A defined contribution based future – experiences from the US market

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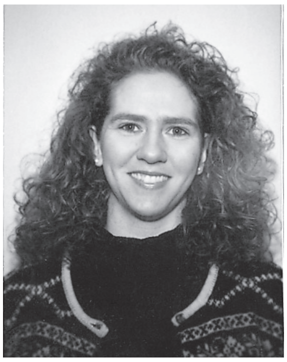

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A contribution based pension scheme has been heavily debated in Norway for the last years. In that connection Ann-Kathrin Halvorsen has looked upon experiences with defined contributions from the US market. Halvorsen, originally from Norway, has worked for M&R, an actuary and consultancy firm, for the last five years, specializing in defined contribution schemes. She has a Masters of Arts degree from the University of Washington, specializing in the European welfare state and the development of pension schemes in Scandinavia.

Like many other Western countries, the U.S. is struggling to find a solution to the financing problem that faces its national pension scheme called Social Security. The quandary is not very different from the one found in other countries; an aging population will put undue strain on the pay-as-you-go financed state pension program founded decades ago. Because reform is technically difficult and because the process is a highly politicized one, radical and swift change is unlikely to happen. Change is needed, however. As a result, emphasis has been put on private employer sponsored pension plans. The American tax code allows for the establishment of tax favored defined benefit (DB) and defined contribution (DC) plans. During the last few years, however, DC plans have gained in popularity both among employers and employees. Named after the section in the tax code, these 401(k) plans move all of the responsibility of amassing retirement income onto the employees. Because these types of plans are fully funded and may put less financial strain on a company (employers are not required to contribute to the plan), they are very much liked by the private sector. Politicians also favor further emphasis on 401(k) plans as they can easily come to serve as a major retirement income supplement. With more and more such individual accounts, cuts in Social Security benefits may be easier to push through in the future. There has been no formal move, however, to make these plans a strong pillar in a new national pension scheme.

Employer sponsored DC plans is a trend

that can be spotted elsewhere in the world, but the unique feature about the American 401(k) plans is the extent to which individuals are in charge of their own investments, the current lack of universality and a total reliance on the market to provide for and regulate retirement savings. When participating in a 401(k) plan an individual must decide what mutual funds to invest in and his or her investment allocation. The investment risk is completely borne by the individual. Of course, investment advice is available, but generally at such a high cost that few can afford personally tailored investment portfolios. Employers and plan consultants generally choose to stay away from direct investment advice due to liability. The retirement account can usually be accessed through a telephone system and/or the internet and an increasing number of the plans are valued on a daily basis. This forces employees to absorb daily market fluctuations. Employees also have relatively easy access to their retirement savings. Most 401(k) plans allow workers to borrow or withdraw from their accounts.

Of course, there are certain advantages associated with a highly individual approach to retirement security. A DC based future fits well with the American culture of strong individualism. Even though the jury is still out on this issue, increased personal savings may have a positive economic effect. The steady inflow of money invested in the American economy over the last decade, mainly from 401(k) like plans and other retirement savings vehicles, may help explain why this country's stockmarkets have proven to be remarkably resilient even through the recent Asian and Russian economic turmoil. Thanks to high long-term returns, investing pension funds in the stock market may also help individuals reach a financially rewarding retirement. A DC environment may also serve the highly mobile American work force better than traditional DB plans. These potential advantages, however, do not justify the existing inequities in American employer sponsored DC plans. The problem with the U.S. DC plans is not necessarily the fact that they are financed on a defined contribution basis, but rather the lack of standardization and mandatory participation. The insurance element prevalent in a defined benefit environment has been replaced by a more precarious savings element.

A varied pension landscape

Lack of Standardization

There is very little uniformity between the many employer sponsored 401(k) plans existing today. The government has created a loosely structured legal framework that allows for great diversity between employers. One part of the legal framework limits the total contributions (the sum of employer and employee contributions) to an employee's account to the lower of 25 % of gross salary and $30.000. How this ceiling is reached, however, varies. Employees may elect to contribute anywhere between 0 % and 25 % of their gross salary, but the employer sets the deferral ceiling. As a result, some employees are entirely responsible for their own funding while others get help from their employer. In an attempt to prevent 401(k) plans from becoming tax shields, an employee can not contribute more than $10.000 per year (1998 figure). More importantly, however, may be the diversity in employer contributions. It is not mandatory for employers to contribute to a 401(k) plan, but when they do, the formula for calculating employer contributions also differ between companies. An often used calculation is to match an employee's contribution by 50 % up to 6 % of pay, but many employers have decided to be more or less generous than that.

