Secure Choice: The Next Chapter in the U.S. Defined Contribution Story

by Kweku Obed

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Several states have established or are considering establishing retirement savings plans for workers who don’t have access to an employer-sponsored plan. Fiduciaries of these plans can take advantage of and build on defined contribution plan best practices.
Secure choice programs or plans (SCPs) are one of the newer developments in the defined contribution (DC) world.

Recent legislation has established SCPs in California, Illinois, Massachusetts, Washington and Oregon. Some 20 other states, including Connecticut, Minnesota, New York, Utah and Vermont, are exploring the adoption of secure choice legislation. While differences will exist between the different SCPs being established across the nation, most if not all will share at least three common traits:

1. **They are public-private partnerships that will give millions of U.S. workers access to a retirement savings plan.** An estimated 70 million U.S. workers do not have direct access to a retirement savings account. That means about 50% of private sector workers—particularly those who are lower income or employed by small firms—lack a workplace retirement savings program primarily because they do not have access to one. By definition, SCPs are publicly administered retirement systems created to provide a retirement savings plan for private sector workers who would otherwise not have access to an employer-sponsored plan.

2. **They are multiple employer plans.** SCPs are likely to have a board of trustees consisting of state, private employer and private employee representatives.

3. **SCPs have clear lines of governance.** It’s likely that an executive director and/or the chief investment officer (CIO) would report directly to a board of trustees. Any investment and/or administrative staff who would work directly for the SCP would report to the CIO. Ultimately, the board and staff would have a fi-
Challenges and Opportunities
SCP fiduciaries have the opportunity from the start to take advantage of both the many commonsense DC-focused best practices promoted by the Pension Protection Act of 2006 (PPA) and the mainstream acceptance of behavioral finance.

DC best practices have evolved over years of trial and error and due to observations of clearly irrational behavior by many DC plan participants over the decades. So, unlike DC fiduciaries of the 1970s, 1980s or 1990s, today’s stewards of secure choice assets have been bequeathed a rule book to build on. This rule book includes PPA-influenced best practices such as automatic enrollment, automatic escalation and age-appropriate target-date funds as the default investment option for participants (Tables I and II, Figure 1).

In addition to PPA, recent initiatives from the Department of Labor (DOL) include the participant fee disclosure regulations of 2010-2012. These require plan administrators to provide participants with specific information related to fees and costs associated with plan investment options.

The mainstream acceptance of behavioral finance has also aided the management of DC programs and the presentation of investment options to plan participants. When voluntary DC plans were first established through the Revenue Act of 1978, there was a widespread—but inaccurate—belief that individuals eligible to invest in DC plans would be in position to make good financial decisions.

TABLE II
Adoption of Automatic Escalation

<table>
<thead>
<tr>
<th>Plans that use automatic enrollment</th>
<th>Plans that do not use automatic enrollment</th>
</tr>
</thead>
<tbody>
<tr>
<td>65.2% automatically increase default rates (autoescalate).</td>
<td>24.6% automatically increase default rates.</td>
</tr>
</tbody>
</table>

Source: Plan Sponsor Council of America, 57th Annual Survey of Profit Sharing and 401(k) Plans on the 2013 plan-year experience.

FIGURE 2
U.S. Diversity—“E Pluribus Unum”
Racial Diversity

<table>
<thead>
<tr>
<th>Racial Group</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Caucasian</td>
<td>62.1%</td>
</tr>
<tr>
<td>Black or African American</td>
<td>17.4%</td>
</tr>
<tr>
<td>American Indian and Alaska Native</td>
<td>5.4%</td>
</tr>
<tr>
<td>Asian</td>
<td>2.5%</td>
</tr>
<tr>
<td>Native Hawaiian and Other Pacific Islander</td>
<td>0.2%</td>
</tr>
<tr>
<td>Two or More Races</td>
<td>1.2%</td>
</tr>
<tr>
<td>Hispanic or Latino</td>
<td>13.2%</td>
</tr>
</tbody>
</table>


Gender Diversity
Female, 50.8%
Male, 49.2%

Ethnic (Language) Diversity
English, 79.3%
Other than English, 20.7%
and could implement these decisions in a rational manner over their working lives; hence, the “do-it-yourself” nature of the DC plan. Decades later, it is clear this optimistic view of individual investor behavior ignored a key finding of behavioral finance, namely, that for a number of different psychological and environmental reasons, many individuals often make poor investment choices that can lead to inappropriate portfolio diversification and, in turn, result in insufficient growth of assets. Table III highlights how today’s common best practices such as a tiered investment structure and targeted communications can help remedy the behavioral deficiencies to which the typical DC investor may be prone.

