Pension Section News

January 2007

Welcome to an important milestone in the evolutionary process of bringing our Pension Section Members the most relevant information in a timely manner. This publication is the first electronic version of the Pension Section News. And, because your Pension Section is sponsoring the all-encompassing retirement system design project *Retirement 20/20,* we decided to dedicate our first e-issue to this topic. Below you find articles that will educate you and bring you up to date on the first *Retirement 20/20* conference, held recently in Washington, D.C.

Not taking anything for granted, your Pension Section Council is asking you to take just a moment, after reading this issue, to complete a brief survey to indicate your preferences for Pension Section News format. The survey is completely anonymous. We will adjust our delivery of the PSN according to your preferences. Thank you for your time and interest.

Martine Sohier

Building the Foundation for New Retirement Systems

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An Actuary's View of The Future of Life Cycle Saving and Investing

By Anna M. Rappaport, FSA

In this article Anna summarizes a conference, The Future of Life Cycle Saving & Investing, which she recently attended. The conference was sponsored jointly by the Federal Reserve Bank of Boston, Boston University, and the CFA Institute.

Phased Retirement Programs: Has the World Changed?

By Anna M. Rappaport, FSA and Steve Siegel, ASA

This article examines the decision process for launching a phased retirement program.

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Introduction

The SOA Pension Section sponsored the first *Retirement 20/20* conference "Building the Foundation for New Retirement Systems" recently in Washington DC. The focus of the conference was on the needs, risks and roles of the stakeholders in retirement systems. The two-day conference attracted a diverse group of actuaries, attorneys, economists, public policy experts and employers from both the US and Canada.

In considering why our system is not working today, conference organizers recognized that it is not meeting the evolving needs of key stakeholders. The first step, therefore, in designing new retirement systems is to reexamine who the stakeholders in the system are, what the system must accomplish to meet their needs, what risks these stakeholders can take on and what role they can play in the system.

The conference considered needs, risks and roles for four key stakeholders in the system:

- Society (generally represented by government systems such as social insurance);
- Individuals;
- Employers (who, in the US and Canada, sponsor retirement plans); and
- Markets (which pool and hedge risks)

The consideration of needs, risks and roles looked at three questions specifically:

- What does each stakeholder need?
- What risks does each stakeholder face?
- What role can the stakeholder play?

The group spent a lot of time talking about what is working, what is not, and what we need to do to make it work going forward. This document will focus on six themes that the discussions returned to again and again throughout the conference. These themes do not necessarily touch specifically on needs, risks and roles but they start to outline the questions we need to address in the development of new retirement systems.

Transition is not easy

At this stage, Retirement 20/20 is focusing on what we need new retirement systems to do. We realize that this focus leaves a big piece of the puzzle out of the picture, namely, how do we get from where we are today to where we need to be?

We know that transition issues are not inconsequential and could derail the success of any new retirement systems. However, at this stage we also believe we need a better picture of where we are going– what the new system might look like – before we can determine what might need to be done to get us there.

Retirement 20/20

The six themes are:

- Systems should be designed to self-adjust;
- Systems should align stakeholders' skills with their roles;
- Systems should consider new norms for work and retirement and the role of the normative retirement age;
- Systems should be better aligned with markets;
- Systems should clarify the role of the employer; and
- Retirement systems will not succeed without improvements in the health and long-term care systems.

This report will highlight the six themes, giving you some insight to what participants talked about. The next two reports will focus on the conference itself, and finally on what we learned from the conference about needs, risks and roles for our four stakeholders. All conference reports will be available at www.retirement2020.soa.orgT.

Systems should be designed to self-adjust

Any system that is to survive should be self-adjusting. Quite simply, the system should be built to be flexible to adapt to changing conditions. For example, increased longevity and the evolution of global competition have changed what we need from a retirement system. This has put pressure on today's system and is part of what is causing it to falter. If today's system had self-adjusted, then it might still be working today.

Participants discussed three things in particular around the issue of system self-adjustment:

- Systems should be self-adjusting based on our evolving ideas on how we use human capital. Retirement systems should adjust as we work (and retire). If we are working longer, or having several careers, then we should have systems – retirement and others – that support these new ideas about work and life. Today's traditional pension plan assumes retirement is an event: one day you are working, the next day you are not. Tomorrow, we may need people to move between periods of work, study and leisure at different stages of their life. Going forward, we need retirement plans that permit more flexibility in how and when benefits are paid, and that can adjust as conditions for workers change as well.

- Systems should self-adjust based on how long we are living. One example where systems do not adjust is retirement age. The typical private sector plan retirement age– 65 – was set by the German Chancellor Bismarck over 100 years ago. We use it because it is enshrined in statute in the US and Canada. As we live longer, this combination of a fixed retirement age with increased longevity has increased the cost of defined benefit pension plans over and above that of inflation. A simple self-adjustment to retirement age would keep the cost of the system affordable but would also keep the promises in line with those made to prior generations.

