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The Uncertain Future of Social Security

The U.S. Social Security program was started in 1935 to – as Franklin Roosevelt said – “give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age.”

Today, more than 58 million people receive Social Security benefits. With projected outlays of \$845 billion in fiscal year 2014 – nearly one-fourth of all federal spending – it is the largest single federal government program.

The Congressional Budget Office (CBO) recently updated its projections on the solvency of the Social Security System as part of its 2014 Long-Term Budget Outlook. While opinions on the state of system certainly vary, the CBO numbers indicate that the program could become insolvent fewer than 20 years from now.

One of the people ringing the clarion bell for change is Andrew Biggs, resident scholar at the American Enterprise Institute and former principal deputy commissioner at the Social Security Administration. *OUTLOOK* recently spoke with Biggs to understand his views on the condition of the Social Security system and how it should be fixed.

OUTLOOK: Your assessment of the future of Social Security is not pretty. Give us your high-level overview of where the system is now and what we can expect over the next two decades.

Andrew Biggs: We’ve known for several decades that Social Security faces an uncertain financial future. The last reforms for Social Security were passed in the early 1980s and they put Social Security on what they thought was a sustainable track. By end of the 80s, it became clear that those reforms had not permanently made the system solvent. At some point, the system’s Trust Funds were going to run out and, lacking any other action, benefits would then be cut across the board for retirees, survivors, and the disabled.

Over the past few years, Social Security’s financial status has worsened considerably. According to the CBO, the long-term deficit of the program has nearly quadrupled since 2008. Back then, the actuarial deficit of the

About this article

Andrew G. Biggs is a resident scholar at the American Enterprise Institute (AEI), where he studies Social Security reform, state and local government pensions, and public sector pay and benefits. Before joining AEI, Biggs was the principal deputy commissioner of the Social Security Administration (SSA), where he oversaw SSA's policy research efforts.

In 2005, as an associate director of the White House National Economic Council, he worked on Social Security reform. In 2001, he joined the staff of the President's Commission to Strengthen Social Security.

Biggs has been interviewed on radio and television as an expert on retirement issues and on public vs. private sector compensation. He has published widely in academic publications as well as in daily newspapers such as *The New York Times*, *The Wall Street Journal*, and *The Washington Post*. He has also testified before Congress on numerous occasions. In 2013, the Society of Actuaries appointed Biggs co-vice chair of a blue ribbon panel tasked with analyzing the causes of underfunding in public pension plans and how governments can securely fund plans in the future.

Biggs holds a bachelor's degree from Queen's University Belfast in Northern Ireland, master's degrees from Cambridge University and the University of London, and a Ph.D. from the London School of Economics.

program was 1 percent of payroll. In other words, a 1 percentage point increase in the Social Security payroll tax – moving from 12.4% to 13.4% using today's numbers – would have been sufficient to keep the trust fund solvent for the next 75 years.

However, the CBO is now projecting a 4 percent gap, so we would have to immediately and permanently raise the Social Security payroll tax from 12.4% to 16.4% to be able to pay full scheduled benefits over the next 75 years. When you consider that the Social Security payroll tax is already the biggest tax that most of us pay – more than we pay in income taxes – that's a significant hike.

OUTLOOK: Why have things gotten so much worse over just the past six years?

AB: One simple factor is just the passage of time. Each year you wait to reform Social Security, the deficit gets a little bit bigger.

A second factor is revisions to the assumptions the CBO uses in projecting Social Security's future financial health. In particular, they've revised their assumptions on life expectancy. Previously, they used the same assumptions that Social Security's Trustees used, which are in the lower end of what most demographers would call the reasonable range of expectations.

CBO started projecting life expectancy improvements more in line with the mainstream demographers and is forecasting faster increases in life expectancies. Longer life spans mean more people collecting benefits for longer period of time and that contributes to the problem, as well.

The third thing is the economy. The economy worsened considerably as a result of the financial crisis and as unemployment rose, fewer people paid into system and fewer taxes were collected. It also meant more people retired early and more people collected disability benefits, which created greater outflows.