Vesting also affects the retirement benefit. In a traditional 401(k) plan, an employee must be fully vested in the employer's contribution portion after no more than seven years, but a company may choose to allow full vesting earlier. In the highly mobile American work force, frequent job turnover is not uncommon and many employees forfeit all or a portion of their retirement benefits when changing jobs.

Investment choices is yet another area where there is little if any standardization. Most employers offer a choice between an equity, a bond and a money market fund, but some employers have a greater selection and offer more diversity than others. Recently, the spotlight has been directed towards fees associated with the administration of 401(k) plans. Commonly, three or four parties are involved in the operation of a DC plan; the employer, a recordkeeper/administrator, and a trustee. Often the employer will also pay an independent financial consultant to review and monitor the investments options. Fees are charged by all of these parties. Some employers may absorb all or some of these charges while others pass all fees on to the employees whose retirement accounts are debited. Depending on what employer you work for, your 401(k) account may take quite a financial hit. Assuming a 7 % rate of return reduced by 0,5 % in fees, a $25.000 401(k) balance would grow to $227.000 in 35 years without any new contributions. If the fees were increased by one percentage point, the same balance would only grow to $163,000.[1]

No employer is required to establish a pension plan for its employees. Even though 401(k) plans have increased dramatically in popularity in the last decade, chances are that you will only be covered by such plan if you work for a large company. According to the Employee Benefit Research Institute, only thirteen out of one hundred firms with less than ten employees offer a pension plan. On the other end of the spectrum, employees working for a company with more than one thousand workers have an 86 % chance of being covered.[2] Unfortunately, the fastest growing sector of the American economy is that of small businesses.

The Semantics of Pension

One important factor which can determine the ability of 401(k) like plans to serve as a true retirement tool is how the purpose of the plan is perceived by employees. At the moment many 401(k) plans are labeled savings plans rather than retirement plans. This distinction enforces the view that these pension vehicles are merely savings accounts that can assist an employee through a rainy day. This view has mandated regulation which makes it easy for employees to borrow and withdraw money from their accounts. Obviously this erodes the savings potential of the 401(k) plan. The government's regulatory framework allows for employee loans up to $50.000 and withdrawals for a myriad of reasons ranging from purchasing a home to covering medical expenses. Often no reason is needed at all to withdraw money from the account. Employers, eager to increase the plan's participation ratio, often believe that a more flexible plan will appeal to employees. That may be so, but the long-term financial interest of the employee is as a result sidelined. Even though more restrictions on access to 401(k) balances may be appropriate, this will be a difficult task to implement in the U.S. Defined contribution plans are very visible through periodic reporting (usually quarterly statements), internet and phone access, and the sense of ownership is strong. Consequently, employees feel they have the right to make decisions about their own money. This is an aspect of employer retirement plans that was virtually absent in a defined benefit atmosphere.

More importantly, however, is what the employee decides to do with the 401(k) balance once (s)he leaves the company (which happens quite frequently during an American's career). At the moment an employee has three options: the money can be left in the plan (if the balance is greater than $5.000), moved to another retirement savings vehicle virtually without tax consequences or withdrawn as cash. Unfortunately, a very high percentage of employees choose the last option despite the tax penalties (a mandatory 20 % federal tax, a 10 % penalty if the employee is less than 59 1/2 years old, and state taxes if they apply). According to the governmental House Subcommittee on Employer-Employee Relations an estimated 75 % of pay-outs are distributed partly or all in cash.[3] Of course, some of these distributions may have been used to buy an annuity or were put into another savings account, but chances are that most of the money were spent on non-essential items. In a country where consumer spending is a prized commodity, the temptation to spend one's retirement benefits is understandable, but the long-term effects may not be fully appreciated by the employee.

Education

In late 1997 the government passed the Savings Are Vital to Everyone's Retirement Act (SAVER). This bill addresses the knowledge gap that exists concerning employer sponsored pension plans. The SAVER act will "maintain an ongoing program of education and outreach to the public." The program consists of public service announcements, public meetings, creation of educational materials, and the establishment of an internet site where workers can, among other things, estimate the amount they need to save in order to reach their retirement goals. However noble the intentions of this act may be, the political process is a time consuming one and much time will pass before the education campaign is in full force.

Employers have in recent years begun to assume responsibility for educating their employees about their benefits and the opportunities that their 401(k) plans offer. As with the American employer pension plans, however, there is little uniformity between employers' communication programs. Some employers should be commended for generating informative education materials and even personal hand-holding, but there is little in the way of targeted education materials. In the diverse American work force, employees have very different needs and formal education levels vary greatly. As a result, a communication program that works well for college educated employees may be lost on individuals with limited exposure to financial markets and economics. Pension administrators, for instance, is still struggling with employees who don't understand the importance of deciding on an investment strategy for their retirement accounts. Very often the contributions are defaulted into extremely conservative money market instruments because employees never chose an asset allocation.

