Retirement Programs Face an "Aging-Population Tsunami"

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Against the backdrop of rising concerns over both public and private pension systems in the U.S., industry experts convened at a recent Wharton conference to debate ways in which retirement programs can be better managed. Participants discussed such topics as the problems facing Social Security, the solvency of the Pension Benefit Guaranty Corp., and the consequences of an increase in defined contribution plans like 401(k)s along with a corresponding decline in defined benefit plans. The conference was titled "The Evolution of Risk and Reward Sharing in Retirement."

Demographic changes, along with volatile capital markets and interest-rate swings, will require continued examination of pension systems across the board, said Olivia Mitchell, executive director of the Pension Research Council and director of the Boettner Center for Pensions and Retirement Research at Wharton. "This is a crucial moment in world history for retirement security. In the United States, the baby boomers are just three years away from receiving Social Security checks and an aging-population tsunami is sweeping the rest of the world as well."

After months of warning that the Social Security system is in danger of future collapse, President Bush has begun to lay out some details in his plan to reform the government-sponsored retirement system. The Bush proposal would cut Social Security benefits by 20% for retirees leaving the workforce in 2055. Those earning the maximum pay subject to Social Security taxes would face a 40% cut in benefits from what is promised under current law. Despite concerns raised by Democrats and some Republicans, Bush remains committed to converting at least part of Social Security into a private investment system.

At the same time, both Congress and the administration are discussing proposals to shore up the Pension Benefit Guaranty Corp. (PBGC), the federal agency that insures private-employer defined-benefit pension plans. The PBGC estimates it is running a projected liability of $450 billion, with almost $100 billion of that amount in plans sponsored by companies that are in financial trouble.

The PBGC took a big hit last week when a federal bankruptcy judge ruled that United Airlines could renege on four of its pension plans, in effect requiring the PBGC to pick up those obligations to the tune of $6.6 billion. It was the largest default in corporate history. According to experts in the field, defaults in the future will most likely come from companies in heavily unionized industries such as auto manufacturers, manufacturers of auto components, construction, airlines and defense.

Social Security: Front and Center

The debate over Social Security has consumed Washington, Douglas Holtz-Eakin, director of the Congressional Budget Office (CBO), told the conference. "Retirement policy is the central policy issue of our time. Period," he said. "Everything is on the table."

Politicians have discretion over only about one-third of the entire U.S. budget, including big-ticket items such as defense, he noted. The rest of the funding goes to mandatory programs, which -- besides Social Security -- include Medicare and Medicaid, the healthcare programs for the elderly, disabled and poor.

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According to Holtz-Eakin, the active debate about Social Security is a major development in retirement policy because this popular federal retirement system for the elderly has long been considered a perilous subject for politicians even to raise. "It's no longer being shunted to the side. It's now front and center."

CBO figures show that Social Security is currently running a surplus. In 2003 it paid out 4.4% of GDP while bringing in revenues of 5% of GDP. Yet by the end of this century, revenues will remain about 5% of GDP, but outlays will outpace that by 2019 and reach 6.1% of GDP in 2030 and 7% in 2100.

Holtz-Eakin maintained that the public discussion about retirement is flawed because it focuses too much on finance and too little on policy. Much of the attention has been on the size of the expected Social Security shortfall and when it will hit. "The debate has not really been about the policy, about what kind of Social Security system we want to have."

To improve the quality of the discussion, Holtz-Eakin said policy makers and the public should weigh the traditional pay-as-you-go system that offers universal coverage against a pre-funded system, which might offer labor and savings incentives that could benefit the economy as a whole. The role of private pensions and private retiree medical benefits should also be part of the debate.

In addition, Holtz-Eakin raised concerns about the expense of long-term care and its impact on retirement security as the nation's elderly population continues to increase. The CBO projects that total long-term care expenditures for seniors, including the value of donated care, will rise to 2.3% of GDP in 2040, up from 2% of GDP in 2000.

The CBO also estimates that in 2004, Medicaid's payments for institutional care for seniors, including both state and federal expenditures, totaled about $36.5 billion. Medicaid paid about 40% of total expenditures on nursing facilities, covering the care of more than half of all elderly nursing home residents. The private market for long-term care insurance is small, expensive and inefficient, said Holtz-Eakin. He suggested that policy makers should think of ways to manage risk and create a better mix between private insurance, government programs, donated care and out-of-pocket payments by families.

Pensions at Risk

The recent wave of pension-fund defaults has put enormous pressure on the nation's private-pension system and led the Bush Administration to draft a proposal to restructure the current pension-guarantee program. "By any standard, we are in a big hole," said Mark Warshawsky, assistant secretary for economic policy at the U.S. Department of Treasury.

Current pension financing rules are overly complicated and offer few incentives for sponsors to prudently fund their plans, noted Warshawsky. An overabundance of rules has led to lax financing as companies focus more on the requirements of the regulations rather than the ultimate funding levels. "The pension insurance premium structure provides little or no incentive for adequate funding."

