



Pensions, Savings Plans, and Public Policy

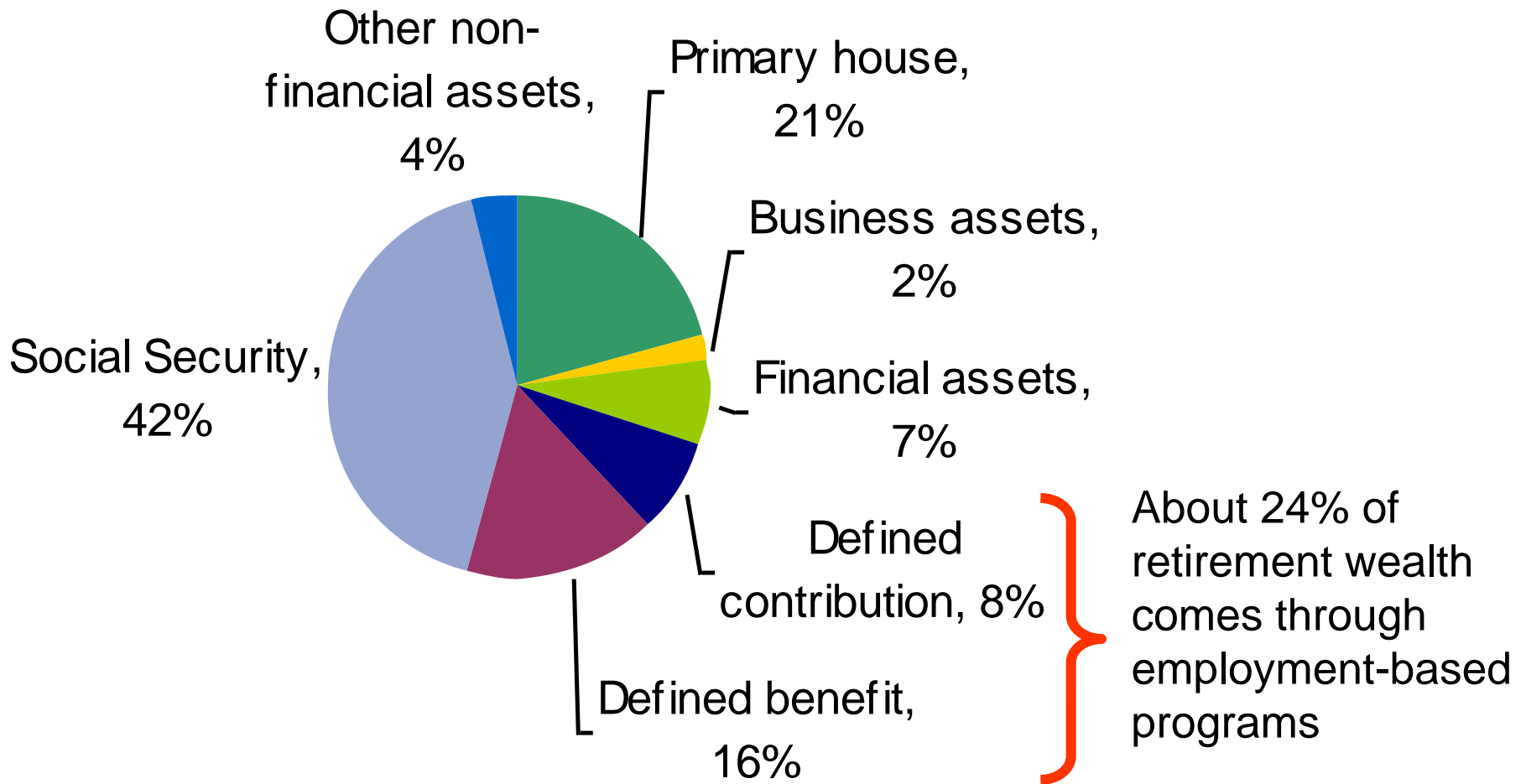
Brigitte Madrian
Harvard University

Usery Workplace Conference on
Labor Market Issues and Policy
April 16-17, 2009



<http://www.politicalcartoons.com/cartoon/3c1f31ac-97d1-497c-8798-303075a47f8b.html>

Wealth composition of individuals reaching retirement...



Source: Center for Retirement Research, calculated from the SCF

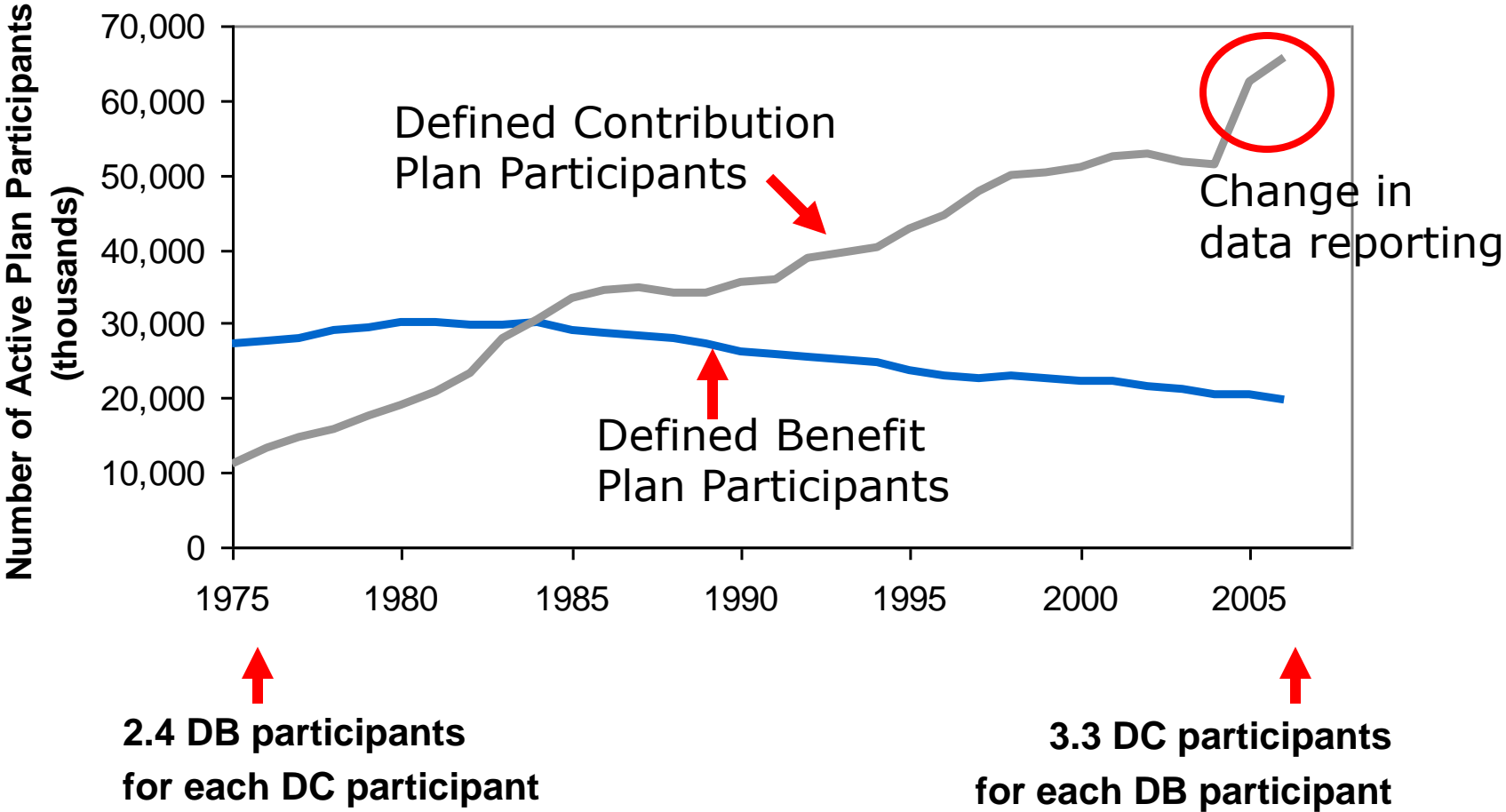
Historical context

- 1974: ERISA
 - **2.4 DB participants for each DC participant**
- 1978: section 401(k) added to IRC
- 1981: IRS clarification that 401(k) contributions are tax deductible
- 1980s: decline of DB plans ensues
- 2006: Pension Protection Act
 - **2.5 DC participants for each DB participant**

