U.S. Defined Contribution Plans: Current Issues

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U.S. retirement system today (private workers)

Social Security

- PAYGO system: compulsory, 90%+ coverage
- Financing: 12.4% payroll tax (split employer/employee)
- Benefits: inflation-adjusted annuity; progressive

401(k) (DC) plans

- Funded occupational system: voluntary, 50%+ coverage
- Contributions: employee (primary) and employer (secondary)
- Lump-sum distributions (including to IRAs)
- $4.6 trillion, > 80 million accounts

Individual Retirement Accounts (IRAs)

- Tax-advantaged household savings
- Funded mostly by "rollovers" from 401(k)s and DB plans
- $7.4 trillion

Sources: Investment Company Institute, *The U.S. Retirement Market, Fourth Quarter 2014 (March 2015)*

Coverage

Coverage

- Recent statistics among private-sector workers:

Offered & contributing to a plan (DB or DC)	
Larger firms (>=100 employees)	68%
Smaller firms (< 100 employees)	39%

Source: Dushi, Iams and Lichenstein (2011).

- Issues: workers not contributing; part-time/contingent workers; small firm sponsorship
- Related problem: high fees (>1%) among small company 401(k) plans

Coverage proposals

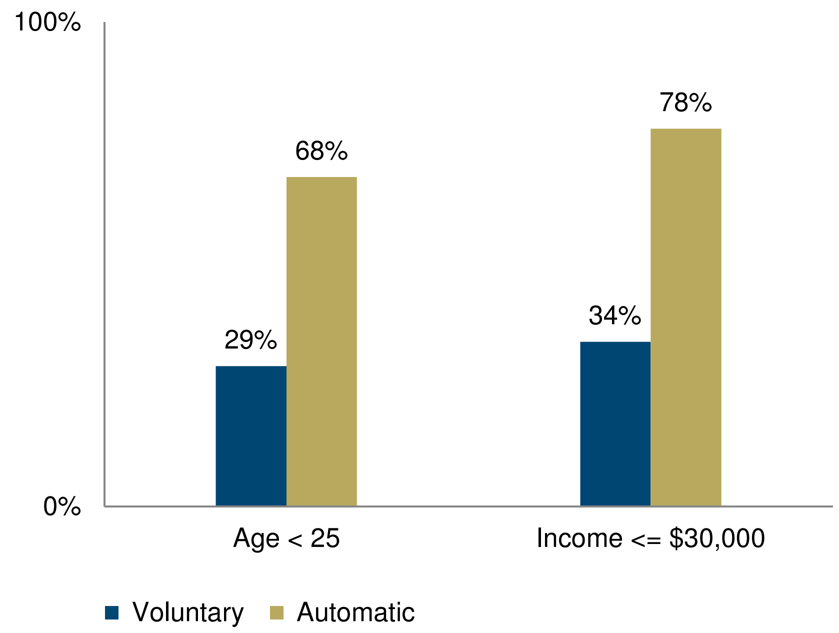
- Major changes include: multiple-employer plans, national auto-enrollment into IRAs, state-run programs, a new system of universal pensions
- Current policy: encouraging automatic enrollment as a voluntary plan feature

The shift to automatic enrollment

Automatic plan design

- One-third of all plans now using auto enrollment. Half of large companies.
- Nearly <u>60% of all new hires</u> automatically enrolled.
- Automatic enrollment dramatically improves participation rates. This is particularly true for low-saving groups including young and low-wage workers and ethnic minorities.
- Typical design is initial 3% employer contribution plus 1% auto-escalation. Plus employer contributions.

Automatic enrollment and plan participation



Source: Vanguard, *How America Saves 2014* .

