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## **POLICY BRIEF**

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# **PERSPECTIVES ON RETIREMENT SYSTEM REFORM FOR THE 21<sup>ST</sup> CENTURY**

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### **EXECUTIVE SUMMARY**

This *Policy Brief* provides essays from five experts in retirement research and policy analysis offering their perspectives on worthwhile reforms to the U.S. retirement system. The authors agree that retirement system reforms are needed to ensure that future generations of American workers have a high likelihood of an adequate and secure retirement income. In particular, the consensus view is that the current system tends to place too much responsibility and risk on households for generating and managing retirement resources. Various reforms are suggested that would encourage retirement income adequacy while providing more efficient risk management and a more equitable distribution of retirement risk burdens.



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**BUILDING A NEW FOUNDATION FOR RETIREMENT INCOME SECURITY**

Jeffrey R. Brown

Providing for a financially secure retirement is an important financial goal shared by Americans across the economic and political spectrums. Unfortunately, the institutional foundations upon which most individuals rely to prepare for retirement is poorly designed, is showing signs of tremendous stress, and in some instances, has already started to crumble. Social Security is on a fiscally unsustainable path that will require significant tax increases or cuts in scheduled benefits. Defined benefit (DB) plans have dramatically declined in importance relative to other sources of retirement income in recent decades, and many remaining DB plans are substantially under-funded. The Pension Benefit Guaranty Corporation, the government corporation that insures the pensions of DB plan participants, is under tremendous fiscal strain. Recent financial market turmoil has exposed the lack of adequate risk management as the Achilles' heel of most 401(k) plans, leaving many Americans substantially less prepared for retirement than they appeared to be just a year or two ago.

It need not be this way. We have the know-how to create solutions that can significantly improve the financial security of future retirees. Policymakers should undertake a holistic re-examination and reform of policies that shape the retirement income landscape. Ideally, reform would include changes to both public and private retirement plans in the U.S., with an eye towards designing a coherent set of policies that promote individual and national saving, encourage longer working lives, and promote the provision of efficient risk management tools throughout a participant's life-cycle.

One critical piece of this holistic approach needs to be a re-thinking of the private retirement system in the U.S., which has evolved in a somewhat haphazard way over the decades and is in need of a substantial overhaul. A few decades ago, the private retirement plan space was dominated by DB plans. For example, in 1980, DB plans covered approximately 30 million workers, while DC plans covered fewer than 20 million.<sup>1</sup> These DB plans had many desirable features for participants—including the provision of guaranteed retirement income for life. However, DB plans also presented many disadvantages, such as the lack of portability for employees, and substantial funding, administrative, regulatory and fiduciary burdens on plan sponsors. These burdens led to the steady displacement of DB plans in the private sector by 401(k)'s and other defined contribution (DC) plans, which had the advantage of providing employees with choice, control and portability, while reducing the uncertainties and burdens on plan sponsors.

The 401(k), which grew out of a provision in the Revenue Act of 1978 that provided that employees would not be taxed on elective deferrals of compensation, was never designed to be the workhorse of the retirement planning process. Thus, the 401(k) lacks a number of important risk management characteristics that would ideally be part of any well-designed retirement plan. For example, numerous studies have documented the prevalence of inefficient portfolio allocation by participants, including the over-concentration of 401(k) plan assets in the stock of a participant's employer.<sup>2</sup> Further, the vast majority of 401(k) plans fail to access to annuities, thus leaving most participants subject to the risk of outliving their savings.<sup>3</sup>

In essence, the last several decades have witnessed a shift in retirement risk-bearing from employers, who did not want to bear the risks and costs of sponsoring a DB plan, to employees, who are even less prepared to bear and manage these risks. Moving forward, we should endeavor to design a retirement system that preserves the best of both the DB and DC world, while improving on those aspects that neither system did particularly well.

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1 Robert Reynolds, "Solving America's Retirement Savings Challenge."

2 For example, see: (1) Jeffrey R. Brown, Nellie Liang and Scott Weisbenner, "401(k) Matching Contributions in Company Stock: Costs and Benefits for Firms and Workers." *Journal of Public Economics*. August 2006, v. 90, iss. 6-7, pp. 1315-46. (2) Shlomo Benartzi, Richard Thaler, Stephen Utkus and Cass Sunstein, "The Law and Economics of Company Stock in 401(k) Plans," *Journal of Law and Economics*, February 2007, v. 50, iss. 1, pp. 45-79. (3) Lisa Meulbroeck, "Company Stock in Pension Plans: How Costly Is It?" *Journal of Law and Economics*, October 2005, v. 48, iss. 2, pp. 443-74.

