

Defined Contribution Schemes; Should Employers or Countries be Permitted  
to Sponsor Them?

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## ABSTRACT

This article is not meant to be a final authority or a source of legal reference. Especially in New Zealand! Its purpose is to persuade actuaries to examine ideas that have not been questioned previously due to cultural disposition or historical mistake. Many New Zealand actuaries hail from North America and, because of the professional requirements "back there," have a responsibility to the participants in retirement schemes.

This article shows that the goals of DC plans can be achieved by permitting participants full access and control over their accumulations. It suggests that to do otherwise subjects the accumulations to unreasonable risks of loss. We believe that actuaries fulfill their obligation to participants by supporting separation from employer control upon vesting.

## Defined Contribution Schemes; Should Employers or Countries be Permitted to Sponsor Them?

Before starting, a little background on who I am and what is being assumed will help in understanding this article. I am a Defined Benefit (DB) scheme actuary. Without DB, I starve! I am sure, and you will agree, this colors my views.

I do believe that Defined Contribution (DC) schemes have a place in encouraging thrift. I do not believe they are suitable to replace DB retirement schemes. I do not believe this is a bias based upon survival.

Since I began my career in America, moved to Canada and now am in Japan, cultural issues are important to me. Culture was important in the separate development of retirement scheme law in Canada and the States - and they share the same continent, the same heritage and the same language. Japan shares none of these. Retirement scheme development here reflects that separation.

However, I am a mathematician and an actuary. I believe that numbers speak for themselves but, many interested parties either don't bother to get the numbers or they don't listen to what the numbers say. As a result, I believe that the numbers should be exposed and explained as much as possible. I believe this is one of the most important roles of actuaries, no matter where they practice.

For purposes of this article, what is meant by "sponsor?" The sponsor of a scheme maintains a significant relationship with the accumulating contributions of the participant, even after the participant is "fully vested" in any contributions made by the sponsor. The article needs to differentiate between, for example, an employer that pays into a tax favored vehicle totally controlled by the participant and an employer that pays into a tax favored vehicle which was selected in some way by the employer. The latter is a "sponsor" for our purposes, the former is not. Respecting the government, an arrangement that enables tax favored contributions to a vehicle totally controlled by the individual is differentiated from one where the investment must be some form of government debt or other choice significantly limited by the government. For the latter, I do not consider quality requirements (unless a proxy for requiring government securities) to be a significant limitation. While both require enabling legislation, we only consider the latter as being "sponsored" by the government.

A participant is what one would normally expect: someone with rights, vested or not, in a scheme. An employee is someone who has the potential right to be a participant. They may not always be properly differentiated in this article.

A goal of this article is to be somewhat startling. The article is not meant to be balanced. I want to consider the limits, the worst that can happen when the unscrupulous get in positions of authority and the rules require employees to place our retirement savings in their care. I hope that the controversy will encourage readers to examine their culturally based preconceptions and those ideas that arise from historical mistakes.

I am reminded of a street in Houston, Texas named many years ago, near my first home there. The area had street names related to the cities and people of Scotland. My street is named Merrick. One street over is Aberdeen. Two streets the other way is Grennoch. Like many concepts we take for granted in the retirement arena, the misspelling has persisted for over 50 years and is not likely to be corrected.

This article has several assumptions and important definitions;

! I refer to an economy where available savings exceed the demand for capital

formation as being "saturated" with savings. It is difficult to put additional savings to productive use in such an environment.

