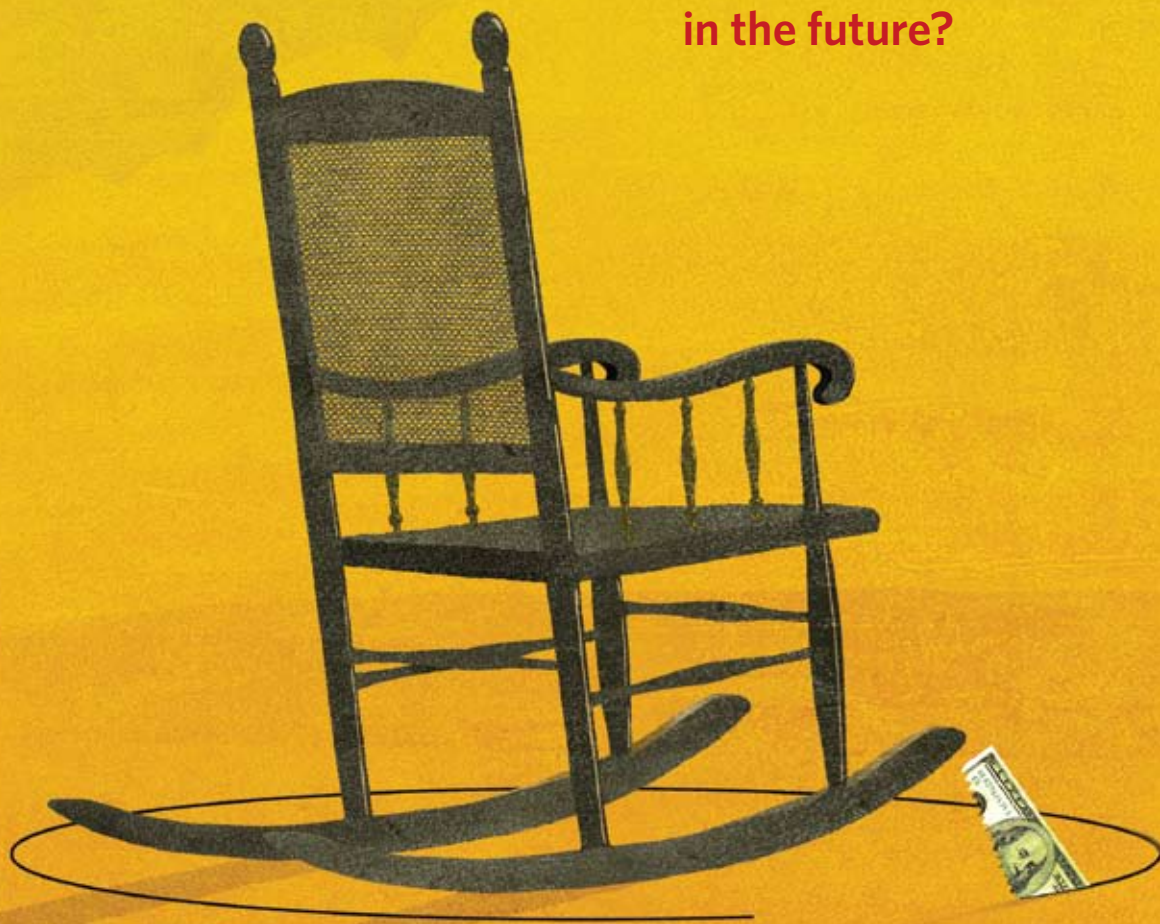


**The United States
isn't getting any younger.
Will the primary sources
of income that anchored
retirement security
in the past suffice
in the future?**



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MICHAEL GLENWOOD

It's Time for a National Discussion on Retirement

By Mark Shemtob

AS WE NAVIGATE THE EARLY YEARS of the 21st century, we face issues (some old, some new) that will affect the financial security of our nation's future retirees. I believe that we need to undertake a comprehensive review of the challenges facing future generations and develop a national retirement policy. Such a policy would reflect the projected demographic landscape of our nation, the philosophical and social changes that we are experiencing, and relevant financial issues.

There are a number of elements to consider. Will the fundamental sources of income that served as the bedrock of retirement security for the past half century—Social Security, employer-sponsored retirement plans, and individual savings and investment—suffice in the future? How best to coordinate and deliver benefits to retirees? Finally, what needs to be on the table as part of any meaningful discussion on achieving comprehensive, fair, and efficient retirement security?