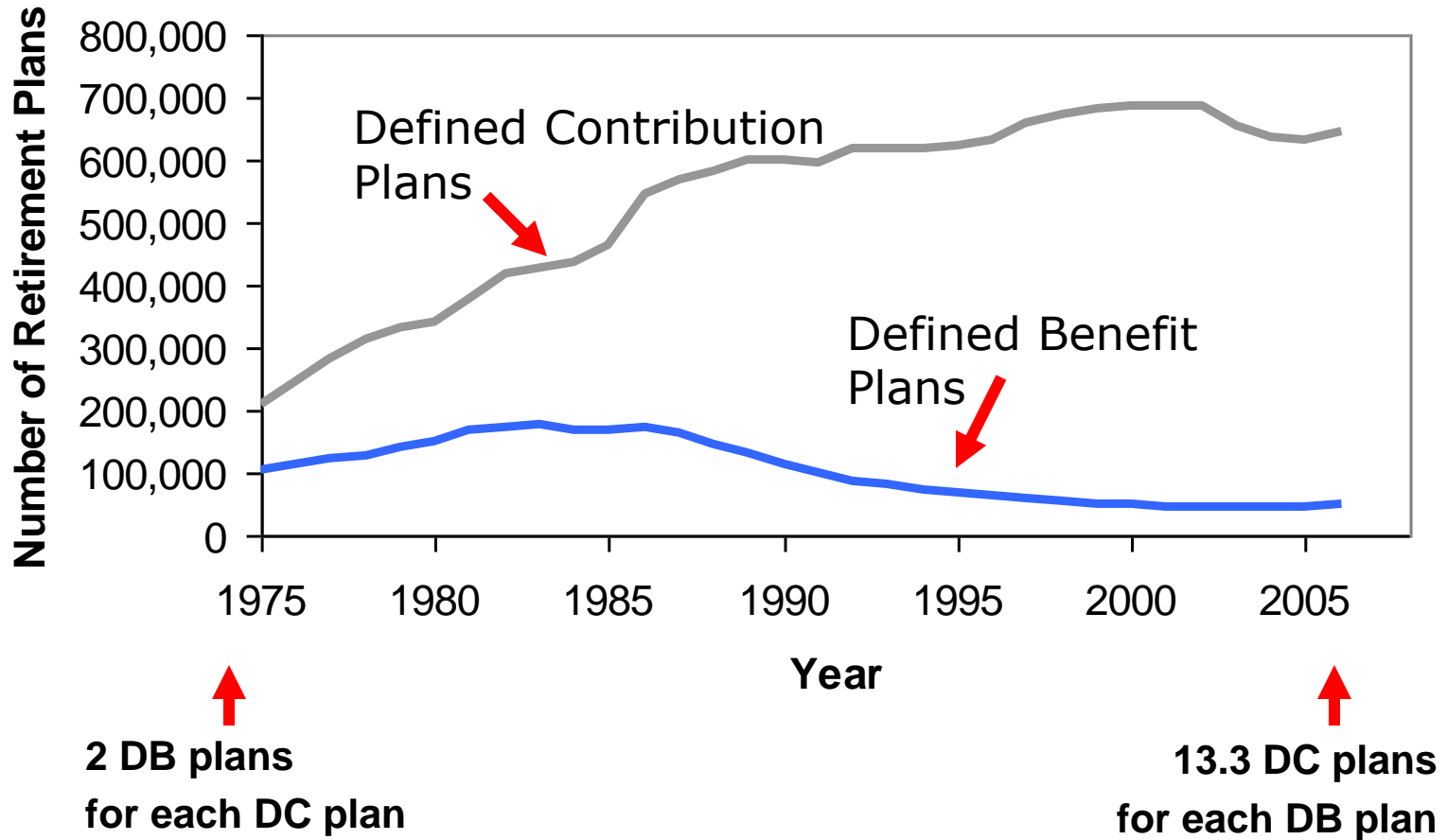
The Changing Pension Landscape

- Dramatic shift from DB to DC Plan
 - DC plans now outnumber DB plans 13 to 1
 - Active participants in DC plans outnumber those in DB plans 3:1
 - The total assets under management in DC plans exceeds that in DB plans by 30%
 - Approximately 44 million private sector workers and retirees covered by DB plans (PBGC 2008 Annual Report)
 - Less than half of these are active participants

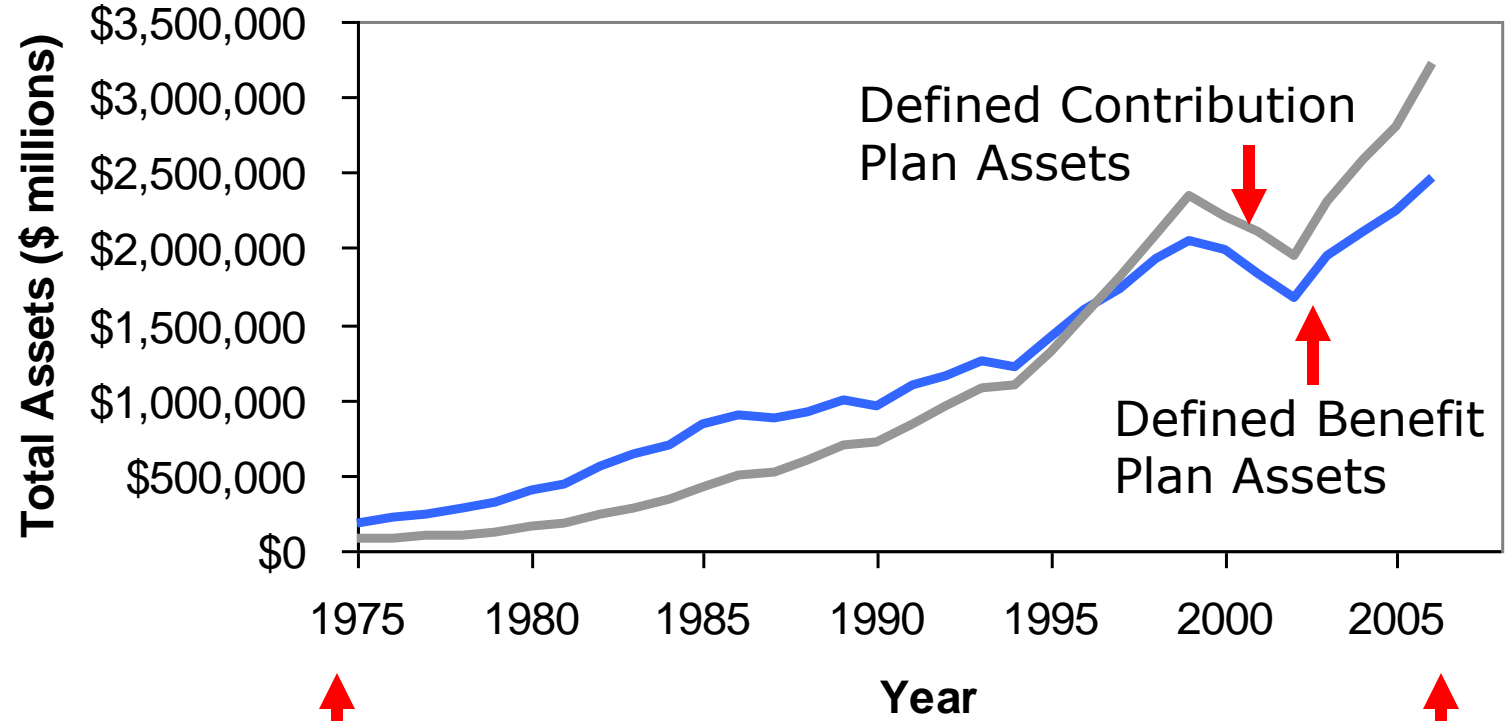
The Changing Composition of Employer Sponsored Retirement Plans: Pension Plan Participants