- ! A retirement scheme is a scheme that is designed to provide money to older participants when they leave employment with the intention of leaving the workforce permanently. I often use the phrase "age retirement" to identify this decrement.
- ! Retirement schemes provide the money in one or a mix of two forms; an annuity or a lump sum.
  - " If the retirement scheme determines benefits as an annuity and all other forms of payment are related in value to the value of the annuity, the scheme is called a "pension scheme;" retirement scheme is the more inclusive term.
  - " When a scheme determines benefits as a lump sum, the fact that a beneficiary has opportunities to purchase, with the scheme lump sum disbursement, an annuity does not change a scheme into a pension scheme, even when that annuity is an alternative form available from the scheme.
  - " A retirement scheme can provide severance benefits. I use the word "termination" to identify this decrement.
  - " A scheme can be named a "pension scheme" even though it is not<sup>1</sup>
- ! A severance scheme is a scheme designed to provide money to participants when they leave employment with the intention of continuing in the work force.
  - " Like "pension scheme," the formal name of the arrangement does not change the fact of the benefits provided.
- ! Retirement schemes, in fact, usually also provide severance benefits. For purposes of this article, a Pension scheme provides these benefits as a deferred annuity payable at normal retirement age or as an amount of money equal in some way to the present value of the deferred annuity.
- ! This article assumes that the scheme sponsor has decided to implement a retirement scheme as opposed to a severance scheme.
- ! It is also assumed that, in the interest of capital efficiency, the sponsor has developed some ideas of how much money should be provided at age retirement and that this concept is being applied in the development of the sponsored scheme.
  - " Likewise, I assume that employees have an idea of how much money they will need at retirement and will try to save this amount in a cost-effective way. For an employee, "cost-effective" means achieving a reasonable balance between satisfying immediate needs and saving.
- ! In general, this article does not apply to schemes that are merely tax deferral schemes or severance schemes.
- ! This article usually refers to the employer-sponsor of a DC scheme as "holding the money." This, of course, is literally false. The phrase is used to emphasize that the money is outside the reach of the participant and that the employer has a very

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<sup>1</sup>The Japanese "Tax Qualified Pension Plan" or TQPP is my favorite example of misnaming. Benefits are based on a lump sum calculation, even though annuities are available, so it is not a "pension plan." For most people in the business of retirement schemes, "Tax Qualified" means that there is an otherwise unavailable tax benefit if one chooses this route. In Japan, "TQPP" are taxable, whereas the unfunded scheme they are meant to replace is not. A TQPP is neither!

important influence on the conduct of the trust or other "person" who actually does hold the money.

Now consider...

You are a professional gambler with a great track record. Your nephew Johnnie has a birthday coming up. You decide to establish an investment account for him in your name that you will give to him when he graduates from university. You decide that you want to encourage him to think, so he will have to contribute to it and decide how to invest it. You set the account up so that your nephew can make his own investment decisions; you have selected four different investment options for his own money and have decided that he can only move money from option to option in 25% increments on months with the letter "r" in them. One of the investment options is to participate in your Friday night poker as a stakeholder; he wins or loses as a strict percentage of your starting stake each week. All of your contributions go to this account only.

As you think about this totally contrived situation, let's revisit what we know about defined contribution (DC) schemes.

Characteristics of DC Schemes:

- ! DC schemes are not pension schemes.
- ! DC schemes are either severance schemes and/or tax deferral schemes.
- ! DC schemes recharacterize current pay. They are perceived as retirement vehicles only because employee participants are not permitted access to their accumulated money until they quit.
- ! DC schemes often require participant contributions in order to attract employer contributions.
- ! In the absence of enabling legislation, participant contributions are fully taxable as ordinary income before being saved.
  - " American enabling legislation recharacterizes participant contributions as employer, thus reducing taxable income and permitting the contribution to remain deductible to the employer as a retirement scheme contribution.
    - Vesting rules recognize these funds as truly belonging to the participant - requiring immediate vesting and participant control.
- ! Even without enabling legislation, amounts paid by the employer sponsor to a DC scheme are tax-deductible. Employers typically deduct amounts paid to employees regardless of whether the scheme is qualified or not since the amounts paid are a reasonable employment expense typically deductible to the employer sponsor.
- ! Benefits are taxable to the beneficiary upon receipt. Any amounts not vested in the beneficiary revert to the employer, perhaps creating a taxable event for the employer. Some jurisdictions permit various types of rollovers to further defer the taxable event for the beneficiary.
- ! Benefits are portable. At severance, scheme participants get the immediate value of the lump sum calculated without regard to the period before normal retirement or age at severance. There is no reduction for early retirement or survivorship.
- ! DC schemes shift risk from the employer to the participant participant when

compared with defined benefit (DB) schemes.

