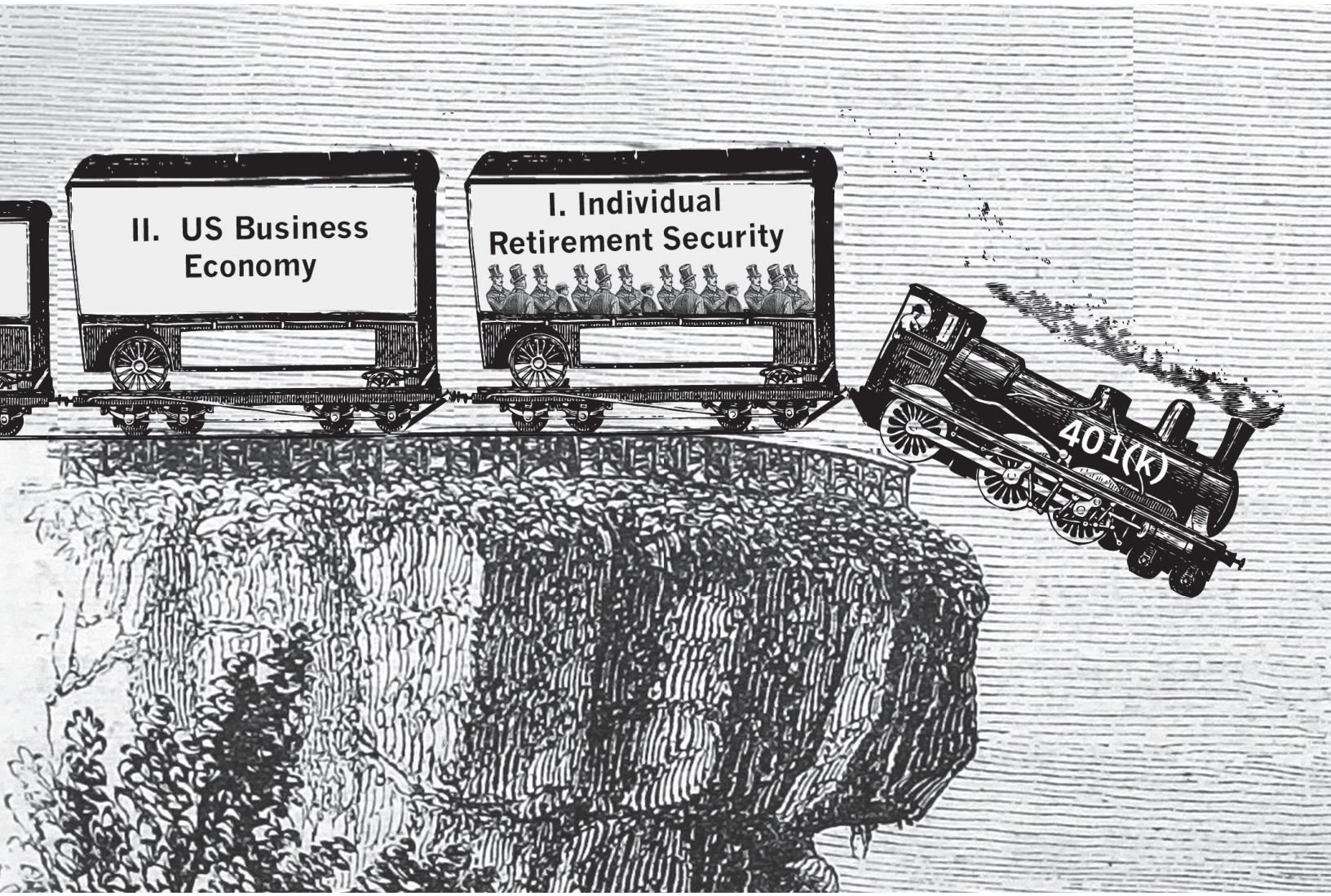
TRANSITION TO 401(K) PLANS

A TRAIN WRECK IN THE MAKING



PART I

LOSS OF RETIREMENT SECURITY

California Retired County Employees Association
Retirement Security Committee
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I. INTRODUCTION

The California Retired County Employees Association (CRCEA), a statewide organization representing approximately 160,000 retirees from 20 California counties, is dedicated to furthering the interests of county retirees. Its Retirement Security Committee was formed in June 2011 to counter misinformation that was being disseminated in the media by advocates of public pension reform.