While many experts believe that tackling this challenge requires radical change, they diverge in their vision of the government's role in helping citizens achieve retirement security. Some advocate moving toward more individual control with minimum government involvement. Others support greater government involvement than current systems provide.

Specific proposals and a critique of which approach, if any, is preferable are beyond the scope of this article. I would just point out that radical change is less likely in an environment driven by special interests. Additionally, I don't think that radical change is critical to the fair and efficient delivery of retirement security.

A final note: When I speak of retirees, I include citizens who may have had little formal paid employment but nevertheless contributed to our country in other ways; e.g., raising families or working as a volunteer.

Social Security

Impending Social Security fiscal problems shouldn't be news to us. Changes in the ratio of tax-paying workers to benefit-receiving retirees will require either benefit reductions or increased taxes. Despite abundant disagreement about the extent of the problem and how to address it, there's universal acceptance that action is required.

Recommendations put forth to date include changing Social Security retirement ages, increasing payroll tax rates, increasing the taxable wage base, adjusting benefit levels through alternative indexing, and varying how the trust fund is invested. More drastic reform options include mandating personal accounts to finance some portion of benefits for future retirees.

Any changes that are ultimately adopted must be part of a comprehensive strategy to modernize Social Security rather than a financial fix that ignores fundamental problems with the current program. We need to address the following three issues openly and honestly if we hope to achieve comprehensive Social Security reform:

➤ At the heart of the impending shortfall is a program design that has current workers funding the benefits of today's retirees. Historically, this approach worked efficiently when the ratio of workers to retirees was high. However, this ratio continues to decline rapidly because of decreased fertility, longer life expectancies, and reduced immigration. Currently, there is a 2:1 worker-to-retiree ratio projection approximately 30 years into the future. At what point are we asking too much of younger generations in funding the financial security of older generations? We need to answer this question not only with respect to Social Security but also in the context of Medicare and the looming national debt. The cost of these obligations could affect the high standard of living we have come to take for granted.

U.S. workers rank among the lowest of all leading industrial nations in voluntary savings. Our preference for consumption over savings has made individual savings and investments the weakest of our three main sources of retirement security.

- › Another issue is the use of Social Security's trust fund balance. Currently, funds collected through payroll taxes exceed benefits paid to retirees. This is the result of reforms (adopted in the early 1980s when the program nearly ran out of funds) to establish a prefunding level in anticipation of baby boomer retirements. These surpluses are projected to continue for approximately 10 more years before reversing. The federal government currently spends, and most likely will continue to spend, the surplus for expenses other than Social Security. Of course, there's a promise that these funds (plus interest) will be repaid to the trust fund to pay benefits. We're justified, however, in wondering how this repayment will be accomplished in light of our nation's staggering accumulating debts.
- › Finally, there's the progressive structure of a benefit formula that provides Social Security with elements of welfare. Workers who paid less in Social Security payroll taxes are allotted proportionately higher benefits under the assumption that they need them more. In addition, significant spousal benefits are paid to individuals who contributed very little into the program, reflecting the traditional family with a working husband and stay-at-home wife. Changes in family structure, as well as the wide variation in employer-provided retirement benefits, favor many with disproportionately larger benefits than were paid for or are needed. It's critical that any future delivery method for enhanced progressive benefits be more efficient in providing for those with the greatest need.

Employer-Sponsored Retirement Programs

Over the past several decades, the defined contribution (DC) model has replaced traditional defined benefit (DB) plans as the most common form of employer-sponsored retirement. This can be attributed to pressures on corporate profits (that are very sensitive to DB plan liabilities), a more mobile workforce, and government policies that have discouraged (or not encouraged) the use of traditional DB plans.

The switch to DC, while initially resisted, is now commonplace and generally accepted. The exceptions are some plans for larger unions and those covering public employees such as educators. In time, even these will succumb to the costs and liabilities associated with the DB model. The Pension Protection Act of 2006 has provisions to improve funding requirements for traditional pension plans but does very little to encourage the creation of new ones.

Unlike DB plans, DC plans don't provide lifetime guaranteed benefits that can help insure against increasing life expectancies. In addition, DC plans generally place the risk associated with investment decisions on the employee. Often the investment alternatives provided and/or educational support available to plan participants are lacking. In some cases, the investment products offered are laden with unreasonable expenses. Managing a DC plan benefit to attain a secure lifetime income poses an enormous

challenge to many individuals, both before and after retirement.

