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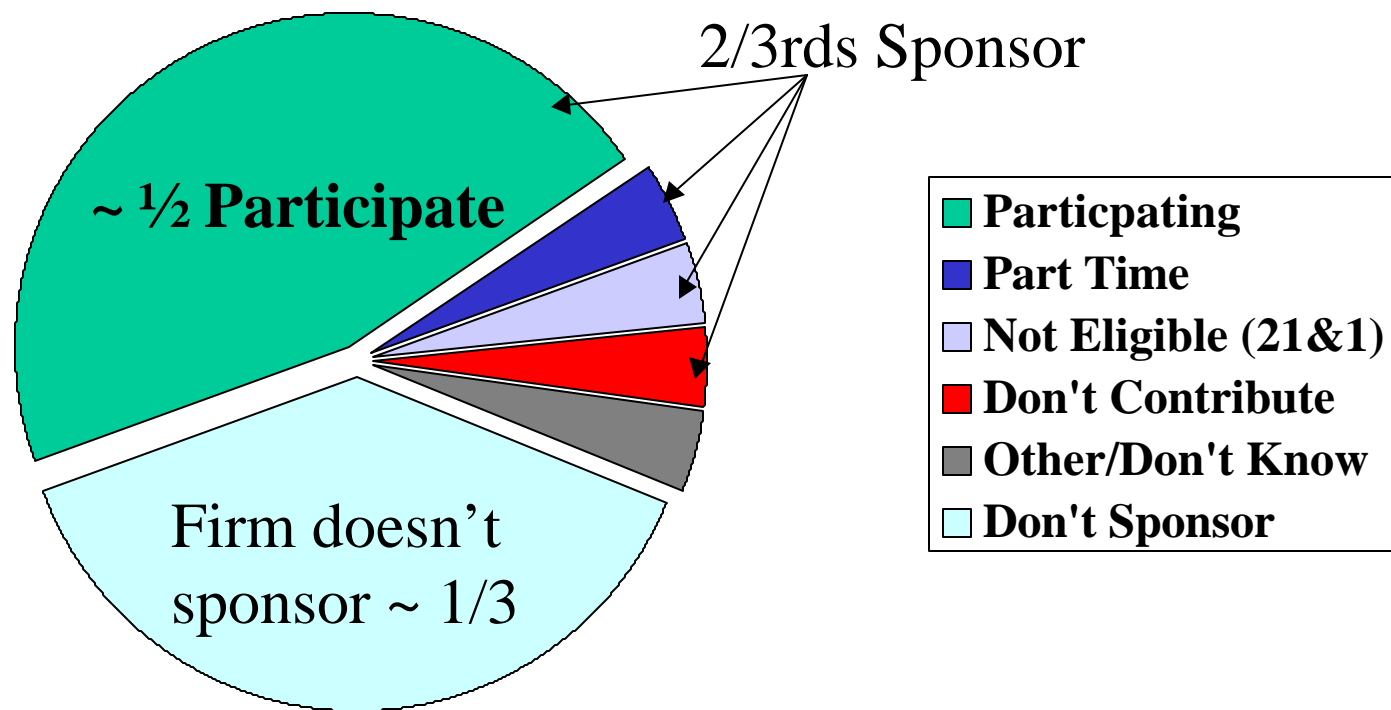
Increasing Pension Coverage & Benefits and Preparing for Retirement

RON GEBHARDTSBAUER
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AMERICAN ACADEMY OF ACTUARIES

The ERISA Advisory Council
Room N-5437 of Labor Department
200 Constitution Avenue
11:00 – 11:45 pm
July 17, 2001

The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, regulators and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance.

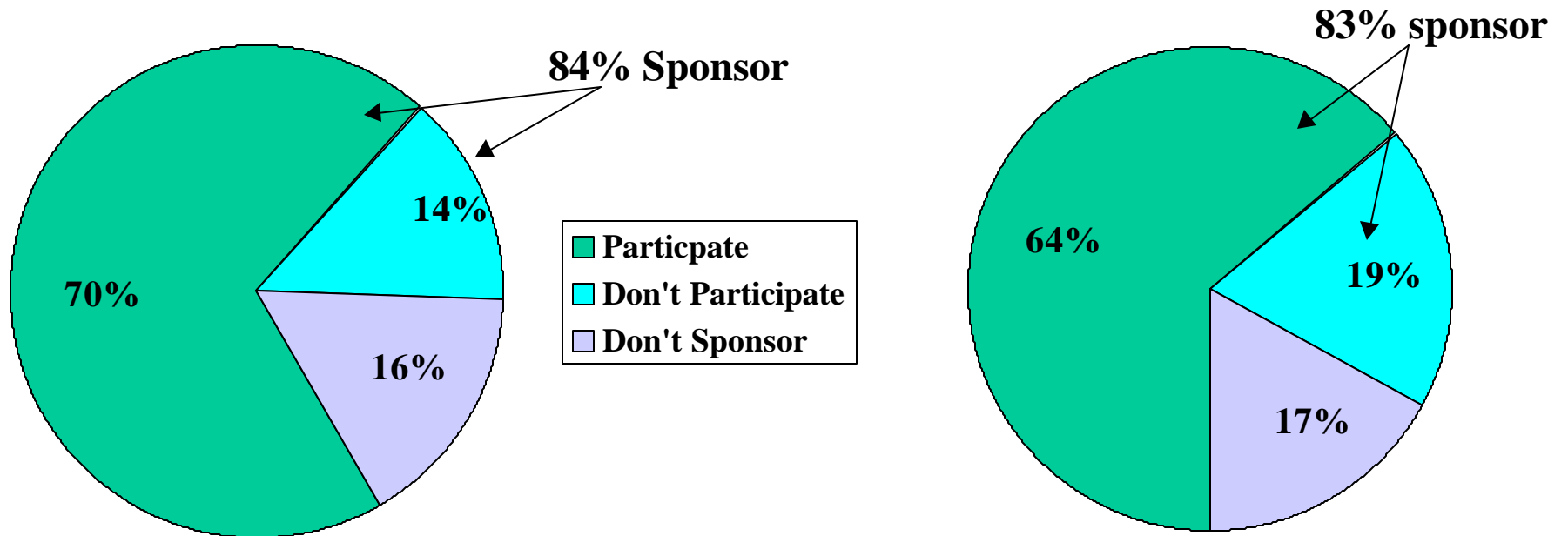
Pension Coverage



Sources: 5/1994 DOL report using 93 CPS & 8/2000 GAO report using 98 CPS
BLS employer survey suggests 58% participate. **Each small slice ~ 4% of workers.**
56% of ERISA workforce participates. 2/3rds of near retirees have vested pension.

Pension Coverage among larger employers (100+)

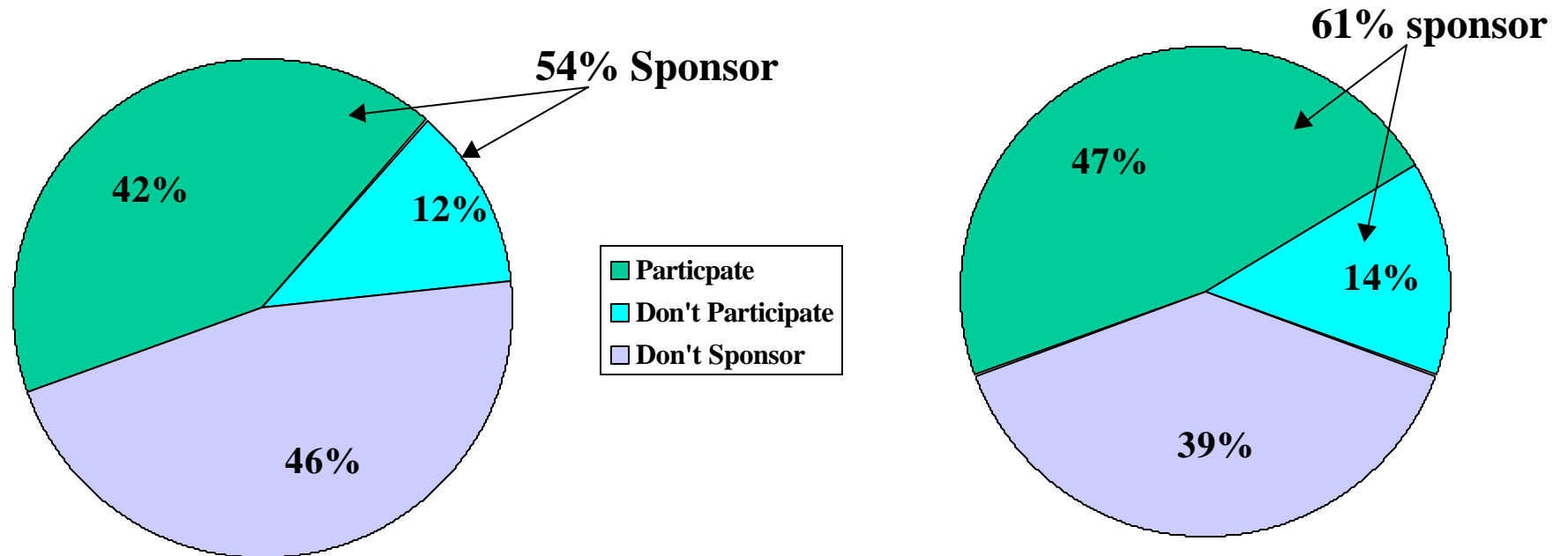
1979



% participating decreased.

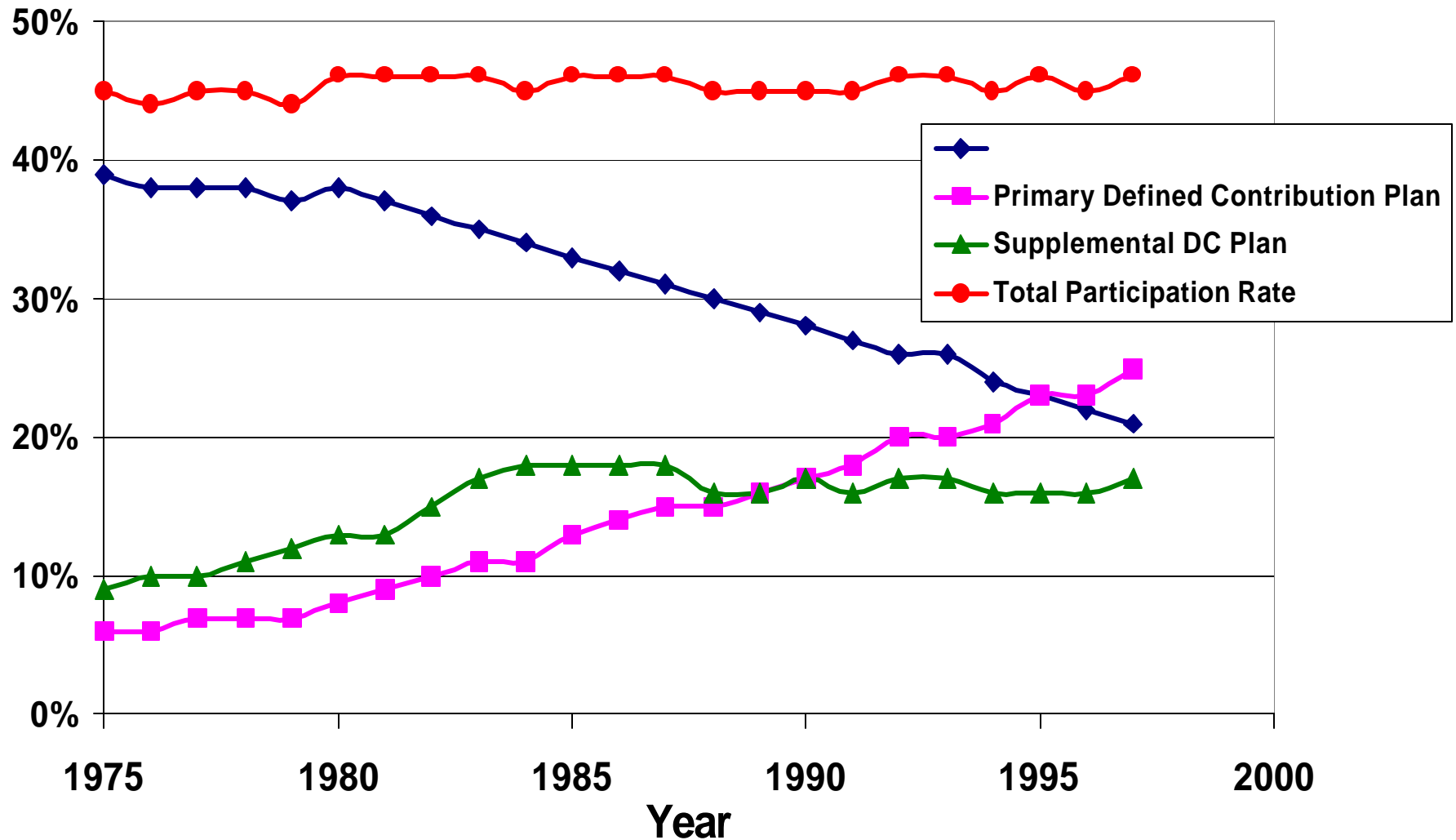
Why? More contingent workers? More 401(k) ?

Pension Coverage



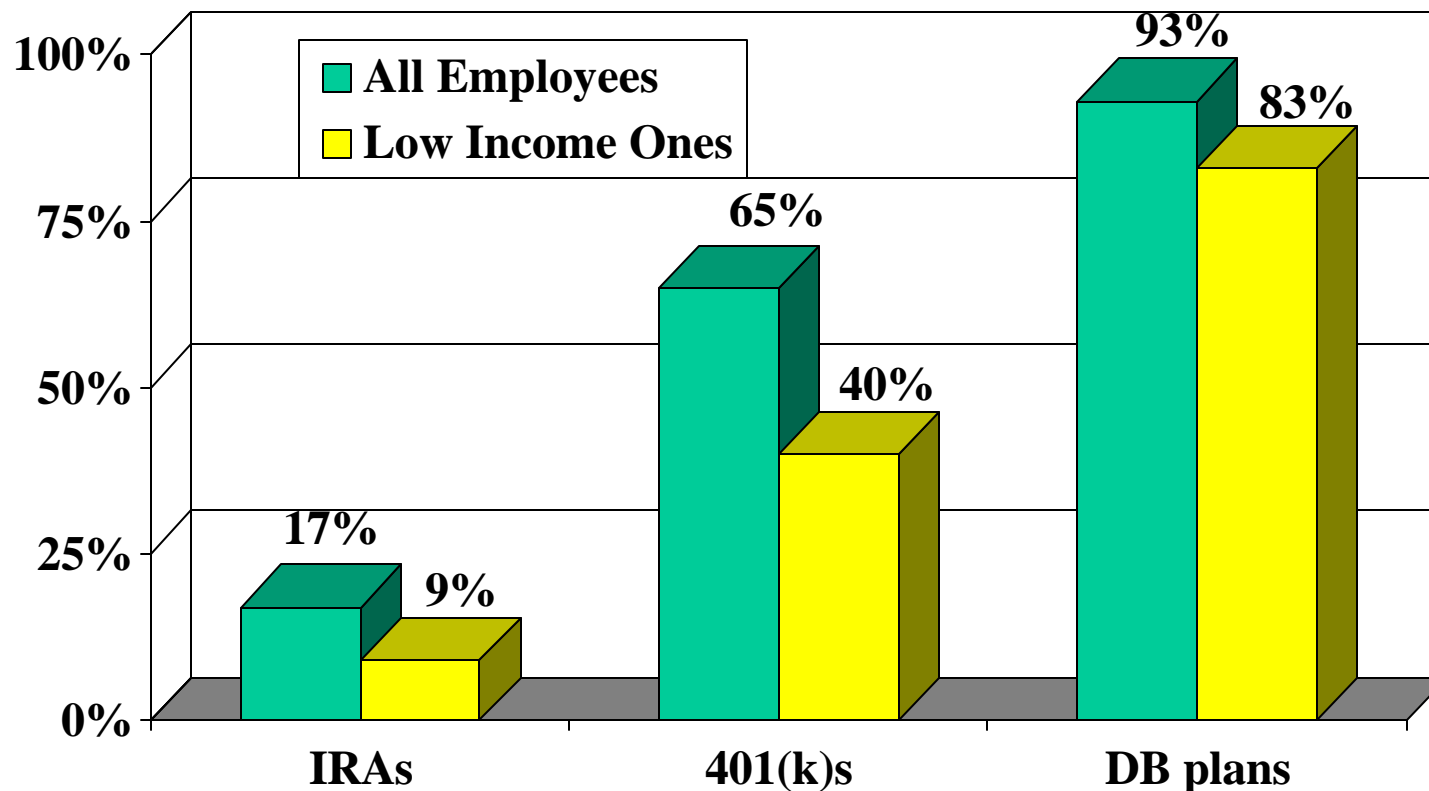
Sponsorship & Participation rates increased, but so did % not participating.
Why? More contingent workers? More 401(k) ?
Increases just got us back up to where we were in 1980.

Participation Rates in Pension Plans



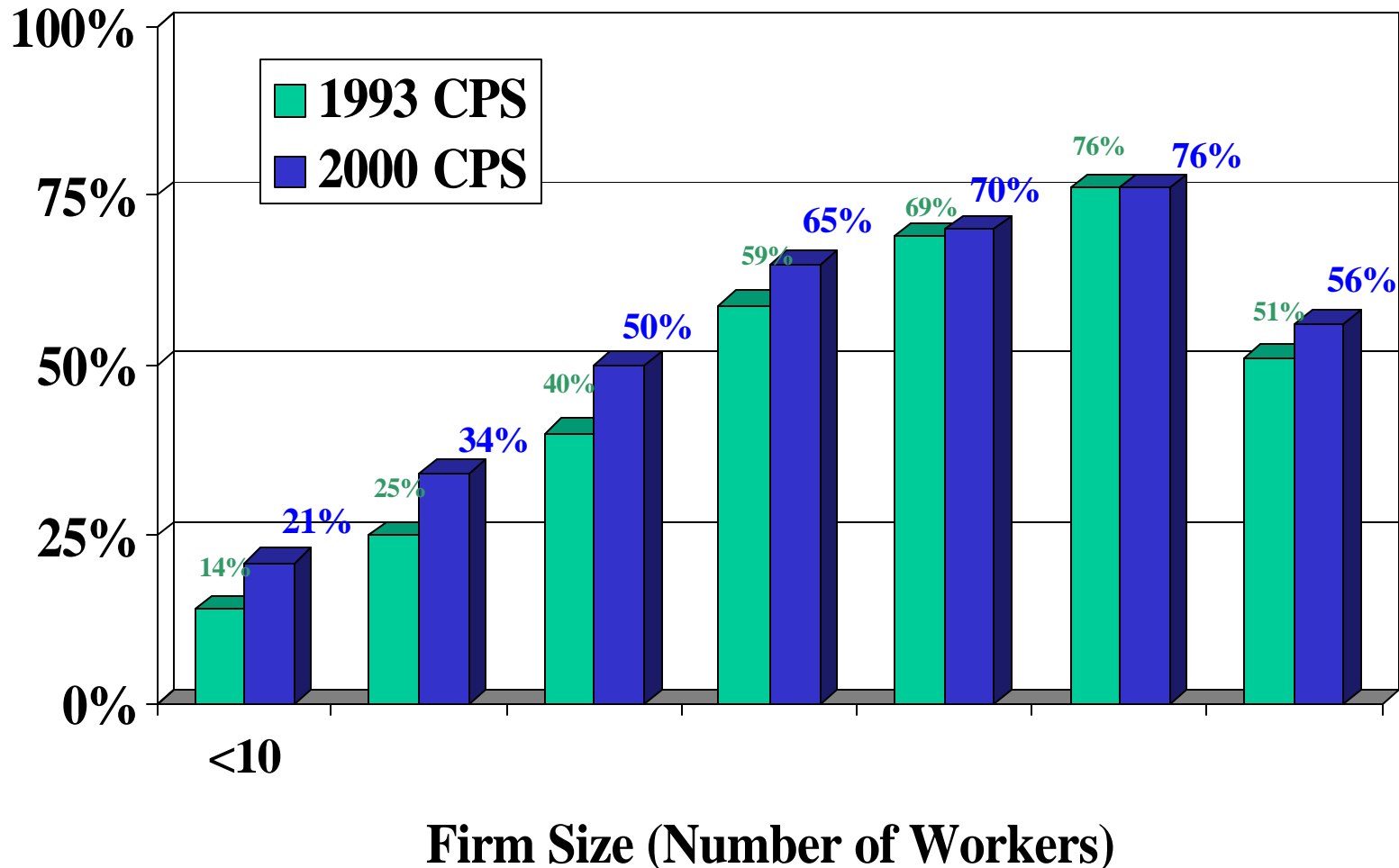
Source: Workers from BLS statistics includes employed (FT & PT) and unemployed wage and salary workers. Coverage from DOL/PWBA/OPR's Abstract of Form 5500 data (Spring 2001). For workers in DB & DC, the DB is primary unless name indicates it is supplemental or PS only.

