A PUBLIC POLICY WHITE PAPER

Sustainability in American Financial Security Programs

June 2015

Developed by the Public Interest Committee
of the American Academy of Actuaries

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Overview

The American public relies on the promises made under many different financial security programs—whether they are public programs like Social Security and Medicare or offered through the private sector such as employer-sponsored pension plans or insurance products. The public must have confidence that these programs can be sustained and continue to meet their goals.

The monetary compensation or other benefits promised by a financial security program provide protection against the financial impact of risks encountered daily. It is important that the benefits are provided as expected. If they are not, the consequences could be as critical as a lack of food, medical care, or other basic needs, in addition to the trauma arising from the unexpected nature of the loss. Beyond the financial impact of the benefits, there is an intangible security effect where program participants gain important "peace of mind."

Sustainability means that a program can be maintained over time. It is only achieved when stakeholders understand and support the relative balance between benefits and costs now and in the future. Solvency, a related concept, can be determined definitively at a point in time, while sustainability cannot. However, a program that is currently solvent is more likely to be sustainable than one that is not.

Stakeholders in the sustainability of a financial security program include direct beneficiaries and, depending on the nature of the program, sponsors such as businesses or government, as well as taxpayers, shareholders, care providers and public policymakers. Individuals or entities might be part of more than one stakeholder group; some stakeholders benefit directly by being more secure and some stakeholders benefit indirectly when security is provided for others. Other stakeholders provide funding or make decisions about financial security programs.

The Public Interest Committee of the American Academy of Actuaries has created this paper to provide a common framework to facilitate productive discussions among policymakers, actuaries, and other stakeholders about the issue of sustainability**.** We begin with the key concepts of financial security programs available in the United States and then move to a discussion of factors that contribute to the sustainability of these programs.

Financial Security Programs

Generally, a "financial security program"[1] is designed to mitigate the financial consequences associated either with risks that include unexpected events such as fire, theft, or illness, or with major life events such as retirement or death. There can be uncertainty about whether an event will occur (e.g., car accident, disability), the timing of an event (e.g., how long an individual will live after retirement), or the cost associated with an event (e.g., cost to

[1] "Financial Security Program" is used in this paper to refer to a range of public and private insurance coverages and retirement systems that rely on actuarial principles.

repair a house, medical care expenditures for an injured individual). The primary purpose of a financial security program is to address financial consequences of this uncertainty; these programs do not directly address the underlying risk.[2]

Financial security programs can be either public or private. Examples of public programs include Social Security and Medicare, unemployment insurance, and Medicaid. Typical private programs include employer-provided pension plans, health insurance, and automobile insurance. Other programs, such as the protections provided by the Pension Benefit Guaranty Corp. (PBGC) or state guaranty funds, may support and enhance the financial security provided by private programs.

Financial security programs are important to a well-functioning society—in addition to making it possible to weather the financial effects of misfortune, they can improve the overall quality of life by providing some peace of mind in an uncertain world.

Financial security programs work by spreading costs. These costs include both the benefits paid and the costs associated with running the program. Costs may be spread across participants,[3] as in car insurance. Or they may be spread over time, as in the case of a pension plan or prepaid college savings plan. They may be spread across generations, as in the case of the Social Security and Medicare programs. Costs may also be spread or transferred to taxpayers, as in the case of unemployment insurance or the Medicaid program, or to employers in the case of an employee benefit program.[4] Programs may use more than one form of cost spreading; for example, long-term care policies and whole life policies spread costs both among policyholders and over time.

Financial security programs involve a promise of one or more future payments contingent on a specified event. Programs take a variety of legal forms, including private insurance contracts, government programs enacted by statute, and employee benefit programs, among others. Regardless of form, they all have certain common elements. They must define who is covered, what events trigger benefits, and how those benefits are determined. Taken together, these constitute the terms of a promise to a "beneficiary," who is the person receiving benefits. The beneficiary may be the covered individual, as when pension benefits are paid to a retiree. In other cases the beneficiary may be someone else, as when a life insurance policy pays death benefits to a surviving spouse.

[2] Programs that directly reduce the likelihood or severity of an underlying risk are often referred to as "loss prevention" or "loss reduction" programs. Examples would include safety and safety inspection programs, health screening and wellness programs, and security systems and installation and maintenance of appropriate safety equipment. Some financial security programs include aspects of loss prevention or reduction, such as free immunizations provided by health insurance or reduced workers' compensation premiums for employers that have safer workplaces. The simple presence of a financial security system can affect the underlying event. For example, a worker with a pension plan may be able to retire when it would otherwise not be possible.