In spite of these positive developments, the rule book SCP fiduciaries have inherited remains a work in progress, as much ground still needs to be covered in order to place a large number of U.S. workers on a better path to retirement readiness. Fiduciaries of SCPs are in a strong position to advance ongoing discussions and spur continued action in many key areas.

**Opportunity Knocks**

In the near term, secure choice fiduciaries may want to focus on three priority areas, either following or in tandem with adoption of a streamlined investment lineup and implementation of a detailed governance and monitoring framework:

1. Fee negotiation (investment and administrative)
2. Monitoring savings and allocation trends based on race, ethnicity and gender
3. The feasibility of guaranteed income solutions for secure choice participants.

**Fee Reduction**

With respect to fees, many strides have been made. For example, in 2000, DC plan participants incurred an average expense ratio of 0.77% for equity funds; by 2014, the average expense ratio had fallen to 0.54%, a 30% decline.8 Also, with respect to administrative or per head fees paid by DC participants, it generally is accepted that recent developments such as DOL fee disclosure requirements have added downward pressure to recordkeeper fees in the past few years.9

While fees in the DC world are headed in the right direction, there is room for additional reductions. A recent study from the Boston College Center for Retirement Research highlights that during 1990-2012, defined benefit (DB) plans outperformed DC plans by 0.7%, with the most

### TABLE III

**Examples of How Department of Labor and Behavioral Finance Have Shaped DC Best Practices**

<table>
<thead>
<tr>
<th>Investment Best Practice</th>
<th>Benefit to Participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tiered structure</td>
<td>Aligns particular types of investments with the investing appetite and inclinations of different plan participants</td>
</tr>
</tbody>
</table>

**Plan Design Best Practices**

- Automatic enrollment
- Automatic escalation
- Qualified default investment alternative (QDIA)

**Benefit to Participants**

- Helps participants to be involved in the savings process as soon as they are eligible
- Increasing the default rate over different intervals is a prudent way to improve the probability of generating a higher retirement balance.
- Has enabled automatically enrolled participants to access one-stop-shop options such as target-date funds

**Administrative Best Practices**

- Fee transparency
- Targeted communication

**Benefit to Participants**

- Puts participants in a stronger position to make informed choices around investment options and gives them the tools to understand how fees impact returns over the long and short term
- Can highlight, for example, whether participants’ portfolios are concentrated in one type of option and the potential benefits of adopting a more diversified portfolio
likely contributor behind this difference being the higher fees paid by DC plans.10

A practical step secure choice fiduciaries could take to keep fees competitive for their programs is reviewing the mix of active and passive options in a lineup. From a plan governance standpoint, it is prudent to offer participants a low-cost suite of passive products as well as best-in-class actively managed core investment strategies.

Because SCPs are publicly administered, fiduciaries may want to explore fee aggregation initiatives with other public entities within the same state. This could be a means of negotiating the most favorable fee structure for SCP investments and other services.11

Race, Ethnicity and Gender

The need to focus on yesterday’s “elephants in the room”—race, ethnicity and gender—can also be a high-priority item on the modern fiduciary’s to-do list. Fiduciaries are obliged to place all of their plan participants on a steadier path to retirement readiness. Unfortunately, several studies from both public and private sources highlight an alarming story about how ill-prepared certain segments of the U.S. population are for retirement.12 Because this is a diverse country, certain states currently implementing SCPs and other states that plan to roll them out in the near future likely have subsets of their workforce that are diverse by gender and/or ethnicity (Figure 2).