- ! Employer costs of DC schemes are more certain than DB schemes.
  - " Over the long term, DC scheme costs are higher than DB schemes for the same planned age retirement benefits.
- ! DC schemes are career-average schemes. They can't provide benefits related to the participant's final standard of living.
  - " DC schemes penalize better than average performance near the end of a career and do little to reward better than average performance occurring early or mid-career.
  - " DC schemes tend to reward savings made during the years of career development and family formation.
- ! No participant ever gets the retirement/severance benefits designed or expected from a DC scheme. The participant gets the market value of the investment account at retirement. If investments have done well, (s)he will get more than planned; if the market is down, (s)he will get less than planned.
- ! DC schemes encourage saving over consumption, often with a tax subsidy. There are two kinds of tax subsidy:
  - " Taxes are deferred to a later date, then taxed as ordinary income (U.S. approach).
  - " Taxes are reduced regardless of payment timing or other income (Japan approach).

Employer-sponsored DC schemes come in a variety of colors. They all make use of some of the following:

- ! Employees must pay to participate.
- ! Employer contributions must be "invested" in company shares.
- ! Employer contributions vest only on service - not by reason for termination.
  - " Encourages the unsavory practice of firing an participant just prior to a cliff vesting service date.
- ! The employer sponsor has no liability once the contribution is made.
- ! The employer has the use of both the participant and employer money for a period before being invested. During that period, the participant is a general creditor.
- ! "Investment options" are totally controlled by the employer sponsor.
  - " There is an intrinsic conflict of interest regarding scheme fees.
- ! Scheme costs are borne by participants usually through a reduction in investment earnings.

Common Misconceptions of Defined Contribution (DC) Schemes:

- ! **Investment returns for funds invested for DC schemes are higher than for funds invested for DB schemes.** The public often confuses the discount rate used by the actuary to value the liabilities of a DB scheme with the actual investment return on the invested DB assets. The public accepts the use of current returns on funds for DC

illustrations versus the assumed discount rate for DB illustrations and seldom question the misleading results.

The current return is virtually never the same as the assumed discount rate, and few actuaries like to have a discount rate that significantly exceeds the current return for any length of time. This plus the fact that DC schemes only look attractive in a bull market tends to make illustrations using higher returns on DC than on DB appear reasonable. It's not.

Funds invested in DC portfolios have (i) shorter horizons, (ii) generally lower risk tolerance and (iii) less ability to diversify toward the efficient frontier. The long-term expected return of DC scheme accounts is significantly lower than the long-term expected return of DB scheme portfolios. Illustrations of future results that use the same rate of return or a higher rate of return for DC schemes versus DB schemes are misleading and incorrect.

- ! **DC schemes cost less for employers.** Administratively, DC schemes tend to have a larger number of smaller participant transactions than DB schemes designed to provide the same benefits and there tend to be more investment transactions, which can make them more expensive. The perception that they cost less is largely due to cost-shifting; expenses are a direct reduction to total investment return meaning that the participants are paying the expenses.

Furthermore in American 401(k) schemes, employer contributions depend on employee participation. Employees who refuse to contribute their own money are denied employer-provided contributions. Those employees who do choose to participate are often expected to buy at least twice as much benefit as the employer (a 50% match). Funds are commingled, and participants fail to notice that employer-provided benefits are, in fact, quite small! The cost of any retirement scheme to an employer is the sum of the benefits provided and the expenses paid by the employer, adjusted for timing. Any scheme that provides less generous employer-provided benefits will generally cost less than any more generous scheme.

