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PORTABILITY, PRESERVATION

AND

THE RETIREMENT INCOME SYSTEM

Statement of
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Summary of Statement of
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What is Portability

Portability involves the transfer of pension benefits from one pension plan to another. This testimony focuses on issues that relate to enhancing the portability of cash distributions. Cash distributions are portable when directly transferred to the employee leaving the sponsoring company or transferred directly to another retirement arrangement.

The Issues Being Addressed

Three bills introduced in Congress over the past two years are intended to improve pension portability. In particular, the Pension Portability Act (H.R. 1961) seeks to increase coverage and improve system portability and benefit preservation by discouraging preretirement cash outs and encouraging the use of annuity provisions.

Jobs and Job Tenure

Benefits are more likely to be dissipated if workers change jobs many times over a career. American workers tend to hold 10 or 11 jobs over a lifetime. Recently observed declines in job tenure, however, are entirely a result of changes in the distribution of workers by age and sex. Thus, concerns about portability can be related to changes in plan provisions and expectations about retirement income but not to actual changes in labor force stability.

What Plans Are Provided

Defined contribution plans have become more prevalent in recent years. As a result, the share of defined benefit plans declined from 34.0 percent in 1976 to 28.6 percent in 1986. Defined contribution plans also represent an increasing share of assets held in private trusteed pension funds. Defined contribution plans held $410 billion of assets or 34.4 percent of the total. If cash distributions from these plans are spent before retirement, benefits will be lost.

The Prevalence of Lump-Sum Distributions

Close to 85 percent of all preretirement distributions received by workers from a pension plan were for amounts of less than $5,000. Only twenty-six percent of persons receiving preretirement distributions for less than $5,000 used some for saving. Lump-sum distributions at retirement were quite common among workers retiring in 1982. Among those retirees, nearly 10 percent of all men with pension coverage reported receiving a lump-sum distribution from their last job. The median value of that distribution was $20,000.

Potential Portability Losses

A simulation model was used to construct examples of the economic consequences of job change on pension entitlement. One example indicated that if a typical manufacturing worker spent distributions from 3 out of 4 jobs, that worker could lose $37,000 out of about $53,000 in retirement benefits. Many early cash outs are for less than $3,500. If a hypothetical employee receives distributions of exactly $3,500 at each of three job changes (indexed for inflation), the total value of these cashouts would be $21,000.

Conclusions

The aim of pension policy is the delivery of benefits. Thus projections of future retirement income can provide further insight into the issue of portability. Using simulation techniques, the baby boom can expect higher levels of retirement income than current retirees. But the total pension replacement rate in retirement -- the ratio of pension and Social Security benefits to preretirement earnings -- will have fallen from 49 to 45 percent by the time the baby boom retires. If portability legislation were enacted, replacement rates could be higher. There are trade-offs between different portability proposals, however. Voluntary incentives may not work. Mandatory rollovers would preserve benefits but workers would lose the flexibility to use their funds for other purposes. Thus, the policy decision may depend on the increasing prevalence of lump-sum payments and on the future structure of the retirement and health care systems.

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What is Portability?

Portability involves the transfer of pension benefits from one pension plan to another. If all employees spend their entire careers working for only one employer, portability would not be an issue. All pensions would be based on full-career service. Similarly, if pensions were only paid through Social Security or some other nationwide plan, benefits would be fully portable between jobs, and all years of service would be credited by the plan. In our society, most employees change jobs and many employers supplement their employees' Social Security benefits through employer-sponsored plans.

In a pension system characterized by a diversity of benefits tailor-made to the specific industry, the company, and the work force, automatic pension credit transfers are difficult to attain. One employer may have a defined contribution plan and the other a defined benefit plan. Benefit and retirement provisions may vary considerably among plans, and plan contribution rates may differ as well.

The benefits of diversity in pension provisions include retirement practices that directly enhance the productivity of the company and that are appropriate to the financial status of the firm. In addition, differences in pension plan provisions can better meet the needs of different workers for their own retirement income. The cost of this diversity, however, is the relative benefit loss that may take place for employees who switch plans.

