

Avoiding the Train Wreck

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Abstract

With defined benefit plans disappearing, Social Security in doubt, and retirement savings potentially inadequate, future retirees worry about outliving their incomes. Retirement Income Security Plans (RISPs) help take some of the want and terror out of old age.

An actuarial train wreck is fast approaching. The wreck will occur when the dearth of defined benefit pension plans, coupled with the lack of adequate retirement savings, collides with ever-improving life expectancies of our nation's baby boomer and future retiree generations. We foresee a time in which our elderly will be out of income options and devoid of income protection insurance.

No legislative initiatives or other approaches address this real problem. Legislators try to apply band-aids to the current broken defined benefit pension and Social Security systems, but that's not the answer. Actuaries and other pension professionals need to define the real problem and use their combined intellect and experience to build the best forward-thinking retirement program system that truly protects our growing elderly population.

1. Retirement Today and Beyond

Traditional defined benefit pension plans treat retirement as a cliff transition from working one day to not working the next.

This is no longer true. People are living longer, healthier lives than ever before. Longevity for many 65-year-olds will soon exceed 40 more years. This improved longevity, combined with low retirement savings in 401(k)s and other voluntary plans, will result in retirement incomes dismally inadequate to maintain acceptable living standards after full work stops at customary retirement ages. Not very many people will be able to afford to completely retire on accumulated savings.

Adding to the problem, traditional retirement plans are being frozen or terminated for a number of reasons:

- Most employees don't appreciate the value of defined benefit pension plans, and offer little resistance to plan terminations or ceasing of future benefits accruals.
- FASB 87, 88 and 132 obligations and disclosures are too unpredictable and their effects too draconian. Existing FASB rules truly impact the ability to run a business well.
- Ever increasing longevity has made providing full benefits for such a long time too expensive.
- Post-retirement accrual rules make it financially unattractive for companies to retain workers beyond age 65 in traditional plans because additional accruals at high ages significantly affect FASB and real costs in a negative way. There is a strong disincentive to let trained employees stay, even though they need, and often want, to continue to work on a diminishing basis. This disincentive is not logical when we know that there is an upcoming employment dearth and people can't afford to fully retire at traditional ages anyway.

We need a new approach to retirement, one that accepts that there must be a transition period from full work to full retirement, allowing the elderly to continue working well past the traditional retirement age. Already a significant and growing percentage of people over the age of 65 continue to work, either full time or part time, in their old jobs or in new.

Our culture needs to change to accommodate retirement income packages that don't have to pick up full income needs until full work cessation. This diminishing

need for full financial support during the transition period can be recognized in the program design and help to make it feasible for an employer to provide for the catastrophic benefits really needed after full work stops.

Since retirement savings programs will no longer have to last a lifetime, their goals can be finite and determinable. Workers can worry less about the adequacy of their pre-retirement savings and be more comfortable about prudently spending down their accounts in retirement.

2. Why Now?

Even though a recent AARP survey of 1,200 baby boomers found that more than 80 percent expect to work at least part-time in their retirement years, no one can work forever. Post-customary-retirement-age work gradually decreases as the individual ages. Cessation of all work-based income doesn't occur until perhaps early 70s or later for a fast-growing percentage of the retirement-age population. The three-legged stool of retirement income (personal savings, Social Security and income from employer-sponsored retirement programs) has become a four-legged stool with the addition of continued part-time employment income.

Current post-retirement accrual, existing funding requirements and Financial Accounting Standards Board (FASB) accounting rules make it nearly impossible for an employer to afford a traditional defined benefit program. Our Social Security program is also suffering. Recently announced legislative initiatives only exacerbate the funding problems.

This predicament is particularly vexing because the future workforce isn't large enough to replace the baby boomers. So why let willing employees who have advanced training and valuable experience fade into the sunset? Instead, employers should be finding ways to entice dedicated, skilled workers to remain on the job past their customary retirement age.

Retirement in today's culture has already ceased to be a single event. But because careers and work may continue for more than 50 years in the new working world, it's important to build career-enhancing and family life care needs income into the retirement programs of the future.

Let's recognize and embrace this cultural change and design an affordable program that provides benefits in a time of crisis, whether for short periods of work

cessation during one's career or during the periods of later-age work slow-down and final cessation. We further suggest that providing work/life balance income during advanced education and training, or approved philanthropic ventures (that could both be valuable to the employer and the employee) or periods when there is a need to take care of sick or elderly family members, be accepted as a form of temporary retirement and be an important part of our proposed retirement program of the future.