The Changing Composition of Employer Sponsored Retirement Plans: Number of Plans



The Changing Composition of Employer Sponsored Retirement Plans: Plan Assets



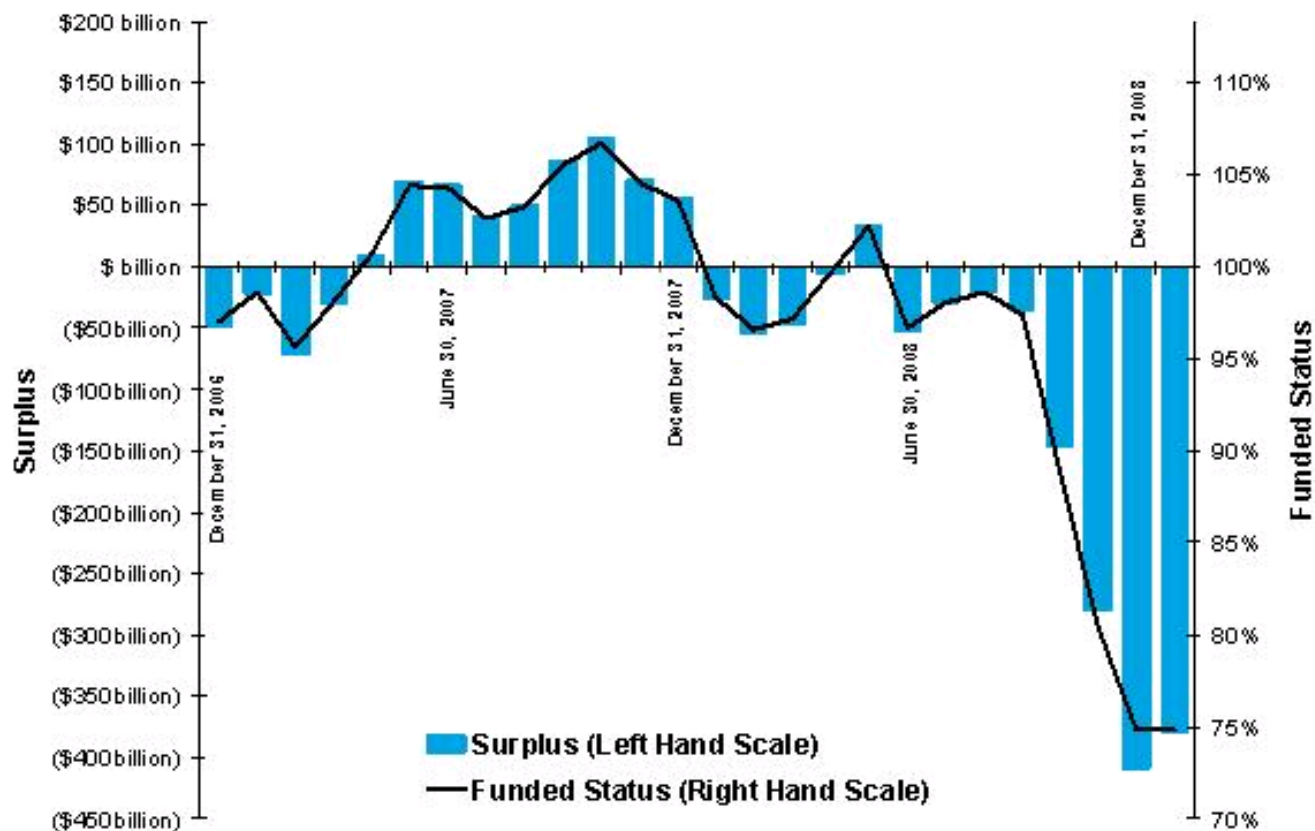
↑
**DB assets 250%
greater than DB assets**

↑
**DC assets 30%
greater than DB assets**

Why Has the Pension System Evolved so Quickly?

- For the employer, DC plans are “the better mousetrap”
- DB pension plans are:
 - More complicated
 - More heavily regulated → larger compliance costs
 - Expose employers to large and unpredictable financial risks
 - e.g., dramatic decline in funding status in 2008
- Changes in job tenure—the chicken or the egg

Funding Status of DB Pension Plans S&P 1500 Companies



Source: Mercer, February 3, 2009.