[3] Sometimes referred to as "pooling."

[4] For purposes of this discussion, we have described only the direct spreading of the costs as a characteristic of a financial security program. Indirect spreading, such as potentially reduced wages because of the costs spread to an employer, are beyond the scope of this discussion.

Financial security programs impact more than just the direct participants and their beneficiaries. Publicly funded programs affect taxpayers. Health insurance ensures that doctors and hospitals are paid for the work they do. Pension plans allow older workers to retire, increasing opportunities for younger workers. Liability insurance ensures that business owners can afford to compensate customers who are accidentally injured on their premises. Long-term care insurance can take pressure off of public assistance programs and is a source of revenue for providers of assistance. Unemployment insurance can help stabilize local economies during economic downturns. All of the individuals and institutions affected by a financial security program, either directly or indirectly, are stakeholders in the program.

Financial security programs must have a funding source. Funding for financial security programs can go directly to pay current benefits or be accumulated to pay future benefits. Typical sources of funding include premiums or contributions from participants, contributions from a plan sponsor or employer, or taxes.

Public financial security programs are generally supported by tax revenues. Some public programs have a dedicated funding mechanism, while others rely on an allocation of general tax revenue through a fiscal budgeting process. Some state programs are conditioned on federal standards tied to the full or partial funding of the program through federal resources. Private benefit plans tend to be funded by a combination of contributions by participants and the program sponsor/employer. Some types of private plans are indirectly supported by favorable income tax treatment of those contributions.

Understanding Sustainability

A financial security program is sustainable if the demands it places on participants, sponsors, and taxpayers are manageable enough that it is unlikely to be discontinued or curtailed. Assessing a program's sustainability should involve asking whether all significant stakeholders accept the relative balance between benefits and costs, and the way in which those costs have been spread. The assessment should also ask whether the program will achieve its goals over its intended time horizon.

In contrast, assessing solvency is a technical endeavor focused on current conditions. A financial security program is generally considered solvent if its assets are sufficient to pay all currently promised benefits as they become due.[5] An insurance program could, for example, have current premiums that cover all of the expected benefits, but future premiums are likely to rise so quickly that most policyholders, given the option, would discontinue coverage. Such a program would be solvent, but the policyholders would not likely see it as sustainable.

The financial factors that affect sustainability include those related to the amount, predictability or timing of costs, and payments to beneficiaries. Sustainability also depends on stakeholder perceptions, which might not be aligned or might even be at odds, and political will; thus sustainability may change over time, even when a program remains technically solvent.

[5] The way in which solvency is measured and tested depends on the form of the program, the specific type of funding used, and how far into the future the promises extend.

Benefit and cost levels

Benefits for financial security programs should be targeted at a level adequate to meet the goals of the program over its intended time horizon. With many programs there is a tension between establishing an adequate benefit level and the cost of funding those benefits. It is this tension that makes creating a sustainable program difficult.

Sustainability is enhanced when the funding source and the benefits promised remain balanced over the lifetime of the program. Designers of programs should take into consideration how future changes could impact both benefits and funding over the long-term horizon while taking into account short-term effects. Benefits and funding may temporarily move in opposite directions, which will magnify the effect of short-term changes. For example, a downturn in the economy will increase benefit payments for unemployment insurance while decreasing the premiums collected, which are a percentage of company payrolls.

Demographic evolutions, such as the effects of the baby boom, can affect the relative balance between the funding source and the benefits promised and the change in that relative balance over time. Identifying, acknowledging, and planning for these changes can be instrumental in enhancing the overall sustainability of the program.

Some programs have built-in self-adjusting mechanisms where benefit levels adjust automatically in response to changing conditions. For example, in several countries, retirement age automatically increases when longevity in the covered population increases.[6] Self-adjusting mechanisms work best to enhance sustainability when the individual changes are relatively small and stakeholders have enough time to adapt to changed expectations about the future.

Sustainability can also be enhanced by allocating benefits in a way that is most aligned with program objectives. For example, expensive medical procedures could be allocated to those who gain the most value from them, or guaranteed retirement income might be provided only to pay for basic needs. Or, programs could be designed with built-in incentives for beneficiaries to make good choices. For example, health care programs might incentivize the use of appropriate, cost-effective care.