3. A New Retirement Perspective

Just as we do for health, life and disability, tomorrow's retirement programs should treat longevity as an insurable event. What does this mean?

Insurance, in its most basic form, is a pool of money that pays benefits only to the premium payers who suffer the fundamental risk (e.g.: sickness, death, disability). Generally, people choose to insure only life-contingent risks that would throw their lifestyles into financial crisis. Those losses that can be predicted and/or easily replaced by current financial income and savings don't need to be insured. Ideally, one should have enough savings to cover all predictable expenses. It's the unpredictable, catastrophic expenses that need to be insured.

Ironically, in this case, living a longer, healthier life is the catastrophic event that needs to be benefits protection.

Purchasing individual insurance policies is generally more expensive and less efficient than buying policies as a group. Employer-sponsored benefit programs have worked well as vehicles to offer this pooled insurance coverage for our working population by offering group health, life and disability insurance. Indeed, a worker's true level of compensation is usually considered to be a combination of wages, contributions to retirement and other savings programs and other employer-paid benefit expenses (such as insurance).

While workers expect that they'll receive each dollar of an employer's contributions to benefit programs such as 401(k) plans, through deposits into their accounts, workers accept that dollars spent on insurance programs are returned only to the people who have the applicable benefit claim. For example, even though the employer may pay \$10,000 in health insurance premiums for an employee, if that employee has only \$2,000 of medical expenses, that's all they'll receive; the remaining \$8,000 stays in the insurance pool to pay the insured benefits of others. In contrast to

wages and savings programs, the average worker knows not to expect a dollar-for-dollar credit for employer-paid insurance premiums.

4. Redefining Retirement

Protecting the risk of outliving income resources in old age is emerging in everyone's awareness as equal in importance to covering other traditional catastrophic life-contingent risks such as medical care and death. This urgent need for catastrophic financial protection can't be met by an employer-sponsored program under today's tax laws. A new kind of benefits program needs to be created to insure against the risk of people outliving their other retirement savings.

This program would work essentially like an annuity and pay a stream of gradually increasing life-contingent benefits. In addition, the program may optionally cover permitted breaks from the workforce before retirement.

Our concept is similar to the growing trend in health care. Health Savings Accounts (HSAs) for day-to-day and predictable medical costs, used in connection with high-deductible health plans for the unpredictable catastrophic medical costs, can work for individuals who understand and accept the concept. Retirement programs should follow this lead by using 401(k) or other account-balance-accumulation type plans as the savings accounts for expected or desired retirement expenses, while a new kind of employer-sponsored retirement program protects against the unpredictable events, such as living too long.

5. Retirement Program of the Future

Based on what we've learned from our industry's retirement plan experiences, and keeping in mind the actual emerging income needs of our nation's retirees, we suggest that where possible, employers sponsor a multi-plan retirement program to meet the retirement income needs of their employees.

No one type of program will do the job. At a minimum, all employers should be strongly encouraged to sponsor a new kind of plan, the Retirement Income Security Plan (RISP), in addition to whatever 401(k) and/or defined benefit plans fit their business goals.

The RISP, essentially a monthly benefit-type program, is intended to provide reasonable, affordable and essential needs-only retirement income protection that's missing today. Without such plans, expect a future social crisis.

Savings plans should be the next most important component of the twofold program of tomorrow. Employers need to sponsor 401(k) programs. These plans provide employees with a vehicle to take responsibility for their retirement, by encouraging them to save personally. In addition, employers have another plan that allows them to add to employee's retirement savings through employer contributions.

Where possible, employers should be encouraged to adopt and sponsor traditional and hybrid defined benefit pension programs. Employers should continue to benefit from these types of plans because they can grow with their business and suit their unique business objectives, while providing employees with additional retirement income.

6. What do RISPs Look Like?

RISPs are not intended to replace current qualified retirement plans. Rather they're to be companion, catastrophic-coverage-only plans. Some features we suggest include:

- Benefits:
 - A benefit formula of 0.5 percent, 1 percent, 1.5 percent or 2 percent of final average compensation times years of service would be used.
 - Years of service can include up to 5 years of past service from effective date.
 - Final average compensation is at least an average over 5 consecutive years, but may be any number of years including career average.
 - Compensation used must be gross compensation as defined for maximum benefit purposes under IRC Section 415.
 - The form of benefit should be an annuity payable for life of the participant, with 50 percent of the benefit continuing to the surviving spouse, if married.
 - No optional benefits, even if actuarially equivalent, should be offered. Allowing smooth benefit payments or lump sums would undermine the purpose of these plans and interfere with new proposed funding rules that apply to RISPs.