Employer-sponsored retirement programs are voluntary but encouraged through attractive tax incentives. To date, any efforts to require employers to offer retirement plans have met with significant resistance. For the most part, larger employers sponsor some form of retirement plan for their employees; unfortunately, this isn't true for smaller organizations—the segment of our nation's business that's posting the most rapid growth.

The range of benefits offered varies widely among businesses that provide them. Some employers offer only employee-funded 401(k) or 403(b) accounts without employer contributions. Others provide very generous pension plans as well as 401(k) or 403(b) options with matching contributions. Unfortunately, many plans exclude part-time employees, leaving this segment of the workforce vulnerable.

Even when they are eligible to participate under employer-sponsored 401(k), 403(b), or similar accounts, employees often contribute at insufficient levels or don't contribute at all. Exacerbating this problem, many employees when changing jobs spend the money distributed to them from employer plans instead of transferring the funds to IRA rollover accounts or to retirement plans sponsored by their new employer. The Pension Protection Act of 2006 provided welcome legislation to increase employee participation in 401(k) plans and encourage participant education about the investment decisions they now control. Congress's response to these shortfalls is a good start but only a start.

Individual Savings and Investment

U.S. workers rank among the lowest of all leading industrial nations in voluntary savings. Our preference for consumption over savings has made individual savings and investments the weakest of our three main sources of retirement security. A tax credit incentive for lower-paid employees who contribute to savings plans has met with limited success. The federal government has provided tax incentives for retirement saving through IRAs for decades. Yet people don't avail themselves of the option for many reasons, including insufficient income for saving, ignorance or discomfort about choosing investment options, lack of discipline, and a belief that Social Security and employer-provided retirement benefits (if available) will suffice. Any comprehensive national retirement policy must consider how to encourage personal savings but must also be realistic about the extent to which people will voluntarily save. This is especially true among lower-paid and younger individuals.

Other sources may be available to fund retirement for some. These include continued part-time employment, financial assistance from children, inheritances, and the use of home equity. It's important to consider how these potential income sources should affect a national retirement policy, especially part-time employment. We also need to consider whether other sources of retirement income exist or could be developed in the future.

Coordination and Delivery

In the formation of a comprehensive national retirement policy, we shouldn't limit the discussion to funding sources. We also must address:

- How every available funding source should integrate with and complement the others;
- The level of overall benefits sufficient to provide retirement security;
- How best to fairly and efficiently deliver benefits.

Whether retirement funding comes from individual savings, an employer-sponsored plan, or the government, one can argue (and many do) that it's the retiree who actually pays (directly or indirectly) for those benefits. For example, the amount that employers pay in payroll taxes under Social Security on behalf of an employee is a form of compensation that rightfully could be paid directly to that employee. There would be no negative effect on profitability if an employer chose not to fund the Social Security program but instead paid that amount to the employee as additional compensation.

A similar argument can be made for employer-funded retirement plans; if the plans didn't exist, funds used to provide those benefits could otherwise be paid to employees for investment on their own. Of course, there's no guarantee that employers actually would pay the funds to employees or that workers would responsibly set them aside for retirement.

Arguing that people essentially fund their own retirements might affect the discussion about how best to achieve widespread retirement security. Note, however, that while employees may be paying indirectly for their benefits, the cost-benefit return at the individual level for Social Security and many employer-sponsored plans isn't proportionate. This is because of intergenerational funding, variations in actual individual longevity, alternative employer-sponsored plan benefits, and the welfare element that's part of the Social Security program.

How much income constitutes sufficient benefits? This question might require the wisdom of Solomon to answer. To start with, we need to agree on what responsibility our society bears in providing its citizens with retirements free from financial hard-

ship. Whether this goes beyond the basic necessities of food, shelter, and health care is fair game for debate.

What are the differences, if any, in responsibilities to retirees who live to 100 as opposed to 80? What about those who didn't save individually for retirement? Do we differentiate among those who could afford to save but didn't and those lacking resources? What about those who didn't work regularly for employers with retirement plans and couldn't accumulate sufficient benefits? The questions are potentially limitless.

Currently, the majority of retirees rely primarily on Social Security. For some, this is supplemented by employer-sponsored benefits (paid in the form of annuities or as lump sums). Finally, personal savings fund a small percentage of our population's retirement. Whether we view all benefit funding as being provided by individuals (directly or indirectly as described above) may affect the debate on whether we consider the allocation to be fair. We must also evaluate intergenerational transfer and welfare aspects that give more to those who have less.