> *"There's no reason actuarially why we can't build in some caveat in the design of plans [public or private] that [says], look if [costs get] way over here, then automatically two or three things happen … Seems to me that we might be able to constrain the risk (the risk being variance) by having some of these default options that, if we get into bad times, [adjustments] automatically occur"*
>
> *Conference participant*

- One aspect of risk in any system is variance: how much do the results vary from the "norm" or "expected" value. Systems should limit risk by constraining variance within the system. If conditions arise such that the costs of a system start to rise above a certain tolerance levels, benefits are adjusted so that all parties – payers and payees – share in the burden. One example of this is Canada's CPP plan. In this plan, if costs rise above a certain level, contributions increase but benefits are also constrained, by limiting the amount of inflationary increase beneficiaries receive. In this way, the variance in the cost of the system is limi

Going forward

Self-adjustment will often shift risk from one stakeholder to another. When we look at this idea, we must consider the following:

- *What parts of the system should self-adjust (e.g. social insurance, private plans)?*
- *What characteristics should be considered for self-adjusting (e.g. retirement age, benefit levels)?*
- *How much should risk be shifted, and how much should any change in the risk be shared between stakeholders in the system?*
- *How do these adjustments change the needs, risks and roles of the various stakeholders?*

Systems should align stakeholders' skills with roles

As participants discussed in depth what role different stakeholders could play in the system, one theme quickly emerged: align each stakeholders' skill set with their roles. This seems obvious but participants cited several examples where it does not currently happen:

- It may not be rational to expect individuals to be experts in retirement planning, particularly investment. One participant cited 13 years of research on the knowledge of individuals as investors and provided several salient conclusions, that "first …the focus on educating participants is an admirable goal, but it hasn't been working. Second, as structured currently, defined contribution plans are not working well for many participants … Third, on paper, 401(k) plans and defined contribution plans provide the right incentives, the right investments, the right educational tools and in many cases, even investment assistance and advice, but in reality human nature gets in the way."

  Other participants cited the work of behavioral economists on the difficulties individuals have with retirement planning. One participant noted that we need to decide what level of financial education is appropriate: "Do we expect people to be able to drive the car, or do they have to know how to fix it in order to drive it?" Historically, the defined contribution system has expected participants to not only drive the car, but to be able to fix it (choose the investment policy) and create the map to know where to drive it (set a level of contributions to provide adequate retirement income). Is such expert knowledge required or legitimately expected? Or can we design systems that work in spite of participants' inertia and lack of knowledge?

  > *"[W]hy would any reasonable person think that people not trained in investments would be able to make these decisions in any sensible way? … I've been teaching investments for 35 years, so to me it's second nature. But let's take an area like medicine … Now I consider myself a reasonably well informed consumer of medical services, but I wouldn't dream of diagnosing my own illnesses …even if my doctor said 'You know performing minor surgery is really not such a big deal. I can give you the equipment and a brochure and you can take care of it on your own.' Well you laugh, [but] that's what we're doing now with 401(k) plans."*
  >
  > *Conference participant*

- It may not be rational to expect every employer to operate a pension plan. At many times during the conference, the role of the employer in the system was examined. We considered whether the employer has the right skill set to operate pension plans, particularly given their complex legal and financial aspects. Employers' exist to create value in their core businesses; do the sponsorship and operation of pension plans enhance this value or detract from it?

Litigation risk with regard to the management of any retirement benefit plan was discussed. Employer representatives echoed repeatedly that the threat of litigation is a significant concern in the operation of retirement plans. One participant noted that it is the mere threat of a lawsuit which is potentially damaging, particularly for large employers.

Other participants brought up the shorter lifespan of corporations relative to traditional defined benefit pension plans. Is it rational for employers to sponsor retirement plans and operate them in a way that creates residual liabilities long after they are gone?

However, many people countered that people do better saving for retirement when their employer is involved. One participant quoted an EBRI statistic that over 77% of people making between $30,000 and $50,000 save in an employer defined contribution plan if one is offered. But, if no plan is offered, in that same income group, only 5% of people save.

Making system work better for politicians

Ideas such as self-adjusting systems and aligning skills with roles could help improve the efficiency of our political process. Why? As taxpayers we entrust politicians with designing and managing our retirement system. If the system is designed in ways that politicians' success is not misaligned against public interest, both politicians and the system can do a better job.

"[W]e might want to consider …introducing structures that would make doing the right thing for individuals a little bit easier for legislators … the political incentives currently for doing the right thing if you're a legislator are very, very low. Representatives in the US Congress face reelection every two years, so they really have a vested interest in delivering the goods now and not making the tough choices."

Conference participant

Going forward

Aligning skills with roles requires a fundamental reexamination of existing structures. Just because it has been done this way does not mean it is the best way to do it. But this represents changes to the system, which should be discussed openly by all stakeholders involved.

What can we reasonably expect from stakeholders without a great deal of knowledge and training? While it is always easy to say "should" (individuals should take more responsibility for retirement, employers should see the value in sponsoring a retirement plan) maybe we ought to be realistic about what is most easily done.

Systems should consider new norms for work and retirement and the role of the normative retirement age

Conference participants kept coming back to issues of work and retirement, particularly retirement age. Retirement age considers both full retirement age – the age at which full benefits are payable (currently 65 for most private plans and gradually increasing to 67 for US Social Security) but also the age at which benefits are first payable (varies, but often age 55 for private plans and currently age 62 for US Social Security). Studies have shown that both the full retirement age and the early retirement age affect people's decisions to retire.

