Improving the Security of Retirement Income

….What can be learned from US experience?

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The Problem

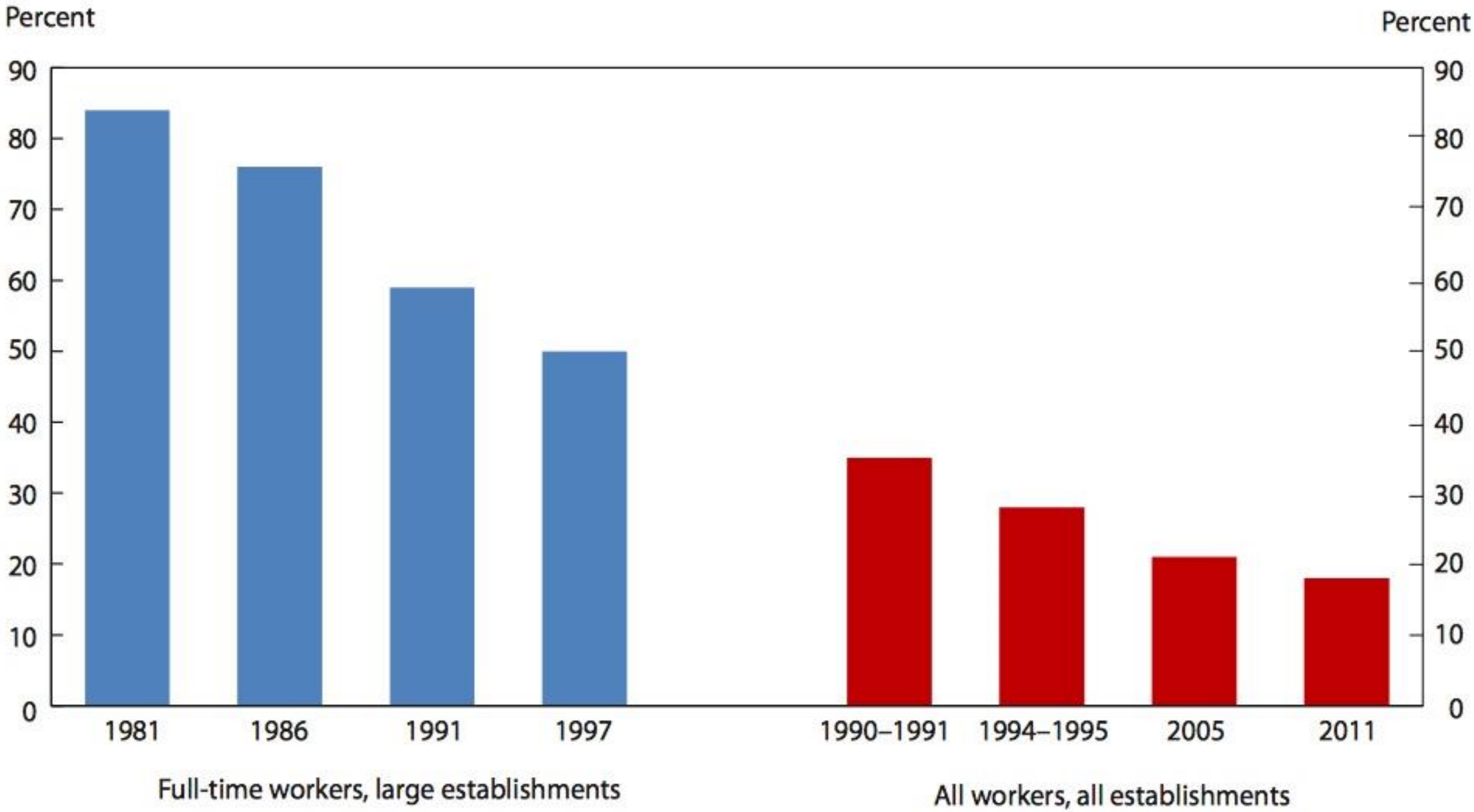
30 Years Ago . . .