<http://www.mercer.com/summary.htm?idContent=1336100#figure1>

Defined Benefit Plan Terminations and Pension Freezes

■ Plan terminations

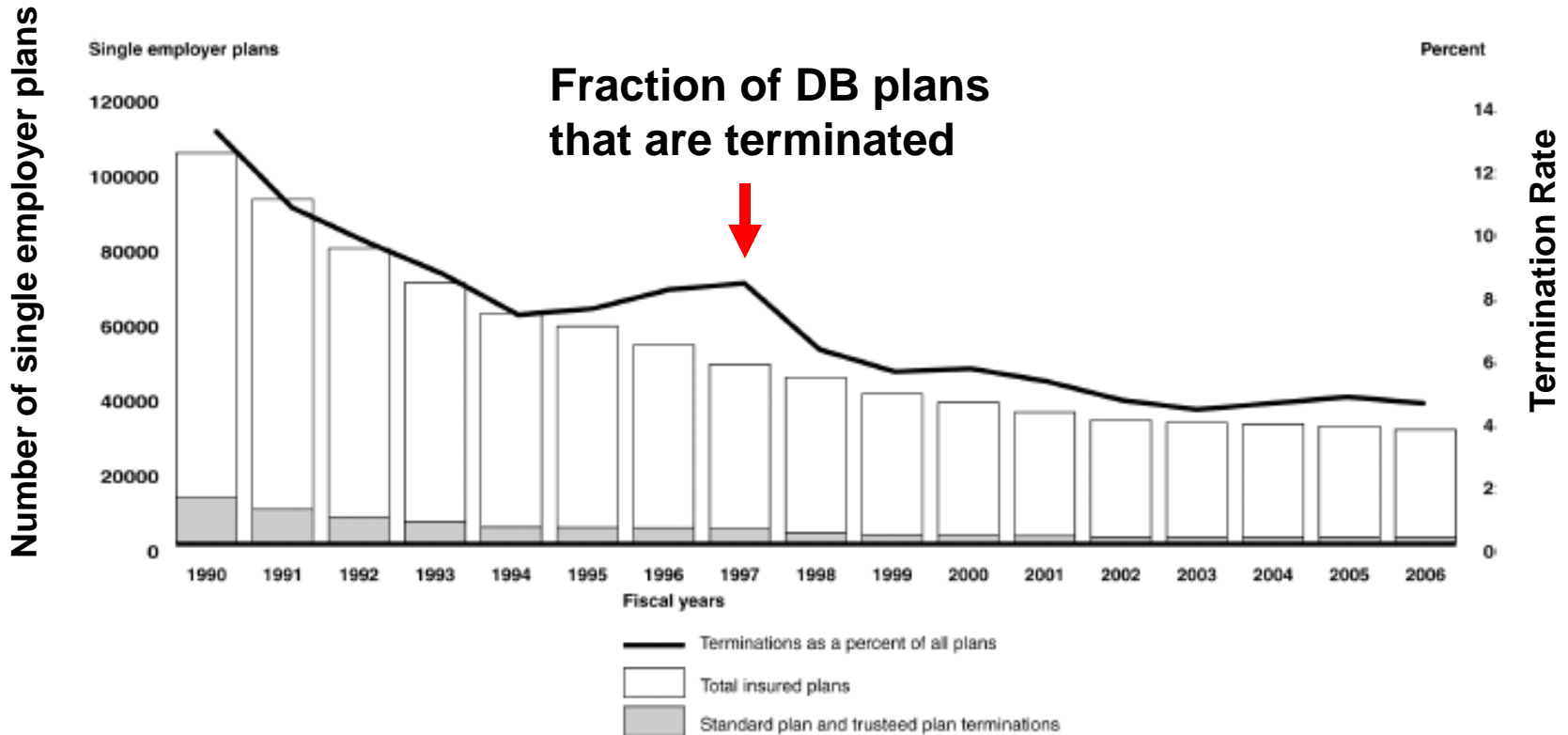
■ Insufficiently funded plans insured by the PBGC

- 3800 terminated plans
- 1.2 million beneficiaries
- \$10.7 billion deficit

■ Pension freezes (GAO 2009)

- 53% of DB pension plans frozen to some extent
 - Hard freeze
 - Soft freeze
- 3.3 million (21%) active participants affected

DB Pension Plan Terminations



Source: GAO analysis of PBGC data.

Source: GAO (2008)

Defined Benefit Pension Plan Terminations and Freezes

- Many companies terminating, freezing, or cutting their DB pension benefits

Anheuser-Busch (2009)

Talbots, Inc. (2009)

E.W. Scripps (2009)

Aon (2009)

Cincinnati Bell (2009)

Saks, Inc. (2009)

Motorola (2008)

Random House (2008)

R.H. Donnelley (2008)

New York Times (2008)

Boeing (2008)

Gannett (2008)

3M (2008)

Northrup Grumman (2008)

Neiman Marcus (2007)

State Street Corp (2007)

Delphi (2007)

Dow Chemical (2007)

NASDAQ (2007)

Dun & Bradstreet (2007)

Fidelity (2007)

Goodyear (2007)

FedEx (2007)

Hewlett Packard (2007)

Ryder (2007)

Whirlpool (2006)

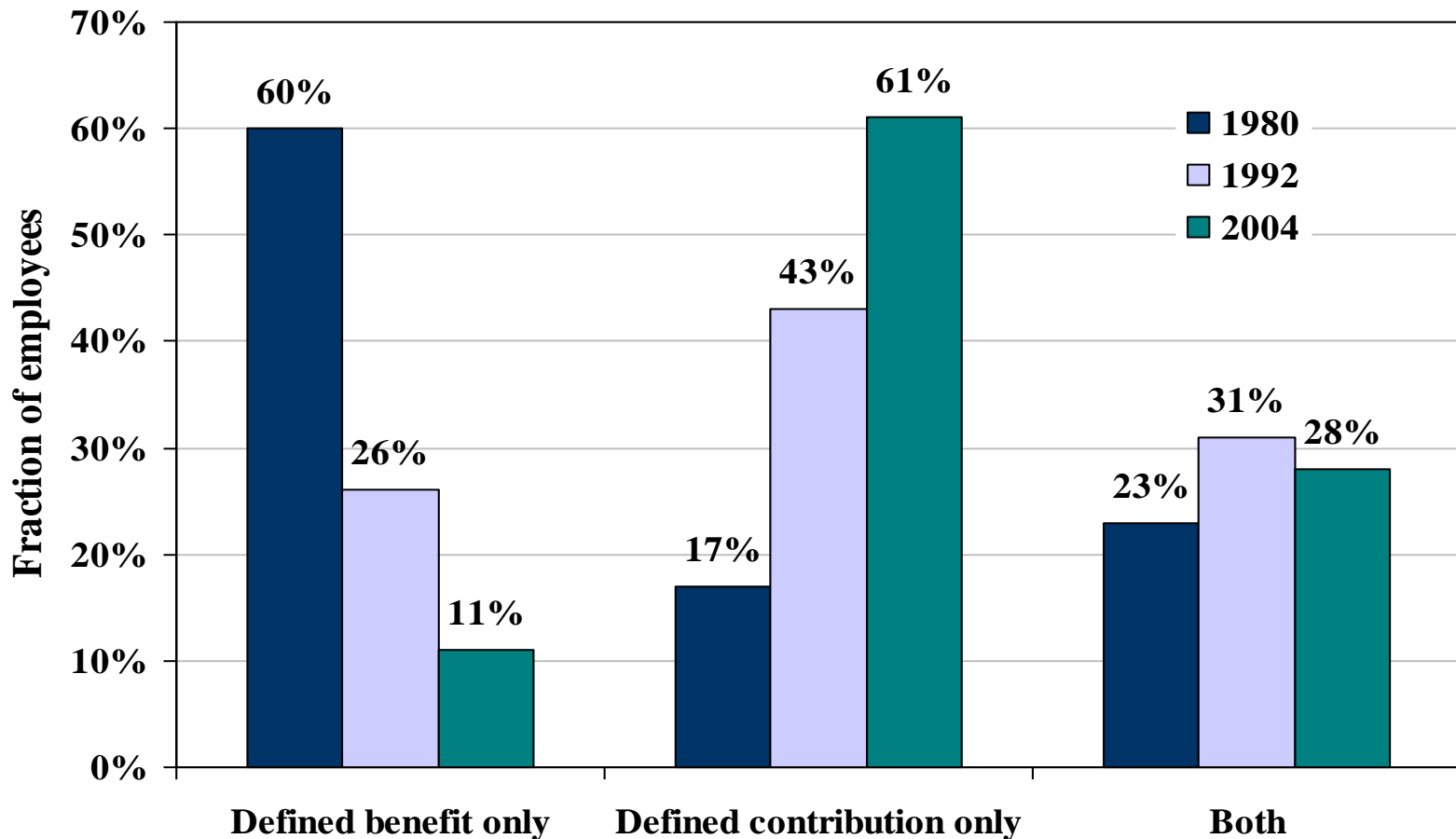
Citigroup (2006)

Aon (2006)

Michelin (2006)

DuPont (2006)

Private Workers with Pension Coverage by Pension Type



Source: Boston College Retirement Research Center (RRC) from U.S. Department of Labor (2004), "Abstract of 1999 Form 5500 Annual Reports," Private Pension Plan Bulletin, and U.S. Department of Labor (2001-2006), Annual Return/Report Form 5500 Series for Plan Years 1999-2004.