> *[T]he need is clear. Many people are going to work longer, if they can. The risk is that workers won't be able to work longer due to ill health or disability or because employers won't want them or because the closer they get to retirement, the better retirement is going to look…. What is the appropriate role of the various stakeholders (government, society, employers and workers) in extending work life and insuring appropriate opportunities are available … and in discouraging the early [commencement] of pension benefits?"*
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> *Conference participant*

On one side, participants argued that there was no need for a retirement age – the system can be set up to adjust benefits to be actuarially equitable at whatever age participants choose to retire. As the retirement experience may vary based on needs – later retirement for knowledge workers, earlier retirement for physical laborers – then not having a set retirement age may more easily meet this need. However, other participants pointed out that retirement ages send signals to individuals as to what age is appropriate for retirement. If we, as a society, want to encourage longer work, then increasing retirement ages is an important tool to drive behavior change. In particular, early retirement age, much more than the full retirement age, acts as a "target" age for individuals in retirement planning. Studies have shown that raising early retirement ages is more effective at delaying retirement than raising full retirement ages.

> *"I'm a big believer in neutrality … when I hear people say 'well, we shouldn't encourage early retirement' I agree with that. But, when I start hearing we should encourage people to work longer, that will very quickly morph into we should punish people who retire at the age they wanted to retire and that's not the job of the system to do."*
>
> *Conference participant*

The role of work at older ages was discussed from many different points of view. From the individuals' point of view, the discussion centered on how much longer can we expect, as a social norm, individuals to work? We already know that many people are not able to work longer, due to the type of job, disability or family needs (e.g. caring for partner/parent). However, participants agreed that if you push out retirement, we have to get much better at providing disability income. From the employers' point of view, do you want to have an older workforce? What sort of challenges does that bring? Can you effectively manage an older workforce with or without retirement plans? In this new process, would retirement plans play a more important workers who cannot work but retain those who can) or do they become a hindrance (use severance packages and individual contracts to choose who you retire and who you retain)?

Going forward

The changing nature of retirement – from an event to a process – is being driven by increases in life span and is in turn driving many changes we see today in the retirement system. Understanding how this is evolving, including where new social norms are headed, is critical to establish a successful new retirement system.

Not everyone will be able to work longer. We need to look carefully at what the different needs for retirement will be based on different individual characteristics. Stakeholder roles may need to change to support those different norms. For example, employers may be more involved in helping those physically no longer able to work after retirement, where as society may encourage as many people as possible to work longer.

Systems should be better aligned with markets

Many participants felt strongly that the system should look to markets to pool and hedge risks, and not leave those risks to the employer, the employers' shareholders or the employees. Today's system is a seesaw – most risk either lies with the employer (and its shareholders, in a traditional DB plan) or with the individual employee (in a DC plan). It is an unsophisticated way to deal with risk, and certainly does not manage risk by pooling it or hedging it in markets. Several participants also argued that employers should not be bearing risks that do not add to shareholder value, and that if employers make promises, they should properly price the commitments they are making.

> *"[Market] discipline [is] a necessary, but not sufficient, condition for a successful retirement system. Number one, policy makers should stop improving on market pricing. Two, we need more complete markets including mortality and inflation security. And three, while waiting for more complete markets, plan designers and regulators should make and price benefits more in line with the securities that are already available."*
>
> *Conference participant*

The principal focus of the discussion was that any new retirement plan designs should work with the markets and utilize the ability of the markets to effectively pool and hedge risks. The arguments made by several conference participants were that capital markets offer efficient pricing and risk bearing and therefore should be utilized as much as possible. Any system that does not use market mechanisms and does not work within market frameworks (e.g. transparent costs) may not be accepted by the markets and may fail. Participants also discussed the value of having groups approach the market rather than having individuals make their own market contracts.

> *"I would certainly urge caution in putting too much faith in either the markets or the public sector … history is replete with examples of markets overshooting and governments overreacting. [H]aving said that, I do believe that prudently regulated markets are better than wholly unregulated markets. It's a calibration that's very difficult to achieve."*
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> *Conference participant*

However, it was noted that today's markets are not complete. Markets do not hedge all the risks they can hedge, and there may be some risks for which the cost of the market hedge may be beyond what individuals are able to pay. Markets also cannot provide the kind of hedging instruments that individuals truly need. The example of longevity bonds was discussed. Longevity bonds are issued to hedge systematic longevity risk (the risk that the average person lives longer than expected). To date, several firms have attempted to issue bonds but with little interest in the market to purchase them. The incompleteness of the model for inflation-linked bonds in the US was also discussed (the TIPS market).

Going forward

Most of the market focus has been on short-term financial risks. Retirement systems present longer risks than most risks the market pools or hedges. This would argue for new market instruments to better meet retirement risks. Markets may not be able to hedge all risks, or may be only able to hedge them at a price individuals cannot afford.

What can the markets do well, and what are the markets currently unable to do (but may be able to do in the future) and what are markets simply unable to accommodate? Where markets cannot hedge risks, should they be borne by individuals? Should they be shared with other generations? Where is transferring risk from one stakeholder to another appropriate?

Systems should clarify the role of the employer

We discussed at length whether the employer based system should continue. As noted earlier, many employers expressed concerns with their role today, particularly in terms of the fiduciary risk faced in the current system. But other concerns about employers' role in the system were raised as well.

> *"[W]e talked about … the short life of a corporation. I have over simplified my thought about that in that I think the only people who should make promises instead of coming up with the cash are those entities that can print money … [the responsibility] probably shouldn't reside within the employer on a defined benefit basis."*
>
> *Conference participant*

- What role do retirement plans serve for employers? There was an acknowledgement that retention and orderly retirement of employees was a key goal of plans. But most employers noted that in terms of attraction of employees, employees only consider whether the employer has a retirement plan or not, and not what the plan looked like or what level of benefits were provided.

