SECURITY ISSUES PAPER
Retirement USA is a national initiative that is working for a new retirement system, which, along with Social Security, will provide universal, secure and adequate income for future retirees. The initiative has developed *12 Principles for a New Retirement System* to provide a framework for a future system in which employers, workers, and the government would share responsibility for the retirement security for all American workers. The Principles are included as an appendix to this paper.

Retirement USA was convened by five organizations – the AFL-CIO, the Economic Policy Institute, the National Committee to Preserve Social Security and Medicare, the Pension Rights Center, and the Service Employees International Union. Twenty-one other organizations support the Retirement USA principles and are coming together to raise awareness about the need for comprehensive reform for the future. A list of conveners and supporters is attached.

These issue papers are part of Retirement USA’s effort to promote discussion on a range of proposals that could lead to a universal, secure, and adequate retirement system. The issue papers cover five broad topics – universality, adequacy, security, design, and administration – and present options for designing features of a system that can provide an adequate and secure retirement for all American workers.

The papers were prepared for Retirement USA by Pension Rights Center staff and consultants. The principal authors were Jane T. Smith, Policy Associate; Norman P. Stein, Senior Policy Advisor; and John A. Turner, Consulting Economist. Editors were Henry Rose, Special Counsel; Nancy Hwa, Communications Director; and Karen Ferguson, Director. Invaluable insights and technical comments were provided for individual papers by Monique Morrissey, economist at the Economic Policy Institute; Alicia Munnell, director of the Center for Retirement Research; Daniel Halperin, professor at Harvard Law School, and Ben Veghte, research associate at the National Academy of Social Insurance.

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**Retirement USA Issues Paper**

**Security**

This paper is one of five focusing on issues to be addressed in meeting Retirement USA’s 12 Principles for a New Retirement System. These papers address the topics of universality, security, adequacy, design, and administration.

A core Retirement USA principle is that every American worker’s retirement income should be secure. “Retirement shouldn’t be a gamble. Workers should be able to count on a steady lifetime stream of retirement income to supplement Social Security.”

This paper focuses on ways of ensuring that retirement money is safe. Other Retirement USA principles address the related issues of how to ensure that sufficient money is accumulated and preserved during a working life and that payouts last a lifetime. Among these principles are shared responsibility, required contributions, pooled professional investment, and lifetime payouts at retirement.1 These principles are discussed in the paper on design.

Policy experts differ on how to achieve security in a private retirement system and on the levels of security to be provided. This paper summarizes alternative approaches that have been proposed for addressing these issues.2

**I. Introduction**

Most discussions of secure retirement income focus on guarantees. These guarantees usually involve the pooling of financial risk among large groups of individuals over long periods of time, and a surplus fund to act as a buffer.3

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2 This paper focuses on the risk of investment loss as a principal contributor to retirement insecurity. Designers of a new private retirement income system will also have to address longevity and inflation risks. If the new system contemplates the conversion of individual accounts to annuities at retirement age, there will also be the risk that reductions in interest rates can produce lower payouts. See John A. Turner, *Pension Policy: The Search for Better Solutions*, Upjohn Institute, 2010, pp. 101 – 122, 2010.

3 The idea of guarantee has two components: one is the promise made to plan participants, which might be a guaranteed rate of return, a minimum guaranteed rate of return, or a guarantee of a specified benefit at retirement. It is possible that a rate guarantee could apply to contributions for a participant during the participant’s years and a benefit guaranty apply in retirement, when an account balance would be converted into an annuity benefit. The
Providing security for retirees in a new private retirement system through guarantees will require decisions on the levels and types of guarantees, the mechanisms for providing the guarantees, the trade-offs – such as reduced payouts or risks assumed by the government and taxpayers – inherent in providing the guarantees, and whether the guarantor or guarantors should be public or private entities or both.

II. PROVIDING RETIREMENT SECURITY THROUGH GUARANTEES

Until recently it was assumed that the government, private employers, and financial institutions could, to varying degrees, be counted on to guarantee that funds promised for retirement would be paid. That assumption has been severely shaken by recent events in the financial markets, making the challenge of developing a secure private retirement income system for the future even more difficult.