Are employees prepared for a defined contribution world?

- John Hancock Financial Services Defined Contribution Plan Survey (2002):
 - 38% of respondents report that they have little or no financial knowledge
 - 40% of respondents believe that a money market fund contains stocks
 - Two-thirds of respondents don't know that it is possible to lose money in government bonds
 - Respondents on average believe that employer stock is less risky than a stock mutual fund
 - Two-thirds report that they would be better off working with an investment advisor than managing investments solo

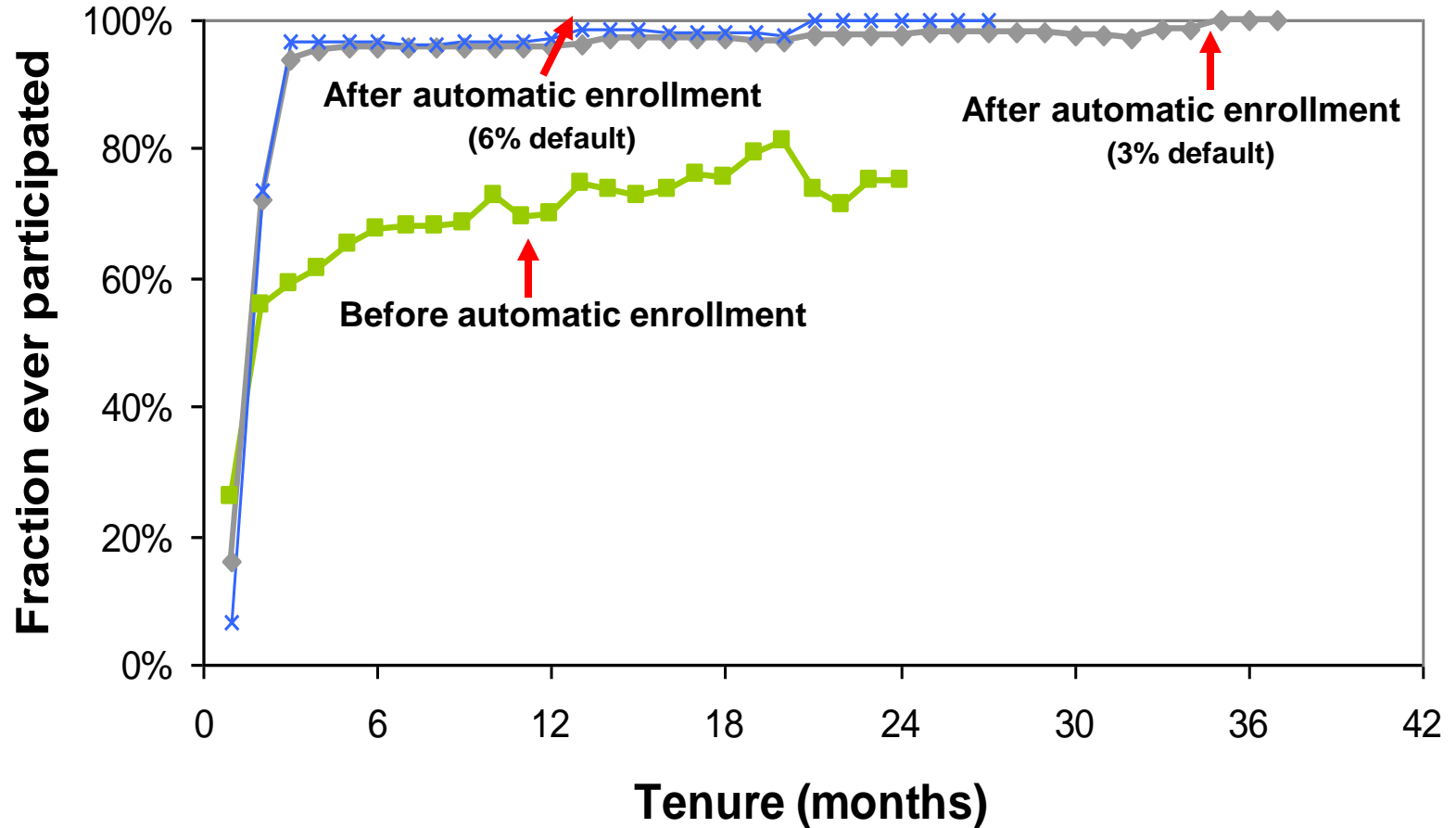
Implications

- Savings outcomes heavily influenced by small changes in plan design
- Empirical evidence
 - Savings plan participation
 - Automatic enrollment
 - Contribution rates
 - Automatic enrollment
 - Contribution escalation
 - Asset allocation
 - Automatic enrollment
 - Employer stock
 - Menu effects

Automatic enrollment and savings plan participation

- Sizeable benefits to 401(k) participation
 - Tax benefits
 - Employer match (100% match up to 6% contribution for company above)
- Striking difference in participation rates before and after automatic enrollment
- Striking similarity in participation rates under automatic enrollment at 3% and 6% default contribution rates

