VIEWPOINT

ADDRESSING AMERICA'S RETIREMENT NEEDS

Longevity Challenge Requires Action

SEPTEMBER 2013

BLACKROCK®

A combination of factors, including a population that is living longer, the lingering effects of the "Great Recession," and simply not enough savings, has created a retirement funding gap in the United States. One study estimated that gap — the difference between what people have saved and what they will need for retirement — at $6.6 trillion.[1] Despite the deficit, a survey conducted by the Employee Benefit Research Institute (EBRI) found that less than 60% of workers are saving for retirement. More troubling, 57% of those surveyed have less than $25,000 in total savings and investments; 28% have less than $1,000.[2]

Given the lack of financial preparedness evident across the United States, it is important that everyone from policy makers and financial institutions to employers and savers rethink today's accepted paradigm of retirement. A critical issue is timing. Statistics show that 10,000 baby boomers reach retirement age every day.[3] We urge policy makers to address America's retirement needs now to offer Americans access to programs that ensure the blessing of longer life is not wrought with financial hardship. This *ViewPoint* surveys the US retirement landscape, looking at existing savings programs and changing demographics, and offers ideas for reinforcing the retirement system in the United States.

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1 The Center for Retirement Research at Boston College, 2010.
2 Employee Benefit Research Institute, 2013 Retirement Confidence Survey.
3 Pew Research Center. www.pewresearch.org .

The opinions expressed are as of September 2013 and may change as subsequent conditions vary.

Clear Intentions, Confusing Results

The need to offer US workers the means for a secure retirement has been acknowledged and advanced in the public policy arena for many years. From the Social Security program, to tax incentives for employers and individuals, to legislation to protect assets and enhance investment returns, retirement planning has been an ongoing focus of policy makers at both the federal and the state levels. This much is clear, and admirable.

In an effort to further this mission, and to address perceived abuses, a series of legislation and tax code changes has been introduced over the past 75 years (see Exhibit 1). The result is a complex patchwork of programs covering various groups of Americans (see Exhibit 2). Each program has its own set of rules related to participant eligibility, funding sources, tax deferrals and distributions. The picture is further complicated by special programs for veterans, changes in existing programs for older workers and retirees versus younger workers, the introduction of new programs and rules over time, and the ability of workers to change jobs and sectors (thereby affecting their plan eligibility). This confusing patchwork also falls short of addressing today's retirement needs.

Exhibit 1: RETIREMENT HAS LONG BEEN ON THE PUBLIC AGENDA

1935 **Social Security** created to provide retirement benefits to American workers; amended in 1939 to include survivor and spousal benefits and in 1956 to add disability benefits.

1974 **Employee Retirement Income Security Act of 1974** (ERISA) enacted to establish minimum standards for pension plans in private industry and to protect the interests of employee benefit plan participants and their beneficiaries by requiring disclosure of financial and other information and establishing standards of conduct for plan fiduciaries.

Individual Retirement Accounts (IRAs) introduced at the time of ERISA enactment to provide private sector employees not covered by an employer retirement plan a method for making tax-deferred contributions to a retirement account.

1980 **401(k) regulations** enacted, formally authorizing "salary reduction/savings plans" that had been in place for several decades, sparking increased adoption of this type of plan by corporations. In 1981, the IRS sanctioned the use of employee salary reductions as a source of retirement contributions.

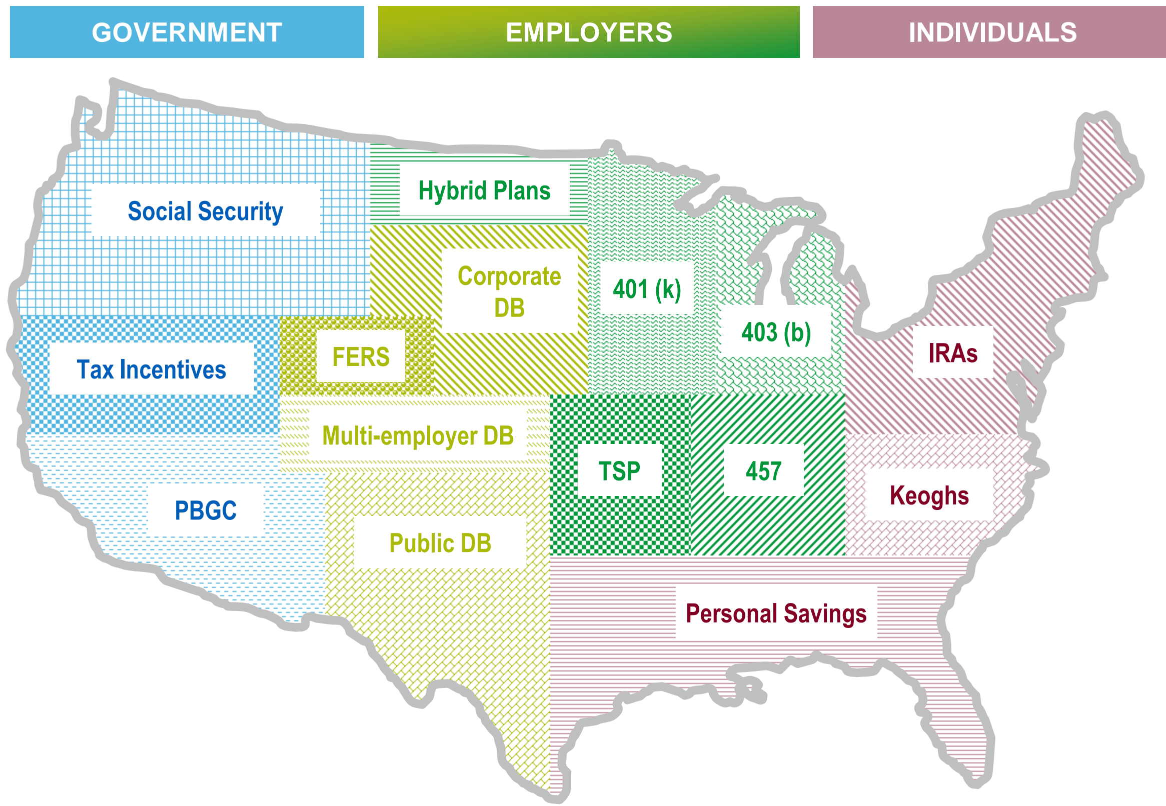
1986 **Federal Employee Retirement System (FERS)/Thrift Savings Plan (TSP)** for federal employees enacted, substituting a defined benefit (DB) plan (the Civil Service Retirement System) for a much smaller DB (FERS) and a defined contribution (DC) plan with an employer match (TSP).

1991 **Congress makes Social Security coverage mandatory** for public sector employees not covered by an alternative public pension plan.

2001 **Economic Growth and Tax Relief Reconciliation Act (EGTRRA)** enacted many changes to DC plans, e.g., increasing maximum employee contributions, requiring faster vesting of employer contributions and allowing rollovers of contributory IRAs into employer-sponsored DC plans.