- Retirement plans must meet corporate goals, or they should not be run by employers. Participants noted that there has to be a reason why employers sponsor retirement plans, other than historical tradition. If retirement plans do not meet corporate goals, then why do they exist? Similarly, the ability of retirement plans to assist in the attraction, retention and retirement of employees must not conflict with the employer's core business.

- Companies exist in a global economy. Many countries do not have employer sponsored retirement (or, for the US, health care) plans. It is difficult to justify the cost of plans for the employers given global competition.

> *"[W]hy do we feel this compulsive urge to jump in the middle of [employees'] retirement plan when we don't feel it anywhere else?… [U]ntil we can give answers to what is in it for the corporation, I think what you're going to here from [outside] directors over and over is we don't want to be the deep pocketed player in the game. We want to be an interested bystander."*
>
> *Conference participant*

- One goal of retirement systems might be the redistribution of income, from more to less wealthy individuals. But does it make sense for employers to redistribute wealth? Employers have goals that often work against this, such as rewarding the most productive workers. If they are to remain part of retirement systems, can we expect them to support social goals of retirement systems as well?

- Statutory frameworks have to encourage rather than discourage employer behavior. Much has been written about this in terms of funding of pension plans and how assets are invested. One area that came up for discussion is to benefits under the current accounting system overstates costs for younger workers and understates costs for older workers who are in defined benefit pension plans. This framework may be one factor discouraging these plans because the cost framework does not match the value the employee and employer sees from the system. This is simply one example of how the cost of the system, as set by funding and accounting bodies, should align well with the employers view of the costs; if they do not, then employers may not be inclined to sponsor plans.

Going forward

We need a fundamental reevaluation of the role of the employer in the system. Conference participants noted studies that have shown that employees trust information received from their employer more than information received from other sources. And employers note the role of retirement systems in helping them to retain and retire employees. But those two goals could be met by other forms of compensation. The group pooling and purchasing that have taken place through employer systems are valuable, but could those be accomplished by other means? Could the employer role simply be to act as a conduit to retirement plans, not as the sponsor of the plan?

The role of work and retirement ages was discussed earlier. Work at older ages will not become the rule rather than the exception unless it is embraced by employers. Keeping workers in the job market requires workers and employers to understand the benefits of work at older ages. It also requires the system to permit employers to differentiate between those workers who can valuably work longer and those who cannot.

Retirement systems will not succeed without improvements in the health and long-term care systems

Finally, conference participants felt strongly that any retirement system redesign will fail unless changes are also made to the health care (particularly in the US) and long-term care systems. Several participants noted the ballooning deficits for Medicare (health care) and Medicaid (long-term care), noting that there would likely be cutbacks in those programs going forward. In addition, most private employers in the US no longer offer health care benefits to retirees (particularly future retirees) and many in the room predicted health care benefits for government retirees would soon disappear in the US with the introduction of new accounting standards for those benefits.

Several concerns were raised that we can create the most perfect retirement systems in the world but it will not work if the health care and long-term care systems are not aligned as well to meet it. Participants cited recent studies showing that individuals will not annuitize their income – protecting them from outliving their assets – because they are concerned about needing large sums to cover medical costs.

In addition, the instability and rapidly rising costs of health care is decreasing future retirement benefits. Employers noted that they have limited budgets to spend on employee benefits, and as health care costs continue to escalate, they are often cutting the retirement benefits to be able to continue to pay for future health care.

Will Retirement 20/20 tackle issues in the health care and long-term care systems?

The Retirement 20/20 project is focused on finding solutions for retirement income. There are no plans to consider necessary revisions to the health care and long-term care systems. Health care affects everyone – children, workers and retirees – and would need to be considered for society as a whole, not just from the point of view of retirees. Long-term care is a complex system in and of itself with issues that go beyond those facing retirement income. Both of these are significant projects which deserve their own dedicated experts working on them. Retirement 20/20 does not have the resources, or the experts, to devote to these issues.

The Pension Section Council will encourage others to take on the challenge of addressing health care and long-term care. We will communicate broadly that changes to the retirement system cannot succeed without also addressing these other vital components of retirement protection.

An Actuary's View of The Future of Life Cycle Saving and Investing
By Anna M. Rappaport, FSA

I recently attended a very interesting conference, The Future of Life Cycle Saving & Investing, sponsored jointly by the Federal Reserve Bank of Boston, Boston University, and the CFA Institute. The conference was attended by a diverse group: several important academics, economists and experts on finance, members of the Federal Reserve bank, actuaries, policymakers and regulators, attorneys, representatives of the financial services industry, CFAs, and people in advisory roles.

The topics including discussion of the Life-Cycle Model, findings from behavioral finance, a discussion of managing risks post-retirement, a discussion of the role of government, some discussion on software, and some perspectives on the future. The full program, papers and presentations can be found on the conference Web site, http://smg.bu.edu/exec/elc/lifecycle/. I recommend the papers to you.

I found a lot of overlap between the topics covered there with recent research within the actuarial profession, and with the topics discussed at Retirement 20/20, a major project of the SOA. This article will link some of the content to topics of interest to actuaries and to some of the work that actuaries have been doing and raise questions and perspective. For a summary of the content, look at the summary provided by Zvi Bodie, a professor of economics and finance, and conference organizer. That summary can be found on the Web site referenced above.