- ! **Higher benefit security.** The individual account nature of DC schemes gives an undeserved perception of benefit security. DC scheme funds tend to be invested in lower risk vehicles than DB schemes and thus the principal investment tends to be more secure over the short term, at a cost of reduced long-term investment return. Having said this, many employer-sponsored schemes require all employer money to be "invested" in employer shares; this is a conflict of interest and very high risk. Participants must depend on the employer remaining solvent until they are permitted to liquidate.

- ! **DC schemes benefit the economy.** This argument was used to enable DC in Japan. The reality is quite different. The leaders of Japan are using DC to shift some of the investment losses of the past 12 years to employees. They are also hoping that participants will bid up the prices of market securities similar to the 90's bubble of the U.S. There are two important economic consequences of DC;

- " If the economy is already saturated with savings, like Japan, increased saving will be a dollar for dollar reduction in consumption, leading, as it has in Japan, to further recession and deflation. Market securities will perform more poorly as a direct result.

- " If the economy is in need of additional capital formation, early returns will be quite favorable, but, the actual increase in available funds will reduce the return on those funds. While this may help the overall economy at first, it produces diminishing returns as the cycle continues. Illustrations prepared at

the beginning of projected accumulated funds, using a fixed interest rate, will turn out to be wildly optimistic.

- " Buying a corporate share is not a purchase like buying a car is, it does not add to economic activity. A share is neither a good nor a service.
- " The purchase of shares after they have been issued does not provide new capital for the economy. It can, of course, encourage the issue of additional shares and result, indirectly, in new capital formation.

### **Recent "discoveries" about DC performance and weaknesses.**

Average people buy high and sell low based on emotional cues. Defined contribution schemes are presumably for average people. Like a lottery, a participant need mostly luck to do well and, when (s)he does do well, others will listen intently to the story about "how I did it."

The discoveries have always been known:

- ! The value of the market on the date of distribution cannot be predicted ahead of time. While the market often fluctuates mildly from day-to-day, wild swings have been experienced.
- ! It is easier for employers to cut back contributions to DC schemes than it is to cut back employer-provided benefits in a DB scheme.
- ! There is no relationship between investment fees and fund performance, unless it is inverse.
- ! The practice of removing poorly performing investment choices from those offered by the employer chosen scheme guarantees that participants will capitalize their losses.
- ! The average investor is below average.
  - " Buys and sells on emotions.
  - " Does not have prompt access to the information that drives markets.
  - " Bets the farm on a "sure thing."
  - " Believes that his/her own account will outperform the illustrated investment returns.
- ! The best way to make money in DC schemes is to be paid a percentage of gross assets under management. the second best way is to be paid for transactions.
- ! Corporate insiders continue to abuse their knowledge and those who do have few qualms about involving participant money.
- ! The penalties for wrongdoing barely scratch the surface of the profits derived and fines do not restore lost funds to the participants.

It always amazes me that people actually think they can outperform the market. Professionals trained for many years at the best universities in investment related fields fail to outperform the market. Marketing material for DC schemes always mentions the importance of educating the participants, teaching them of dollar cost averaging, of diversification and of the efficient frontier. Can an hour a week begin to provide the knowledge necessary to invest adequately, let alone, well? Recent events have proven that they can't.

The education offered DC scheme participants is not enough to raise the average investor

above the level of gambling. I remember talking to scheme administrator in the late 90's about the opinions of participants about the investments being made for the fund. The answer was "as long as we have a lot of Microsoft, the participants are happy." Well MSFT has beaten the pants off of my personal portfolio - it's only down about 50%! In the past three years, those investors who have outperformed the market have done so by selling shares they didn't own to people who thought they were making an investment! I wonder how many times the "long" positions in my portfolio have been borrowed?

Most arguments for getting everyone investing rely on the, probably correct, notion that the market is always going to go up. Those marketing the ideas, however, fail to point out that the market is not a simple hill - it is a great range of mountains with included valleys and rivers and lakes. There are tremendous opportunities for taking a bath and going under water during that uphill climb! They also fail to point out that, while the market will never go broke, individual companies and investors will. Ruin theory is very much a part of the discipline of investing.

