

Olivia S. Mitchell

Developments in the US Pension Marketplace

World pension assets currently stand at 23 trillion US-dollar, and the US share of the global retirement asset pool amounts to about 60 percent of the total. But all is not well in the US pension marketplace. Just five years ago, US pensions held more than half the assets of the world's largest pension funds; now, US plan representation has slipped to 43 percent. And new troubles emerge daily in the retirement security arena. Several large companies have recently frozen their defined benefit (DB) plans; General Motors is moving to terminate its DB pension for unionized employees; and many state and city governments face funding challenges for their public sector worker pensions.

The Employee Retirement Income Security Act

To understand today's tensions, we must roll the clock back to 1974 when the US Congress passed important legislation designed to secure defined benefit promises for private sector employees. The Employee Retirement Income Security Act (Erisa) codified the federal government's intent to force corporations to set aside dedicated assets to pre-fund DB promises made to workers. These assets had to be segregated from company coffers, and by law, the money was to be invested solely in participants' best interests. Because many DB plan sponsors had insufficient pension funding at the time, Erisa gave corporations 30 years to gradually build up sufficient assets to back their DB promises.

In addition, the law established the Pension Benefit Guaranty Corporation (PBGC), a government-run corporation responsible for paying retirees a portion of their promised benefits in the event of corporate bankruptcy. This insurance is paid for by a

mandatory insurance premium levied on corporations offering DB plans; furthermore, at bankruptcy, the PBGC can take over a DB plan's assets (if it has any) along with its liabilities. The DB guarantee is fixed in nominal terms and capped; in 2007 the benefit maximum is 49,500 US-dollars per year for a 65-year old retiree, and the maximum is also actuarially reduced for younger retirees (so for example, at age 55, the benefit cap is only 45 percent of the age-65 benefit.)

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Aus den Erfahrungen in den USA leitet die Autorin einige Schlussfolgerungen für die laufende Altersvorsorge-Diskussion in Europa ab. So haben die in den Vereinigten Staaten praktizierten traditionellen Varianten der bAV, siehe Enron, erhebliche Risiken für Angestellte, Ruheständler und Aktionäre mit sich gebracht. Kaum ein Arbeitgeber in den USA, so schildert sie die Konsequenz, bietet heute einen neuen Vorsorgeplan an und viele bestehende werden aufgelöst. Bei staatlichen Vorsorgeplänen stellt sich wiederum die bekannte Frage nach der Finanzierung. Arbeitgeberbasierte private Altersvorsorgepläne (Defined Contribution Plans) sieht die Altersvorsorge-Beraterin der Bush-Regierung auch für Europa als mögliches Modell an: Sie sind steuerabzugsfähig, lassen eine Diversifikation bei der Anlage zu und die Investitionen sind nicht fest an einen Arbeitgeber gebunden – aus ihrer Sicht allesamt wichtige Merkmale in einem sich immer schneller veränderten Arbeitsmarkt. Mit einer automatisierten Teilnahme und Standard-Investmentportfolios, so ihr Credo, lassen sich die Pläne noch verfeinern. (Red.)

Today, more than three decades post-Erisa, it is clear that this legislation did not avoid – and in some cases it surely exacerbated – deep fissures in the US defined benefit edifice. Naturally there is much blame to go around. Investment consultants have recommended to pension managers to hold high percentages – 70 or more – of the DB portfolio in volatile equities, without paying careful attention to how well (or poorly) these risky assets match benefit payment obligations. Hence when the stock market sinks, DB plan assets move in tandem.

Accounting and actuarial methodology has also permitted many firms to skip on DB contributions: for instance, strategically chosen assumptions and pension asset smoothing techniques can often reduce required contributions. Expected returns, rather than actual returns, are used in estimating needed revenues and all too often, optimistic expectations are not met. The net result is that DB plans have become quite risky and far from transparent, such that workers, retirees, shareholders, and other stakeholders cannot easily determine how well-funded a DB plan may be at any given time. To make matters worse, the largest DB pension plans are concentrated in firms facing tenuous and volatile economic prospects – airlines, automakers, and steel manufacturers.

Mark-to-market accounting

Pension analysts have suggested that two recent developments may mitigate some of these DB problems. First, the US Financial Accounting Standards Board (FASB) is slowing moving toward DB plan mark-to-market accounting; nevertheless this is phasing in more slowly than in the UK with Financial Reporting Standard 19 (and the International Accounting Standards Board

parallel ruling). Second, in 2006, the US Congress passed the Pension Protection Act (PPA), which imposed stricter full funding targets, made it harder for underfunded plans to boost benefit promises, and raised and better risk-adjusted PBGC insurance premiums.

Since the PPA is being phased in over several years, little immediate impact will be felt right away. Longer-term, these developments will likely make it more difficult for DB plan sponsors to invest in equities, to promise benefits and not fully fund them, and to underfund without paying higher premiums. But the PBGC itself has already taken on promised benefits that exceed its assets by more than 18 billion US-dollars, and underfunding in firms still operating could conceivably drive this number up by as much as 25 times. Evidently, some resolution of this deficit must be confronted by a future Congress.

