Solvency Risk

Are you planning on the government or your employer to take care of you in retirement?
Many investors nearing retirement assume that Social Security, Medicare, and defined-benefit pension plans will meet the majority of their retirement needs. However, demographic and economic forces are placing these systems under extreme stress. Social Security and Medicare are likely to reduce benefits over time, while pension plans frequently default or reduce benefits to those already in retirement.

If your current retirement planning depends on promises made by the government and former corporate employers, beware! Many retirees are grappling with the prospect that the benefits they were counting on in retirement may be reduced or even eliminated.

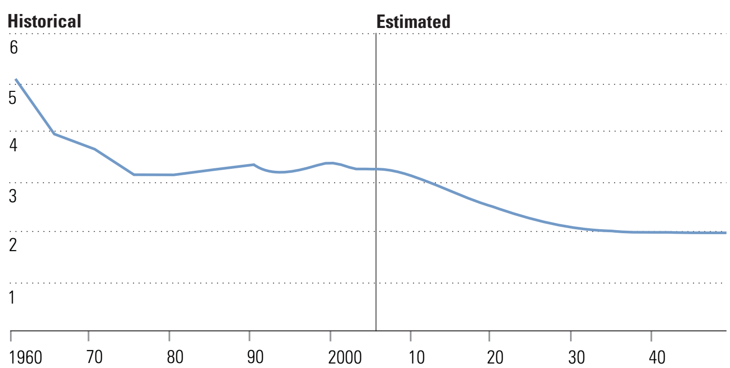
In an article in October 2005, Time magazine aptly referred to this situation as the "wholesale downsizing of the American Dream." What the struggling retirees highlighted in this article didn't account for was solvency risk, that is, the possibility that a corporation or even the U.S. government can't afford to honor the promises they have made to you. While this risk may not affect all retirees, the impact will be dramatic for those it does affect.

Three distinct systems that retirees rely on are subject to significant solvency risk—Social Security, Medicare, and defined-benefit pension plans.

Social Security benefits will need to be cut

Contrary to popular belief, Social Security is not a "trust fund," but rather a "pay-as-you-go" system: The Social Security taxes taken out of workers' paychecks are used mainly to pay benefits to today's retirees. Social Security has been taking in more money than it has had to pay out since the 1980s. Rather than locking away the surplus, it is loaned to the U.S. Treasury in the form of special Treasury bonds, and can be spent at the government's discretion.

Social Security is under strain from fewer workers per retiree[1]
Ratio of Workers to Beneficiary



Such a pay-as-you-go system depends upon a healthy balance of money being paid into it each year relative to money being paid out each year in benefits. The image above is based on information from the Social Security Administration which indicates how the number of workers paying into the system for every person receiving benefits has plummeted from 42 workers per beneficiary in 1945 to 3.3 in 2006. It is projected to fall to 2.1 workers per beneficiary by 2040.

In the face of such demographic pressure, the Social Security system will eventually collapse unless Congress acts to increase payroll taxes, reduce benefits, or push back the eligibility date for benefits. All three actions are likely. The Social Security Administration estimates that benefits paid will exceed payroll taxes collected by 2017, at which point it will begin calling in all the Treasury bonds it has issued in order to continue making benefit payments. By 2040 there won't be any bonds left to call in, at which point the Social Security Administration would be forced to reduce benefits.[2]

Will Medicare cover all your medical needs in retirement?
In the past, Medicare used to provide all the medical insurance coverage necessary for retirees. Today, as retirees are living longer and striving for healthier lifestyles, Medicare is insufficient to meet your needs. There are gaps in Medicare's coverage forcing retirees to look elsewhere for supplemental health insurance coverage. Medicare benefits continue to be reduced or cut and the overall coverage provided is not keeping up with rising health-care costs.

What is covered and what is not covered by Medicare?
Medicare provides health insurance coverage to elderly and disabled people. It is the second-largest U.S. entitlement program after Social Security, and like Social Security, is a "pay-as-you-go" system. In 2005, Medicare spent about $330 billion on health care benefits for 42.5 million people[3].

Medicare consists of two programs—Hospital Insurance (HI) and Supplementary Medical Insurance (often referred to as Part B). The HI program pays for inpatient care in hospitals, some stays in skilled nursing facilities, some home health care, and hospice services. The Part B program pays for services from physicians, medical suppliers, and outpatient care facilities as well as for some home health care. Medicare also added a prescription drug benefit in 2006, called Part D, which requires a separate premium for those who elect it.

Many experts believe that the solvency risk of Medicare is even more severe than that of Social Security. While both programs face similar demographic challenges, Medicare also is impacted by the rate of health-care inflation, which recently has run about 2% higher than the overall rate of inflation. As a result of these two pressures, Medicare's annual costs, currently about 60% of Social Security's costs, are projected to surpass Social Security's in a little more than 20 years.