- Vast majority of US employees were covered by funded defined benefit plans
- IF one spent a full career on one employer, he/she could expect a retirement income stream of about 50% of final 5 year average pay after 30 years service; 60% after 40 years
  - In most cases, not indexed for inflation
- If one changed jobs once half-way through their career, retirement benefits were eroded by about 25-35% since typically terminated vested pensions are not indexed

Shifting Landscape

- Introduction of 401K plans in the early 80s
- Initially ***supplemental*** to defined benefit pensions
- Then coordinated with DB pensions through offset/floor plans etc.
- By late 80s, early 90s, the erosion of DB plans had begun through
  - Conversation to “cash balance” or “pension account” plans
  - Closure to new entrants
  - Freezing of benefits (mostly without allowing for salary growth)

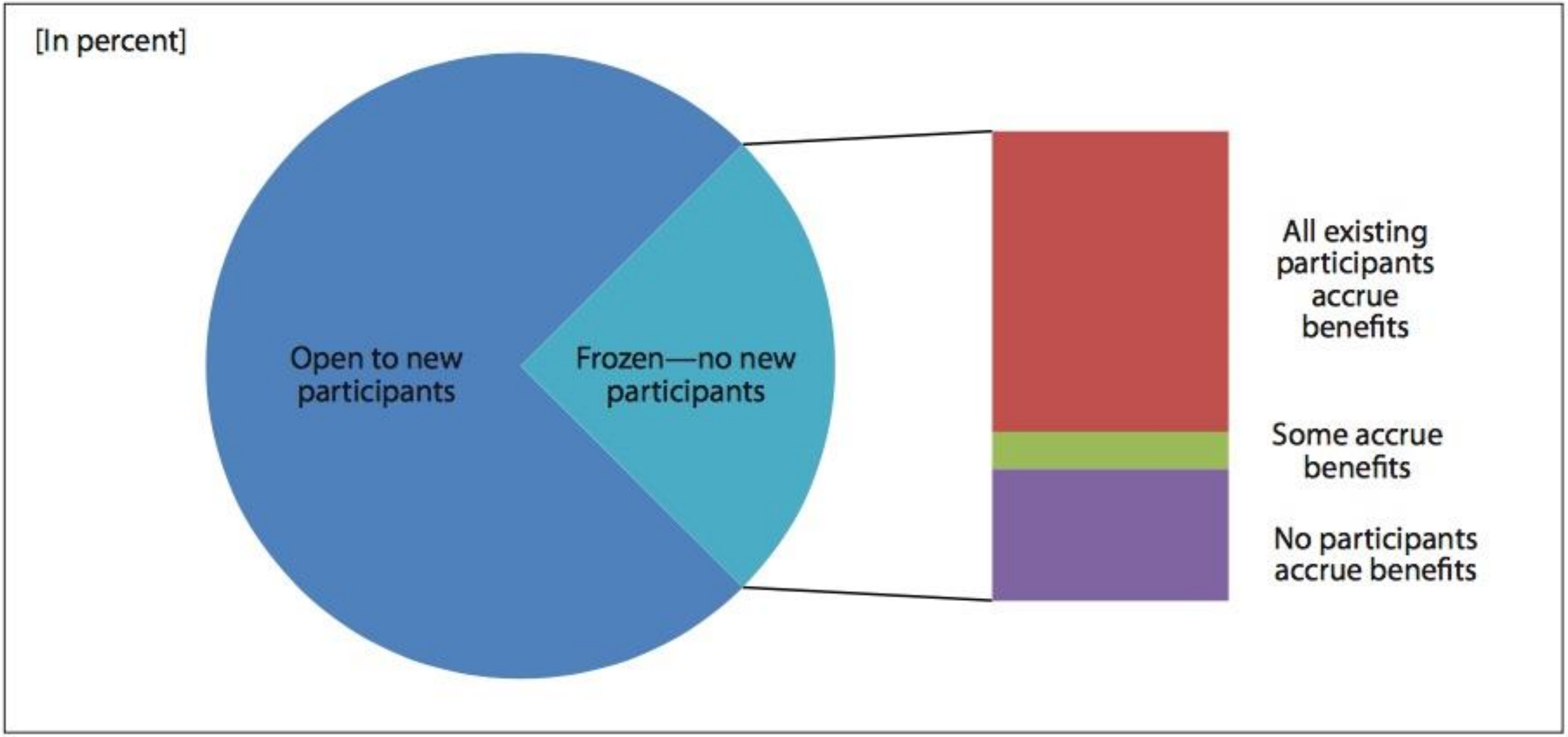
Percentage of employees participating in defined benefit pension plans, private industry, for selected years during 1981–2011



