

Reflections on the Regulation and Supervision of Private Pensions

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Background

- First pillar (Social Security) insufficient to replace 75-85% of pre-retirement income
- Tradition of minimizing reliance on government, maximizing free market
- Hence complementary private pension system
- Purposes

The US Private Pension System

- Voluntary for employers and employees
- Both closed (occupational) funds and open (individual) funds
 - Closed (employer plans): DB and DC including employee-funded 401(k)
 - Open: individual retirement accounts (IRAs)
- Basic public-private bargain: tax preferences for compliance
- Tax expenditures ca. US \$125b a year
- Highly regulated under tax and labor law

What Works and What Doesn't

GLASS HALF FULL:

- Largest pool of private investment capital in the world
 - Private DBs, DCs, IRAs, DBs and DCs for govt employees total over US \$11 trillion, nearly = 100% of GDP
- 65 million workers covered
- Millions receive meaningful benefits

What Works and What Doesn't

GLASS HALF EMPTY:

- Over 1/2 of workers uncovered; tied to ER
- Pension/tax benefits skewed to high-income
- Investment underperformance; expenses
- Leakage upon job change
- Lump sums displacing lifetime guaranteed income (annuitization)
- DB underfunding and accelerating decline spurred by 401(k) expansion

Participation Shortfalls

- DB to 401(k) trend means less employer funding, more employee funding/initiative
- In 401(k) 1/3 to 1/4 of eligibles “leave money on the table” – fail to participate
- IRA participation: 5 to 15% of eligibles
- Especially lower- and moderate-income
- Traditional 401(k) requires employee to take initiative to participate, choose contribution level and investments

Asset Accumulation Shortfalls

- Employee-directed 401(k) and IRA investments underperforming professionally managed DBs
- Causes:
 - Suboptimal asset allocation, under-diversification
 - Specifically: Enron (too much employer stock) but also too much money market
 - Market timing, following the market, not rebalancing

Accumulation Shortfalls (cont'd)

- Root causes
 - Legal (ERISA) exceptions to diversification & prudence: employer stock & self-direction
- Diversification and asset allocation require discipline, rebalancing
- Nonprofessional investors busy, distracted, often uninformed re diversification/asset allocation

Savings Preservation Shortfalls

- Leakage from the pension system: DB and DC savings accessible upon job change
- IRA withdrawals unrestricted except 10% penalty
- More lump sums consumed than saved, though affluent tend to transfer to IRAs
- Wealth illusion and increasing longevity: lump sums replacing annuities even at retirement age

Partial Solution: 401(k) Plans on Auto-Pilot

- Maximize Participation and Contributions
Automatic Enrollment
Convert tax exemption/deduction to credit
- 2. Maximize Investment Returns –
Automatic Investment
- 3. Maximize Preservation of Savings
(Minimize Leakage) – Automatic Rollover

Automatic IRAs

- Could give workers universal right to request payroll deposit to IRA as saving channel
- No employer contributions, responsibility, or liability: employer mere conduit
- Simple best practices in enrollment and investment
- Encourage automatic debit and direct deposit of refunds by self-employed

Possible New Initiatives

- 401(k) type matching contributions inducing voluntary contributions – saver's tax credit
- Higher rate of match for lower-income
- Build on and enhance private pensions
 - Protect employer plans
 - Sensitivity to imposing new obligations on sponsors
 - IRA leakage and investment reform
- Make saving easier & more automatic
 - Payroll deduction; autoenrollment; tax refunds

Regulatory Objectives: Accountability

Need to leverage scarce gov't resources to encourage compliance

- Pursue public-private partnership
 - First voluntary compliance
 - Private-sector ambassadors, interpreters
- Enact workable laws and regulations
 - Dangers of “ivory tower” and undue complexity
- Take into account realities of human behavior

Methods

Methods of enforcing compliance

- Personal liability for fiduciary violations
- US a litigious society: army of private enforcers (private bar)
- Adverse publicity
- Plan disqualification vs. fines, etc.
 - US uses IRS and tax system
 - Voluntary compliance, self-correction (EPCRS)

Regulatory Objectives: Transparency & Disclosure

- Same 3 guiding principles
- Funding: delayed, actuarial vs. immediate
- Standardization and simplification of plan designs and investment options facilitate comparison
- Uniform disclosure of expenses
- Model disclosures: plain language, real time, public

Drawing Conclusions

- Drawing comparisons: beware the differences
 - History
 - National culture and habits
 - Economy, financial system
 - Political system
 - Legal system and tax regime
- Regulation: a delicate balancing