Challenges to Traditional Ideas Challenges to traditional investment ideas were central to the discussion. Bodie has collected numerous examples of ideas that he views as false, that are in the public domain and presented as correct information on the Web sites of large and highly regarded institutions. Bodie identifies three notions he suggests purging from the popular literature along with three replacement ideas from the discipline of financial economics that are, in contrast, worthy of wide promotion:

Popular literature	**Financial Economics**
Saving is for the short run. Investing is for the long run.	Saving means income minus consumption; investing means selecting your portfolio of assets.
The only way to reduce risk is to diversify.	The simplest ways to reduce risk are to hedge, insure or hold safe assets. A safe way to achieve a future consumption target is with CPI-linked bonds.
Stocks become safe in the long run due to "time diversification."	Stocks do not become safe even in the long run. If they did, they would not have a risk premium.

He raises an important issue with regard to equity investment and causes us to ask the question "When is it appropriate for individuals to invest in stocks?" I find it very interesting that well schooled financial people including economists, actuaries and others have very different views about the appropriateness of stock investment in different circumstances. Divergent views exist within each of these professions. I also think that some of the discussion about stock investment, while appropriately focusing on the risk, fails to recognize that stock investment is a form of ownership and gives people a chance to participate in the growth of the economy. I am not prepared to take a position on the question of who is right and who is wrong in these many discussions.

Perspectives on Consumption Targets

The key paper, "The Theory of Optimal Life Cycle Saving and Investing," by Zvi Bodie, Jonathan Treussard and Paul Willen sets the stage for the dialogue. The authors review the theory and point out that there are gaps between theory and practice. In her discussion, Deborah Lucas from Northwestern University raised practical issues about the use of this model. She cautioned us to realize that people have many different life paths and that an exclusive focus on phases of the life cycle tends to oversimplify for many people. She also focused on the importance of contingent events, and emphasized the importance of decisions such as marriage, divorce and family size and the fact that uncertainly surrounding them limits the ability to make forecasts with precision.

Another paper by Laurence Kotlikoff introduced practical models and focused us on consumption smoothing. Life cycle saving and investing are linked to consumption smoothing or some other method of reallocating consumption over the life cycle. A common way of focusing on income needed after retirement is through the use of [O1] replacement ratios. Actuaries have commonly used replacement ratios in thinking about pension plan design and measuring benefit adequacy. Some of the models of life cycle financial planning presented focused on lifetime consumption smoothing (usually inflation adjusted [O2]). While this is appropriate for some people, many others will have different ideas. It is hoped that actuaries can have some dialogue on this issue, focusing on different approaches to determining what is needed and wanted in retirement, how they differ and how they are the same. I see actuaries as being able to add to the discussion in several key areas:

Identification of risks together with information about what risks can be transferred effectively in the current marketplace and how.

Very good participants in a discussion about how the marketplace may evolve.
Practical knowledge of how retirement systems work, and regulations interact with each other. Many actuaries have hands-on experience working within the system. The combination of hands-on experience and theoretical knowledge is very valuable as we think about these issues.

My opinion about life cycle consumption as we think about retirement needs and wants is as follows:

A way to link traditional replacement ratios and consumption targets is to make an implicit assumption that income is consumed except for the amount saved and paid in taxes, and what does not need to be replaced is savings, Social Security payroll taxes and/or work related expenses.

For example, an individual who was saving about 10 percent of income prior to retirement and consuming all the rest of current income, and who no longer does paid work and therefore no longer pays Social Security payroll taxes can probably continue his or her standard of living with about 70 percent to 80 percent of pre-retirement income plus the increased cost of medical premiums. This links traditional replacement ratios with consumption targets.

That amount would be adjusted in some common situations. For example, a family saving more than 10 percent would need a lower amount relative to pre-retirement income. This assumes that a family pays off its mortgage at time of retirement, so that the income needed to maintain consumption post-retirement is reduced. Similarly, a family that had heavy college expenses in the years before retirement will not need to count that money in consumption that will continue into retirement.

During retirement, consumption may be higher early on as people pursue their retirement dreams, such as travel for example.

Consumption levels may also change. Some people may want to stay in the same house and geographic area, whereas others want to move, perhaps to lower cost housing to enable earlier retirement. Others may want to spend more on housing and become snowbirds or have multiple-type dwellings for different uses. People who have larger homes are ultimately likely to downsize, even if they do not have to for economic reasons. The problem of caring for larger homes can be substantial later in life.

Medical costs and the need for care are likely to increase in retirement. When an individual not eligible for Medicare exits an employer paid health plan, costs for insurance are likely to increase greatly.

Consumption varies over working adult life, and the new retiree probably will want to continue or modify based on consumption just before retirement.

We can think about income as representing a bare minimum, plus added amounts to do things that we want to do. We might think about the need for guaranteed income as linked to the bare minimum.

In my view, neither consumption smoothing or traditional replacement ratios properly address the issue of changing needs during retirement, by focusing on the one-time transition from pre-retirement to retirement. The premise of consumption smoothing is a good start, however, by recognizing at least the reality of fluctuations due to the occurrence of different events over time.

Part of the discussion about consumption smoothing over the life cycle included the idea of borrowing early in life. If borrowing goes beyond student loans and a home mortgage, I do not think it is a good idea. We do not really know what our ultimate income will be.

I also find that inadequate focus on risk management is a failure of both consumption smoothing and traditional risk management.

The Role of Defined Benefit Plans Most of the conference was focused on challenges with regard to providing retirement security and income in personal savings accounts and defined contribution plans.