2006 **Pension Protection Act (PPA)** introduced significant changes in ERISA and tax rules governing private sector DB and DC plans, including changes intended to address underfunding of DB plans, and authorized auto-enrollment, auto-escalation and "qualified default investment alternatives"(QDIA) for DC plans.

Exhibit 2: PATCHWORK OF US RETIREMENT PROGRAMS



PROGRAM	TYPE OF WORKER COVERED		
	FEDERAL CIVILIAN EMPLOYEES	NON-FEDERAL PUBLIC EMPLOYEES	PRIVATE SECTOR EMPLOYEES[1]
Social Security	YES[2]	MAYBE[3]	YES
Public DB	NO[4]	YES[4]	NO
ERISA DB	NO	NO	YES[5]
Federal Thrift Savings Plan (TSP)	YES	NO	NO
401(k) Plans	NO	NO	YES
457 Plans	NO	YES	NO
IRAs	YES	YES	YES
Keoghs	NO	NO	YES[6]

1. As of 2011, according to EBRI, only about half of private sector workers were covered by an employer-sponsored retirement plan of any kind.
2. Federal employees hired post-1984 contribute to and are covered by Social Security, and are eligible to receive a small annuity from employer contributions (FERS).
3. Participation subject to election made by each municipality under Section 218 of the Social Security law.
4. Indicates change in program with different classes of workers over time.
5. Indicates both employees of corporations and multi-employer plans; also subject to changes in program with different classes of workers over time.
6. Most commonly used by self-employed individuals.

Assessing the Current Retirement Funding Paradigm

Looking past the complexities, the US retirement funding paradigm consists of three broad components: i) the federal Social Security program, ii) employer-sponsored plans, both defined benefit (DB) and defined contribution (DC), and iii) personal savings plans and similar programs for the self-employed.

Regardless of the type of plan, certain axioms apply. First, the benefit available is based on eligibility and participation, funding (by the employer and/or the individual), and investment returns. Second, the level of benefit needed for retirement by an individual is a function of retirement age, longevity and annual consumption requirements. While everyone has different priorities, consumption requirements include both non-discretionary (e.g., housing, healthcare, and daily living requirements) and discretionary (e.g., travel, leisure) expenses. In addition, inflation and other unknowns (most obviously an individual's health-related expenses) contribute to a need to have greater retirement assets to protect against financial uncertainties.

Following is a discussion of the major existing programs and key plan characteristics. For each program, it is important to understand (see Exhibit 3):

- Who funds the savings;
- who selects the investment risk;
- who bears the investment risk;
- who determines the form of the post-retirement payout;
- does the plan include portability features; and
- are longevity risks pooled or individual?

> "*Social Security was never intended by itself to provide a secure retirement.*"

Social Security

Social Security is essentially a DB plan funded by taxpayers (including employers and employees), which promises to pay a defined benefit based on contributions made during an employee's working years. For most Americans, Social Security underpins retirement security. In fact, more than one-third of retirees are getting 90% or more of their income from the program.[4] However, Social Security was never intended by *itself* to provide a secure retirement. In addition, the program was designed generations ago for demographics that are significantly different from those that exist today. When Social Security was launched in 1935, a 21-year-old male had roughly a 50% chance of living to age 65 and collecting benefits.[5] Today, life expectancies are closer to 80 years, and about one in four Americans who are 65 today will live past 90.[6] Funding this increased longevity puts a strain on the federal budget, as the ratio of workers paying into the system to retirees has dropped from 5 to 1 in 1960[7] to less than 3 to 1 today, and is projected to be approximately 2 to 1 by 2033.[8] The most recent Old-Age and Survivors and Disability Insurance (OASDI) Trustees report estimates that Social Security reserves will be depleted and unable to pay scheduled benefits in full by 2033.[9]

Not all US workers are eligible for payments under Social Security at retirement, as public employee groups already covered by a plan have the ability to elect whether or not to participate.[10] While federal government civilian employees began to participate in 1984, a number of municipalities have opted not to participate in Social Security on the theory that

Exhibit 3: COMPARISON OF KEY PLAN CHARACTERISTICS

	SOCIAL SECURITY	DEFINED BENEFIT PLANS	DEFINED CONTRIBUTION PLANS
Who funds retirement savings?	TAXPAYERS	EMPLOYER AND EMPLOYEE	EMPLOYEE AND EMPLOYER
Who selects investment risk?	FEDERAL GOVERNMENT	EMPLOYER	EMPLOYEE
Who bears the investment risk?	TAXPAYERS	EMPLOYER	EMPLOYEE
Who determines the form of the post-retirement payout?	FEDERAL GOVERNMENT	EMPLOYER/ NEGOTIATION/ERISA	EMPLOYEE AND EMPLOYER
Does the plan include portability features?	YES	NO	YES
Are longevity risks pooled or individual?	POOLED	POOLED	INDIVIDUAL

4 Fast Facts & Figures About Social Security. www.ssa.gov.
5 Social Security Website, "Life Expectancy for Social Security". www.ssa.gov.
6 Social Security. Calculators: Life Expectancy. www.ssa.gov.
7 Social Security Online – History. Ratio of Social Security Covered Workers to Beneficiaries Calendar Years 1940-2010. www.ssa.gov.
8 Social Security Basic Facts. July 2013. www.ssa.gov.
9 Social Security Administration, "The 2013 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds."
10 The election to participate is done by referendum, involves groups of employees by positions (not individual workers) and since 1983 a decision to participate cannot be changed—once a position is covered it remains so. CRS Report to Congress, "Social Security: Mandatory Coverage of State and Local Employees" (July 2011).

they, and in many cases their employees, contribute to an established DB plan. However, recent events such as Detroit's bankruptcy filing, which seeks to reduce the municipality's retirement obligations, illustrates that retirement security can become more tenuous for career public sector workers who have not accrued credits in the Social Security system.

Defined Benefit Plans

DB plans provide more certainty to employees, as the benefits are generally defined as a certain payout based on years of service, income level, retirement age, vesting, and other variables. During the working years, contributions are made by the employer and/or the employee, and generally employees become vested in their benefits by staying at a single employer for many years. In DB plans, the investment risk is borne by the plan sponsor, and longevity risk is managed by the pooling of all covered employees. As such, the employer holds the ultimate risk. In the private sector, the cost and risk associated with this guarantee has increasingly driven sponsors away from providing this form of benefit as corporations seek ways to de-risk their own balance sheets. In the public sector, underfunding issues are threatening benefits and many municipalities are re-evaluating and modifying various aspects of their plans. Like Social Security, both corporate and public DB plans were created in an era when life expectancies were much shorter and investment assumptions were more optimistic. Today, corporations and municipalities find themselves struggling under the weight of the promised benefits, as discussed in more detail below.