Participation Rates



Source: April 1993 CPS. DB numbers are estimates. IRA numbers are from 1983 when everyone was eligible. Recent data suggests greater 401(k) participation rates (75% and 50%)
Law used to give fewer advantages to 401(k)s because some people won't contribute

Pension Coverage Rates of Firms

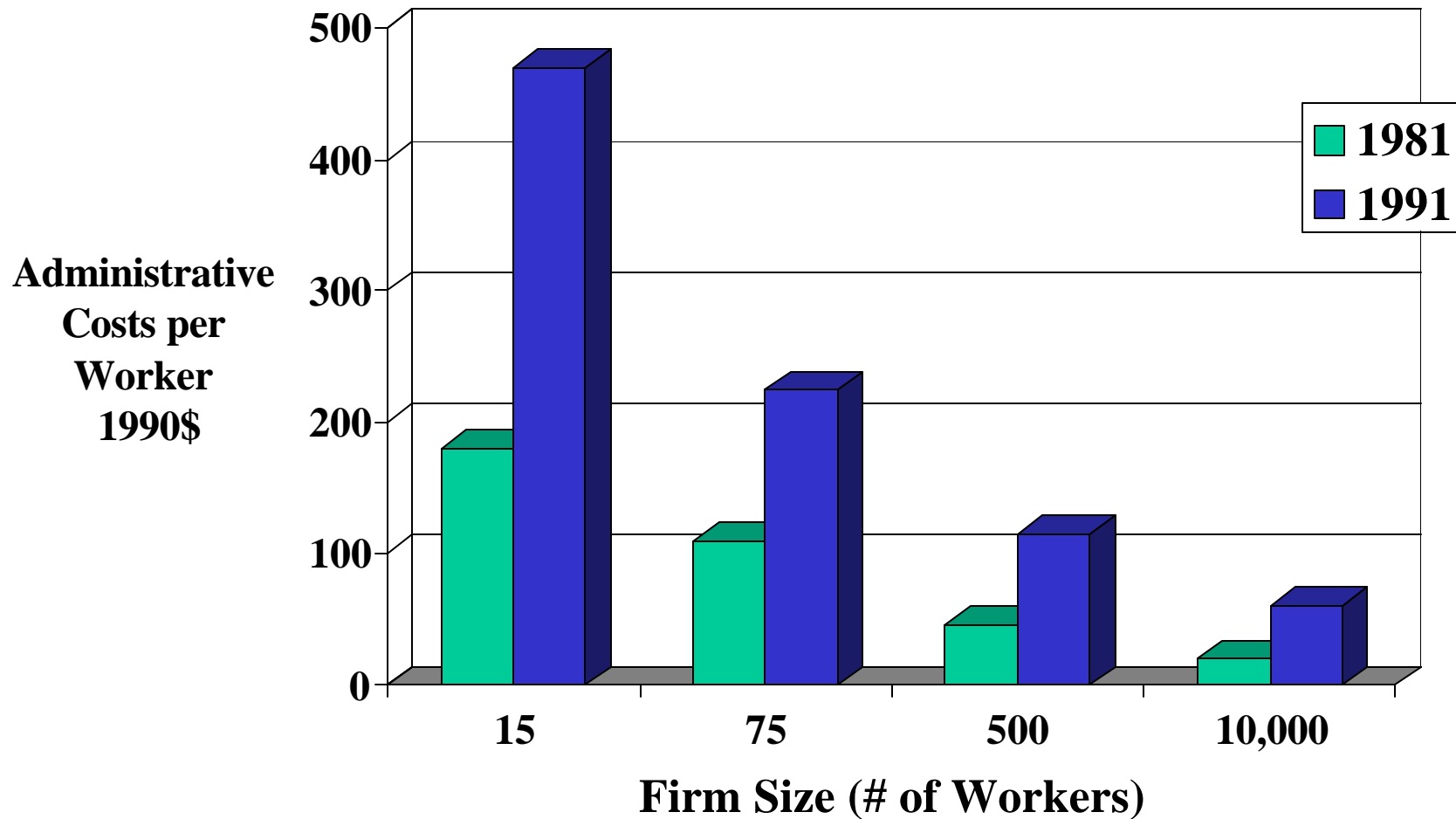


Source: March Supplement to Current Population Survey (CPS) using ferret.bls.census.gov Participation declined a lot among employers in late 80's, but has **increased lately, especially among small employers**. This is important because about half of employees work for firms with under 100 employees. **However, we should be concerned about large employers too. They can't have the DB plans they need and may get out. We need to simplify rules for all plans.**

Why Employers Don't Sponsor

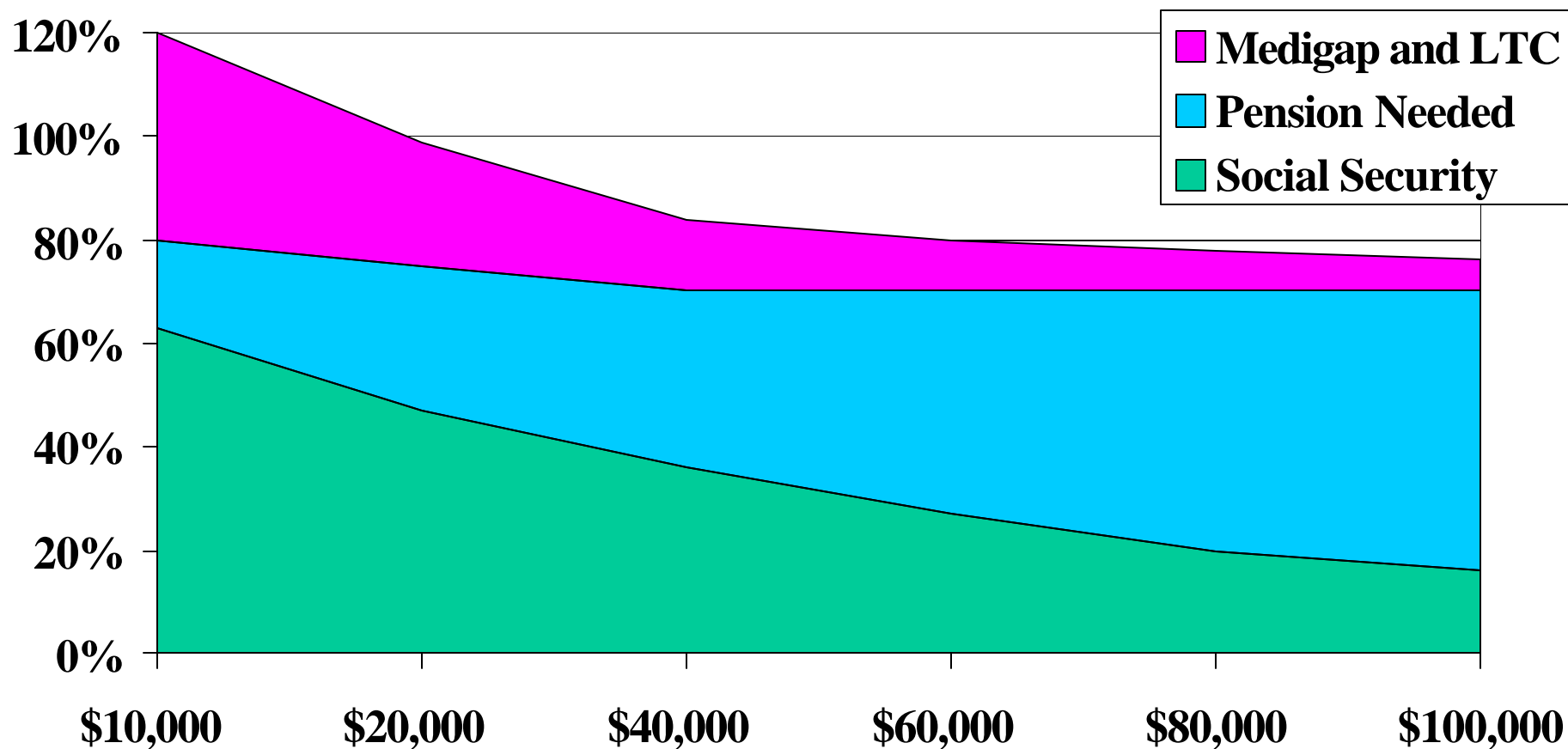
- Cost of pensions
 - Volatility of contribution requirements Allow pre tax deferrals & matches in DB
- Complex, Restrictive, & Conflicting Laws & Regs
 - Inability of laws to accommodate new plans (e.g., Cash Balance)
- Expensive cost of administration, compliance
- Unpredictable sources of funds
 - Especially new/small employers
- Many part-time, seasonal employees
- Don't value DB benefits/tax advantage or the need
- Employers don't know about simple alternatives
 - More education is needed for employers and employees

Defined Benefit Plans Regulatory Costs



Expenses offset tax advantages (especially noticeable for small employers). 9
Costs for large employers **tripled**. Source: Hay Huggins Company

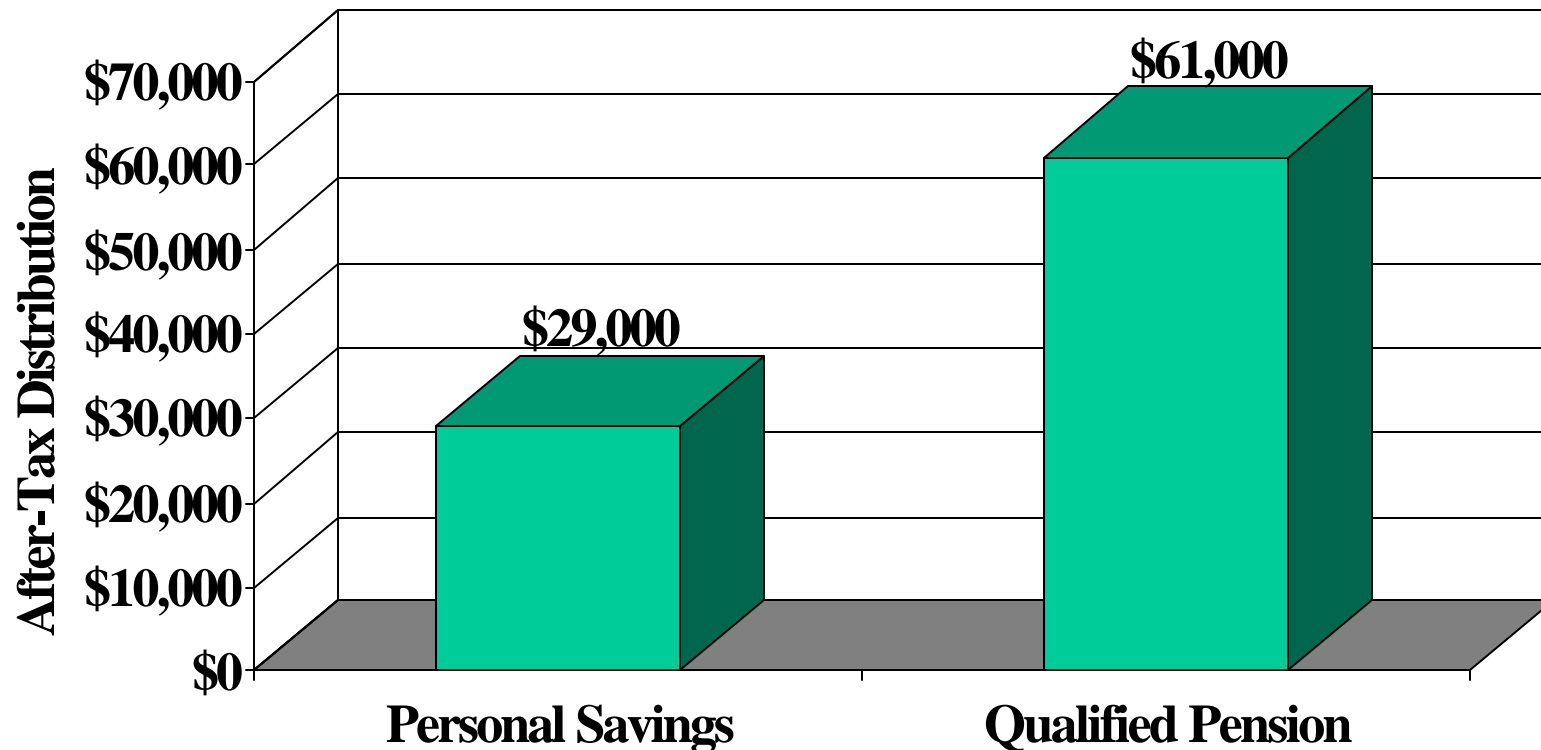
Retirement Income Needed for 100% Replacement of Spendable Income at Age 65 Single Person



Wages just before retirement in 2000

Tax Advantages of Pension Plans

In 20 years, \$20,000 becomes:



Assumes 8% interest rate, 35% tax bracket (fed + local), and 7.65% FICA tax from employer and employee

Academy Survey of DB Terminations

Primary reasons for terminating (88-90)

- Business concerns – 23%
 - Financial Hardship
 - Merger, plant closing, downsizing
 - Principal Owner retired
- Plan too costly – 22%
- Didn't meet needs of employer/employees – 17%
- Government regulation – 29%
 - 44% cited as one of top 3 reasons
 - Only 13% cited for terminations in 80 – 82
- Replacement plans
 - None for over ½ of small firms
 - Replacements were generally DC and less generous

Top Reasons Small Employers Don't Sponsor Pension Plans

- Perceived lack of interest from employees
 - Wages and Health Insurance more immediate need - 21%
 - They don't realize how much \$ they need for retirement (see next chart)
- Many employees are seasonal, PT, new- 18%
- Newness of Business - 11%
- Administrative Costs - 9%
- Expense of Contributions - 8%
- Government Red Tape - 3%

Source: 2000 EBRI Survey

Top Reasons Small Employers Don't Sponsor Pension Plans

- Lack of Pension Knowledge
 - 54% never heard of SEP, 33% never heard of SIMPLE
 - Owners don't know advantages of plan sponsorship
 - Owners don't know about benefits for themselves

Top Reasons Small Employers Gave for **Having** Pension Plans

- Competitive advantage in recruitment & retention - 35%
- Positive effect on employee morale & performance - 21%
- Perceived obligation to provide pension - 13%
- Tax Advantages for employees - 10%
- Employee demand or expectation - 5%
- Tax Advantages for key executives - 5%

What would change their minds?

- Increased company profits - 69%
- Tax Credits - 65%
- Reduced Administrative costs - 52%
- Easy to understand information - 50%
- Increased employee demand - 49%
- Added incentives for key employees - 49%
- Lengthening of vesting percent - 27%

40% said they are likely to start one soon

Tax Credits

- EGTRRA added tax credit match
 - For IRAs initially
 - Added 401(k), 403(b), 457, SIMPLE, SEP
 - Similar Provision for DBs dropped (1/2 of NHCE NC 3% wages)
 - DB plans used to be (should be) favored (better for nation, welfare, SS)
 - higher participation levels, annuities, less risk, windows, more efficient markets
 - Other problems with provision
 - Worker won't know match until eoy (50%, 20%, 10%, 0%)
 - Creates cliffs when match rate changes
 - Marginal tax rate > 100% at cliffs
 - Earn extra \$1 and match decreases from 50% of \$2,000 to 20% of \$2,000, so worker loses \$599
 - Not refundable, so lowest paid get no match
 - Would Congress allow if some came from EITC?

High Fixed Administrative Costs

- If costs of administration and benefits exceed tax advantage, much of owners incentive is lost
- EGTRRA gives tax credit to small employers
 - 50% of first \$1,000 of expenses for 3 years
 - If plan has a Non-HCE
- Increase credit & give to all, or simplify rules

Rules not easy to understand

- Rules confusing to employees/employers
 - Litigation increases
 - Value is reduced & Employers will walk
 - Rules can cause problems for good things like:
 - Greater Of, Choice, Higher Investment Credits, Subsidized Annuities, Phased Retirement, Reducing age-weighting
- Simplify rules (see attached ideas)
- Incentives for what you want, not mandates
 - e.g., capital gains tax rate, tax credit, or higher max
- Create one pension agency for consistent rules
 - PWBA/PBGC/IRS/SSA
 - First step: Require joint rulemaking
 - Is one committee per House possible?

Coverage of Low Wage Earners

- Who is responsible? Who should help?
 - No one wants increased costs
 - Who pays for their living now?

Coverage of Low Wage Earners

- Employers could:
 - Lower 1000 hour rule
 - Won't help much without accelerated vesting
 - Doesn't increase DB benefits much
 - DC/401(k): increases benefits and costs
 - Level playing field? they get pre-tax deferrals, matches, No annuity requirement, less R&D
 - Could incent employers with higher max & less regs to have:
 - Negative elections at date of hire & pay increase dates
 - For all workers (PT, Temps, Contractors)
 - Allow excluding them from testing and matches
 - Gives them tax credit match! And payroll deduction
 - 1% of pay non-elective contribution for 401(k) match safe harbor
 - Limit to first \$20,000 of pay, and phase out by \$40,000
 - Increase maximum if NHCE ADP closer to HCE

Coverage of Low Wage Earners

- Government could:
 - Make tax credit match refundable
 - But there is little on-budget revenue
 - Match doesn't help those who don't contribute
 - USA's had automatic contribution - expensive
 - Who should be responsible? Sharing costs reduces govt expense
 - May need minimum contribution = \$500 or expenses eat up yields in early yrs
 - Some \$ from EITC (for low paid)
 - Some \$ from ETC (for those going back to school mid career)
 - Some \$ from SSI (IRA stamps for under-employed)
 - Those who stop working can do an IRA
 - Largest hole: non-participating workers
 - All 3 (government, employers, individuals)

Coverage of Low Wage Earners

- Largest hole: non-participating workers
 - All 3 (government, employers, individuals) can help
 - Employers don't want admin. costs of ERISA ineligibles
 - Small Employers didn't want MUPS expense
 - Or the administrative expense
 - SS Privatizers suggest govt. clearinghouse for them
 - But don't want higher costs
 - They want carve out (requires SS benefit cuts)
 - Compromise on 1% carve out, 1% add-on, & on-budget surplus
 - Add-on comes from employer or employee
 - BUT waived if they are already in pension plan = cheaper than USAs



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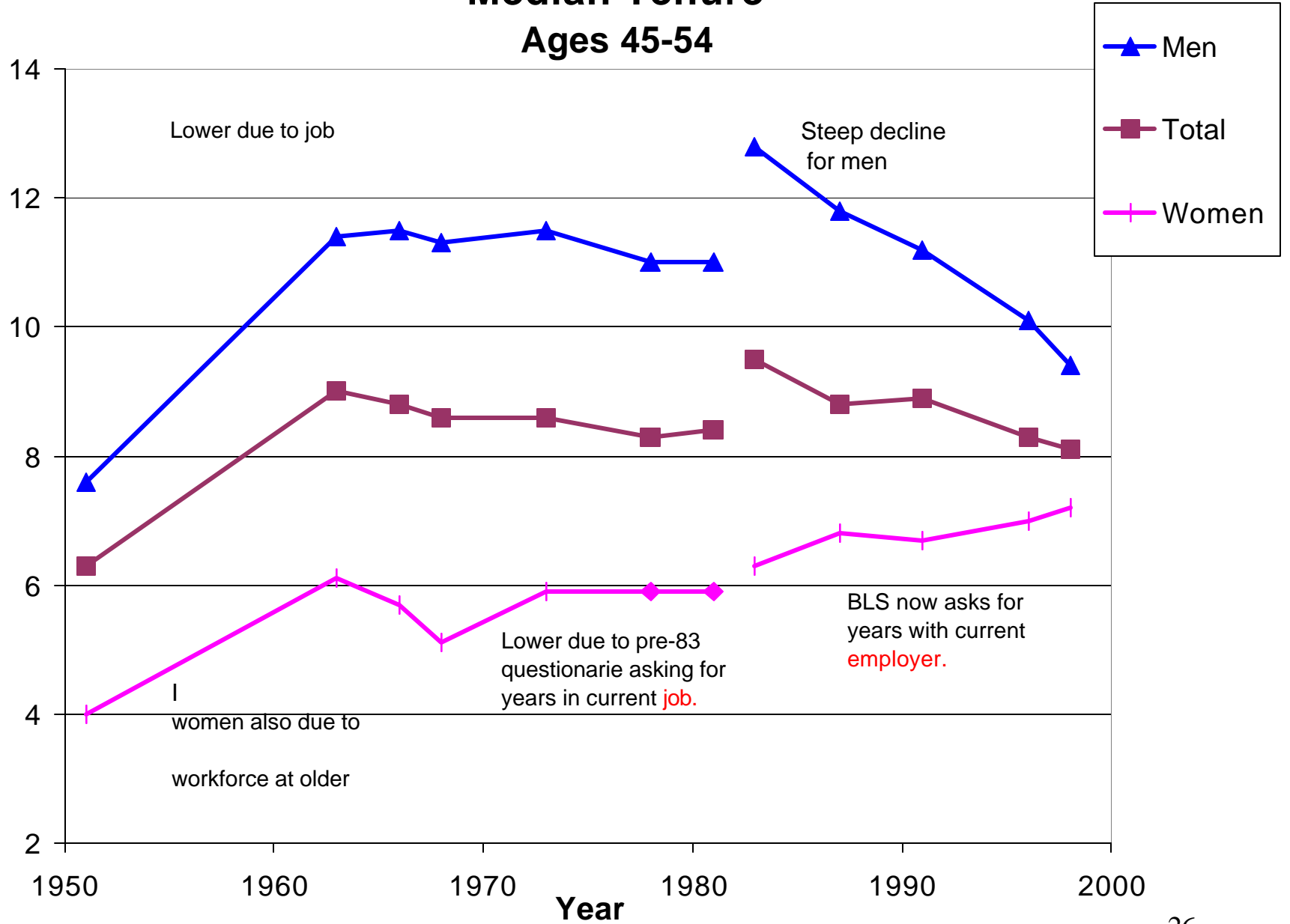
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Preparing for Retirement 25 years ago

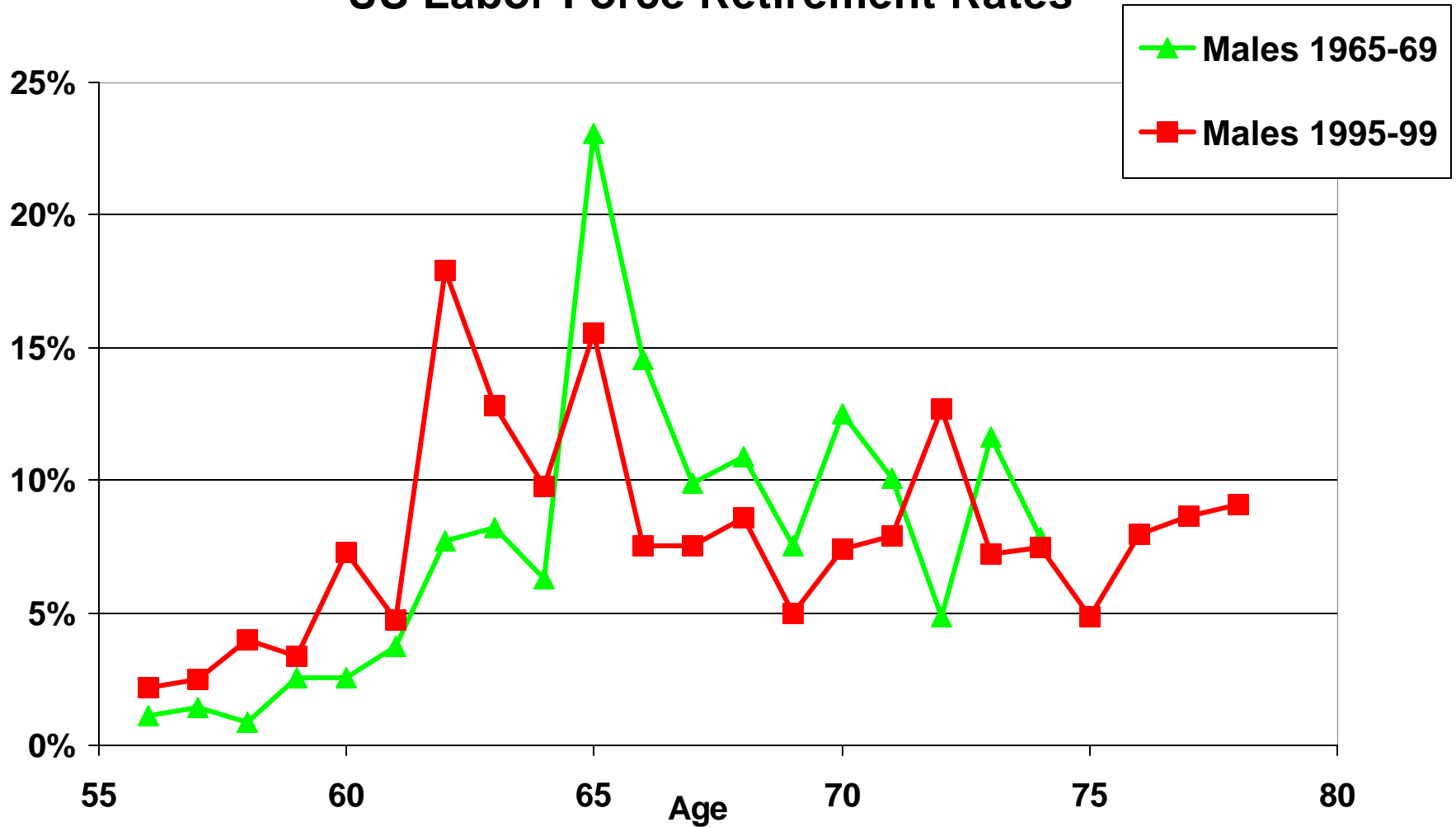
Much Easier.

