Retirement News Highlights

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DB still a better deal vs. DC on cost, says report

By Rob Kozlowski
Pensions & Investments
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Defined benefit plans continue to provide greater cost advantages to plan sponsors than defined contribution plans, according to a report from the National Institute on Retirement Security.

The report, "A Better Bang for the Buck 3.0: Post-Retirement Experience Drives Pension Cost Advantage," says a typical DB plan has a 49% cost advantage compared to a typical DC plan account, due to higher investment returns, optimally balanced investment portfolios and longevity risk pooling.

The report is an updated version of reports previously issued by NIRS in 2008 and 2014 comparing DB plans and DC plans, and analyzes the costs of the two different types of retirement plans as a percentage of payroll. According to the latest analysis, the cost of an individually directed DC plan equals 32.3% of payroll, while the typical cost of a DB plan equals only 16.5% of payroll. In the 2014 report, a typical DB plan had a 48% cost advantage over DC for an identical level of benefit.

The report says superior investment returns coming from professional managers and lower fees accounts for 30% of the 49% cost savings, while more diversified portfolios account for 12% of the cost savings and longevity risk pooling accounts for 7% of the savings.

"Pensions have economies of scale and risk pooling that just can't be replicated by individual savings accounts," said Dan Doonan, NIRS executive director and co-author of the report, in a news release Thursday. "This means pensions can provide retirement benefits at a much lower cost."

The report also says 80% of the cost difference between a DB plan and individually directed DC plan occurs after retirement, because individual retirees in a DC plan manage their assets on a short-term basis without the benefits of longevity risk pooling.

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401(k) Retirement Accounts Substantially More Costly than Pension Plans, According to New Analysis from the National Institute on Retirement Security

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WASHINGTON, Jan. 6, 2022 /PRNewswire/ -- A new analysis finds that defined benefit (DB) pension plans offer substantial cost advantages over 401(k)-style defined contribution (DC) accounts. A typical pension has a 49 percent cost advantage as compared to a typical DC account, with the cost advantages stemming from longevity risk pooling, higher investment returns, and optimally balanced investment portfolios.

A new analysis finds defined benefit pensions offer substantial cost advantages over defined contribution accounts.

The analysis also indicates that about four-fifths of the cost difference occurs during post-retirement years. Once retired, individuals typically experience substantially higher fees when retirement assets are withdrawn from a workplace retirement plan. Also, retired individuals often shift their savings to lower risk, lower return asset classes, which is further complicated by today's historically low interest rate environment.

These findings are contained in a new research report from the National Institute on Retirement Security (NIRS), A Better Bang for the Buck 3.0: Post-Retirement Experience Drives the Pension Cost Advantage. The research is co-authored by Dan Doonan, NIRS executive director, and William Fornia, FSA, Pension Trustee Advisors president.

Read the research here. A webinar is scheduled for Thursday, January 13, 2022, at 1:00 PM ET to review the research and respond to questions. Register here.

"Pensions have economies of scale and risk pooling that just can't be replicated by individual savings accounts," Doonan said. "This means pensions can provide retirement benefits at a much lower cost. At the same time, 401(k)s have made significant progress in recent years when it comes to reducing costs and making investing easier for individuals. But the post-retirement period remains difficult to navigate for those in a 401(k) account. Retirees are transitioning from saving to spending down their retirement income at the right rate so they don't outlive their savings. Also, post-retirement is the source of most of the cost difference between pensions and 401(k) accounts."

"These cost differences are a key consideration for employers and policymakers given that most Americans are deeply worried about retirement and retirement savings levels are dangerously low for the typical U.S. household. Policymakers are wise to protect existing pensions while also fostering innovation in DC plans to improve the financial security of those relying on 401(k) accounts," Doonan explained.

The analysis indicates that to achieve roughly the same target retirement benefit to replace 54 percent of final salary, a DB pension plan requires contributions equal to 16.5 percent of payroll. In contrast, an individually directed DC account requires contributions almost twice as high as the DB plan, at 32.3 percent of payroll.