Private Sector DB Plans

According to a recent study by Milliman,[11] as of June 2013, the top 100 corporate DB plans (by accrued liability) had aggregate underfunded liabilities of approximately $179 billion, with a funded ratio of approximately 88%. Given corporations' concerns for their own financial health, combined with current accounting rules, many corporations have taken steps to de-risk. In some cases, this amounts to closing DB plans and shifting to DC plans, essentially transferring investment responsibility and risk to the participant. In other instances, companies have offered participants lump-sum payouts and the option of an annuity purchase.

The closing of DB plans can impact different employees in very different ways. In some cases, existing employees are grandfathered while new employees are excluded, resulting in disparate outcomes for legacy versus new workers. In other plans, all participants are frozen at current levels and future benefits accrue in a DC scheme. A few companies have transferred full elements of a plan's liabilities to an insurance company at a fixed price. The most notable large companies to have done so are GM (for certain retirees; see Exhibit 4) and Verizon. In the cases of shifting to DC plans or providing lump-sum payouts, employees take on the funding and longevity risks, whereas in the insurance transactions, the insurance companies become liable for providing the benefits.

Exhibit 4: GENERAL MOTORS PENSION RISK TRANSFER: A CASE STUDY

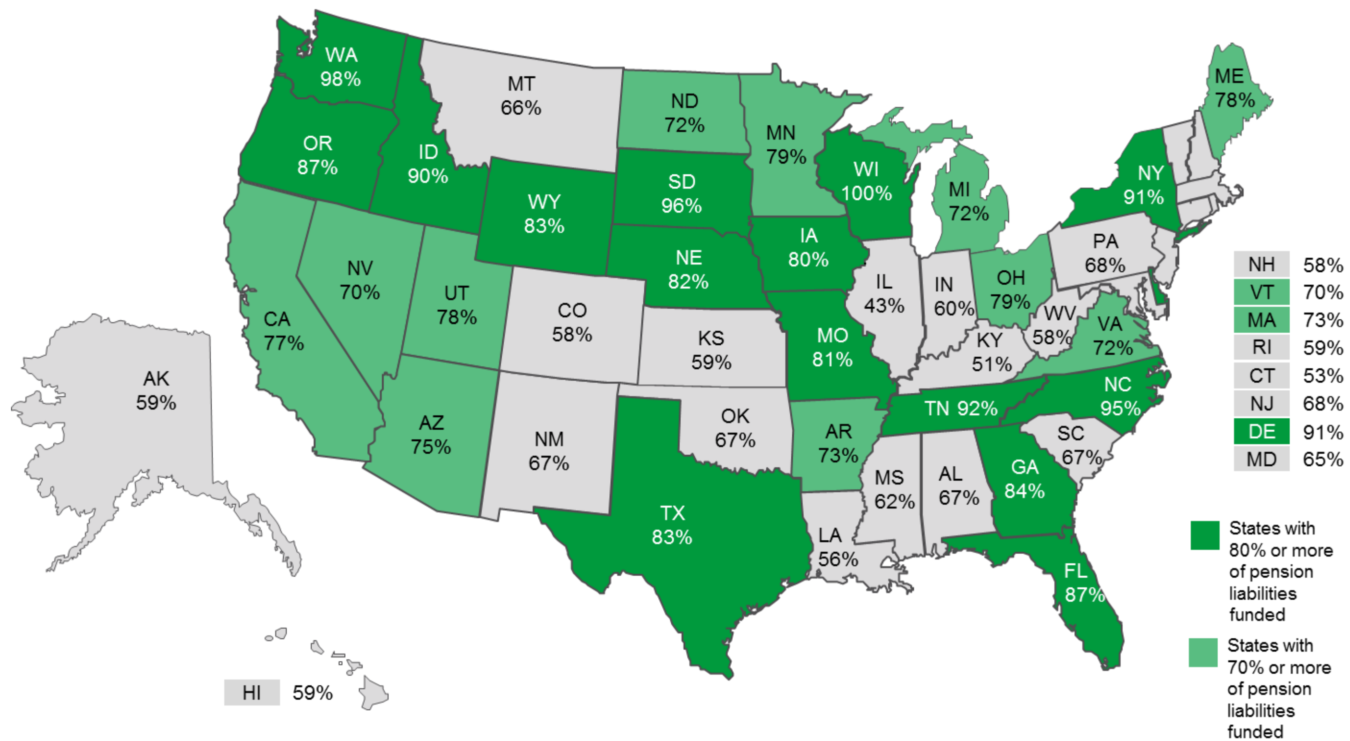
In November 2012, GM executed the single-largest US corporate pension risk transfer through a combination of lump-sum payouts and purchasing a group annuity. GM offered lump-sum payments to a class of existing retirees and beneficiaries, including 44,000 individuals representing approximately 36% of its retiree and beneficiary population. GM purchased a group annuity for 76,000 others, as well as for those who declined the lump-sum offer, effectively transferring the obligation to the insurer. In aggregate, GM reduced its US pension obligations by $28 billion, while protecting retirement security for its retirees and beneficiaries.

Many of the rules governing the design of corporate and multi-employer DB plans, including ERISA, were established in the 1970s and do not reflect today's environment. Unfortunately, the laws are relatively rigid and severely limit employers' ability to modify benefit structures, despite lower investment returns and dramatic changes to longevity expectations. As a result, private sector employers are increasingly exiting DB plans, and the trend towards de-risking existing plans continues.

An important back-stop for private sector employees who are DB plan participants is the Pension Benefit Guaranty Corporation (PBGC). This government entity was created under ERISA in 1974 to provide pension benefits to DB plan participants when an employer becomes insolvent or is otherwise unable to continue to operate and fund its plan. The PBGC also provides limited financial assistance in the form of a guaranty to ensure payment of certain benefits to participants in the case of an insolvent multi-employer DB plan. In its 2012 fiscal year, PBGC reported it had responsibility for more than 4,500 DB plans that were terminated or unable to meet obligations to beneficiaries. In these situations, the payments made to plan participants are capped and these payments are generally at a level that is lower than the benefit originally promised from the employer plan. In order to provide this back-stop, PBGC collects insurance premiums from employers that sponsor insured

11 Milliman, 100 Pension Fund Index (July 2013).

Exhibit 5: UNDERFUNDING OF RETIREMENT OBLIGATIONS BY STATE



Source: Morningstar. Data as of 2011.

pension plans. Over the past few years, these premiums have risen substantially as the government tries to improve the PBGC's funded status. PBGC also receives assets from pension plans that it takes over, and earns money from its investment portfolio. As of its fiscal year-end 2012, PBGC's deficit exceeded $34 billion.[12]

Public Sector DB Plans

Public sector DB plans arguably face even more trouble than those in the private sector. According to Milliman, at year-end 2011, the aggregate underfunding of the largest 100 public pension plans (by accrued liability) was over $1 trillion, with an average funded ratio of approximately 67%.[13] As recently reported, several states and municipalities have significant pension-funding gaps (see Exhibit 5), which are negatively impacting their credit ratings.

In many cases, as municipalities struggled with budgetary and fiscal challenges, pension contributions were delayed, further exacerbating lower-than-projected investment returns.