Automatic Enrollment for New Hires and Savings Plan Participation

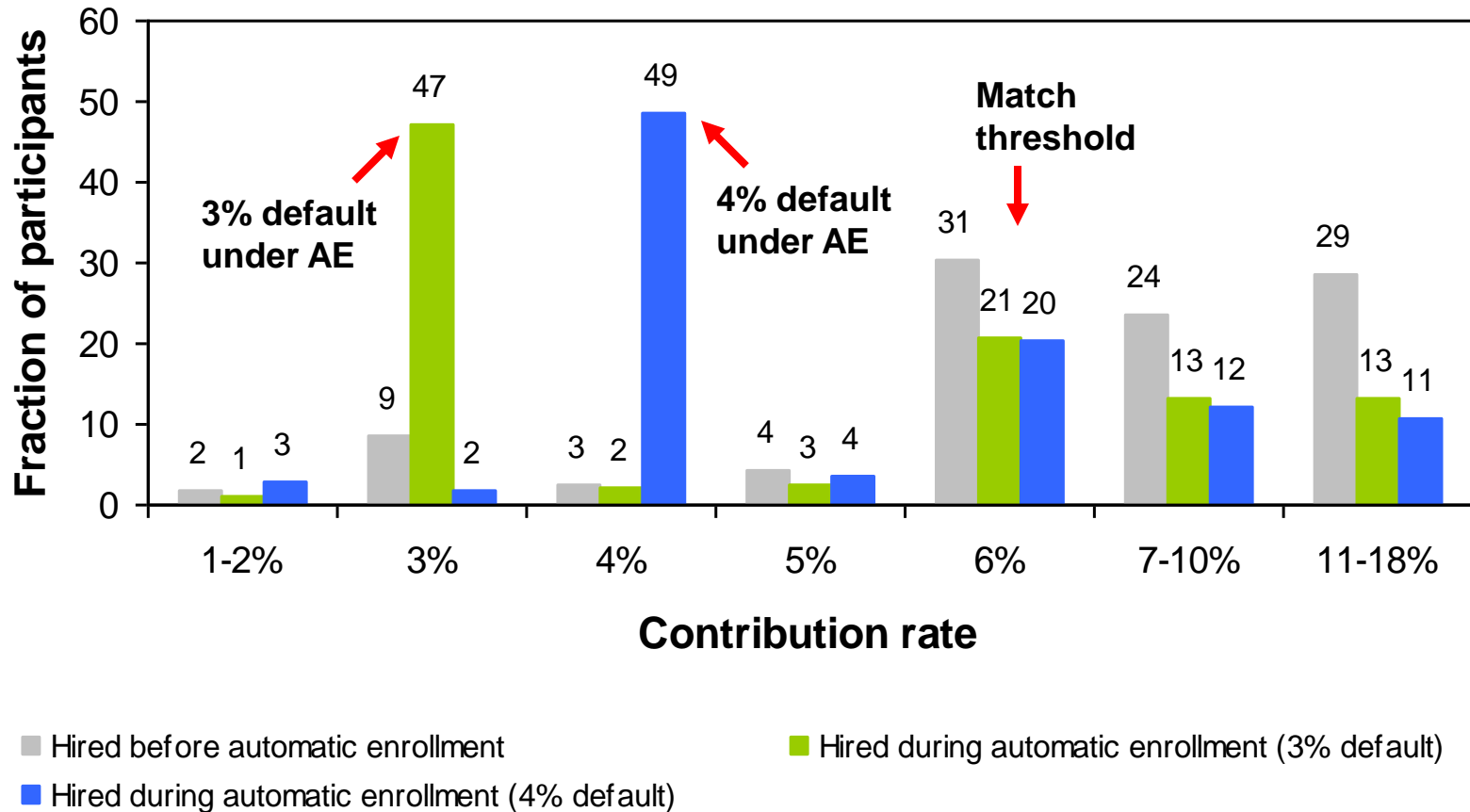


Source: Beshears, Choi, Laibson and Madrian (2008)

Automatic enrollment and savings plan participation

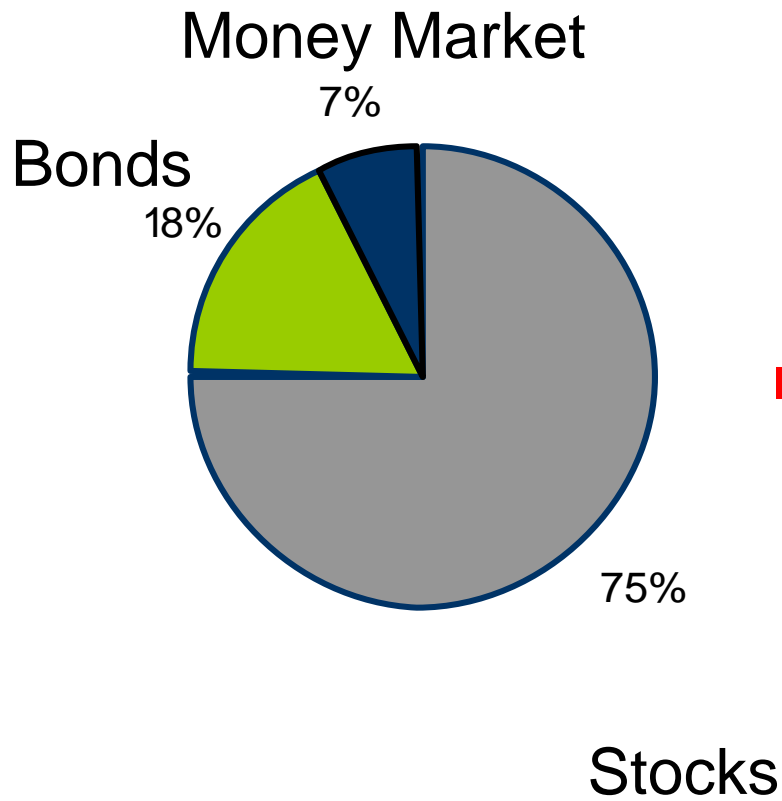
- Are individuals really indifferent?
- Unlikely....
 - Big financial implications: nothing vs. 12%
 - Opt-out rate from automatic enrollment low
 - Opt-out rate before automatic enrollment high
 - When required to choose, participation rates high (Carroll et al. forthcoming)
 - Individuals state a preference to save more
- Collectively, evidence suggests that most individuals prefer savings plan participation to non-participation
- Complexity of decision task leads to delay in the absence of automatic enrollment

Automatic Enrollment and the Distribution of Savings Plan Contribution Rates

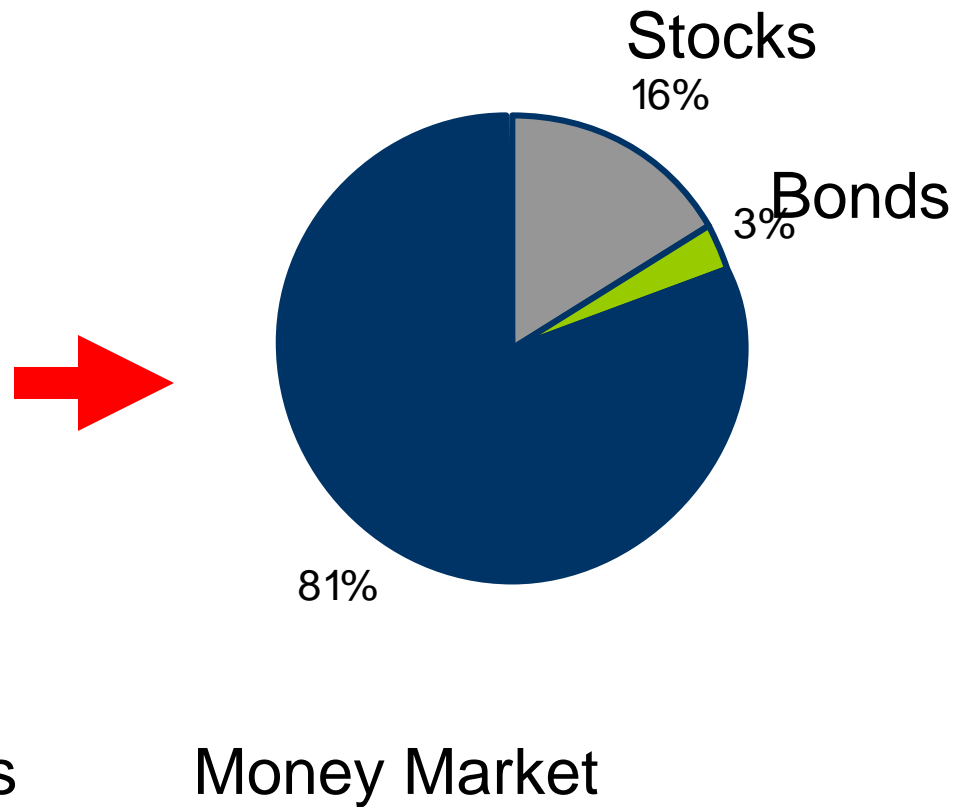


Source: Choi, Laibson, Madrian and Metrick (2006)