Any discussion would be incomplete without addressing retirees' need to hedge against the dangers of outliving retirement funds. With the demise of traditional employer-provided lifetime monthly pensions for many workers (aka DB plans), the only guaranteed lifetime income that many can rely on is Social Security. We need to explore how best to protect against life expectancy ranging into the 90s (and, for some, beyond 100), without expecting that all retirees will live to such ripe old ages.

Ultimately, individuals will retire with varying income levels, alternative spending expectations, different health scenarios, and a range of life expectancies. The minority will want and use educational materials to create a plan and select optimum financial products for their needs. The overwhelming majority will not be in this position and will need unbiased guidance from competent, well-informed professionals, both initially and, in some cases, on a continuing basis. Most financial professionals in today's market work on commission, and there's a risk that some might not be as independent as we would wish in guiding retirees through this process.

● POLICY CREATION

ANATIONAL RETIREMENT POLICY SHOULD be embraced by organizations representing the diverse retirement security interests of workers, retirees, employers, financial institutions, pension professionals, and other interested entities. The policy should emanate from representative organizations willing to engage in open, candid dialogue and debate, preferably working through a respected nonpartisan organization experienced in developing national public policy.

Once created, a national retirement policy would serve as a blueprint to encourage both governmental and nongovernmental initiatives aimed at ensuring financial security in retirement. Through proper education, support from the government, the expertise of financial professionals, and long-term planning, this

can be achieved in a fair, efficient, and responsible manner. It's vital that we recognize the importance of the many different elements that will be needed to deliver a comprehensive solution.

Here's my shortlist of what needs to be on the table in any such discussion.

1 Limiting Intergenerational Funding of Social Security Benefits

Reducing this dependence could be achieved most efficiently through transition from the current model to one with substantially more prefunding. Whether we include more DC elements is a design issue. What's critical is the understanding that in order to reduce intergenerational dependency, we must require larger current contributions and/or lower future benefits.

2 Exploring Social Security Investment Alternatives

It's important to debate new methods of investing excess Social Security funds. Any past discussion of this has met with the criticism that the government shouldn't be investing (directly or indirectly) in private domestic or international business or in foreign countries. Such an idea seems outdated in today's global economy. Nevertheless, investments must be secure, well-diversified, and handled without inappropriate government influence.

3 Restructuring Social Security to Improve Benefit Delivery

One way to achieve this would be through the creation of a two-tier structure. One tier would provide a benefit directly related to payroll taxes paid by each individual and on behalf of that individual by his/her employer. The second tier would provide a supplemental need-based benefit, calculated on all sources of retirement income available to the worker and his or her spouse and paid for by a special payroll tax on all workers. This feature would preserve the progressive element of Social Security.

4 Encouraging Employer Programs That Guarantee Lifetime Benefits

The traditional DB plan is unlikely to survive unless the government adopts strong initiatives to encourage its use. These include allowing employee pretax contributions to fund DB plans, providing alternatives to Pension Benefit Guaranty Corp. insurance, and allowing benefits earned under DB plans to be adjusted based on the plans' funded status (for plans that satisfy certain specified investment and contribution level standards).

Another option for providing lifetime income protection for employees would be to create tax-favored incentives that allow employers to prefund longevity insurance benefits (discussed in detail below). We also need a comprehensive analysis to determine how best to encourage the use of annuity contracts instead of lump-sum benefits under DC plans.

5 Promoting Financial Education

The most effective time to start any educational process is at an early age. The government should look at ways of encouraging a universal high school course requirement. Such a course would cover the more important financial concepts and help young people understand how to achieve long-term financial security. Subjects covered should include different investment categories, classes, and products; risk/reward characteristics of investments; concepts of investment diversification; and how investments are bought and sold, including fees and costs associated with such products and transactions. Because education is a lifetime endeavor, the government should also sponsor and promote adult education classes covering financial security.

6 Curtailing Premature Use of Retirement Funds

Increasing the current penalty tax (10 percent) on distributions from IRAs and employer-sponsored plans that aren't rolled over would discourage the premature use of retirement funds. However, recognizing that some financial hardships necessitating premature fund distributions may occur, exceptions should be allowed.

7 Urging Small Businesses to Establish Retirement Plans

Incentives for small businesses to establish plans already exist; these include tax benefits and the attraction and retention of quality employees. But the tax credits generally aren't large enough to offset the cost of plan administration. Because most small companies aren't attractive client prospects for retirement planning professionals, they are seldom approached with offers to help in establishing plans. As a result, most simplified retirement plan options available to small businesses have failed to meaningfully expand plan coverage.