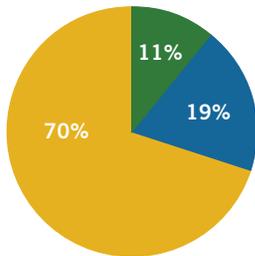
OUTLOOK: What is the CBO's current forecast?

AB: The CBO previously forecasted that Social Security would collect more in taxes than it pays out in benefits through around 2017 to 2019. That forecast meant running a Social Security surplus and building up the trust fund until that time. In fact, Social Security started running payroll tax deficits back in 2010, and it is never expected to come back into surplus again.

Similarly, back in 2008 the CBO projected that the Social Security Trust Funds would remain solvent until about 2049. Today it's projecting solvency

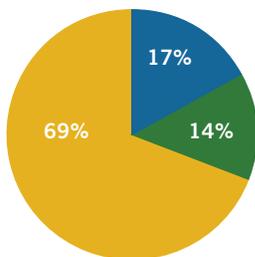
SOCIAL SECURITY BENEFICIARIES

- Retired workers / spouses / children
- Deceased workers / survivors
- Disabled workers / spouses / children



SOCIAL SECURITY BENEFITS

- Retired workers / spouses / children
- Deceased workers / survivors
- Disabled workers / spouses / children



Source: Congressional Budget Office

until about 2030, so we've lost about 20 years off the life of the Trust Funds due to this worsening of the various conditions affecting the system's financing.

OUTLOOK: Why is this happening in general? How have we gotten to this point?

AB: For the most part, it's a demographic issue. Social Security is what you call a pay-as-you-go program. It differs from a private-sector pension where workers put in money that is saved and invested, and they withdraw the money later. Social Security is a transfer program. Workers pay taxes today and that money is paying benefits for today's retirees.

That kind of system is very dependent, financially speaking, on the number of workers versus the number of beneficiaries. In the 1950s, there were about 15 workers paying into Social Security for each person collecting benefits. Today, it's fewer than three workers per beneficiary. Looking forward into 2020 or 2030, it will become less than two workers per beneficiary.

The average Social Security benefit is equal to around 40 percent of the average worker's wages. In the future, if there are only two workers supporting each beneficiary, that amounts to an implicit tax rate of around 20 percent to finance the program. That's a big increase over the 2 percent rate when the system started in 1935.

OUTLOOK: To what extent did the high unemployment levels resulting from the financial crisis result in this issue?

AB: The real effects of the recession were very direct and very simple. With unemployment growing from 5 to 10 percent, fewer people were working – and wage growth was low – which simply meant less money collected in the system. It was magnified by the number of people near retirement age who, once they became unemployed, chose to stay out of the workforce. Fewer people working and lower wages equals lower payroll tax revenues.

A secondary effect is interest rates. Since the onset of the Great Recession, interest rates have remained very low, which further stunted the growth of the Trust Fund and shortened the time period over which it could be expected to last.

OUTLOOK: The trends appear to be clear. Why has there been so much disagreement about the status of the system and the need to fix it?

AB: One source of disagreement has been simply over the status of the Social Security Trust Funds – what they are and what they're intended to do.

“I think there’s a general inclination – which is part of human nature and very much a part of politics – to want to promise benefits but not want to pay for them.

One group of people views the Trust Funds as an accounting device that don’t do anything to make it easier to pay for Social Security benefits in the future. In other words, when Social Security runs a surplus, the rest of the government spends that money and credits it to the Trust Funds. Yes, it’s credited to the Trust Funds, but the money has still been spent. And when it comes time to repay the Trust Funds, the government has to either raise taxes, cut other programs, or increase the budget deficit – exactly the same choices the government would face if it didn’t have a trust fund.

Another group believes that, because the Trust Funds have government bonds, it’s the same as any other investment fund. Their response is, “Why should we care? If the Social Security Trustees say the program is solvent through 2030 or 2040, then that’s a good thing.” The Trust Funds might be a debt to the rest of the budget, but they are an asset to Social Security.

So you have disagreement over how large the problem is and when the problem really starts.