3 Pamela J. Perun, "Putting Annuities Back Into Savings Plans." Society of Actuaries, Symposium on Managing Retirement Assets, 2004. Available at SSRN: <http://ssrn.com/abstract=696842>

What would such a system look like? Features of the DB world that are worth preserving include automatic participation and a focus on the provision of lifelong income after retirement. Features of the DC world that are worth preserving include respect for individual control and choice, the ability to tailor a plan to the needs and preferences of individuals, and portability across employers. Features that need to be re-engineered include the efficient provision of risk management. Rather than having investment, inflation, and mortality risk borne by employers (whose expertise lies in their primary line of business rather than in pension provision), employees (who, research shows, exhibit low average levels of financial literacy), or the government (which is already under tremendous financial strain from existing entitlement programs), these risks should be managed and borne by insurance companies and other financial services providers that have the requisite expertise to deliver effective and efficient retirement risk management solutions.

In essence, we should encourage financial services providers to create products that help individuals create an individualized, life-long retirement income security plan. Such products would ideally include the following features:

- **Universal availability.** We should continue to encourage employers who wish to provide retirement plans as part of their workforce management strategy to do so. Individuals whose employers do not offer such a plan should be able to participate in a retirement plan through an individual market with similar opportunities for tax deferral. The non-employer based market could be implemented in a variety of ways, such as through a modified IRA system or through an “add on” to Social Security.
- **Automatic enrollment.** There is overwhelming empirical evidence that individuals are more likely to participate in retirement savings programs when they are automatically enrolled with an option to opt-out, rather than when they must proactively opt-in to the program. Policy should actively encourage automatic enrollment, while respecting an individual’s right to opt out of the plan.
- **Automatic escalation of contributions.** Research also suggests that individuals are more likely to increase their contributions over time when they can pre-plan to increase their contributions at pre-determined points in the future (such as whenever they receive a pay increase). As with auto-enrollment, individuals would preserve the right to actively change their mind at any time.
- **Automatic rollovers.** In the current 401(k) system, there is significant “leakage” of assets from the retirement system when individuals change employers or leave the labor force. Under this new arrangement, participants who leave an employer would have their account automatically rolled over into another qualified retirement plan.
- **Individualized, lifecycle funds as the default investments.** Individuals who are enrolled in a retirement savings plan should be automatically invested into a low-cost, well-diversified, life-cycle investment portfolio. Ideally, this portfolio would include U.S. and international stocks and bonds, real estate, and other investments that efficiently expand the risk-reward frontier. The portfolio mix should change over time to reduce the volatility of an individual’s overall financial portfolio as they approach and enter retirement. These default investment options should be able to be customized to each individual to taken into account differences in the risk of an individual’s labor income stream and differences in risk preferences.

A focus on sustainable retirement income rather than account balances. Individuals save for retirement in order to have the resources to consume the goods and services that they desire during their retirement years. Given that all individuals face some uncertainty about length-of-life, it is important that retirement products provide a source of income in retirement that will always be there, no matter how long an individual lives. An ideal life-cycle portfolio would gradually convert account an increasing share of one’s portfolio into deferred life annuities as one approaches and enters into retirement. In addition, all account communications should emphasize the individual’s progress toward meeting income needs, rather than simply stating a point-in-time account balance.

- **Access to objective financial advice.** Many of the features outlined above automatically make “default” decisions for individuals at every stage of the retirement planning process. Automatic defaults are considered a useful way of encouraging financially sound behavior while preserving individual choice. However, there are legitimate concerns about the reliance on defaults, such as the risk that the defaults will not be optimal for everyone, that some individuals will mistakenly believe that they do not have to think about their own situation, that the reduced incentive to invest time and resources into learning about retirement planning can disrupt the creation and dissemination of valuable information, and the risk that defaults can, in the long-run, lead to “harder” paternalistic policies. In order to combat these tendencies, and in order to help individuals make the best possible retirement planning decisions, it is important that individuals be provided with opportunities to access unbiased financial advice, both through employer and non-employer sources.

Financial services providers have the knowledge, skills and abilities to create and deliver retirement income solutions that meet all of the above objectives. However, there are a myriad of regulatory, fiduciary, legal and other constraints that make the emergence of such retirement income solutions unlikely in the current environment. A top policy priority should be to remove or modify laws and regulations that stand in the way of innovative retirement income solutions.