- Fewer Employers
- More likely to be in DB plan
 - That paid only pensions
- They saved more
- More likely retired at 65
- Ask Personnel for SLO benefit (& got J&S)
- SS + Pension enough?
 - Will it cover my basic needs? Yes? I can retire

Median Tenure Ages 45-54



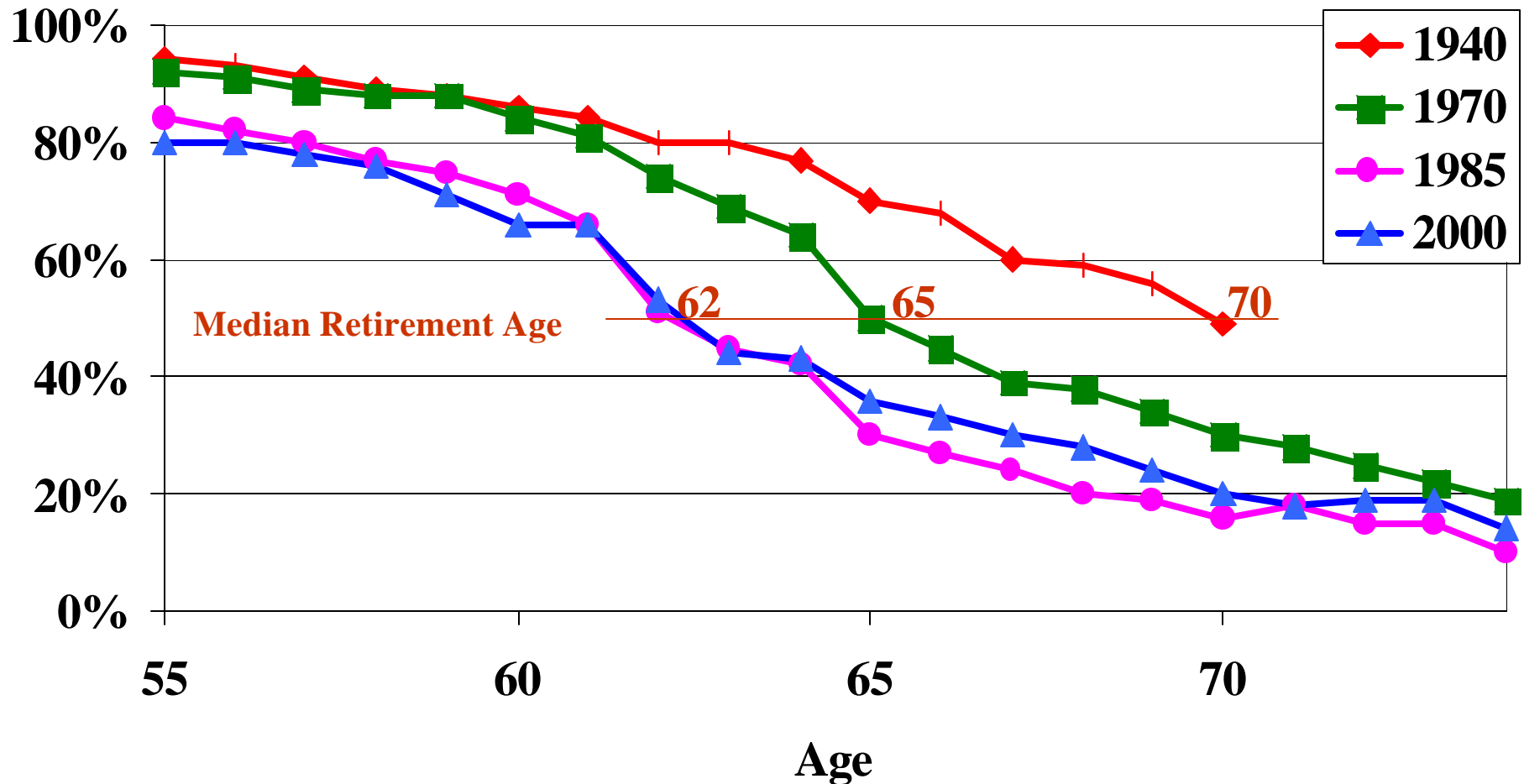
US Labor Force Retirement Rates



Note the spike in retirements at ages 62 & 65 (the eligibility ages for Social Security & Medicare, respectively).
Retirement Rate = Labor Force % in next year/ Labor Force % in current year.
Source: Unpublished data from BLS Consumer Population Survey

US Labor Force Participation Rates

Male

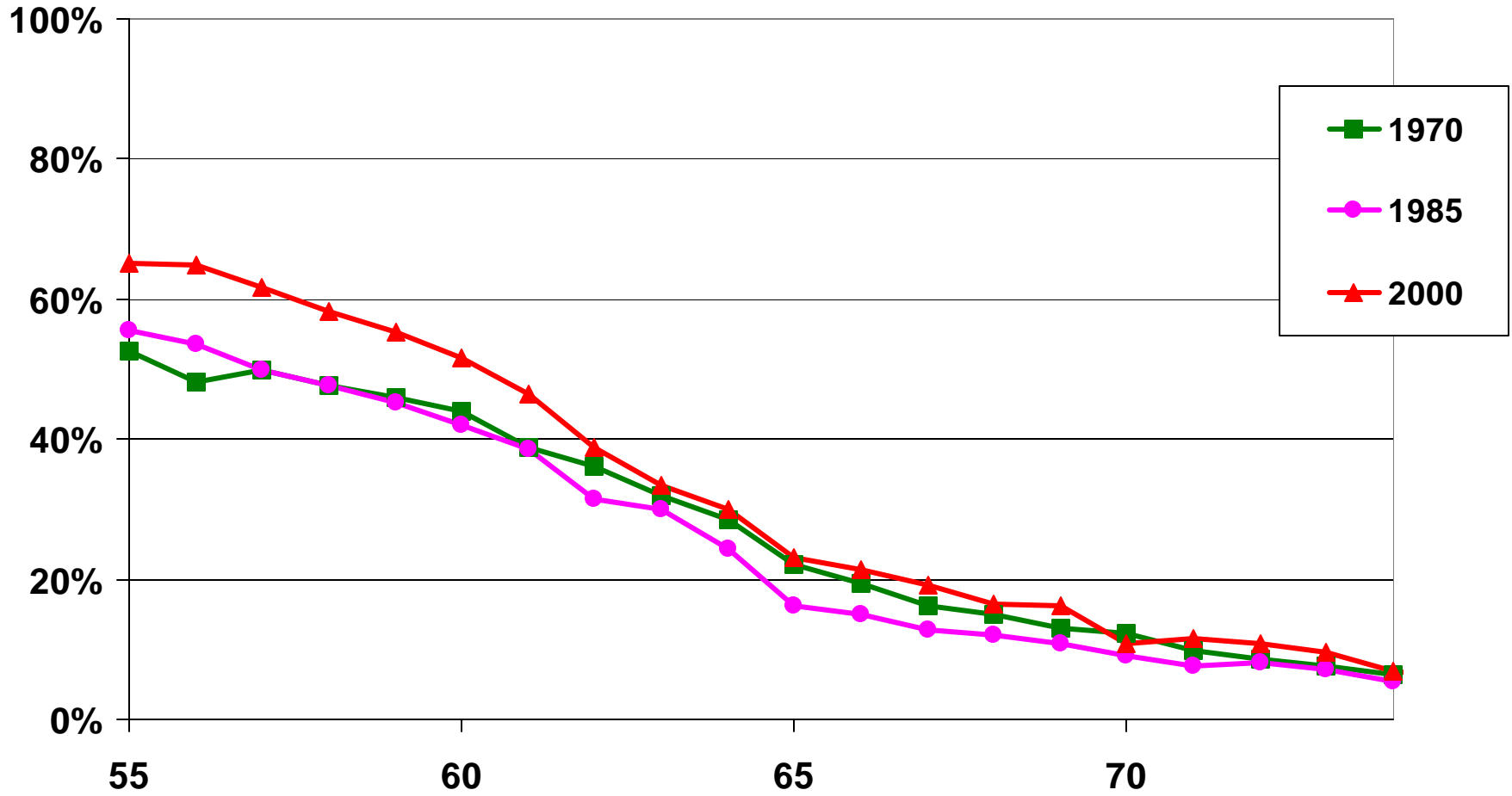


Source: 1940 data from US Census; 1965 and later from Consumer Population Survey data (BLS)

Note the dramatic decreases in labor force participation pre-1985. Much is due to Social Security and Medicare.

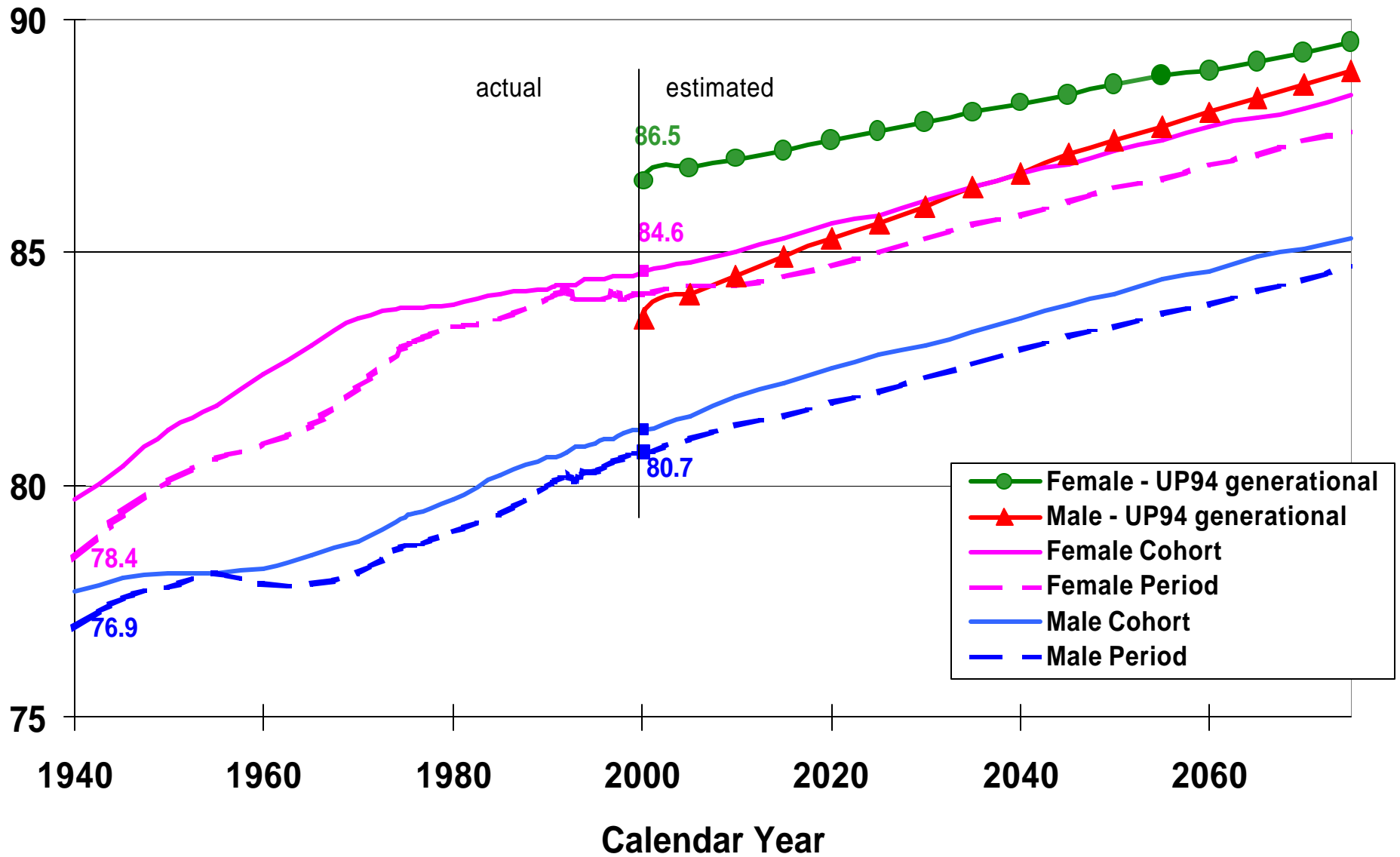
Since 1985 participation rates have gone up a little post-65, possibly due to pro-work policies and fewer new workers.

US Labor Force Participation Rates



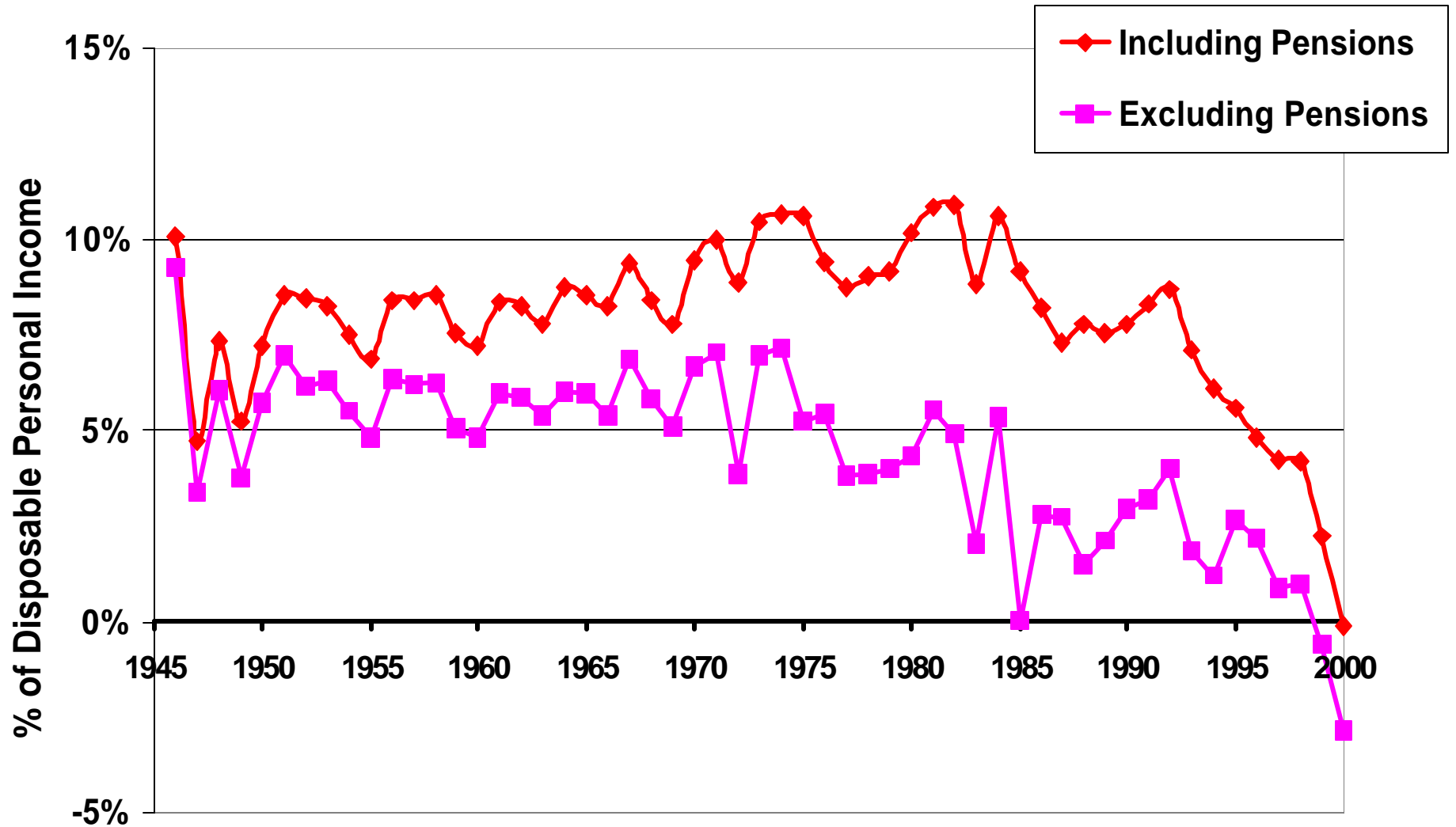
Note the INCREASE in labor force participation for women, especially at younger ages.

Period & Cohort Life Expectancies at Age 65

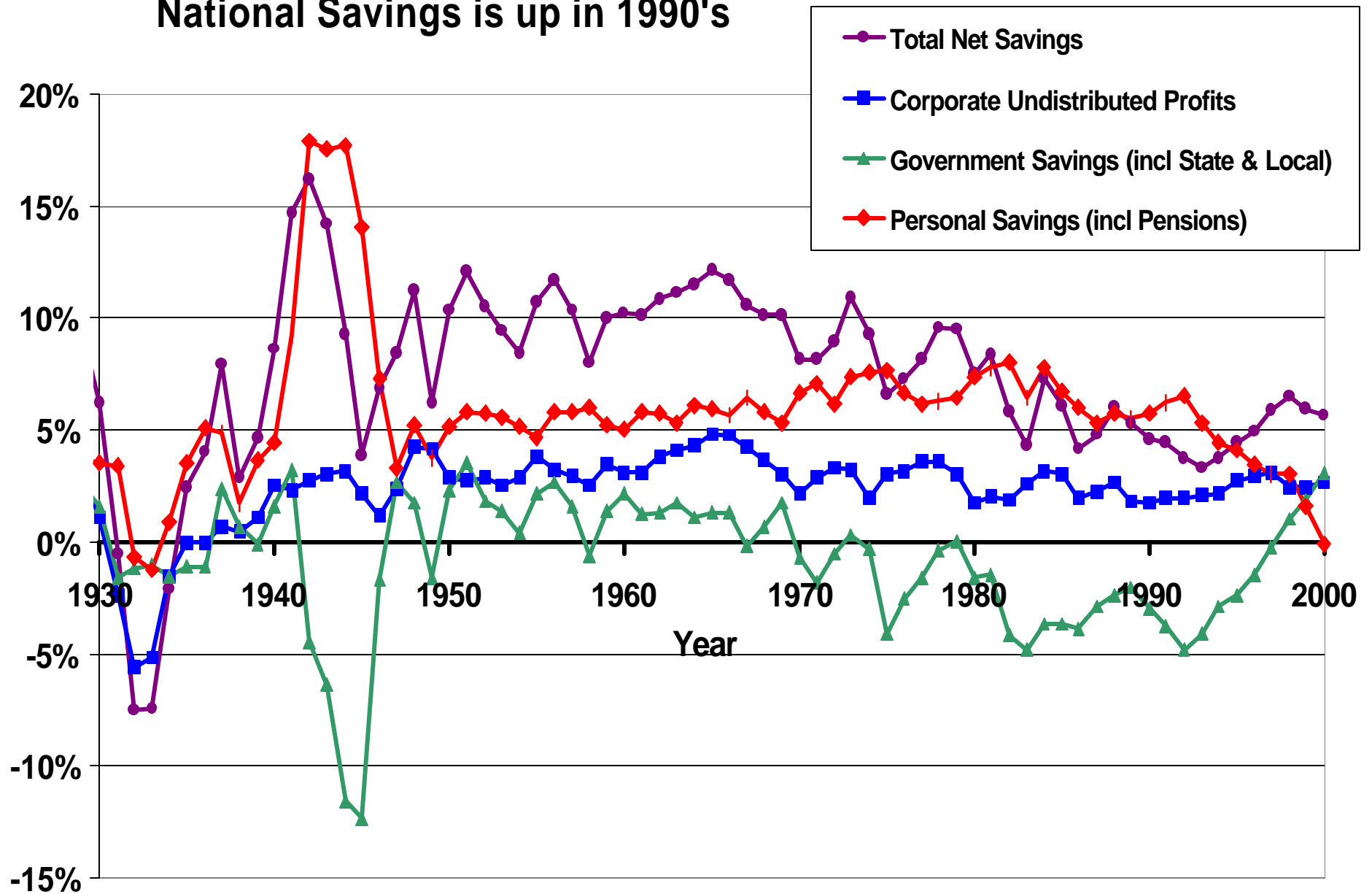


Source: 2001 SSA Trustees' Report, Table V.A3 (intermediate assumptions)
 UP94 generational life expectancies are based on mortality of employees with pensions

Personal Savings Rates are Down



National Savings is up in 1990's



Sources: 3/01 NIPA from Survey of Current Business by BEA, Tables 1.1 and 5.1

Net Savings is net of consumption of fixed capital.

Other sources: 1/01 Economic Report of the President by CEA, Tables B1 and B32 OR 3/9/01 Flow of Funds report by Fed, Table F.8

Preparing for Retirement Today

Much Different & More Difficult

- More Employers (\$ in more places, or gone)
- More likely to be in DC plan
 - That pay lump sums (we have no idea what annuity they buy)
- We saved less (less wiggle room if run out)
- Our DB benefits, if any + Social Security
 - Won't cover basic expenses, so we may need an annuity
- We're retiring before 62, and we'll live 2 years longer
 - Annuities will be much more expensive
 - \$100,000 will buy \$10,000 for life (male 65)
 - 10% Less if Female, 20% less if 55, 30% less if Indexed

\$100,000 will buy annuity of about:

	Male	Female	Joint & 66% to either survivor
Age 65	\$10,000	\$9,000	\$9,000
Age 65 & indexed	\$7,000	\$6,500	\$6,500
Age 55	\$8,100	\$7,800	\$7,800
Age 55 & indexed	\$5,500	\$5,000	\$5,000

Transparency

- Buzz word around the world
 - Cash is transparent to a worker
 - But NOT to someone retiring
- They may have lots of \$ (or at least they think it's a lot)
- But they want security
 - Knowledge that \$ money run out
- How can you turn \$ into security?
- One way is: spend the right amount each year
 - Do you know exactly when you are going to die?
 - If wrong, can you go back to work? At age 80?

Transparent?

- My fear: people think \$100,000 is a lot
 - And retire too early
 - Realize at age 80
 - When it's too late to go back to work
- Remedy = Education
 - Accumulation Side
 - Knowledge of investing is happening
 - People need to save more & value DB plans
 - Education even more important on the deaccumulation side

Education re: When to Retire

- When is NORMAL retirement age?
 - Not 55 or 62
 - We are living longer and saved less
 - Fewer DB plans with subsidized early retirement benefits
 - Social Security is moving to age 67
 - Our poll showed ½ don't know it
 - Should be 70
 - Living 5 years longer than when SS created
 - Health at 70 now is same as 65 back then

Education re: When to Retire

- Social Security
 - Move NRA gradually from 67 to 70
 - Doesn't have to affect benefits
 - Or could reduce benefits some to help SS financially
 - In 1983 it didn't affect people over age 45
- Allow pensions to move NRA to 70 in §411(a)(8) & 401(a)(14)
 - Doesn't require smaller benefits
 - Still won't be easy, many won't do it
 - Why would government prefer 65?
 - Recent policy has been to encourage people to work longer
- Move age 70 ½ to 75 or 80 in §401(a)(9)
 - Makes sense to buy annuities at those ages

Education re: Conversions

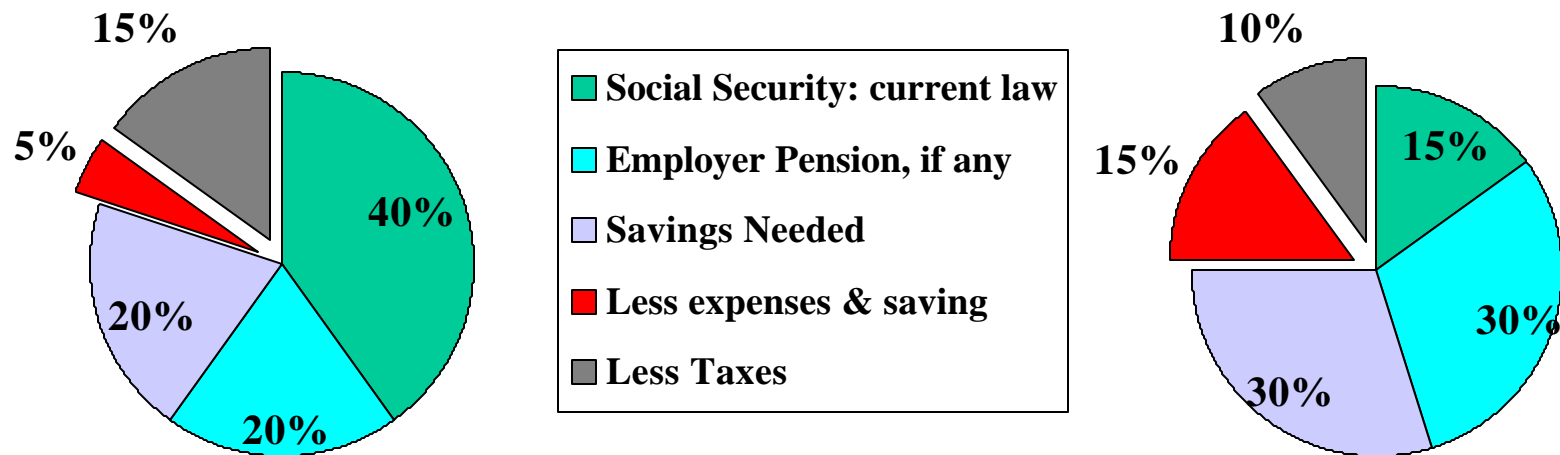
- Help people convert \$ to lifetime income
 - DOL websites
 - SSA benefit statements
- Needs to be personalized
 - Include on the periodic DC/401(k) statements
 - Next to account balance
 - Using plan purchase rate or insurer rates (which change)
 - Complex – so DOL could provide calculation (simplify/do only if age >50)
 - Litigious – so DOL could provide language
 - “This information is being supplied with the help of DOL
 - Require custodians/trustees to include on IRA statements
 - If insurer it makes good business sense anyway

Education re: Income Needs

- You probably won't need 100% of income replaced
- No more FICA taxes – 7.65% of wages up to \$80,400
 - SECA taxes are twice that
- Income taxes may go down – up to 15% of income
 - Lower marginal tax bracket
 - SS is taxed less
 - Roth IRAs not taxed
 - Return of your basis not taxed
 - Employee contributions & price of annuity
- No more work-related expenses – 3% to 7% of income
- No more wages to save – up to 15% of income?

