Conflicts of interest

Ron Watson

Americans should be able to retire with dignity and a reasonable level of economic security after a lifetime of work. Fifty years ago, most American workers were covered by employer-sponsored retirement benefits in the form of pensions. Starting in the mid-1970s, there was a dramatic shift by employers to replace pensions with IRAs, 401(k)s and similar retirement savings plans. That shift has changed middle-class retirement security in fundamental ways.

A pension retirement system generally is funded by contributions (often calculated as a percentage of base pay) by both the employee and employer over the work-life of the employee. The contributions of all the covered employees are co-mingled in a trust fund. Once an employee reaches certain age and years-of-service criteria, and decides to retire, he or she is paid a pension (sometimes known as an annuity)—a guaranteed set amount, calculated using a set formula (often using years-of-service and level of pay), for life. The annuity payments are drawn from the trust fund. Pensions are known as "defined benefit" plans. This is because the amount of the pension benefit is defined, and the duration is for life.

In 1974, Congress passed a law that created Individual Retirement Accounts (IRAs). In 1978, the tax code was revised to create 401(k)s. In these retirement plans, individual employees elect how much they contribute and how their contributions are invested. In some cases, the employer also contributes to the employee's retirement account. Each individual's contributions and investment earnings are specific to his or her own retirement account. Once the employee reaches a certain age, he or she can begin withdrawing from his or her account. There is no guaranteed payout—the amount of retirement benefits depends on how much the employee contributed and how well the investments did. These plans are known as "defined contribution" plans.

After passage of these laws, American employers began aggressively discontinuing pension plans in favor of defined-contribution retirement plans. Congress followed this trend for federal employees in the mid-1980s when it discontinued (for new employees) the Civil Service Retirement System (CSRS) and replaced it with the Federal Employees Retirement System (FERS). FERS is a hybrid plan. It does retain a pension component, but it also has a defined contribution component—the Thrift Savings Plan (TSP).

Studies have shown that the shift from defined-benefit retirement systems to defined-contribution systems has resulted in retirement security problems for many workers. In defined-benefit plans, the investment risk remains with the employer—pension benefits are guaranteed. In defined-contribution plans, the investment risk falls on the worker.

That investment risk can be compounded by financial firms that recommend and sell investment products to retirees (and active employees) making decisions about where to invest their retirement savings. Some firms benefit from selling financial products that have back-door payments and hidden fees buried in the fine print, resulting in high costs and low returns. These firms recommend products that put their own profits ahead of their clients' best interests. An analysis by the White House Council of Economic Advisors showed that middle-class families receiving such conflicted advice earn roughly 1 percentage point lower returns on their investments each year. Based just on the total $1.7 trillion currently invested in IRAs, that is a $17 billion annual loss in retirement savings of American workers.

Working letter carriers are not subject to the risk of receiving conflicted advice when it comes to their TSP investments. This is because the TSP is administered by a board that, as a matter of law, must make all investment decisions solely in the financial interest of the account holders. On the other hand, there are salespeople who will try to convince working carriers to stop investing in the TSP and instead divert future savings into other accounts.

Retired letter carriers are at a greater risk of receiving conflicted advice from financial advisers, brokers and other securities salespeople. This is because retired carriers must make TSP withdrawal decisions.

Here is a list of questions that should be asked whenever a salesperson or financial advisor suggests moving funds out of the TSP or diverting future funds away from the TSP:

- What is the average net expense I will pay for every $1,000 I invest?
- What additional annual fees, commissions or charges will I pay for investments?
- What profit do you make if I invest with you?
- Do you have a responsibility (fiduciary obligation) to put my interests ahead of your own?
- Will your plan protect my retirement funds from creditors' claims?
- When I retire, can I receive a series of scheduled withdrawals without giving up control of my account?
- Can I change my investments or take withdrawals without being subject to surrender fees or back end charges?

Obtaining answers to these questions will shed light on possible conflicts between your financial interests and those of the salesperson or financial advisor. And that could help ensure your financial security.