Many states and local governments have taken the initial steps toward pension reform. Some have addressed their liabilities by placing new hires into DC plans, creating hybrid DB/DC plans, and/or modifying the payouts for future retirees. Some municipalities have raised the retirement age, increased the service requirement for pension eligibility, increased both employee and employer contributions, reduced or eliminated cost of living adjustments (COLAs), and/or issued pension obligation bonds to help fund their retirement systems. Many of these efforts, while laudable, have had only limited impact on the funding status of public DB plans. Additionally, changes that increase costs to employees or alter benefits have in certain cases been challenged in court, delaying implementation. In the extreme case of Detroit, Michigan, retirement benefit woes (including pension and medical benefits) played a large role in the city's bankruptcy filing. Unfortunately, small or deferred changes to pension liabilities only serve to postpone long-term funding issues, which left unsolved, could result in additional cases of municipal distress.

12 PBGC 2012 Annual Report. http://www.pbgc.gov/documents/2012-annual-report.pdf#page=7.
13 2012 Public Pension Funding Study. Milliman. Figure represents "recalibrated figures."

> “Today, the DC plan is the primary or only retirement plan for many US workers.”

Defined Contribution Plans

DC plans were first formalized in the 1980 tax code as a *supplemental savings* plan wherein employees could voluntarily set aside a percentage of their wages for retirement, with employers offering some type and degree of company match. Often the match was in company stock. While the employee’s contributions were immediately vested, the company match generally took several years to vest. The participation rate in these programs varied significantly, with many employees either not participating or opting not to make the maximum allowed contribution. As supplemental savings plans augmenting traditional DB plans, this was not problematic. However, as corporations began freezing DB plans, the role of the DC plan changed significantly. Many newer companies, particularly in the technology sector, have only offered DC plans. Today, the DC plan is the primary or only retirement plan for many US workers. The growth in DC assets among private and public sector employees reflects this more prominent role (see Exhibit 6 “The Growing Role of DC Plans”).

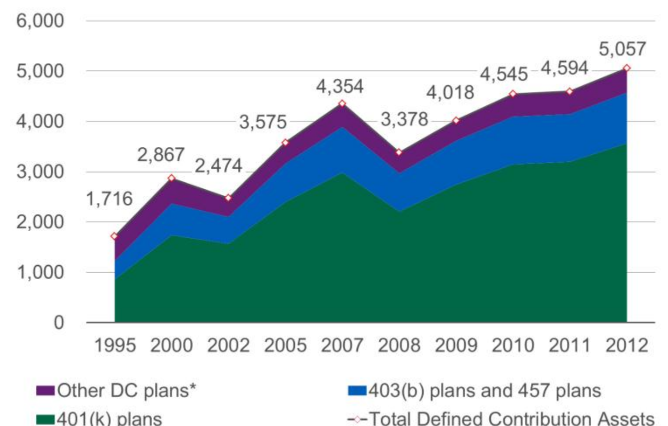
Notably, DC plans shift the investment risk to the participant. Because DC plans most often do not allow for pooled longevity risk, individuals must self-insure against life expectancy. This requires saving for the longest life to ensure they do not run out of money. (Capital pooling, such as that afforded in DB plans and Social Security, recognizes that some individuals live beyond life expectancy while others do not achieve life expectancy, thereby providing for the efficient delivery of lifetime income to all investors in the pool.) To realize income in retirement from a DC plan that is equivalent to a mortality-pool-backed plan, we estimate that individuals will need approximately 30% greater savings.[14]

For a mobile workforce, DC plans have an advantage over DB plans, where eligibility rules may limit vesting. DC monies accrued (both employee and employer vested contributions) are portable. This is significant when you consider that the median number of years a new hire stays with the same employer is approximately 4.6 years. Cliff vesting (the amount of time required at a company to be eligible for some level of benefits) under DB plan rules can be as long as five years; graduated or graded vesting can cover three to seven years.[15] DC plan rules provide for cliff vesting in employer contributions in three years and graduated vesting over six years. Of course, the employee in a DC plan is immediately vested in his or her own contributions.

Exhibit 6: THE GROWING ROLE OF DC PLANS

Over the past three decades, 401(k) plans have grown to be the most common private sector employer-sponsored retirement plan. At year-end 2011, 401(k) plan assets had grown to $3.2 trillion, representing 18% of all retirement assets, with an estimated 51 million workers as active participants.[16] Other DC plans (457 plans for state and local government employees, 403(b) plans for education and tax-exempt employees) are increasingly offered as a supplement or substitute for traditional DB plans. Likewise, beginning in 1986, all new federal civilian employees became eligible to enroll in the Thrift Savings Plan (TSP), which replaced the Civil Service Retirement System, a traditional DB plan. As of 2008, federal employees were auto-enrolled in TSP, and by the end of 2012, the TSP had grown to nearly $330 billion, with 4.6 million participants.[17]

Breakdown of Defined Contribution Plan Assets



*Includes Keoghs and other DC plans without 401(k) features
Source: Investment Company Institute 2013 Factbook

The Pension Protection Act (PPA) of 2006 affirmed the growing role of DC plans and the need to increase participation by sanctioning auto-enrollment of employees (opt-out versus opt-in) and auto-escalation of contributions.[18] Prior to PPA, the vast majority of employees held a combination of company stock and conservative fixed income funds in their 401(k) accounts. Following the authority granted in the PPA, the Department of Labor (DoL) issued regulations that authorized as “qualified default investment alternatives” a series of asset allocation products, including target date funds, balanced funds and managed accounts, for those participants who fail to make their own investment elections. Not addressed by the PPA is the post-savings phase during which participants have to draw on their savings to provide income and fund their retirement years.

14 Source: BlackRock; Calculated using BlackRock’s CoRI Index methodology to estimate the fair value of 30 cash flows starting at age 65 discounted for mortality, compared to the estimated fair value of the same series of cash flows unadjusted for mortality.
15 “Employee Tenure in 2012”. US Bureau of Labor Statistics. Economic News Release. September18, 2012. http://data.bls.gov.
16 EBRI Issue Brief, No. 380 (December 2012).
17 Thrift Savings Fund Financial Statements. December 31, 2012 and 2011.
18 Auto-enrollment has been shown to increase employee participation rates. AON Hewitt’s 2013 Universe Benchmarks report on employee savings and investing behavior in DC plans found that the participation rate for employees subject to automatic enrollment was 81.4% versus 63.5% for those not subject to automatic enrollment.

Hybrid Plans

A number of private- and public-sector employers have moved to "hybrid plans"—a catch-all phrase that covers variations on what is essentially a plan with some level of minimum benefit provided by the employer. The most common type of hybrid plan is known as a cash-balance plan, which is a DB plan that defines the benefit in terms that are more characteristic of a DC plan, inasmuch as it defines the promised benefit in terms of a stated account balance. This type of plan credits the employee's individual account using a set percentage of salary, and this account value grows in line with investment credits and future service credits. There can be a choice over investment risk profiles, but the employer manages the savings and investments during the employment period, much like a DB plan. Upon retiring, the individual typically takes the accumulated amount or lump sum as a benefit and assumes responsibility for managing his or her money with regard to investment and decumulation strategies. Alternatively, he or she may select an annuity based on the balance available to fund the annuity at that point in time.

