

CHAPTER 1

DC Version 2.0

The earliest versions of computer spreadsheet programs—from VisiCalc in the late 1970s on—were designed for experts: academics, accountants, and computer geeks.¹ Built by guys with beards and sandals for guys with beards and sandals. Functionality was very limited indeed by today's standards. Interest was low initially. Fast-forward 30 years and Microsoft Excel is everywhere. It is enormously superior to early spreadsheets. It can calculate the inverse matrix for a matrix stored in an array or the probability density function of a Weibull distribution, which is nice if that's what you want it to do. However, most of you don't want it to do that. While improved functionality in a spreadsheet program is important, what matters even more is that it is easy for a book club secretary to type a list of members' names and telephone numbers and distribute that list to the others. Yes, the software needs the power behind it to do an awesome range of complex things for the few, but that ability cannot be at the expense of how well the far simpler needs of the many are met.

DC plans (the most popular type in the United States are called 401(k) plans, because that's the section of the Internal Revenue Code under which their tax-favored status arises²) are almost as old as VisiCalc. They, too, have moved on. And the developments currently under way are so fundamental that we refer to the new breed of 401(k) plan as version 2.0.

The lesson of Microsoft Excel applies to version 2.0 of the 401(k) plan. Broad-ranging success will depend on how well the needs of the many are met, more than on the esoteric features that have been built for the most expert users of the system. The ability to trade daily, for example, provides enormous flexibility for the few who really want it. Daily trading was one of a number of developments built into version 1.0 (around version 1.5, perhaps, if we want to get very literal with our analogy) that were driven by the wishes of the most interested users. Other such developments were education and advice programs, brokerage windows, mutual funds, and specialist investments such as technology funds.

But underpinning version 2.0 is the realization that these features are not the main point and that it is far more important for individuals who do not hold strong investment views to be provided with a simple-to-use but robust vehicle for retirement saving. These—the many—are the ones who most need an effective 401(k) system. These are the ones for whom version 1.0 did not work well (and version 1.5 possibly even less well), and whose needs are now really driving change. We will see again and again that what makes the new breed of 401(k) plan different is how it addresses the needs of the many, not the bells and whistles designed for the few.

COMING OF AGE

In this chapter, we will argue that the 401(k) plan is undergoing a complete redesign in corporations across America. That's not necessarily how any individual corporation sees it; they may feel that they are simply responding to changes in their regulatory and competitive environments. But behind those changes and the corporate response to them lies a fundamental reassessment of what a 401(k) plan is for. If we go beyond the plan-by-plan situation and look at the retirement system itself, the picture that emerges is a transition, led by large employers, to a totally new type of 401(k) plan.

The seeds of change were sown when the 401(k) plan stopped being regarded as a supplement to a DB plan, and instead became seen as an alternative to it. Since their inception in the early 1980s, 401(k)s have grown to cover 47.5 million workers³ and to total more than \$3 trillion⁴ in assets. In the process, they outgrew their old skin. Over time, they reached a tipping point at which they stopped being merely a convenient, tax-efficient way to save, and instead became the primary vehicle for providing financial security in retirement for Americans working in the private sector.

Because 401(k) plans now play a central role in the nation's retirement provision, they have become a matter of public policy. Their new role at the center of the system became official, in a sense, on August 17, 2006, when President Bush signed the Pension Protection Act of 2006 (PPA) into law. The PPA's origins lay in the DB system's challenges, but by the time it became law it had evolved to address the pressing issues of the DC system as well. Behind the provisions lay a message: official recognition that 401(k) plans represented the future. At a stroke, the bar was raised and a spotlight was turned on these plans' weaknesses. Michael Barry of Plan Advisory Services has pointed out that, "Policymakers will not accept going from an efficient system to an inefficient one."⁵

Since the PPA was enacted, 401(k) plans—and the DC system of which they are part—have got serious about coming to terms with their new role. They are being upgraded. Before our eyes, and at a quite remarkable pace, 401(k) version 2.0 is being designed, built, tested, and launched. The new version starts with a different objective, allocates important responsibilities to different players, and indeed does just about everything differently from how version 1.0 did it. But existing 401(k) plans may be falling short in their new role.

THE NEW RETIREMENT SUPERPOWER

Few would now disagree that the 401(k) plan, not the DB plan, is the new retirement superpower. Nancy Webman, editor of *Pensions and Investments*, wrote shortly after the passage of PPA that “the new law clearly signals Washington’s acceptance of the growing dominance of defined contribution plans.”⁶

With the role of retirement superpower comes a world of responsibility, and 401(k) plans are now firmly in the spotlight of regulators, the press, and the public. Expectations are correspondingly higher.