A second factor is uncertainty, which you have any time you make long-term projections. The CBO is very open about the uncertainty of its projections, as are the Social Security Trustees. The CBO and the Social Security Trustees go to great lengths to guesstimate the range of possible outcomes. But with that there’s an element of wishful thinking where some people look at the uncertainty of these projection and say, “Maybe we won’t have a problem after all so let’s delay any action until we know for sure.” In reality, uncertainty means that the problem could just as easily turn out to be worse than expected, so I don’t think it’s a good reason to delay reforms.

Finally, I think there’s a general inclination – which is part of human nature and very much a part of politics – to want to promise benefits but not want to pay for them. This results in failing to address the current problem and kicking it down the road for future generations to handle. The fact is, current generations vote and future generations don’t. More specifically, older Americans vote more than younger Americans do, so the weight of the political impetus is to try to put off the problem rather than to confront it.

OUTLOOK: What is the political environment around the Social Security system? Is there a political party dynamic to the issue?

AB: There is definitely a party dynamic to it. If you go back to the 1990s or mid-2000s, there was a real push among many Republicans to fix Social

Both sides need to come together and say, “What can we do in a practical sense to make the system solvent?”

Security. There was a movement to introduce personal retirement accounts to give people the option of investing part of their Social Security taxes on their own. That’s an idea that is attractive in a variety of ways but it was opposed very strongly by most Democrats, who saw it as undermining the system.

Today, more activity on Social Security comes from the Democratic side of the aisle, but it’s much less about how to fix the solvency of Social Security than to expand the program. For example, there are proposals from Senator Tom Harkin of Iowa and a joint plan from Senators Patty Murray of Washington and Mark Begich of Alaska that would expand Social Security benefits – in some cases very significantly. The idea with these proposals is that Americans are not saving enough for retirement, so we need to make the system bigger to help them out. Senator Elizabeth Warren of Massachusetts has spoken in favor of this too.

There’s a cyclical pattern here and I think both sides need to come together and ask, “What can we do in a practical sense to make the system solvent?” That means finding ways to make the system work better while not necessarily spending more. For example, finding ways in which the system can better target benefits, encourage people to save more or even delay retirement.

OUTLOOK: What are the public’s sentiments around Social Security? Do we recognize these issues?

AB: I think people understand reasonably well how the different options for Social Security work. If you talk to people about raising the retirement age, Cost-of-Living Adjustments (COLAs) or raising tax rates, they have a rough idea of what those mean. It’s a reasonably well-understood policy issue, at least relative to the other things that Congress handles.

However, and understandably to some degree, the general public and politicians approach the issue in much the same way – nobody wants to take any of the medicine themselves. You often see opinion polls that ask people, “Which of these policy options for Social Security do you favor? Raising taxes, cutting benefits, raising retirements, et cetera.” Naturally, they don’t favor any of them because in an ideal world none of them would be necessary.

What we need to start asking is, “How do you put together a package of changes – none of which are particularly attractive – that is going to make the system solvent?” We have to do something, but there’s always this element of

What's needed is political leadership, which is about getting not just elected officials but also the public to wake up and realize that if we don't fix this problem, it's not going to go away.

wishful thinking – hoping the problem will go away – or push it off as long as possible so that it becomes somebody else's problem.

What's needed is political leadership, which is about getting not just elected officials but also the public to wake up and realize that if we don't fix this problem, it's not going to go away. I think there's a possibility of this, but it really does demand leadership because people won't do it on their own.

OUTLOOK: How do we go about fixing this issue?

AB: One way to think about it is to go with a blank slate and create a new system – one that would work 30 or 40 years from now. In doing that, I think we'd probably come out with something that has stronger protections for lower-income people.