NOTE: Information shown for 1990–1991 and 1994–1995 uses combined data from separate surveys of small and large private establishments.

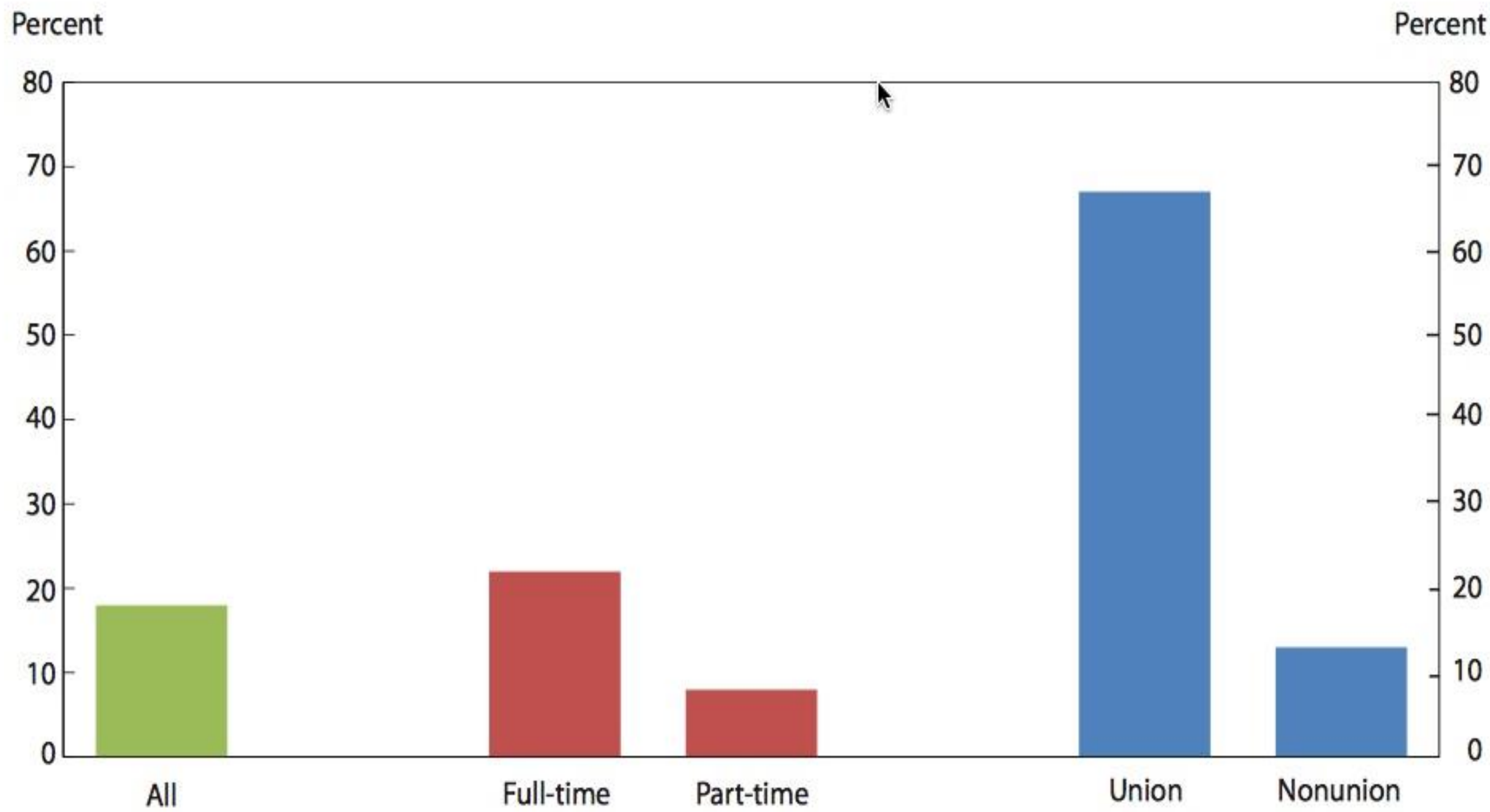
SOURCE: U.S. Bureau of Labor Statistics.