Serious questions have been raised about whether 401(k) plans are able to handle this new role. Alicia Munnell and Annika Sundén have noted that “. . . at every step along the way, a significant fraction of participants make serious mistakes. If 401(k) plans are to become a successful vehicle for providing retirement income, the system has to be changed.”⁷ This quote is taken from *Coming Up Short*, a book published in 2004. A great deal has happened in the short time since then, and these words seem prescient today. As the impact of changes such as the PPA play out, the system *is* being changed. And it is being changed at just about every step along the way.

As attention has turned to the weaknesses of the 401(k) system, some of the specific areas that are receiving most attention are:

- *Participation.* In 1988, 43 percent of workers eligible to participate in a 401(k) plan did not do so. This figure has trended downward, reaching 21 percent as of 2004; however, that is still a significant proportion of the workforce that plans were failing to provide for.⁸
- *Contribution levels.* Of course, it is not enough just to participate. Typical contributions into DC plans are lower than into DB plans and there is no mystery here: What does not go in will not come out.
- *Investment decisions.* The quality of decision making within 401(k) plans is frequently poor. For example, allocations to company stock

were often higher than sound investment principles would dictate, a problem for which Enron became the poster child.⁹

- *Fees.* There is concern among some policy makers that 401(k) fees may be unreasonably high, or that undisclosed fees may be leading to conflicts of interest. There is much regulatory and other activity on this front.
- *Early withdrawals.* Munnell and Sundén estimate that, in 2001, 14.1 percent of those who could borrow from their 401(k) plans had done so and that 15.9 percent of workers had received a lump-sum distribution at some point. That using 401(k) assets for other purposes (notwithstanding the tax consequences) is relatively easy and is sometimes seen as normal practice reduces their effectiveness as a retirement savings vehicle.

That is by no means a complete list of the criticisms that have been made. We will examine each of these as well as other, more subtle issues that are likely to be different in version 2.0 of the 401(k) plan. But, first, it is informative to note how, like any successful occupying power, DC is incorporating elements of the old regime. Indeed, version 2.0 of DC will look in some regards remarkably like DB.

COMING SOON TO A DICTIONARY NEAR YOU: DBization

To capture this trend, the term *DBization* has entered the retirement-planning vocabulary. It is not in any dictionary you can buy—yet. But the term has gained traction because it rings true: Many of the most obvious weaknesses of DC in its new role are weaknesses the DB model has been able to (more or less) successfully address.

After all, DB plans were built explicitly with the goal of income replacement from the very beginning; they allow wide participation, without burden, to participants; investment decisions are made by qualified experts; and so on.

It is hardly surprising that the new challenges being faced by 401(k) plans are being met with solutions largely borrowed from a system that faced the same challenges in the past. As we look at the features that will be built into version 2.0 of the 401(k) system, we have a chance to learn from what was effective in the DB system, as well to learn from the factors that led to its weakening and decline.

AT THE HEART OF VERSION 2.0: A DIFFERENT OBJECTIVE

Let's begin with the basics: What is the purpose of a 401(k)?

Ted Benna, who was involved in one of the earliest applications of the 401(k) provisions, describes becoming interested in the potential for Section 401(k) of the Internal Revenue Code to enable higher-paid employees to save their bonuses in a flexible, tax-efficient way. The fact that the saving was for retirement was largely incidental—and perhaps even a drawback in that “most of the employees weren't thrilled to have the cash bonus replaced by a plan that tied up their money for retirement.”¹⁰

But version 2.0 of the 401(k) can much more easily be understood if it is thought of as a pension plan, rather than as a savings plan. This is, for example, why participation is an issue: Wealth management is for the wealthy, but retirement planning should be for everyone. In Benna's world, broad participation was a hoop to be jumped through (“The one catch was that I had to get the lower-paid two thirds to put enough money into the plan.”) Broad participation was necessary in order to gain the tax break needed for the executive suite, but was not a basic principle, as it is for a DB plan.

The language we use can be revealing; it is still common in the United States to use the term *pension* to refer specifically to a DB benefit, but not to 401(k)s or other DC plans. Benna talks of a 401(k) savings plan, not a 401(k) pension plan. Indeed, the comments President Bush made when he signed the PPA included the term *pension plan* to refer to defined benefit plans. But terminology is changing. Internet searches show that the term *401(k) pension plan* is gaining ground in government and corporate web sites. This subtle change in language is one sign of the changing role that underlies the move to version 2.0.¹¹

INCOME REPLACEMENT

If a savings plan is about a pot of money, a pension plan is about providing income. In the case of a DB plan, the income replacement objective is obviously central to the whole design and operation. And many of the changes occurring today are driven by the growing realization that income replacement has become the name of the game for DC plans, too.