While it is true that recent financial and economic events have exposed many of the pre-existing weaknesses in the foundations of our retirement system, the appropriately optimistic view is that we have the resources and knowledge with which to build a new, stronger foundation for an efficient and effective retirement income system for the 21<sup>st</sup> century. If we can add the final ingredient—the political will and leadership to undertake a substantial restructuring of retirement policy in the U.S.—then we have the opportunity to create a retirement income security system that will substantially improve the well-being of future generations of retirees.

## RETIREMENT USA

By Karen W. Ferguson

The nation's patchwork private retirement system has already failed millions of workers and retirees, and is currently on track to fail millions more. Companies are freezing and terminating their pension plans at unprecedented rates, already-low retirement savings plan account balances have declined precipitously, and more than half of all private sector employees still have no retirement plan at work.<sup>4</sup>

### WHAT SHOULD BE DONE?

The AFL-CIO, the Economic Policy Institute, the National Committee to Preserve Social Security and Medicare, the Pension Rights Center, and the Service Employees International Union have convened Retirement USA, a groundbreaking initiative committed to working for a *universal, secure, and adequate* private retirement system that, together with Social Security, will ensure that future generations will retire with financial security.

Retirement USA has put forward twelve principles for a new retirement system that offer a framework for measuring reform proposals and building a new structure for the future. The core principles are that any future system must be *Universal, Secure, and Adequate*—the *U, S, and A* in the name.

- **Universal Coverage** – *Every worker should be covered by a retirement plan in addition to Social Security.* A new retirement system that supplements Social Security should include all workers unless they are already in plans that provide equally secure and adequate benefits.
- **Secure Retirement** – *Retirement shouldn't be a gamble.* Workers should be able to count on a steady lifetime stream of retirement income to supplement Social Security.
- **Adequate Income** – *Everyone should have an adequate retirement income after a lifetime of work.* The average worker should have sufficient income, together with Social Security, to maintain a reasonable standard of living in retirement.

### Other principles are:

- **Shared Responsibility.** Retirement should be the shared responsibility of employers, employees and the government.
- **Required Contributions.** Employers and employees should be required to contribute, and the government should provide subsidies for moderate- and lower-income Americans.
- **Pooled Assets.** Contributions to the system should be pooled and professionally managed to minimize costs and financial risks.
- **Payouts Only at Retirement.** No withdrawals or loans should be permitted before retirement, except for permanent disability.
- **Lifetime Payouts.** Benefits should be paid out over the lifetime of retirees and any surviving spouses, domestic partners, and former spouses.
- **Portable Benefits.** Benefits should be portable when workers change jobs.
- **Voluntary Savings.** Additional voluntary contributions should be permitted, with reasonable limits on tax subsidies for such contributions.
- **Efficient and Transparent Administration.** The system should be administered by a governmental agency or by one or more private non-profit institutions that are efficient, transparent, and governed by boards of trustees that include employer, employee, and retiree representatives.
- **Effective Oversight.** Oversight of the new system should be by a single government regulator dedicated solely to promoting retirement security.

Since the launch of Retirement USA in March 2009, 19 groups have signed on in support of these principles. The groups include labor unions, such as the United Food and Commercial Workers International Union; women's organizations, such

<sup>4</sup> Monique Morrissey, *Toward a Universal, Secure, and Adequate Retirement System*, Retirement USA Conference Report, October 21, 2009.

as the American Association of University Women; organizations representing minorities such as the National Center and Caucus on the Black Aged; consumer advocates, such as the National Consumers League; and retiree organizations, such as the Alliance for Retired Americans.

At the launch, Retirement USA issued a call for proposals that meet these principles. Twenty-two proposals were submitted, and six were presented at a Retirement USA conference on October 21, 2009 in Washington, D.C.<sup>5</sup>

Retirement USA is now inviting the submission of additional proposals, reaching out to other organizations to seek their support of the principles, and laying the groundwork for a nationwide public education and grassroots campaign.

### **IS A VISIONARY SYSTEM POSSIBLE?**

There are real-world models that meet many of the principles. For example, the TIAA General Account within the TIAA-CREF system includes non-discretionary employer contributions in many plans, pooled professional investment, a guaranteed minimum return, portability of accounts among different employers within an industry, low administrative costs, lifetime payments and survivor protections.

Similarly, non-profit Superannuation Funds in Australia have employer contributions, pooled, professionally invested funds, portability among funds, money locked in until retirement, worker representation on boards of trustees, and low administrative costs. New plans in the Netherlands, called Collective Defined Contribution Plans, also provide instructive models. These plans, which require employer and employee contributions, provide pooled professional investment management, money locked in until retirement, lifetime payments, and worker representation. What is unique about these plans is that employees and retirees collectively share the risk of investment loss.

