

## **Defined Contribution Plans: Current Practices Will Likely Produce Future Retirement Benefits That Are Inadequate for Most**

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It has been well established that, over the past quarter century, a major trend in employee benefits has been migration from defined benefit plans to defined contribution plans [Employee Participation in Defined Benefit and Defined Contribution Plans, 1985–2006, <http://www.bls.gov/opub/cwc/content/cm20030325tb01.stm>]. Moving from a defined benefit to defined contribution structure does not eliminate risk and responsibility, but rather transfers it from the plan sponsor to mostly unprepared plan participants. Individual participants in defined contribution plans now hold much greater control and personal responsibility for building an adequate retirement benefit than they did under the defined benefit plan structure. However, most employees have never been trained nor prepared to assume this important role [Mercer Consulting, “Defined Contribution Plans: The Challenge of Achieving Benefit Adequacy,” October 19, 2007, © 2009 Mercer LLC].

Rather than focusing on the desired outcome of an adequate retirement benefit, defined contribution plans have historically been dominated by “bell and whistle” type sales features that commonly have little to do with accumulating sufficient benefits for retirement. Features such as Internet-based daily valuation of account values, faster turn-around time in processing plan loans, and a myriad of multiple mutual fund investment choices have usually been used to describe the “benefits” of the 401(k) plan. While these features may be interesting, they actually have virtually nothing to do with whether the participant will adequately replace their retirement income when they retire. Nonetheless, as vendors tried to differentiate themselves in the crowded marketplace, an “arms race” developed whereby the vendors used such ancillary sales features as the main reason to hire them.

Most defined contribution plan participants (at least half, and more likely 75–80 percent) will fail to achieve a benefit of adequate retirement income replacement [Unified Trust Company Plan Outcome Data Analysis National Compiled Data © 2009, and Almeida, B. “Retirement Readiness: What Difference Does a Pension Make?” National Institute on Retirement Security, May 2008]. This is typically attributed to the fact that participants are not “expert investors,” but a more important fact is that participants are not actuaries and cannot model with any precision the future benefit that they will need [Orszag, Peter, “The Effects of Recent Turmoil in Financial Markets on Retirement Security,” Statement before the Committee on Education and Labor U.S. House of Representatives October 7, 2008]. In fact, the average 401(k) participant cannot calculate the price of peanut butter per ounce [Nadler, M. “Nonparticipant-Directed Plans as an Alternative to Employee Investment Education,” *Employee Benefit News*, July 1, 2009]. Therefore, the participants not only lack the skills to invest their funds appropriately, but have no idea what the goal that such investment is meant to achieve is. Today, legislators are concentrating their concern on the expanded disclosure of plan fees [Brandon, E., “401(k) Fee Disclosure Bill Introduced to Senate,” *U.S. News and World Report*, February 12, 2009, and H.R. 1984, California Representative Miller, “401(k) Fair Disclosure for Retirement Security Act of 2009”]. While the transparent disclosure of plan fees is no doubt a good thing, it is certainly not the only step required to produce an adequate retirement benefit. In fact, if the only step taken is disclosure plan fees, little change can reasonably be expected in terms of benefit adequacy for most participants.

In the final analysis, the retirement plan income replacement objectives for all employees are most effectively served by traditional defined benefit plans. When an employee goes to retire, the amount of



replacement income available from the retirement plan is the only thing that is truly meaningful to the employee. Therefore, the ultimate outcome goal for both defined benefit and defined contribution plans should be the same: providing sufficient income for retirement. The only real difference between the two types of structures is identifying which entity was responsible for contributing funds that are sufficient to provide that benefit, and which is responsible for absorbing the risk of investment returns being less than anticipated. In the defined contribution 401(k)-based system, most of the contribution funding obligation and investment risk is on the employee, whereas in the defined benefit world, most of the funding and investment burdens belong to the plan sponsor. Once the plan has received a contribution, the need for and theories behind investment management, actuarial analysis, and “midcourse corrections” are the same for both systems that over the long haul seek to produce an adequate income replacement benefit.

In response to policymaker’s concerns, it is essential that the 401(k) industry develop an effective solution to save the private retirement system. There is no doubt that the industry can craft a better solution than a state-run, centralized, and likely underfunded pay-as-you-go government program.