Since Retirement USA principles envision that a new system could be centralized or decentralized, and that it could be administered either by a government agency or by a number of private non-profit institutions, the options discussed below contemplate these alternatives. 4

Who should be the guarantor of a new private retirement income system?

Guarantees to private retirement income programs can be provided by the federal government, government-sponsored enterprises, insurance companies, and investment management firms. If guarantees are provided in a new system, it is likely that one or a combination of these guarantors will be selected.

The federal government provides guaranteed payments through the Social Security Administration and the government’s pension systems for the military, railroad employees, and its own employees. In the event of a shortfall, the government can meet the guarantee commitments by transferring funds from general revenues, which might entail raising taxes or borrowing.

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4 “The system should be administered by a governmental agency or by private, non-profit institutions that are efficient, transparent, and governed by boards of trustees that include employer, employee, and retiree representatives.” Alternative structures are discussed in the Retirement USA issue paper on administration.
Guarantees can also be provided through government-sponsored corporations, such as the Pension Benefit Guaranty Corporation. That agency insures private sector defined benefit plans that pay premiums for this protection. The agency has limits on the guarantees provided and can ask Congress to raise premiums in the event of a shortfall. Although Congress has not provided an explicit statutory authority for taxpayers to backstop the agency, it is unlikely to allow the agency to fail.

Private insurance companies provide guarantees when retirement savings are paid in the form of annuities. In the event that insurance companies were to fail, state guaranty funds, funded by the insurance companies within a state, are supposed to serve as a backstop. The claims-paying ability of insurance companies varies, however. The amount that is guaranteed differs depending on the residence of the retiree, and some state guaranty funds may lack adequate resources to insure against large failures.

The federal government, government-sponsored corporations, and insurance companies could also provide guarantees to other providers of retirement benefits, such as the non-profit institutions envisioned by the Retirement USA principles as a structural alternative to one or more government agencies. Conceivably, the institutions could call for competitive bids from potential guarantors. The premiums paid for the guarantee could be passed on to contributing employers and employees (with government subsidies for low-income workers). Guarantees could be in the form of direct financial backup in the event of insolvency or loans. The guarantor(s) would necessarily be involved in overseeing investment policies and reserve requirements, and in intensive ongoing monitoring.

What should be guaranteed in a new private retirement income system?

In traditional pensions, guarantees are typically provided for at least a portion of promised benefits. In retirement savings plans, guarantees can be provided for some or all of the accumulated assets and, in some instances, for specified rates of return.

For example, in the case of accumulations that will be converted into annuity payments at retirement, a new retirement system could guarantee that individuals would not lose

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5 Insurance companies can also purchase reinsurance from other companies, but reinsurance companies can also fail. AIG is an example. In addition to AIG, several other insurance companies Troubled Asset Relief Program (TARP) funds from the Treasury to prevent their collapse during the recent financial crisis. The Hartford, Principal Financial, and Lincoln National were among six insurance companies that received TARP funds. http://www.washingtonpost.com/wp-dyn/content/article/2009/05/14/AR2009051403866.html

6 Participants in the TIAA portion of TIAA-CREF, the retirement program for college and university professors, have protection for their annuities of up to $500,000 since TIAA-CREF was established under New York State insurance law. The protection is capped at $300,000 in the District of Columbia and at $100,000 in Massachusetts. http://www.annuityadvantage.com/stateguarantee.htm
the amounts they contributed to their accounts. This kind of guarantee can be characterized as a catastrophic guarantee. It does not guarantee a positive rate of return, but it guarantees accumulated contributions against losses when the stock market declines. Japan and Germany are examples of systems that provide this kind of guarantee of return of principal. Since the guarantee is not adjusted for inflation, the “real” value of retirees’ payments is likely to be less than the amounts actually contributed.\(^7\)

Guarantees can also be provided for a return of principal plus investment return. Rate of return guarantees can be for a fixed rate of return, a fixed minimum rate of return, or a variable rate tied to some index.

