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Look to Chile, Asia for defined contribution innovation

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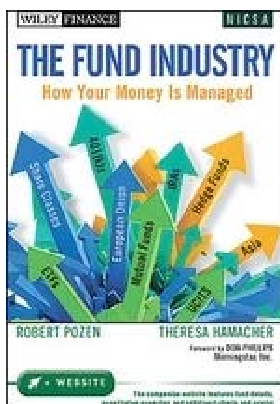

Believers in American exceptionalism can find much to applaud in the U.S. approach to funding retirement income. It's a system that rewards self-reliance, encourages thrift and hard work, leaves lots of room for personal choice — and that has no parallel in the rest of the world. But, in our view, it doesn't do enough to help Americans achieve financial security in retirement, so we should adopt best practices from other countries.

The average American retiree receives about 40% of income from Social Security. Another 20% comes from private retirement plans, which increasingly are likely to be defined contribution plans and individual retirement accounts, rather than traditional pensions. The remaining 40% of retiree income comes from personal savings outside of retirement plans and from earnings.

That's a significant departure from the model that still dominates in most of the developed world, where retirees get at least half — and sometimes as much as 70% — of their income from tax-supported Social Security and much of the rest from a defined benefit pension. It's a comfortable cocoon of retirement security — but it's financially unsustainable, as the number of workers per retirees dwindles in aging societies and as corporations become less willing to provide lifelong pensions. The United States — by providing ample incentives for workers to save today for future retirement needs — is ahead of its developed-world counterparts in addressing the looming problem.

In that regard, the United States has a lot more in common with the emerging markets than with other members of the G-7. Many of the wealthier emerging markets, including Chile, Hong Kong and Singapore — together with Australia in the developed world — have made defined contribution plans the centerpiece of their retirement systems. Workers in these countries have individual savings accounts funded through payroll deductions or employer contributions — accounts that look an awful lot like 401(k) plans.

However, the similarities are only skin deep. Countries that rely heavily on defined contribution plans have made them mandatory. All workers have access to them, and workers or employers — or both — are required to contribute to them. In Hong Kong, for example, workers must put 5% of their salary into the Mandatory Provident Fund, while their employers contribute an additional 5%. Investment choices are quite limited. For instance, most retirement plan assets in Singapore earn a fixed rate of return paid by the government, leaving plan participants investment discretion over only a small portion of their accounts, while Chileans may choose an investment manager, but not specific investments. Withdrawals are also severely restricted, especially before retirement, and retirees may be required to receive all or part of their benefits in the form of a life annuity.

These public-private hybrids — often called “collective” defined contribution plans — have many advantages over the U.S. 401(k) model. First and foremost, they provide coverage for all workers. That's certainly not the case in the United States now, where half of workers — predominantly lower-income workers — aren't covered by a retirement plan at work, leaving a gaping hole in the social safety net. Collective plans can also be cheaper to administer. Perhaps most importantly, collective defined contribution plans reduce the burden on individuals. Planning over 40 to 50 years for a retirement that could last 35 years — or could be significantly shorter — is a daunting task even for trained actuaries.

Yet the U.S. has a laissez-faire retirement system, which implicitly assumes that everyone learn about life

expectancies, investment returns, tax planning and sustainable withdrawal rates. While it would be difficult — if not impossible — to impose many mandatory features given the political climate in the United States today, we still believe American plans could make retirement planning easier for individuals. Specifically, we suggest policymakers seriously consider the following options:

Universal coverage. All workers should have access to a retirement plan through their place of employment. We strongly endorse the "automatic individual retirement account" proposals that would give workers who are not covered by a traditional pension or defined contribution plan the ability to put money into an individual retirement account through payroll deduction — receiving the same tax benefits that they would if they set up a traditional or Roth IRA on their own. These proposals do not require employer contributions, just that employers connect their payroll systems to a qualified financial institution.

Mandatory participation. Workers would be automatically enrolled in the plan available to them at a minimum contribution level — unless they take action to opt out. This minimum contribution could be gradually increased for all participants — again with an opt-out.

Professional investment allocation. All plan contributions would be invested in a balanced fund that invests roughly half its assets in stock, unless participants expressly choose another investment vehicle. We suggest balanced funds because they are low cost, easy to understand — unlike target-date funds, which have generated much investor confusion — and will serve most plan participants well until the decade before retirement. At that time, plan participants should be encouraged to review their asset allocation and make changes to match their particular circumstances — with the help of a professional adviser if needed and feasible.

Limitations on lump-sum withdrawals. To help retirees convert assets into a steady income stream, half of the account balance in an IRA or 401(k) at retirement would be put into a life annuity, providing full protection against longevity risk. Here, too, participants could opt out, by either placing the assets into a managed payout mutual fund or taking the full account balance as a lump sum, although in the latter case the withdrawal would be taxable.

By making it easier for more Americans to fund their own retirement income needs, we believe these changes would make the American retirement system not merely different — but better than those in most other countries.

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