Sound public policy development has taken a back seat to ideology and sound bites with a dearth of information provided to the voting public on what pension reform proposals really mean to the individual, the economy, or the future of this country.

A dominant solution to the retirement questions touted regularly in the media is to follow the lead of the private sector and transition public workers from traditional pension plans to 401(k) plans. While there are similarities in the public and private sectors that allow for each to benefit from the other's experience, there are also dramatic differences that need to be addressed when examining pension issues. The so often claimed "fact" that business was "saved" by transitioning their employees to 401(k) plans says absolutely nothing about the ultimate effect of that transition on the individual or the economy. It does not address the rationales applicable to business but not to government, nor does it mention that the level of benefit and structural deficiencies of a 401(k) plan are poor substitutes for a properly run defined benefit plan.

This paper deals with the destruction of retirement security in the private sector resulting from a transition to 401(k) plans.

II. LOSS OF RETIREMENT SECURITY IN THE PRIVATE SECTOR

Most employers in the private sector have closed defined benefit pension plans ("DB plans") and now offer primarily, if not exclusively, 401(k) plans. The move to 401(k) plans in the private sector has allowed employers to cut their pension costs from the 6-8% of payroll range for DB plans to the 2-3% range for 401(k) plans, while at the same time shifting the burden for pension fund management and other responsibilities to their employees.[1]

The shift from DB plans to 401(k) plans has destroyed retirement security for today's workers in the private sector:

- Review of polling shows that 84% of Americans are in a state of panic about their retirement security.[2]

- The median household headed by a person of age 60-62 with a 401(k) account has saved less than one-fourth (1/4) of what is needed to maintain its standard of living.[3]

- Over 60% of all U.S. workers now rely on 401(k) plans as their primary retirement fund, and this percentage continues to increase each year. Unfortunately, these plans are woefully underfunded. The average 401(k) account balance of workers with 30 years of private sector experience is only $149,000 to support decades of retirement.[4]

- In 1991, 50% of workers expected to retire by age 65. Today, only 23% of workers expect to retire by that age.[5]

Experience in the private sector demonstrates that 401(k) plans have utterly failed in providing an adequate retirement fund. As this negatively impacts both individuals and the economy, it would be the worst of public policy to repeat that failure in the public sector.

The transition to 401(k) plans is, without a doubt, **a train wreck in the making.**

III. 401(K) PLANS FAIL TO MEET THE REQUIREMENTS FOR A SUCCESSFUL PRIMARY RETIREMENT PLAN

A retirement plan, to be successful as the primary source of retirement security, should meet the following three requirements:

- Sufficient contributions during the entire work career regardless of the number of jobs;

- Sufficient returns on investments during the entire 30+ work career as well as during post retirement years;

- Inability to invade the assets of the retirement fund for nonretirement purposes.

A. Failure To Provide For Sufficient Contributions

While employers can contribute to a worker's 401(k) plan, they are not required to. During the recent economic downturn many employers reduced or eliminated their 401(k) contributions. Many workers contribute only as much as they can afford in order to pay monthly bills. And two out of three workers under age 30 fail to contribute anything, even if their employer matches their contribution.[6] And the later

one begins to fully contribute to the plan, the higher the annual contribution needs to be.

Determining the amount one should contribute to the 401(k) requires a crystal ball and considerable expertise to predict earnings, inflation rates, rates of return on investments, anticipated employer contributions, retirement age, Social Security interface, life expectancy, and on and on. Most of us can't predict what the stock market will do tomorrow, nor do we have ready access to the kind of regular periodic professional actuarial assistance needed to help solve the individual complex equation. Why is this factor so important?

Let's compare two employees who retired at age 65 after 35 years of service and with an ending salary of $48,000. Employee A has a DB plan with a 2% at 55 formula that generates an annual pension of $35,000. Employee B, with a 401(k) plan, would need a balance of over $850,000 in his or her account to achieve the same retirement benefit as employee A. To achieve that balance, employee B would have to contribute to the 401(k) account far more than was paid in by employee A – specifically 25% of his or her annual income, less any employer contribution. If employee B is supporting a family of virtually any size, especially a large family, he or she would be hard pressed to consistently pay out 25% of salary over the course of his or her career, even with consistent help from the employer, which has proved improbable at best. Complicating matters more, periodic increases to the federal annual contribution limit have been slow to keep pace with the need. This, coupled with employer trends to decrease or eliminate their contribution, has resulted in 401(k) participants having far less retirement income than they would have had if the same or even less resources had been put into a well-run defined benefit plan.