What else have we learned recently? Tyco, GE and Intel illustrate the ease with which management can transfer all corporate earnings into their own pockets. Enron and Worldcom tell us something about the ways management can unload shares on insider knowledge without notice and engage in cross transactions that benefit a few at the expense of the owners, transferring sums wildly exceeding earnings into their own pockets.

AOL taught us that actuarial probabilities can apply to allocating an income stream to CDs that are passed out for free. Thank goodness that no actuary did those calculations. A side thought is, would professional censure apply to an actuary who recognized income from similar transactions?

Bell Labs, owned by Lucent, reported scientific discoveries of Nobel prize stature. They were faked.

Several companies taught us how to borrow money and report it as income. "the "pro forma" income statement used to report quarterly earnings permits an unreasonable number of sins and avoids what the accounting profession is trying to achieve - namely comparability.

Double counting (infinite, in the case of Enron), misallocation of expenses, funny income, swaps and "round trips". Buying political advantage with someone else's money. Can we teach our employees to be sufficiently aware? Again, the investment pro's lost immense amounts of money also; of course, they can still pay their mortgages.

Early DB rules permitted a certain amount of assets to be "invested" in company instruments. The DC rules derived from these and tended to carry the same restrictions. Did that make sense? DC schemes are marketed as being "more secure" than DB schemes, since they are always "fully funded." Ask yourself if you feel that your DC scheme is fully funded when 25% of your contributions plus investment earnings and 100% of vested employer contributions and investment earnings are in employer shares? It is only "fully funded" from the sponsor point of view that there is no responsibility or legal liability for capital losses when they occur. The sponsor's complete obligation is totally fulfilled when the contribution is made.

### **Control**

There is a belief that participants have investment discretion in their employer-sponsored DC schemes. But do they?

In an employer-sponsored DC scheme, should employer shares be an investment option on any portion of account fully vested in the participant? I have had an ongoing argument with a friend here in Tokyo who says that the participant should have that choice. He claims that it is "free" choice and the participant should understand and accept the risks.

Is it a fair choice? The employer controls the investment options and is able to control perception of value versus risk to a considerable degree. I think everyone would agree that a DC scheme that offered only two options - a principal guarantee product and employer shares - would fall short of appropriate choice. Look at what happened at Enron. Every one knows that the participants were railroaded into imprudent proportions of company shares on their own accounts. Lawmakers are looking for ways to prevent such behavior or to limit such losses in the future. Of course, they are missing the important point - as long as an employer has the unilateral right to hold the participant's money, the risk that there will be an abuse of responsibilities exists.

What about the "grapevine?" While there is supposed to be good privacy protection, the grapevine will disclose who "loves and trusts" the company and who doesn't. Again, beating Enron to death, I can not be persuaded that there was not significant moral pressure on employees to invest as much as possible in Enron stock. Employees who didn't clearly were not on board the company train. Many would argue that the protections of privacy should work, but I have to argue that at company that would permit executives to defraud investors and employees of 100's of millions of U.S. dollars would not honor the porous rules protecting the privacy of participant investment decisions.

If a participant does not have the full universe of investment options, a choice of employer shares cannot be permitted. Of course, if the participant has the full range of investment options, why should the extra costs of the employer's fiduciaries and consultants reduce investment return? Why not let him/her fully control the investments in his/her own self-directed, tax deferred account? Why not pay him/her all monies as they vest? I can assure you that the participant's choice to invest in employer shares would then be a truly free decision when made.

### **Conflicts of Interest**

While we've touched on this subject a bit already, it is really important to more fully consider it.

Why would your employer set up a bank account for you? Obviously, the rules for DC schemes require the DC scheme to be an employer scheme. But, what is the reality? In the U.S., the most popular DC scheme is the "401(k)" which is mostly voluntary participant money. A recent article was attempting to compare DC vs DB; it pointed out that the DB scheme it used for comparison would provide a pension of 34.7% of final pay. The DC comparison would provide 54.7% - clearly a better deal according to the authors.

