Pension Section News

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The Importance of Employer Plans—A Dialogue on a Key Issue

by Anna M. Rappaport

Retirement security in the United States comes from Social Security, employer-sponsored benefits, and personal assets including housing and individual savings. The retirement system today is faced with a lot of change, threat and uncertainty. This article deals with the question: How do employers add value by sponsoring plans? It is positioned to open up a dialogue among actuaries and include embedded questions that are italicized throughout this article.

First question: Should the SOA put together a research paper on this topic? You are encouraged to participate in this discussion by sending your comments to The *Pension Section News* Letters to the Editor. These can be sent in an e-mail addressed to Art Assantes, newsletter editor, at *ajassantes@hhconsultants.com*. Letters will be selectively published in the next edition of the *Pension Section News*.

The Proposition

Americans are much more likely to have a secure retirement when they have an employer-sponsored benefit and a longer-term job so that they have time to earn benefits. They are much more likely to save for retirement when they have access to employer-sponsored savings programs such as a 401(k) plan (or 403(b) plan for not-for-profit employers and 457 plan for some governmental employers.) This article provides an overview of the advantages of employer plans and of saving in an employer sponsored plan rather than an individual plan. It offers some data and encourages you, the reader, to contribute more data and ideas.

What an Employer-Sponsored Defined Benefit Plan Offers

An employer-sponsored defined benefit offers benefits, generally defined as monthly income for all who work longer enough to meeting vesting requirements. Private sector plans are generally non-contributory and public sector plans are generally contributory. These plans pool longevity and investment risk and provide much greater retirement security than the same amount contributed to a defined contribution plan. It has been estimated by some that you can achieve two to three times as much retirement benefit for a dollar contributed to a defined benefit plan when compared to a dollar contributed to a defined contribution plan.

Please join the dialogue and provide your estimate and information about why you support it.

These plans provide monthly income to the employee and spouse. By pooling longevity risk, it is not necessary to "oversave" in order to achieve a reasonable change that assets will not be outlived. These plans are ideal to provide adequate benefits to long service employees when an employer wishes to protect primarily those with long service. In most noncontributory plans, no decisions or action are needed until leaving the firm. The downside of this is that employees may not know much about the plans and may not identify much with them. However, today people are learning more about their benefits.

What an Employer-Sponsored Savings Plan Offers

An employer-sponsored defined contribution plan generally makes it easier to save and encourages savings. The employer provides for easy (sometimes automatic) enrollment and payroll deduction. The employee makes the decision to save once, and while it can be changed, savings continues unless a step is taken to change it. The employer program offers both education provided by the employer and those hired to provide education, but also in many cases, support and encouragement from peers.

Many employers make it very worthwhile for employees to save in their programs by matching contributions. A common match is 50 percent of the first 6 percent saved. Some employers match 100 percent of some employee savings. If the employer matches 50 percent, that means that for every $500 the employee saves, the employer will add $250.

Employers can often get a better deal for employees than they get by saving on their own. There are a number of areas of potential saving including low administrative charges, and access to mutual funds or investment options with a combination of strong professional management and low charges. Employers, by prescreening investment options, can also help increase the chance that employees will get a good return on their money.

Next area for member input: How would you compare expenses between typical employer plans and individual savings opportunity? Do you have data?

Lessons Learned and Implications for Employers Sponsoring Defined Contribution Plans

Recent research on what the public knows about retirement savings, as well as the teachings of behavioral finance, serve to reinforce for us the importance of employer plans. Managing retirement saving completely independently is a daunting task for many. Having the help of an employer makes it much more achievable. Left alone, many people will not save enough (or maybe not at all) for a secure retirement. An employer can help improve the chances of employees saving enough by adding matching contributions, providing strong default options in plans, encouraging maximum participation, and educating its workforce on retirement planning and investment considerations. Customized retirement planning information can be particularly helpful. Our experience tells us that:

- Many employees chose default options and stay in them for the entire time that they stay in their jobs.

  Next question for the dialogue: Do you have evidence about this, or comments about how we might get such evidence?