These systems do not usually provide lifetime income and offer significant challenges with regard to lifetime security. These challenges do not exist in traditional defined benefit plans, which are a natural way to provide income. While most of the discussion in "The Future of Life-Cycle Saving & Investing" relates to individual saving and defined contribution plans, we need to remember that defined benefit plans work very well in the appropriate setting.

These plans are facing many challenges today. A key question is whether it is worth trying to meet those challenges and continue to use defined benefit plans. Public sector employers are generally continuing defined benefit plans, although state legislatures are increasingly challenging them. [O3]The number of private sector employers offering these plans is shrinking markedly. The paper by Alicia Munnell provides trend data on the overall use of various plan types.[O4] The discussion by Deborah Lucas focuses on the importance of DB plans.

I believe that DB plans provide a direct and easy way to provide lifetime income, and that they remain valuable. There are many threats to these plans and the existing designs are not attractive to plan sponsors in the U.S. accounting and regulatory environment. There are different views of how to move forward. Some people are seeking ways to strengthen and preserve these plans, some are seeking new plan models, and others have essentially given up on defined benefit plans as a part of the future retirement income delivery system. I strongly encourage not giving up on defined benefit plans, but rather seeking out models that can work in the evolving environment.

Risks and Risk Management

The primary focus of the conference was on lifecycle saving and investing, with a lot of focus on consumption smoothing. At the same time, speakers recognized that risk management and particularly lifetime income are part of the picture. My paper focused on post-retirement risks and risk management issues. Mark Warshawsky focused on long term care risk, and how packaging long-term care with a life annuity may be a good way to manage both risks. Jerry Golden talked about income annuities and how their price might vary depending on the risk management decisions the buyer made. He showed the difference in cost for a single life annuity versus a joint and survivor annuity, and then showed the effect of life-care provisions, indexing and inflation and some other features. I believe that one of the primary weaknesses of much personal financial planning is an inadequate focus on risk and how to manage it.

The Role and Importance of the Employer

The conference discussed the employer's role and the importance of the employer several times although there was no panel specifically focused on that topic. I feel that there was inadequate focus on the importance of the employer. It was clear from the discussion that individuals are not managing well enough on their own, and that some combination of government programs, employer programs and mandates are essential for financial security. There was no way to conclude from the discussion what the preferred mix was by the group in total. However, from the panel on the role of government, it was clear that some presenters preferred mandates to plans voluntarily established by employers.

Traditionally employers offer income through defined benefit plans, and while they offer a reliable source of life income, most private sector plans in the United States do not include inflation indexing [zb6], leaving a gap in income protection. However, most defined contribution plans offer lump sums and not life income and as these plans are growing, it is important to consider issues surrounding life income in defined contribution plans. These plans have evolved, are more often the primary retirement vehicle and in the last few years there has been a growing focus on results produced by these plans. For instance, default options are now recognized as critically important, since many employees stay with them and do not make an active choice. The paper presented by David Laibson made clear just how important default options are and how much they influence the results produced by plans. Common defaults today include auto-enrollment, auto-increases and investment defaults using balanced and life cycle funds. It is uncommon to find benefit distribution defaults in DC other than a lump sum. This is an area for further development and default options for payment of benefits were discussed in several different panels.

The distribution of benefits and making funds last during retirement are important issues in achieving success and meeting life savings plan goals and employer plan goals. Satisfactory results post-retirement will depend on having good methods for providing advice and life income to employees and retirees in an efficient and unbiased manner. Employers could play a key role in selecting the providers that would offer group products for risk protection through the employer.

Plan sponsors are reluctant to offer annuity options directly because few people choose them and in addition, regulatory issues such as joint and survivor annuity and spousal consent requirements, the implications of the Norris decision, "safest annuity rule issues," and/or fiduciary responsibilities, etc., create more work and uncertainty. It should be noted that the regulatory climate tends to offer incentives to employers not to offer income. The employer who offers only a lump sum option does not need to get spousal consent for plan distributions. In contrast, the employer who offers an annuity option must offer a joint and survivor annuity and must get spousal consent in order for someone to elect out of the option. One of the other complexities is linked to the Norris decision: while annuities are usually priced using different rates for males and females, employers are prohibited from using sex-based rates or features inside of defined contribution pension plans. A third complexity is the minimum distribution rules. The most desirable form of annuity option would be one that allows purchase in several chunks over time, but the minimum distribution rules fight against this. The safest annuity rule also opens the employer up to fiduciary liability.

Instead of offering income directly through the defined contribution pension plan, companies such as IBM are beginning to offer annuity options outside of the plan, but with institutional pricing through a third-party IRA rollover program. Under one third-party program now being used by some large companies, the annuity is shopped using an automated process to get a good price, it can be purchased at retirement or later, and in steps over time. A group of employers is also working on an annuity purchasing coalition using institutional pricing of the product. Note that the Pension Protection Act opens the way to an easing of the safest annuity rule issues. Working through the employer is one way to deal effectively with the distribution system issues. It will, however, have a chance only if the regulatory issues are dealt with to make it easier.

Regulatory Issues and the Role of Government Alicia Munnell presented a paper on The Role of Government in Life Cycle Saving and Investing. That paper focused on longer term options for the role of government. The author recognizes that there are limitations on the effectiveness of individual efforts and she recommends mandated saving as a second layer on top of Social Security. Such a mandate is similar to the MUPS, recommended by the President's Commission on Pension Policy in the Carter administration or to add-on private accounts in Social Security. There was also a discussion about the Netherlands and its approach to retirement security [O7].

