

IS A BAILOUT NEEDED FOR THE U.S. RETIREMENT SYSTEM?

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ABSTRACT

Within the last year there has been a bailout of commercial banks, investment banks, AIG Insurance Company, the two giant secondary mortgage companies (Fannie Mae and Freddie Mac), and the US automobile industry. These bailouts have cost taxpayers billions of dollars. Bailouts are now being requested by state and local government entities that had invested operating funds in conservative, interest-bearing securities until needed. Those safe, highly rated securities were issued by Lehman Brothers, and became worthless when the firm failed. The purpose of this paper is to evaluate another area where another bailout may be requested in the not too distant future, the U.S. retirement system. The paper will explore the causes of the crisis that is developing in our retirement system, the consequences on the economy, and what can be done now by individuals, employers, and the federal government to avert the problem.

INTRODUCTION

We have a free market system that has provided for greater prosperity for its residents than any other country in the world. Companies have the freedom to develop products and services which can result in substantial returns for the owners when operations are run profitably. Individuals have the opportunity to reap substantial benefits from the system as owners, employees, and consumers. The system also allows for negative outcomes; losses can result in bankruptcy, loss of jobs, and the evaporation of investment assets.

In the capitalist system it is expected that there will be profits and losses, expansions and recessions, bull markets and bear markets -- without significant governmental interference; when businesses, institutions, and individuals are negatively impacted, it is just a part of the normal vicissitudes of the economy. However when the results are such that policy makers feel that the viability of the economy is threatened, there is deemed to be a need for some type of governmental intervention. The crisis in housing and in our financial institutions and the recession has created a need for several bailouts.

NEED FOR BAILOUTS

The decline in the stock market in early 2008 indicated that there was a serious potential problem with the economy. It was the collapse of Lehman Brothers and the financial chaos that followed that alerted the policy makers that governmental action was necessary [7]. Lehman Brothers was one of the oldest and most respected investment banking firm in the country, and its collapse had a major impact on world financial markets. There was a need to restore confidence in the financial system since several other large institutions had failed or were close to failure.

Bailout of Commercial Banks

Commercial banks have long ago moved away from their traditional lending business - making short term loans to businesses to carry their inventories and accounts receivable. To increase their profits, banks in recent years have made substantial investments in the mortgage market by purchasing mortgage backed securities. These securities were assumed to be safe investments since 1) the securities were backed by mortgages and homeowners were expected to make every effort to pay their mortgages; 2) rising home prices were expected to keep the value of the property above the balance due on the mortgage; and 3) the securities were rated AAA by the rating agencies [8]. However, many of the mortgages went into foreclosure and the resulting decline in the value of the securities related to those mortgages drove some banks toward insolvency. Potential bank failures were also related to insider loans, credit card defaults, and problems in the commercial mortgage market [3]. To reduce future loan defaults, banks became very stringent in making new loans.

To prevent the failure of a large part of the commercial banking industry, a government bailout was prepared. Congress approved \$700 billion which was designed to help banks get rid of their "toxic assets" and to encourage them to increase their lending to businesses. The rescue plan included the purchase of some of the banks' "toxic assets," guarantees against losses on some other assets, and the purchase of bank stock [18] [17]. The banking system seems to be recovering; some banks have already repaid the funds they obtained from the government.

Bailout of Investment Banks

Investment in mortgage related securities also led to the demise of the largest investment banking firms. Lehman Brothers was allowed to fail, but with government assistance Bear Stearns was merged into J.P. Morgan Chase and Merrill Lynch was acquired by Bank of America. The other two large firms, Goldman Sachs and Morgan Stanley, were reorganized into bank holding companies.

Auto industry

The industry-wide drop in auto sales in 2008 forced the three U.S. automakers to request government assistance. The drop in sales was exacerbated by the guaranteed health care and pensions that the automakers' retirees were receiving. Most of the foreign automobile competitors did not have these legacy costs, and thus had a competitive advantage in the market place. Ford decided that it did not need government funds, but General Motors and Chrysler received bailout funds [18]. In spite of this assistance, these firms filed for bankruptcy.