Predictability of benefits and costs

A sustainable financial security program must strike an appropriate balance between 1) allocating the effects of uncertainty (risk), and 2) the desires of those who provide funds and those who receive benefits to have predictable costs and "guaranteed" benefits, respectively.

Risk assessment and measurement can help stakeholders understand the potential for changes in funding or benefits. Risks typically are attributable to unknowable future events such as investment returns, the life span of participants, or the need for health care. Proper modeling and clear communication about risk can help stakeholders achieve an appropriate balance between beneficiary security and cost predictability.

[6] "Autopilot: Self-Adjusting Mechanisms for Sustainable Retirement Systems," John A. Turner, 2007.

A program with an accumulation of funds to support future benefits (prefunding) should undergo proper evaluation of the assets supporting those future benefit payments. A program that relies on investment risk to generate greater returns to meet its goals might also make costs or benefits unpredictable and increase the risk of falling short of its beneficiaries' expectations.

Guaranty funds[7] may provide an additional level of benefit security, which seemingly enhances sustainability. However, guaranty programs that are not supported by appropriate regulation and oversight could also introduce moral hazard that can damage a program by eliminating the consequences of risky actions. For example, the PBGC has been identified as a potential factor in incentivizing pension plan sponsors to hold higher levels of equity investment in their pension funds.[8]

Timing

Financial security programs that promise benefits to participants due many years in the future can be at greater risk of being perceived as unsustainable. Over long time frames, the ability or willingness to fund benefits may wane. This could happen due to the compounding effect of low investment returns, increases in life expectancy, or unexpectedly high health care cost inflation.

Intergenerational equity—allocating the costs of a generation's benefits to that generation—can enhance the sustainability of a program. When costs are aligned with benefits, each generation is more likely to be willing to fund those benefits. Future generations might be unwilling to bear costs passed on by a prior generation, as might occur in "pay-as-you-go" systems such as Social Security or Medicare, or in advance-funded systems where funding targets are not met, e.g., some public sector pension systems.

Funding benefits in advance of the "pay-as-you-go" need can enhance the sustainability of a program. Appropriate levels of funding will improve intergenerational equity, and if all benefits are funded in advance, no part of a generation's cost is passed on to later generations.

Managing Sustainability

Managing large financial commitments over decades-long time frames is a complex process. Appropriate governance structures need to be established, and the right experts need the right information to make good decisions. All stakeholders need clear communication of the objectives, benefits, costs, and risks of financial security programs.

Good communication also requires transparency about the status of a program and the way it is managed, as well as disclosure of potential conflicts of interest. Otherwise, some stakeholders might benefit at the expense of others, detracting from a program's objectives and weakening the commitment to maintain it.

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[7] Guaranty systems in the United States include state programs that protect policyholders when an insurer becomes insolvent; the PBGC, which protects pension benefits when corporate pension plan sponsors go bankrupt; and implicit government guarantees of financial institutions.

[8] Congressional Budget Office, The Risk Exposure of the Pension Benefit Guaranty Corporation, page 9, 2005 http://www.cbo.gov/sites/default/files/09-15-pbgc.pdf.

Pay-as-you-go programs—or those that fall behind on funding current benefits—are sustainable only to the extent that those who pay into the program have the will to support and pay for the program. Good communications can help sustain that will; populations that see societal benefits in a program may be willing to bear the costs to maintain it, even in the absence of intergenerational equity.

A well-designed and broadly accepted regulatory environment can help ensure sustainable practices by requiring appropriate funding, risk management, governance or stakeholder communication. However, poorly designed or overly rigid regulations could reduce program efficiency and sustainability.

Conclusion

The American people need financial security systems for our society and economy to function successfully. These systems will be most effective when they continually deliver the intended benefits as expected. In other words, they must be sustainable in order to be effective. A clear and common understanding of the concept of "sustainability" will facilitate the ability of these programs to contribute to our economic well-being. This document presents a framework for describing sustainability and the factors that contribute to it so that all stakeholders can examine the sustainability of the financial security programs that affect them in a serious and transparent manner.

Some financial security programs have come under scrutiny in recent years because they do not appear to be sustainable. The American Academy of Actuaries is committed to working toward solutions that help restore public confidence in and enhance the sustainability of these important programs.