Percentage of defined benefit pension plan participants in open and frozen plans, private industry, 2011



SOURCE: U.S. Bureau of Labor Statistics.

Percentage of employees participating in defined benefit pension plans, by selected characteristics, private industry, 2011



SOURCE: U.S. Bureau of Labor Statistics.

DB Plans No Longer a Factor

- Other than unionized employees and in some industries (principally pharmaceuticals), DB plans are not a signification factor in private employment
- In the public sector, many DB plans exist but all are under severe pressure

On the Other Hand . . . .

- Defined Contribution/401k plans now cover 94% employees working at medium and large employers
- The “typical” DC plan allows employees to contribute up 10% pay, of which up to 6% is matched, at a typical rate of 50%
- So, the typical employee has an opportunity to defer up to 9% of annual pay subject to IRS limits

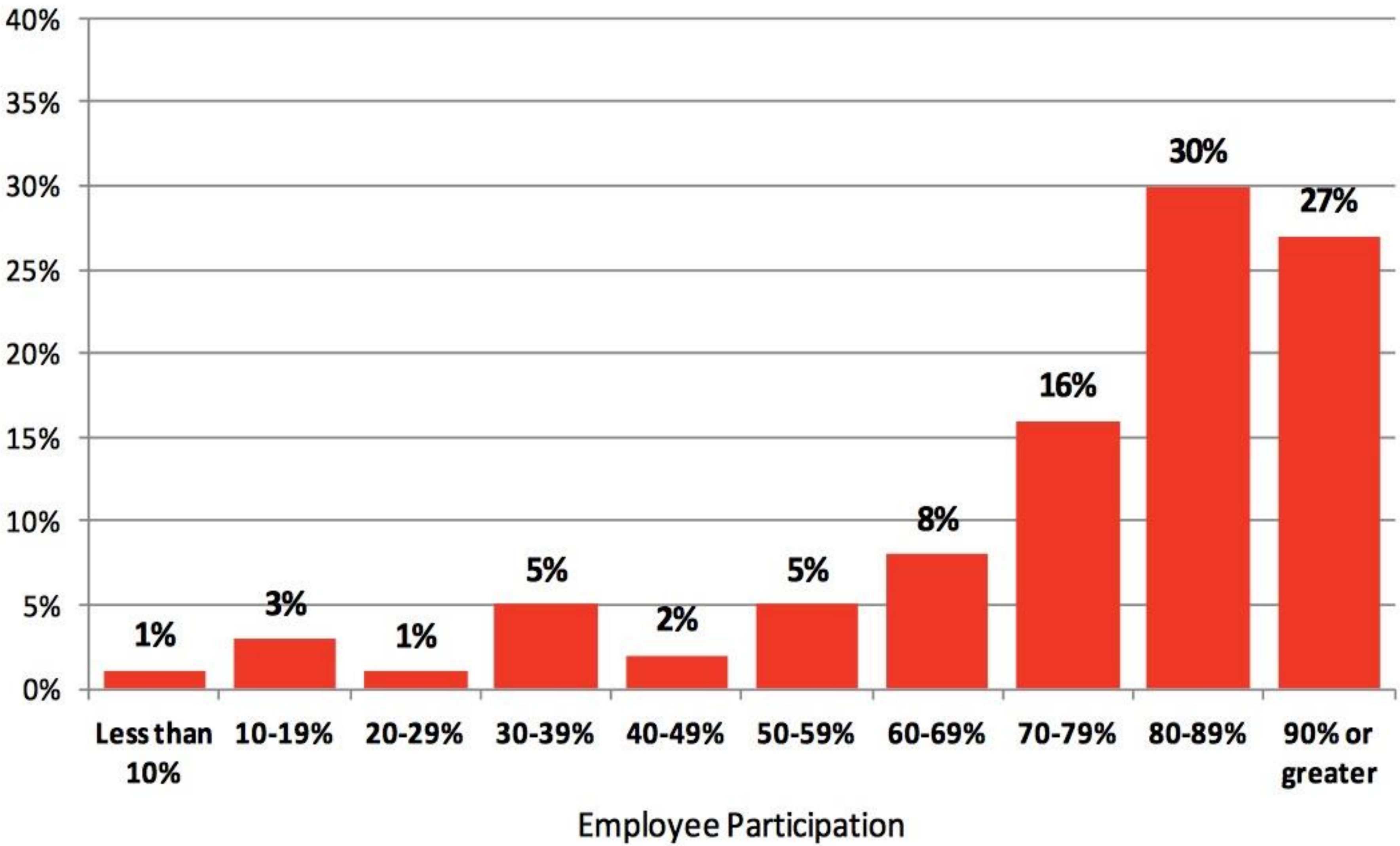
Source: 2014 WorldatWork survey

So Far, So Good

- A 9% annual contribution invested for 40 years can provide retirement income of 55-60% of final average pay
- Assumptions:
  - Investment return: 7%
  - Salary Increases: 3%
  - Inflation: 4%
  - Straight life annuity at age 65

Figure 3: Percentage of Employees Participating in a Plan

"What percentage of your organization's U.S./eligible employees is currently participating in the 401(k) plan?" (n=369)



Source: WorldatWork 2014 survey

Now, the Reality

- Low participation
- Low contributions
- Immediate gratification (Stanford Marshmallow experiment)
- Ability to borrow money
- Availability of hardship withdrawals
- Low initial contributions not increased