Personal Savings Plans

A variety of retirement-savings programs exists for individual investors and those who are either self-employed or not covered by an employer-sponsored plan. IRAs are the most common, holding an estimated $5.4 trillion in assets at the end of second quarter 2012.[19] The growth in IRA assets in both absolute and relative terms is staggering. While the overall value of retirement assets has increased, IRAs have grown to represent approximately 28% of US total retirement assets as of 2012 compared to 19% nearly two decades ago, in 1995.[20]

The second most common is the Keogh plan, which is named after its Congressional sponsor (the late Rep. Eugene Keogh of NY) and principally designed for small-business owners. Keogh plans have higher contribution limits than other qualified plans. However, the plans' popularity is constrained somewhat by the fact that it entails considerable paperwork to set up, maintain and calculate payouts.

Self-directed retirement plans, whether employer-sponsored or personal savings plans, raise particular challenges as to the ability of participants to make asset allocation and specific investment decisions that are neither too conservative nor too risky. Many participants simply do not have the knowledge, interest or time to manage their own retirement assets. And for those at retirement age, further decisions need to be made about how and when to take distributions to avoid outliving their savings. Decumulation strategies have become ever more critical as a large portion of the population moves into retirement. This was traditionally a period to de-risk investment strategies. However, assuming retirement at age 65 and longevity estimated at 80+, many individuals are facing a retirement investment horizon of 15 years or more. As such, an appropriate amount of risk must be taken to hedge longevity risk (i.e., the risk of outliving savings). As DC plans become the dominant retirement savings vehicle, these risks are often borne by the individual. The dilemma of what to do with savings post-retirement is as real and complex as how to save and invest in the accumulation phase.

Changes Currently in Contemplation

Given the magnitude of the retirement-funding challenge, the state of retirement programs has earned attention at both the federal and state levels. Changes have been proposed, some of which alter the weight and responsibility of liabilities and some that affect the assets of retirement plans. A survey of the US retirement landscape would not be complete without acknowledging these proposals and their potential implications for Americans' retirement readiness.

Senator Harkin's White Paper

In July 2012, Senator Tom Harkin (D-SD), Chairman of the Senate Health, Education, Labor and Pensions (HELP) Committee, issued a white paper proposing a two-part plan for resolving the retirement crisis. One part would provide universal access to a new type of private pension plan that the paper calls "Universal, Secure and Adaptable" (USA) Retirement Funds. Employers that did not offer a workplace retirement plan with automatic enrollment and a specified minimum level of employer contributions would be required to automatically withhold a portion of employees' pay that, along with any employer contributions, would be pooled in funds that would be professionally managed. Participants would earn lifetime income benefits, with the monthly payment determined based on an individual's total contributions and the investment performance in the funds selected by the individual over time. The second part of Senator Harkin's plan would enhance the Social Security program by changing the benefit calculations to increase payments, paying for these changes by eliminating the cap on wages subject to Social Security taxes.

This paper is largely conceptual and still in a very early stage. The HELP Committee has held numerous hearings on these proposals and other suggestions for improving retirement security. The portability of the employee accounts is seen as a positive; however, some concerns have been expressed. Some employers are wary of a government mandate requiring their participation and contribution, especially if potential fiduciary liability issues are not adequately addressed. A

19 ICI, 2013 Investment Company Fact Book. www.ici.org.
20 2013 Investment Company Fact Book. Figure 7.4: US Retirement Assets Rose in 2012. Investment Company Institute. www.ici.org.

significant infrastructure build to payroll and other systems may be necessary in order to manage contributions and withdrawals and provide recordkeeping services for both the investment managers and employees. And of course, concerns have been raised about what is essentially a large tax increase to fund expanded Social Security benefits.

Senator Hatch's Proposed Legislation

In July 2013, Senator Orrin Hatch (R-UT), Ranking Member of the Senate Finance Committee, introduced legislation that would address several retirement issues. The most publicly discussed feature would provide public sector employers the ability to fund annuities for their employees, with the annuities managed by insurance companies and backed by the state insurance guaranty funds. This would be a new type of plan that appears to be only for future benefits. The proposal for public sector annuitization is well intentioned; however, it presumes the government entities that sponsor these plans will have sufficient resources to purchase annuities (especially since many public sector plans have been chronically underfunded). Reliance on the state insurance guaranty funds is intended to eliminate concerns about the failure of any particular insurance company, but could challenge the available resources of these guaranty funds which are, in turn, funded by all insurers in a particular state. Title II of the bill proposes a number of improvements for existing private sector DB and DC plans, including enhancements to DC plans' auto-enrollment and auto-escalation. Title II also includes necessary improvements to ERISA and the tax code to advance the concepts introduced in the PPA, and to preserve existing DB plans.

Department of Labor Proposal

The Department of Labor (DoL) has oversight for all pension plans governed by ERISA and Section 4975 of the Internal Revenue Code, which includes private sector DB plans, 401(k) plans, and IRAs.[21] In late 2010, the DoL proposed sweeping changes to the definition of "fiduciary" under ERISA. These changes would have had profound effects on plan sponsors, plan participants, IRA investors, custodians and other market participants. Although the proposed rule was withdrawn, the DoL intends to offer a revised proposal before year-end 2013. A key concern related to the initial proposal was that it could impede investors' ability to obtain needed advice on how to manage their retirement savings. Plan sponsors were concerned that the education they provide could be construed as advice, and advice providers, such as investment advisers and brokers, were concerned that becoming an ERISA fiduciary might limit investor choice on investments and how they choose to pay for services. It will be important for the re-proposal to address these and other considerations.

President Obama's Proposed Budget

While most proposals related to retirement tacitly aim to improve the current system, it is clear that the retirement saving crisis competes with other national priorities. In the budget proposal released by the Administration in April 2013, tax incentives tied to retirement savings are targeted for change as a potential source of incremental revenue. These proposals seek to limit an individual's deduction for contributions to retirement programs to an effective rate of 28%, and to limit the lifetime accumulation of funds in qualified plans (including 401(k) and IRA assets) to approximately $3 million. This factors in the estimated amount needed to purchase a $200,000 per annum annuity, and reflects the Administration's view that "wealthy" taxpayers should be subject to higher effective tax rates. This proposal to reduce retirement savings incentives ignores the fact that, for many types of plans, taxes on retirement savings are deferred, not eliminated. Not only do these proposals fail to acknowledge that most distributions are taxed when received at then-prevailing ordinary income rates, but they also send mixed messages to Americans about the importance of retirement savings. Unfortunately, these proposals would introduce additional complexity into the retirement system for service providers and taxpayers at a time when simplification is needed to increase both employer and employee participation.

