# Evolution of private voluntary savings plans in the U.S.

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# A brief history

## 19th Century to World War II

- 1875. American Express establishes first corporate pension plan.
- Growth of PAYGO DB plans in industries such as railroads and utilities.
- 1935. Social Security (old-age state pension) created during Great Depression.

## Golden era of DB plans: WWII–1981

- Post-WWII: expansion of industries (autos, steel, etc.) with unions and DB pensions.
- Smaller growth in DC "profit-sharing" movement.
- 1963. Studebaker bankruptcy. Most workers get nothing from DB pension.
- 1974. Employee Retirement Income Security Act (ERISA): DB funding, DB insurer (PBGC).
- By 1974:
  - Half of private workforce were in occupational plans.
  - 80% of occupational pensions were DB, 20% were trustee-directed DC.
  - DB or DC pensions were overwhelmingly employer-funded.

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# A brief history (cont'd)

## The 401(k) era: 1981-present

- Revenue Act of 1978. In amendment to tax code section 401(k), Congress allows pre-tax employee contributions to existing DC corporate savings plans.
- 1981. First 401(k) regulations issued.
- From 1981 to present: the DB to 401(k) switch.
  - New service-sector companies, with high job growth, adopted DC as first pension plan.
  - Established companies switched from DB to DC.
  - 401(k)s shifted from trustee to participant investment direction.
- Today, > 80% of private occupational pensions are DC, with a 401(k) funding feature and participant investment choice.

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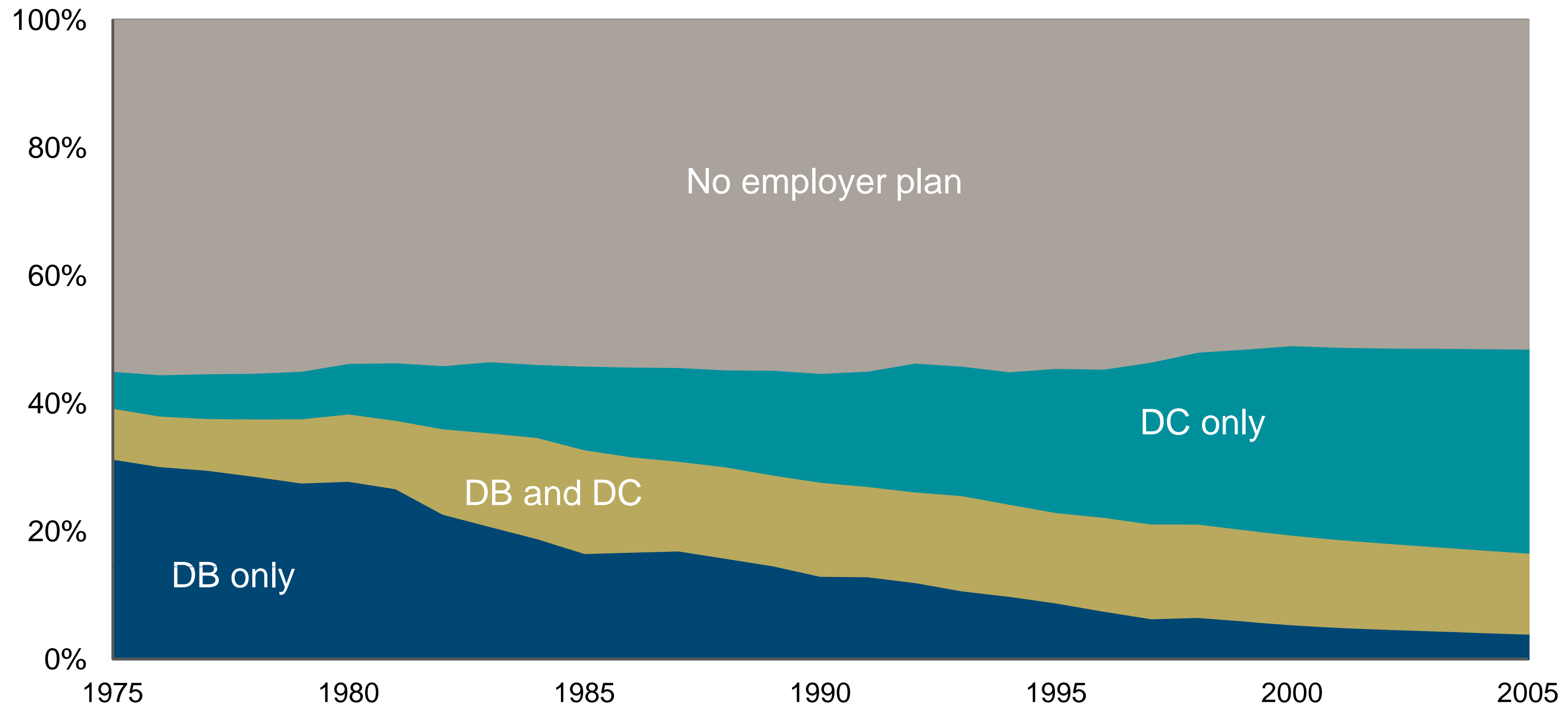
# Private worker plan coverage (1975-2005)




Source: Department of Labor, Vanguard.