In an age when information is readily available, fiduciaries can work closely with recordkeepers to establish whether—based on gender, race or ethnicity—different savings behaviors are prevalent within pockets of their SCP participant populations. And, in the same way that defined benefit (DB) plans are known for conducting asset allocation studies to determine if they are strategically on the right path, it may be beneficial for SCP fiduciaries to establish a best practice of reviewing participant behaviors in detail at least every two or three years as well as after targeted communication campaigns or changes to the fund lineup.

By consciously monitoring participant behavior, SCP fiduciaries can establish an effective process to gauge trends (both good and bad) within subsets of their participant populations.

Related to this, SCP fiduciaries can be confident that established methods like automatic escalation, reenrollment, targeted communications and one-on-one professional advice have proved effective in reinforcing and influencing positive savings behaviors of DC plan participants.13

Feasibility of Guaranteed Income Products

In theory, guaranteed income or annuity-like options such as a guaranteed lifetime withdrawal benefit are ways DC plan participants can exchange the present value of their DC assets for a stream of predictable and guaranteed future payments at retirement.14

There are practical reasons why guaranteed income options could be appealing for DC plan participants, including the predictability and security that come with a regular income stream during retirement and the shift of market risk (volatility) from plan participants to annuity providers (insurance companies). The latter would be particularly beneficial to participants during extreme down markets.

When rolled out to the U.S. workforce in the late 1970s and the 1980s, DC plans were presented as a means of augmenting a fixed DB pension benefit. But as traditional DB pension plans have continued to be phased out, DC plans have evolved from a supplementary retirement vehicle to the main source of retirement income other than Social Security benefits. A number of independent research papers and studies from asset managers and insurance companies highlight a phenomenon called longevity risk—the risk of a DC plan participant out-

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living the assets in his or her portfolio. Recent research has highlighted how guaranteed income options can better manage this risk.\textsuperscript{15}

Guaranteed income products can also buffer plan participants from significant bouts of volatility in down markets and during crucial points in their accumulation and distribution cycles. The global financial crisis of 2008 was a painful reminder that DC plan benefits for those at or near retirement are neither fixed nor guaranteed. DC assets declined by roughly 22% from $4.6 trillion at the end of 2007 to $3.6 trillion at the end of 2008\textsuperscript{16} while plan participants aged 55-64 saw their average account balances decrease by over 20.2% over the same period.

That widespread loss of wealth for those at or nearing retirement was a catalyst for broad discussions around incorporating guaranteed income options within DC lineups. The availability of such options would mean that during an extreme bear market, DC participants could rely on a set income stream that would not fluctuate based on stock market performance.

However, the reality is that only a handful\textsuperscript{17} of DC plans currently offer some type of guaranteed income option. Many plan sponsors say they are reluctant to adopt a guaranteed income option because of these products’ operational complexity, cost and lack of portability and the perceived lack of clear guidance from regulatory organizations like DOL.

Secure choice fiduciaries will want to continue to educate themselves on the types of guaranteed income options available in the marketplace. These options, like every other type of investment product, come in many varieties. Education will put fiduciaries in a better position to establish which concerns are more nuanced (e.g., products’ complexity and limited transferability) and which are relatively easier to address (e.g., the misperception that there is a lack of clear direction from regulatory organizations).

To address concerns around the additional operational complexity of guaranteed income products, SCP fiduciaries could initiate discussions with DC plans that have successfully incorporated retirement income options in their programs. A potential benefit of this approach would be to take advantage of the intellectual capital and research used by these innovative plans; SCP fiduciaries might not have to re-create the learning curve on the potential use and implementation of these options.

Similarly, SCP fiduciaries could walk through implementation case studies with the asset managers and insurance companies that currently manage guaranteed solutions in the DC marketplace. By interacting with these product providers, fiduciaries could obtain a sense of the potential hard-dollar costs associated with the different retirement income options and review how early adopters were able to address operational and transferability hurdles.

Finally, with respect to overcoming concerns such as the perceived lack of direction from regulatory organizations on implementing and monitoring guaranteed income products, education sessions could highlight to SCP fiduciaries that the DOL’s Annuity Selection Safe Harbor Regulation for DC Plans (2015) and the Treasury Department’s guidance on qualifying longevity annuity contracts (QLACs) (2014) are recent examples of practical guidance provided to DC plan sponsors.