Reinforcing America's Retirement Funding Framework

Retirement security is a complex problem to solve, especially given the large number of legacy components, the wide range of stakeholders, and the significant financial and fiscal implications inherent in any action—or inaction. On a positive note, the consensus appears to acknowledge the importance of retirement savings and there is a growing sense that bold steps may be required to address the current situation.

While the prevailing retirement funding model is broadly three pillars—i) Social Security, ii) employer-sponsored plans and iii) personal savings—we would argue that each pillar has become weaker and is in urgent need of reinforcement. As already discussed, several components of retirement funding are sagging under their weight. Based on today's longevity expectations and projected needs in retirement, all three of these critical building blocks need to be strengthened and modified, as discussed below. Ideally, policy makers can take a holistic rather than a piecemeal approach; however, we recognize this will require tremendous coordination and cooperation. Retirement savings is a national issue and the dialogue must begin immediately.

21 Enforcement issues relating to IRAs are the province of the Internal Revenue Service.

"The consensus appears to acknowledge the importance of retirement savings…there is a growing sense that bold steps may be required to address the current situation."

Pillar I: Social Security

If Social Security were to be re-fashioned to its original purpose—principally a safety net program for those who need it and only a small part of retirement assets for those who don't, then policy makers could consider major revisions to those aspects that drive Social Security liabilities, including eligibility requirements and participant benefits. While currently controversial, serious consideration must be given to increasing the retirement age for those who are currently far from retirement, as this would more accurately reflect changes in health and longevity. As proposed in President Obama's recent budget, COLA calculations need to be altered. Additionally, means testing or a benefits cap for those who have other significant sources of income or savings should be considered. Finally, the issue of funding disability income programs from the same source of tax revenue needs to be reconsidered, as the explosion of disability claimants contributes significantly to Social Security liabilities, threatening the program's ability to meet its retirement funding promises.

The asset side of Social Security also needs to be re-evaluated. Under the current system, employer and employee contributions are invested in US government securities and held in one of two trust funds (one for retirement benefits and the other for disability payments). The system is "pay as you go," meaning existing workers help fund benefits for retirees and those collecting disability. As demographics shift and the ratio of workers to retirees declines, the trust funds are being depleted. By investing Social Security tax payments in a wider range of assets, the value of the trusts could be maximized and the reliance on funds from current workers could be reduced.

Reinforcing (and Relieving) Social Security

- Re-establish Social Security as a "safety net" and not the primary source of retirement savings.
- Consider increasing retirement age to account for increased longevity.
- Alter COLA calculations, as proposed in Obama budget.
- Consider means testing or benefits cap where other large sources of retirement income exist.
- Section out the funding of disability income.
- Invest Social Security funds in a wider range of assets to maximize trust values.

Pillar II: Employer-Sponsored Retirement Plans

Despite the wide range of employer-sponsored plans that exist, there are still many employees who are not covered by any of these plans. In our new paradigm, all employers, from small to large, would be incentivized to provide retirement benefits to all full-time and part-time employees. This includes evaluating tax incentives, funding requirements, and administrative burdens with the intention of encouraging employers to offer defined contribution and/or defined benefit plans.

"In our new paradigm, all employers, from small to large, would be incentivized to provide retirement benefits to all full-time and part-time employees."

As a first order of importance, we need to improve the fiscal health of existing DB plans using sound actuarial and investment return assumptions. Under the PPA, corporate plans were to be fully funded by 2015. This seemed highly achievable in 2006, but subsequent market downdrafts and a historically low interest-rate environment (which has kept liability discount rates lower) caused corporate plans to seek further flexibility in calculating corporate pension obligations. Specifically, legislation enacted in 2012[22] affords corporations the ability to discount liabilities at a higher assumed rate of return, effectively reducing the contribution amount required to reach fully funded status. While this may have short-term benefits, corporations still need a means to get their DB plans to a fully funded state. This could be achieved through some combination of tax incentives, the increased use of employer securities or property, and/or changes to benefits rules that would enable plans to improve their funding status.

Likewise, states and municipalities must address their underfunding sooner rather than later. Changes and proposed changes to accounting rules for government-sponsored retirement benefits obligations are expected to increase the stated liabilities for these plans and make the funding challenges greater. Moody's recently said its rating criteria will factor in discounting these liabilities at a risk-free rate, increasing ratings (and funding) risks for public plan sponsors. Many states have begun the process of addressing underfunding by increasing funding and/or decreasing liabilities. Realistically, more needs to be done to put these plans on a path to fiscal health.

22 Moving Ahead for Progress in the 21st Century Act (MAP-21). For more information on MAP-21 and its impact on private plans, see BlackRock's "Corporate Pension Funding Update". (August 2012).

Another important order of business relates to the challenge of lifetime income generation for plan participants. While most initiatives to date (such as auto-enrollment and auto-escalation in DC plans) are focused on bolstering the accumulation stage of retirement funding, the decumulation phase requires equal attention. Investors have little guidance when it comes to drawing income from their savings in a manner that will ensure their assets do not fall short of their longevity. This topic is discussed in Exhibit 7.

Meanwhile, cost and complexity for employers also needs to be addressed. Many employers, especially smaller companies, are reluctant to offer pension plans based on concerns regarding administrative costs, the risks of compliance errors, and fear of litigation. The current system includes a complex set of tax and ERISA rules, and creates concerns about potentially large legal exposures. Congress or the DoL should provide clear and simple guidance for plan sponsors to avoid unnecessary liability. For example, so-called "excessive fee" cases now being brought against DC plan sponsors could be appropriately addressed by providing a safe harbor and an affirmative defense to these cases if the plan sponsor sought bids through an RFP, required responses to specific questions, and had a robust evaluation process.

"Congress or the DoL should provide clear and simple guidance for plan sponsors to avoid unnecessary liability."

We recommend a comprehensive review of legal/compliance burdens imposed by ERISA and similar state laws to determine what rules are truly necessary to protect participants. Those that are not required should be eliminated so as to simplify and streamline the system.

Exhibit 7: THE RETIREMENT INCOME CHALLENGE

While auto-enrollment and auto-escalation have facilitated the "accumulation" side of the equation when it comes to DC plans, the challenge of "decumulation" has yet to be effectively addressed. Following are some proposals and recommendations intended to tackle the challenge of drawing income in an era of increased longevity:

Establish "longevity annuities:" These are part of a package proposed by the Treasury Department intended to remove some of the impediments underlying retirement income distribution. Essentially, an annuity that costs no more than 25% of a participant's account balance or (if less) $100,000 and that will begin by age 85 is not subject to the minimum distribution requirements. The goal is to promote the use of such annuities in DC plans and IRAs by eliminating the risk that the participant will outlive his or her assets or have insufficient liquid assets to take the required minimum distributions before he or she reaches age 85.

