FINANCIAL ECONOMISTS ROUNDTABLE

For release
October 18, 2006

STATEMENT ON "BEST PRACTICES FOR THE DESIGN OF DEFINED CONTRIBUTION PENSION PLANS"

The Financial Economists Roundtable (FER) is a group of senior financial economists, who have made significant contributions to the finance literature and seek to apply their knowledge to current policy debates. The Roundtable focuses on microeconomic issues in investments, corporate finance, and financial institutions and markets, both in the U.S. and internationally. Its major objective is to create a forum for intellectual interaction that promotes in-depth analyses of current policy issues in order to raise the level of public and private policy debate and improve the quality of policy decision.

FER was founded in 1993 and meets annually. Members attending a FER meeting discuss specific policy issues on which statements may be adopted. When a statement is issued, it reflects a consensus among the majority of the attending members and is signed by all members supporting it. The statements are intended to increase the awareness and understanding of public policy makers, the financial economics profession, the communications media, and the general public. FER statements are distributed to relevant policy makers and the media.

The following statement on "Best Practices for the Design of a Defined Contribution Plan" is the result of a discussion at FER's annual meeting on July 9-10, 2006 in Bretton Woods, New Hampshire. A list of members approving the statement and their current or most recent affiliation is attached.

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Statement of the Financial Economists Roundtable

On

Best Practices for the Design of Defined Contribution Pension Plans

October, 2006

Over the last two or three decades, there has been a marked shift in private pension plans from defined benefit to defined contribution plans. In 1980, over 60 percent of employees in a private pension plan were in defined benefit plans. Now, the numbers are reversed with over 60 percent in defined contribution plans.[1]

The key characteristics of employer-provided defined benefit (DB) plan are that the benefits are tied typically to some measure of the employees' earnings and number of years of work at that employer and are paid during the remaining life of the retired employee and possibly the spouse. The key characteristics of a defined contribution (DC) plan are that the employee contributes to the plan with a possible match from the employer, owns the assets, usually determines how to invest these assets, and must choose a payout option upon retirement. Payout options typically include a choice of one or more annuities or a lump sum payment. The magnitude of the payout is determined by the market value of the plan at retirement, and not directly by the employee's salary.

[1] Improving Defined Contribution Plans, Economic Policy Brief, Joint Economic Committee Democrats, October 2005 and Private Pension Plan Bulletin: Abstract of 2001 Form 5500 Annual Reports, US Department of Labor, February 2006. These percentages involve some double counting as an employee may have both a defined benefit plan and a defined contribution plan. This publication omits government plans.

On July 9 and 10, 2006, the Financial Economist Roundtable (FER) met at Bretton Woods, New Hampshire, to examine the implications of the shift toward defined contribution plans and to make recommendations to improve their design.

The Pros and Cons of Defined Contribution Pension Plans

The principal advantage of a defined contribution plan over a defined benefit plan is that the employee has ownership rights over the assets in the plan. Thus, with a DC plan the assets are portable and benefits from these assets do not depend upon the viability of the employer. (Witness the recent DB defaults in the airline industry, which were not all covered by the Pension Benefits Guarantee Corporation.) Another potential advantage is that the employee, who has some control over how the funds are invested, may be able to integrate the investment of these funds with the rest of his portfolio of assets and liabilities.

However, there are some major disadvantages of defined contribution plans as well. Specifically:

- Participants may be ill-informed and make poor investment choices.
- Participants, and even those who make well-informed decisions, bear the risk of market losses.
- DC plans are less likely to assure that all participants have adequate savings for retirement, because each participant determines how much to save and how to allocate these savings across investment choices.
- DC plans expose most participants who do not annuitize to longevity risk—the risk that an employee could outlive his or her assets.

In theory, a defined benefit plan suffers from none of these disadvantages.

Many of the potential disadvantages are related to the possibility of human error: Defined contribution plans are designed for well-informed people who take active interest in planning for their retirement and who can evaluate longevity risks, portfolio allocation, and saving decisions. But, the large number of people who are prone to error, including spouses who can suffer from their partner's errors, is of social concern. Governments have erected social safety nets to protect such people from the worst consequences of these errors. Since the general public bears the expense of such safety nets, the amount of savings in defined contribution plans and how they are invested is a valid public policy concern.

Even if employees do not fall into social safety nets, differences in their choice of savings and investments may lead to large differences in retirement incomes, even among employees with the same earnings profile. Such inequalities may create demands for the government to redistribute income.

Addressing these concerns involves a delicate balance between instructing the unschooled and the mandatory imposition of saving levels and investment vehicles. Nonetheless it is the FER's view that a combination of increasing the emphasis on automatic enrollment and specifying an appropriate default portfolio would be a major improvement in pension design in the United States.