Personalized Education re: Income needs

\$25,000 wage earner



What you need depends on many factors which vary by income.
E.G., Taxes will go down more at lower incomes, because their Social Security benefits won't be taxed.

Personalized Education re: Income Needs

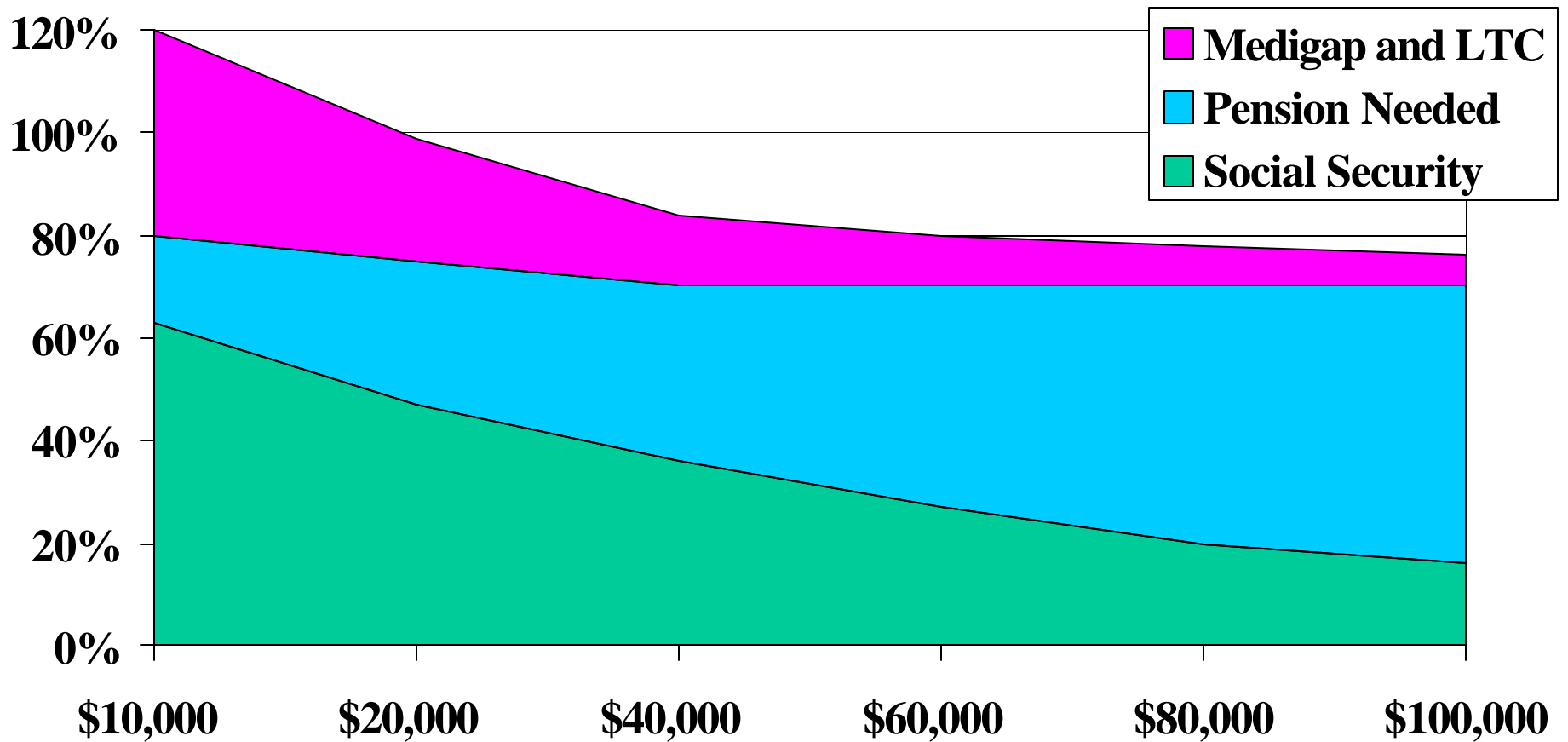
- Expenses may go down by 30% of income
- Only 70% needs replacing
- Low-income people may need 80% to 85%
- Lower if no mortgage
- Higher if employer doesn't pay
 - LTC (\$2,000+ is 20% of income for someone getting only \$10,000)
 - Medigap (\$2,000 is 20% of income for someone getting only \$10,000)
- Cost of \$20,000 per year for life starting at age 65

	<u>CPI-indexed</u>	<u>Level Income</u>
– Women	\$310,000	\$220,000
– Men	\$290,000	\$200,000

Personalized Education

- In assessing income needs
 - Don't forget to include LTC & Medigap premiums
 - For both spouses/partners
 - LTC: Especially for the more-likely survivor
 - » Who won't have you to take care of her/him
 - Include inflation-indexing in LTC policy
 - Consider paying lump sum premium for it
 - So you don't forget to pay premium when old
 - Cheaper and has tax advantages (no tax on yields)

Retirement Income Needed for 100% Replacement of Spendable Income at Age 65 Single Person



Wages just before retirement in 2000

Personalized Education

- Is Social Security enough?
- Not if you want to maintain your standard of living
- You'd be ok if on top of SS, you also had:
 - Pension (from a 30 year job)
 - Post-retirement medical

Personalized Education

- Should you take your pension in cash?
 - I used to encourage taking pension
 - I can't say that now in good conscience
 - Due to low interest rate mandated in §417(e)
 - We dropped PBGC rates when they got too low
 - Now Treasuries are so low, lump sum easily more valuable than annuity
 - **QJSA can't be most valuable option.** We can't subsidize annuity.
 - **You might discuss changing it to corporate bond rate**

Personalized Education

- Once employee knows:
 - What lifetime income their assets can buy
 - Social Security benefit
 - Income needs
- They can figure if they can retire now
 - Hopefully this will reduce # people retiring too early and needing welfare
- Who should do the education?
 - Employers, DOL, PBGC, SSA, AoA at HHS, PAL?

Education re: Do it yourself

- Many investment advisors say skip annuity
- Invest \$ yourself (with their help)
- You can do better with \$ in stocks (on average)
- You can run out of money (see WSJ article)

6/2/98
WSJ
page C1

After Scrimping to Build a Nest Egg, Brace Yourself for Withdrawal Angst

How golden will your golden years be? Figuring out how much to withdraw each year from your retirement portfolio is probably the trickiest financial choice you will ever face. And today's lofty stock market makes the decision doubly difficult.

Sure, the calculation seems straightforward. You start with some assumptions about investment returns and your life expectancy in retirement.

Let's say you expect stocks to gain 10% a year and bonds 6%. Also assume annual inflation of 3% and a 25-year retirement. If you hold 50% stocks and 50% bonds, you ought to be able to withdraw 6.7% of your portfolio's value in the first year of retirement. This withdrawal would come partly from dividends and interest and partly from selling securities.

Thereafter, even if you boost the sum you withdraw each year along with inflation, your money should last through a 25-year retirement.

Easy, right? Unfortunately not. "The vagaries of the market can wreak havoc with the best-laid investment plans," says Steven Norwitz, a vice president with T. Rowe Price Associates, the Baltimore fund company.

What to do? Here are five strategies for coping with Wall Street turbulence.

■ **Don't expect history to repeat itself.**

If you want to see how fickle markets can be, consider the past 25 years. According to Chicago researchers Ibbotson Associates, annual returns were fairly generous, with Standard & Poor's 500-stock index gaining 13.1%, intermediate-term government bonds returning 8.9% and inflation climbing at 5.5%.

But for those who retired at the start of this 25-year stretch, it was a nightmare, because it began with the brutal 1973-74 bear market. If you had begun the period with 50% in the S&P 500 and 50% in intermediate bonds, pulled out 6.7% in the first year and then stepped up your withdrawals with inflation, you would have been penniless within 13 years, T. Rowe Price calculates.

"If you start your retirement with a bear market, you wipe out a lot of capital before you really start withdrawing," says William Bengen, a financial planner in El Cajon, Calif. "The bear market is telling you that you're basing your withdrawals on inflated market values and you really need to reduce them."

■ **Spread your bets.**

Would a more broadly diversified portfolio have fared better? Let us say you still had a 50-50 mix of stocks and conservative investments but it was divided up as 30% S&P 500, 10% small stocks, 10% foreign stocks, 35% intermediate bonds and

15% Treasury bills.

T. Rowe Price calculates that, with a 6.7% withdrawal rate, this better-diversified portfolio would have left you broke within 15 years, a tad longer than the less-diversified portfolio.

What kills the portfolio is when inflation starts roaring, says Minneapolis financial planner Ross Levin. "You might substitute inflation-indexed bonds for some of the intermediate-government bonds. You might also put a small amount in some sort of hedge, like real-estate investment trusts."

■ **Leave room for error.**

One solution is to spend less right from the start of your retirement. T. Rowe Price figures that the more-diversified stock portfolio would have seen you through the last 25 years if you had used a 5.1% withdrawal rate.

A good idea? Keep in mind that you pay a steep price for this margin of safety. If you cut your withdrawal rate to 5.1% from 6.7%, that means an almost 24% hit in your standard of living.

■ **Don't feed the bear.**

As a compromise, you might start with a withdrawal rate closer to 6% but be ready to slash your withdrawals if the market turns sour. Curtailing your spending, or taking on part-time work to earn extra money, is especially important if you get hit with a bear market early in retirement.

"That's the worst-case scenario," Mr. Bengen says. "You want to be conservative and cut back. It's the same thing any business does. If profits drop, they cut back on costs. You should do the same thing."

Mr. Bengen suggests you may want to trim your spending by as much as 20% until the rout is over and you have a better sense of the damage done to your portfolio. What if you don't scale back immediately? You will severely deplete your portfolio and will likely face more drastic cuts later.

■ **Adopt a five-year plan.**

Suppose you expect a 25-year retirement and you own an equal mix of stocks and bonds. To give yourself some margin for error, you opt for a 6% withdrawal rate.

Even if returns are neither surprisingly good nor surprisingly bad over the next five years, go back and review your spending strategy to make sure you're on track. Five years into your retirement, and with 20 years still to go, your withdrawal rate should equal about 7% of your retirement assets at that time. If you are spending more than that, look to cut back.

Another five years have passed? With a 15-year life expectancy, a withdrawal rate of 8.5% should be OK. "You've got to reassess periodically," Mr. Norwitz says, "or you risk running out of money."



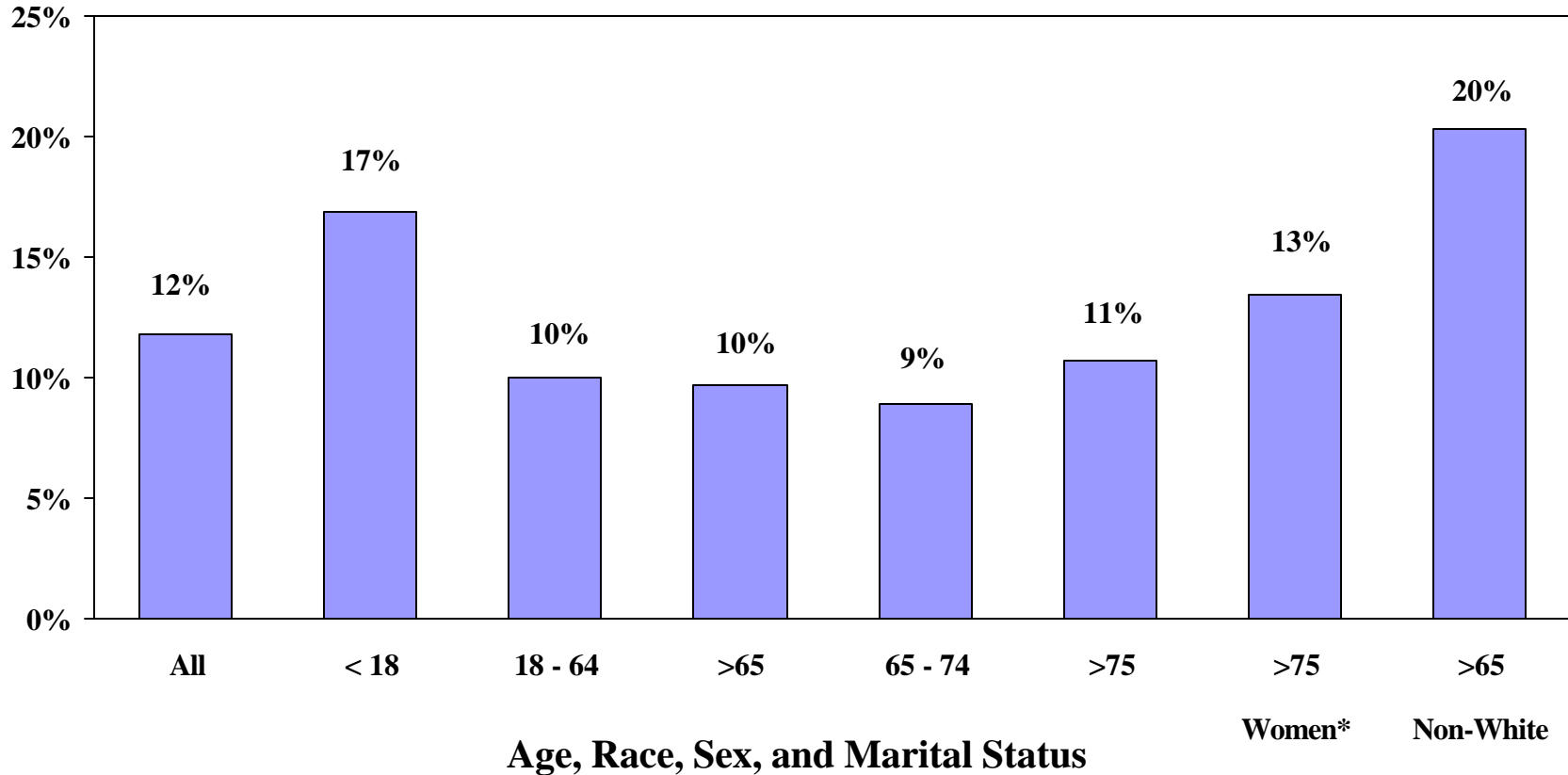
Roman Scott

OR Just stay in DB plan & Social Securis
or Buy an Annuity

Problems

- Higher poverty rates at older ages
 - People take money out too fast, and run out
 - Fixed incomes not great in times of high inflation
- Higher poverty rates among single women
 - Pensions payable just to husband?
 - Husband uses up assets in LTC costs before dying
 - Survivor has no caregiver, and needs \$ for it
- How can we fix those problems?
 - Indexed pensions/annuities for life of employee & spouse/partner
 - LTC and Medigap insurance

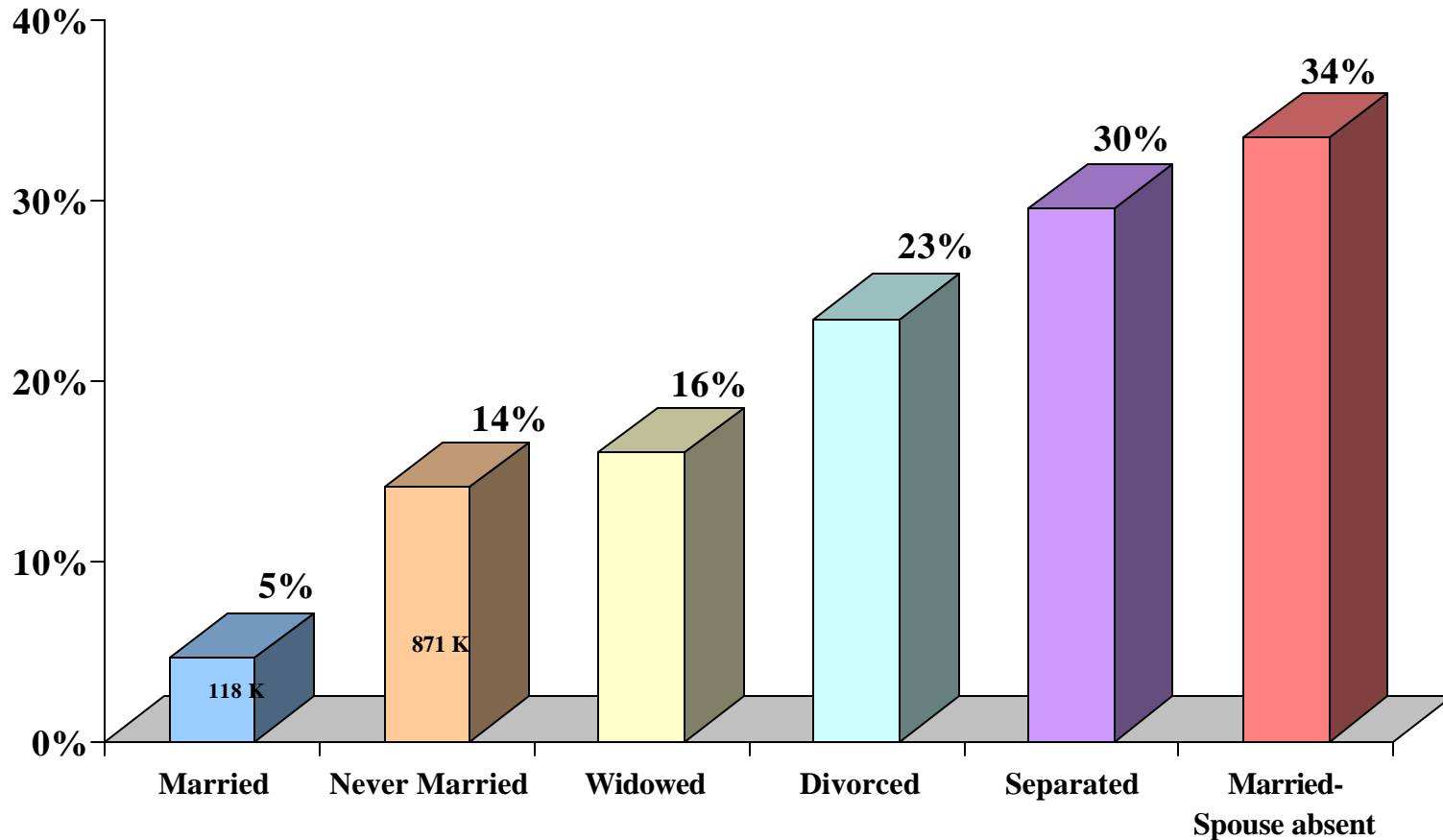
Poverty Rates for 1999



Note that poverty rates of elderly are the same as those of working age! They may be lower at 65-74 since they can work and access assets too fast. Excluding wage-earners from people over 65, raises those poverty rates by approximately 1 percentage point (~1%). Experimental poverty measures that reflect taxes, EITC, & govt benefits lowers rates by ~ 2%. Reflecting net rental value of owner-occupied housing lowers rates by ~5% for elderly. What about reflecting other assets? NAS recommendation to eliminate the lower elderly threshold increases their rate, while the recommendation to lower single's threshold from 79% to 71% (Betson & Int'l) or 62% (NAS), lowers them. Reducing income by MOOP (medical out-of-pocket) expenses raises rates by ~ 8% and more for very elderly women (but note that people can pay more MOOP by selling assets). SIPP data lowers rates by ~2% because elderly under-report income on CPS. These modifications change rates, but rankings stay about the same.

