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Comments on

"The Tracker Plan: A Controlled Risk Defined-Contribution Retirement Program"

by Faisal Siddiqi

1. Overview

Rowland Davis first discusses the problem facing the U.S. retirement system. He feels that many workers are headed toward retirement with insufficient or no retirement savings. This will lead to dramatic reductions in living standards for future senior citizens and/or require significant increases in social security pensions. To avoid this and manage the risk inherent in the current retirement system, Davis proposes the Controlled Risk Defined-Contribution Retirement Program or the Tracker Plan.

Rowland Davis' Tracker Plan is designed to increase the level of retirement savings among all workers, expand coverage of retirement savings, and manage the risk in traditional defined-benefit (DB) and defined-contribution plans (DC). Davis proposes that the Tracker Plan be implemented as a mandatory (or auto-enrolled) DC plan with independent investment management so that all workers can have coverage and at an affordable level for all parties. It is intended to work hand in hand with the pension provided by U.S. Social Security.

The Tracker Plan is designed to share the risk between employers and employees with any ultimate financial risk falling to the employee like all DC arrangements since the employer risk is subject to a hard cap. The risk to the employee is managed through various plan features. The beauty behind the plan is that probability targets are assigned to measure the successful accumulation of retirement savings. The Tracker Plan, as its name implies, tracks an individual's retirement savings relative to what is required to successfully achieve a retirement savings target. Davis provides lots of sensitivity analysis to the assumptions he chooses to illustrate how the plan works and the historical back testing over multiple 40-year periods proves that it can work. The system is a comprehensive design with a well-designed investment approach and can easily be implemented on a large scale basis.

2. Key Elements of the System

From an individual participant's perspective, the plan works as follows:

- There is a single investment vehicle that gradually reduces risk over the course of a participant's career. The vehicle is similar to a target-date fund with the level of equity assets decreasing over time with the replacement of bonds and stable value funds.

- There is a standard contribution pattern to follow throughout a participant's career that is designed to accumulate the required target amount of retirement savings.

- Based on the risk analysis Davis has done, he recommends an employee contribution level starting at 4 percent and increasing to 8 percent with a 100 percent employer match. Contribution levels increase at age 30 by 2 percent reaching the 16 percent level in total by age 33.

- Participation will be mandatory or will be done on an auto-enrolment basis.

- Progress toward the target is monitored and adjustments are made based on tracking error. If experience is adverse, additional contributions are triggered, up to a maximum. If experience is favorable, then the investment risk is reduced to preserve the higher than expected retirement savings.

The risk of reaching one's retirement goals is measured using confidence intervals. Davis uses a 90 percent test to see that a participant will meet or exceed their goals and if there is a risk of not meeting the goal, Davis suggests changes that will not require the participant to work more than one additional year.

From an employer's perspective, the plan works as follows:

- The contributions participants make are subject to an earnings cap. This controls an employer's financial exposure. Davis suggests a cap of $50,000 (or 130 percent of the Average Wage Index from two years prior) representing the median level of earnings for a 55 to 64 year old, and he further suggests this cap be indexed to average wage increases.

- If an employer wants to, they can set up a supplemental plan to cover earnings levels above the cap.

- The retirement savings target will be 75 percent of income at age 65, inclusive of Social Security. Davis assumes the Social Security benefit to be paid will be the one expected for 2049. Since that will cover 32 percent of income, the Tracker Plan is designed to provide 43 percent income replacement.

- Based on the 90 percent confidence interval, the Tracker Plan is designed to provide a benefit that will not be less than 38 percent of final pay.

- Davis determines that the size of the fund required at retirement to replace 43 percent of income is a fund equal to about 7.5 to 9 times pay. It depends on assumptions for inflation and retirement age.

- The Tracker Plan will annuitize benefits at age 65 with assumed post-retirement indexing of 2.5 percent per annum

The fund investments will work as follows:

- There will be three pools of investment funds: (a) a risk asset portfolio consisting of equities and other expected higher-income producing asset classes, (b) a fixed-income portfolio with holdings similar to Barclay's Aggregate Bond Index, and (c) a stable value fund invested in TIPS (Treasury inflation-protected securities).

- The funds have to operate to control risk and have low expenses.