In addition to existing programs, there are proposals that have been developed by employee and employer groups that meet all or some of the principles. For example, the Economic Policy Institute has put forward the Guaranteed Retirement Account plan, which calls for employer and employee contributions, a progressive government subsidy that offsets most or all of the contributions of low-income workers, pooled professional investment management, a guaranteed minimum return, money locked in until retirement, lifetime payments, and worker representation.

The Guaranteed Benefit Plan proposed by the ERISA Industry Committee is a hybrid defined benefit plan guaranteed by the federal government's pension insurance program. Employers can choose to make contributions to independent benefit administrators which would pool and professionally invest money that would be locked in until retirement and then paid out over retirees' lifetimes.

Information about these programs and proposals is summarized in a Retirement USA working paper, "Principles for a New Retirement System."<sup>6</sup>

While Retirement USA members are working hard to preserve defined benefit pensions, improve retirement savings plans, and expand retirement plan coverage for current workers, the economic turmoil of the last year has shown us that we need to begin working on a new, more comprehensive system for future workers.

As the healthcare debate has demonstrated, it will take time to develop and implement a visionary new retirement income system to supplement Social Security – but we cannot afford to wait any longer. Delay will only make it harder to provide true retirement security for all working Americans.

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5 See Release "Conference Calls for a New Approach to Retirement Security, Looks at Proposals for Visionary System." October 21, 2009. See also Christine Dugas, *USA Today*, "Group Seeks Answers for Retirement 'Crisis'," October 20, 2009, B1 for summary of the six proposals.

6 Robert Stowe England, *Principles for a New Retirement System*, Retirement USA Working Paper, March 10, 2009, pp. 19-33. See also United States Accountability Office, *Private Pensions: Alternative Approaches Could Address Retirement Risks Faced by Workers but Pose Trade-Offs*, GAO-09-642, July 2009, which includes summaries of the Guaranteed Retirement Account and Guaranteed Benefit Plan proposals, as well as other proposals. The GAO report also describes defined benefit plans in Switzerland and the Netherlands, and a new mandated retirement savings plan in Great Britain.

## **BIGGER AND BETTER: REDESIGNING OUR RETIREMENT SYSTEM IN THE WAKE OF THE FINANCIAL COLLAPSE**

By Alicia H. Munnell

The financial crisis has dramatically demonstrated how a collapse in equity prices can decimate retirement savings. The crisis has also highlighted the fragility of existing 401(k) plans as the only supplement to Social Security. Investing in equities is a central tenet of any effective retirement saving strategy, because the higher expected return offers the potential for lower required contributions. But the upside of equities comes with the risk of sudden and steep declines or extended periods of sluggish returns. Absorbing such blows is difficult in any circumstances. It is especially difficult given the large-scale shift in risk from employers to individuals that has occurred over the past quarter century.

The inadequacies of our current retirement system go beyond the vulnerabilities revealed by the current crisis. Even without the stock market collapse, future retirees were projected to end up with too little retirement income because the whole system is contracting – including, notably, Social Security replacement rates – while retirement income needs are increasing due to rising longevity and health care costs.

In response, a new direction is needed that would tackle both problems – concentrated equity exposure and insufficient retirement income – at the same time. The best bet is to establish a new tier of universal retirement saving that would aim to replace about 20 percent of a worker’s pre-retirement income. Since contributions would take decades to produce this level of replacement, the new tier would not provide much in relief to those currently approaching retirement, but would be of great value to middle-age and younger retirees who are unlikely to do as well on their investments as baby boomers have done, even with the recent market collapse. This proposed 20-percent replacement rate from the new tier combined with 36 percent (before Medicare deductions and taxes) from Social Security would produce 56 percent of pre-retirement earnings for the average earner at age 65. Middle and high-income workers would want to save more through 401(k)s and other mechanisms.<sup>7</sup>

Participation in the new tier should be either mandatory or strongly encouraged (through defaults such as auto-enrollment). The accounts would be funded by contributions from employees, and perhaps employers, with low-income workers receiving some form of government subsidy. Participants should have very limited access to money before retirement, and benefits should be paid as annuities. The new tier should reside as much as possible in the private sector. However, the question of how to handle the investments in such accounts is a vexing one.