- All benefit payments will commence at age 65, regardless of the participant's employment status.
- Benefits will be payable in gradually increasing increments; 25 percent of the full benefit formula from ages 65 through 67, 50 percent from ages 68 through 71, 75 percent from ages 72 through 74, and 100 percent starting at age 75.
- RISP annuity benefits are calculated as of the earlier of termination of employment or age 65, with no increases to the benefit level after 65 due to additional service or compensation. Benefits would, however, be increased at each benefit tier (*e.g.*, when the benefit level increases from 25 percent to 50 percent). Increases would be tied to some economic index, such as the average wage base that Social Security uses. If the individual is still employed, employer contributions and accruals, if any, would continue after benefits from the 401(k) commence.
- Pre-retirement death benefit is the minimum Qualified Pre-retirement Survivor Annuity (as per existing Qualified Pre-retirement Survivor Annuity rules).
- No early retirement subsidies or options are available.
- No subsidized disability benefits are provided.
- The plan sponsor may reduce, increase, or freeze future benefit accruals, depending upon their business needs.
- Plan eligibility rules should follow existing minimum statutory rules.
- Controlled groups may sponsor a single RISP.
- Mid-career benefit payouts:
 - These payouts would be available for a limited period of time.
 - These payouts might occur for approved work-related academic or training sabbatical, a pressing family care need, or an approved philanthropic venture.
 - These mid-career payouts might be permitted once every 'x' number of years, or perhaps only a certain number of times the retirement benefit begins. The participant would need to be unemployed during these mid-career payout periods.
- Funding/FASB:
 - Assumptions:
 - Interest rate assumptions must equal the yield curve rate or other prescribed rate (*i.e.*, as ultimately adopted for ERISA required funding)

- Choice of all other actuarial valuation assumptions (e.g. pre-retirement turnover, disability, mortality, cost of living, mid-career benefit, marital status probabilities) are to be chosen at the discretion of the plan's Enrolled Actuary, based upon the best estimate of future experience.
- Funding method must be 'level percent of pay' or 'level dollar' Entry Age Normal, with entry age calculated as of the date of the first year of service credit (which can be no more than 5 years prior to plan adoption).
- Each tier of annuity benefit will be funded for separately, that is:
 - 25 percent of the full annuity benefit due to commence at age 65 will be funded from entry age to age 65.
 - An additional 25 percent of the full annuity benefit (with assumed cost of living increase) which commences at age 68 will be funded from entry age to age 68.
 - The same will occur for the 25 percent benefit increases (with assumed cost of living increases) at ages 72 and 75.
- All amortization bases, including past service bases, may be funded immediately or over no more than 5 years, at the annual election of the plan sponsor
- Mid-career benefits would be funded actuarially, as would any other ancillary benefit, and it would be considered as part of the Entry Age Normal Accrued Liability during the first retirement benefit age tier (age 65) funding period.
- Current Liability is equal to the Entry Age Normal Accrued Liability .
- Contributions must be adjusted by the required funding interest rate assumption from date of valuation to dates of deposit.
- FASB disclosures are based upon Entry Age Normal Accrued Liabilities and FASB net periodic pension costs equal actual contribution obligations. That is, the Enrolled Actuary's funding actuarial valuation matches the FASB disclosures and amounts.

7. The Final Question

Why would an employer sponsor such an insurance-type benefits program with companion 401(k) plan or similar savings program? If the U.S. population is to enter its later years of life with financial security and peace of mind, employers must take on the responsibility of adding this type of guaranteed longevity income benefit to their benefits program.

The three 'R's of wage and benefit programs never change: recruit, retain and reward. Our proposed type of program helps to support this. As employees begin to understand that survival beyond one's means is a distinct probability, they'll be attracted to employers who offer this type of benefits program. Retention and appreciation would improve. With new smoother funding and FASB rules, RISPs would be much more affordable and much less volatile than today's qualified defined benefit pension programs that are quickly becoming extinct.

It's time to redefine retirement. Let our industry lead in this area, and let us build a better, but more secure, U.S. retirement system.