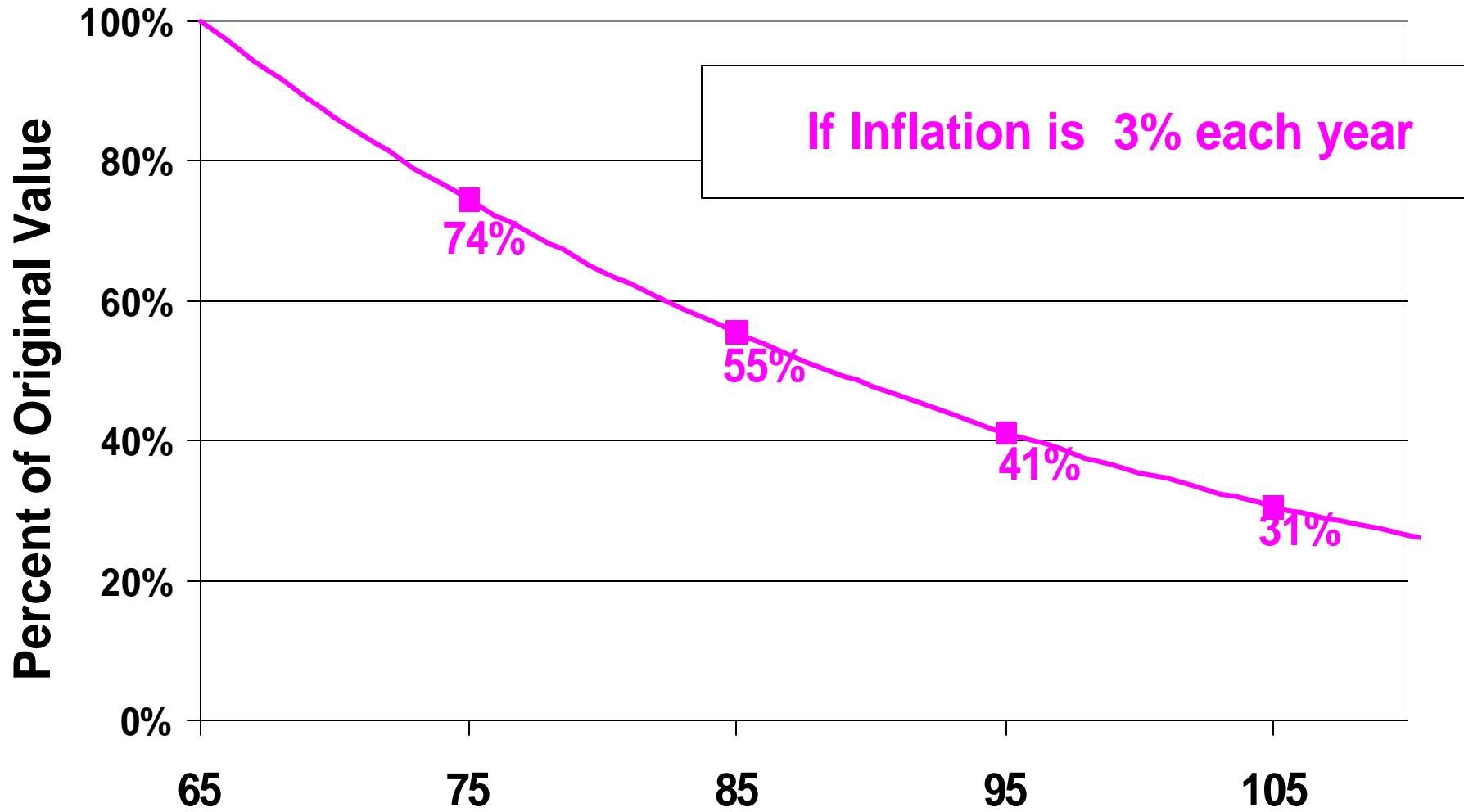
Source: CPS, March 2000 Supplement (using ferret.bls.census.gov) and www.census.gov/hhes/www/poverty.html

1999 Poverty Rates of Women Age 75 & Over
(and Number in Poverty)



Reflecting home ownership reduces elderly poverty rates by 5% (10% for elderly widows). Reflecting MOOP (medical out-of-pocket) expenses increases them. Recommendation to reduce single's threshold from 79% to 71% of couple's threshold (Betson & Int'l) or 62% (NAS), brings elderly women's rates towards married women's rates. Experimental measures increased poverty rates of married couples by 4%, but changed widows little (BLS: Johnson 2/2000). Source: CPS March 2000 Supplement (using ferret.bls.census.gov)

Purchasing Power is reduced by Inflation



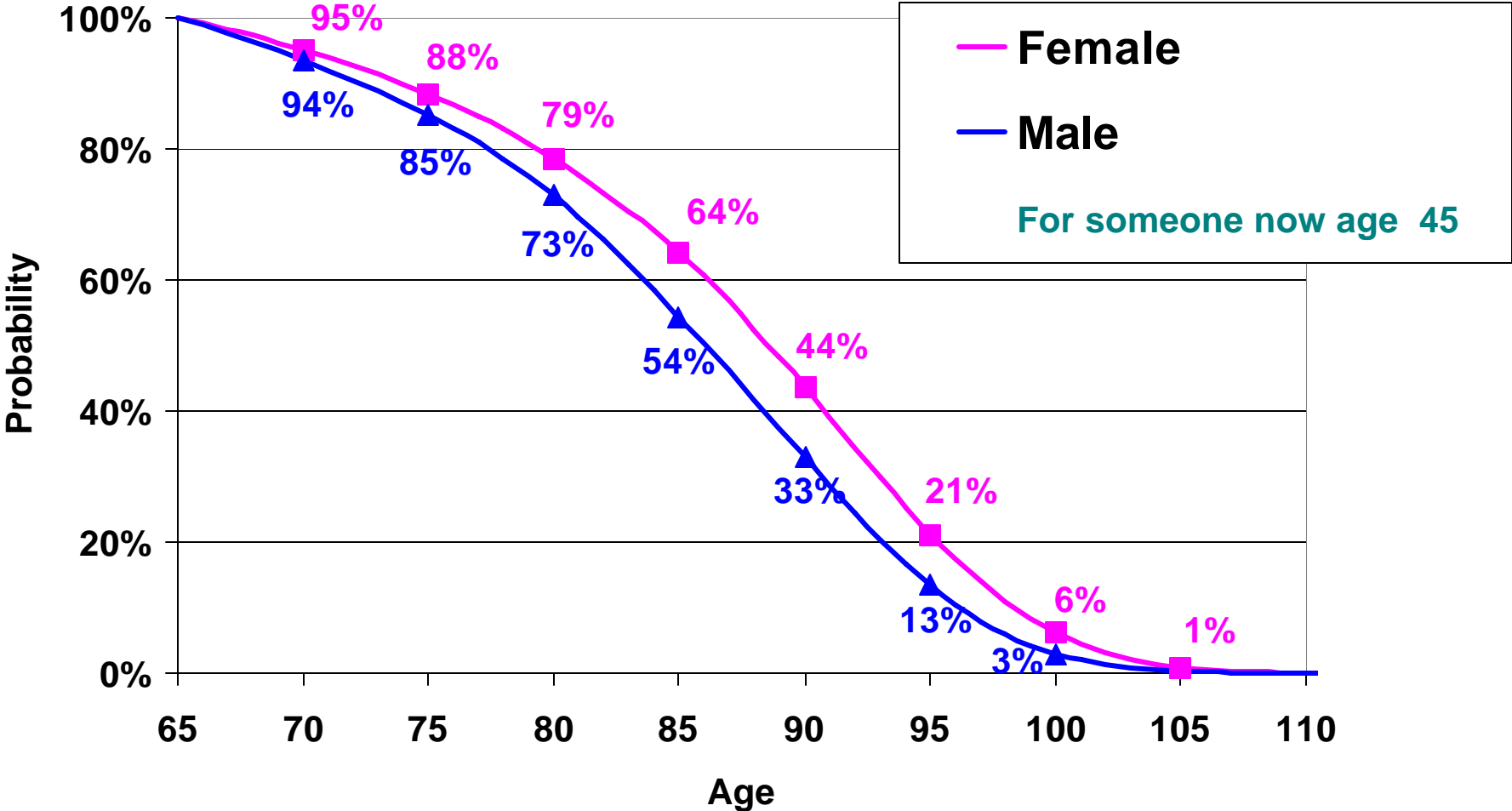
Do it yourself

- Doing it yourself makes sense if:
 - You are multi-millionaire & won't run out of \$
 - Your SS + Pension covers all your needs for life
 - AND your spouse's/partner's
 - You want your money to go to your heirs, or
 - You don't mind falling on welfare (SSI & Medicaid)
 - You **know** you will die soon
 - You need the cash
- Charts show alternative ways to do it yourself⁵⁴

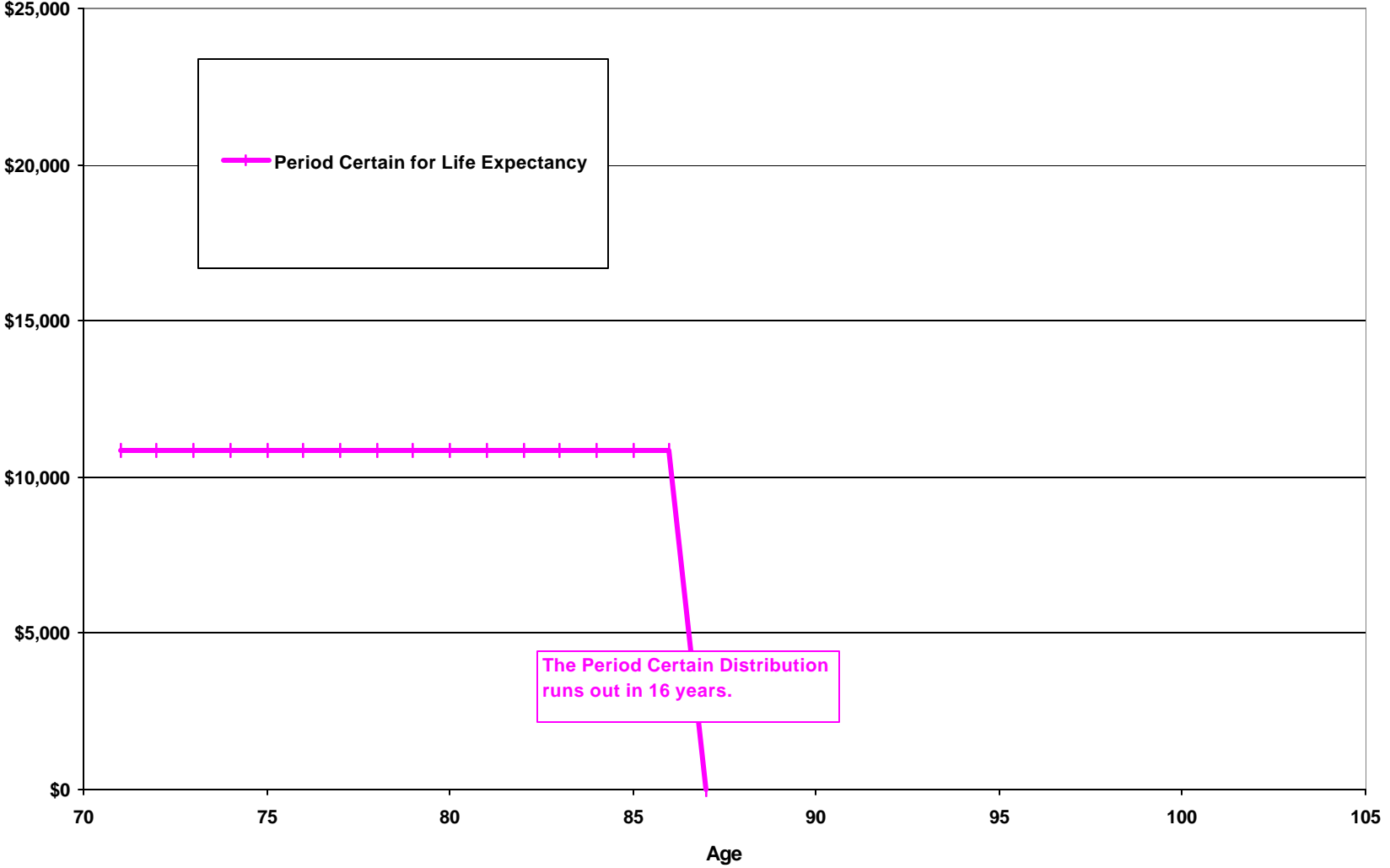
Do it yourself

- Estimate your life expectancy (or use IRS tables)
- Estimate your future investment yields (net)
- Determine amount that uses up \$ over that time
- What if you overestimate amount?
 - You'll run out of \$
 - Can you go back to work? (at age 80?)
- What if you underestimate amount?
 - Live like pauper (& then find out you didn't need to)

Probability of Living From Age 65 to Specified Age



**Chart I : "Do It Yourself" Distributions
vs
Lifetime Pensions / Annuities**



IRS minimum distributions

- At 70 ½ you must start taking distributions
- Old rules: divide by your life expectancy
- New rules: divide by joint life expectancy
 - As if you have a spouse 10 years younger
 - Withdrawal is much lower
 - You can still run out of money (but less likely)
- Investing in stocks helps, unless market tanks

Chart II : "Do It Yourself" Distributions
vs
Lifetime Pensions / Annuities

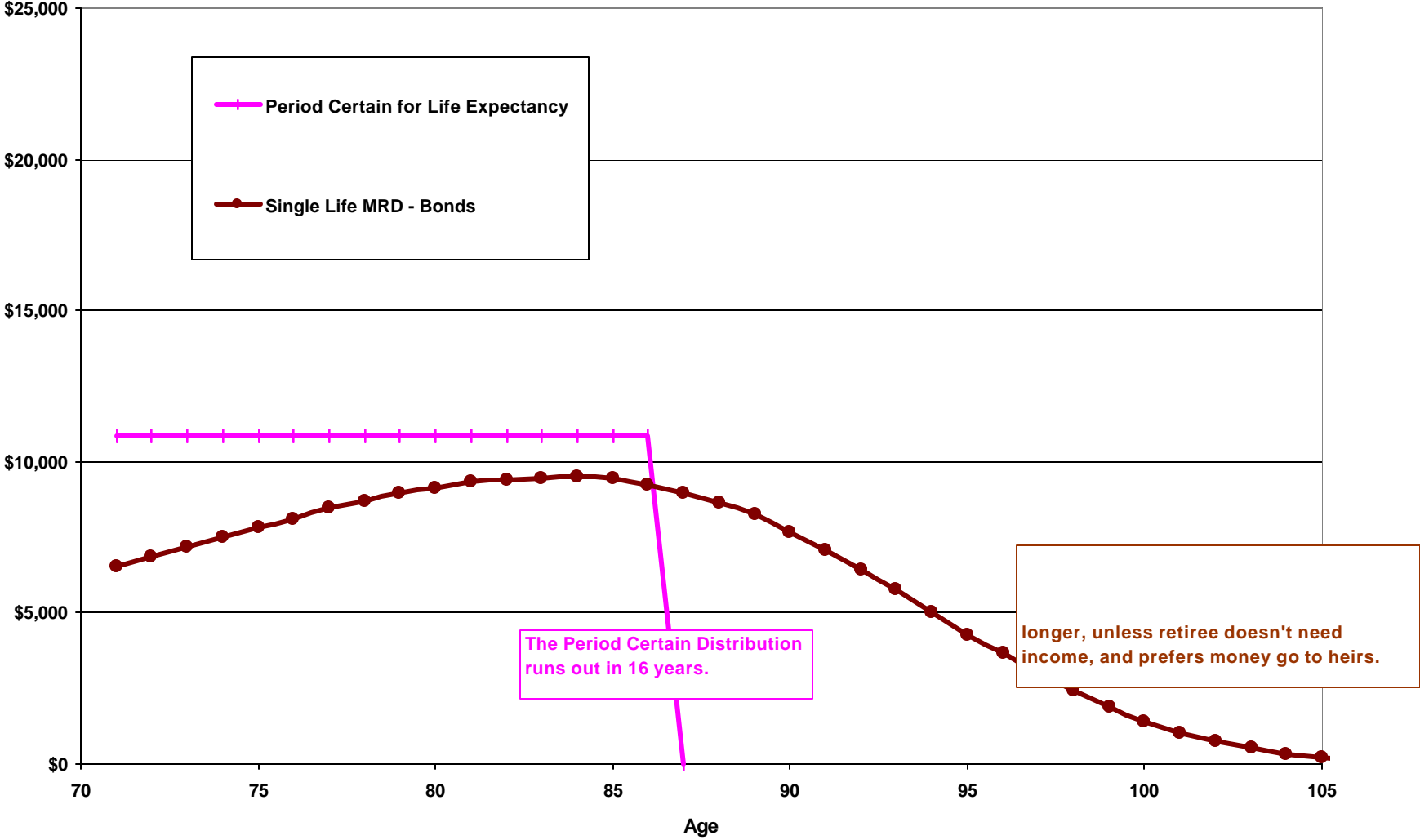
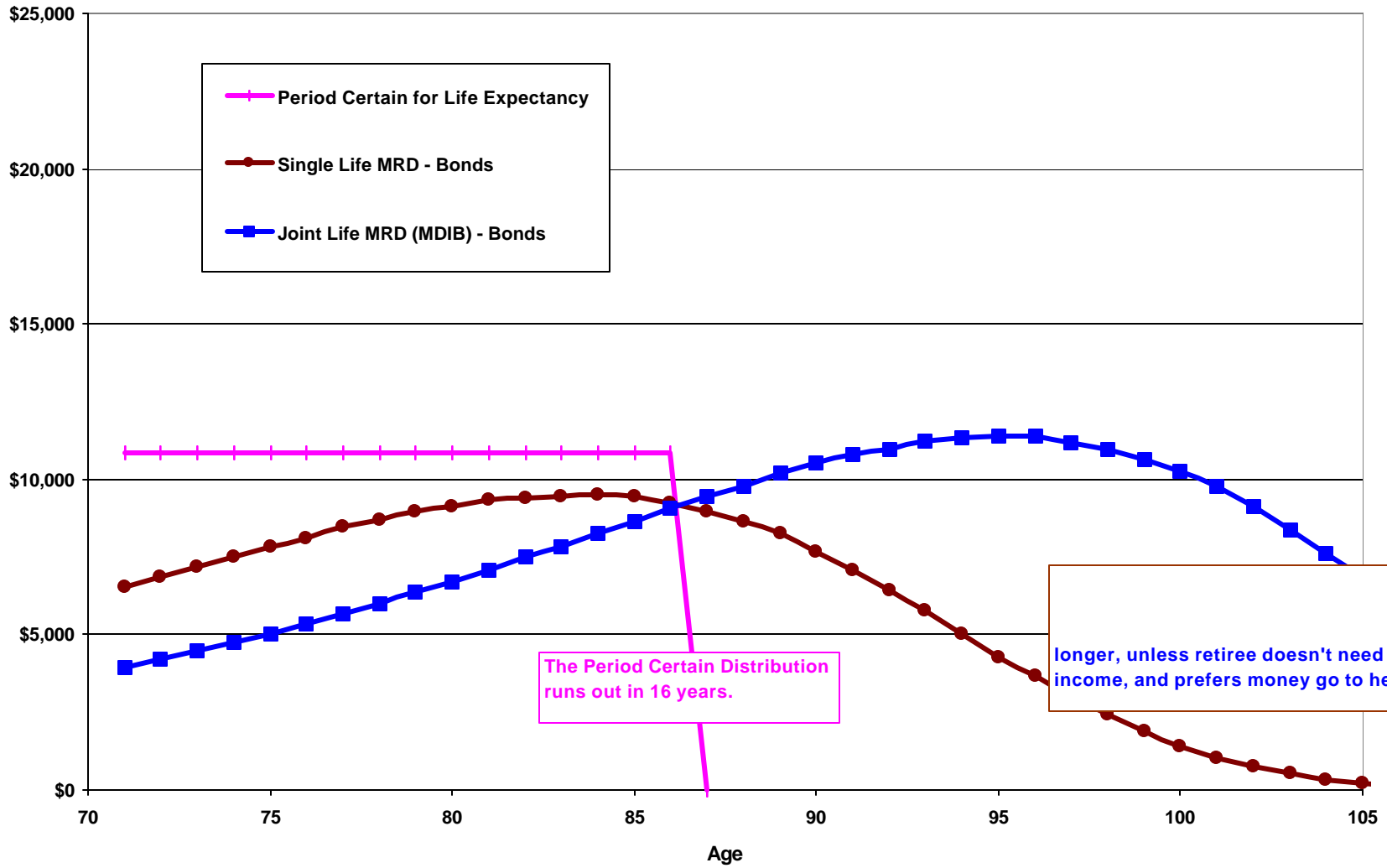


Chart III : "Do It Yourself" Distributions
 VS
 Lifetime Pensions / Annuities



The Period Certain Distribution runs out in 16 years.

longer, unless retiree doesn't need income, and prefers money go to heirs.