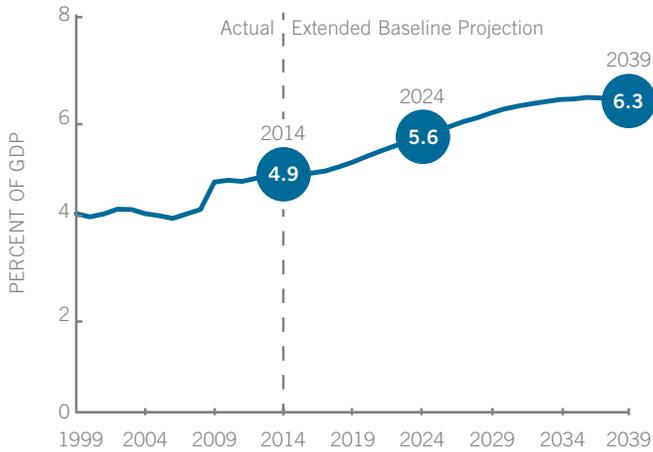
Social Security's safety-net aspects are pretty leaky. We will still have about 9 percent of seniors living in poverty, despite spending \$725 billion a year on Social Security. For that kind of money, we could give every retiree in America a poverty-level benefit and essentially eliminate poverty in the senior segment. So the idea that Social Security's poverty protection can't be improved is wrong.

At the same time, though, it's clear that middle- and upper-level income people have to save more on their own. There is academic research showing that a big part of the decline in the American savings rate since World War II is because of the advent of Social Security and Medicare. When you think about it, one reason you save is to provide for your income and healthcare needs in retirement. When the government is providing for those things, you're rationally going to save less. You're not being dumb by saving less – you're simply doing what the incentives tell you to do.

But that's not good for the government budget. Nor is it good for the economy. When individuals save on their own, it provides capital you can use to build factories or do research and development. When the government provides this sort of pseudo-savings – transferring money from workers to retirees – it doesn't do anything to help the economy as a side benefit. So I think we would want a stronger safety-net for people at the bottom, but we would also want people in the middle and upper classes to save more on their own.

If you establish that, for example, as your goal, then you have to design ways of getting from here to there. It would allow you to create a system focused

SOCIAL SECURITY SPENDING VS. GDP



Source: Congressional Budget Office

more on benefits for the low-income people who needed the most, but also establish policies – such as automatic enrollment in an employer pension plan – to make sure everybody is saving something for retirement.

OUTLOOK: How would that be different from the system we have today?

AB: Many people think about Social Security as forced savings program. If you were starting Social Security today and wanted to force people to save, you would simply require – or provide incentives for – them to save. You wouldn't collect money in a payroll tax, credit it to a trust fund and credit it back through some convoluted benefit formula. Instead, you would have a retirement plan if you were employed and you would be required to put money into it. Sometimes a simple solution, in fact, is a better solution.

If combined in a schematic sort of way, we could get a system that really provides a better safety net at the low end, but also provides better incentives to work and save. It benefits the economy and it's better for the federal budget.

Too often, the inclination of Congressional or White House staff is to think in terms of tweaks – to make the system's future benefits equal to its taxes. They look at it purely a budgetary problem in which you raise the retirement age, reduce COLAs or raise the payroll tax rate. The result, however, is a policy that isn't very clear about what it wants to achieve in terms of making the system actually work for people. You also get a policy that's impossible to explain.

OUTLOOK: Let's move outside of the Social Security system. How well-prepared are Baby Boomers for their upcoming retirement?

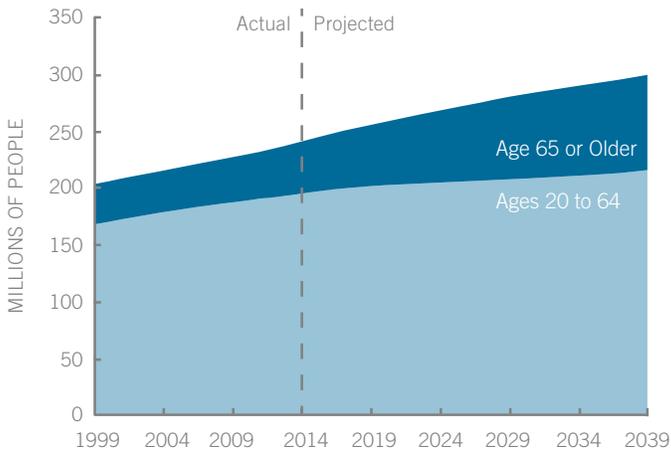
AB: It's a huge issue and there's a big debate about it. Certain people say that most Americans are unprepared for retirement. Some studies claim that 60 percent of Americans are underprepared to retire. Others say it's 85 percent of Americans.

