Building a Strong Retirement Program: One for the AGES

The Forward Thinking Task Force of the American Academy of Actuaries developed the Retirement for the AGES framework to provide a straightforward and unbiased way to assess and compare different retirement security proposals. This article discusses factors impacting retirement security in the future, explains the Retirement for the AGES framework, and shows how AGES assessments have been applied to the traditional defined benefit system, safe harbor defined contribution plans, the South Dakota Retirement System, the New Brunswick Shared Risk Model, and the USA Retirement Funds proposal. The AGES assessments reveal how difficult it is to design an ideal retirement program that would balance many competing needs and objectives. They also show that it is possible to improve on the current system. As the United States begins to address its growing retirement challenges, this framework will be a useful and important tool to compare and assess various proposals.

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Due to the convergence of multiple factors, achieving retirement security is becoming more and more difficult for many Americans. We anticipate that discussions about retirement policy and solutions will come to the forefront over the next few years. The Forward Thinking Task Force of the American Academy of Actuaries has developed a straightforward and unbiased framework called Retirement for the AGES that provides a means to assess and compare various retirement system proposals and reforms. The framework is built on four basic principles: (1) Alignment, (2) Governance, (3) Efficiency and (4) Sustainability (AGES). These principles measure the ability of different programs to deliver retirement security.

The academy has published AGES assessments for both a traditional single employer defined benefit (DB) plan and a safe harbor defined contribution (DC) plan under the current U.S. retirement system. Both of these long-existing structures have flaws that help explain the retirement challenges many individuals face today. In addition, the AGES framework has been applied to several emerging proposals. The challenges faced in retirement public policy are complex and will require new thinking and a level of innovation yet to be seen. Retirement security is a global issue, and the AGES principles can help assess existing and proposed retirement programs around the world as well as within the United States.

Retirement Security Is a Growing Issue

The convergence of a number of factors will demand a hard look at the retirement infrastructure in the U.S. over the coming years. These factors include:

- A rapidly aging population (e.g., it has been reported that 10,000 Americans reach the age of 65 every day). This aging population also is living longer; life expectancy from the age of 65 increased by 5.2 years for men and 4.3 years for women between 1965 and 2015.[1]
- A transition of employer-provided retirement programs from DB to DC plans. The number of single employer DB pension plans covered by the Pension Benefit Guaranty Corporation (PBGC) is below 23,000, down from an all-time high of 112,000 plans in 1985—and this count includes frozen as well as open plans.
- Interest rates and investment returns that are expected to remain low for the foreseeable future
- A shortage of access to employer-sponsored retirement vehicles for many individuals. According to an analysis by the Employee Benefit Research Institute (EBRI), only 48.6% of all workers in 2012 worked for an employer that sponsored a retirement plan, and only 39.4% of all workers actually participated in such a plan. The percentages are even lower for employees working for small employers.[2]
- The projected financial shortfall of the Medicare and Social Security programs (with the Medicare hospital trust fund estimated to be depleted in 2028 and the Social Security trust fund estimated to run short on assets by 2034)[3]
- Pressures on some multiemployer and public plan pension systems, thereby placing some retiree benefits at risk
- A lack of education for many individuals about how to save and invest sufficient assets for retirement as well as how to spend down savings to make them last a lifetime.

While there is an awareness of these issues on Capitol Hill, retirement policy will face stiff competition for the attention of lawmakers and regulators, who also will be focused on priorities including health care, infrastructure, trade, tax reform and the environment. One thing to keep in mind, however, is the unique long-term nature of retirement—The earlier one starts to save, the easier it is to accumulate sufficient wealth at retirement. The corollary to this is that the longer a country (or an individual) waits to address these issues, the fewer options there will be for solutions, and the options that remain will become more and more difficult to successfully implement.

Retirement for the AGES Framework

The start to building any structure is a firm foundation. If something is built without a blueprint or adherence to basic construction principles, it is unlikely to meet its stated objectives or last for a sustained period. Retirement programs are not made of bricks and mortar, but they must be designed and built as carefully as a building. The principles contained in the Retirement for the AGES framework allow policy makers and the public to assess how well each plan provides retirement security.

Projected Medicare and Social Security shortfalls may finally be the catalyst to push retirement policy to the front of the line for policy makers. When this happens, it will be important to take a holistic view of the retirement needs of the country—one that reflects all of the factors mentioned above. Retirement for the AGES can be a valuable tool when that time comes.

Retirement for the AGES provides a framework based on fundamental principles that illustrates the strengths and shortcomings of retirement systems and proposals to reform them. It addresses the needs of retirement plan stakeholders in both the private and public sectors. The framework is based upon four key principles, with specific elements that can be graded or scored:

1. **Alignment** between stakeholders' roles and their competencies
2. **Governance** that defines roles, reduces conflicts of interest, manages competing needs and properly staffs boards
3. **Efficiency** in maximizing returns and minimizing risks
4. **Sustainability** of the system, which is achieved through appropriate cost allocation and protection from extraordinary market gyrations and inflation.