Before Automatic Enrollment

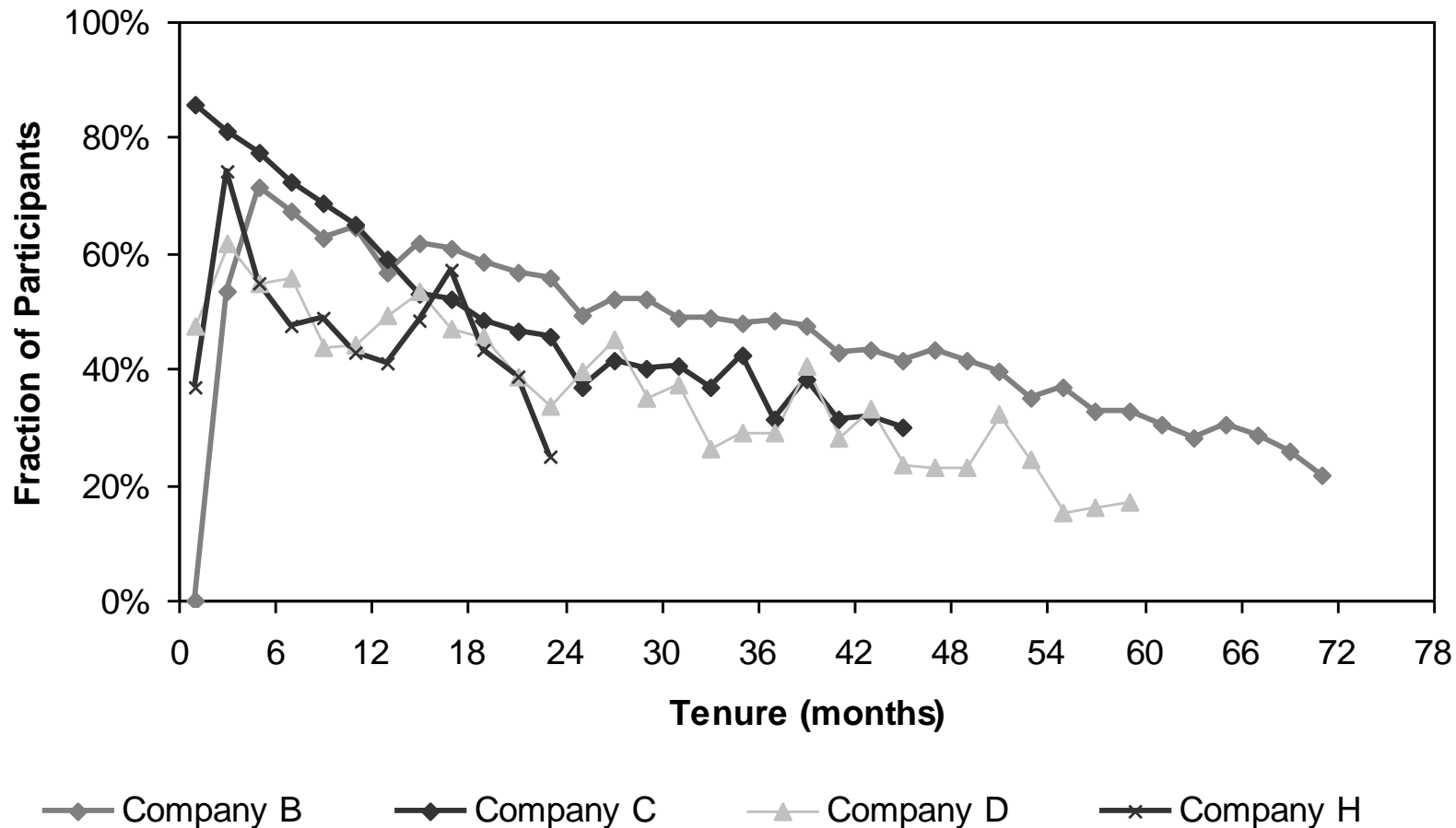


After Automatic Enrollment Money Market Default Fund



Source: Madrian and Shea (2001)

Fraction of Participants Hired During Automatic Enrollment at the Automatic Enrollment Defaults



Source: Choi, Laibson, Madrian and Metrick (2006)

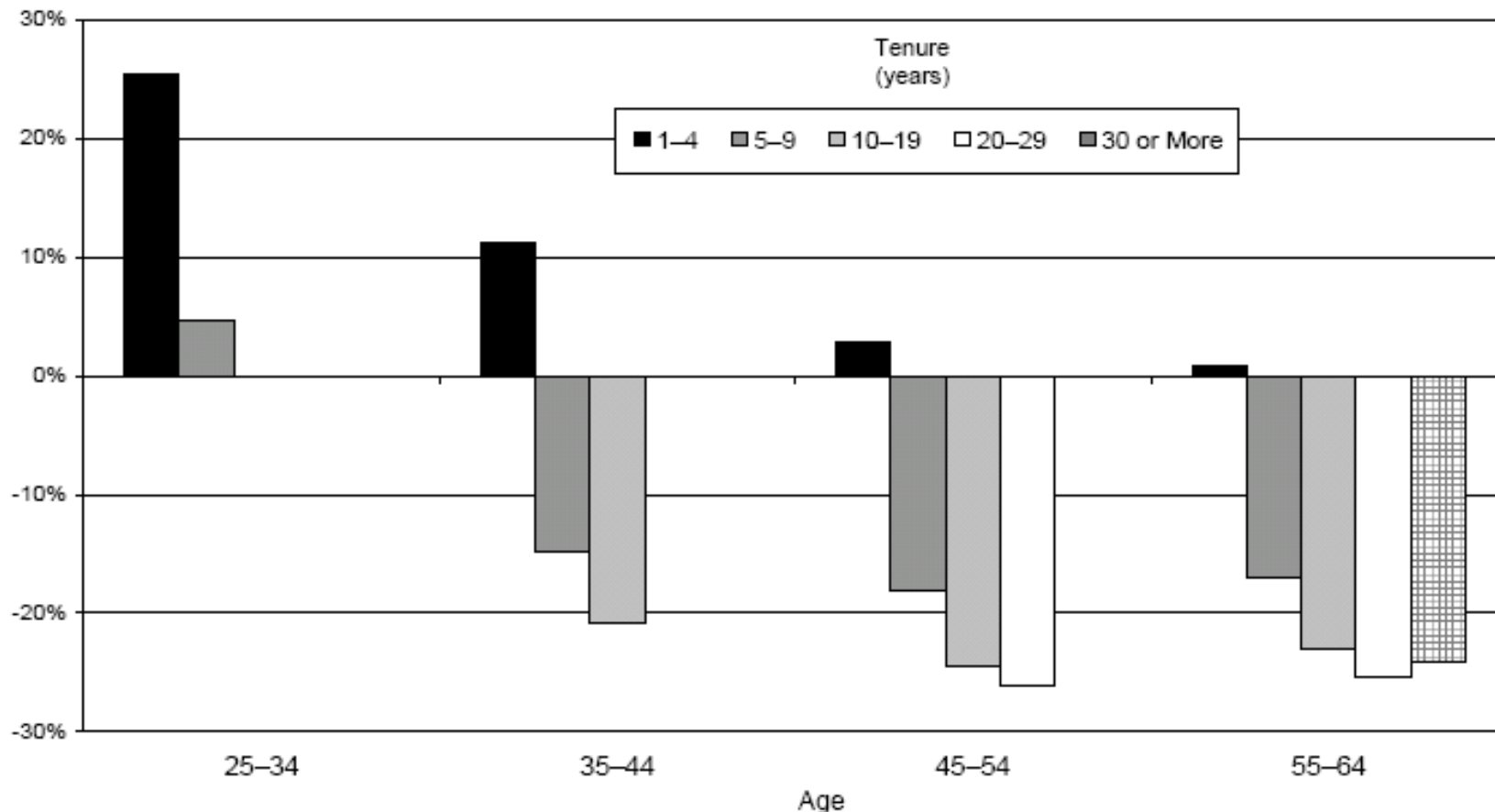
Automatic enrollment and asset accumulation