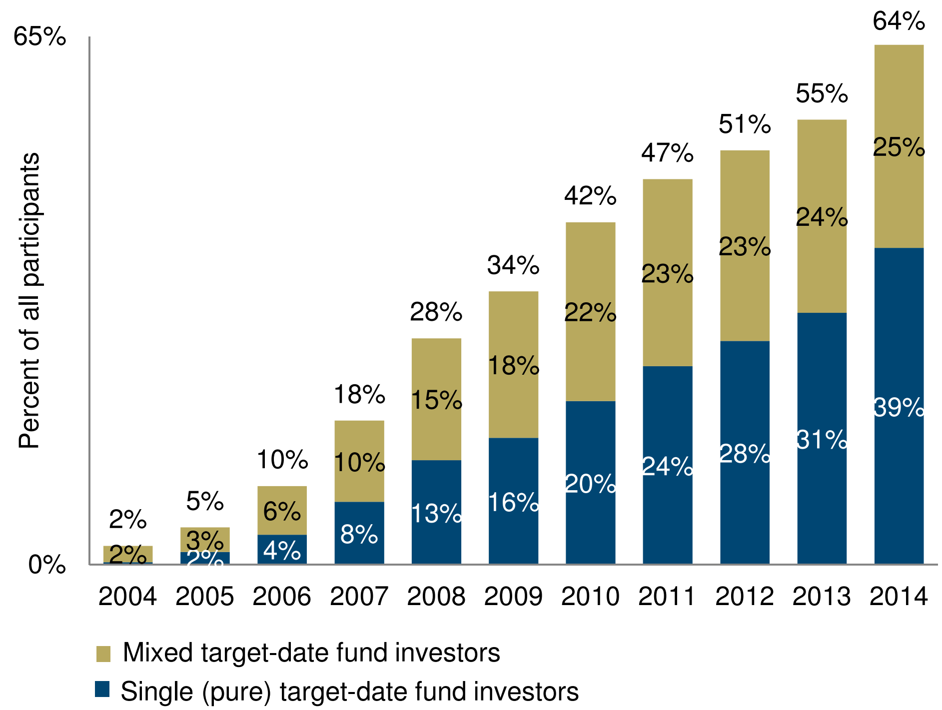
The rise of target-date funds

Target-date fund (TDF) adoption

- Participant use of TDFs is the result of both plan default (automatic enrollment) and own choice (voluntary enrollment)

Note: Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in a target-date fund is not guaranteed at any time, including on or after the target date.

Percentage of participants using target-date funds 2004–2014



Source*: Target-date fund adoption in 2014,* Young, 2015.

Two other contemporary issues

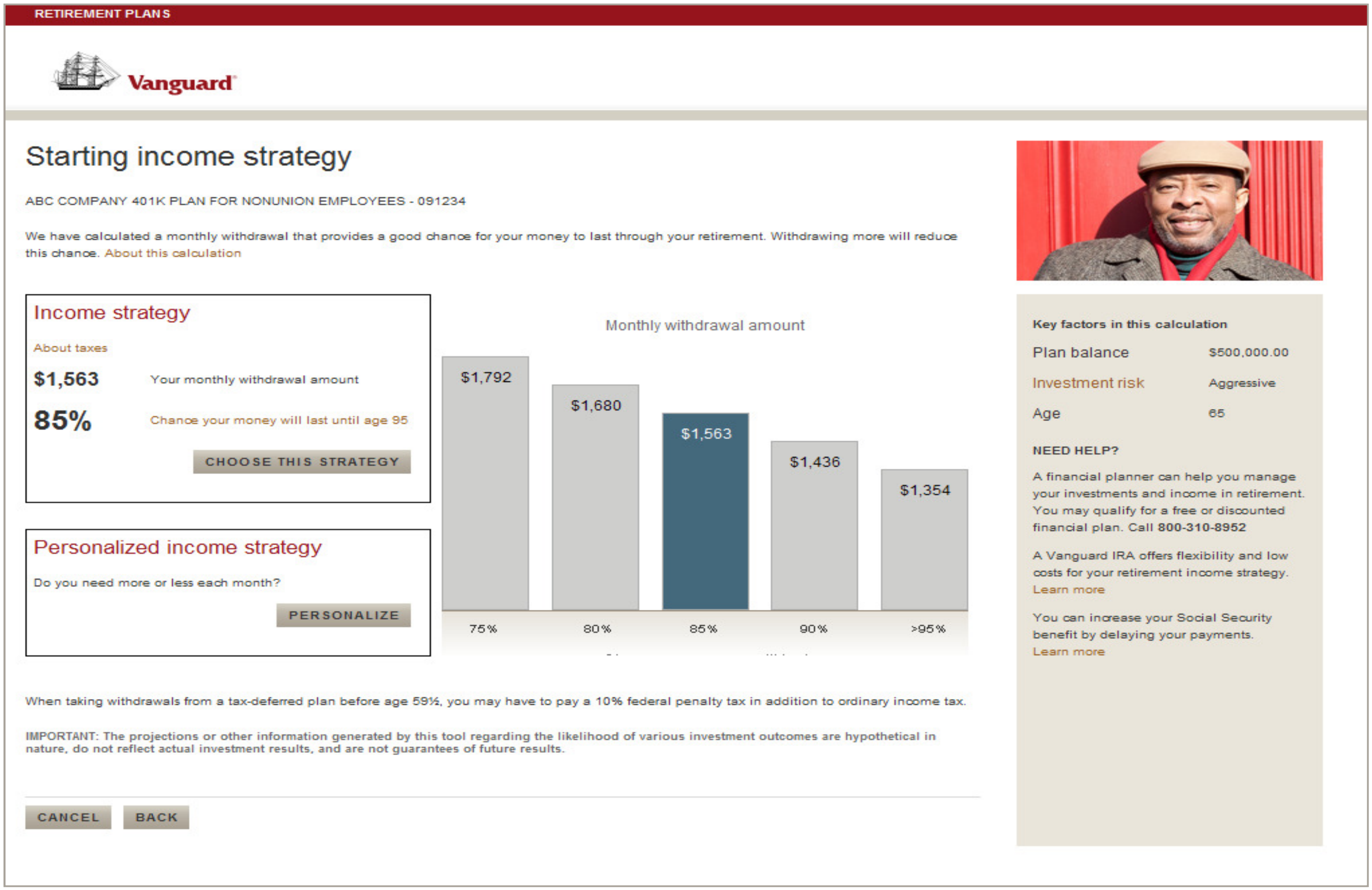
Leakage

- Loan feature: 20% of account holders have loan outstanding. But 90% repaid.
- Hardship withdrawals: include homeownership and college financing
- Cash-outs among job change: all monies accessible (with tax penalty) on job change.
  - The largest source of leakage by far
  - The most liberal rules of any DC system