One option would be to have the government guarantee a rate of return. For such a guarantee to be consequential, it would need to be above the risk-free rate. While an analysis of past market returns suggests such an approach would have been quite feasible, guarantees for unknown prospective returns would only work if the government were less risk averse than the market as a whole. Theory suggests that the government could shoulder greater risk, but setting up a new system of universal accounts run by private investment managers with a meaningful government guarantee could prove challenging.<sup>8</sup>

Therefore, a second approach would remove the challenge of equity risk from the new accounts. The accounts would instead invest more conservatively, while the Social Security Trust Fund would take on the task of equity investment. This approach would thus use an existing mechanism to share equity risk across generations and, by reducing the cost of funding Social Security, it would free up government resources to help subsidize the new accounts. Under this structure, 401(k)s would return to their original place as a third tier on top of a strengthened Social Security system and the new universal second-tier savings accounts with low risk exposure.

7 Munnell, Alicia H. 2003. “The Declining Role of Social Security.” *Just the Facts on Retirement Issues 6*. Chestnut Hill, MA: Center for Retirement Research at Boston College.

8 Munnell, Alicia H., Alex Golub-Sass, Richard W. Kopcke, and Anthony Webb. 2009. “What Does It Cost to Guarantee Returns?” *Issue in Brief 9-4*. Chestnut Hill, MA: Center for Retirement Research at Boston College.

Some might argue for skipping the new tier altogether and simply expanding Social Security. But several considerations argue against such an approach: the new tier should be viewed solely as a mechanism for generating replacement income not as part of a program with redistributive goals; the funded nature of a new tier will supplement the PAYGO structure of Social Security in a way that provides a more balanced retirement system; and, from a political standpoint, providing additional saving through the private sector is likely to be much more palatable than substantially expanding a government program.

The final challenge would be designing the Social Security equity investment program to adjust to financial shocks in an equitable way. Other countries with central equity investment have adjustment mechanisms, but the impact of the market crash suggests that these mechanisms are incomplete. For example, the intergenerational risk sharing mechanisms in Canada, Sweden, and the Netherlands place a disproportionate share of the burden on current retirees, who tend to be the most risk-averse portion of the population. Ideally, those who are more risk averse should bear less of the aggregate risk. Employed workers can adjust their earnings and consumption and how long they might work; and because their remaining life expectancies are longer, they can more easily smooth consumption following an unexpected income shock, by making smaller adjustments over more years. These considerations should be taken into account when designing any intergenerational risk sharing mechanism for the United States. Surmounting this final hurdle is important for establishing an efficient and resilient retirement system that can stand the test of time.

## POLICY PRINCIPLES FOR A 21<sup>ST</sup> CENTURY RETIREMENT SYSTEM

By David P. Richardson

The goal of a retirement income system should be to provide an adequate and secure income for retirees and their surviving spouses. Adequacy can be defined as providing a level of income that keeps retirees out of poverty. For the United States, adequacy is more often defined as a level of income that allows retirees to maintain their pre-retirement standard-of-living. Security is harder to define. From a household's perspective, security could mean a system that minimizes the risks that a retiree has inadequate retirement income, outlives retirement income, or that a dependent spouse would be left destitute if the retiree dies. However, this definition tends to ignore the broader risk management issues associated with a national retirement system. From this broader perspective, security can be defined as prudent risk management and an equitable distribution of the risks associated with accumulating and distributing retirement wealth.

The programs supporting the goals of retirement income policy have traditionally been Social Security, employer sponsored retirement plans and personal saving. Aspects of our three-part system have served prior and current generations of retirees very well. Social Security has been very effective at helping reduce old-age poverty, with recent statistics indicating that those aged 65 and over have the lowest poverty rates of any age cohort in the economy.<sup>9</sup> In addition, the mixture of employer plans and personal saving has worked well in complimenting Social Security. Research shows that for the recent generation of retirees, over 80 percent have accumulated sufficient assets to maintain their pre-retirement standard-of-living, and for those with inadequate assets the gap is generally small.<sup>10</sup> However, these retirees faced significantly different labor market conditions than the current generations of workers, in particular with respect to the form of employment based retirement benefits. Because of these differences, retirement system reform should be considered to ensure that future retirees also have an adequate and secure retirement.

While public sector employees have always had primary Defined Benefit (DB) plan coverage, a fundamental shift in private sector retirement benefits began in the early 1980s with the advent of 401(k) plans. In 1975, 67 percent of all private sector plans were Defined Contribution (DC). However, only 26 percent of participants were in a DC plan, with 31 percent of those covered by a single employer plan and only 3 percent of workers in a multi-employer plan participating in a DC plan. By 2006, 93 percent of all plans were DC. Moreover, 65 percent of participants were in DC plans, with 70 percent of workers covered by a single employer plan and 27 percent of those with a multi-employer plan participating in a DC plan.<sup>11</sup> This dramatic shift in private sector employment based coverage has shifted many of the responsibilities and risks of building retirement wealth away from employers onto workers.