- Whenever there are matching contributions on employee savings, it is beneficial for employees to participate and they are much more likely to do so.
- Traditionally, defined contribution plans that offered choice were based on the idea that choice is good and the more, the better. In the last few years, behavioral finance has taught us that too much choice is confusing, and that no matter how attractive and informative the educational materials, many employees will not be engaged.
- Some employers have determined that the most effective way to ensure security is to create "autopilot" plans. These plans allow choice, but the default options provide for safe harbors resulting in significant amounts of savings, sometimes with annual increases, and offering a diversified portfolio. The employees who do not actively elect to join the plan are not left out as they would be under traditional plans.
- Payroll deduction is a very valuable feature of employer-sponsored defined contribution plans.
- Education is critically needed, even if there are segments of the working population that will not take it seriously.
- Employees often do not have a sufficient financial background to make appropriate investment decisions when given the choice. The employer, by selecting a limited number of options offers prescreening and fiduciary due diligence. In addition, the employer can offer education about investment mixes appropriate for different situations and/or personal advice.
- Employer defined contribution plans cannot make longevity risk go away, but many larger and well established companies offer a combination of a defined contribution and defined benefit plan. This combination serves as a portfolio that helps employees address longevity risk.
- Employees who seek to manage their own money in retirement will choose different spending patterns. While some will do fine, others may not use their assets in the best way. Some will spend too fast and need to cut back later and/or run out of assets. Others may spend too slowly, cutting back more than needed and missed out on some of what they can enjoy in retirement. Retirees who are afraid to use their assets may experience a greatly reduced standard of living. Employers can help employees understand the implications of different withdrawal strategies.

Some Evidence

Actual experience demonstrates that people are more likely to save in employer plans than in Individual Retirement Accounts. While IRA assets are a major component of the total retirement assets in the United States, much of that money came from rollovers. In 2001, contributions to traditional IRAs were $9.8 billion compared to rollovers coming in at $187.1 billion. In 2000, contributions were $10.0 billion compared to rollovers of $225.6 billion. Total assets at the end of 2003 were $2,730 billion.[1] Roth IRAs added another $102.0 billion at the end of 2003. At the end of 2004, $45.2

(continued on page 8)

[1] Table 5, *Investment Company Institute Perspective* Vol. 11, No. 1, February 2005: The Individual Retirement Account at Age 30.

million households, or 40.4 percent of U.S. households owned IRAs. The median balance for traditional IRAs was $24,000 and the mean was $76,000.[2] IRAs have been around for 30 years, and individuals have demonstrated that they are less likely to save on their own than with the support of an employer.

"The Vital Connection," a 1998 paper from the ERISA Industry Committee reinforces that employer plans work more effectively than IRAs, and that younger individuals are more likely to save in employer plans. Of the approximately 59 million households eligible to make deductible contributions to an IRA in 1992, only 6.6 percent (3.9 million) made such contributions. Even during the 1981-1986 period when all households could contribute to IRAs, the maximum number of tax returns claiming an IRA deduction was 16.2 million in 1985. By contrast, of the 105.8 million civilian non-agricultural workers in the United States in 1993, 25.2 million or 23.8 percent made contributions to employer sponsored 401(k) plans.[3]

An analysis of projected retirement status of workers aged 50 to 61 showed that households with a defined contribution plan are much more likely to have adequate retirement resources than those without such plans. Defined contribution participants include those with only defined contribution plans and those with a combination of defined contribution and defined benefit plans. Few individuals today have only defined benefit plans so this represents nearly the entire universe with employer-sponsored retirement benefits, and the result can be restated to indicate that households with employer -sponsored retirement benefits are much more likely to have adequate resources for retirement. This paper indicated that based on planned retirement age, 79 percent of those aged 50-61 are likely to be able to maintain preretirement living standards compared to 47 percent of those without such plans. At retirement age 65, the percentages increase to 88 percent and 50 percent.[4]

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Next question for you: Can you provide more evidence and data to help explain the importance of employer plans?

Conclusions

Private sector pension plans and asset accumulation are a vital part of retirement security for most Americans. Experience has shown that few people have the discipline and knowledge to save successfully on their own without help and support. Employer-sponsored retirement plans that offer attractive savings options for those with substantial service in organizations are a big help. Plans that provide benefits automatically even if an employee takes no action provide the best level of protection, considering that many people do not have the motivation and knowledge to take action. This paper does not conclude that those with plans will have enough money. In fact, many with plans need to save more or accept a lower living standard in retirement. However, without plans, a very large number of people will be in poor financial condition in old age.

Next Steps in This Dialogue

These are some ideas to get a dialogue started. Please send in your responses to the italicized questions and any other related thoughts to the *Pension Section News*. The dialogue will continue in the next issue. Depending on your comments, the Pension Section may also decide to prepare a larger paper on this topic. ◆

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2 Tables 7, 10 and 13, *Investment Company Institute Perspective* Vol. 11, No. 1, February 2005: "The Individual Retirement Account at Age 30."

3 *The Vital Connection*, page 12, ERISA Industry Committee, 1998.

4 Table 8, *Projected Retirement Adequacy for Workers Age 50 to 61: Changes between 1998 and 2001*, by Sherman Hanna, E. Thomas Garman and Rui Yao, June 2003, published on PSCA Web site.