With a fixed rate-of-return guarantee, investment earnings above the guaranteed rate are retained by the guarantor if the guarantor is responsible for the investment of the relevant pool of assets\(^8\) With a minimum rate of return guarantee in an arrangement in which the guarantor is the pooler the participant would retain some or all of the earnings above the minimum rate.\(^9\)

The guarantees can be defined in “nominal” terms – for example, a guarantee of three percent that is not adjusted for inflation – or they can be defined in "real" terms, such as a guarantee of three percent above inflation. In the case of an inflation rate of three percent, the latter would be equivalent to a nominal guarantee of six percent. The TIAA portion of TIAA-CREF offers a guaranteed rate of return equal to three percent nominal, plus dividends.\(^10\)

Guaranteed rates of return also can be variable, generally tied to an index. For example, hybrid pension plans known as “cash balance plans” typically guarantee contributions to a plan plus a rate of return equal to a bond or stock index.\(^11\)

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\(^{7}\) A catastrophic guarantee providing a zero percent rate of return, although assuring that participants would get all of their money back, would result in a guarantee of negative real rate of return of three percent if the inflation rate were three percent. John A. Turner, Pension Policy Center, “Guarantees,” Capital Matters Conference, Harvard Law School, May 1, 2009.

\(^{8}\) Alternatively, the guarantor can for a fee guarantee an investment return for a pool of assets invested in accordance with specified portfolio requirements.

\(^{9}\) If the participants retained all of the assets in excess of the guarantee, the guarantor would charge a fee, which would of course indirectly reduce the overall rate of return.

\(^{10}\) The YMCA Retirement Fund, a money purchase plan exempt from many of the provisions of the federal private pension law, also provides a rate of return guarantee. This guarantee is provided through reserves built up when investment earnings exceed the guarantee. Recently, as a result of the economic downturn, the Fund had to reduce the level of the guarantee. John A. Turner and David M. Rajnes, “Pension Rate of Return Guarantees in Market Meltdowns: A Longitudinal Analysis,” paper prepared for the Netspar conference, Zurich, Switzerland, June 10-11, 2010 at pp. 26-27.

\(^{11}\) It is theoretically possible for a variable index to produce a negative rate of return in a cash balance plan.
Variable rates of return can be pegged to the performance of other financial entities. In Chile the guaranteed rate of return for its privatized social security funds is "relative" to the rates of return earned by all Chilean pension fund management companies.

**When should a guarantee start? How long should it last?**

In traditional pension plans, benefits keep pace with real wage growth and inflation during an individual’s work life but typically only the nominal benefit is guaranteed during retirement. For accumulations in individual retirement plans, strategies for providing a measure of security short of a government guarantee can include investments purchased from an insurance company, such as a deferred annuity.

When rate-of-return guarantees are provided within defined contribution plans, they may be offered at different rates over different periods of time. For example, a rate-of-return guarantee can be provided annually. The shorter the term, the more the guarantee takes on the characteristics of a variable-rate guarantee. Other guarantees are changed as needed. Guarantees at low rates, such as zero percent, are unlikely to be changed, but “fixed” guarantees at higher levels may be reduced.

In addition, a guarantee can be provided for all, or a portion of, an account balance at a particular age. It is also possible for the portion subject to the guarantee to increase with age. The nature of the guarantee can also change with time; for example, a relative guarantee tied to an index might change to a fixed rate of return when a participant reaches a certain age.

An additional parameter of guarantees is the frequency with which they are applied. For example, the sponsor might guarantee a three percent return for each year of a person’s participation in the new system. A less stringent guarantee would only apply at retirement or on changing jobs. New Zealand originally applied a guarantee annually but found that an annual guarantee was costly. The guarantee is now applied when a participant receives benefits at retirement. Applying a rate-of-return guarantee over a longer period of time effectively smoothes the up and down returns of the financial markets.

In Switzerland the government sets the minimum required guaranteed rate of return for retirement funds based on returns in the financial markets. The minimum guaranteed rate of return paid by Swiss plans on the account balances of individuals in 2009 was two percent, a reduction from the 2008 rate of 2.75 percent due to the crisis in the financial markets. Swiss plans usually pay only the minimum guaranteed rate of return
regardless of how much the account balance has earned, saving the excess for reserves.\textsuperscript{12}

How should a guarantee be financed in a new retirement income system?