The four principles underlying the AGES framework are described further below.

Alignment

It seemingly takes a village to manage a retirement system successfully, but outcomes will be suboptimal if those involved do not have the right expertise and skills to carry out their designated functions. A retirement system should align stakeholders' roles with their skills. Important tasks such as financial analysis, investment management and retirement plan administration should be the responsibility of those who have the knowledge and experience to perform them well. Many individuals are uncomfortable making retirement-related decisions, and many of those who are capable procrastinate or do not fully engage in making key decisions. Choices for individuals should be structured and defined in a way that helps them make informed decisions.

Governance

A retirement system brings with it significant responsibility for ensuring that the plan is in compliance with applicable rules and regulations and that the stakeholders are carrying out their respective roles while avoiding any potential conflicts of interest. Making and implementing good decisions are essential for successful retirement plans. Good governance helps balance the complex needs of various stakeholders and provides oversight of significant administrative and investment functions.

Efficiency

Delivering security through a retirement program offers immense benefits to participants and ideally achieves a result far better than what an individual could do on his or her own. The power of pooling and risk sharing is enormous. These tools, along with accurate pricing, appropriate use of guarantees and other financial techniques, should be adopted or incorporated to ensure that a retirement system is efficient and maximizes income while avoiding excessive risk to both plan sponsors and plan participants.

Sustainability

Lack of confidence in a retirement program can undermine its purpose. Imagine being informed at retirement, or even after you have retired, that the benefits you were counting on are suddenly no longer there. Long-term sustainability is a must. Roles and skills, good governance and financial efficiency should be structured to support a sustainable retirement system that provides lifetime income to participants. Costs should be allocated appropriately among individuals, employers and society, as well as across generations. In particular, the system should be able to withstand the financial shocks of recessions, times of extraordinary inflation or changes in workforce demographics.

A shorthand review of the key factors that are assessed under each of the basic principles can be found in the sidebar.

It is important to note that adequacy was intentionally excluded from the basic AGES principles for a sound retirement program. Any particular plan can be calibrated to deliver a specified level of retirement benefits. In addition, the level of benefits that is considered adequate can vary significantly from individual to individual. How much retirement income a plan ultimately delivers is certainly an important factor. However, the focus of the AGES assessment process is the foundation on which that benefit is delivered; namely, alignment, governance, efficiency and sustainability, as described above.

Findings to Date

AGES assessments have been completed and published for five retirement programs to date, and further assessments are in various stages of completion for several other programs. These upcoming assessments range from the superannuation program in Australia to various proposals for state-sponsored retirement programs as well as proposed reforms for multiemployer plans in the U.S. A final AGES assessment includes a letter grade for each of the AGES principles in addition to an overall grade. This allows for easier comparison across programs.

The first two AGES assessments consider traditional DB and DC plans, which constitute the vast majority of today's U.S. retirement system.

- **Traditional single employer DB plan.** Certain aspects of the traditional DB plan make it very effective in delivering retirement income. This fact comes through in high grades for alignment and efficiency. However, the AGES assessment also highlights shortcomings in governance and sustainability. These shortcomings help explain the trend of employers moving away from traditional DB plans, in large part because of cost volatility and complexity of compliance. The resulting overall grade is a C+, which clearly shows room for improvement.

- **Safe harbor DC plan.** DC plans were originally intended to supplement DB plans and were not necessarily designed to be the primary source of retirement income. However, the movement away from DB plans has resulted in DC approaches becoming the predominant type of employer-sponsored retirement program. Interestingly, the AGES assessment shows that the strengths of the DC plan are the areas of DB plan weakness and vice versa—perhaps explaining the search for ways to capture the best features of each program. The resulting overall effectiveness of the DC plan is similar to that of the DB plan, which is borne out by the overall grade of C in the AGES assessment.

The Forward Thinking Task Force was particularly interested in some of the newer designs that were emerging at the time of its initial assessments. The task force identified three examples that received higher grades. Two of these programs exist today—a public employee retirement system adopted in South Dakota and a system developed in New Brunswick, Canada that has been adopted by some public and private sector employers. Both of these fall under the umbrella of DB risk-sharing arrangements. The third program, the USA Retirement Funds proposal, was included in a bill proposed by retired Senator Tom Harkin (D-Iowa) that has not yet passed.