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# So why the switch from DB to 401(k)?

- For employers:
  - 401(k)s are cheaper for employers. Employees are main source of funding.
  - Employer costs are predictable—unlike unpredictable DB contributions. Plus no financial statement impact as with DB.
  - Benefit is more transparent to employees, given daily valuation, and so more valued.
  - New service-sector companies, with high job growth, were likely to adopt as first and only retirement plan.

- For employees:
  - 401(k)s are portable—from one employer to another, or to own IRA.
  - 401(k)s are more transparent, more valued.
  - Control and flexibility (over contributions, investments) appeal to educated and/or service-sector workers.

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# U.S. retirement system today (private workers)

**Social Security**

- World Bank pillar 1: compulsory, 90%+ coverage
- PAYGO system: 12.4% payroll tax (split employer/employee)
- Inflation-adjusted annuity; progressive benefits structure

**401(k) (DC) plans**

- World Bank pillar 3: voluntary, occupational, 50%+ coverage
- Employee contributions as main funding
- Lump-sum distributions (including to IRAs)
- $3.1 trillion, > 80 million accounts

**Individual Retirement Accounts (IRAs)**

- World Bank pillar 3: tax-advantaged individual savings
- Mostly funded from “rollovers” from 401(k)s
- $4.9 trillion

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# 401(k) characteristics

- Sponsorship of any occupational plan in U.S. is voluntary. But if offered, a plan must comply with a complex regulatory regime.

- Plans are encouraged through meaningful tax incentives.
  - "PPT" system: contributions are pre-tax, earnings pre-tax, then all are taxed in retirement
  - Current limits: \$17,000 (if < 50), \$22,500 (if 50+)
  - New Roth version: "TPP"
  - 2nd largest tax subsidy in U.S. (est. \$80+bn/year, although this overstates true cost)

- Plans are overseen by comprehensive regulatory system:

| | |
|---|---|
| Internal Revenue Service | tax law compliance |
| Department of Labor | fiduciary oversight |
| Securities and Exchange Commission | investment regulation |

- Not just 401(k)—also 403(b), 457, profit-sharing, money purchase, KSOP, Simple, SEP. There are many plan types, leading to concerns about complexity.

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# Changing nature of contributions

- 2/3rds of eligible workers contribute to plan – the “participation problem”

- Median contribution among those contributors

| | |
|---|---|
| Employee contribution | 6% of pay |
| Employer “match” | 3% |
| Total contribution | 9% |

- However, contributions vary considerably:
  - At one extreme, an employee contributes 1–2% of own money *versus*
  - At the other, employee and employer contribute 18%–20%

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# Changing nature of investment offerings

- Most plans offer diversified investment offerings with daily valuation and with high transparency as to strategies, holdings, and risk and return characteristics

- One caveat: some large plans are concentrated in company stock (risk is falling over time)

- "Typical" plan menu today:

| | |
|---|---|
| Tier 1 | 10+ target-date funds: 2010, 2015, 2020,…2055, 2060 |
| Tier 2 | 10+ funds: U.S. large and mid/small stocks, developed and emerging stocks, balanced, bonds, money market/stable value, specialty |

- Steady increase in passive investing due to interest in low-cost investing, relative predictability of performance '

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# The behavioral finance revolution

## Research findings

- Many workers lack saving and planning skills – they are "hyperbolic discounters"
- Workers lack strong portfolio preferences, are inattentive/inexperienced money managers

## Opt-out contributions (auto-enrollment)

- Auto-enrollment nearly triples participation rates among low-wage, young, ethnic minorities
- Main issue: auto-enrollment rate set at 3%. Best practice is to "auto escalate":

| **Year** | **1** | **2** | **3** | **4** | **5 …** | **Cap** |
|---|---|---|---|---|---|---|
| EE contributions | 3% | 4% | 5% | 6% | 7% … | 10%? |

*(Employer contributions in addition)*

## Professionally managed investments

- From "be your own money manager" to "we'll do it for you"
- Two vehicles to simplify decision-making: target-date funds and managed account advice
- Also, greater "default" investing into target-date funds due to automatic enrollment
- By 2016, we estimate over half of participants in professionally managed allocations

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# Member (participant) experience

- Three phases of education
  - Extensive promotion for enrollment – print, web, meetings, email, etc.  (less with auto-enrollment plan)
  - Ongoing education: newsletter, targeted communications, and customized programs
  - Pre-retirement planning

- Advice: managed accounts, pre-retirement financial planning

- Service model
  - Increasingly web-centric: 80% of all transactions on the internet
  - Mobility (smartphone, tablet) access is growing even faster than the web did

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# Current issues

**Adequacy**

- Improving coverage: a problem largely in small firms
- Raising contributions, particularly among low wage
- Reducing “leakage”: lump sums accessible upon job change

**Fee disclosure**

- New 2012 regulations: disclosure for sponsor and employee
- Goal: reduce fees through transparency

**Retirement income (drawdown)**

- Policy initiative to encourage in-plan income options
- Little annuity use today
- Most money in IRAs managed as lump sum

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