These structures offer alternatives for reconfiguring the retirement income system. Within the present system, there are regulatory issues that create roadblocks to payment of retirement funds as income. These regulations are important in understanding the functioning of the current system, and modifying them offers a path to improving income delivery aspects of the system. In addition to the issues mentioned above, the intersection of regulations affecting the insurer and plan sponsor must also be considered. When the regulatory issues facing all of the stakeholders in the retirement system are merged, the total impact of the regulations is overwhelming. Two of the most serious issues are the conflicts with regard to unisex rates and issues surrounding minimum distribution rules. Employer plans are not permitted to use sex-based rates, whereas virtually all annuity contracts are priced using sex-based rates. The minimum distribution rules require that qualified plan funds be distributed beginning after age 70-and-a-half. Their structure creates complexity for purchasing annuities over time on a staggered basis and for combination products that put annuity and long-term care into the same insurance product. Both annuities and long-term care are heavily regulated, but by different rules, and the regulations make it hard to combine them. Provisions of the Pension Protection Act open the way to combination products in the future.

There are also regulatory complexities in products sold to individuals. Some of these products require compliance with both securities and insurance law.

Conclusion This is a time of major change and challenge to the American retirement landscape. This conference set forth many interesting ideas and perspectives. The way of thinking about the ideas is quite different from much of what we have traditionally done. It helped me to think more about benefit adequacy and replacement ratios and the retirement system, ideas that I have lived with for many years. My concerns about the discussion were as follows:

Lifetime consumption smoothing is unrealistic. However, when taken together with replacement ratios, a focus on consumption adds to our understanding of retirement needs.

Risk management needs to be much more prominent in our thinking about this topic.

The employer is a very important part of the retirement system and we need to encourage and value employer sponsorship of plans.

Regulation is often in the way of doing some things that are desirable.

I plan to bring these ideas back to the Committee on Post-Retirement Needs and Risks. One of the issues that needs work, which the Committee identified over the last few years, is retirement needs and more understanding of spending. We have a paper-call out on that topic. It is hoped that this article will also encourage you to think about these issues, read the papers and add to the dialogue.

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Phased Retirement Programs: Has the World Changed?

By Anna M. Rappaport, F.S.A. and Steve Siegel, A.S.A.

F. Scott Fitzgerald, the novelist who coined the expression the "Jazz Age" to describe the 1920's, once said "There are no second acts in American lives." Although the "Great Gatsby" did not make it to retirement, millions of Americans are disproving this maxim by varying their approach to traditional retirement in what is commonly known as "phased retirement." It's clear the world has changed greatly since the 1920's and there has been much discussion in recent years about the importance of phased retirement as evidenced by growing numbers of employees leaving the labor force in other than traditional ways.

An important development in this evolution is the recently enacted Pension Protection Act of 2006 which now allows defined benefit plans to make payments to active employees beyond the age of 62 with distributions permitted in plan years beginning on or after January 1, 2007.

Previously, the inability to make such distributions before an employee either terminated employment or reached the plan's normal retirement age had been one of the barriers to formal employer supported phased retirement. Now, with this new legislation, will we see major change with a great number of employers suddenly embracing phased retirement programs? In this article, we will share our opinions and hope that you will write in and share yours as well.

To address this question, it is first helpful to think about the decision process for launching a phased retirement program along with the program's goals, benefits, and potential hurdles. In addition, to provide a full perspective when contemplating these programs, it is beneficial to examine how these programs have evolved in recent years.

What are the initial considerations for planning?

Our view is that the optimum way to plan for phased retirement is to first consider what options should be offered, to whom they should be offered, and how those who choose them should be paid. For example, some employees may simply want to continue in their same job with a reduced schedule. In this situation, pro-rata payment may be fair and reasonable compensation, provided that their health insurance is continued and they keep earning pension credits and/or receive a partial pension payment. For employees who will be used for special projects, as opposed to working a regular, although reduced schedule, the best option may be to let them formally retire and collect their pensions. The employer can then pay them for the project work, although it may want to limit project work to no more than 1,000 hours per year. In all of these situations, the guiding principle should be that the pattern of compensation to the employee should bear some relationship to the pattern of the work.

What needs to be contemplated from a legal and compliance perspective?

Prior to the Pension Protection Act, there were a number of legal issues involved in establishing a phased retirement program including compliance with the Age Discrimination in Employment Act, general non-discrimination rules, rules affecting the rehiring of retirees, the ability to make in-service distributions from a defined benefit plan and a host of other issues. The Pension Protection Act addressed only the in-service distribution issue so many other complexities and compliance issues surrounding phased retirement remain unchanged. In addition, final regulations incorporating the Pension Protection Act still need to be drafted and the ultimate language could alter an employer's optimum approach.

How large should the program be?

When thinking about the size of the program, it is important to assess current and future organizational resource needs and how the group of employees nearing retirement link to these needs. Some pertinent questions include:

What talent gaps is the employer likely to have and for how long? Do they relate to numbers of full-time equivalents (FTE's) or firm-specific knowledge? Examples of firm-specific knowledge include relationships fostered with key customers, product expertise, institutional history, customized computer systems, etc.

How many employees are likely to be eligible for such a program?

Are there individuals associated publicly with the employer's brand? For example, a chief economist in a bank may provide a great deal of market prestige.

