

Key Points

- Social Security normal retirement age has been raised to 67 for all individuals born after 1960.
- ERISA currently does not allow a plan sponsor to raise the normal retirement age for DB plans beyond age 65 to be consistent with Social Security.
- Aligning the normal retirement age for DB plans with the Social Security normal retirement age would facilitate and encourage more workers to remain in the workforce longer.
- Changes to ERISA should allow, but not require, employers to increase their normal retirement age.
- Transition rules should be considered carefully.
- Many plan sponsors may elect to keep their current normal retirement age.

Rethinking Normal Retirement Age for Pension Plans

The American Academy of Actuaries currently advocates that any resolution to the long-term financing problems of the Social Security system should include an increase in the Social Security normal retirement age. This issue brief investigates the effect of similarly raising the normal retirement age in a qualified defined benefit (DB) pension plan, and analyzes the merits of such a move.

Many of the issues identified in the Academy's 2008 Social Security position statement, *Actuaries Advocate Raising Social Security's Retirement Age*, and the Social Security Committee's 2010 issue brief, *Raising the Retirement Age for Social Security*, including longevity and demographic concerns, apply equally to the idea of allowing employer-sponsored plans to raise their plan's normal retirement age. Notably, that issue brief discusses important behavioral effects that a defined normal retirement age can have. Permitting employers to increase the normal retirement age in their qualified DB plans would better align these important behavioral signals with the current increases in the Social Security normal retirement age and possibly encourage workers to remain in the workforce and retire later. Delaying retirement would mean more benefit accruals in a worker's pension plan, allow individuals more time to accumulate retirement savings, and lead to higher standards of living in retirement. Further, encouraging workers to remain a productive part of society not only increases the individual's financial security, but also increases the capacity of our national workforce.

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Background

The Social Security normal retirement age, sometimes called full retirement age, is the age at which a person may first receive full or unreduced retirement benefits. The normal retirement age was initially set at age 65 when established in 1935, based on the precedents set by the few existing private and state pension plans at that time, and on an actuarial analysis that showed age 65 was actuarially feasible given life expectancies at that time. When the Employee Retirement Income Security Act of 1974 (ERISA) was enacted, setting age 65 as the maximum normal retirement age for private plans was a well-established precedent. However, in the three-quarters of a century that has passed since Social Security was enacted, the life expectancy of a 65 year-old American has increased more than forty percent.¹ While the Social Security normal retirement age has been increased from 65 to 67 (for those born in 1960 or later²), the normal retirement age in qualified DB plans has not changed.

ERISA requires a DB plan to define the plan's normal retirement age and sets age 65 as the maximum allowable normal retirement age.³ While most plans use age 65, there are many examples of plans that use younger ages.⁴ The nor-

mal retirement age has a few important implications. At that age:

- The participant may leave employment and immediately begin receiving the accrued benefit.
- The participant must be 100% vested.
- If the participant works beyond normal retirement age, a "suspension of benefits" notice must be provided, unless benefits payments commence at that age or benefits are modified after that age to reflect actuarial adjustment.⁵

Increasing the maximum allowable normal retirement age would not require any plan to make a change, but would permit sponsors who wanted to raise their plan's normal retirement age to do so.

Impact of a Higher Private Pension Normal Retirement Age

The current disconnect between the Social Security retirement age and the normal retirement age requirements for employer-provided plans dampens the message that the later Social Security retirement age sends to retirees regarding the value of remaining in the workforce. Allowing the alignment of the normal retirement age in the employer system with that of Social Se-

¹Since 1940, the life expectancy for a male age 65 has increased 5.9 years (46%) while the expectancy for a 65 year-old female has increased 6.0 years (40%). 2011 *Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds*, which is available at: http://www.ssa.gov/oact/TR/2011/V_A_demo.html#221776.

²Social Security Amendments of 1983, P.L. 98-21, (H.R. 1900) <http://www.finance.senate.gov/library/reports/conference/download/?id=81c09277-78c2-4c6f-98cd-3f0d0a1072a4>.

³Technically, the maximum age is the later of age 65 or the participant's age on the 5th anniversary of entry into the plan.

⁴26 CFR 1.401(a)-1(b)(2) requires that the normal retirement age under a plan cannot be earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed. A normal retirement age of 62 or later (50 or later for qualified public safety employees) is deemed a safe harbor, with a facts and circumstances test applying to early retirement ages between 55 and 62.

⁵Some plans provide unreduced benefits for all participants at an age earlier than normal retirement. Such plans would generally be unaffected by a change in the normal retirement age with the exception of the age at which the suspension of benefits notice would be required.

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curity would strengthen the retirement signaling effect⁶ generated by specified retirement ages. The ability to align retirement ages in private sector pension plans with Social Security would deliver a clearer message about our society's expectations for retirement.⁷ Such a message could be a powerful incentive to retire later — even if there is little or no change in the amount of the benefits provided.

