as is done in Sweden) or defined benefit retirement plans that base cost of living improvements on plan funding ratios. A key aspect of these self-adjusting mechanisms is that they are based on pre-determined rules, which generally eliminate the need for human intervention at the time when adjustment is needed. They can allow a plan to remain viable as demographic and economic changes occur and ensure that problems are fixed before they evolve into a crisis situation.

Self-adjusting mechanisms have the advantage of allowing stakeholders to develop a set of rules that allow for risk-sharing and that take a long-term perspective, and to do so away from the emotion that may occur if changes are needed in the midst of a crisis. However, depending on the governance of the plan or system, there is also a “moral hazard” risk that the mechanism can be overturned (particularly in a financial downturn). The idea of self-adjusting systems can seem great conceptually, but the reality of what it means for individuals can result in overriding actions by the governing group. For example, one participant told the story of how a decrease in benefits to participants was overridden the first time the self-adjusting mechanism actually prescribed such a decrease. The success of

these systems is generally a function of good governance, good communication, and the resolve to manage the system for the long term by allowing the adjustments built into the system to occur.

Two different retirement systems were highlighted to illustrate different self-adjusting mechanisms. The Dutch retirement system and in particular their industry-wide pension funds are often viewed as a model for other systems. These plans cover all employees who work in a particular industry (somewhat analogous to North American multi-employer pension plans) and in combination with employer-provided plans cover nearly 100 percent of the Dutch workforce. These plans typically provide a traditional career average pay benefit formula, but incorporate self-adjusting mechanisms that can change the contributions made by employees and employers, the post-retirement indexation of benefits for retirees, the asset allocation, the amount of accrued benefits, and even the retirement age. These different provisions are changed based on the funding ratios (assets to liabilities) and are viewed as a model because risk is shared between employees and employers and across generations. Also, the fact that these plans are industry-wide allows them to operate with significant economies of scale and very low transaction costs.

There are some criticisms leveled at the Dutch plans in terms of the true extent of the inter-generational equity and the sustainability of the self-adjusting mechanisms, particularly in a financial downturn as currently being experienced. But overall, there are many lessons to be learned from the Dutch with respect to their system's design.

Another plan with some self-adjusting mechanisms is the Ontario Teachers' Pension Plan which covers all teachers in the province of Ontario (278,000 members, \$108.5 billion in assets at Dec. 31, 2007). This system is frequently praised for its strong governance features and recently implemented a self-adjusting mechanism where benefit indexing is conditional on certain financial criteria. This conditional indexing was implemented after extensive surveying of their membership that indicated a willingness to make concessions on indexing provisions but not on other features like their early retirement "rule of 85." The plan amendment was successfully negotiated in part because it incorporates a risk-sharing (or cost-sharing) mechanism. If the teachers fail to get the "normal" indexation, then the funding bodies must contribute more to the plan.

Common themes in both of these case studies are the importance of good governance, the sharing of risk among various stakeholders, and a general understanding and communication of the risk and the details of the self-adjusting mechanism to participants. In discussions, the need for participants to fully understand the self-adjusting mechanism was questioned, but there was agreement that it is helpful for participants to at least understand that risk-sharing is occurring. Also, it was acknowledged that self-adjusting mechanisms are not the end-all solution and may require intervention in extreme financial situations. Thus, self-adjusting mechanisms don't guarantee financial sustainability. And, while they don't exempt a plan from the need for good governance and sound decision-making practices, they can nevertheless be an important feature in our future retirement system.

Market Hedging Opportunities

The final theme of the 2008 conference was the role of markets in providing product solutions that will be needed for new retirement systems. A key question is whether the appropriate "raw" tools exist within the markets to deal with the challenges of longevity and inflation risk. Much discussion focused on the fundamental characteristics and effectiveness of markets,

particularly in light of the current financial crisis, in developing products that can hedge retirement-related risks.

The markets are generally the best place to create efficient prices for particular risks, but only to the extent that there is sufficient liquidity. So, for example, creating a product to trade mortality or longevity risk would only be effective if there is sufficient market demand from enough participants on both the “long” and “short” side of the trade. Questions were raised about whether government intervention is needed to create new products as happened with the TIPS market (inflation bonds) in the United States a decade ago. Ultimately it becomes a “chicken and egg” argument about whether you generate supply or demand first, with discussion leaning toward institutions creating products or systems that create demand first—with supply following.

An additional key topic of discussion was that of informational asymmetry. A good example of this is in the retail annuity marketplace. There, informational asymmetry exists because the buyers of products lack information or knowledge as compared to the seller. The role of education was seen as limited. One argument was made that if the information asymmetry is structural, it may require public choice (through defaults, mandates, or strong framing) to correct the problem.

The role of markets in hedging retirement risks and providing good product solutions will be an ongoing discussion area within the *Retirement 20/20* initiative, particularly as the markets adjust and evolve in the aftermath of the current financial crisis.

What's Next?

Now that we're three years into the *Retirement 20/20* project, where do we go from here? We've gathered a lot of input on the skills of stakeholders, and the optimal objectives and characteristics for a new retirement system. We believe that we've developed a sound foundation. Now, the focus needs to shift to developing blueprints of what a new retirement system might look like. With the change in the United States presidential administration and the ongoing financial crisis creating challenges for retirement plans on both sides of the Canada/U.S. border, the time is ripe for new ideas.

While we'd like to come up with a perfect solution that would be the panacea of retirement plans, we recognize that this is not a realistic expectation. Our plans for 2009 include consolidating and documenting the work done to date, as well as accelerating our efforts to evaluate existing plans and potential new designs using the Measurement Framework. The Pension Section Council expects to finalize its detailed plan for the coming year around the time this newsletter is distributed. More details will be forthcoming and we anticipate many volunteer opportunities. As stated, the goal of creating a better retirement system is an ambitious one for our profession, but we believe it's an important one worth pursuing.

Special Note: If you would like to learn more about this initiative, please review the *Retirement 20/20* Web site for more information (www.retirement2020.soa.org). If you're interested in volunteering on this initiative, please contact any Pension Section Council member, Andrew Peterson (apeterson@soa.org) or Emily Kessler (ekessler@soa.org) at the SOA. If you'd like to have someone do a *Retirement 20/20* presentation at your employer or to your actuarial club, contact Ann Gineo (agineo@sibson.com).

Andrew Peterson, FSA, FCA, EA, is staff fellow, retirement systems, at the Society of Actuaries in Schaumburg, Illinois. He can be reached at apeterson@soa.org.

[<< Previous Article](#) | [Next Article >>](#)

Actuaries
Risk is Opportunity.™