Personal account pensions offer more positive experience

One powerful lesson from the US experience in the DB arena is that greater transparency is essential for a well-managed system, so that stakeholders can better understand the long-term promises made and the assets backing them. Another lesson is that government reinsurance for DB plans is a difficult, costly, and ultimately political venture; the recently established Pension Protection Fund in the UK which backs DB promises underscores this point.

Offsetting gloom over DB plans is the much more positive experience with personal account pensions, including defined contri-

bution (DC) pensions at the workplace and Individual Retirement Accounts (IRA) held outside one's place of employ. The most popular form of employer-based defined contribution plan is the so-called 401(k), named after the section of tax legislation permitting private sector employees to contribute part of their salaries tax-deferred, to individually-managed accounts under this plan type. In addition, investment earnings on assets in these plans are also tax deferred until retirement.

To underscore how popular such plans have become, corporate DC assets now total almost three trillion US-dollar, compared to the corporate DB total of two trillion US-dollar. In the 401(k) environment, workers decide how much to contribute ("salary-defer") to the plan per year (up to a ceiling set by tax law), and they invest their money in one or more funds included in the plan menu designed by their employer. Frequently the employer will also contribute some set amount to each worker's account which sometimes is invested in company stock. Generally the money is portable at job change, so the worker may "roll over" his 401(k) funds to an Individual Retirement Account (IRA) while preserving the tax deferral. IRA assets have also grown rapidly, currently amounting to more than 3.7 trillion US-dollars. Generally the latter are managed by mutual funds, banks, or insurers.

Policymakers expressing reservations

Notwithstanding the impressive growth of the personal pension field, policymakers have also expressed reservations about aspects of these plans. First, workers generally have choice regarding whether, and how much, to contribute to their 401(k) plan. The problem arises because employees invited to "opt into" a plan sometimes fail to do so; in practice, more than half of eligible employees tend not to enroll. Second, when workers are financially illiterate or lack confidence about investing, their portfolio allocations tend to be driven by non-financial decision rules. For instance, some employees simply spread their money evenly across all the funds offered, irrespective of the funds' character, which can result in nonsensical portfolio allocations.

Third, the investments in these funds are generally not guaranteed, so people can

lose money. A case receiving much public attention was the Enron bankruptcy, after which it turned out that some employees had invested their entire 401(k) money in Enron stock – which then became worthless. This is currently still permitted under pension law.

Automatic enrolment

Congress has responded to some of these problems by adding new PPA rules for defined contribution pensions. For instance, in the future, companies will be permitted to "automatically enroll" workers into their 401(k) plans, which is anticipated to double plan participation. Furthermore, employers may now automatically allocate worker contributions to so-called "QDIA" (qualified default investment alternatives), which are funds deemed acceptable for pension money. This is important since plan sponsors feared being held liable for pension investment losses in the past. Post-PPA, companies adopting target retirement date funds, balanced funds, or professionally-managed accounts will receive protection against this sort of claim.

Target maturity date funds are also growing particularly rapidly, as they offer automatically rebalanced asset allocations that start out more aggressive and move toward safer allocations as the selected retirement or "target" year nears. Research shows that younger, lower-paid, and female employees have favored the target maturity funds, as do newly hired workers. Overall, the government has estimated that these changes will boost 401(k) plan assets by 45 to 90 billion US-dollars. Perhaps the most important finding from the US experience with DC plans is that these have become very popular, they permit excellent portability across jobs, and they require some thought as to sensible design; the secret is to default workers who do not care to exert any decisionmaking effort into low-cost and well diversified investment portfolios.

Government Pension Plans

Having explored US corporate pensions, we turn now to a discussion of the 3.8 trillion US-dollars in pension assets managed by government pension plans. Of this sum, roughly 70 percent are found in state and local government pension accounts, with the remainder held in federal government

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employee plans. Overall, public DB plans seem to be relatively well funded, though several have experienced accounting and funding troubles in recent years, akin to those in the corporate sector. Furthermore, public employee pensions are not regulated by Erisa or the PPA, nor are they protected by the PBGC. Therefore when these plans become underfunded, retirees must hope for continued economic growth so that tax revenue can be raised to pay benefits if shortfalls arise.

Recently, however, it has become increasingly difficult for politicians to boost taxes to pay for generous public pensions, particularly when private sector pensions are being frozen and terminated. Further, the governmental accounting entity (GASB) has not yet adopted the mark-to-market philosophy now sweeping corporate pension finance circles, so that the full amount of underfunding may not yet be known. In all, reforms to public plans may be a decade behind the corporate pension sector.

Defined contribution plans as a popular solution

In sum, as European nations ponder pension reform options in light of demographic aging, the US pension fund experience of the last 30 years suggests some paths to avoid and some to follow.

Most analysts today understand that employer-based DB plans can be far riskier than acknowledged decades ago, for workers, retirees, and shareholders. Few US employers today would establish a DB plan de novo, and indeed many employers indicate they intend to freeze/terminate their existing DB plans in the near future. Government efforts to reinsure corporate DB plans have been costly and sometimes they have induced moral hazard.

Public DB plans also suffer from funding problems flowing from outmoded accounting approaches; this is also a problem in the European context. Defined contribution plans would likely be very popular to the extent that they permit tax-protected salary deferral, allow investment diversification, and are portable – all appealing features in an increasingly mobile labor market. Finally, automatic enrolment and default investment portfolios requiring investor diversification seem to be sensible additions to the DC mix. ■■■■■