This report follows two previous analyses conducted in 2008 and 2014 comparing DB plans and DC accounts, and it includes two new elements not included in the previous studies: 1) the impact of the current low interest rate environment; and 2) how saving mid-career rather than early career reduces total retirement savings.

The research's key findings are as follows:

- A typical DB plan has a 49 percent cost advantage compared to a typical individually directed DC plan because of longevity risk pooling, asset allocation, low fees, and professional management. Longevity risk pooling accounts for seven percent of the cost savings, a more diversified portfolio drives another 12 percent of the cost savings, and superior net investment returns from lower fees and professional asset management generate a 30 percent cost reduction.
- A DB pension plan costs 27 percent less than an "ideal" DC plan, with below-average fees and no individual investor deficiencies.
- Four-fifths of the difference in costs between the DB plan and an individually directed DC plan occurs during the post-retirement period. Retirees typically move from an environment that benefits from a long investment horizon and fiduciary protections to one where individuals manage their spend-down on a short-term basis without the benefits associated with longevity risk pooling.

In terms of the methodology, this research compares the relative costs of DB plans and DC accounts by constructing a model that first calculates the cost of achieving a target retirement benefit in a typical public sector DB plan. This includes calculating this cost as a level percent of payroll over a career, then calculating the cost of providing the same retirement benefit under two different types of DC plans: an "ideal" DC plan modeled with generous assumptions and a typical individually directed DC plan. Additional details on the methodology that account for the impact of alternative economic and demographic assumptions can be found in the report's Technical Appendix.

The National Institute on Retirement Security is a non-profit, non-partisan organization established to contribute to informed policymaking by fostering a deep understanding of the value of retirement security to employees, employers, and the economy as a whole. Located in Washington, D.C., NIRS membership includes financial services firms, employee benefit plans, trade associations, and other retirement service providers. More information is available at www.nirsonline.org. Follow NIRS on Twitter @NIRSonline.

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Fiscal sustainability of DB pensions more important than overall liabilities: report

By Gideon Scanlon
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The viability of a public defined benefit pension plan is best judged by its fiscal sustainability rather than its overall liabilities, according to a new report by the National Conference on Public Employee Retirement Systems.

The report, written by Michael Kahn, director of research at the NCPERS, found fiscally sustainable pension plans have higher funding levels and lower contribution levels than plans more focused on lowering their liabilities. Fiscal sustainability refers to the ratio between debt and overall assets. When it's stable, a debt is considered sustainable. Despite this, public sector plans in the U.S. are often criticized on the basis of liabilities alone.

"The fundamental error that critics of public pensions commit over and over is to compare 30-year pension liabilities — that is, liabilities that are amortized over 30 years — with one-year state and local revenues."

This tendency to question the viability of public sector pension plans on the basis of a single year's budget can have devastating consequences for public sector plans. In an interview about the report, Hank Kim, executive director and counsel for NCPERS (pictured left), points to the example of the Oklahoma Public Sector Retirement System.

"Soon after the global financial crisis, Oklahoma closed its plan for state employees. Effectively, [critics] used the GFC and the mismatch of 30 years of liabilities versus only a year of state revenue to pressure the state into closing the plan."

According to the report, which based its findings on figures from 2018, the unfunded liabilities of U.S. public pension plans were about three per cent higher than the sustainable level. Balancing the liabilities of all public pension plans would cost about US$141 billion or 0.8 per cent of U.S. gross domestic product.

The report also argued that pension plan sponsors can help keep their plans stable by conducting sustainability valuations. These valuations, conducted on an ongoing basis, allow for fiscal adjustments to be made to keep the ratio between unfunded liabilities and economic capacity stable.

"The sustainability valuation is a new tool to provide context on the affordability of public pensions. It works by measuring the capacity of the plan sponsor," says Kim. "There are a number of good tools to measure costs of pensions. These existing tools are valuable, but they don't provide context. What was missing was a measure of affordability. Sustainability valuation provides the context and should be used in conjunction with existing cost measurements."

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