I'm on the other end of that scale. While I don't think that we're all saving at proper levels, I think the number of people under-saving for retirement is much smaller – about 25 percent of the people. And even among that group, most are not disastrously under-saving. They're just not as prepared as they should be.

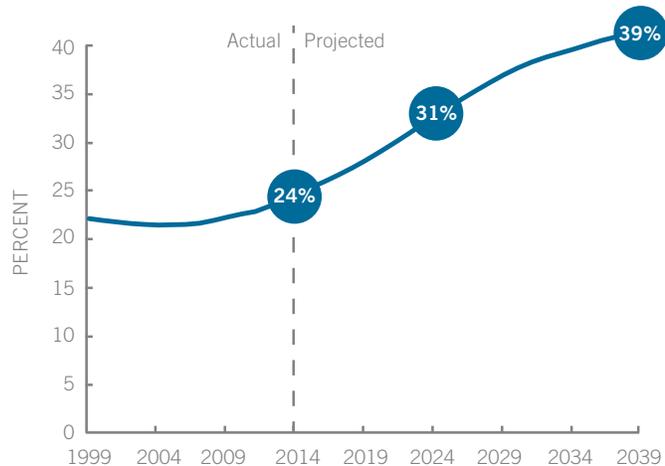
Of course, this kind of debate leads you to different conclusions. If you think 85 percent of Americans are under-saving for retirement, then policies like big expansion of Social Security and re-thinking 401(k)s begin to make a bit more sense.

CHANGES IN POPULATION, BY AGE GROUP

Population Age 65 or Older Relative to the Population Ages 20 to 64



Ratio of the Population Age 65 or Older to the Population Ages 20 to 64



Source: Congressional Budget Office

If you think the problem is more restricted – say, a quarter of Americans are under-saving by relatively modest amounts – then you want to think about targeted policies. Along those lines, we need to look much more closely at who is unprepared for retirement and why.

But I tend to think a lot of the claims of a retirement crisis in America are exaggerated. The Social Security Administration has very good models for projecting incomes and calculating replacement rates – which are retirement incomes relative to pre-retirement earnings – and they don't show a big drop-off between people retired today, the baby boomers and the Gen Xers down the road. Some people think we're headed for a crisis but the better models just don't support it.

OUTLOOK: *How does the U.S. compare to other developed countries or regions, such as Western Europe? Are they facing similar issues in their social security systems?*

AB: Financially speaking, the Western European countries are in tougher shape than we are because their government pension plans are, in general, more generous than ours.

The U.S. Social Security system is roughly on par in terms of generosity with other plans in the Anglo countries: UK, Canada, Australia, and New Zealand. Within that group, we're in the middle of the pack in terms of generosity – more generous than some, less generous than others.

The bigger issue is not just how much money people are getting from the government but how much money they have in retirement, in general. There

“If we do nothing and the Social Security Trust Funds run out some time in the early 2030s, benefits for all beneficiaries – retired, disabled and survivors – will be cut by around 25 percent across the board.

are studies that compare the relative income and well-being of retirees in different countries. Although we're not the top country – maybe third or fourth – the U.S. generally does very well in those studies. And many of the countries where you would think retirees are well-off, are not doing so well.

The reason is that the American Social Security program may not be incredibly generous, but we do have income from other sources such as IRAs and 401(k)s. We also tend to work longer. We're not retiring at 50 like many people in other countries.

Overall retirement income for Americans is actually not bad, but it really depends on your perspective. If you think that only government benefits matter, then America is no Luxembourg, which has very rich government benefits. However, if you care more about welfare in retirement, then America actually looks much better.

OUTLOOK: What happens if we do nothing?

