

# Social Security Reform: Solutions Outside the Box

Proposals Including Individual Accounts

A Luncheon Briefing Sponsored By  
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# Overview



# Possible Advantages of Individual Accounts

- **Give workers ownership and control**
- **Potentially greater return on contributions**
- **Address Social Security's long-term deficit**
- **Help economy raise investment capital**
- **More individual equity**



# Possible Disadvantages of Individual Accounts

- **High “transition costs”**
- **Increase risks to workers and families**
- **Increase administrative costs**
- **Cut benefits for lower-paid workers**
- **Burden on other social programs if workers make poor decisions**



# Individual Accounts would bring major changes

- **Investments: Choices, communication, management, politics**
- **Administration: Record-keeping, education, payouts**
- **Program would have two tiers**
  - Proposals usually shift about 2 percent of taxable wages to IAs
  - Traditional defined benefits would continue, with reductions for people with IAs
- **Transition: Need to close financing gap and keep paying existing benefits**



# Possible models: IRA, federal TSP, 401(k)

- Investment choices – Few vs. many? Use index funds?
- Recordkeeping – Centralized vs. decentralized?
- Payouts – Allow access to funds before retirement?
- Level of expense charges – Retail vs. wholesale?
- Investment education – Teaching workers how to invest



# Designing Individual Accounts: 10 Key Issues

- **Should IAs be mandatory or voluntary?**
- **How to keep benefits adequate for low-paid workers?**
- **How to grandfather older workers and retirees?**
- **How to preserve disability benefits?**
- **Should all individual accounts be managed centrally?**
- **What investment choices should workers have?**
- **How can workers make informed investment decisions?**
- **Should workers have access to funds before retirement?**
- **Should payout annuities be mandatory or voluntary?**
- **How to design and administer payout annuities?**



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# Basic Design



# Should Individual Accounts be voluntary or mandatory?

- **Issues to be addressed in a voluntary system**
- **Open seasons – extra handling, extra costs**
- **Inertia – many would stay in current program**
- **Second thoughts – workers may want to change their elections if investments perform poorly or current program modified**
  - **Should workers with IAs get benefit guarantees?**
  - **Would current benefits be protected against cuts?**



# Adequacy Issues

- **Current benefits favor workers with low pay, employment gaps, dependents**
  - Benefit formula is weighted to help lower-paid workers
  - Benefit formula also helps workers with gaps in employment
- **IA plan will either make up these subsidies or create winners and losers**
  - To help small accounts, charge investment expenses as a % of assets
  - Could also subsidize accounts of low-paid workers



# Likely design of basic benefits

- Existing beneficiaries – maintain benefits in pay status, including survivors & COLAs
- Older workers, e.g., 55 & up – also maintain current program
- Younger workers – they pay the current S.S. contribution minus amount going to IAs. They get current program's benefits, offset by benefits derived from IAs
- Future workers – get scaled-back defined benefits
- Disability and survivors' benefits – to be restructured, reflecting benefits from IAs



# Offset for benefits derived from individual account

- **Worker's basic benefit is usually offset by an estimated benefit derived from IA**
- **Formula might assume all IA contributions earn a 3% real rate of return**
  - For workers earning over 3% real, IA benefits will exceed offset
  - For workers earning less, offset will exceed IA benefits
- **Actual benefits and costs are very sensitive to this assumed rate of return**
- **Proponents of IAs often tout high potential returns on stocks, but workers may invest more conservatively**
- **In practice, offset formula may hurt public acceptance**



# Earnings sharing, in case of divorce

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- **Should each spouse get half of benefits during the marriage**
- **With traditional Social Security, difficult to administer**
- **With individual accounts, much more workable**



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# Administration & Investing



# Administrative issues & challenges

- **Keeping politics out of investing**
- **Holding down costs to manage & invest accounts**
- **Educating workers about investing**
- **Payout of funds for retirement income**
- **These issues are critical to success of IA plan**



# Keeping politics out of investing

- **If government agency handles investment, security selection could be seen as government endorsement**
- **Alternatives include:**
  - Government approved private investment funds
  - Index funds
- **Should “socially responsible investment” be permitted?**
  - If so, who decides “good” from “bad”?
  - Can weapon makers be excluded while the government wages war?



# Holding down costs to manage & invest accounts

- **Such costs add up over time, reduce retirement funds**
- **IRA approach**
  - Individual chooses from many providers & funds
  - Investment advice may not be objective
  - High “retail” costs to handle & invest
- **TSP approach**
  - Few investment choices, central administration
  - Government controls investment advice
  - Lower “wholesale” costs to handle
  - Index funds have low costs to invest



# Educating workers about investing

- **Not many workers understand investments**
  - Must explain choices clearly, answer questions
  - Small employers can't help much
- **Simple plan with few choices would simplify worker education**
- **Sophisticated investors may clamor for greater flexibility**
  - They can also better afford costs of “retail” investing
  - Equity issues if wealthy enjoy more choices



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# Payout of Funds



# Before retirement: loans & withdrawals

- **Before retirement, many workers will want to tap funds**
- **Some of these individuals will be in dire financial need**
- **Policy makers must decide up front whether to allow access to funds in hardship cases**
  - Any exceptions weaken the program as a retirement vehicle
  - Better for individuals to use other programs & resources
- **At worker's death, beneficiary can be paid the account balance**



# After retirement: should annuity be mandatory?

- **Disadvantages**

- Worker may want to keep control
- Annuities favor people with longer life expectancies
- Annuities favor married people and especially those with young spouses unless benefits actuarially reduced for survivor benefits

- **Advantages**

- Retirees can't outlive resources
- Avoids tough problems of self-managed retirement fund, particularly among the very aged or infirm
- Cuts annuity costs – broad spread of risk, low expenses
- Makes unisex pricing feasible – attractive to women



# What form of annuity?

- **Specifying a standard form has advantages**
  - Suggest lifetime annuity in fixed amount with automatic COLAs
  - After death of married worker, continue 2/3rds to surviving spouse
  - After death of worker and spouse, pay account balance at retirement minus all annuity payments
- **This guarantees that benefits will at least equal the account balance at retirement**
- **Death benefit doesn't change abruptly at retirement**
- **No tough decisions or complex comparisons**



# Who should provide the annuities?

- **Why not let the government run the annuity program, working through private firms?**
  - Annuities would be cheaper, covering a cross-section of risks with low handling costs
  - Can avoid any risk of loss due to insurer insolvency if government assumes risk
  - Accommodates inflation-indexed annuities and unisex rates
  - Can cut costs by coordinating payments with basic Social Security benefits



# Timing of annuity purchases at retirement

- **Cashing out stocks to buy an annuity can be risky**
- **Worst case is when stocks are down and annuity yields are also down**
  - Can spread sale of stock funds over a few years
  - Can either buy annuities gradually or lock in favorable annuity rates
  - In UK, full annuitization mandatory by age 70



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