Are there any groups of employees with highly specialized knowledge who are difficult to replace, e.g. research scientists in a pharmaceutical company, emergency room nurses in a hospital, nuclear engineers, etc.?

Are there critical strategic business initiatives that would suffer without certain employees continuing their involvement because of retirement?

At what age/length of service does the employer want to start offering phasing?

How long would an employer need such a program in the qualified defined benefit plan and is it possible to eliminate it once it is there?

How extensive should eligibility for the program be - only selected individuals, certain classes of employees or all employees?

For many larger companies it could require a significant research effort to address these and other related questions. In addition, the ultimate impact of the Pension Protection Act may be minimal or nonexistent for employers that want to be either selective with their programs or offer them to employees before age 62. In this sense, the world will have not have changed for those employers. Furthermore, for many other employers, more pressing strategic issues may need to take priority before meaningful progress on a phased retirement program can be accomplished.

How should the program be structured?

Once the employer has completed an initial evaluation of those individuals who might be eligible for the program and whether the program will be all-inclusive or selective, the employer's next step is to think about the structure of the available options. Some structural-related questions include:

How can the potentially competing goals of how an employee adds value to the organization and what the employee wants from a phased retirement program be reconciled? (The key to success is finding the area that represents what the employee wants to do and what is valuable to the company.)

When is the ideal timing for phasing to begin -- before the start of what was previously considered traditional retirement; or, after traditional retirement (i.e., rehiring retirees); or both time periods?

What will be the extent of job restructuring, if any? How will pre-phasing duties, work schedule, and location be impacted?

What work arrangements would be necessary to retain these employees or to attract these employees if the employer is seeking to hire another firm's retirees? Would it be regular part-time work throughout the year, full time seasonal-only work, or some other flexible work arrangement?

Would the phasing program necessarily require mentoring, transfer of intellectual capital, transitioning external relationships with customers and others, and/or developing successors in specific roles?

Is employee feedback such that the preference is for extensive phasing or minimal phasing or a combination of both? Do options need to accommodate a variety of work schedules?

To date, the marketplace has seen more activity in the rehiring of retirees, rather than phasing beginning before the start of traditional retirement. However, if the general election of part-time work options were counted, then it is unclear where there has been more activity. As we think about the impact of the new law, if we are focused on options for the rehire of retirees, there is no impact.

What adjustments to compensation and benefits are needed?

To ensure the program will operate smoothly, adjustments to compensation schedules and benefit plans may be needed. Key questions to be considered include:

For phasing before retirement, will pro-rata pay or pay at the same rate be acceptable for both employer and employee? If not and the employer wants to encourage phased retirement, is the employer willing to compensate at higher levels to encourage participation in the phased retirement program? Further, are there non-monetary incentives that can be used? For rehire of retirees, what will be acceptable?

Will phased retirees be in the active or the retiree health plan, or neither? How would health benefit plan eligibility provisions (such as minimum number of hours worked per week, etc.) be impacted?

Would coordination with Medicare be affected? (Note that Medicare is secondary for individuals in the active employee health plan.)

Would the program conflict with any employer policies for the provision of retiree health benefits? (The program would not work if the retirees lose their health benefits.)

Other decisions relate to an employer's pension plans. For final average pay plans, plan design must address :

The method of crediting continuing service and compensation for partially retired employees.

The amount of benefit paid during partial retirement and its form (lump sum versus a stream of payments).

The procedure for reconciling expected and actual work schedules, including resulting benefit adjustments, if any.

The frequency and methodology for recalculation of benefits.

The time limit, if any, for partial payments.

A great deal of thought and detailed analysis will be needed to define the options linked to cash pay and benefits that support the employer's objectives. Here the world has changed and the new law enables new options. Employers sponsoring defined benefit plans have new options with regard to people age 62 and over. We do not know yet what will be in regulations, and that may make these options more or less attractive. The world has changed for companies that want to offer general programs for phasing into retirement and can live with age 62. That may not be a very large number of companies however.

How does an employer ensure a smooth program launch after the pieces have been put together?

In order for the program to work well, it needs to be positively supported by all levels of management and meld with the corporate culture. Managers need clear guidelines on the rules that apply and extent of independence they have when striking deals with their direct reports as well as their limitations. Further, there needs to be a well-documented process for instances when the human resources department needs to be involved in any negotiations. If the process that is implemented generates noncompliance and/or excessive employee complaints because of unclear policy rules, it can prove detrimental to effective implementation and acceptance of the program. Therefore, it is crucial to have properly communicated the ground rules of the program and decision-making procedure well before the launch of the program.

Has the Society of Actuaries done any work on this?

A focus of the Society of Actuaries 2005 Risk and Process of Retirement Survey was on how retirement is changing and the alternative paths many retirees are taking as they leave their primary careers. A report highlighting key findings from the survey as well as commentary on their relationship to other sources can be found at www.soa.org.

Will there be a deluge of phased retirement programs? The bottom line

While it is too early to tell how significant the Pension Protection Act will be as a significant motivator for more phased retirement, it is clear that there will not be a major increase in programs in the short run. Changes will depend on employers' evaluations of the questions outlined in this article. Furthermore, since the Act addresses only a relatively narrow aspect of phased retirement programs, it seems unlikely that it alone can be the catalyst for many additional programs. However as more employers are affected by the aging of America and if further enabling legislation were passed, we may see the beginning of a new era --- an era that, if F. Scott Fitzgerald were here today, he might have called, the "Phased (Phazzed?) Age."

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