We should consider a different type of government-sponsored, simplified retirement program for small businesses. Such an option would use IRA-type accounts that incorporate investment choices approved by the Labor Department. The program would be funded by employees, would require a small-employer contribution, would be exempt from ERISA compliance rules, and would provide tax credits to the businesses based on the cost of employer contributions for non-key employees.

8 Covering Permanent Part-Time Employees

Many employer-sponsored plans can legally exclude employees working fewer than 1,000 hours per year. It may be appropriate to consider eliminating this exclusion for permanent part-timers (e.g., those who have been employed for at least three years by the company). Another alternative would be to allow employers the choice of covering permanent part-time employees under an IRA-type program as described above.

9 Encouraging Individual Savings

This can best be achieved through investment and retirement planning education, more universal coverage of employees under employer-sponsored plans, and the availability of investment products that are easily understood.

10 Improving Investment Options

Fortunately, we are experiencing a trend toward the use of lifestyle, life-cycle, and managed-risk investments in participant-directed retirement plans. The expansion of disclosure requirements for fees and other expenses associated with both investment and record-keeping services is another welcome change. These are both relatively new developments growing out of efforts by the government and the professional community servicing these plans and should be encouraged further, especially with respect to fee and expense transparency. Too many employers still provide investment options that aren't in the best interest of plan participants.

We might also consider requiring that all participant-directed DC plans include options that favor the life-cycle, lifestyle, or managed-portfolio approach. Participants who elect not to use such an approach would be asked to verify that they are aware of risks associated with investing and have the knowledge or professional assistance available to structure their own asset allocation models.

11 Determining a Minimum Retiree Income Level

One approach might be a geographically based determination of costs associated with basic retirement living necessities.

Another might be a retirement replacement income based on national average earnings. Clearly, other standards can be developed. This determination of a minimum income level would be useful in establishing financial safety nets for those who are unable to accumulate sufficient retirement assets and income.

12 Integrating Benefits into Minimum Financial Security

The number of individuals able to accumulate sufficient retirement income from various sources should grow as the result of improvements in employer coverage, benefit alternatives, individual participation, education, investment options, and awareness of the importance of personal savings. However, not all retirees will be so fortunate. This is where the second-tier Social Security benefit could take effect. What is needed is a comprehensive individual approach to protect those retirees who don't have sufficient retirement income. But it will be critical to structure these benefits so as not to encourage a dependence on them.

13 Planning for a Long Retirement

Retirees living into their 90s or beyond will face the challenge of making their retirement nest egg last until their deaths. One new option is longevity insurance, which provides benefits only to those who survive to an age beyond what was expected when they retired. What makes longevity insurance particularly attractive is the potentially high benefit level available per dollar of paid premium.

This is possible for two reasons. First, many buyers can expect to receive no benefit. This provides for the pooling of risk (the essence of insurance) and significant leverage on a benefit-to-cost ratio. Second, the insurer isn't required to pay out a benefit for many years and thus can engage in longer-term investments that provide higher rates of return to fund the eventual benefit.

It's too soon to know whether retirees will buy this insurance, as impediments exist. These include insurance anti-selection, since those most likely to buy a policy plan on living long enough to collect benefits. Premiums will rise or benefits will be reduced as insurance companies use mortality tables that protect them from losses, and unless there's sufficient demand for the product, there may not be enough insurance carriers in the market to generate price competition. As a result, individual longevity insurance could wind up as just an expensive boutique product for a select few. To expand the cost efficiency and appeal of longevity insurance, the government should act to provide favorable tax incentives to employers offering such plans.

14 Refocusing Financial Consultants Toward Retirement Needs

Financial planning for retiring and retired individuals differs from planning for those still in the workforce. Planning and products must be geared toward the use of accumulated assets as opposed to asset accumulation. The financial services community should establish a designation for professionals who have demonstrated expertise in the particular needs of clients entering or already in retirement, as well as comprehensive knowledge of the product range and planning appropriate for these needs.

15 Avoiding Conflicts of Interest in Adviser Compensation

To limit potential conflicts, we should require that all commissioned income for products sold to retirees be fully disclosed in an understandable format prior to the actual sale. We might also consider promoting the use of retirement advisers whose compensation comes from a time-based fee arrangement rather than commissions.

16 Considering Alternative Sources of Income

It's important not to overlook additional financial resources—beyond Social Security, employer plans, and individual savings—that are available for use in retirement. In addition, the determination of any second-tier Social Security benefits should take such resources into account.

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