While the basic concept of a fully portable pension is easy to understand, it is considerably more complex to categorize the ways in which our diversified system fails to meet full portability. To do so, the components of portability can be described in terms of: (1) vesting; (2) credited service; and (3) accrued current values (cash distributions).

Vesting

Benefit portability is enhanced when vesting schedules are shorter. Employees who leave company plans without meeting vesting standards forfeit all benefits that would have been earned had they stayed on the job. Employees changing jobs after meeting vesting standards are entitled to unforfeitable pension rights. The 1986 Tax Reform Act (TRA) radically changed vesting standards for employees covered by single-employer, private-sector, defined benefit plans. Such changes, effective in plans years beginning after December 31, 1988 will essentially reduce the earlier Employee Retirement Income Security Act's (ERISA) 10-year vesting standard to a 5-year vesting provision. Five-year vesting will affect both defined benefit and defined contribution plans, although defined contribution plans typically had shorter vesting schedules even prior to TRA. Projections indicate that because of 5-year vesting, over 70 percent of the baby-boom cohort will have pension income at retirement from employer-sponsored pension plans.

Credit Portability

A second type of portability is that of credited service. When credited service is portable, years of service credited to one plan are maintained even upon job change. For instance, even if the employee has not met the vesting standard, years of participation would be carried over into the next employer's plan and would count toward the employee's pension on the next job. Multiemployer pension plans are often used to illustrate service portability. In this case, employees may change jobs among a number of participating employers and continue to credit their service to their pension. With defined benefit plans, when credited service is not portable across employers, vested benefits are frozen when employees change jobs before retirement. Furthermore, nonvested years of participation yield no future benefits at all.

The problems inherent in proposing a system of service-credit portability, however, are evident in the situation of the former Bell System. After divestiture, the Deficit Reduction Act of 1984 required that service credits be recognized for employees moving among companies of the former Bell system. The 11 former Bell companies affected codified their obligations to their employees (as of December 31, 1983) in a document known as the Mandatory Portability Agreement. It took nearly one year for the companies to resolve most of the major issues related to crediting service and transferring assets. Since the agreement, concerns have been raised about recognition of prior service, retiree medical coverage and the assumption of unfunded liabilities. Furthermore, administration is reported to be costly and time-consuming. Recognition of so many problems in a favorable situation may have tempered active legislative interest in this area.

Portability of Values

Portability of accrued current values (cash distributions) refers to the cash value of vested benefits. Distributions are portable when directly transferred to the employee leaving the sponsoring company or transferred directly to another retirement arrangement. The first situation is by far the most common.

Cash distributions are most often associated with distributions from defined contribution plans but may apply to certain defined benefit plans as well. Most defined contribution plans distribute vested benefits in the form of a cash lump-sum distribution, or "cash out" upon job change and at retirement. If preretirement cash outs are invested, the funds will continue to earn a market return until retirement, which, on average, would be roughly equivalent to what the employee would have received from the plan at retirement. A loss in retirement benefits occurs if the distribution from the plan is used for current expenditures rather than being saved and invested. This portability loss has been the focus of recent congressional interest. This testimony focuses on issues that relate to enhancing the portability of accrued current values.

The Issues Being Addressed?

Three bills introduced in Congress in 1987 are intended to improve pension portability. The first, the Pension Portability Act (H.R. 1962 and S. 944) seeks to increase coverage and improve portability through a new type of retirement plan and through changes in Simplified Employee Pensions (SEPs). It also seeks to use pension rollovers to improve system portability and benefit preservation. The proposal was, in part, a reintroduction of the 1985 Retirement U.S.A. proposal. The pension portability act was also reintroduced in 1988 (H.R.1961). The second bill, the Portable Pension Plan Act (H.R. 1992) seeks to encourage pension portability, preserve benefits, improve SEPs and help small employers. The third bill, the Pension Portability Improvement Act (H.R. 2643 and S.1349) also seeks to improve pension portability, preserve benefits and encourage SEPs. All three bills have similar concerns. Each seeks to ensure that lump-sum distributions are saved until retirement. And each seeks to ensure that assets held until retirement are used for retirement income.