Expand mortality pools: Regulators might consider extending the reach and capabilities of mortality pools. The current structures, and the regulations underlying them, have remained largely unchanged for close to 100 years. As a result, these structures are not able to take advantage of the numerous financial innovations that have taken place over time. The ability to create and administrate mortality pooling structures for DC plans could have far-reaching benefits.

Offer clear guidance: Changes are needed to make it easier for plan sponsors to provide lifetime income options. The DoL should issue its long-awaited guidance on the fiduciary responsibilities of employers in providing "income" in the form of an annuity, a guaranteed minimum withdrawal benefit or others as a distribution option from a DC plan. Absent guidance similar to what the DoL provided with respect to qualified default investment options, plan sponsors will be reluctant to adopt these distribution options. Similarly, the Treasury should clarify its regulations related to employees' investment options when taking distributions from qualified plans — options that include annuity contact investments or guaranteed minimum withdrawal benefits. Lack of clarity here continues to impede employer adoption.

Expand portability: The portability of in-plan lifetime income options should be considered. If an employer plan discontinued lifetime income, affected participants should be allowed to roll over the entire amount invested in the lifetime income-related investment to an IRA that provides the same or similar lifetime income protection. This would allow participants to preserve the guarantee feature and their already-paid-for protection.

Promote innovation. The DoL's recent proposals to provide information on benefit statements as to projected income in retirement are well meaning. However, if this information is mandated in a prescriptive manner, it will halt the progress and innovation that the industry has shown in developing methodologies to illustrate to participants what they can expect in retirement. Plan fiduciaries that provide such information using reasonable assumptions (based on accepted financial theories) should be afforded a safe harbor so as to encourage additional innovation in this area.

This review should include an analysis of all the disclosures and information provided to participants to determine whether they are serving their intended purpose, as the preparation and dissemination of this material imposes a cost on all service providers that ultimately affects the monies available for benefits. We recommend a similar approach to simplifying tax rules and related compliance.

We are intrigued by California HB 2345 (see Exhibit 8) and similar proposals under consideration by various state legislators. In these plans, employers would enroll workers in a DC plan where the assets are pooled and will be managed by the state retirement systems or other investment professionals. We applaud these ideas as innovative and encouraging a way to address the need for retirement savings. However, we are also cautious that issues regarding the cost to employers and the applicability of ERISA and other legal issues will need to be addressed. Whether as part of these programs, or under current rules, we recommend increasing "start-up" tax credits and other incentives to encourage employers to create plans and to include part-time employees in these plans. The current tax credit of $500 for creating a DC plan significantly understates the true costs to an employer of establishing a plan.

Reinforcing Employer-Sponsored Plans

- Improve the fiscal health of existing DB plans; restore funding levels.
- Consider tax incentives to encourage employers to offer DB or DC plans.
- Address the problem of decumulation/income distribution with better guidance and clarity around existing rules.
- Assess and modify the costs and complexities that discourage employers from establishing plans.
- Review compliance burdens imposed by ERISA and similar laws at the state level; retain necessary protections and eliminate unnecessary rules that discourage employers from establishing plans.
- Encourage innovative public/private partnerships that have the potential to increase overall participation.

Pillar III: Personal Savings

As discussed above, in 2006, the PPA introduced significant changes for defined contribution plans. These changes, as implemented over the last six years, have generally positioned DC plans to better deliver to younger workers on the promise of sufficient funds for their retirement. Even with these improvements, 32%[23] of employees eligible to participate in an employer-sponsored DC plan fail to do so, or do so only at minimum levels. One potential solution is to require those employees whose employers provide a plan to participate and at a specified minimum contribution level based on salary. If an employee has retirement savings in the aggregate from other sources (such as a DB plan from a prior employer or an IRA) the minimum contribution could be modified. On the other hand, a 3% contribution rate, as suggested by the California legislation, without other retirement resources, is insufficient to provide for appropriate retirement savings.

Exhibit 8: PRIVATE SECTOR EMPLOYEE ACCESS TO PUBLIC PLANS

California recently enacted legislation (HB 2345) intended to create a publicly administered retirement savings program for its private sector workers. It would require private employers that do not provide a retirement plan to automatically enroll their employees in a state-run plan and deduct 3% of earnings as the employee contribution. The goal is to provide employees with a retirement plan to accumulate assets, and to couple this with professional management of these assets. Such a program must clear several hurdles before implementation, including: a feasibility study, relief from ERISA liability granted by the DoL and IRS, start-up funding, and a return to the legislature for final approval to move forward. Of note, additional state level policy makers are considering similar programs to this one if it succeeds. While this could be a positive development, we remain concerned that 3% is not sufficient as a complete solution.

Another potential solution is to mandate personal retirement savings, as has been done in Australia (see Exhibit 9). This would require a phased-in approach starting with a small percentage of income that increases each year, accompanied by tax deferral or other tax incentives. Care would need to be taken so as not to encourage employers to drop existing plans, be they DB or DC. A mandated savings program would allow Americans to build wealth over time. Ideally, individuals could accumulate as much as they want; however, the mandatory savings might become voluntary above a specified level. Depending on the program, individuals could be allowed to direct their own investments or invest in government-sponsored pools.

The merit of such an approach is perhaps best illustrated in the numbers: consider that an individual retiring at age 65 today who made the maximum contributions to Social Security will collect annual benefits of roughly $28,500 a year. Based on current tax rules, the retirement saver and his/her employer has to contribute more than 12% of eligible yearly income to the Social Security trust fund every year. If that same amount were invested in a diversified portfolio of

23 EBRI, Issue Brief (November 2012).

90% US stocks and 10% US bonds when the worker was 30, gradually adjusting to a more conservative mix of 60% bonds/40% equities over time, the retirement income after 35 years (based on actual historical returns) would be approximately $42,000.[24]

Exhibit 9: AUSTRALIA SUPERANNUATION FUNDS: A CASE STUDY

The Australia Superannuation Fund System enhances retirement security and is composed of three parts.

1. A mandatory employee contribution requirement established in 1986 (originally 3% and scheduled to rise to 12% by 2020, which is invested in privately managed funds (subject to government oversight) chosen by the employee. Investments in Superannuation Funds reached AUS$1.58 trillion[25] at the end of March 2013.
2. Mandatory savings augmented by tax-incentivized voluntary savings.
3. A government-provided, means-tested minimum payment, funded through general revenue taxes, provides a "safety net."

The result is a higher overall level of savings (savings in Australia's Superannuation System is nearly one quarter of the country's GDP[26]), enhanced retirement income, and less pressure on the government budget.

Increasing the level of retirement savings is important, and individuals need information that will help both with determining the optimal level and how to anticipate the yearly income post retirement that a certain amount of savings will produce, As the focus has begun to turn to decumulation, a number of ways to calculate future potential income have been put forward, and these methodologies continue to evolve. BlackRock's CoRI™ Retirement Indexes (described in Exhibit 10) are the latest example of this evolution.