For higher salaried employees, the federal annual tax-favored contribution restriction, set at $16,500 for the employee and 6% for the employer in 2011, presents a different problem. When the limit, and therefore 401(k) savings are reached, these employees can be expected to place substantial upward pressure on salaries to compensate for the inability to increase their 401(k) plan savings and earn revenue on those savings on a tax-deferred basis. This places the employer in a position of having to pay more dollars in salary, in lieu of a typically far lower benefit payment.

B. Failure To Provide For Sufficient Investment Returns

From 1999 to 2009 there was effectively no return on the stock market.[7] From October 2007 until January 2009, 401(k)s lost a collective $1 trillion in value; that is fully a third of the value of all 401(k) plan balances.[8] So where can one invest to get a sufficient return? The entire Social Security fund is invested in special issues of the U.S. Treasuries that paid an average of 2.76% for 2010 and 2.82% for 2011.[9] Even if made available to 401(k) investors, this is clearly not the kind of return on

investment that will meet the individual needs of a 401(k) account holder to build retirement security.

As a major contrast, government defined benefit pension plans have historically achieved long-term investment returns in the range of 8.1% over 20 years, and 9.3% over 25 years.[10] This drastically reduces the amount of employee and employer contributions needed to fund a pension (annuity) dollar.

Several factors explain the lower investment returns achieved by 401(k) plans. As a 401(k) participant gets closer to retirement, investments must become more conservative. DB plans, however, can invest more aggressively in a balanced, diversified portfolio for a very long period due to the ability to pool longevity risks. And DB plans achieve higher returns due to professional asset management, the ability to hedge risks through alternative investment opportunities, and lower asset management fees.

Further impairing 401(k) investment returns is Wall Street's propensity to pounce on unsophisticated investors by deducting up to a dozen undisclosed fees on mutual funds including legal fees, trustee fees, transactional fees, bookkeeping fees, stewardship fees, and finder's fees, just to name a few. The financial lobby in Washington has been successful in preventing any bills from being introduced that would require disclosure of these fees. Congressional testimony shows that these fees can eat up one half (1/2) of 401(k) investment income over a 30 year span.[11]

C. Failure To Prevent Invading Funds For Non-retirement Purposes

Many 401(k) participants cash out their accounts when they change jobs. By doing so they incur a 10% tax penalty, with the employer required to withhold taxes equal to 20%. And in 2009, 21% of participants had "loan" balances on their accounts.[12]

IV. THE LOSS OF RETIREMENT SECURITY HAS DIRE CONSEQUENCES FOR THE NATION

The majority of the American workforce has no retirement plan (and savings under $2,000) and will be dependent on Social Security when they retire (if it still exists as it does today).[13] And six (6) out of ten (10) working Americans believe they will get no Social Security when they retire.[14] No one wants to be a burden to family, friends or society in their old age. But the U.S. workforce is clearly headed for a bleak future if we continue on this projected course.

The current move to 401(k) systems is not a win/win situation and is far from optimal pension policy for both the private and public sectors. While it may initially appear to be financially beneficial for the employer (and Wall Street), this is short-term thinking. These underfunded 401(k) plans will have a very detrimental impact on business and the economy. Unlike the positive impact (multiplier effect) that has traditionally been associated with defined benefit plans that return $2.36 for every $1.00 of pension expenditure,[15] 401(k) plans promise to be a future drag on the economy. Consumer spending today accounts for a very significant portion (40-70%, depending on the factors used) of our nation's economic activity. With a huge population of elderly retirees struggling to barely get by financially, our consumer-driven economy will be in a disastrous state.

CONCLUSION

The transition in the private sector from defined benefit plans to 401(k) plans has resulted in a disastrous loss of retirement security. Continuation of this trend in the private sector, and expansion of the transition to the public sector is an individual and economy-wide **train wreck in the making.**

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[5] Employee Benefit Research Institute, March 15, 2011, "2011 Retirement Confidence Survey-2011 Results"

[6] Congressional Budget Office, "Utilization of Tax Incentives for Retirement Saving in 2006", updated October 2011

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[11] 60 Minutes on CNBC, March 23, 2010, "The Collapse-The Shortcomings on Relying on a 401(k) for Retirement"

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[15] National Institute on Retirement Security 2011, Pensionomics-Measuring the Economic Impact of State and Local Pension Plans