Portability of Values

Just as recent portability proposals seek to preserve preretirement distributions for retirement, the 1986 Tax Reform Act sought to achieve this goal by imposing a 10-percent penalty tax on lump-sum distributions that were not rolled over into an IRA. It is too early to determine the extent to which this additional tax has achieved that goal. The three current portability proposals differ in the extent to which they would keep the decision to rollover funds in the hands of the employee.

The Portable Pension Plan Act requires employers to make direct transfers to portability maintenance accounts, such as defined contribution plans or IRAs. Defined contribution plans do not have to accept distributions from other plans, however. Defined contribution plans must offer transfers upon job termination but defined benefit plans need not. The bill makes it more difficult for employees to directly receive and spend their preretirement distributions. Only SEPs and IRAs would be allowed to make direct participant transfers. Furthermore, the penalty tax on preretirement cashouts would be increased from 10 to 20 percent as a further incentive to preserve early pension distributions until retirement. The Pension Portability Improvements Act takes these provisions one step further. Distributions would not be permitted from any pension plan before retirement except in the form of an annuity. In other words, distributions would not be available before retirement.

The Portable Pension Plan Act, which would continue to allow preretirement lump-sum distributions if the penalty tax were paid, requires defined contribution plans to accept rollovers from other plans. By contrast, the Portable Pension Plan Act requires the U.S. General Accounting Office to study ways for defined contribution plans to accept rollovers.

Preservation

A second concern is to ensure that retirement benefits are available for retirement income. Just as preretirement distributions may be spent for current consumption at retirement, lump-sum retirement distributions may be spent early in retirement reducing retirement income in later vulnerable years. This concern dovetails with other equity issues related to spousal benefits. The Retirement Equity Act of 1984 expanded ERISA by requiring that spouses explicitly sign-off on benefit distributions made in other than the joint and survivor form. (ERISA made the joint and survivor annuity the normal option for married couples.) Concern about the form of distribution was motivated by evidence that widows usually have significantly lower income than married couples. Recent concerns are, in part, motivated by the knowledge that older retirees often have lower income than recent retirees.

Under the Pension Portability Act, joint and survivor distributions would be required for SEPs and portable pension plans. Annuity payments would be provided unless specifically waived by the participant and the participant's spouse. Under the Portable Pension Plan Act, the normal benefit option would be a stream of payments for life unless another form of distribution were requested by both spouses. Under the Pension

Portability Improvements Act, distributions would not be permitted from any pension plan except as a lifetime annuity (or equivalent stream of payments)

Jobs and Job Tenure

The need for portability and preservation legislation is integrally related to the way the labor market functions. Benefits are more likely to be dissipated if workers change jobs many times over a career. American workers exhibit many patterns of lifetime labor force participation. Some individuals have held their job with the same company for their entire lifetime; in the future, others will to do the same. But many workers have many jobs. Women have more irregular careers than men and have shorter job tenure. Nevertheless, certain overall career patterns have important implications for portability.

Lifetime Employment

The reason many employees can expect to receive lump-sum distributions from prior jobs is because relatively few workers have lifetime employment. Many younger workers use their early years on the job for experimentation, changing jobs before they find a career that is, hopefully, both interesting and financially rewarding. Other workers make job changes later on to take advantage of new opportunities. And, of course, some individuals become unemployed or decide to leave the labor force for personal reasons. In a seminal study, Robert Hall used Census data to show that both men and women typically hold 10 or 11 jobs over a lifetime. By age 24, the average worker will have held the first 4 jobs out of a total of 10. The next 15 years will contribute another 4 jobs. Consequently most employees will not have vested in their plans during their early work years.

This hypothesis is reinforced by data on the proportions of wage and salary workers with 5 years or more on the job -- a rough proxy for vesting standards after tax reform. Only 7.3 percent of workers under age 25 had 5 or more years of tenure in 1983. This figure increased to 37 percent of those age 25 to 35 and continued increasing gradually so that over 75 percent of all nonfarm workers age 55 to 59 ended up with 5 or more years on the job. These figures demonstrate why many workers can count on pension benefits at retirement. They also suggest that many workers will accumulate pensions from more than one job. The issue is whether these benefits will be maintained until retirement.