Any retirement system requires management of four risks – funding risk, investment risk, mortality risk, and longevity risk.<sup>12</sup> Funding risk is the risk of not setting aside adequate resources for a secure retirement. Investment risk occurs because poor investment choices can result in negative portfolio returns, reducing assets available for consumption in retirement. Longevity risk is simply the risk of outliving retirement resources. Mortality risk is the risk of a worker dying early and forfeiting retirement assets that could have passed through to an estate or beneficiary (e.g. a spouse). The management of these risks should be the shared responsibilities of employers, workers, and the government. Unfortunately, the marginal reform approach used for the U.S. retirement system has resulted in an unequal and likely inefficient distribution of risk burdens. This problem is especially evident in the distribution of risks for employer sponsored plans.

9 U.S. Census Bureau, Current Population Survey, 2009 Annual Social and Economic Supplement, Table POV01.

10 Scholz, John Karl, Ananth Shesadri, and Surachai Khitatrakun, (2006) "Are Americans Saving 'Optimally' for Retirement?" *Journal of Political Economy*, vol. 114, no. 4, pp. 607 – 643.

11 Source: TIAA-CREF Institute tabulations of U.S. Department of Labor Form 5500 data.

12 Other research discusses other risks such as catastrophic risk and lifestyle risk. For example, see *Retirement Income Redesign: Master Plans for Distribution: An Advisor's Guide for Funding Boomer's Best Years*. Edited by Harold Evansky and Deena Katz. Bloomberg Press, 2006.

Under a traditional DB framework, employers bear funding, investment and longevity risk, and employees bear mortality risk. For private sector DB plans, employers bear these risks by law and are required to ensure the plans are adequately funded and have sufficient assets on hand to pay all accrued benefit liabilities. By contrast, under a typical DC system, employees bear funding, investment, and longevity risk, and there is no mortality risk. Taxpayers can also bear substantial risk. For example, taxpayers bear funding, investment, and longevity risk in public sector DB plans and with Social Security. In addition, it can be argued that taxpayers ultimately bear the risk of private sector DB plans through the Pension Benefit Guaranty Corporation's underwriting of private sector benefit promises.

The marginal reform approach utilized over the past 40 years has resulted in a hodgepodge of plan designs, with coverage type and participation rates that are highly idiosyncratic to various sectors of the labor force. This has created a retirement system with unequal risk burdens and many households bearing unprecedented responsibility for managing retirement risks. Holistic, system-wide reform is needed to ensure that future generations of Americans reach retirement with adequate resources for a secure retirement. Principles for system-wide policy reform include:

- **System Integration.** Reform should focus on creating a more integrated retirement system that increases the likelihood an individual will have adequate and secure retirement income. Public policy should steer employers toward Social Security integrated plan designs as an effective way of ensuring retirement income adequacy.
- **Retirement Risk Management.** Reform should encourage development of integrated measures of how risk burdens are distributed. Evidence suggests that the pure DB model shifts too much risk to employers and the pure DC model places too much risk on employees. Public policy should encourage the adoption of a hybrid DB/DC model, similar to the program offered by the federal government, which provides a more equitable distribution of risks.<sup>13</sup>
- **Retirement Adequacy.** Reform should encourage early participation and adequate contributions. Research indicates that these are the key factors to achieving an adequate income replacement rate in retirement.<sup>14</sup> Public Policy should steer employers to plan designs that offer auto-enrollment, minimum funding, and auto-escalation of contributions.
- **Retirement Security.** Reform should ensure that households are not unduly burdened by longevity and mortality risk. While Social Security provides some protection from longevity risk, public policy should encourage individuals to annuitize sufficient assets to ensure they do not suffer a serious decline in living standards late in life. In addition, public policy should require minimum payment guarantees to protect at-risk portions of the retiree population (e.g. those with relatively low life expectancy).

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<sup>13</sup> The Federal Employees Retirement System is a mandatory participation primary DC plan with a supplemental DB plan.

<sup>14</sup> Hammond, P. Brett, and David P. Richardson. "Retirement Saving Adequacy and Individual Investment Risk Management Using the Asset/Salary Ratio." Pension Research Council Working Paper WP2009-13, The Wharton School, University of Pennsylvania (September 2009).