The Board of Trustees for Medicare estimates that Medicare benefits paid will exceed taxes collected by 2006 and Medicare will be bankrupt in 2018. As with Social Security, Medicare will require some combination of higher taxes and lower benefits to resolve this solvency issue.

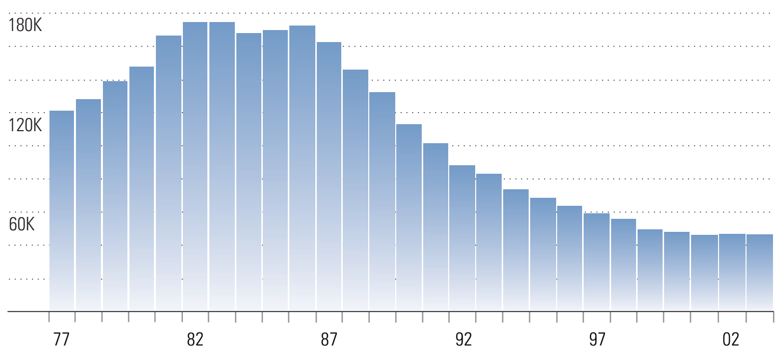
Medicare Part B and Part D are projected to remain financed into the indefinite future because current law automatically sets financing each year to meet the next year's expected costs.

As you review your own health status and family history, it is essential that you start planning earlier rather than later. Medicare will not cover all of your medical expenses in retirement.

Traditional pension plans are a thing of the past

Traditional defined-benefit pension plans offered by corporations are subject to the same demographic pressures as Social Security. In addition, corporations are under enormous pressure each quarter to deliver profits, which can be significantly reduced by their pension liabilities. That is a dangerous combination.

Employers are cutting defined-benefit plans[4]
Number of defined benefit plans 1977–2003



Corporations are cleaning up their balance sheets by reducing their pension and health-care liabilities. Many are replacing the traditional defined-benefit pension plan that pays a benefit for life with a defined contribution plan in which the responsibility for saving for retirement falls squarely on the employee. The image above shows how the number of corporations offering defined-benefit pensions has decreased 73% since 1983.

Other companies are reducing or eliminating benefits for employees who are in or near retirement. For example, from 1988 to 2006, the percentage of employers with more than 200 workers offering retiree health insurance fell from 66% to only 35%[5]. When such benefit cuts occur, people don't have enough time to respond.

For example, *The Wall Street Journal* reported on a couple who, at the husband's retirement date, elected to receive a reduced monthly benefit in retirement in exchange for a spousal benefit that would continue to pay the wife a pension in the event of the husband's death. But the company eliminated the spousal benefit one month before the husband died, so the wife did not receive the pension benefit. The corporation was not required to "make whole" on the money the couple would have received by not taking the spousal election. Broken promises like this are becoming quite common.

Questions to ask your advisor:

- Should you assume your full Social Security benefit will be paid over your retirement, or would it be safer to assume a reduced benefit?
- Should you assume that your Medicare benefits will be reduced? To what degree will your Medicare premiums increase over time to keep pace with health-care inflation?
- If you have a corporate defined-benefit pension:
  - How financially stable is your employer?
  - How adequately funded is your pension plan?
  - What rate of return is your employer assuming on pension assets?
  - Should you take your benefit as a lump sum instead of as an annual benefit?
  - Should you elect a spousal benefit in exchange for lower monthly benefits?
  - Should you consider annuitizing a portion of your savings in order to create guaranteed pension-like income?

So, how widespread is solvency risk for defined-benefit plans? Very. The Pension Benefit Guarantee Corporation, the government agency responsible for guaranteeing corporate pension benefits, estimates that corporate pension plans are underfunded by $350 billion. In 2005 and 2006, the PBGC assumed responsibility for 120 and 94 insolvent pension plans, respectively.

In total, the PBGC now overseas 3,683 pension plans for approximately 1.3 million people. It has added nearly 900,000 participants since 1994. Solvency risk doesn't discriminate and there is a good chance your corporate pension plan could be next, especially if you work in struggling industries, such as steel, auto, and airlines.

[1]Source: Social Security Administration.

[2]Source: "The 2006 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds," Social Security Administration, May 2006.

[3]Source: "2006 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds," Centers for Medicare & Medicaid Services, U.S. Department of Health and Human Services, May 2006.

[4]Source: "Private Pension Plan Bulletin, Abstract of 2003 Form 5500 Annual Reports," October 2006, United States Department of Labor, Employee Benefits Security Administration.

[5]Source: The Kaiser Family Foundation and Health Research and Educational Trust Employer Health Benefits 2005 Annual Survey.