Reporting is going to be affected. An individual participant in a 401(k) plan has been accustomed to seeing a statement that might say something like: “You have saved \$50,000.” A DB plan participant, in contrast, might

see a statement that says: “You have accrued an annual pension of \$5,000.” As the DC focus shifts to income replacement, the accrued value figure will need to be supplemented with more information—information that is relevant to what the plan is there for, perhaps something like: “This \$50,000 is likely to provide you with about \$X in monthly income, which should be enough to replace about 15 percent of your salary, if you retire at age 60.”

Left to their own devices, most people do not make this connection between their savings and their retirement income needs. For example, the 2008 EBRI Retirement Confidence Survey (its 18th annual) reveals that 53 percent of respondents had not tried to figure out how much money they will need in order to live comfortably in retirement.¹²

This reframing from a savings perspective to a pension perspective applies to the plan sponsor, too. At present, plan sponsors have little real gauge of how effective their 401(k) plan is in terms of retirement income. They know how much money is going *into* the plan. They know the accumulated value of the assets. They know, usually, the return that has been earned on those accumulated assets. But they do not know how this all fits together—that is, how effective the overall program is in terms of its fundamental purpose. In version 2.0 of the 401(k) plan, plan sponsors will have a clearer view of this big picture.

Income replacement is a high bar to set. In our previous example, \$50,000 may well sound like a lot of money to the typical plan participant, but the implied level of income replacement may be much less reassuring. Income seems especially puny when interest rates are low and when life expectancy is increasing.

Income replacement in retirement for the many is a much tougher task than tax-efficient accumulation of wealth for the few.

IS THIS THE FIRST NAIL IN THE COFFIN OF DEFINED CONTRIBUTION?

Version 2.0 is being asked to do a lot more than version 1.0 and is going to be judged to a higher standard. In many cases, 401(k) plans will not compare favorably to DB plans. While DC plans *can* provide DB-like levels of benefit, they will require DB-like levels of contribution to do so. And the growth of DC has been driven in part by a desire to cut costs, so those DB-like levels of contribution are the exception, rather than the rule.

As a result, clearer reporting may lead to some dissatisfaction. When the question of income-replacement reporting first came up several years ago, one colleague, John Gillies, posed the question: “Is this the first nail in

the coffin for DC?” His point: Clear reporting reassures if projections are acceptable and provides advance warning if they are not. The arithmetic must be confronted and assumptions must be laid bare. If better income-replacement reporting throws light on low levels of contribution and other inadequacies in the system, it is better to do that today—unwelcome as that news may be—than to be confronted with the social strains it would produce in 15 or 20 years’ time.

This is an important point. The twin realities that lie behind any retirement system are, first, that retirement provision is expensive and, second, that investment returns are uncertain. A key factor in the decline of the DB system was that these twin realities were for a long time not fully acknowledged, with neither the cost nor the uncertainty fully reflected on corporate balance sheets for many years. Reporting changes came after falls in equity markets and at a time when interest rates were low—so the system was less well placed to face what the reporting changes revealed than it would have been a few years earlier. There are lessons from DB about what *not* to do, and this is one of them.

Moving from DB to DC removes a significant source of uncertainty from corporate balance sheets but that uncertainty does not go away: It is moved onto the balance sheets of individuals. In the DC system, people do not know how much income their plans may provide. Similarly, retirement provision is expensive no matter which way you go about building it.

DC’s eventual success may well depend on better reporting, even though in the short term that will draw attention to some inconvenient realities.

“HOLD ON A SECOND . . .”

Not everybody will agree with what we have just said. In particular, many plan sponsors will balk at the idea that 401(k) plans are now pension plans, designed for the provision of retirement income, rather than savings plans. Focusing on income replacement is more complex and demanding than focusing on savings. This new world would mean that plan sponsors can no longer just hire a record keeper, put in their company match, and call it good.

When confronted with the notion of 401(k)-as-pension-plan, plan sponsors vary in their responses. Some welcome the idea: They view a Version 2.0 DBized 401(k) plan as a superior benefit, and they want to be part of it. Others wonder what is in it for them: After all, many of them have just closed their DB plans in order to get out of the business of providing retirement income, and they have no wish to be back in it. In part, this just

reflects different corporate cultures. Whatever the reason, there are many plan sponsors who would take the view that version 1.0 was fine, thank you very much.

But whether or not plan sponsors feel this way is, in a sense, irrelevant. There are wider societal forces that are driving the 401(k) system to reinvent itself. The changes in the PPA signal that the effectiveness of the system is now a matter of public policy. DC is new again; we have a chance to build it better this time.