Trends in Job Tenure

Some are interested in augmenting pension portability because of the perception that workers now change jobs more frequently than they used to. U.S. Census Bureau data do indicate that the average job tenure of working men fell between 1963 and 1987 from 5.7 years to 5.0 years. But almost all of this decline was a result of the changing age distribution of the work force. Among prime-age working men age 25 to 34, job tenure increased from 3.5 years in 1963 to 3.7 years in 1987. Tenure for men 35-44 averaged 7.6 years in both years. Men age 45 to 54 averaged 11.4 years on the job in 1963 and 12.3 years in 1987. Job tenure for women increased overall with gains particularly noticeable among women 35 years of age and older. Thus, observed declines in job tenure are entirely a result of changes in the distribution of workers by age and sex. Women have shorter tenure than men and younger workers have shorter tenure than older workers. In view of this evidence, portability may be of increasing concern due to changes in plan provision and societal expectations about retirement income but not because job stability has, on average, declined. Nonetheless, some, such as Pat Choat, suggest that changes taking place in the economy will require more flexible employment relationships in the future to maintain competitiveness. These arguments would predict that job tenure will be shorter in the future.

What Plans Are Provided?

Neither career patterns nor the provision of benefits operate within a static environment. Portability and preservation issues become more important as lump-sum distributions become more prevalent and are called upon to provide a greater fraction of retirement income. An expansion in the role of lump-sum distributions can stem from the greater prevalence of defined contribution plans and from greater asset accumulation within those plans. Lump-sum distributions could become a more common option in defined benefit plans. For the moment, the expansion of defined contribution plans seems the more significant trend.

More Defined Contribution Plans

The number of defined contribution plans has grown since 1974 from an estimated 245,000 in 1974 to 606,000 in 1986. Over 70 percent of all plans are defined contribution plans. Defined benefit plans actually account for the majority of plan participants, however, since many defined contribution plans are pension and profit sharing plans sponsored by small employers,. Moreover, many participants in defined contribution plans also are in defined benefit plans.

The proportion of defined contribution plans has increased since the enactment of ERISA but not necessarily as a direct result of that legislation. Many believed that ERISA's changes -- including minimum funding standards and mandated insurance for defined benefit plans -- would result in a significant decrease in the number of defined benefit plans. Contrary to expectations, the absolute number of defined benefit plans has grown every year (expect 1976 and 1984). According to EBRI's plan-count statistics, defined benefit plans grew at an average annual rate of 5.6 percent between 1976 and 1986. But, as a proportion of all plans, the share of defined benefit plans fell 5.4 percentage points over the same period from 34.0 percent to 28.6 percent of all plans.

While the shift towards defined benefit plans has not been consistent in every year, other evidence suggests that it represents a long-run trend. Many employers have added defined contribution plans as secondary plans, and many employers are now restructuring their benefits to prepare for the baby boom's retirement. Employers have found that younger workers of baby boom age react favorably to defined contribution plans because they can see an immediate current cash value. In addition, employers realize that defined contribution plans are no longer simply an extra emolument. The benefit buildups are too great and the baby boom's retirement is too costly. Thus, defined contribution plans are becoming an integral part of retirement income planning. To the extent that cash distributions from these plans are spent before retirement, retirement benefits will be lost

The Assets in Defined Contribution Plans

Defined contribution plans represent an increasing portion of assets in all private trusteed pension funds. According to EBRI data from the Quarterly Pension Investment Report (QPIR), total assets in trusteed pension funds amounted to $1.2 billion by the end of the first quarter of 1988. Defined contribution plans held $410 billion of those assets or 34.4 percent of the total. Defined benefit plans accounted for 55.2 percent of trusted fund assets and multiemployer plans for 10.3 percent. The share held by defined contribution plans has increased considerably over the past 5 years from 29.9 percent of trusteed funds in 1982. Defined contribution plans are expected to continue to play an increasing role in financial markets.

The Prevalence of Lump-sum Distributions?

