



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

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

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



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

Knowledge@Wharton's coverage of the conference is in two parts. Below, we provide a discussion of policy issues ranging from pension fund management to accounting reform to transparency. In our next issue, we will cover participant discussion of trends in demographics and workers' expectations.

The Tail Wagging the Dog

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

Klein said that trust has eroded somewhat, in part, because of complex pension laws designed to protect workers but that some plan sponsors believe have been irregularly enforced. He suggested a tradeoff in which regulators give plan sponsors more flexibility in how plans are designed and run; in exchange, the regulated community would accept harsher penalties for violating rules. Klein also proposed a negotiated system of rulemaking. Now, he said, regulators take input on regulations and then come back with a final

set of rules, with no room for back-and-forth trade-offs. Under a negotiated system, “the substantive results might be better, but even if not, the parties would have greater faith in the system knowing they were more involved in the process.”

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

110 Pension Plan Choices

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

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

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

Keith P. Ambachtsheer, president and founder of KPA Advisory Service of Toronto, suggested that pension funds could be better managed. He examined Cost Effectiveness Measurement’s database on 256 pension funds for 10 years prior to 2002 and found little variance in terms of asset mix among the different portfolios. The old view, which favored a 60-40 or 70-30 asset mix between equities and bonds, worked well in the 1980s and 1990s when equities performed better than bonds. But economic upheaval in 2000 through 2002 showed the standard asset mix left defined pension plans vulnerable.

In the old paradigm, Ambachtsheer said, plan managers took a great deal of long-horizon risk but little short-term risk. “If you really think you’re good at short-horizon risky strategies, why only do a little bit of it?” he asked. He suggested a new paradigm based on what he called defensible investment beliefs, including the notion of a varying equity risk premium. He also said there is a need to restate investment policy in terms of the balance sheet, not just assets, and the risk tolerance of stakeholders.

\$2.1 Trillion in Public Pension Assets

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

The public plans do offer flexibility, including short vesting periods, the opportunity to buy service credits, return-to-work opportunities and lump-sum early retirement options. Anderson noted that governments act not only as employers, but also as policy makers, and consequently need to set a good example in operating their own pension plans. “These people are secure and not dependent on government programs in their retirement years. I think that’s a good example to set. Public sector plans have not gotten the recognition we deserve for the innovations we’ve made and the impact on the retirement status of our country.”

According to Brainard, more than \$2.1 trillion in public pension assets are an important source of liquidity and stability for financial markets. “Public pension assets serve as an important source of entrepreneurial capital funding because of their long-term horizon. They create economic stimulus for generating and distributing investment returns greater than what individual investors would accrue in defined contribution plans.”

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

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

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

Douglas Fore, principal research fellow at the TIAA-CREF Institute, told the conference that important new pension accounting rules have been formulated in Europe and are being imposed on U.S. companies as the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards

Board (FASB) seek convergence. “Pension accounting in the U.S. has widely been recognized as one of the most backward areas of all accounting and in dire need of reform. Everybody knows we got ourselves in a terrible mess the last few years. The accounting rules are part of this,” said Fore.

The old accounting rules allowed companies to smooth out rate-of-return assumptions over time, creating a strong pro-equity bias, he noted. “In the ‘90s, this didn’t matter at all; the stock market did the heavy lifting for everybody. But when the tide turned in March 2000 things [changed] dramatically.” The prior smoothing had made the situation even worse, he said. At the end of 1999, defined benefit plans of the S&P 500 firms were overfunded by \$350 billion. Four years later, the same pension plans were underfunded by the same amount.

In December, FASB announced a new statement (No. 132) improving disclosure on pension fund assets that required plans, for the first time, to break down assets by category, such as equity, debt and real estate. The new rule requires funds to provide a description of their investment policies, strategies and target allocation percentages. “What was very opaque is much clearer,” Fore commented. British authorities went through a similar change, but they did it at a time when companies were reeling from the 2000 stock slump, leading many companies to back off from defined benefit plans. “In essence defined benefit plans have been frozen to new entrants in the U.K.,” said Fore. “They have been substituted for defined contribution plans.”

The scandals at Enron and other U.S. firms, he added, have led to an international attack on U.S. Generally Accepted Accounting Principles (GAAP) which has already led to changes in accounting for stock options and will likely change insurance accounting rules.

Pet Insurance over Financial Planning

In the wake of all these changes – and the continued lack of a savings cushion for the bulge of retiring baby boomers – William J. Arnone, a partner in Ernst & Young’s Human Capital Practice, suggested it is now time to remove the word baby from the phrase “baby boomer.” “We have not learned the lessons,” he said. “Someone’s going to pay the price for our acting in less than an adult manner.”

Arnone, who runs investor education programs for employers, said companies began offering financial literacy programs in the early 1980s as they encouraged workers to take early retirement. “The rationale was that if these older employees did the calculations, they would conclude they were better off (taking early retirement). I think we’re going to have a resurgence, only now they are going to conclude, ‘I cannot retire as soon as I thought I could.’” No more than 20% of large employers initiated financial education programs, added Arnone. His own firm used to offer financial planning in its flexible benefits program, but many other choices, including pet insurance, were more popular.

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

Martha Priddy Patterson, a director at Deloitte Consulting, said she is concerned about the possibility that the accounting changes will lead to a decline in defined benefit plans in the United States. “There have

been so many pressures on defined benefit plans that I am opposed to anything else that will, in any way, adversely affect them,” said Patterson.

Tax rules inhibit funding defined-benefit plans, she added. “It’s increasingly hard to stuff money in the plan when you have a boom year to ride out the bust years.” Patterson also said the phrase “pension surplus” on balance sheets is confusing. “A lot of people I thought of as sophisticated don’t understand that the big number there on the financials doesn’t mean the employer can do anything with it [the employer] wants,” she said. Patterson is also concerned that a rise in interest rates will lead to a termination of defined-benefit plans. She pointed out that even if companies provide financial education, by the time employees are in the workforce, it’s too late. “It should be cradle to grave.” Another reason she said employers may be reluctant to provide financial education is that they are concerned about liability and privacy issues.

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

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

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

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

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