- **South Dakota Retirement System:** This program sets a target of 55% of pay replacement, with both a DB and DC component. There is a fixed employer contribution with required adjustments (up or down) to benefits or funding when the plan is out of alignment. The resulting grade is a B+, with strong marks across each of the AGES principles.
- **New Brunswick shared risk model:** This program adopts a shared risk DB approach and sets a funding strategy based on a targeted 97.5% probability of success for delivery of the core benefit formula. If a pro-

Retirement for the AGES Assessment Principles

Key factors of a retirement program that are assessed under each of the basic AGES principles are:

Alignment

- Aligns stakeholder roles with their skills
- Redefines employer roles by placing responsibility for important roles with the appropriate entities
- Helps individuals by structuring their choices to be well-defined and enhance good decision making
- Develops systemic ways to enhance financial security through appropriate levels of laws and regulations

Governance

- Clearly defines roles and responsibilities and acts in accordance with them
- Reduces real and potential conflicts of interest
- Recognizes and manages competing needs
- Staffs boards with financial and other professionals who possess relevant expertise

Efficiency

- Allows smaller plans to group together, with standard and transparent fees to lower plan costs
- Provides consistent opportunities to accumulate assets during working lifetime to enhance participation and coverage
- Minimizes leakage for nonretirement benefits during accumulation and payout phases
- Encourages pooling and effective risk sharing so funds can provide lifetime income
- Incentivizes narrowing the variability of benefits by fostering risk hedging and allowing for pricing benefits and guarantees

Sustainability

- Promotes intergenerational equity
- Allocates cost properly among stakeholders
- Withstands market shocks
- Maintains balance between sustainability and adequacy.

TABLE

Retirement for the AGES Summary of Assessments

Plan	Traditional DB (Current System)	Safe Harbor DC (Current System)	South Dakota Retirement System	New Brunswick Shared Risk Model	USA Retirement Funds
Description	1.5% final average pay (FAP) with subsidized early retirement	Safe harbor match, target date, autoescalation	1.55% three-year FAP with subsidized early retirement, with some risk-sharing options	DB shared risk model; 97.5% for base benefit; 76% for ancillary benefit	Legislation proposed by former Senator Tom Harkin
Overall Assessment	**C**+	**C**	**B**+	**A**−	**A**−
Alignment	B+	C−	A	A−	B+
Governance	C−	C+	B+	A−	A−
Efficiency	A−	D+	A−	A−	A−
Sustainability	D−	C+	B	A	A

jected shortfall develops, the plan spells out how to adjust benefits (beginning with certain ancillary benefits) to bring the plan back into alignment. Benefits are not fully guaranteed, but the program is designed to deliver the targeted benefits with a high degree of probability, provided that risks are managed appropriately. The resulting AGES grade is an A− for this program.

- **USA Retirement Funds:** This program would offer universal coverage to all individuals and attempts to capture the best of DB plan features, such as pooled and professionally managed investments and delivery of lifetime income, while operating much like a DC plan during the accumulation phase. It also reduces the role of the employer, with the program being managed by providers with appropriate skills and expertise. The AGES grade is an A− for this program. This proposal has not been acted upon to date.

The table provides the breakdown of grades for each of these five programs. The full assessments and more information about the AGES process can be found on the Academy website at http://actuary.org/Retirement-for-the-AGES.

Conclusion

The experience of the Forward Thinking Task Force in developing the AGES assessments revealed how difficult it is to design an ideal retirement program. The right balance must be found among many competing needs and objectives, which is not an easy task. Nonetheless, the AGES assessments demonstrate that it is possible to improve the current system, and there is hope that creative ideas will continue to emerge. Programs that can pool investment risk and longevity risk, share these risks between employers and employees in an equitable and sustainable way, and provide lifetime income to employees show particular promise and should continue to be explored. Countries such as the Netherlands and Canada are taking lead roles in exploring some of these new designs.

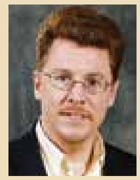
Attempts to capture the best features of DB and DC plans are not new. However, fitting them into the existing legal and regulatory environment has been a challenge. Legislative changes may be needed to facilitate the development of such innovative programs. The funding, reporting and compliance regimes that apply to such programs should provide adequate protections to participants while not being overly burdensome to employers.

We will continue to learn more as new proposals are introduced and as AGES assessments are completed for more reform proposals and programs.

The AGES framework can serve as an excellent means of helping countries, employers, policy makers and other stakeholders assess new programs and new approaches to retirement security. As the U.S. begins to address forthrightly its growing retirement challenges, this framework will be a useful and important tool to compare and assess various proposals.

Endnotes

1. Social Security Administration, *2016 OASDI Trustees Report,* Table V.A4: Period Life Expectancy. Accessed at www.ssa.gov/oact/tr/2016/X1_trLOT.html, on June 1, 2017.
2. Employee Benefit Research Institute, *EBRI Databook on Employee Benefits,* Chapter 6: Employment-Based Retirement Plan Participation, updated July 2014. Accessed at www.ebri.org/pdf/publications/books/databook/DB.Chapter%2006.pdf on June 1, 2017.
3. For a detailed outlook on this, see: American Academy of Actuaries Issue Brief "An Actuarial Perspective on the 2016 Social Security Trustees Report," June 2016 (accessed at www.actuary.org/files/publications/Social_Sec_Trustees_IB_2016.pdf, on June 1, 2017) and American Academy of Actuaries Issue Brief "Medicare's Financial Condition: Beyond Actuarial Balance," June 2016 (accessed at www.actuary.org/files/Medicare_Trustees_IB_FINAL_061113.pdf on June 1, 2017).



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