While changes in job tenure and modifications in the structure of pension plans and plan provisions will substantially affect future benefit payments, lump-sum distributions at retirement and upon job change are extremely important even today. Information on current distributions provides baseline data to help understand the future.

Preretirement Distributions

Many workers have received or can expect to receive preretirement distributions. In 1983, some 6.6 million workers said that they had received a distribution from their pension plan. Close to 85 percent were for amounts of less than $5,000. How these preretirement cashouts were used depended on the dollar amount of the distribution. Twenty-six percent of persons receiving preretirement distributions worth less than $5,000 used some for savings compared to 87 percent of persons receiving distributions worth more than $20,000. Over half of all persons receiving cash outs in the $5,000 to $9,999 range, spent, rather than saved, some or all of the distribution. Thus, a substantial proportion of benefits provided by employer-sponsored plans before retirement are never translated into retirement income. Furthermore, among workers who met ERISA standards for plan participation in 1983, 21 percent of those entitled to current vested benefits and 57 percent of those entitled to past vested benefits, report those benefits were received or could be received as a lump-sum distribution.

Distributions at Retirement

Current retirees are less likely to have received lump-sum distributions than future retirees. Defined contribution plans were less prevalent than they are today (or are likely to be in the future). Most retirees received pension benefits in the form of an annuity. And many employers regarded defined contribution plans as savings plans not as an integral part of retirement income security. Nonetheless, even among workers retiring in 1982, lump-sum distributions at retirement were quite common. Among those retirees, nearly 10 percent of all men with pension coverage from any job they worked on reported receiving a lump-sum distribution from the primary plan on their last job. The median value of that retirement distribution was $20,000. Another 4 percent of male beneficiaries covered by a pension plan received a lump-sum benefit from the primary plan on their longest job (other than their last job). The median value of that distribution was $10,000.

Lump-sum distribution amounts received by women from their primary pension plans were considerably lower and their recipiency rates higher than those of men. Nearly 15 percent of all women with pension coverage on any reported job received a lump sum distribution. Another 4 percent of women covered by a pension reported receiving a lump-sum distribution from the primary pension plan on their longest job; that distribution only averaged $2,000.

These figures underreport the prevalence of lump-sum distributions, however, as they only report distributions from primary plans and not from secondary plans. Furthermore, how retirees spend their distributions is not reported.

Potential Portability Losses

In order to determine potential benefit losses if benefits are spent rather than saved, a simulation model was used to construct examples of the economic consequences of pension portability. The following general assumptions are used to analyze cashouts from defined contribution plans. Workers are assumed to be first hired on a job with a pension at age 25 and work each year until age 65. The employee stays with the first employer for 5 years, then moves to a new job that lasts 10 years; the third job is also for 10 years and a fourth job lasts 15 years. Assets are assumed to grow at a rate of 7.5 percent. Illustrations were computed for four workers: (1) a female clerical worker in the service sector; (2) a female professional in retail trade; (3) a male production worker in manufacturing; and (4) a male professional worker in the financial sector. Benefits were made equivalent to those workers with four jobs would receive if they had been covered on each job by a defined benefit plan typical to their industry and occupation.

For Different Workers

The typical four-job worker with pension coverage is entitled to substantial pension benefits at retirement. The clerical worker would receive \$25,626 in benefits from her plan and the retail-trade professional \$106,448. The production worker would accrue \$52,907 from his four jobs and the professional in financial services would have \$145,664 (all in 1987 dollars). These sums would only be available at retirement if pension accruals from each of the three earlier jobs were maintained in the plan or rolled over into an IRA (or other employer plan) and saved. If the distributions were spent, the retirement income losses would be considerable. The female clerical worker could lose \$18,290 and the retail-trade professional could lose \$75,740. The production worker in manufacturing could lose \$37,031 and the financial professional could give up \$103,462 of his future pension. These losses are even greater than those workers would forego if they had spent distributions from comparable defined benefit plans. Accrued benefits from defined benefit plans are weighted towards later years when defined benefit plans have final pay formulas.

Of course, gains or losses in defined contribution plans depend upon the actual yield of the investments. Individuals can do better or worse than the market. Yet potential losses of over 70 percent of benefits represent a substantial fraction of retirement income for these illustrative workers.