- Based on a Monte Carlo analysis, Davis recommends that the risky portfolio start with 75 percent equities and decrease starting at age 35 gradually to 15 percent by age 60, and the bond portfolio start at 25 percent and eventually switch to the stable value fund to avoid sudden inflationary losses.

- Davis proposes one fund for those under age 35 (75/25 fund) and 10 additional funds for those aged 35 to 65 (using three-year cohort groupings).

There are automatic adjustments in the Tracker Plan to help keep accumulations on the desired path, as follows:

- Increasing contributions, if experience is unfavorable.

- Increasing allocation of assets to the bond portfolio, if experience is favorable.

3. Public Policy Issues

Davis feels strongly that the Tracker Plan will help address the critical issues facing Americans as they head toward retirement—issues of coverage, sufficient income, and risk management.

Coverage is the most important issue. The current scheme of voluntarily sponsored pension plans by employers is leaving many parts of society without adequate retirement income. Davis feels the strength of his proposal is having universal coverage so that everyone has something. He also feels that universal coverage will address the second issue of sufficient income. Since the Tracker Plan is designed to provide sufficient retirement income, its establishment will ensure this objective.

The next issue to consider is uniformity. A uniform plan will provide for simplicity of administration and communication.

There may also be concerns around the 75 percent replacement ratio objective and proposed level of employer and employee contributions. Davis discusses various alternatives to targeting a lower replacement ratio, assuming a higher normal retirement age versus the age 65 in his proposal, and assuming a lower level of post-retirement indexation. In the end if the Tracker Plan were to be implemented, there are many political choices that would have to be made but at least the impact of these choices would be apparent whether they impact coverage, cost, sufficiency of retirement income, risk management, or investment policy.

4. Pros and Cons of the Proposed Plan

Pros

- Mandatory and auto-enrollment forces broad labor force participation. This is key to address the coverage issue.

- Contributions at 8 percent from an employee's perspective may seem high initially, but they will help to ensure a secure retirement at least for participants up to the median earnings level. Again, this is key to avoiding an insecure retirement.

- Having funds invested in a set number of funds with appropriate risk profiles will minimize costs and help control risk. Again, this is a key to accumulating sufficient funds for retirement.

- The tracking error feature will help cohorts either preserve savings if results are good or help them achieve their targets via higher contributions if results are not good.

- The graph of where their retirement savings should be is very useful. The visual of percent of pay that needs to be accumulated will make the system easy to understand.

- The earnings cap will address the financial exposure for employers.

- Portability will be easy for participants.

- The uniformity of the plan is important to maintain simple communications and ultimately simpler administration of the plan.

- Because it is a DC plan, it will avoid having unfunded deficiencies and will help address one of the big issues with Social Security.

- In-service hardship withdrawals and loans can be allowed, though this would create leakage in the system.

- Forcing annuities to be purchased will address the longevity risk inherent in many DC plans today, so that is a good idea.

- The back testing through a very tumultuous 40-year period from 1970 to 2010 shows the Tracker Plan achieved and exceeded its 75 percent target and was not impacted by the poor equity returns in the 2000s.

- The back testing through 1940 to 1980 also achieved target results, but just barely. This shows the robustness of the Tracker Plan.

- As many retirees know, the indexing feature of the Tracker Plan is also very important. It helps to preserve purchasing power.

Cons

- I don't have any negatives to discuss for this proposed plan. It makes a lot of sense, and Davis has done so much sensitivity analysis that all the alternatives that one could come back with him on have been discussed, whether it be individuals to cover, level of contributions, assumptions, investment approach, public policy issues, administration, or communication.

5. Questions for the Author

- The political will to implement the Tracker Plan will be the biggest hurdle. How could this idea be implemented?

- It is interesting that the Canadian government is essentially implementing a basic DC pension plan for all its federal employees, though on a voluntary basis. The plan in Canada is called a Pooled Registered Pension Plan (PRPP). I would be interested to know what Mr. Davis has to say about this proposal relative to the Tracker Plan.

6. Conclusion

After having read Rowland Davis' paper, I find it as a great solution to an important problem facing society today—not just in the United States but in many countries. The Tracker Plan he proposes has a lot of merit to it for many stakeholders, and I can only hope that it is implemented in some shape or form. Thanks for a great contribution.

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