Retirement income

- Regulators are pursuing plan to encourage lifetime income from 401(k) plans
- Current rules have eliminated some barriers to annuities, but major obstacles remain
- DC recordkeepers are introducing non-guaranteed “income” or “drawdown” services for participants in retirement

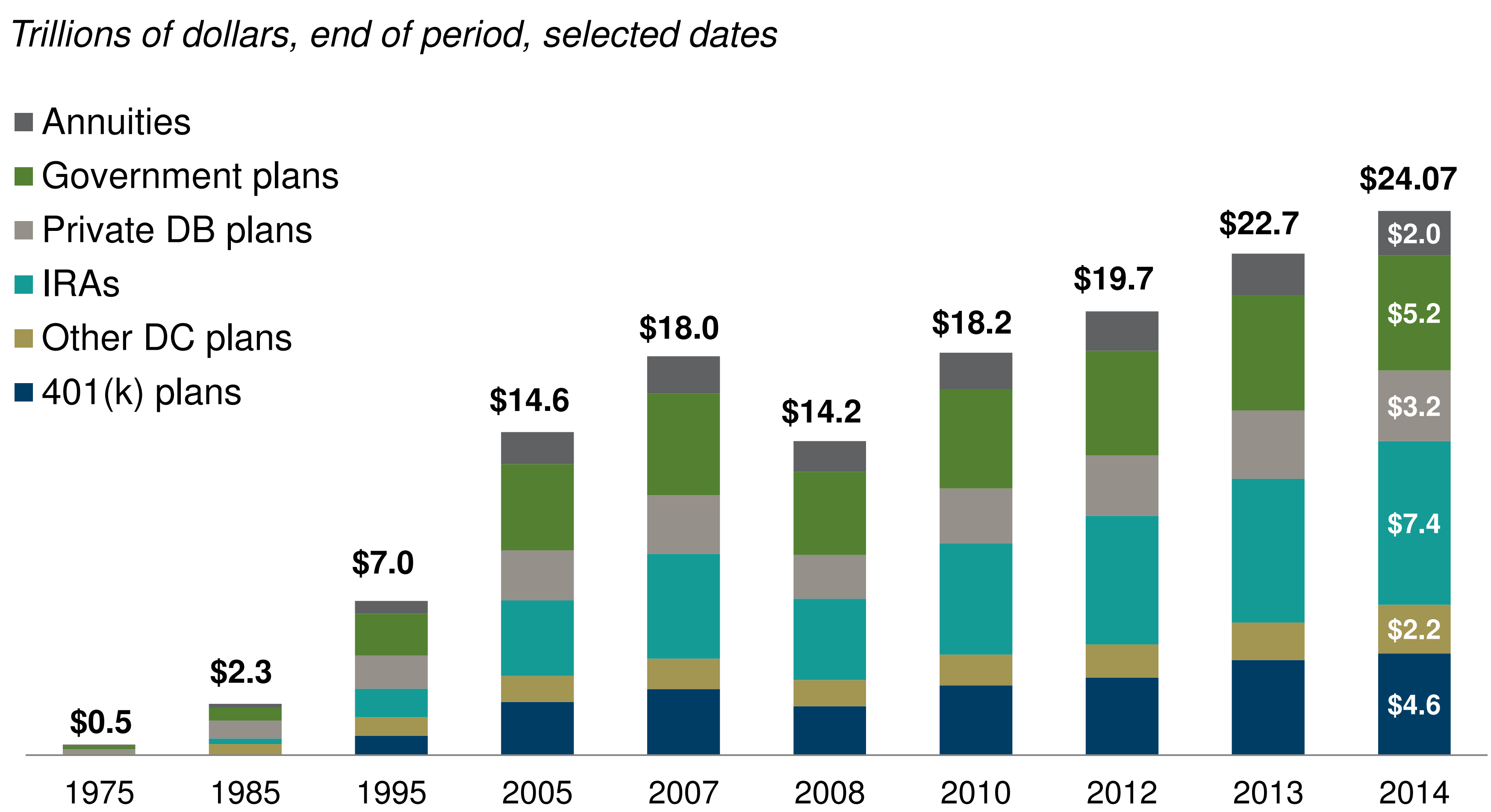
Example of web-based income service



Important information

All investing is subject to risk, including the possible loss of the money you invest.

Appendix: Retirement asset marketplace in the U.S.



Source: Investment Company Institute, *The U.S. Retirement Market, First Quarter 2014 (June 2014)*