The Bush proposal would require accurate measures of assets and liabilities, said Warshawsky, adding that the administration's plan calls for a single liability measure as opposed to the current law, which can lead to an "almost infinite number of liability calculations."

The administration wants expected benefit payments to be calculated using a corporate bond spot yield curve - defined in the administration's proposal as a measure created to discount long-term pension liabilities based on real rates for AA corporate bonds staggered over 1-year to 30-year terms. In addition, the plan aims at correcting current incentives for plan sponsors who in financial trouble and promise generous pension benefits rather than raise wages, putting more participants and the PBGC at risk. Under the proposal, bankrupt companies would not be allowed to raise the level of benefits if they are 20

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percentage points below their required funding level. Companies with good credit ratings would be able to increase benefits if they are below 40 percentage points of their targeted funding level.

According to Warshawsky, the plan also addresses criticism from pension fund sponsors that tax rules prohibit them from making extra tax deductible contributions during good times, forcing them to make up shortfalls during down cycles, just when it is most difficult to do so.

Finally, the administration has proposed changes in the premiums paid for government pension guarantees. The plan would raise the per-participant premium from $19 to $30, said Warshawsky. "This proposal simplifies the premium structure and recognizes the actual exposure, but not in a punitive way."

The goal of the Bush proposal as well as a bill that Congress is expected to introduce over the next month is to avoid a taxpayer bailout of the PBGC, much as taxpayers were called upon to bail out the savings and loan industry in the 1990s.

Pros and Cons of 401(k)s

Other speakers raised concerns about defined contribution savings programs, such as 401(k) plans, which have displaced many defined benefit pensions in which retirees are guaranteed monthly payments for life.

Stephen Utkus, director of the Vanguard Center for Retirement Research, presented a paper written with Olivia Mitchell and Stella Yang, a doctoral candidate at Wharton, indicating that 401(k) plans have been designed as a way to shift compensation to higher paid employees. "Matching contributions are a nice form of tax-incentivized compensation, but they are not designed to further the cause of retirement security," said Utkus. Policy makers who hope to boost participation in defined contribution plans should consider other solutions, he suggested, such as automatic enrollment and employer or government non-elective contributions to private plans.

Douglas Fore, principal research fellow at the Teachers Insurance Annuity Association-College Retirement Equities Fund (TIAA-CREF), said defined benefit pensions have not kept pace with evolving trends in the labor market and are now concentrated in industries that are under stress, such as steel and airlines. Fore recommended that defined benefit plans should be preserved because many people still depend on them and they provide a lifetime payout, regardless of how long a retiree lives. "The world is a riskier place for American workers. We think there is a collective interest in assuring lifetime financial security," said Fore. "Problems we see cropping up in 401(k)s suggest people are not interested in, or very good at, doing it on their own."

Fore suggested the possibility of developing a portable defined benefit plan in which employees could work toward a defined benefit pension even if they switch jobs. To do that, a system based on common actuarial standards and plan-benefit design would have to be developed. He also suggested individuals could purchase service credits and carry them along as they switch jobs. "We have just begun to sketch this out, but we do think this approach has some potential."

Being Your Own Investment Manager

The shift from defined benefit plans to defined contribution programs has put workers at greater risk of not having enough savings for retirement, according to Phyllis Borzi, research professor in the School of Public Health and Health Services at the George Washington University Medical Center.

In 1992, 40% of families had a member enrolled in a defined benefit plan, but that figure had dropped to 19.5% by 2001. Meanwhile, families with a participant in a defined contribution plan rose from 37.5% in 1992 to 57.5% in the same period. Of the defined contribution plans, she said, 75% are 401(k) plans and 80% of those are self-directed plans. "This is great news for people willing to become investment

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managers," said Borzi, "but it's bad news for people who have neither the talent nor the expertise to make their own investments."

According to Borzi, there are many risks for workers in defined contribution plans, including the risk that they may be forced to retire earlier than planned or they might live longer than expected. She also pointed to "post-distribution" risk, which occurs when workers receive a lump sum either at retirement or when switching jobs. Research indicates workers often fail to reinvest those savings, she noted. "We should not be saying all defined benefit plans are good and all defined contribution plans are bad or vice versa. You need both. No one plan is superior for a worker at every stage of their working career."

The experience of defined contribution plans is difficult to measure because today's retirees have been in the plans for only 25 years at most. To determine what might happen to younger workers, a financial model was created by Sarah Holden, senior economist at the Investment Company Institute, and Jack VanDerhei, a fellow at the Employee Benefit Research Institute and a faculty member at Temple University's Fox School of Business and Management.

The research shows that if workers remain in a 401(k) plan for their entire career, those turning 65 between 2030 and 2039 will replace 50.7% to 67.2% of their salary at the time of retirement depending on their income level. However, if they are not always in a 401(k) plan, the figures drop to between 23.3% and 27.7%. "There is a good replacement rate when you consider Social Security and 401(k) combined," said Holden. "But if you don't have a 401(k) plan, replacement rates fall dramatically. The worst that can happen to you is to land at an employer without a plan."

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