Automatic Enrollment

There is much empirical evidence that the initial default provisions of a defined contribution plan play a key role in the decision whether to participate and, if so, how much to contribute and how to allocate that contribution across investment choices. In many existing plans, an employee must take the initiative to participate or opt-in. A significant percentage of employees, particularly new employees, do not take the initiative to participate.

If an employee decides to participate, there are usually defaults as to the percentage of salary that is contributed and the type of investment. The default contribution percentages are usually less than the maximum allowed, and the default investment is frequently a money market fund. One reason that an employer chooses a money market fund over a perhaps more suitable diversified portfolio of bonds, stocks, and other assets is to guard against lawsuits over potential losses.

The FER recommends that new employees be automatically enrolled unless they take the initiative to opt-out.[2] It takes no position on the level of the default contribution rate, although it noted that contribution rates are often too low to provide adequate retirement income, and consequently the FER was intrigued with the Save More Tomorrow Plan where employees commit to increase their contribution rates at a later date. It concluded that the default investment option should be a low-cost, low-risk, prudently diversified portfolio, which may be a life-cycle portfolio whose asset allocation changes over time[3].

Until recently, laws in some states effectively ruled out automatic enrollment, as an employer could not take a deduction without the employer's consent. The recently

[2] There was some discussion as to whether making the default option mandatory with an opt-out provision would reduce the number of corporations offering defined contribution plans, but the overwhelming sentiment was that the advantage of mandatory enrollment outweighed this possible reduction in the availability of defined contribution plans.
[3] There were some members who thought that this portfolio should include TIPS as an inflation-hedge; others thought that the inflation rate facing retired employees was not well captured by the usual CPI, making TIPS a poor inflation hedge.

passed Pension Protection Act makes it easier for employers to offer automatic enrollment. Also, employers need assurance that, as long as they chose a low-cost low-risk prudently diversified portfolio as the default option, they are protected from lawsuits if the returns of such a portfolio turn out to be negative. The Department of Labor is currently examining the nature of the investment default option.

Company Stock

Company stock is often a significant component of a defined benefit plan. The recent collapse of Enron reveals the risk of such holdings. The FER distinguished between holdings purchased with employee contributions from holdings purchased with employer contributions. Since the employer's contribution are voluntary, if the employer wants to give company stock, the FER believes that employers' contribution of stock should be allowed. However, the FER concludes that employees' contributions should generally not be invested in company stock except for the small amount in which investments would occur in index funds and well diversified actively managed funds.

Annuities

As noted at the outset, longevity risk is retained by most plan participants in any DC plan. Annuities eliminate this longevity risk, as they provide payments as long as the beneficiaries or joint beneficiaries live. Annuities come in various forms. The most widely known are immediate annuities that make payments periodically, such as monthly or yearly. Most annuities pay a fixed nominal amount, but a limited number provide payments that are indexed to inflation or even to the return on an equity or bond portfolio. Deferred annuities have an accumulation period where the premiums earn a fixed or variable return, and the annuities are deferred in that the payments begin sometime after the purchase.

Individuals who buy annuities directly in the retail market generally receive less favorable rates that those buying through employer groups. The reason is that providers incur more marketing expenses in the retail market. In addition, they may charge higher prices to protect themselves against the adverse selection that a disproportionate number of retail purchasers in comparison to those in employer plans expect and often do live longer than the average member of their age cohort.

The FER concluded that annuities can play a major role in eliminating longevity risk, and employers should offer at retirement the default option of joint life annuities that protect both employees and spouses. An employer can obtain annuities at group rates and may be in a better position than an individual employee to evaluate different annuities.

The Pension Protection Act recognizes the importance of annuities by allowing the tax-free incorporation of long-term insurance into annuities. It also directs the Department of Labor to clarify the current “safest available annuity” standard.

Education

The FER recognizes the importance of investor education to enable employees to make better investment decisions. Employers are often reluctant to provide this education, as they worry about potential liability. It is increasingly common for employers to subcontract this education function. One danger of this subcontracting is that the subcontractor may also be profiting from the recommended investments, thereby creating a conflict of interest[4]. In this regard, it might be noted that the Pension Protection Act explicitly allows the providers of investment vehicles to provide this education. Still, it is FER's view that employers, either directly or through subcontracting, should bear the primary responsibility for financial education.

[4] The FER considered recommending the creation of a tax-free education institute financed by either public or private funds. However, some FER participants noted the slow and troubled start of the independent research organizations created by the SEC in response to the recent financial analysts' scandal and financed by the industry.

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