Encouraging employees to retire later can result in increasing retirees' standards of living in multiple ways. Extending one's working career enables additional wage earnings and facilitates additional personal saving accumulations. Delaying retirement also has the effect of reducing the expected pay-down period allowing for higher payouts. As a result, even a comparable savings balance can support a higher standard of living because the retirement period is shorter. Furthermore, if improved signaling resulted in delaying retirement, more retirees would receive benefits at their Social Security normal retirement age rather than electing to receive those benefits early in a reduced amount. Despite the current Social Security normal retirement age of 66 for those retiring now, 49 percent of males and 55 percent of females receive benefits at age 62—the earliest available age. In contrast, only 6 percent of participants elect to initiate benefits after full retirement age.⁸ As Social Security benefits can be significant portions of retirees' income, lessening or eliminating the 20 to 30 percent reduction retirees incur by commencing benefits early can, in many cases, materially improve their standards of living.

Voluntary versus Mandatory Higher Normal Retirement Age

The Social Security Committee's 2010 issue brief observes that longevity for lower-wage workers has not increased as much as for higher-wage workers.⁹ Therefore, the argument that raising the normal retirement age reflects increased longevity does not as readily apply to lower-wage workers. Also, many lower-wage workers and blue-collar workers might not be able to work to a later normal retirement age because they have more health problems, have fewer skills that could keep them working to a later retirement, and work in more physically demanding jobs. Many current DB plans reflect these facts by defining normal retirement age as less than the current maximum of age 65.

For these reasons, changing the maximum allowable normal retirement age should be a voluntary decision of plan sponsors, not a mandate. Many organizations may choose to keep the current DB plan retirement age. Any transition to a higher retirement age for employer-provided plans should be done in a way that considers these factors and achieves some form of balance through the transition rules.

Transitioning to a Higher Retirement Age

Raising the normal retirement age, absent other changes, lessens the value of benefit accruals to the participant (since they are paid at a later date) and thereby lowers the ongoing cost of the plan to the sponsor. But the transition method could include other adjustments to mitigate this

⁶Signaling theory in economics refers to communicating information between parties involved in a potential transaction. In this case it refers to plan sponsors and government sending a message to employees about the desirability of various retirement ages.

⁷For additional discussion of important retirement signals, see "Signals, Retirement Options, Phased Retirement and Retirement Decisions" by Anna Rappaport, available at <http://www.soa.org/library/monographs/retirement-systems/retirement2020/2008/november/mono-2008-m-rs08-01-rappaport-signals.pdf>.

⁸Percentages are calculated exclusive of the 12.1%11.5% of retirements (male/female) accounted for as disability conversions at age 65. Table 6.B5 of the Annual Statistical Supplement to the Social Security Bulletin, 2011 Social Security Administration, available at: <http://www.ssa.gov/policy/docs/statcomps/supplement/2011/6b.pdf>.

⁹An analysis of the impact of compensation on mortality improvement can be found at: <http://www.socialsecurity.gov/policy/docs/workingpapers/wp108.pdf>.

effect. Here are four possible methods, generally moving from the least to the most generous method:

- All accrued benefits and future accruals could immediately change to the new retirement age. This approach would have the strongest signaling effect, and be the easiest to understand and administer. However, it would be the harshest transition, particularly for those near retirement age and would require explicit legislative exception to the Internal Revenue Code (IRC) Section 411(d)(6) rules.
- All accrued benefits and future accruals could immediately change to the new retirement age with a minimum benefit equal to the accrued benefit at transition payable at the former normal retirement age (or former early retirement age with former reduction factors). This transition protects the accrued benefit at transition, but may reduce future accruals beyond just the change to the normal retirement age for some participants.
- Future benefit accruals change to the new normal retirement age, but accruals as of the transition date remain at the former retirement age. This method protects the accrued benefit and provides full future accruals based on the new normal retirement age, but introduces the complexity of administering two normal retirement ages based on accruals before and after the transition date.
- Accrued benefits at the transition date could be actuarially increased to reflect the higher retirement age. All accruals are then administered as payable at the new retire-

ment age. The actuarial increase preserves the value of the accrued benefit at the former normal retirement age. This method produces the same benefit payments as the previous method without the administrative complexity, but would require a legislative or regulatory safe harbor to comply with rules such as suspension of benefits and IRC Section 411(d)(6).

Any of these methods could adopt a transition date several years in the future that would allow participants more time to adjust and plan their retirements. Methods might also be combined, such as one method for participants near retirement and a second method for those with more time to adjust.

When considering a voluntary transition to a higher normal retirement age, policy makers should consider the relative merits of these transition methods and the effects they will have on workers and plan sponsors. When considering a voluntary change in the normal retirement age, plan sponsors would need to balance administrative complexity, the cost of the plan, and the commitment to participants.

Conclusion

Plan sponsors should be permitted to increase the normal retirement age in private sector DB plans beyond age 65 to align their plans with Social Security. This voluntary change would encourage American workers to remain productively employed longer. Additional employment would increase the monthly benefits they receive from both the private plan and Social Security, and would increase their financial security in retirement.