Reinforcing Personal Savings

- Establish savings targets and allow individuals to meet them using a combination of employer-sponsored and individual savings.
- Mandate personal retirement savings perhaps via a phased approach that gradually increases income contributions over time.
- Offer tax deferral and other incentives to encourage participation.
- Provide savers with the option to direct their own investments or participate in government-sponsored pools.
- Address decumulation/income distribution with clear guidance.

Exhibit 10: BLACKROCK'S CoRI™ RETIREMENT INDEXES

The years just before retirement can be among the most anxious, as participants struggle to answer the critical question: "Do I have enough money to retire?" BlackRock's CoRI™ Retirement Indexes (CoRI Indexes), launched in June 2013, are one resource that may help. This new suite of US bond indexes tracks the estimated cost of $1 of future, cost of living-adjusted annual lifetime income starting when an individual turns 65. In other words, they provide a quick, simple method for estimating the retirement income potential of a lump sum savings, or conversely, the amount of savings needed to meet an income goal, as early as 10 years before retirement. Updated daily based on publicly available, real-time market data, each CoRI Index consists of an investable portfolio of US dollar-denominated corporate bonds, US government bonds and US Treasury STRIPS. The CoRI Indexes are not a product and do not "lock in" any course of action. They simply offer individuals, advisors, consultants, and plan sponsors a more precise, transparent and flexible benchmark for retirement readiness, during the critical "pre-retirement" period, when good planning and appropriate course-correction are vital. For more information and to interact with the tool visit www.blackrock.com/cori.

1. Index level reflects the CoRI Index 2018 level as of 30 July 2013 (Source BlackRock).

24 Source: BlackRock. Calculated using price only returns.
25 APRA, Quarterly Superannuation Performance, March 2013.
26 Represents 2006-2010 average gross national saving as a percent of GDP. Australian Government Treasury. Economic Roundup Issue 3, 2011. http://www.treasury.gov.au.

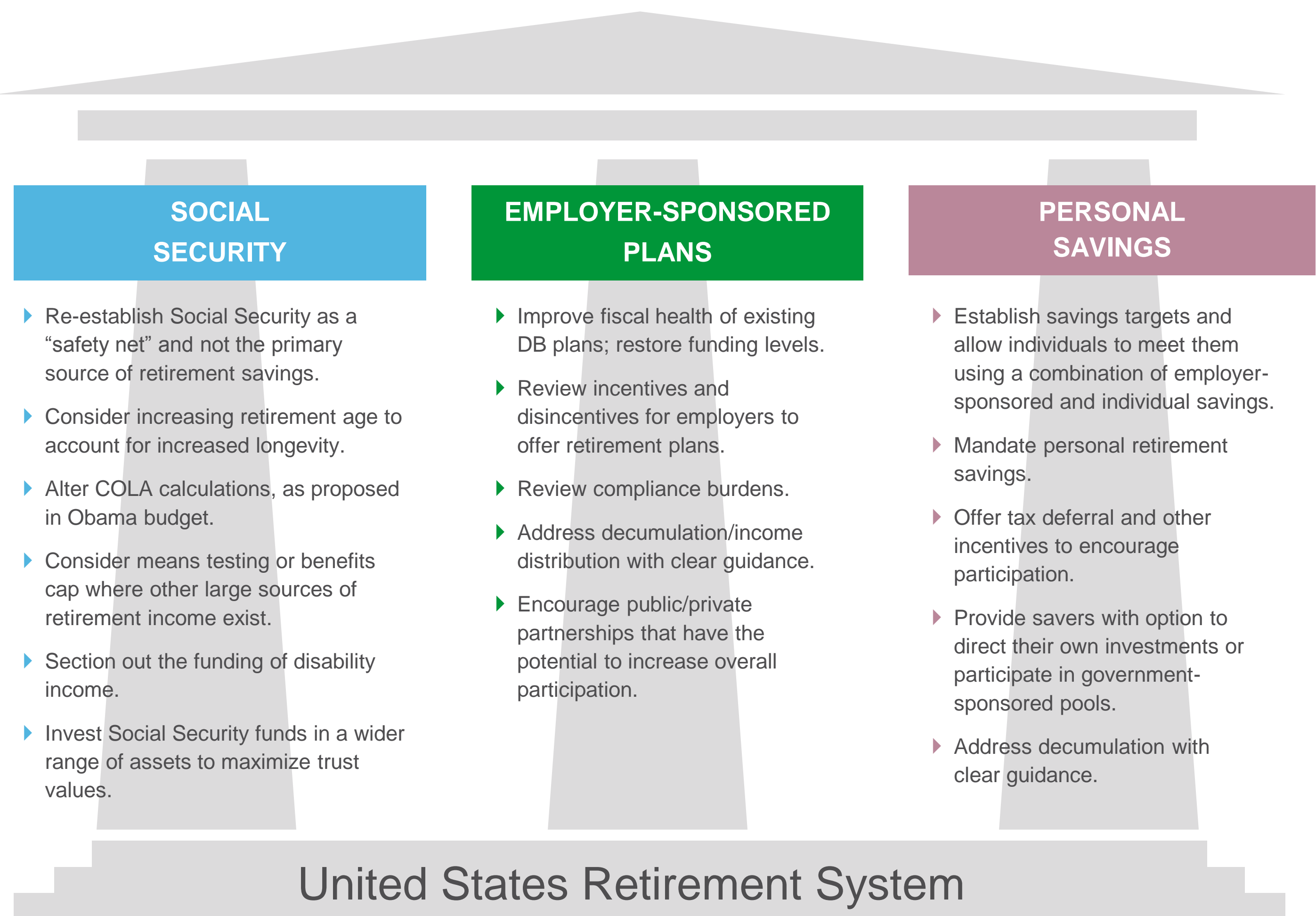
Conclusion

Retirement is an eventuality for every American, making it perhaps the most unifying of financial goals. Yet the funding of that goal is increasingly strained as lifespans increase and the potency of the existing retirement saving paradigm wanes. While steps have been taken and proposals made to address many of the existing programs on the margins, these have offered Band-Aids rather than the wholesale reinforcement and restructuring that is needed. Worryingly, the problem only gets larger the longer it remains unaddressed.

Clearly the Social Security pillar of the US retirement system needs to be preserved, as it provides important disability and survivor protections that all Americans deserve. However, we believe there is a strong case for bolstering the remaining two pillars, particularly the personal savings pillar, to ensure Americans have the financial means to see them through many years of retirement.

As an investment manager and fiduciary for our clients, BlackRock is responsible for billions of dollars in invested retirement assets. We see the retirement crisis clearly and firsthand, and we understand the need to act before the financial well-being of scores of Americans is jeopardized. It is imperative that policy makers consider a holistic approach now—one that bolsters each pillar of retirement savings (see Exhibit 11). Only in this way is it possible to ensure that all Americans have the hard-earned opportunity to enjoy their longer lifespans without the burden of financial hardship.

Exhibit 11: RECOMMENDATIONS FOR THREE PILLARS OF RETIREMENT SECURITY



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