They state for the example that 2/3rds of the DC benefit was purchased by participant money (50% match), meaning of course, that only 1/3 or 18.2% was purchased by employer money. Reality is, the employer provided benefit is roughly half under the DC scheme. Smoke and mirrors; the participant did better solely because (s)he saved more of his/her own money than (s)he would have otherwise. The example assumed an 8% return for the DC scheme for a period of 30 years. Fairly optimistic return for a small investor in today's climate. In the exact same investment conditions, the employer money would have provided significantly greater age retirement benefits, but, of course, smaller termination benefits - but, then, the purpose of a retirement scheme is to provide age retirement benefits.

The article plays a similar game with scheme expenses, saying, incorrectly, that a DB scheme will cost the employer more than a DC scheme (blaming we actuaries for a big part of that, by-the-way!), ultimately reducing benefits available to participants. Of course, the typical DC scheme assesses expenses to the fund - the participants pay expenses, saving the employer money.

The situation for DB is very different. Few employers have fine tuned their DB schemes to adjust benefits for expenses. In the U.S. where expenses due to compliance have grown significantly, employers are not passing expenses on to the participants, they are terminating their schemes.

In America, unions typically require and are awarded DB schemes in their contract negotiations. One has to ask why their advisors would lead them down that path when, virtually all of the news about DC is complimentary. DB schemes are employer-provided, period. The employer pays for the benefits and also pays the expenses. DB schemes are always an add-on employee benefit. Basic pay has to be competitive within a certain range - an employer cannot successfully pay less than that for any length of time and maintain the business.

Any decent pay specialist can show an employer how to adopt a total pay system so that, even the apparent employer contribution is participant paid. As mentioned above, the expenses are paid by the participants by direct deductions from the accumulating funds. Participants take all risks and, over the long term, earn much lower rates of return on their investments than is possible with employer portfolios. And, as employees of Enron discovered, the probability of ruin of a small concentrated portfolio is much higher than a large diversified one.

Then, we have to consider how an employer chooses the investment vehicles, other than employer shares, which are an obvious conflict of interest as already discussed. What is the employer's interest? Employer liability has already been extinguished by the contribution. Expense levels are not part of the consideration since the employer does not pay scheme expenses. The employer has no investment risk, so, proven investment performance is also not required. The only obvious decision point left is to award the work based on existing business relationships. And, every time the discrete group of choices is reconsidered, participants pay for the analysis through a reduction of investment return.

Other than low expenses and good investment performance, what benefits the participant? Literally nothing more; the participant needs the best investment return possible, net of expenses, since the participant pays expenses. But, these are not part of the employer's interest.

I can't speculate, but I can assure you that there is ample opportunity for funny stuff! Controlling a large amount of money with little oversight can easily lead to insider manipulation, assisting or opposing takeover efforts, less than arms length loans and other abuses. While there are fiduciary rules, there is ample insurance and poor disclosure so that trustees, selected by the employer, can do a less than stellar job with little personal risk. The employer sponsor's risk is virtually nonexistent.

This same risk has always existed in DB scheme funds also, but, at least the employer had an obligation to make up the losses to a degree<sup>2</sup>. In a DC scheme, the losses will be blamed on

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<sup>2</sup>A major flaw in benefit security, in my opinion, derives from insolvency law. Earned but deferred income due participants disappears from the balance sheet of an insolvent employer. Participants must look to external funds and any social guarantees for security.

the poor investment decisions of the run-of-the-mill workers. Legal recourse is beyond their reach and, even when pursuable, actual recovery will be nil to small!

So, there are two important weaknesses right off the bat; DC scheme participants do not have the education and experience to invest appropriately and they are limited to a discrete set of investments that were not chosen for their benefit.