Potential Solutions

Increased Communication

- Financial
- Behaviorial

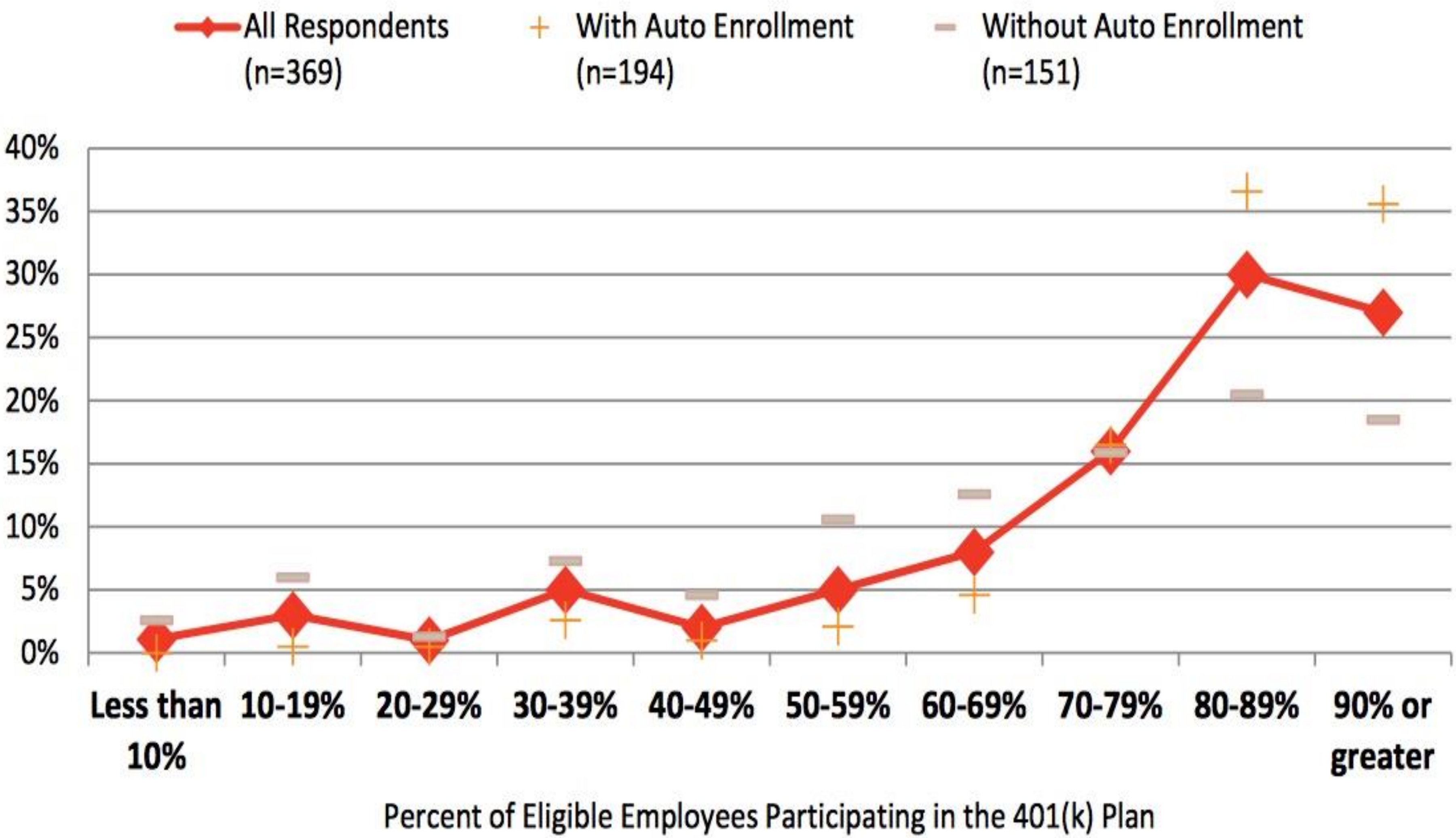
Increased Education

- Modeling tools
- Investment strategies including lifecycle investment
- Investment advice
- Role of annuities during payout phase

Use or Increased Use of Auto Features

- Auto-enrollment (allowed in US since 2006)
  - In US, subject to restrictions on levels, required employer contributions and investment choices
- Auto escalation of participant contributions
- Default investment choices

The graph below includes the employee participation information above as well as differences in participation levels depending on whether an organization offers automatic 401(k) plan enrollment. (See Figure 14 for more detail on automatic enrollment.)



Source: WorldatWork 2014 Survey

Conclusions

Lessons Learned from US

- DB plans are gone for good
  - Too high employer risk
  - Today's workforce too mobile
    - Frequent job changes
    - Much part-time
    - Job sharing
  - Low perceived current value in future annuity stream

Lessons Learned from US

- DC plans are here to stay
  - Highly appreciated by employers and employees
  - Tax effective
  - Attractive to top management
- In most cases, a DC plan will NOT provide an adequate retirement income
  - Marshmallow effect
  - Too many diversions before retirement
  - Powerful attraction of lump sum at retirement
  - Low rate of savings

Lessons Learned from the US

- To improve adequacy of retirement income provided from DC plans, interventions are needed. Examples:
  - Auto-enrollment
  - Auto contribution increases
  - Financial and behavioral education and modification
  - Investment education and advice
  - More aggressive positioning of annuity payout options

Thank You!

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