In traditional U.S. private pension plans, the guarantee is provided first by the employer and ultimately by the Pension Benefit Guaranty Corporation. Funding for the employer’s guarantee comes from employer contributions and investment returns typically from a balanced portfolio of stocks and bonds, and, in the case of larger plans, real estate, venture capital, private equity, and other investments. The Pension Benefit Guaranty Corporation receives premiums from employers, which it invests in government bonds, and assets from terminated plans, which it invests in stocks and corporate bonds.

In a new private retirement income system, the guarantee could be supported by contributions from employers and employees, returns from conservative investments (such as Treasury Inflation-Protected Securities), and a reserve fund built up over time. The guarantee could be backed by the government (all taxpayers), a government-sponsored corporation, and/or by participating financial institutions.

In the case of a government guarantee for the new system, guarantee payments could be delayed until the program reached a designated insolvency level, perhaps the point at which the plan lacks sufficient assets to make full payments. Until that point, the plan could use assets allocated to active participants’ accounts to continue making benefit payments. These obligations might never have to be repaid if the plan’s future investment growth exceeds the plan’s future guarantees and the debt to the other participants. The risk of loss in such a system would be shifted from all participants to active participants and, depending on when the designated insolvency point was reached, could be shifted to young and perhaps unborn participants (although in that case the government loans or some other mechanism would have to serve as a proxy for the young and unborn participants).

Guarantees can be financed through the development of a reserve fund. When the pension fund rate of return exceeds the guarantee amount, all or part of the excess can be set aside in a reserve fund. When the pension fund rate of return is less than the guarantee amount, the reserve fund can be drawn down. When reserves drop to a certain level, the rate of return guarantee can be adjusted temporarily to accommodate market conditions. If the reserve fund is exhausted, either the guarantee can cease,

\textsuperscript{12} Turner and Rajnes at pp. 12-13.
with the possibility of it being made up subsequently, or the fund can book an unfunded liability, with the total amount credited to pension participants exceeding the assets in the pension fund.\footnote{Private-sector retirement savings plans covered by ERISA must credit to participants all the investment earnings received on their accounts. This requirement prohibits setting up reserve funds. However, state and local government and church plans are not covered under ERISA and often have reserve funds.}

**What are the tradeoffs for guarantees in a new retirement income system?**

The architects of a new retirement system will have to determine the tradeoff of certainty for a potentially higher rate of return. Lower investment returns are usually the tradeoff for guarantees.

For example, if the new program invested all of its assets in government-backed, guaranteed securities, it would be possible to guarantee against loss of principal (at least for the period of maturity of the shortest-maturity obligation), but any additional guarantee of rate of return would necessarily be low.\footnote{As government bonds matured, new bonds would need to be purchased, which might have a lower (or higher) return.}

If the assets were invested in inflation-adjusted bonds, the guarantee would be “real” rather than just “nominal” – but the inflation-adjusted return to participants would be even lower.

If the new program’s assets were to be invested at least partially in stocks, it might be possible to guarantee principal and a slightly higher rate of return.

A recent study based on historical data showed that, under certain assumptions, a program that had invested in a hypothetical portfolio of equities between the years 1883 and 2008 over an average individual’s work life would never have had to pay out on a guarantee, if the guarantee were only a real rate of return of two or three percent. That is because a portfolio fully invested in equities during that period would never have yielded less than 3.8 percent real return averaged over the individual’s work life. The program could have guaranteed a higher rate of return if it had been structured so.\footnote{Alicia H. Munnell, Alex Golub-Sass, Richard W. Kopcke, and Anthony Webb, “What Does It Cost To Guarantee Returns?” Center for Retirement Research, Issue in Brief, February 2009, Number 9-4. http://crr.bc.edu/briefs/what_does_it_cost_to_guarantee_returns_.html The model used for this study assumes a worker works steadily for 43 years and retires at 65. In addition, this average individual experiences a real wage growth of two percent per year and contributes four percent of income to the retirement account each year.}
III. PROVIDING RETIREMENT SECURITY THROUGH RISK SHARING

Pooling of assets in diversified funds can provide some protection against both firm- and industry-specific market risks, because

- Pooled funds tend to be invested in a more broadly diversified portfolio than the average investor could achieve.\(^{16}\)
- Losses in some investments can be balanced by gains in others.
- Individuals at retirement can rely on the collective assets and not just individual investment results.