**Answering the Call to Provide Security and Choice**

The latest incarnation of the U.S. DC plan is the SCP, a state-administered DC plan that will be offered to private sector employees who lack access to an employer-sponsored retirement plan. While SCPs are a relatively new concept in America, the challenges SCP participants and fiduciaries face are far from new. In fact, relative to DC trustees and service providers from a few decades ago, fiduciaries of SCPs are in a somewhat enviable position. They can
“hit the ground running” by taking advantage of years of innovation in areas such as plan design, investment monitoring and behavioral finance. In addition, the rollout of SCPs in various states coincides with the creation of forward-looking DC-focused policies in previously untested areas; the safe harbor implications of guaranteed income options to DC plan participants are a prime example. Going forward, the success of SCPs should be measured by additional progress and innovation on the following plan features:

• Fee reductions
• The disturbing savings trends characteristic of certain segments of the working population
• Guaranteed income options for plan participants.

Given the sheer numbers of U.S. workers who eventually could have access to an SCP, fiduciaries should be prepared to meet the challenges that lie in wait to positively influence the latest chapter of the U.S retirement story.

Endnotes

1. Sources: Pensions and Investments, Georgetown University and the Pension Rights Center (PRC).
4. As an example, refer to the introductory section of the Defined Contribution Institutional Investment Association (DCIIA) 2014 Plan Sponsor Survey (published June 2015) that highlights the transformative nature of PPA.
5. Books such as Nudge: Improving Decisions About Health, Wealth, and Happiness by Richard H. Thaler and Cass R. Sunstein and the Time Magazine article “Fuel Your 401(k) with the Secrets of Behavioral Finance” by J. D. Roth provide examples of how behavioral finance concepts have become a part of mainstream discussion and how behavioral finance is no longer perceived within the mainstream as a purely academic discipline.
6. Organizations such as the Plan Sponsor Council of America (PSCA), DCIIA and the Employee Benefit Research Institute (EBRI) have highlighted how the addition of autofeatures can have a positive impact for many DC participants (including those who fall in a low-income category). Prior to PPA, many employers were reluctant to autoenroll plan participants because they feared they would be opening themselves to legal liability under a variety of scenarios.
7. The Revenue Act of 1978 established qualified deferred compensation plans (Code Section 401(k) plans), which allowed for pretax employee deferrals. Under the act, employees are permitted to withdraw their contributions from such plans after the age of 59½ or upon separation from service (currently “severance from employment”) or because of hardship or disability (Source: Georgetown University Law Center).
10. Alicia H. Munnell, Jean-Pierre Aubry and Caroline V. Crawford, Investment Returns: Defined Benefit vs. Defined Contribution Plans. Their analysis compares returns by plan type from 1990-2012 using data from the U.S. Department of Labor’s Form 5500. Their report shows that during this period, DB plans outperformed 401(k) plans by an average of 0.7% per year, even after controlling for plan size and asset allocation.
11. Fee aggregation arrangements are a way for independently governed plan sponsors to pool their assets together for negotiating purposes with recordkeepers, asset managers and other vendors. Lower fees are one potential benefit from this type of cooperative agreement.
12. As examples, see the ERISA Advisory Council 2010 report, Disparities for Women and Minorities in Retirement Savings; the New Republic article “The Alarming Retirement Crisis Facing Minorities in America” by Danny Vinik, February 2015; the Reuters article “Why minorities are losing the retirement race” by Mark Miller, December 2013; and the ING Retirement Research Institute’s 2012 study, Retirement Revealed.
14. The guaranteed income stream would be a function of the financial strength and claims-paying ability of the insurance company/companies that sponsor the guaranteed income options in the DC plan.
15. Natalia Orlova, Matthew Rutledge and April Wu, The Transition from Defined Benefit to Defined Contribution Pensions: Does It Influence Elderly Poverty? 2015. A main conclusion of the research is that households with liquid assets (like DC plans) that do not receive annuity payments were more likely to dip below 150% or 200% of the poverty line.
17. 8.5%, per Plan Sponsor Council of America.

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