Housing

It is widely recognized that the heart of problem in our current financial downturn is the large number of foreclosures. There are several factors that have lead to this problem [4]:

1. homeowners who stretched their finances to the limit to move from one neighborhood to acquire a more expensive house in a "better" neighborhood
2. people who lied about their income to get loans they could not afford (mortgage fraud)
3. lenders who made loans knowing that borrowers were misstating their income
4. people who did not read (or did not understand) the contracts on their initial low rate loans, and were unable to make the higher monthly payments when the contracted interest rate increased
5. Borrowers who used the interest only loan with the intention of refinancing at a later time when their incomes had increased
6. low or no downpayment loans, a situation that increased some borrowers willingness to walk away from their loans
7. people who used their home equity as an ATM to remodel, take vacations, buy cars, and make normal monthly payments, including the mortgage payment
8. people who refinanced several times as property values rose; funds used to pay down credit card balances; but higher mortgage balances meant higher monthly payments, and when property values declined, this source of funds was no longer available
9. government attempts to increase homeownership among low income households; the great majority of loans made to these borrowers are current, but their foreclosure rate is higher than that of the standard market
10. The location of houses in the vicinity of foreclosed properties causes those houses to decline in value and decreases the desirability of the neighborhood, making it difficult to refinance or sell the houses
11. The decline in property values that in many cases reduced the market value of the house below the balance owed on the mortgage; if a need to sell the house arose, these homeowners were not able to sell because of this underwater situation
12. Investors who used maximum leverage to make real estate investments based on the belief that housing prices would always rise
13. Homeowners' financial mismanagement
14. Loss of a job as the current recession has deepened

To help homeowners threatened with foreclosure, \$75 billion was made available to provide refinancing for borrowers as long as their mortgage was no more than 105% of the home's value [14]. To encourage new home buyers to enter the market, an \$8,000 tax credit has been provided.

AIG and other Insurance Companies

By far the largest amount of bailout funds made to an individual company was the \$85 billion loan made to AIG, one of the world's largest insurance company[5]. Several other insurance companies have also received bailout funds [10] [21].

These bailouts have cost the taxpayers billions of dollars, but they were undertaken because of a perceived need to protect the economy. Recent developments in the economy suggest that another bailout might be needed: there is a need to protect the retirement income of a large number of elderly retirees.

RETIREMENT SYSTEM PROBLEMS

We are moving to a society of two types of retirees: those who have adequate retirement income and those who do not. There are a number of reasons why we are facing a retirement situation that might be in need of a bailout.

Employer Sponsored Defined Benefit Plans

Retirees have traditionally depended on a pension from their employers. One works for 30 or 35 years, retires, and then receives a pension for the remainder of his life. There is no requirement, however, that a firm provide a retirement plan for its employees. According to data from the Bureau of Labor Statistics, only 64% of employees at organizations with 100 or more employees were covered by a retirement plan, and for employers with less than 100 employees the figure was 34% [20]. Thus, there is a vast number of workers who are not covered by an employer-sponsored retirement plan.

For those firms that offered retirement plans, the traditional plan has been the defined benefit plan. Planned retirement benefits are available based on contributions made to a fund by the employer (and sometimes by the employee) and earning on the fund. There were approximately 130,000 of these pension plans in 1985, but there are only about one quarter of that amount today [1]. Some firms that still offer these plans do not permit new employees to join them. The problem is the many companies have found that it is too expensive to maintain their defined benefit plans; they are not able to pay the promised benefits. As revenues have declined in this recession, firms have attempted to reduce costs in any way possible, and reducing or eliminating their retirement plan contributions is one approach taken. Furthermore, returns on retirement investments have been lower than anticipated, and benefits have been underestimated; all of the risk in supporting these plans is with the employer. Thus, for many firms defined benefit plans are no longer viable. Most companies that have dropped their defined benefit plans have adopted a defined contribution plan, the most popular of which is the 401(k) plan.