Chart IV : "Do It Yourself" Distributions
 VS
 Lifetime Pensions / Annuities

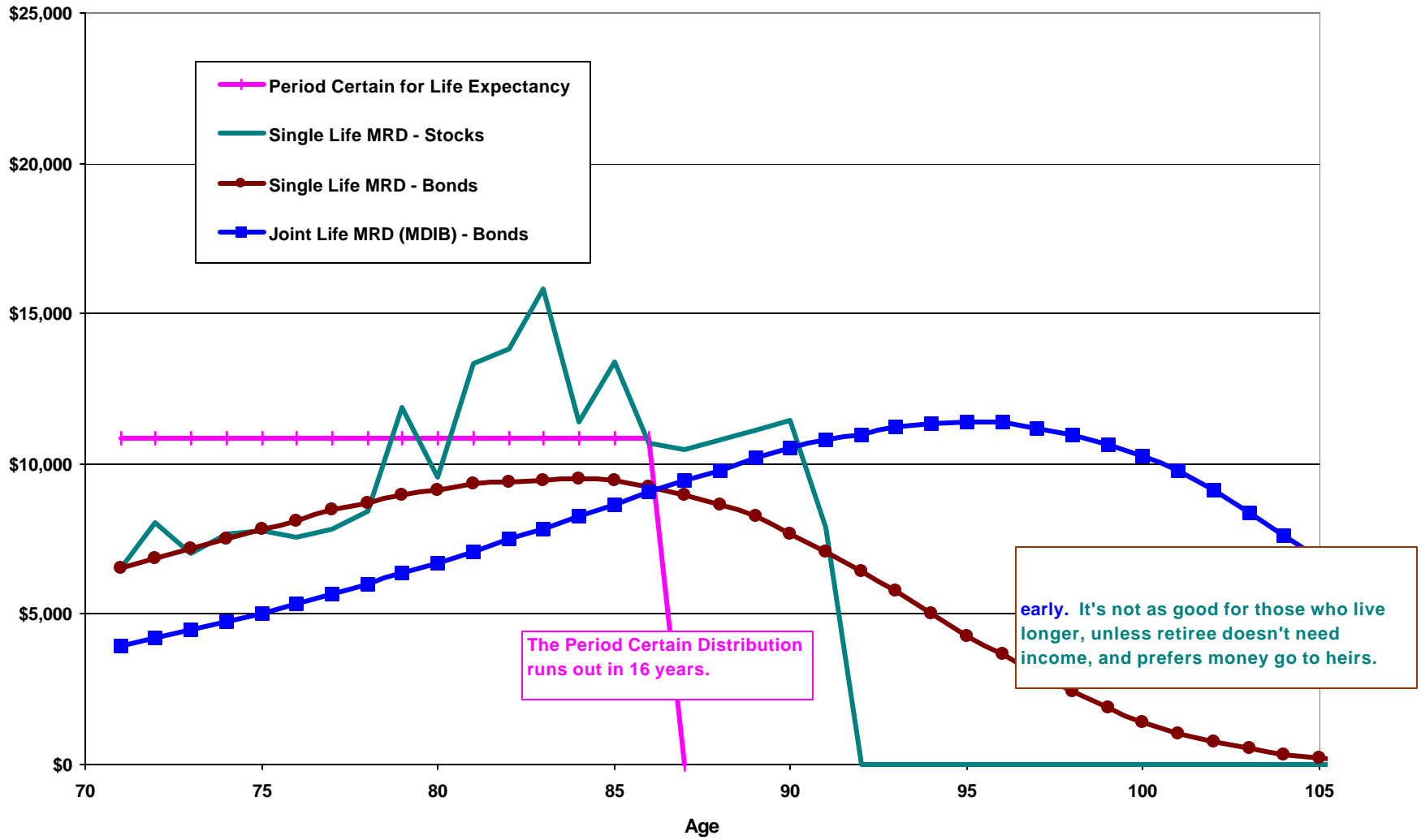


Chart VII : "Do It Yourself" Distributions
vs
Lifetime Pensions / Annuities

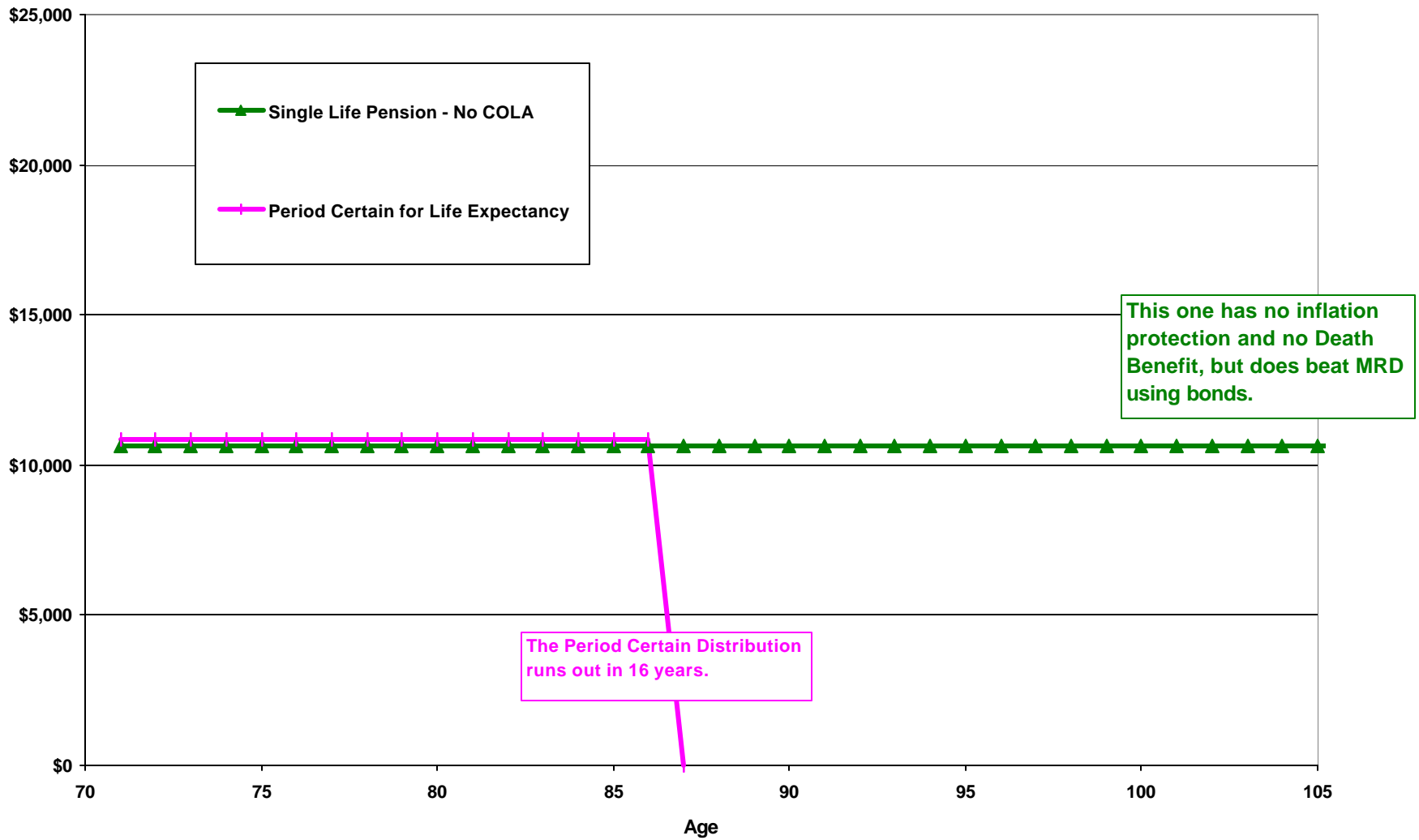
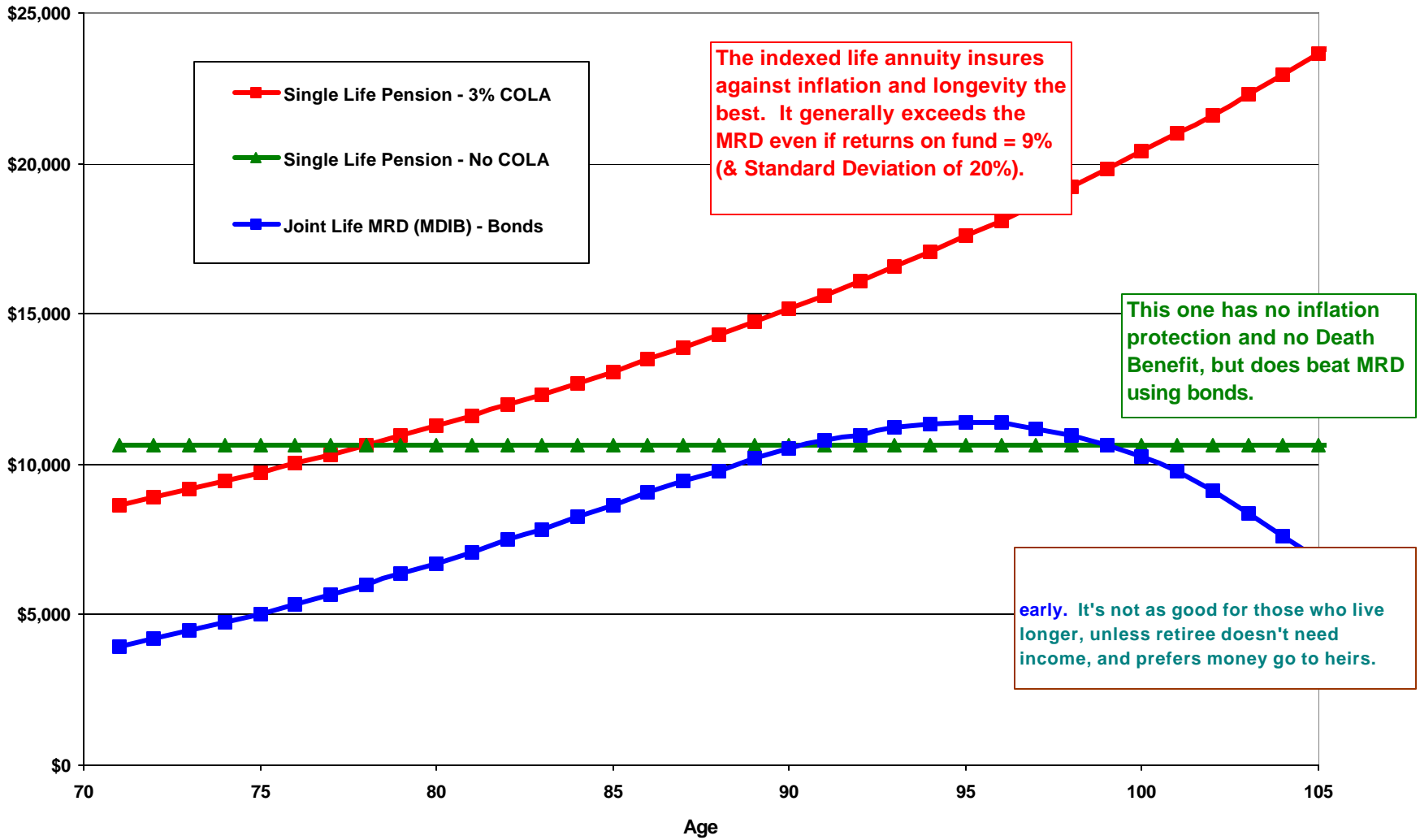


Chart VIII : "Do It Yourself" Distributions
 VS
 Lifetime Pensions / Annuities



Annuity can be larger

- How can that be?
 - Insurance companies have high expenses!
- Because Ins Co won't "waste" money on those that die
 - Nothing goes to heir
 - Unless you request a period certain benefit or buy life insurance
- Ins Co can lock in current 7% bond yields for your full life
 - MM fund doesn't know when you'll take your money out
 - So it has to be in liquid assets (< 6%)
 - Stocks can have a higher return
 - But they also entail risk that you will get less
 - Which defeats your purpose
 - Employer pensions can give you stock returns, without giving you the risk
 - Employer takes the risk
 - Use to be spread out, but FAS87 and IRC §412(l) increased risk on employer

Other Advantages

- Annuities are payable for life
 - Longevity Risk eliminated (no matter how long you live)
 - Investment Risk eliminated (no matter what happens to markets)
 - All states have Guarantee Funds (in case Insurer goes bankrupt)
- Inflation Risk can be eliminated
 - Some Pensions are CPI-indexed (SS & most state plans)
 - You can now get CPI-indexed annuities in US!
 - UK has had them for some time
- Annuities have tax advantages
 - Taxes on earnings are spread evenly over life expectancy
 - Instead of mostly up front
 - But it's at income tax rates (not Capital Gains rates)
- Pensions/Annuities relieve pressure on SS

Form of Pension/Annuity

- For life
- Including life of spouse/partner
 - One person needs 75% (?) of what two needed
- Still have minor kids?
 - Include a guarantee period until they can work
- Indexed to go up with inflation?
 - Will your expenses go up with inflation?
- I'm discussing Immediate Annuities
 - Not Deferred Annuities (sometimes called Variable Annuities)
 - Deferred Annuities are just another type of investment
 - Make projections: compare returns, expenses, and tax advantages

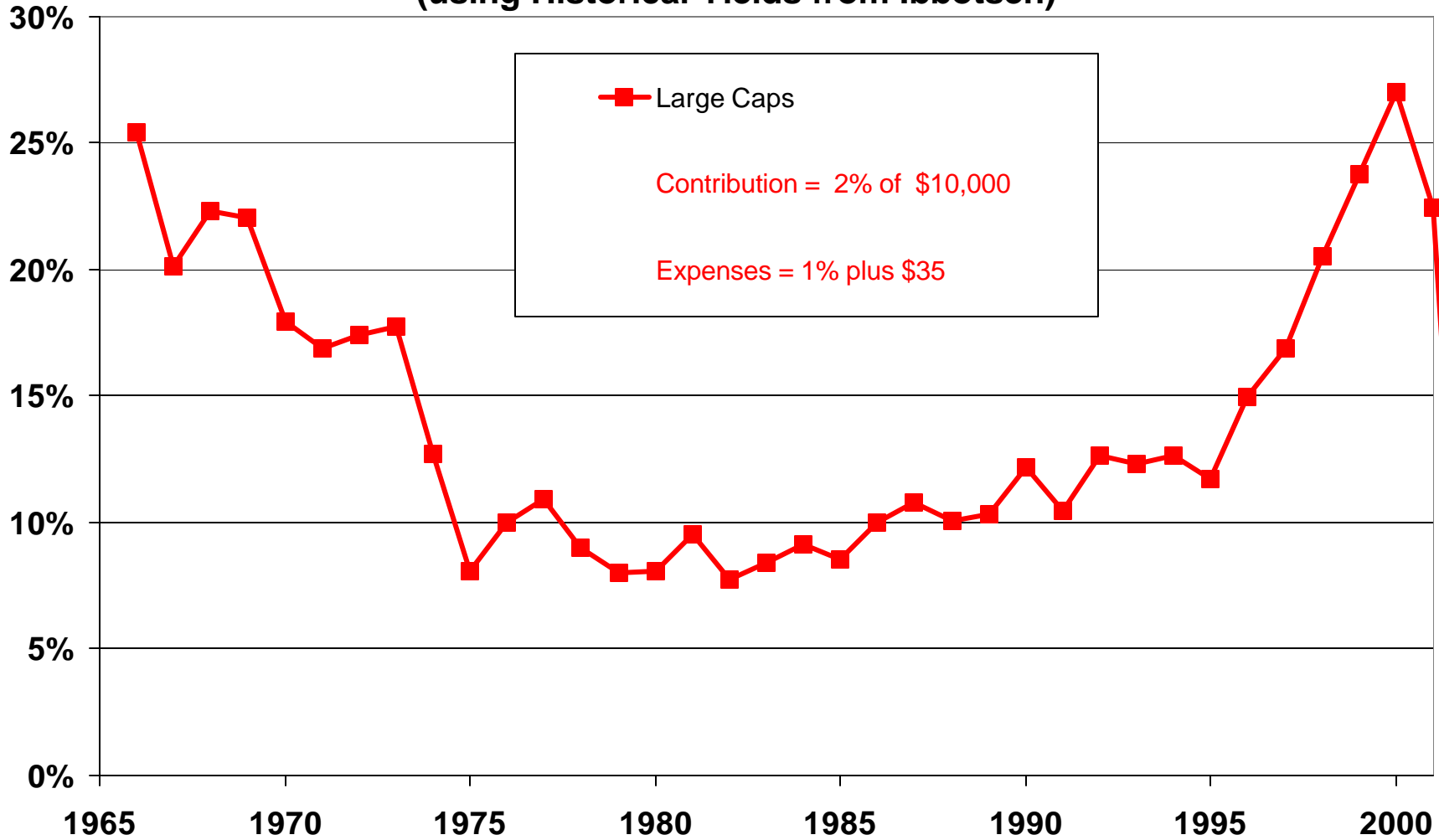
When to start lifetime income

- When you retire
 - Unless your assets in stock market are down
 - Wait until your assets come back up
 - Gradually move to bonds or diversify
 - Unless annuity prices are high
 - Wait until interest rates are higher
 - This rule may conflict with prior one
- If can't time market, could gradually buy bonds

When to start lifetime income

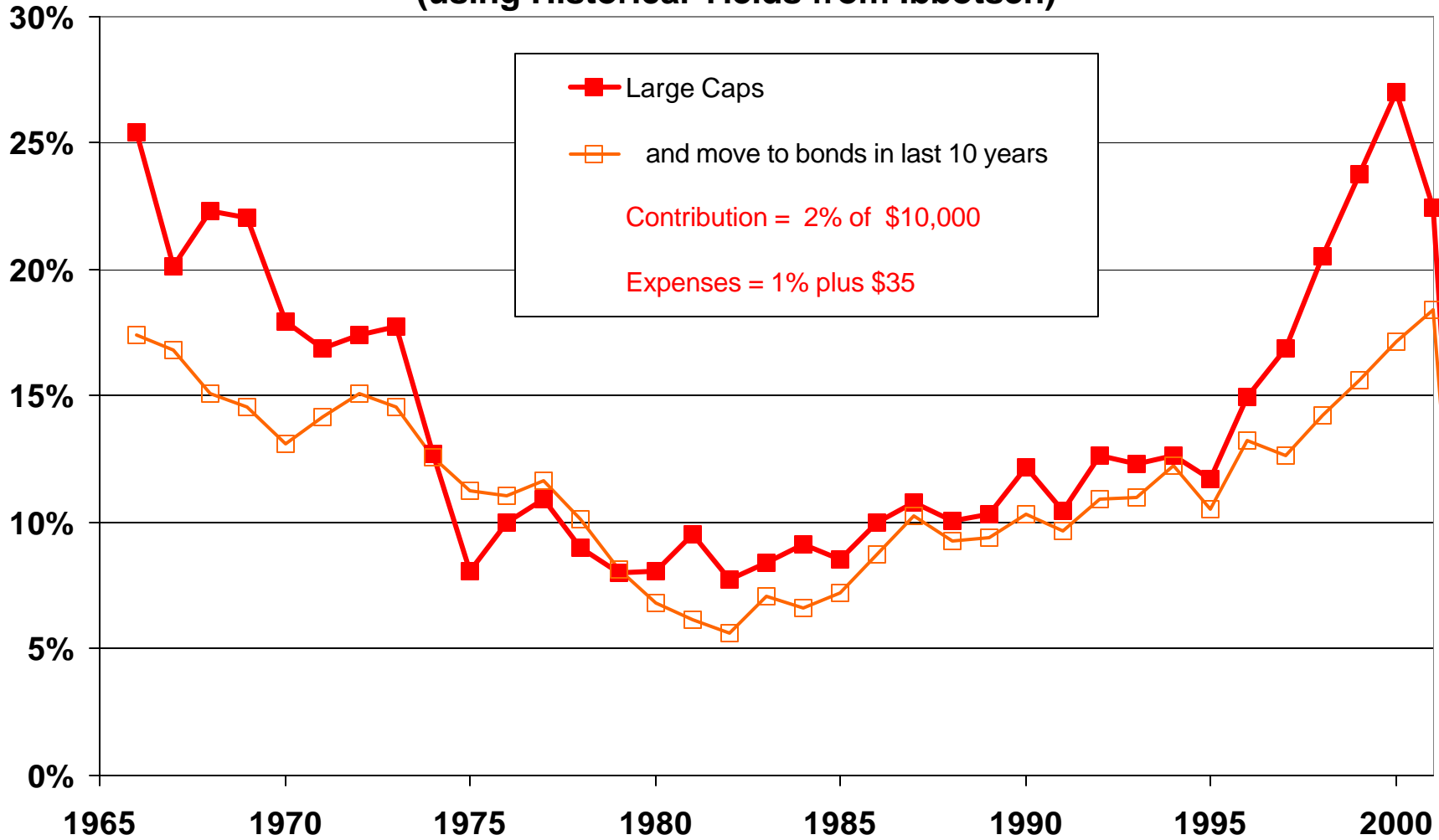
- Some say wait until you're 80 to buy annuity
 - In Plan:
 - Would help if pension plan had DB side and DC side
 - Move to DC side to invest after quit/retire
 - Move back to DB side at 80 to buy annuity
 - Get better annuity price from employer, even on indexed annuity
 - » Because employer can reflect stock returns
 - » BUT Low 417(e) rate will mess that up
 - Or from IRA, buy annuity
 - At 80 you get larger mortality gain from insurer~5%
 - Offsets the lower return insurer gets in bonds
 - 5% + bond return > stock return

Replacement Rates from Individual Accounts started at age 25 (using Historical Yields from Ibbotsen)



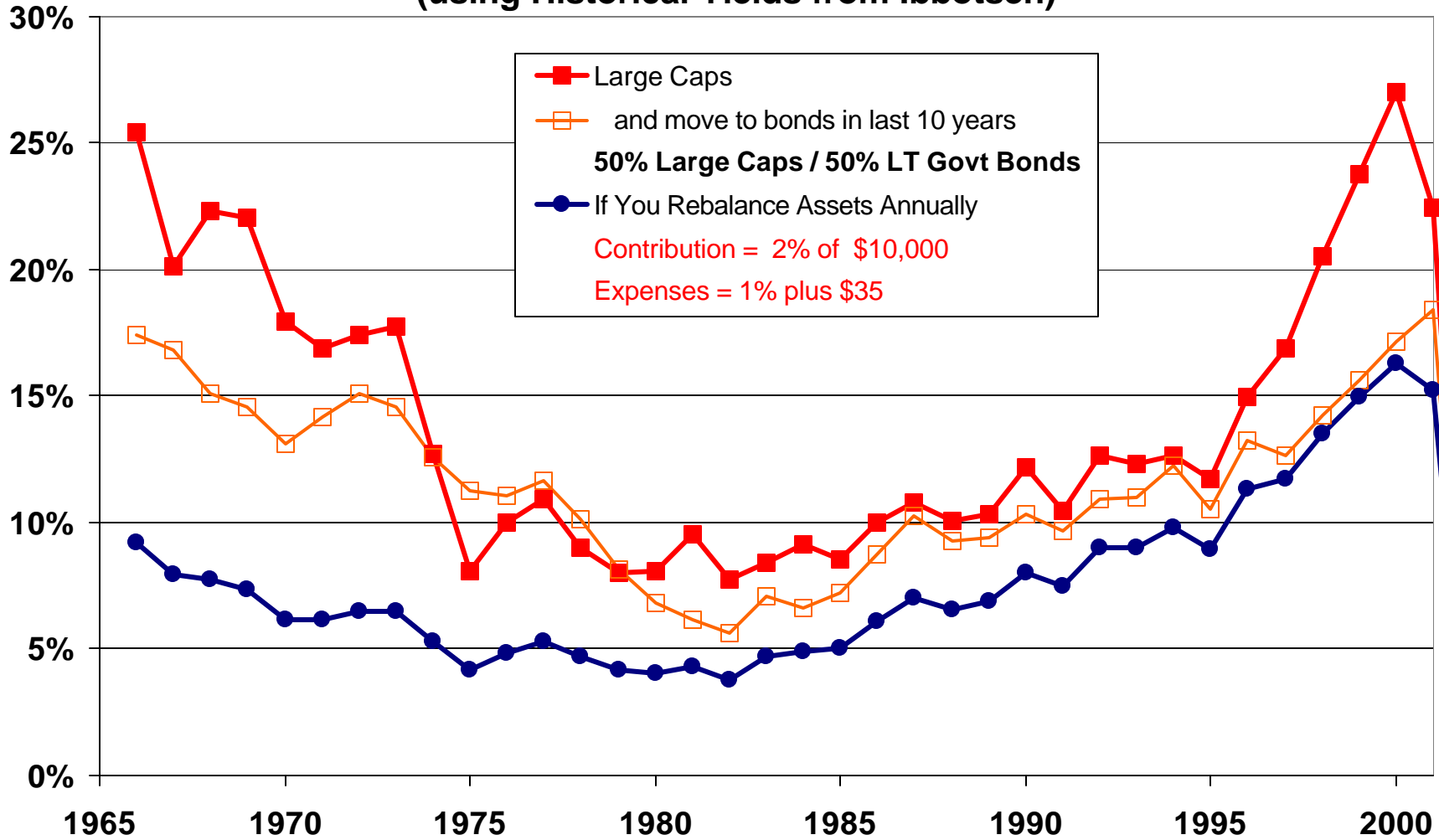
Retirement on Jan 1 of above year at Age 65 with a CPI-indexed life annuity

Replacement Rates from Individual Accounts started at age 25 (using Historical Yields from Ibbotsen)



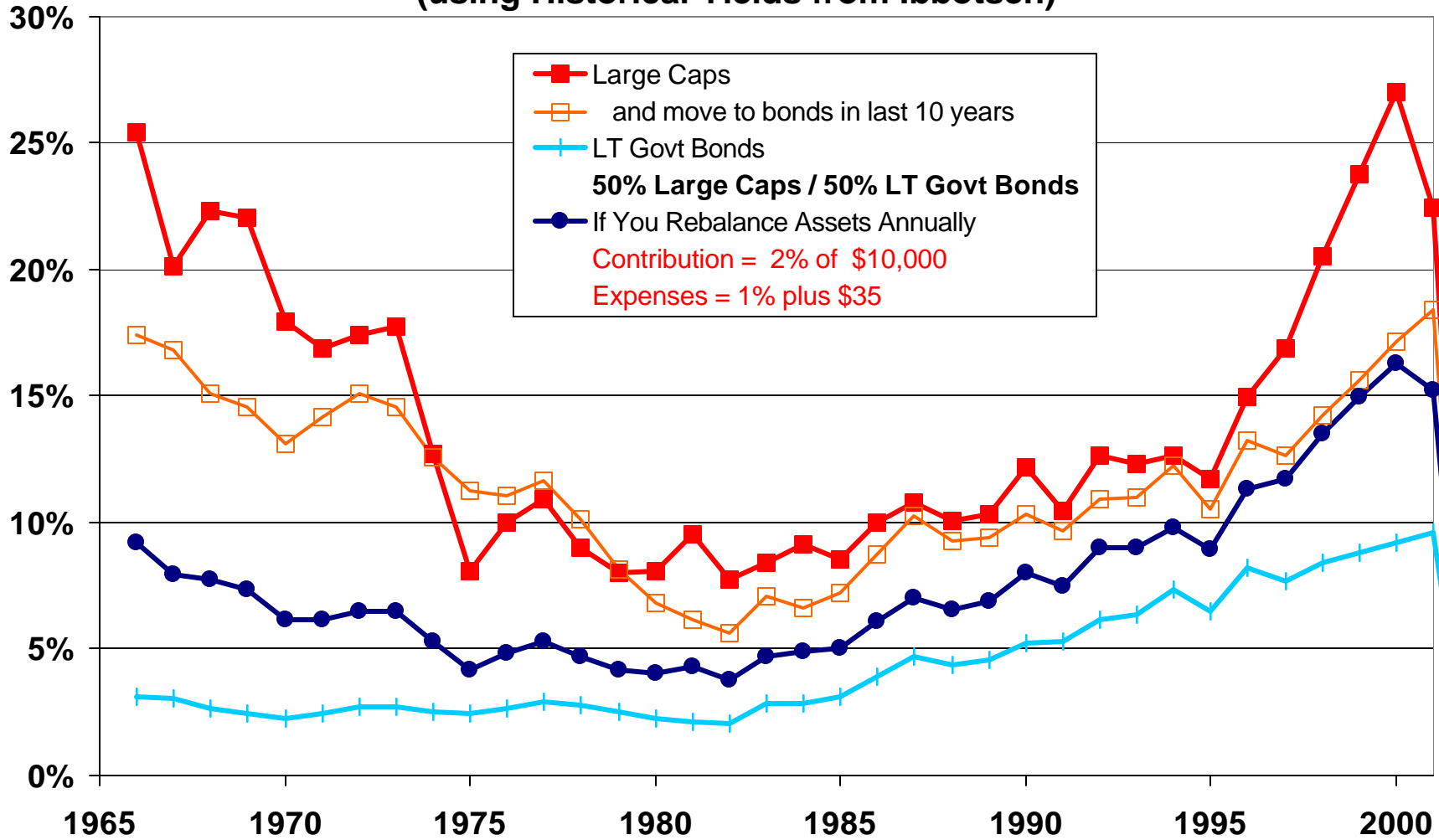
Retirement on Jan 1 of above year at Age 65 with a CPI-indexed life annuity

Replacement Rates from Individual Accounts started at age 25 (using Historical Yields from Ibbotsen)



Retirement on Jan 1 of above year at Age 65 with a CPI-indexed life annuity

Replacement Rates from Individual Accounts started at age 25 (using Historical Yields from Ibbotsen)



Retirement on Jan 1 of above year at Age 65 with a CPI-indexed life annuity

Advantages of Annuities

- Pensions/Annuities can eliminate:
 - Longevity Risk
 - Investment Risk
 - Inflation Risk
 - So now you can spend your other assets!
 - If you have LTC/Medigap Insurance too for you and spouse/partner
- Annuities can pay larger amounts than MRDs
- Have tax advantages
- Help relieve pressure on govt. programs
- But less \$ for heirs
 - Unless you buy life insurance, or add a period certain
- Amount is heavily affected by assets at purchase date

Conclusion

- Education is sorely needed in payout phase
- How can it happen?
 - Especially for those who can't pay for advice
- Need to encourage
 - Lifetime pensions (lower tax rate)
 - Requiring lump sums to be more valuable than QJSA goes against policy
 - LTC & Medigap (tax advantages)
 - Tax advantages cost money
 - Tax expenditures: offset by **pv** of lower SSI payments
 - More education of employees about retirement planning by?
 - Employers/trustees/custodians to provide DOL supplied info on what lifetime incomes account balances will buy
 - Accommodate moving DC accounts to DB plans to get pension

Presentation Before ERISA Advisory Council Working Groups on Increasing Pension Coverage, Participation, & Benefits and Preparing For Retirement

Good Morning. My name is Ron Gebhardtsbauer, and I am the Senior Pension Fellow at the American Academy of Actuaries. We are the non-partisan professional organization for all US actuaries. Thank you for inviting us to speak to you today on: How to Increase Pension Coverage, Participation, and Benefits, and also preparing for retirement. I will discuss them in that order. A more complete discussion is in my handout.