## REFORMING THE DEFINED CONTRIBUTION SYSTEM

By Paul J. Yakoboski

The US retirement income system faces numerous challenges—Social Security is facing a long-run deficit,<sup>15</sup> at any point in time about one-half of workers are not covered by a retirement plan through work,<sup>16</sup> and employer-sponsored plans are often not designed to provide retirement income security. This essay focuses on the challenges posed by the 401(k) model which is now the dominant type of employer-sponsored retirement plan. In some cases it is the primary (even sole) plan sponsored by an employer and in other cases it is supplemental to another plan.

Assuming the primary objective of a retirement plan is to produce an adequate and secure income for workers throughout retirement, the typical 401(k) plan is ill-designed in numerous regards.<sup>17</sup> The typical 401(k) design is flawed for well-documented reasons—

- Eligible workers not participating.
- Inadequate contributions.
- Poor investment allocations.
- Pre-retirement leakage.
- Lack of annuitization in retirement.

These shortcomings can be addressed, however, through changes to basic plan design.

The proposals discussed here draw from the lessons of behavioral finance and involve a degree of “enlightened paternalism.” They are not unique, having been discussed elsewhere. But ensuring that sponsored plans function as retirement plans necessitates comprehensive reform of the defined contribution model, not piecemeal changes. The question for public policy makers then regards what designs should be required of employer-sponsored tax-qualified plans?

### PARTICIPATION

Twenty percent of eligible workers do not participate in a 401(k) plan.<sup>18</sup> Auto-enrollment of workers has proven effective in increasing participation rates<sup>19</sup> and should be a plan requirement. At the same time, policy makers could go further and require that eligible workers participate in a sponsored plan. There is precedent for mandatory participation with a number of large public-sector DC plans that serve as the primary retirement plan for state and local government employees, as well as higher education employees.<sup>20</sup>

15 Within 7 years the program will begin paying more in benefits than it collects in taxes and by 2037 the trust funds will be exhausted. At that point, payroll taxes and other income will be sufficient to pay approximately 76 percent of program costs. The funding shortfall over the next 75 years is 2 percent of taxable payroll. (Source: *Fast Facts & Figures about Social Security*, Social Security Administration (2009).)

16 Among wage and salary workers ages 21–64, 47 percent participated in an employment-based retirement plan in 2007. (Source: Employee Benefit Research Institute estimates from the 2008 March Current Population Survey.)

17 While not the focus here, typical defined benefit plans also have design shortcomings given labor market realities—a benefit structure where accumulations are back-loaded to later years of service, where accumulated benefits are generally not portable except for multiemployer settings, and where benefit levels are frozen at the point of job change. The majority of workers never had career employment with an employer sponsoring a traditional pension—at any point in time at least half of workers have not been covered by a plan (Current Population Survey data) and career jobs never existed for most workers (the percentage of workers age 60 to 64 with tenure of 25 years or more was 17 percent in 2006, in 1983 it was 23 percent (US Bureau of Labor Statistics)).

18 Source: (Source: *51st Annual Survey of Profit Sharing and 401(k) Plans*, Profit Sharing/401k Council of America (2008).

19 See Madrian, Brigitte. “Enhancing Retirement Savings Outcomes in Employer Sponsored Savings Plans : Part 1 - Increasing Participation.” TIAA-CREF Institute *Trends and Issues* (October 2005).

20 See Crane, Roderick B., Michael Heller and Paul Yakoboski. “Best-Practice Benchmarks for Public-Sector Core Defined Contribution Plans.” TIAA-CREF Institute *Trends and Issues* (July 2008).

**CONTRIBUTIONS**

Research has demonstrated the overriding importance of contribution levels relative to other factors, such as asset allocation, for ensuring an adequate level of retirement income from DC plans.<sup>21</sup> Aggregate contributions in the range of 10-14 percent of earnings are necessary (assuming realistic investment returns) to target a retirement income replacement ratio of 70 percent.<sup>22, 23</sup> Company contributions to 401(k) plans average 3.2 percent of payroll, while average participant deferrals fall in the 6-7 percent range of pay.<sup>24</sup> Policy makers should require non-discretionary employer and employee contributions in sponsored plans at a combined minimum of 10 percent of earnings. Non-discretionary contributions are common in public sector primary DC plans.<sup>25</sup> In the case of low income workers, government contributions will need to be partially substituted for participant contributions.

**INVESTMENTS**

Retirement savers are often “guilty” of fundamental investment misallocation given time horizons, over-exposure to an asset class, chasing returns, trying to time markets and lack of rebalancing. And a sponsored plan can actually offer too many investment options.<sup>26</sup> In 401(k) plans, the median and average number of investment options is 15 and 17, respectively.<sup>27</sup> Public policy should require that a target-date life-cycle fund serve as the default investment in sponsored plans. In addition, plans should offer a limited array of 10 to 15 investments covering the major asset classes, including the life-cycle option.