401(k) Plans

The 401(k) plan gives the employee the option to contribute toward his retirement, and if the employee contributes, the sponsoring firm has the option to match a portion of that contribution. These

contributions are invested in a fund, and retirement benefits are based on these contributions and the return earned on the fund. Thus the employee is fully responsible for funding his retirement plan and is subject to investment risk in the plan. Unfortunately, many employees do not make any contributions to their plans, and thus they have no retirement assets. For those that do contribute, many contribute only moderate amounts. A survey by Northwestern Mutual found that only 6% of employees with 401(k) plans contributed enough to qualify for their company's entire matching contribution [15]. To meet current obligations some employees have borrowed or withdrawn funds from their 401(k) accounts, and in recent years many companies have reduced or eliminated their matching contribution [2] [9].

Thus, there are millions of employees who will reach retirement age with little or no retirement benefits from their employers.

Personal Savings

Personal savings could take up the slack from employer sponsored plans, but many individuals have relatively small amounts in savings accounts. Studies by the Center for Retirement Research at Boston College indicated that only 39% of workers were adequately saving for retirement [9]. A MetLife survey indicated that 44% of employees live paycheck to paycheck, and Edward Wolff, an economist specializing in the study of poverty and income distribution, found that 48% of American households have less than \$5,000 in liquid assets [13].

Layoffs

The recession has resulted in a record number of layoffs as companies attempt to reduce costs. There were approximately 2.6 million job losses in 2008, the most since 1945, and job losses are continuing in 2009 [6]. Many laid off workers have some savings, but it gets spent if a new job not found soon. To pay monthly bills it may be necessary to use credit cards, use home equity lines of credit, and use funds from IRAs and 401(k) accounts. Thus many individuals who have been laid off find themselves with substantial debt and little or no savings.

Personal Bankruptcy

The downturn in the economy has pushed thousands of families into bankruptcy. In 2007 there were 819,115 personal bankruptcy filings; the number increased to 1,086,130 in 2008, and the American Bankruptcy Institute estimates the number could hit 1.4 million in 2009 [11] [12]. In order of stave off bankruptcy, many persons will exhaust their savings, investment, and retirement accounts. Thus, persons going through a bankruptcy will emerge with little or no retirement assets.

Foreclosure

There has been a similar rise in foreclosures. The Center for Responsible Lending estimated that there were 2.2 million subprime foreclosures in 2008; it is projecting 2.4 million foreclosures of all loans in 2009, and 9 million during 2009 - 2012 [16]. Many homeowners heading toward foreclosure will also exhaust their savings, investment and retirement accounts in an attempt to save their homes. After foreclosure they will have little or no retirement assets. Of course, there are some homeowners with adequate financial resources who could continue making their monthly payments, but chose not to do so and walked away from their homes. And there have been many foreclosures on properties owned by investors, many of whom had substantial wealth but chose to let the properties go into foreclosure [19].

IMPACT ON THE ECONOMY

Because of the drop in company sponsored retirement plans, low savings rates, lay offs, personal bankruptcies, and foreclosures, millions of Americans will enter retirement with little more than social security income. The impact on the economy of a large group of individuals with reduced spending capability will be tremendous. There would be a drop in consumer spending, which would reduce national income. Seniors would ask for a real bailout from the government, which, if granted, would cost the treasury billions of dollars. Those seniors who owned their homes could take advantage of a reverse mortgage, but persons with little savings would probably not own their homes.

Those seniors who are physically capable could continue working; others would become dependent on family members. There would be a temptation by some individuals to take extreme investment risks for a quick payoff and others might play the lottery, thus losing what little money they had. Those in society who prey on the elderly would find easy victims and crime by the elderly would probably increase.

None of these potential impacts is desirable and efforts must be undertaken to prevent the problem from occurring.

WHAT MUST BE DONE

The majority of Americans are well prepared for retirement: they have generous pension plans, they maximize their contributions to their 401(k), 403(B), and 457 plans, and they have investments in IRAs, stock, bonds, real estate, and other assets. It is those others who are facing a financial nightmare as they approach retirement. There is a real prospect that not in the too distant future there will be millions of elderly Americans who will not be able to take care of themselves financially. This crisis can be prevented, however, if action is taken now. A bailout is needed, but it is not the type that will cost the taxpayers billions of dollars. Appropriate actions should be taken by individuals, employers, and the federal government.