Increasing Pension Coverage, Participation, & Benefits

Current Coverage Rates: Based on a May 1994 DOL report using the 1993 Current Population Survey (CPS) and an August 2000 GAO report using the 1998 CPS, it appears that almost 2/3 of employees work at companies that sponsor a plan. However, some of them don't participate because they are:

- (1) Part-time,
- (2) Don't meet the plan's eligibility conditions,
- (3) Don't contribute, or
- (4) Other/Don't Know (including a small percent that said they were in excluded job classes).

The 1993 DOL report says that each of these groups not participating in their employer plan comprised about 4% of the workforce, and they total 15% of the workforce (some are in more than one category). Thus, if we were to change the law to either include some more part-time employees by lowering the 1000-hour threshold or lower the age 21 and 1 year of service rule, we'd increase the participation rate by less than 3% of the workforce. However, it might increase the percent of people with a pension at retirement by less than 1% of the workforce, because many of them would never become vested.

Subtracting the workers that don't participate gets us to the familiar participation rate of about 1/2 of the workforce.¹ If we look at only full-time workers who meet ERISA's most common eligibility criteria (age 21 and 1 year of service) the participation rate increases to 56% and if we look at people close to retirement with a vested pension we get closer to 2/3 of the workforce.²

The 2000 GAO report noted that while sponsorship rates increased from 54% to 61% between 1988 and 1998, the participation rates only increased from 42% to 47%. Thus, the percentage not participating in the plan increased by 2% of the workforce, from 12% to 14%. It would be interesting to know why. Could it be because there are more companies with just 401(k)-type profit sharing plans? Participation rates in a plan vary by type of plan³. DB plans and Money Purchase DC plans generally cover almost all employees of an employer, whereas 401(k)s generally only cover 2/3 of the employees. IRA participation rates in 1983 (when everyone was eligible to contribute to them) were a very low 17% (and only 9% for low income people). Thus, it may be easier to encourage employers to set up 401(k)s, but their participation rates are not as good. For this reason, the law gave employers fewer advantages for 401(k) profit sharing plans compared to Money Purchase plans or DB plans which had higher participation rates. However, EGTRRA changed that, to the point where it may not make sense to have a Money Purchase (MP) plan anymore, because an owner can get enough advantages from a 401(k) or profit sharing plan to satisfy them. Clearly, EGTRRA helped 401(k)s and Profit Sharing plans more than Money Purchase and DB plans.

¹ BLS surveys of *employers* suggest that 58% participate. The employer surveys produce higher rates possibly because (1) some individuals may say they don't participate when in fact they do, and (2) employer surveys may not handle people with multiple jobs and the self-employed as well.

² Source: Retirement Benefits of American Workers (July 1995 Preview and September 1995 Final). However, looking at the Income of the Aged Chartbook published by the Social Security Administration, we find that only 50% of aged between ages 70 and 75 get a pension other than Social Security. Possible reasons why this is under 2/3 are some people are still working and thus don't have to receive their pension yet, and some may classify it incorrectly as income from assets (and not pensions). In addition, these people would have fewer years of post-ERISA service (which is also why the percentages are lower at even older age groups).

³ Source: EBRI 11/94 Issue Brief (Table 1) and EBRI Databook, 4th Edition, page 126

Coverage Rates by Subgroups: If we look at subgroups of the workforce, we find the following results. Coverage rates were lower for:

- (1) Private employers (than for public employers),
- (2) Small employers (than for larger employers)
- (3) Women (than for men), although they aren't much lower (except at older ages),
- (4) Employees in the construction and retail trade industries (much below other industries),
- (5) Young (than for the old, possibly because they are less likely to contribute to a 401(k), and are more likely to be ineligible under the age 25 and 1 year of service rules)
- (6) Short-service employees (than long-service employees, probably for similar reasons)
- (7) Part-time employees (than for Full-Time employees, probably for similar reasons)
- (8) Hispanics (than for blacks or whites), and
- (9) Less educated and lower income people.

Looking at the trend lines for the above subcategories between 1979 and 1993⁴, we find not much change in participation rates, except that participation rates dropped a lot for medium and large employers (100 or more employees) in the 1980's, particularly in DB plans. This drop may have been due to increased regulations, as discussed in the next section. One hopeful sign is that participation rates at small employers have improved a fair amount since 1993 (see graph based on my recent extractions of CPS data). Maybe the increased coverage was due to SBJPA, which means that we can make a difference when we modify the law⁵. However, I must note that the increases in participation in small plans since 1993 don't completely offset the losses in participation among medium and large employers. Thus, fixing the rules for large and medium-sized employers can have just as beneficial an impact as fixing the rules for small plans. That's why we at the American Academy of Actuaries suggest you improve the rules for all plans, whether DB or DC, small or large. We want to stress this point, particularly because EGTRRA primarily helped small companies and DC plans. Maybe that is because it is easier for Congress to understand DC plans and fix their problems. It was also because the lowest coverage rates are at small firms, and increasing them is a very worthwhile goal. However, as I point out above, if we want to improve the participation rates now (or at least not let them deteriorate as employers get so frustrated with the rules that they drop their plans), we will get more bang for the buck if we work on the problems of all plans. In addition, because the playing field set by Congress and the courts has come to favor DC plans⁶ so much over DB plans, it biases employers toward DC plans, even if the employer would have otherwise preferred a DB plan, and even though DB plans have advantages for the nation that DC plans don't have. We need to fix that!

Why don't some employers provide benefits? Some reasons employers don't have pension plans are:

1. Cost of pensions
2. Complex, restrictive, and conflicting laws and regulations
3. Inability of rules to accommodate new plans (such as Cash Balance plans)
4. Expensive cost of administration and compliance, especially for small firms
5. Unpredictable sources of funds of small employers
6. Newness of business
7. Many seasonal or part-time employees
8. Volatile contribution requirements
9. Employees don't value benefits as much as cash
10. Employers don't know about simple alternatives (An EBRI survey notes that over half of employers don't even know about SEPs and they don't know about the tax advantages of pension plans. Over half said they might have a plan if the rules were easier to understand).

⁴ Ibid

⁵ The GAO Report also noted an increase in participation rates between 1988 and 1998 of 5%, and noted it could be due to (a) the better economy, which made it easier for employers to sponsor a plan (a better economy can also make it more necessary for employers to compete for labor by providing better benefits), and (b) concerns of baby boomers about retirement and the financial problems of Social Security.

⁶ For example, the rules give 401(k)s many advantages over DB plans. They can have pre-tax employee deferrals, employer matches, no annuity, and little reporting and disclosure.

A survey asking employers why they terminated their DB pension plans, conducted by the American Academy of Actuaries in 1991-2, stated that 23% of terminations in 1988 to 1990 were primarily due to business concerns not directly related to the plan (such as financial hardship, company merger, plant closing, downsizing, and the retirement of the firm's principal owner). Another 22% said the plan was too costly, and 17% said it did not meet the needs of the employee or employer. However, the most frequently cited reason was government regulation, cited by 29% as the primary reason (41% of small employers cited this as the primary reason for their terminations in 1988 to 1991). In addition, 44% cited government regulations as one of the top 3 reasons. For terminations in 1980 to 1982, government regulation was cited only 13% of the time. The most frequent rules cited were (in order of prominence) new funding limits in OBRA87, reductions in tax advantages, and the non-discrimination rules in TRA86. The Academy also asked what the terminated plan was replaced with. There was no replacement plan for over ½ of small employers (under 25 employees), 1/3 of medium sized employers, and 16% of large employers. If there was a replacement plan it was more likely to be a DC plan (including 401(k)) and less generous.

What could get employers to start/maintain plans? Some of the top suggestions provided by small employers in an EBRI survey were:

- (1) Tax Credits – 65%
- (2) Reduced Administration costs – 52%
- (3) Easier to understand rules – 50%

It would be interesting to see what larger employees provide. I'll first comment on the above 3 ideas, then go on to providing a list of suggestions for improving the laws.

The tax law that just passed (EGTRRA2001) added **tax credits** to match employee contributions to IRAs. When it was pointed out that it could hurt 401(k) participation, a provision was added so that it applied to 401(k)s also. Thus, it will be interesting to see if and by how much this increases participation among the lower paid. There are some concerns with the new provision however, such as:

- (1) The percent match has cliffs
- (2) The taxpayer won't know until year end whether their match is 50%, 20%, 10%, or 0%
- (3) The marginal tax rates exceed 100% at the cliffs (e.g., earn \$1 more and your match goes from 50% of \$2,000 to 20% of \$2,000 – that is, you lose \$599)
- (4) It's not refundable so the lowest paid employees (the ones that only pay the Social Security payroll tax and no income tax) won't get it. (Would Congress pass it if it came partially from the Earned Income Tax Credit?)

It doesn't go to DB plans, which again hurts the level playing field. Why have a DB plan, if the government gives you more tax advantages to have a 401(k)? Earlier versions of the bill included a tax credit for DB plans, based on the amount of the employer contribution that went to NHCE's. This was dropped from the bill. You might want to push it again to level the playing field.

Small employers are particularly concerned about the **high fixed administrative costs** of DB plans. A survey of DB regulatory costs by Hay Huggins showed that the per person administrative costs increased from about \$180 per employee to about \$470 (in 1990 dollars) between 1981 and 1991. While the costs for very large plans⁷ tripled, they still were way below \$100 per employee in 1991. This is still very much a concern for large employers, but you can see that for small employers, it can easily make the difference between sponsoring a plan or not. I'll explain why. If a small employer has some excess money, he (or she) can set it aside for their retirement, or put it in a pension plan and almost double the money, because it can accumulate tax-free until paid out. This tax advantage is very valuable, but if the administration costs and costs of benefits for other employees exceed the tax advantages, then the employer may decide to just use the funds for himself (herself). Larger employers may also see the advantages for workforce management, so this calculation may not be as crucial for them. One proposal for this would be to increase the tax credit that EGTRRA gave to small employers to offset their administrative expenses, and expand it to larger employers.

All employers hope they will be appreciated for sponsoring a plan, so it would help them greatly if the **rules were easier to understand**. If the company pension plan becomes confusing to employees (or

⁷ Over 10,000 workers

employers) due to the law and court decisions, then it loses value, and employers may decide it's not worth sponsoring one. Here's an example. Some employers who changed their pension plan formula decided to add a provision to keep their employees (and Congress) happy. It would ensure that no one would get a benefit less than what the prior pension formula would have provided. The IRS said this could run afoul of a technicality in the accrual rules (and ditto for many other final pay pension plans that have a career average benefit minimum). There is clearly no one that wants this to happen. However, the rule hasn't been fixed yet, because it is very difficult for government to change its rules, but meanwhile it exposes generous employers (who thought they were doing a good thing for their employees) to litigation and/or disqualification. There are many more stories like this because the law is often used as a weapon, instead of a tool to improve this nation's retirement security. The pension provisions in EGTRRA2001 show how Congress can work with employers and employee groups to create laws encouraging increased pension coverage. However, it took 4 years to pass these provisions. In addition, if it also takes this long to make fixes in the law, we need to make sure that we don't pass bad legislation or we need to find ways to change the rules quicker (by law or regulation). One major idea to improve rulemaking would be to have one pension agency and one committee in each house that deals with pension legislation. I hope you can consider this idea for your report.

Low & moderate-income employees: You were particularly interested in how to increase coverage rates and benefits for moderate and low-income employees. This subgroup probably is highly correlated with the other subgroups that have lower coverage rates. Employees with income under \$10,000 are more likely to be part-time or temporary, working at a farm, or are otherwise self-employed, or underreporting their income.⁸

Asking employers to help their low-income employees more is not much different from asking the government. Both will find it expensive and resist. I guess it gets down to **who is responsible (or who should be responsible) for this problem: the employer, the individual, or the government?** And I guess the answer varies with each person. It might be interesting to review a list of people and decide who should be responsible.⁹ With that in mind, I will mention some ideas, but they all increase someone's expenses of course, which will make them difficult to pass. And increasing the costs of part-time employees can reduce the number of jobs available to them.

Employers could help by lowering the 1000-hour participation thresholds in pension plans to cover more part-time employees. However, as mentioned earlier, there is less likelihood that they will vest, so this may not help them, unless vesting rules are also lowered. Lowering the 1000 hour rules and accelerating vesting create a lot of administrative work for employers, but won't help much in traditional DB plans because the lump sums will be small. However, their benefits in DC plans would be larger, so it may make more sense to lower the 1000 hour rule in DC plans. But for the same reason, it will cost the employer more, especially if they have lots of temporary or part-time workers. This also opens up the concern of a level playing field. Congress should not bias the decision of whether an employer should choose a DB or a DC plan. It should be up to the employer to decide which makes the most sense for its organization. If the playing field were level already this would be a big concern, but since it is tilted in favor of DC plans, this concern may not be as important.

Instead of mandating something lower than 1000 hours, you could provide incentives for employers to lower it themselves, by giving them higher maximums or reducing some rules for them. Incentives (or

⁸ I am not sure how someone lives on such a low income, but maybe they have other support. Many of these people will undoubtedly increase their income as they age, or when they are no longer a student or caring for family members, or when they otherwise lose their financial support. Consequently, their higher incomes in the future will improve their pension and Social Security benefits. During the period when they are not working full time though, it may be a joint **responsibility** with the person supporting them, to help them contribute to an IRA.

⁹ For example, who should be responsible for pension contributions for someone who goes back to school in their 40's, someone taking care of the family at home, a farmer (owner or worker), someone who can't get a job for health, education, or ability reasons, etc. Should it be the government, employer, or individual (or their financial supporter).

mandates possibly) could also be used to get employers to have negative elections at date of hire and pay raise dates (automatic deductions to the plan with a default investment approved by the DOL, unless affirmatively rejected by employee), and allow immediate participation in the 401(k) plan at date of hire (at least for employee deferrals, not the employer match), and this could apply to part-time employees. Employers could be encouraged by incentives (or mandated) to include employees with less than 1000 hours in the 401(k), and even include their other contingent workforce, such as contractors. The employer may not mind if the law says they never have to pay a match or include them in the non-discrimination testing. Another advantage of this is that the contingent employee could then get the government tax credit match in the 401(k) – and payroll deduction is easier than having to take the initiative to set up an IRA and make the contribution. If an employer waits until the employees have gotten use to spending their entire paycheck, they won't be able to contribute much.

Since 401(k) participation rates and contributions are much lower for low-paid employees, Congress could try to increase them by law. One of the reasons 401(k)s have done so well, is that the rules gave an employer the incentive to encourage employees to contribute. However, the safe harbor 3% non-elective contribution rule undid that incentive. Many top-heavy plans with 401(k) features had to give employees 3% of pay anyway, so obviously they switched to this safe harbor to avoid the ADP/ACP tests (and only had to vest it faster for that advantage). If they had a match provision, they had no incentive to encourage employee contributions, because that just increased their expenses. With EGTRRA, however, this disincentive is gone, because employers can offset the 3% contribution with the match. The effect on the employees though, is that they no longer get a match incentive to contribute. The other 401(k) safe harbor (the match rule) reverses the incentive. The more the NHCE contributes, the more the employer must contribute without any direct advantage to the employer. Due to EGTRRA exempting it from the TH rule, more employers could switch to this match (and avoid the 3% TH contribution). You could eliminate this 401(k) safe harbor match or make it stronger by requiring an automatic 1% of pay non-elective employer contribution. However, employers won't want their expenses increased. A compromise would be to limit the contribution to just lower income people (for example, 1% of pay on pay up to \$20,000 and phase it out over the next \$20,000). Alternatively, you could give employers incentives for providing the 1% automatic contribution (for example, give them a higher maximum if they do it). Similarly, increase the 401(k) maximum the more that NHCE deferral rates approach the HCE deferral rates.

Government could help by making the tax credit match in EGTRRA refundable, and pay it to DB plans also¹⁰. However, this will require on-budget tax revenue; something that Congress has little of now. Another problem is that this doesn't help employees who don't contribute, which gets us back to the responsibility issue. Maybe it is good to put more responsibility on individuals for their retirement security. For moderate-income people who can find the funds, this match technique leverages the government money. However, low-income people may not be able to find the funds. The Clinton administration advanced the USA proposal, which would pay an automatic contribution to the individual's IRA or 401(k). Alternatively, if the government couldn't find the revenue, the contribution could come out of the Earned Income Tax Credit refund (and be paid directly to the custodian). Here's where we could go over the list of who should be responsible for the contribution. If it is someone getting EITC, the contribution could come from their EITC, if they go back to school in mid-career, the contribution could come from their assets or their Education Tax Credits. If they take off a year or more from work, maybe it should be up to them to do an IRA. If they are receiving SSI, could IRA stamps (similar to food stamps) be workable? In addition, you might want to set a minimum claw back from their EITC/ETC/SSI of say \$400 so that fees don't wipe out investment earning, and/or the government could hold all small accounts and charge only a small investment fee. Thus, maybe there is a way that all three: government, employers, and individuals can be involved in closing the retirement security gap.

¹⁰ Portman-Cardin originally had a tax credit in it for DB plans. The plan would get a tax credit of 50% of contributions to NHCEs up to 3% of compensation. The contribution could be based on the current liability normal cost as reported on the Schedule B.

Helping employees prepare for retirement

The past: Preparing for retirement twenty-five years ago was much easier. People worked for fewer employers, were more likely to be in a DB plan that only paid pensions, they saved more, and most didn't expect to retire before 65. When they wanted to retire (which was more likely to be age 65), they asked personnel what their DB benefit would be¹¹. Thus, they could quickly determine whether they could retire and live off their pension and Social Security income. And often, Social Security plus your pension was enough to cover basic needs.

Today, preparing for retirement is much different and much more difficult. People today have

- (1) Worked for more employers (so our retirement money is in many different places OR spent),
- (2) We are more likely to have DC-type money or IRA rollovers from prior plans (and we have no idea what kind of income they will provide),
- (3) We've saved less (so we have less wiggle room if we run out of pension money),
- (4) We want to retire before 62 (because Social Security benefits are available at age 62, and many pension plans have benefits payable at age 55 with subsidized reductions for early retirement, so over half of us retire before age 62),
- (5) Our DB benefits plus Social Security won't cover our basic expenses, so we should consider buying an annuity (and we know nothing about them, other than we don't want to lose money if we die early), and
- (6) Since we will live 2 years longer on average, annuities will cost a lot more, especially if indexed¹². For example, people may think that the \$100,000 in their 401(k) is a lot of money, but it will only buy an annuity of \$8,000 for life if they are age 55. The following table provides other sample annuity amounts (in round numbers)¹³:

	Male	Female	Joint & 66% to either survivor
Age 65	\$10,000	\$9,000	\$9,000
Age 65 Indexed	\$7,000	\$6,500	\$6,500
Age 55	\$8,100	\$7,800	\$7,800
Age 55 Indexed	\$5,500	\$5,000	\$5,000

Transparency: Policy makers around the world are talking about creating transparent retirement systems that include personal accounts. They acknowledge that we need investment education. However, while cash may seem like a transparent commodity while we are working, it isn't very transparent to someone who is preparing for retirement. What pre-retirees want to know is how much money will they need so that it won't run out before they die. Most people don't have a clue what lifetime income \$100,000 will buy, or how much to withdraw from it each year. If they don't know that, then how can they determine whether they can retire? My fear is that people will see their big \$100,000 and assume that it is so much that they can retire, and then find out at age 80 that they didn't have enough. They should have worked longer and retired later. Of course, at age 80 they won't be able to go back to work, so we have a big problem. How can we help them? Education! Will it work? First of all, people need to save more and they should value jobs at companies with DB plans more. However, I'm assuming this task force wants to move beyond the

¹¹ Since this is post ERISA, they would be told their J&50%S benefit amount.

¹² Luckily, we have had high investment returns, and inflation is a lot lower now than in the 1970's, so at least we have that in our favor. However, this may lull us into thinking that it will stay that way in the future, which could be way off. If we have the huge reductions in the labor force forecasted in the coming years (due to heavy levels of retirements), our assets may drop and inflation may increase.

¹³ You will note from the table that women get 10% less because they live longer on average. Interestingly, the J&66%S annuity was about the same as the female annuity. A Joint & 50% Survivor annuity would be the average of the male and female amounts. The indexed annuity is about 30% less initially, but after 30 years of indexation it will be twice as large as the level annuities (assuming 3.5% inflation). The calculations were performed using 7.3% and the 1994 GAR mortality table with 5% loading. Indexed annuities were calculated at a 3.8% real return (which is similar to using a 3.5% inflation rate) and a 10% loading (based on market prices suggested by annuitynet.com).

accumulation issues, where I think people are actually becoming much better educated (because of their 401(k) plans and also because the stock market has done so well – although some of that experience gave them bad information, i.e., that stocks aren't so risky). I think the really bigger education job now is for the de-accumulation phase. We need to educate people on that much more. And it needs to start earlier, because it can help people decide how much to save. What is entailed in this education?