Next, participants have limited access to their money. Since the accumulations have special tax status, certainly, social limitations are appropriate and required. But, in order for a participant to exercise the rights they do have, they must work through employer appointees. As with the privacy issues, these appointees have an obligation merely to implement the scheme rules, neither judging nor reporting. Again, how sure can the participant be of maintaining that privacy? Reality is - it shouldn't even be an issue. We believe that, even if the possibility of inappropriate publicity makes a participant hesitate in taking an action, the situation is unacceptable.

This creates additional and unnecessary layers of cost. Expenses are assessed to the commingled funds before allocation of net investment earnings. A loan must be handled and approved twice - by the company administrators and by the actual custodian of the assets.

We have already mentioned that, despite the rules that typically attempt to protect participant accounts and privacy, the temptations to ignore or circumvent them are enormous. Even indirect methods destroy participant value when they have retirement funds "invested" in employer shares. Companies such as Intel, Tyco, Enron and GE appear to be "rewarding" managers with literally all of the profits earned under their stewardship. Shareholders and employees are being deprived of their appropriate share of corporate success, needing to rely on hype and speculation for any increase in share value.

We have not touched yet on government-sponsored schemes. Governments are subject to the same temptations, perhaps more so, as private industry.

Consider the situation in Japan. Large Japanese firms and groups of smaller firms that can form a minimum critical mass are permitted to opt out of the government sponsored National Pension Insurance Scheme by providing essentially the same benefits through private means (an EPF -Employee Pension Fund). The funds for these schemes have suffered enormously due primarily to inappropriate actuarial methods and inadequate funding actuarial assumptions required by the government. The investment climate has also damaged principal amounts.

An organization known as the Pension Fund Association (PFA) has supervisory authority over these funds and also maintains related funds for special situations. While these are private funds, the government has significant ability to influence conduct. Participants have no legal recourse (the legal entity of a trust does not exist in Japanese law).

Investment losses in PFA funds have been extraordinary - recently reported to be in trillions of yen. The government has been directing the PFA to buy shares to support share prices in Japan - ultimately the banks. Needless to say, neither the economy nor the participants have benefitted. Things have grown so out of control that, as of September 19, the Bank of Japan has decided to buy shares directly from some banks.

While this may seem to be a good thing for the PFA, it is not. The PFA has been directed to buy other instruments that are currently illegal for the bank of Japan to buy. It is important to remember that these assets are the only assets backing up the promises made by employers using EPF.

How does this relate to DC schemes? The new "Japan 401K" is designed in such a way that

participants who change employment can not have access to any of their money until age 60. The accumulated account is transferred from the losing employer to essentially the PFA. While participants are supposed to have the ability to direct their investments, the program is too new to determine how it will work.

### **Benefits to Society**

Does society benefit? The usual argument is that healthy retirement schemes of all kinds reduce pressure on the social schemes. But do DC schemes succeed?

Experience in the U.S. shows that the people who most rely on social assistance are least likely to participate in employee initiated (no match) DC Schemes. DC schemes in the U.S. have helped people who have had other resources going into retirement achieve a higher standard of living in retirement. Those who depend exclusively on social assistance continue to depend on social assistance exclusively.

Low income earners get very little tax benefit from any tax-deferred arrangement. The usual argument of a tax deduction under a high tax taken into income later under a low tax doesn't work well for these employees. The risks of loss combined with anticipated taxes in retirement mitigate against participation.

For those who do participate, a significant proportion use their DC accounts as tax-deferred savings vehicles as opposed to retirement accounts. In the unusual case where an participant actually stays with the same employer for a long time, we can see a significant reduction in available value due to loans and other account accesses during the career of the participant. In the U.S., a loan attracts no tax whatsoever, while a full distribution attracts taxes at the highest marginal rate of the earner plus 10% excise tax if the withdrawal is "premature." Loans are very attractive until it's time to pay the piper at termination of employment. An participant can be faced with the unpleasant reality that the after-tax balance is virtually zero.