Individuals

Individuals have a duty to take care of themselves; it is important that they develop the discipline to save regularly and in reasonable amounts. Persons with 401(k) plans should save an amount at least equal to their employer's match; going beyond that amount is certainly desirable. Persons without employer sponsored plans could take advantage of IRAs. A payroll deduction plan, where fixed amounts are systematically set aside each pay period, will work well for most workers.

Some individuals who have invested for their retirement have still arrived at retirement with meager assets because of risks taken. Some investors are willing to take great risks for the higher potential returns, while others are more conservative and settle for lower returns and less risk. It is the younger employees who should invest in riskier portfolios; but as one approaches retirement it is important to reduce the risk. Financial planners have developed a number of strategies in an attempt to accomplish this goal.

Adequate diversification must be at the heart of any retirement plan. Persons who placed the bulk of their retirement funds in the local bank (the bedrock of the community, but many of these later failed), the

seventh largest company in the country (Enron), or the largest company in its industry and a dominant force in the American economy (General Motors) found that their assets, some of which had been amassed over a lifetime, evaporated when these firms failed.

Other investors have seen their retirement assets evaporate because of scams and fraud. In the recent Bernie Madoff scheme hundreds of investors, some with over a million dollars in assets, lost everything. It is important that investors understand what their funds are invested in.

Employers

In spite of any discussion about payroll deduction plans, the risk-return tradeoff, and diversification, there are thousands of individuals who will not save voluntarily. For these workers, there is a need for a mandatory employer sponsored retirement plan. A specified percentage of each employee's income would be deducted and set aside for retirement. The employer would have the option of matching the employee's contribution, and the employee should have the option of setting aside an amount greater than the specified percentage. This approach is certainly not a novel one. For example, employees of the state of North Carolina have a mandatory 6% of their gross income deducted for retirement purposes. The state makes an additional contribution, and these amounts are invested in the state plan or with TIAA-CREF (the employee decides which to use). At retirement the employee can choose from a number of monthly income options.

To insure that the funds are available for retirement, 1) withdrawals and borrowing from the fund should not be permitted, 2) lump-sum distributions should not be permitted if the employee leaves the employer; the funds should remain invested until retirement; and 3) lump sum distributions should not be permitted at retirement; several monthly income options should be made available.

The downturn in the economy has caused companies to place a tremendous emphasis on managing costs. It would not be wise to introduce a program of required mandates that would substantially increase firms' operating costs. This plan to require employee contributions would impose minimal costs to the employer. The plan would be a defined contribution plan, not a defined benefit one; thus there would be no required employer contributions. There would be administrative costs, but these costs could be borne by the investment funds of the employees.

Government

Governmental intervention will be necessary to fully implement a plan of mandatory retirement savings. Many employees will not save voluntarily and it is likely that many employers will not act to require that their employees save on a regular basis. A bailout is envisioned in the form of legislation that would require the establishment of mandatory employer sponsored retirement plans. The legislation would require consistent employee contributions, no borrowing or withdrawals from the plan, no lump sum distributions, and monthly payments at retirement. There would be a need to establish guidelines and qualifications for companies that manage the accounts. The administrative costs of managing the accounts would be borne by the participants, not by the government. This bailout plan, then, would not be a tax-payer funded give away; it would not require the spending of billions of dollars in an attempt to fix a broken down system; nor would there be a need for any new bureaucracy.

Governmental action to force individuals to act in their own best interests may be paternalistic, but it is certainly not new. There are seat belt laws, helmet requirements for motorcycle riders, anti-drug laws, and age limitations for the purchase of cigarettes and alcoholic beverages. A partnership between the government and our retirement system is needed to secure the financial future of millions of Americans. A real problem in retirement income is developing, but it can be prevented if we begin to act now.

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