When to retire? What is the NORMAL retirement Age? First off, people need to be educated that age 55 or age 62 is probably too early for many of us to retire. Somehow over the past 20 years we have come to think that 55 or 62 (or somewhere in between) is the normal retirement age. Everyone is doing it, so that's what I want to do, even though our generation saved less, has fewer DB plans and more 401(k) plans with small amounts (remember, \$100,000 is small), and we will live 2 years longer on average. That doesn't add up. We need to change the national belief in retirement before 62 to normal retirement age is 70. Our life expectancies have gone up by 5 years since Social Security was created. In addition, we are as healthy at age 70 now, as people were at age 65 back then¹⁴. Thus, if we were setting the normal retirement age now (for the first time), we might have chosen age 70. How can we adjust people's thinking to see that retirement before age 70 is really **early** retirement. If we want to retire before age 70, then we better think hard about whether we have enough money to retire early. How can we encourage this thinking?

One idea is to allow employers to gradually move their retirement ages in their pension plans up to age 70. ERISA and the IRC still use age 65 in the definition of Normal Retirement Age (65 & 5) in §411(a)(8), which is used for the vesting and accrual rules, and the commencement rules (65 & 10) in §401(a)(14). This idea does NOT require that benefits will be reduced or delayed. The anti-cutback rules probably prohibit that¹⁵. Still, it may not be an easy task for employers to raise retirement ages in their plans, and many employers may not do it. But surely they should be allowed to do it if they want to. I'm not sure why the government would prefer that an employer's retirement age be 65 instead of 70. In fact, government policy over the past 20 years has been to encourage people to work longer. But government rules are part of the problem if want to stop encouraging people to retire too early.

In order for our national psyche to think of 70 as the normal retirement age, it would make sense for Social Security to gradually increase its normal retirement age to 70. Just as with pensions, it wouldn't have to decrease benefits at all. The age 70 benefit could be the same as it is now. (On the other hand, benefits could be reduced a little if we wanted to help Social Security's financial problems, but we wouldn't have to. In addition, any reductions can be phased in gradually so that we can plan ahead for them, and like the 1983 changes, they wouldn't have to affect anyone over 45.) We could also increase the age at which Social Security benefits can be first received to age 65 (the age when Medicare is first available for retirees). That might have just as much or more of an effect on average retirement ages. However, even though it doesn't decrease benefits at ages 65 and above, it might be difficult to pass, because some people (particularly those with physically-demanding jobs, or people with short life spans) would understandably be against it. Another idea that won't pass is to increase the age after which people get an extra standard tax deduction (from age 65 to age 70). This is a good reason for being careful when we put special provisions in the tax laws. It's difficult to modify or eliminate them.

In addition, you could move the age for late pension/IRA distributions in §401(a)(9) from 70 ½ to 75 or 80. In fact, it may make more sense for some people to buy an annuity at age 80 rather than at age 70.

Education regarding lifetime income: We also need to educate people so that they know how much lifetime income their account balances can provide. The DOL could provide this information on its websites, and SSA could include it on their annual statements. However, I think it needs to be personalized

¹⁴ According to the demographers Manton, Corder, and Stallard's paper reviewing Activities of Daily Living statistics in Proceedings of the National Academy of Sciences (Vol. 94, pp 2593-2598, March 1997).

¹⁵ By the way, when Congress increased the Social Security normal retirement age gradually to 67 in 1983, they didn't comply with an anti-cutback rule. You may not want to go that far for pensions, but some accommodation might help.

in order for it to really help workers. One way to do that would be for employers to include it on the periodic DC/401(k) statements they provide, right next to the account balance. Then workers will start to understand the relationship between assets and lifetime income. If the pension plan provides annuities, then the employer would use plan's annuity purchase rates. If not, employers could use the actual annuity purchase rates. Since this could be a bit of work for employers, especially small ones, the government could help by supplying the annuity prices to use (so that it doesn't burden employers). Employers might also be concerned about the liability for providing wrong or misleading information. To reduce this concern, DOL could provide the language to use, including a phrase to the effect that this information is being supplied with the help of the DOL.¹⁶

Since we change jobs so often, people may have their assets in many different places. The recently passed portability rules may help reduce the number of places where the assets are, but employers and employees don't have to pay or accept rollovers, if they don't want to. Thus, you might also consider requiring any trustee/custodian that holds IRA or qualified money to include the same annuity amounts and language as discussed in the prior paragraph. Since the language and prices are provided by the DOL, this shouldn't be too much work, and for insurance companies (and banks allied with insurers) this makes good business sense anyway.

Education regarding future income needs: People will also need to know how much income they need to live on in retirement. Retirees may only need 70% of their pre-retirement income, because:

- (1) FICA taxes are eliminated – 7.65% of wages up to \$80,400
 - a. Twice that if SECA
- (2) Income taxes may go down – up to 15% of income
 - a. Lower marginal tax bracket
 - b. Social Security is taxed less
 - c. Roth IRA distributions not taxed
 - d. Return of basis not taxed
 - i. Basis = employee contributions and price of annuity
- (3) No more work-related expenses – 3% to 7% of income
- (4) No more wages to save – up to 15% of income?

However, these percentages are approximations and are full of assumptions, so prospective retirees will need to determine this for themselves. For example, low-income people may need 80% to 85% replaced because their taxes don't go down as much. In addition, if the employer doesn't continue paying health care expenses in retirement, then about \$2,000 will be needed for Medigap insurance and another at least \$2,000 will be needed for Long Term Care insurance. This \$4,000 is an additional 40% of income for retirees with incomes of \$10,000, so it could bump their needs up to 120% of pre-retirement income (unless they don't mind using Medicaid, and I don't think that is something policymakers want to encourage). Fortunately, other expenses may go down in retirement (e.g., the mortgage payments may end) and you might work part-time for a while, so the percent replacement rate needed could be lower too. In fact, if you own your home, you may not need much more than Social Security and your employer pension (particularly if you live on a farm – until you or your live-in children can't maintain it).

¹⁶ The DOL could do the calculation as if the account earns the current Moody's corporate bond rate until retirement (ages 60, 65 and 70 could be used), and buys an annuity at current purchase prices. It should be divided by pay projected to the retirement date, to arrive at a replacement rate, because people won't be able to understand future dollars in terms of their current wages (even if discounted by inflation rates). There should be no inclusion of future contributions since it is not known whether the plan will continue or the employee will continue working at the company. However, this calculation could be quite complicated and people may not understand replacement rates. To make it simple, you might only require it for people over age 50, and just use the current balance as if the employee was already at retirement age on the statement date. The only problem I see with that is: annuity prices could change a lot by the time the person retires, but people would just have to learn that these things happen just like the stock market fluctuates.

There is also a question of whether you should increase your pension with inflation. Some experts contend that a retiree's total expenses don't go up by the full amount of inflation, because they travel less and spend less on themselves as they get older. However, the statistics showing this may be affected by the fact that many people didn't get indexed annuities so they couldn't continue their standard of living in retirement.

Who should do the Education? Once employees understand how much lifetime income their retirement assets can buy, know their Social Security benefit, and their income needs, it will be easier for them to decide if they can retire. Hopefully, it will reduce the number of people who retire too early and end up needing welfare. Still, people are going to need help, as discussed in the last (and next) section. It would also be good if the laws could encourage employers to assist employees with these retirement issues¹⁷, but I'm not sure how to do that. They already get to deduct the cost of the education. I don't know that we should mandate employers to help their employees. It can be quite difficult and open employers to liability. Instead, maybe a better place to get this help would be at the SSA offices when you apply for benefits. I also think the Administration on Aging at HHS can help, but SSA makes more sense. Should we require SSA counselors to help? It will cost us.

Should you take your pension or cash it in? If your pension plan pays lump sums, you should see if the lump sum from your pension plan buys a larger annuity than the pension plan would pay. This can happen currently because IRC §417(e) requires the use of the 30-year Treasury rate in the calculation of the annuity, which is unusually low right now because the US is paying off its debt so fast. In the past, I used to encourage employees to elect the pension. However, I can't in good conscience recommend taking the annuity now, because the law forces the lump sum to have a greater value than the pension. It is quite strange because regulations require that the Joint and Survivor annuity option be the most valuable option payable from the plan (because lawmakers wanted to encourage employees to provide survivor pensions to their spouses). For example, at today's rates a male age 55 could request a lump sum instead of his \$10,000 pension and buy an \$11,100 immediate annuity with the lump sum. This will only get worse when interest rates continue to go down due to continued debt repayment and also when the 83GAM unisex mortality table is updated by the IRS as required by law. At age 45 the current rules can create lump sums that are 30% more valuable than the QJSA, and it's even more at younger ages. I encourage you to take a careful look at this problem, and consider allowing pension plans to use a higher interest rate – something related to corporate bond returns, which is what insurers use to price annuities.

Choosing how to pay yourself: Even if people don't retire too early, there can still be problems. If retirees don't get a lifetime income, they can spend their money too fast, and run out of assets too soon, or they can live in poverty for fear of running out of money.

However, investment managers advise people to skip the annuity and invest it in stocks with their help, and you will do better. This can make sense¹⁸, but you can also run out of money too early. This is one of the reasons that poverty rates are higher at the oldest ages. People's investments didn't do as well as expected and they spent their money too fast.¹⁹ An article in the 6/2/98 Wall Street Journal on page C1 discusses withdrawal angst. They suggest going back to work if you run out of funds early. However, that may not be possible if you are 80 years old!

¹⁷ Including helping employees buy annuities, Medigap, and LTC insurance. This advice/education would have to be offered to everyone, without discrimination. IRA custodians, employers, and/or PBGC could be required to advise and assist IRA holders in making these decisions and in buying annuities, Medigap, and LTC insurance. Section 4009 of ERISA already requires PBGC to help on rollover decisions.

¹⁸ It can make sense to skip the annuity and do it yourself if: (1) you're a multi-millionaire and will never run out of money, (2) your Social Security and Pension are enough to cover your basic needs for life (and your spouse's/partner's), (3) you want more of your money to go to your heirs, (4) you don't mind falling on welfare, (5) you need the cash for immediate needs, or (6) you know you will die soon.

¹⁹ It is also due to: (1) means test rules for Medicaid and SSI, which require people to eliminate their assets in order to get benefits, (2) heavy expenses around the first spouse's death, (3) lack of pension continuation to the surviving spouse, etc.

Let's take an example of someone who skips buying an annuity and does it themselves. What amount should they pay themselves? First determine your life expectancy. You can ask an actuary or use IRS tables if you think you are average. Then estimate what you think your future net investment returns²⁰ will be over your remaining lifetime. Then using a financial calculator, determine the amount (with indexation?) that will use up your money over that time period. Alternatively, you can use the lifetime income amount that your financial statements said your account balance would buy. Of course, if you live longer than expected, you will run out of money, and about half of people will live longer than their life expectancy, because it is an average. So this doesn't sound like a good answer.

Another way is to use the IRS minimum distribution rules. They suggest you divide the money you have by your life expectancy. The new rules let you divide by the joint life expectancy of you and someone 10 years younger (or you and your spouse, if younger). Since it doesn't take into account investment earning (as in the calculation in the last paragraph), your withdrawals will be smaller and last longer. Since the withdrawals are smaller, you should do this calculation before you decide to retire, because now you may not be ready to retire. The minimum distribution calculation preserves more of your money for your heirs, but you can still go broke too soon.

On the other hand, you could buy an annuity that would have paid you more at every age, but would mean little or nothing for your heirs. You may ask, how can an annuity be more, since insurance companies are known to have high expenses. It is because insurance companies don't "waste" money on those that die (and nothing goes to their heirs – unless the retiree buys life insurance or an annuity with a death benefit feature, such as a 10-year payment guarantee or return of premium rule). In addition, the insurance company can lock in a corporate bond yield rate of 7% or more for your full lifetime, whereas your money market fund doesn't know when you plan to withdraw your money, so it may only give you 3% or 5%. Stocks can have a higher yield, but you will keep the investment and longevity risk. Annuities and lifetime pensions have other advantages. They are payable for life, so you can eliminate your longevity risk and your investment risk. If the insurance company fails, there are state insurer guarantee funds in all 50 states and DC that will cover the insurer's promises up to generally \$100,000. You can eliminate the inflation risk by buying an indexed annuity that increases with the CPI²¹. Lifetime pensions and annuities have tax advantages: the investment earnings are spread evenly over one's life expectancy, instead of being mostly upfront with a money market fund or bond fund. (Individual stocks can have better tax advantages if dividends are small, you don't churn your assets, and their gains are only taxed at capital gains rates (10% and 20%.)) Lifetime pensions and annuities are taxed at the higher income tax rates. If you want to encourage annuities, since they relieve pressure on welfare, you might propose lowering the tax rates on lifetime annuities and pensions.

Types of Lifetime Pensions/Annuities: If you decide to take a lifetime pension or immediate annuity²², there are many forms available:

- (1) Payable for life
- (2) Provides a survivor pension for the life of spouse or partner. Government poverty statistics suggest that it costs one person 75% as much as it cost two people to live, so some people encourage electing 75% continuation to the survivor. It lowers your initial benefit, but if you choose the J&S annuity option that drops on the death of either annuitant, it may not decrease your pension/annuity much at all.
- (3) It can include a guarantee that payments will continue for at least 5, 10, or 20 years, even if you don't live that long. This can be helpful if you have children
- (4) It can be indexed with inflation or by some percentage, such as 3% each year.

²⁰ I used returns (plural), because using a flat average rate can cause problems. If rates are low now and expected to get higher in the future, your funds won't do as well as if the average rate of return occurred. Thus, you will take too much money out in this scenario.

²¹ Lincoln National sells one through annuitynet.com

²² I am not discussing deferred annuities, which are really investment contracts with the option to buy an immediate annuity at a later date.

When to start payments: People also need some education on when to start their lifetime pension or annuity. You could do it when you retire. However, if your assets in the stock market are down, you might want to pay yourself from other assets, and wait until your stock assets come back up before buying an annuity. Because of this concern over stock fluctuations, some people gradually move their retirement assets (or at least the portion that they want to use to buy an annuity) into bonds, before buying the annuity.²³ Bond prices and annuity prices can go up and down about the same percentage, if the duration of the bonds is similar to your expected lifespan. That's why moving to bonds is sometimes called immunization. Life cycle mutual funds may do this. Of course, this strategy only makes sense if the stock market is high. You wouldn't want to sell stocks for bonds when the stock market is in a trough. It would just be locking in your losses. You also don't want to do it when interest rates were low, because that's when bonds are expensive. These rules may conflict with each other (when the stock market is not in the trough, bonds may be expensive due to interest rates being low), so it may be difficult to find a good time. And it won't be easy for people to understand all this and do everything right. In fact, it entails predicting the market to some extent (being a market-timer), so it is very possible to mess this up.

Some people suggest that we wait until our late 70's to buy an annuity. In the meantime, if you don't mind the risks entailed in investing in stocks, you can achieve a better return on average, and then buy a larger annuity later. Of course, that means you keep the investment and inflation risks until you buy the annuity. The reason the annuity becomes a better deal at older ages, is because you get the mortality gain from the insurer added to their bond return rate. Since the probability of death at age 80 is around 4% to 6%, you get an extra 4% to 6% added to the bond return, and that is enough to make it better than the average stock return.

Conclusion: In summary, education is sorely needed regarding the payout phase and we need to think about how it can happen, and who can do it well (especially in the case where people can't pay for the advice). In addition, lifetime pensions/annuities and LTC and Medigap insurance relieve the pressure on government welfare and Social Security, so we might want to consider ways to encourage more people to take their pension (or buy an annuity). A lower tax rate on pension/annuities will help, but it is expensive. Tax expenditure calculations should reflect lower SSI outlays, but much of that will be beyond the budget window. They should be reflected. (Two ways to do that would be to extend the budget window, or even better, to use present value calculations to reflect the full reduction in SSI outlays in the future.) In addition, we should think hard about whether we want to continue to force employers to subsidize the lump sum options in their pension plans. We should also consider requiring employers/trustees/custodians to provide DOL supplied information on what lifetime pensions their account balances will buy to employees/customers.

²³ Since retirement assets are tax-deferred you don't need to worry about capital gains taxes when you sell the stocks.

Ideas for Increasing Pension Coverage and Retirement Security

The following is a list of ideas from Academy brainstorming sessions that could encourage employers to sponsor pensions, or that could increase coverage and retirement security for more Americans. While the Academy generally does not propose legislation, we thought they might provide some ideas for you to consider. While many of these ideas are more relevant to IRS, Treasury, and PBGC, we thought we would provide you with the full list.

- (1) Combine DOL/PWBA, PBGC, and IRS/EP into one pension agency (and possibly include Social Security?). As an interim step, you could require DOL, IRS, and Treasury to issue their regulations jointly, or require them to clear each other's regulations before final. PBGC must do this already (with DOL, Commerce, Treasury, and OMB)
- (2) Have one committee in each house of Congress that deals with pension legislation. This would improve the consistency of pension laws and regulations.
- (3) Simplify the laws and regulations, eliminate redundancies, and reduce administrative expenses for sponsoring a pension plan (or provide a tax credit to help employers pay for these expenses)²⁴
- (4) Determine ways in which laws can be more dynamic when new types of pension plans are introduced (e.g., Cash Balance plans, PEP plans, Indexed Plans) or quickly pass laws & write regulations that clarify how the old law applies to new plans. Determination letters and private letter rulings are good, but they don't protect a plan from Title I litigation. For example:
 - a. Accommodate "greater of" and "choice" for pension changes, and higher investment credits, subsidized annuities, and reductions in age weighting. Define the accrued benefit as the account balance. Clearly employees (and members of Congress) like these ideas, but they can run afoul of technical interpretations of back loading rules, non-discrimination rules, and lump sum rules. Employers want to do the right thing. Just let them know what that is. Otherwise, individuals can take them to court over literal readings of the law, which don't apply well to new types of plans.
- (5) Encourage more Negotiated Rule-making like PBGC did on reporting requirements
- (6) Government policy should prefer DB plans over DC plans too, because DB plans are more likely to pay annuities for life, thus reducing the nation's dependency on Social Security and welfare. At the very least, the government should level the playing field, so that the law doesn't bias the employer's decision toward DC plans over DB plans. Some employers have DC plans now, even though they would have preferred to have a DB plan. The law should clearly still provide advantages for DB plans over 401(k)s and IRAs, since public policy should encourage plans that have higher participation rates.
- (7) Provide incentives for DC/401(k)s to lower the 1000 hour threshold, require immediate participation (but exclude them from match and non-discrimination testing) and a 1% of pay employer contribution, include part-time employees and contractors (just for employee deferrals and without including them in non-discrimination tests), reduce age weighting and integration, have a J&50%S annuity option and spousal consent, and accelerate vesting to the 3 year rule (or 6-year graded) required of 401(k) matches. The incentives could be giving them higher maximums or reduced regulation if they do the above.
- (8) Clarify rules for moving account balances to DB plans
- (9) Encourage the payment of lifetime pensions by taxing them at a lower rate than lump sums and increasing the interest rate specified in 417(e) for calculating lump sums.
- (10) Increase the 30-year Treasury rate cited in law (used for funding, lump sums, and PBGC premiums) to Moody's Composite Corporate Bond rate minus 0 or 50 or 100 basis points, or something that approximates annuities (i.e., that reflects the yield curve).
- (11) Fix laws to accommodate Phased-Retirement:
 - a. Allow in-service distributions after age 55
 - b. Modify QJSA, annuity starting date, non-discrimination, participation, and anti-cutback rules to accommodate phased retirement

²⁴ EGTRRA has a tax credit provision that pays 50% of up to \$1,000 in administrative costs for small employers

- c. Academy and Society of Actuaries are doing a poll to find out interest in Phased Retirement programs
- (12) Simplify nondiscrimination rules
 - a. Test benefits at just normal retirement
 - b. Pick one rule instead of having both effective availability and current availability.
 - c. Allow Social Security offset plans (subject to 2 for 1 rule)
- (13) Allow plan assets above the full funding limit (or Entry Age Normal actuarial liability on projected benefit rates for flat benefit plans) to be used for other employee benefits. That way employers will be able to take advantage of the upside potential from DB investments (as well as have to handle the downside problems)
- (14) Allow level earnings for an improved 133 1/3 % accrual rule.
- (15) Permit pre-tax contributions and matches in DB. Eliminate 401(k)(4) to permit additional benefits.
- (16) Fix tax credit match by eliminating cliffs, also paying to DB plans (as in the original bill for NHCE's), and making refundable so that low income workers can get it. If necessary to reduce the cost of making it refundable, government could get some of the needed funds from the EITC
- (17) Allow elimination of certain optional forms (e.g., lump sums) in DB plans with 2-year notice.
- (18) Increase age 65 and 70 ½ in law, as per the Social Security NRA increases
- (19) Single definition of compensation
- (20) Simplify funding rules
 - a. Eliminate the 412(l) deficit reduction contribution for underfunded plans, and replace with quicker amortization periods for underfunded plans, especially if retiree liability is not covered by assets.
 - b. Change Current Liability to Termination Liability and allow actuary to determine assumptions (since Termination Liability can be clearly defined)
 - c. Accelerate funding for bargained plans
 - d. Allow projections of maximum limits for funding purposes
 - e. Eliminate special interest rates for waivers and missed contributions (since each assumption must now be reasonable)
 - f. Allow funding up to Termination Liabilities before doing a spin off
 - g. Allow fresh start on the Funding Standard Account after a spin off outside a controlled group
 - h. Allow valuations every 3 years, if actuary certifies projection included all significant events or if plan is well funded.
 - i. Eliminate quarterly contributions and just require security
 - j. Allow/encourage the ABCD to use it's counseling/discipline process rather than specify/regulate assumptions
- (21) Improve PBGC rules
 - a. There should be only one valuation basis, not 8 (R&D, 4011, 4010, Current Liability, Variable Premium, 412(b) Minimum Funding, 412 deficit reduction contribution, 404)
 - b. Charge premium for shutdown benefits and subsidized early benefits, or eliminate coverage of them
 - c. Reduce PBGC premiums (since PBGC is well funded)
 - i. Per person premium
 - ii. Use settlement assumptions for Variable Rate Premium (VRP)
 - iii. Allow VRP to be negative, and thus offset per person premium for very well funded plans
 - iv. Eliminate premium for first 3 years of a plan, since guarantees are small then
 - d. Simplify rules for calculating PBGC benefits
 - i. Simplify phase-in rules from 5 year phase-in to 3 year cliff
 - ii. Guarantee employee contributions with interest and eliminate PC1 (voluntary contributions) and PC2 (mandatory employee contributions)
 - iii. Move priority of PC3 (retirees with large benefits) to be after PC4 (guaranteed benefits) and guarantee supplements
 - e. Apply MEPPA ideas to single employer plans

- i. Provide financial assistance to employers in reorganization, don't take over their pension plan
 - f. Create a private sector Board of Actuaries for PBGC
 - g. Allow (or require) agency to adjust their premiums downward when over-funded (like FDIC)
 - h. Consider moving probable termination liabilities from balance statement to footnotes.
- (22) Require immediate participation in 401(k) plans for employee contributions (and allow excluding them from non-discrimination testing)
- (23) Increase participation rates and contributions for 401(k)s
 - a. One of the reasons 401(k)s have done so well, is that the rules gave an employer the incentive to encourage employees to contribute. The safe harbor not only undoes that incentive, it reverses it. The more the NHCE contributes, the more the employer must contribute without any direct advantage to the employer. You could eliminate the 401(k) safe harbor or make it stronger by requiring an automatic 1% of pay contribution (on pay up to say \$25,000) and phase-out by say twice that amount. Since that may not get thru Congress, you could give incentives for providing the 1% automatic contribution (e.g., higher maximum)
 - b. Similarly, increase the 401(k) maximum the more that NHCE deferrals and match rates approach the HCE deferral and match rates
- (24) Increase excise tax on early distributions to encourage distributions be used for retirement purposes.