AB: Literally, if we do nothing and the Social Security Trust Funds run out some time in the early 2030s, benefits for all beneficiaries – retired, disabled and survivors – will be cut by around 25 percent across the board. That's what the law says is going to happen.

Social Security doesn't have any provision to borrow extra money. It doesn't have any provision to pay benefits that aren't in the Trust Funds. As long as we're all paying our 12.4 percent payroll tax, there's going to be money to pay benefits, but there will not be enough money to pay what's been promised.

Some people act as if these things can never happen, but we're facing it. In 2016, the disability part of Social Security is projected to go insolvent. If we can't agree on a solution, benefits will be cut. That is the cost of delay and procrastination on this – it's just a bad outcome. But that's the outcome you get when people are not willing to put aside their differences and come to a deal. ■

Interest Rates and Economic Indicators

The interest rate and economic data on this page were updated as of 10/31/14. They are intended to provide rate or cost indications only and are for notional amounts in excess of \$5 million except for forward fixed rates.

KEY ECONOMIC INDICATORS

Gross Domestic Product (GDP) measures the change in total output of the U.S. economy. The Consumer Price Index (CPI) is a measure of consumer inflation. The federal funds rate is the rate charged by banks to one another on overnight funds. The target federal funds rate is set by the Federal Reserve as one of the tools of monetary policy. The interest rate on the 10-year U.S. Treasury Note is considered a reflection of the market's view of longer-term macroeconomic performance; the 2-year projection provides a view of more near-term economic performance.

ECONOMIC AND INTEREST RATE PROJECTIONS

Source: Insight Economics, LLC and Blue Chip Economic Indicators

US Treasury Securities

	2014	GDP	CPI	Funds	2-year	10-year
Q4	3.00%	1.60%	0.10%	0.70%	2.67%	
2015	GDP	CPI	Funds	2-year	10-year	
Q1	2.90%	1.90%	0.10%	0.91%	2.86%	
Q2	2.90%	2.00%	0.17%	1.14%	3.03%	
Q3	2.90%	2.10%	0.33%	1.41%	3.21%	
Q4	2.90%	2.10%	0.56%	1.66%	3.37%	

PROJECTIONS OF FUTURE INTEREST RATES

The table below reflects current market expectations about interest rates at given points in the future. Implied forward rates are the most commonly used measure of the outlook for interest rates. The forward rates listed are derived from the current interest rate curve using a mathematical formula to project future interest rate levels.

IMPLIED FORWARD SWAP RATES

Years Forward	3-month LIBOR	1-year Swap	3-year Swap	5-year Swap	7-year Swap	10-year Swap
Today	0.24%	0.33%	1.16%	1.79%	2.17%	2.51%
0.25	0.25%	0.46%	1.33%	1.92%	2.26%	2.56%
0.50	0.33%	0.65%	1.54%	2.05%	2.37%	2.64%
0.75	0.53%	0.89%	1.73%	2.21%	2.50%	2.76%
1.00	0.75%	1.13%	1.91%	2.33%	2.58%	2.81%
1.50	1.26%	1.61%	2.25%	2.59%	2.79%	2.99%
2.00	1.71%	2.03%	2.49%	2.75%	2.92%	3.07%
2.50	2.07%	2.32%	2.68%	2.89%	3.03%	3.16%
3.00	2.43%	2.62%	2.87%	3.03%	3.13%	3.25%
4.00	2.76%	2.91%	3.08%	3.19%	3.26%	3.35%
5.00	2.99%	3.09%	3.20%	3.32%	3.37%	3.42%

HEDGING THE COST OF FUTURE LOANS

A forward fixed rate is a fixed loan rate on a specified balance that can be drawn on or before a predetermined future date. The table below lists the additional cost incurred today to fix a loan at a future date.

