Changing Pension Risks Confronting Participants

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Evolution of Risk for Covered Individuals

- Nature and significance of risks to participants are changing
  - Just a decade ago, most participants in employer-sponsored plans were in traditional defined benefit pension plans with small or no employee contributions, professional management of assets and employers responsible for promised benefits
  - Today, most participants are in individual account plans, funded substantially or entirely by employee contributions, self-invested, and with no back-up employer guarantee of adequacy

Number of Individuals Enrolled in Employer-Sponsored Plans

Type of Plan	1992	2001
Defined benefit (DB) only	40%	19.5 %
Defined contribution (DC) only	37.5%	57.7%
Both DB and DC	22%	22%

Distinguishing between DB and DC Plans

- DB
  - Benefits paid at retirement
  - Typical form of distribution: Periodic annuity payments
  - Employer contributions in pooled common trust
  - Employer liable to make up shortfall if trust inadequate to pay benefits
- DC
  - Benefits paid at termination of employment (regardless of age)
  - Typical form of distribution: lump sum
  - Employee contributions and employer contributions (if any) in individual accounts, not pooled
  - No employer liability to supplement individual accounts

401(k) Plans

- More than 75% of all DC plans are 401(k) plans
- More than 80% of 401(k) plans are “self-directed” plans (participants invest the assets in their account themselves)
- Good news for participants who are or are willing to become investment experts
- Bad news for those who have neither the talent, interest or expertise to handle investments

Why Movement To Self-Direction?

- Employer interest in minimizing fiduciary liability
- Depending on how plan is designed, often cheaper for employer
- Marketing by mutual fund industry and other financial vendors
- Interest by some plan participants in controlling investments

Risks to Participants of Self-Direction

- Four basic types of risk to participants
- Those related to:
  - Accumulation
  - Investment
  - Retirement
  - Post-distribution asset management

Accumulation Risks

- **Inadequate funding**
  - Lack of continuous access to 401(k) plan
    - Employer doesn’t offer one
    - Periods of unemployment, part-time or temporary employment
  - Failure to participate
    - Inertia
    - Deliberate decision not to enroll (affordability; fear of investing)
  - Failure to contribute regularly or in sufficient amounts
    - Loss of employer match
  - Underestimating amount of needed retirement income
  - Loans and hardship withdrawals

Investment Risks

- Failure to invest wisely
  - Lack of investment expertise
    - Difficulty and cost of acquiring expertise
  - Lack of professional advice
  - Wide variation in asset allocation
  - Lack of diversification
    - Employer stock
  - Overly conservative investments
  - Excessive and undisclosed fees

Retirement Risks

- Retiring earlier than planned
  - Corporate restructuring
  - Downsizing and layoffs
  - Illness or disability
- Retiring at the “wrong time”
  - Interest rates
  - Market value
  - Inflation

Post-Distribution Risks

- Dissipation of retirement income by failure to roll over distributions
- Longevity (outliving your retirement money)
  - Purchase an annuity
  - Self-annuitize
    - Determine life expectancy
    - Determine amount and pattern of retirement spending

Premises for Assuring Greater Retirement Income Security

- Not all DB plans are good; not all DC plans are bad
- Not all DB plans are bad; not all DC plans are good
- No one type of plan is superior for every participant in every stage of his/her career
- Individuals need both DB and DC-type coverage because that results in shared allocation of risk

Suggestions For Reducing Risk to Participants

- Recognize that not all participants want to or have the expertise to control investment decisions; alternative to opt for professional management (lifestyle funds?)
- Recognize that greater risk to individual retirement security exists when plans provide for lump sum distributions without annuity alternatives

Reducing Participant Risk, cont.

- Investment advice by independent experts could be helpful, but not if those giving advice are conflicted
- Establishing default options in 401(k) plans that facilitate participation are worth more study
- Greater focus on improving financial literacy generally would be helpful
- Post-distribution advice on financial management would also be useful