Although pooling alone will not yield the same level of security against investment loss as guarantees, it can smooth the up and down effects of financial markets.

One example of private retirement income programs that rely on pooling among large groups is the Australian Superannuation Funds for nonprofit employees. Typically, a fund or plan will serve a particular industry or nonprofit sector, thus spreading the risk among very large numbers of participants.\(^{17}\)

An example of pooling assets across generations is the Netherlands Collective Defined Contribution system.\(^{18}\) If the plan faces an investment shortfall, generally it first reduces cost-of-living adjustments for retirees. If additional adjustments are needed, consideration will be given to reducing future accruals for employees, increasing required contributions, and, in extreme cases, reducing already-earned benefits of both retirees and workers. Thus, if reductions in benefits were to be necessary they would be spread among generations.\(^{19}\)

\(^{16}\) Individual investors in our current defined contribution system typically pool funds through the purchase of shares in mutual funds. Investors, however, generally have broad discretion in selecting which mutual funds to use and some investors make choices that are not broadly diversified. Moreover, the mutual funds in our current system tend to charge investors with high investment fees.

\(^{17}\) In Australia all employers are required to contribute to financial institutions or multiemployer pension plans for their employees. Typically, a fund or plan will serve a particular industry or nonprofit sector. The funds are administered by trustees representing employers and employees, are closely regulated by three government agencies, and are conservatively invested.

\(^{18}\) Employers contribute to industry-wide funds that pool the funds for investment purposes, and invest conservatively under the supervision of the Dutch Central Bank. Contribution amounts are negotiated every five years. When a fund’s assets fall below a specified threshold, the plan is required to close the funding gap within five years.

Principles for a New Retirement System

**Universal Coverage.** *Every worker should be covered by a retirement plan in addition to Social Security.* A new retirement system should include all workers unless they are in plans that provide equally secure and adequate benefits.

**Secure Retirement.** *Retirement shouldn’t be a gamble.* Workers should be able to count on a steady lifetime stream of retirement income to supplement Social Security.

**Adequate Income.** *Everyone should be able to have an adequate retirement income after a lifetime of work.* The average worker should have sufficient income, together with Social Security, to maintain a reasonable standard of living in retirement.

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**Shared Responsibility.** Retirement should be the shared responsibility of employers, employees and the government.

**Required Contributions.** Employers and employees should be required to contribute a specified percentage of pay, and the government should subsidize the contributions of lower-income workers.

**Pooled Assets.** Contributions to the system should be pooled and professionally managed to minimize costs and financial risks.

**Payouts Only at Retirement.** No withdrawals or loans should be permitted before retirement, except for permanent disability.

**Lifetime Payouts.** Benefits should be paid out over the lifetime of retirees and any surviving spouses, domestic partners, and former spouses.

**Portable Benefits.** Benefits should be portable when workers change jobs.

**Voluntary Savings.** Additional voluntary contributions should be permitted, with reasonable limits for tax-favored contributions.

**Efficient and Transparent Administration.** The system should be administered by a governmental agency or by private, non-profit institutions that are efficient, transparent, and governed by boards of trustees that include employer, employee, and retiree representatives.

**Effective Oversight.** Oversight of the new system should be by a single government regulator dedicated solely to promoting retirement security.
Retirement USA Steering Committee
AFL-CIO
Economic Policy Institute
National Committee to Preserve Social Security and Medicare
Pension Rights Center
Service Employees International Union

Supporters of the Retirement USA Principles
Alliance for Retired Americans
American Federation of State, County and Municipal Employees
American Association of University Women (AAUW)
Association of BellTel Retirees, Inc.
Building Movement Project
Campaign for America’s Future
Change to Win
Demos
GM National Retiree Association/Over the Hill Car People LLC
National Association of Senior Legal Hotlines
National Caucus and Center for the Black Aged, Inc.
National Consumers League
National Employment Law Project
National Retiree Legislative Network
National Senior Citizens Law Center
National Women’s Law Center
OWL - the Voice of Midlife and Older Women
Public Citizen
United Food and Commercial Workers International Union
Woman’s National Democratic Club
Wider Opportunities for Women