- The double-edged sword of automatic enrollment...
 - Higher participation → greater asset accumulation for those who would not have participated
 - BUT...potential change in asset accumulation for those who would have participated even without automatic enrollment
 - Whether this is good or bad depends on the default and the persistence at the default
 - Persistence at a “bad” default → lower rate of growth in asset accumulation
 - In the long run, a “bad” default can *reduce* asset accumulation

The Verdict on Defined Contribution Plans?

- For the employer, DC plans are “the better mousetrap”—what does this imply for employees?
- As historically structured
 - Presumes some degree (a lot?) of financial knowledge by participants
 - Requires self management
 - Financial risk
- BUT, defined contribution plans are here to stay

Change in Average Account Balances From Jan. 1, 2008–Jan. 20, 2009, by Age and Tenure, Among 401(k) Participants With Account Balances as of Dec. 31, 2007



Sources: 2007 Account Balances: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project; 2008 and 2009 account balances: EBRI estimates. The analysis is based on all participants with account balances at the end of 2007 and contribution information for that year.

Making Defined Contribution Plans Work Better...the Best of Both Worlds

- Improving savings outcomes with DC plans
- Expanding coverage of workplace-based savings plans
- Turning accumulated wealth into retirement income

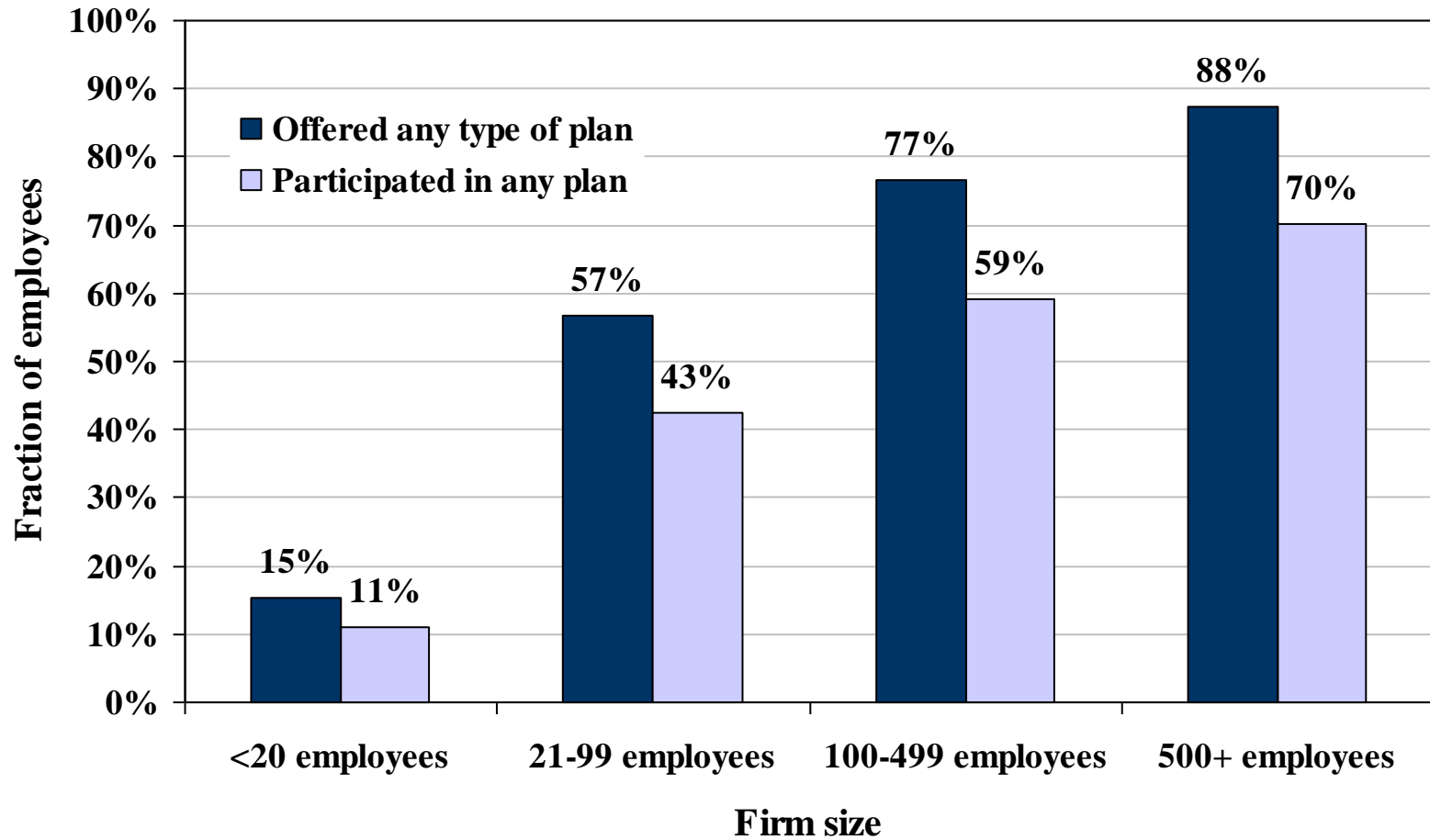
Improving Savings Outcomes in DC Plans

- Participation
 - Automatic enrollment
 - Active Decision
 - Simplification
- Contribution rates
 - Contribution escalation
 - Restructure employer match
- Non-contingent contributions
- Asset allocation
 - Employer stock
 - Automatic enrollment default funds—how much equity exposure?

Expanding the Reach of Employer-Sponsored Savings Plans

- Who cares? PAYROLL DEDUCTION!!
- About half of all workers are participating in an employment-based savings plan
 - Strongly related to firm size
- Policy options
 - Piggyback off of Federal Thrift Savings Plans or state employee DC plans
 - Automatic IRA

Participation in Employer-Sponsored Retirement Plans of Any Kind



Source: Congressional Research Service analysis of the 2007 Survey of Consumer Finances. Patrick Purcell (2009), "Retirement Saving and Household Wealth in 2007."

Turning Accumulated Wealth into Retirement Income

- The annuity puzzle
- Annuitization within DC savings plans
 - Pre-PPA, legal regime actually discouraged employer provision of an annuity option
 - Automatic full- or partial-annuitization
 - Employer match
- Annuitization outside DC plans
 - Mandatory full- or partial-annuitization
 - Tax incentives for annuitization

Two Big Questions?

- How much should individuals be savings for retirement?
 - What is individually optimal?
 - What is socially optimal?
- Total savings impact of employer-sponsored savings plans?
 - Is the increased saving in employer-sponsored plans with automatic enrollment new saving?
 - Or does it displace other saving?
 - Or is it offset by higher credit card or mortgage debt?