For Small Distributions

Many early cash outs are for sums of less than \$3,500. This represents the value of accrued benefits that employers can, at their discretion, distribute to employees who change jobs. For instance, all the cash outs calculated in the clerical worker example are less than \$3,500. If a hypothetical employee received distributions of exactly \$3,500 at each job change, and that sum were indexed for inflation, the total value of those cash outs at age 65 would be \$21,254 (in 1987 dollars) under a 7.5 percent interest assumption. If the \$3,500 figure were not indexed for inflation, the value of those \$3,500 unindexed cash outs would still reach \$15,766 (in 1987 dollars) by the time the person reached age 65. In other words, small cash outs would be worth a sizable percentage of, for instance, the full \$25,633 cash value of pension benefits that a female clerical worker would receive at retirement. It would also represent a significant proportion of the \$52,937 benefit (in 1987 dollars) accrued by a male production worker who held four jobs between ages 25 and 65.

Conclusions

What conclusions can be drawn from research findings about the need for increased portability and benefit preservation? We live in a world in which lump sum-distributions already go to many current workers and retirees. Most of these distributions are small and are spent upon receipt. Although job tenure has not become shorter, pension vesting standards have been reduced and more workers can expect to receive lump-sum distributions in the future. Current data indicate that defined contribution plans are becoming more important both in numbers and in the assets they command. Defined contribution plans are most likely to provide lump-sum distributions upon job change. These facts suggest that portability will be of increasing importance to tomorrow's retirees. But the aim of pension policy is always the delivery of benefits and not the policy in and of itself. Thus, projections of future retirement income can provide further insights.

Future Retirement Benefits

Earlier work has shown that today's retirees have income that is roughly equivalent to that of the rest of the population. Projections using a microsimulation model indicate that the baby boom can expect higher levels of retirement income than current retirees. Couples can expect income of $14,300 annually from pensions and Social Security. Single retirees can expect $11,300 a year. Much of these income gains can be attributed to the increased receipt of benefits from employer-sponsored plans and from higher benefit amounts from those plans. But the total pension replacement rate in retirement -- the ratio of pension and Social Security benefits to preretirement earnings -- will have fallen from 49 percent for the current generation of retirees to 45 percent for the baby-boom cohort. Part of this decline represents the realignment of Social Security benefits provided by the 1983 Social Security Amendments. These rates are based on the assumption that workers will spend their preretirement distributions just as they do today.

Better Benefits with Preservation

If portability legislation were enacted that ensured that preretirement distributions were saved until retirement, replacement rates would be higher. The gains would depend upon how portability was ensured, be it through voluntary incentives or mandatory rollovers. While no data are currently available on lump-sum distributions from secondary plans, a 1985 study conducted by the U.S. General Accounting Office suggested that savings plans could significantly raise replacement rates in retirement. That study presented calculations based on information from five different organizations. The study indicated that for employees who retire at age 65 with 20 years of credited service and a $20,000 salary, replacement rates are about 55 percent for those with no participation in a supplemental thrift plan, over 65 percent for those with 50-percent participation and 78 percent for those with a full 6-percent contribution to a supplemental plan. Thus, supplemental plans have the potential to replace preretirement earnings at rates in line with retirement income goals such as those put forward by the Carter Pension Commission.

Portability legislation, in part, intends to ensure that preretirement distributions are saved for retirement. Such rollovers frequently stem from distributions from secondary defined contribution plans. These supplements may have the potential to increase replacement rates beyond those currently forecast. There are trade-offs between the different portability proposals, however. On the one hand, little is known about the efficacy of further voluntary incentives. The Tax Reform Act's 10-percent surcharge on cash outs has yet to be evaluated. Voluntary incentives possibly may not work. On the other hand, mandatory rollovers would certainly preserve benefits until retirement. But workers would lose the flexibility to use their funds for other purposes they determine to be in their best interests. Hence, Congress must decide whether the need for higher retirement income (be it for day-to-day living or crises such as long-term care) justify restricting choice. That decision may, in turn, depend on the increasing prevalence of lump-sum payments and the future structure of the retirement and health care systems.