**PRE-RETIREMENT DISTRIBUTIONS**

Pre-retirement distributions are a threat to retirement income security. Money saved in defined contribution plans is often cashed-out when an individual changes jobs. As of 2006, 16.2 million workers had taken a lump-sum distribution of their retirement savings; the average distribution was \$32,219 and the median was \$10,000.<sup>28</sup> Asset leakage can also occur through hardship distributions and plan loans. Almost all 401(k) plans (98 percent) have a loan provision and 94 percent allow participants to make withdrawals due to financial hardship.<sup>29</sup> Cash-outs at job change from tax-qualified plans should not be allowed. In addition, sponsored plans should not permit loans or hardship withdrawals, or at a minimum they should be greatly limited.

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21 Hammond, P. Brett, and David P. Richardson. “Retirement Saving Adequacy and Individual Investment Risk Management Using the Asset/ Salary Ratio.” Pension Research Council Working Paper WP2009-13, The Wharton School, University of Pennsylvania (September 2009).

22 See Crane, Roderick B., Michael Heller and Paul Yakoboski. “Defined Contribution Pension Plans in the Public Sector; A Benchmark Analysis,” in *The Future of Public Employee Retirement Systems*, edited by Olivia S. Mitchell and Gary Anderson, Oxford University Press (2009).

23 There is a range of opinion regarding appropriate replacement rates. For example see the *2008 Replacement Ratio Study* (Aon Consulting and Georgia State University) and “The New Retirement Reality: Calculating the True Cost of Retirement Income Security” by Lori Lucas and Allen Steinberg (*Benefits Quarterly*, Fourth Quarter 2006). Seventy percent is used here for illustrative purposes.

24 Numerous formulas are used to determine company contributions. The most common formula is a fixed match only, present in 25 percent of plans (including plans with safe harbor matches). For plans with fixed matches, the most common matches are \$.50 per \$1.00 up to the first 6 percent of pay (26 percent of plans), \$1.00 per \$1.00 up to the first 4 percent of pay (10 percent of plans) and \$1.00 per \$1.00 up to the first 3 percent of pay (8 percent of plans). (Source: Id. at 4.)

25 Id. at 6.

26 See Iyengar, Sheena. “The Effects of Choice Proliferation on Retirement Savings Behavior.” TIAA-CREF Institute Trends and Issues (May 2008).

27 Source: Hewitt Associates, *Survey Findings: Trends and Experiences in 401(k) Plans 2007* (Hewitt Associates: Lincolnshire, IL, 2007)

28 Copeland, Craig. “More Detail on Lump-Sum Distributions of Workers Who Have Left a Job, 2006.” EBRI Notes, Vol. 30, No. 7 (July 2009.)

29 Id. at 12.

## **RETIREMENT DISTRIBUTIONS**

Savings must be converted into income during retirement. Furthermore, retirees need a stream of income, in addition to Social Security, throughout their retirement. Annuitization of savings is the only means for an individual to guarantee a steady stream of retirement income for life. All 401(k) plans offer a lump sum distribution option, but only 15-20 percent offer retirees the ability to annuitize their account balance.<sup>30</sup> Sponsored plans should be required to offer an annuitization payout option to retirees and participants should be required to annuitize a minimum percentage of their account balance in retirement.<sup>31</sup>

## **UNCOVERED WORKERS**

The 50 percent of workers not covered by a retirement plan should have the opportunity to save for retirement through a payroll deduction IRA, as is often proposed. The reality, however, is that many will not save even with such an option available. Some genuinely can not afford to save. Others will not, even if they fully intend to do so; many will just never get around to acting upon their intent. Thus policy makers should consider auto-enrollment for such individuals into payroll deduction IRAs, with a default contribution rate of, say, 5 percent. The other design elements discussed above would apply to these payroll deduction IRAs as well.

## **CONCLUSION**

Defined contribution plans are the dominant form of employment-based retirement plan in the United States. Such plans have the potential for generating meaningful retirement income, but the typical 401(k) plan does not lend itself to such an outcome. This is purely a function of plan design. Appropriate DC design regarding participation, contributions, investments and distributions results in a plan focused on providing participants with an adequate and secure retirement income.

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<sup>30</sup> Id. at 4 and 12.

<sup>31</sup> Meeting the required degree of annuitization could be spread over the first several years of retirement. An analogous requirement would be needed for IRAs.

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