Highly versus non-highly compensated employees

In a DC environment the benefit is closely linked to compensation. As a result, higher paid employees will amass greater wealth. This is in and of itself not a problem as higher paid employees require a higher total balance in order to achieve an appropriate replacement wage in retirement. The regulatory framework surrounding the 401(k) pension plans, however, allow higher paid employees to defer a higher percentage of compensation than lower paid employees. A highly compensated employee is defined as someone earning more than $68.400 a year (1998 figure). Existing discrimination testing of pension plans limit the difference in average deferral rates between highly and non-highly compensated employees, but a consistently higher deferral rate by highly compensated employees can over time aggravate the economic differences between the haves and the have-nots. In addition, the highly and non-highly compensated employees are tested as a group. Consequently, a high deferral rate by a few non-highly compensated employees may result in a passable average deferral rate for the entire group. The discrepancy between highly and non-highly compensated employees are as a result further distorted.

Of course, 401(k) plans are also tested to make sure they provide coverage for an adequate percentage of the work force. However, employers are allowed to exclude part-time or contract workers and union employees who may have collectively bargained for other benefits. In addition, employers may require a waiting period before participation is allowed. The waiting period can easily amount to a full year of employment in which a set number of hours have been worked. Limited entry dates may prolong this waiting period even further. Some employees may as a result not qualify for their employers retirement plan before they move on. Coverage testing of 401(k) plans is more of a design issue and does not address discrepancy in deferral rates.

Marginalized Groups

Individuals who are out of the work force for long periods of time are at a disadvantage under the current system of employer sponsored DC plans. Women, unemployed and seasonal workers all fall into this category. Their savings potential is undermined by periods with no new contributions. Just 39 % of all female full-time workers are covered by an employer sponsored retirement plan versus 46 % of men. Vesting rights may also work against these groups as women and seasonal workers may forfeit part of their benefits or need more time to become fully vested.

Part-time employees also suffer under the existing system. Employers have the legal right to exclude part-time and contract workers completely from plan participation and this right is often exercised. Even in plans where part-time workers are eligible, their low earnings often prohibit them from channeling a portion of pay into a retirement plan. Other low income workers also face the same dilemma. Yet another unfortunate distortion is the fact that many of low income workers are minorities. For example, 13,5 % of the American population live below the poverty line, but an astonishing 31 % of Hispanics remain below this threshold. From 1979 to 1993 Hispanic participation in pension plans fell while overall participation rose. While 51 % of white workers participate in an employer sponsored pension plan, only 32 % of Hispanics and 38 % of African-Americans do.[4] This skews the retirement savings picture further and exacerbates economic differences between race segments in the population.

Thoughts for the Future

In order for employer sponsored DC plans to serve as a viable part of the future American national pension scheme, the voluntary nature of the system must be replaced by increased universality and standardization along with mandatory participation. Under the current system, too few employees are covered and obvious differences between income levels threaten to aggravate economic differences during retirement. The wisdom of relying completely on the stockmarket for investment should also be questioned. The U.S. has recently experienced a lengthy bull market which has helped justify such an investment strategy, but the high risk involved should be addressed. If changes towards standardization are made in the American employer pension market, DC plans have the ability to become a strong pillar in the national pension scheme and to empower individuals. This will undoubtedly be a slow process as the American government will find it difficult to impose strict regulation on employers. Failed attempts in the early part of the Clinton administration to mandate all employers to provide health insurance, show the strength of the American belief in the market and the power of capital interest groups.

As DC financed plans are becoming increasingly popular in Scandinavia, American experiences may be relevant. Of course, the Scandinavian work force is very different from its American counterpart. A much higher unionization ratio, strong employer organizations, a well-defined negotiation process between employers and employees, and a solid social democratic past will all help to establish a much more equitable foundation on which defined contribution plans can be built. Smaller populations and a less fragmented educational system may also make a retirement education program more effective. Even so, experiences from the American market can help in design issues and in investment strategy questions.

Notes

1. Pension and Welfare Benefits Administration, A Look at 401(k) Plan Fees, 1998, 2.
2. Corbel Connection, Summer 1998, 3.
3. Speech by Harris W. Fawell, Chairman of House Subcommittee on Employer-Employee Relations, at the National Summit on Retirement Savings, June 4, 1998.
4. Speech by former speaker of the House, Newt Gingrich, at the SAVER's Retirement Summit, June 4, 1998.