In the more typical case of an participant changing jobs frequently, the taxes (income plus excise in the U.S.) imposed on the benefit paid do not stop the participant from using the money for some other purpose than eventual retirement from the workforce. This unfortunate result is magnified when the change of employment is involuntary. Retiring from the work force with a net balance of zero puts pressure on the social assistance schemes.

On the other hand, payroll deduction is an effective way to save. In our modern world, however, direct debit is entirely possible from bank accounts receiving employee pay. It is no longer necessary to rely on the employer for planned savings debits. The historical idea that payroll deduction was required so that an individual could save the money before (s)he saw it no longer applies. With direct deposit and the other services available, such a result - saving it before you see it - can be achieved without employer involvement in the transaction.

Finally, you have the insanity represented by recent legislated initiatives in Japan. There, the economy suffers from a lack of consumption; Japanese are about the best savers in the world and are now being further rewarded by deflation. Add to that the fact that distributions from DB schemes there are not reduced for early retirement or early distribution and taxes on such distributions are nonexistent to small. The government has enacted permission for DC schemes named after the U.S. Internal Revenue Code ("Japan 401K") that have even better tax treatment than distributions from DB schemes. The expected result, more savings, is being achieved. Unfortunately, the capital market is already saturated<sup>3</sup> and company shares

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<sup>3</sup>It may help to mention that, Japan carries a big part of U.S. debt due to the fact that there are few capital opportunities in post-bubble Japan.

continue to test 20 year lows. There is little to no social benefit.

## **Taxes**

One of the arguments for the employer keeping the money is that the original version of "tax or deferred" permitted an employer to retain ownership on pay voluntarily deferred by the employee. The agreement between the participant and the company was based on the participant giving back to his/her employer a specified amount of gross pay. The employer promised to pay this money to the participant at some specified future date, but, the money really was given back to the employer. The participant got lower taxes for reduced pay. The employer was able to deduct amounts contributed to the retirement scheme once recognized. Note that, in the interval between withholding the participant contribution and paying it to the external fund, there was no enforceable employer liability.

In the U.S., the enabling legislation for this technique was seen as being too open and soon significant limitations were applied. The money which started out having the appearance of employer money soon became tax-preferred participant money. For some reason, money that really was employer money stayed under the employer's control (i.e., the requirement to buy employer shares) even after it fully vested except for severance of the employment relationship. Frankly, where the employer keeps the rights of ownership on vested funds, tax deductibility should be deferred until the participant gets full control.

## **The Bottom Line**

Many countries that enable employer-sponsored DC schemes also have permitted individual tax-deferred accounts. In the U.S., these accounts are permitted to be self-directed investment accounts. There are other jurisdictions where the same holds true.

These accounts can be established with banks and brokerages that have no direct relationship with the employer. Privacy is far more assured than with money administered by the employer. Investment decisions are truly freely made.

The basic question is, why should fully vested participant money require termination of employment to become completely controlled by the participant and independent of the employer? Termination of employment shouldn't be required. Virtually all of the DC rules recognize these accounts as being fully vested in the participants. It should be paid to them as vested without the need for termination of employment. Incidentally, it could be argued that an account fully controlled by the participant at severance of employment while remaining in the workforce would less likely be used for living expenses. The former employee would not be receiving a large check that had the appearance of being a cash benefit from the former employer.

One doesn't want to accuse all employers or governments of being duplicit or worse - it's just not supportable. But why put vested participant money at any kind of avoidable risk whatsoever? The technology already exists for automatically transferring funds to individual accounts. It should be utilized. If the participant wants to invest in the company or the country, there are a multitude of investment vehicles to accomplish that.

I would argue that employers and governments that wish to provide retirement security to their people should be required to do so with the technique that is not readily available to individuals - DB retirement schemes. Where DC schemes are established to promote self reliance and thrift, the funds should be placed outside the reach of the employer or the

government as soon as practicable.

We think the deal for "Johnnie" is inappropriate.