FORWARD FIXED RATES

Cost of Forward Funds

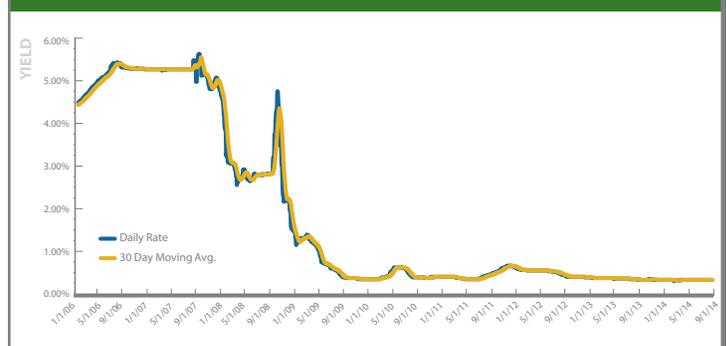
Forward Period (Days)	Average Life of Loan			
	2-yr	3-yr	5-yr	10-yr
30	9	9	7	5
90	22	22	18	12
180	39	41	34	22
365	91	84	69	43

Costs are stated in basis points per year.

SHORT-TERM INTEREST RATES

This graph depicts the recent history of the cost to fund floating rate loans. Three-month LIBOR is the most commonly used index for short-term financing.

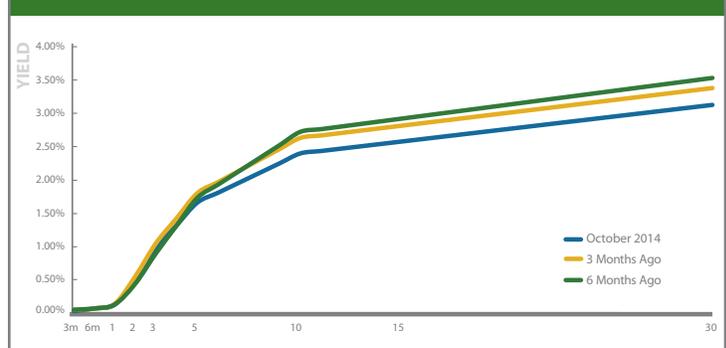
3-MONTH LIBOR



RELATION OF INTEREST RATE TO MATURITY

The yield curve is the relation between the cost of borrowing and the time to maturity of debt for a given borrower in a given currency. Typically, interest rates on long-term securities are higher than rates on short-term securities. Long-term securities generally require a risk premium for inflation uncertainty, for liquidity, and for potential default risk.

TREASURY YIELD CURVE





About CoBank

CoBank is a \$102 billion cooperative bank serving vital industries across rural America. The bank provides loans, leases, export financing and other financial services to agribusinesses and rural power, water and communications providers in all 50 states. The bank also provides wholesale loans and other financial services to affiliated Farm Credit associations serving farmers, ranchers and other rural borrowers in 23 states around the country.

CoBank is a member of the Farm Credit System, a nationwide network of banks and retail lending associations chartered to support the borrowing needs of U.S. agriculture and the nation's rural economy.

Headquartered outside Denver, Colorado, CoBank serves customers from regional banking centers across the U.S. and also maintains an international representative office in Singapore.

For more information about CoBank, visit the bank's web site at www.cobank.com.

Commentary in Outlook is for general information only and does not necessarily reflect the opinion of CoBank. The information was obtained from sources that CoBank believes to be reliable but is not intended to provide specific advice.

CoBank Named Safest Bank in U.S.

CoBank Again Named To "World's 50 Safest Banks" List
By *Global Finance Magazine*

CoBank, a leading cooperative bank serving agribusinesses, rural infrastructure providers and Farm Credit associations throughout the United States, has been named to *Global Finance* magazine's list of the world's safest banks for a fourth consecutive year.

Global Finance, which covers the financial services industry, publishes the "World's 50 Safest Banks" list annually. Banks are ranked using a methodology that includes total assets and an evaluation of long-term ratings from major rating agencies. CoBank was first named to the list in 2011.



Robert B. Engel

"We're very pleased to have earned this distinction for the fourth year in a row," said Robert B. Engel, CoBank's chief executive officer. "We greatly value the trust our customers place in us. It is essential that we continue to deliver exceptional value, manage the bank efficiently and steadily build our financial strength for the long term."

The ranking will be published in the October issue of *Global Finance*. Further information is available at the magazine's web site at www.gfmag.com. ■