Defined Contribution Plans: Growing and Evolving

As defined contribution plans have become the primary retirement savings vehicle in the United States, much work remains to be done to get participants saving adequately and investing prudently.

by | **Kweku Obed**

The percentage of the U.S. workforce that is covered by a traditional defined benefit (DB) pension has steadily declined in recent decades. Over the same period, defined contribution (DC) plans (401(a)s, 401(k)s, 403(b)s, 457s, thrift savings plans and the like) have risen in prominence to become the most commonly used employer-sponsored retirement savings vehicle in the United States. In 2013, approximately 32% of assets in the 1,000 largest U.S. plans and roughly 27% of the 200 biggest retirement funds were in DC plans. With respect to assets under management, DC plans hit a record $6.6 trillion during the second and third quarter of 2014. In contrast, private DB plan assets stood at roughly $3.2 trillion over the same period[1] (Figure 1).

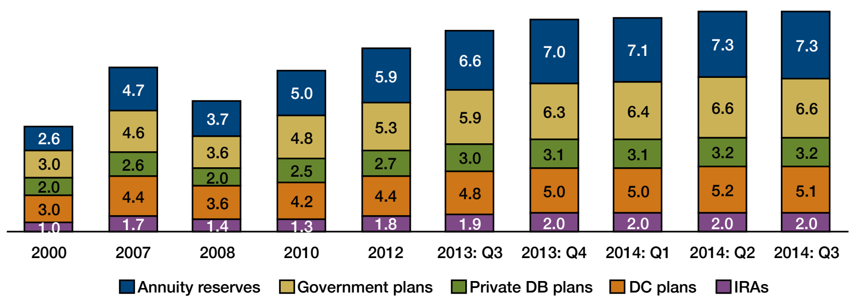
Of the $6.6 trillion that U.S. workers allocated to DC plans

- $4.4 trillion was held in 401(k) plans
- $555 billion was held in other private sector DC plans
- $941 billion was in 403(b) plans
- $255 billion was in 457 plans
- $401 billion was in the Federal Employees Retirement System's Thrift Savings Plan (TSP).

While the public DC market is relatively less mature than the private market, over the next few years public DC plans in aggregate are projected to grow at a slightly faster rate than their corporate cousins. This forecasted growth for public DC plans arises from a perfect storm of socioeconomic, political and macroeconomic factors—Growing DB liabilities across a large number of

FIGURE 1

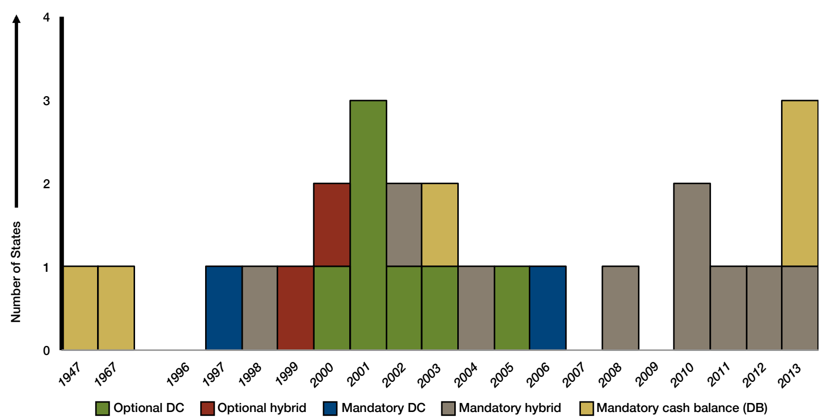
U.S. Total Retirement Market ($Trillion)



Sources: Investment Company Institute, Federal Reserve Board, NAGDCA, American Council of Life Insurers and the Internal Revenue Service Statistics of Income Division.

FIGURE 2

Introduction of State Defined Contribution Plans by Year



Sources: Center for Retirement Research at Boston College and National Association of State Retirement Administrators.

states and flat to slow-growing government revenues have driven the recent switches from DB to DC plans. Since the early 2000s and as a direct result of the socioeconomic factors, many public DB plans and systems have made structural changes to their benefits policies in an effort to reduce liabilities and subsequent required contributions (Figure 2). Generally speaking, policymakers have been supportive of benefit changes that seek to control the growth of state and local government contributions.[2]

Given that a growing percentage of the U.S. labor force will increasingly rely on DC plans as a key source of retirement income, we should continue to see the evolution of best practices around the design, monitoring and accessibility of DC plans. In tandem with this evolution, we expect to see increased direction from regulatory organizations such as the Department of Labor (DOL) regarding best practices for DC plan sponsors.

Evolving Best Practices

Arguably, the ongoing augmentation of best practices around DC plan governance has occurred due to (1) the Pension Protection Act (PPA) of 2006,[3] (2) the rapid growth in the use of DC plans and (3) a willingness by regulators, recordkeepers, consultants and plan sponsors to openly acknowledge that so-called academic fields such as behavioral finance can be both practical and relevant when trying to understand the behavior of the typical real-world DC investor.

A growing number of studies and surveys highlight the fact that many DC plan participants are not saving enough for retirement or making the best use of available investment options. In stark contrast to the 1980s and 1990s—periods when such studies and data were scarce—today's typical plan sponsor and consultant can no longer implicitly assume that participants make all the "right" choices around plan participation, such as enrollment, percentage of salary contributed *(deferral rate)*, selection of investment managers or interpretation of fees.

So, rather than leave each individual DC investor to fend for himself or herself, plan fiduciaries are looking to educate DC plan participants in making better informed decisions via streamlined investment lineups, targeted communications and other measures such as autoenrollment and autoescalation. (See the table.)

The Tiered Investment Lineup

Given the varying degrees of sophistication among plan participants

TABLE

Evolution of DC Plan Design

Plan Feature	Yesterday	Today
Plan design	Bundled	Separating investments and administration
Communications	Homogenous	Personalized
Administration	Closed architecture	Open architecture
Investments	Offer everything	Streamlined tiered structure
Fees	"What fees?"	Greater transparency
Success metrics	Participation	Retirement readiness
Choice menu	Participants use rational expectations	Participants can make irrational choices
Governance	Limited committee involvement	Greater committee involvement
Default option	Stable value/money market	Age-appropriate target-date fund
Target-date funds	Off the shelf	Choose the best glidepath (off the shelf or customized)
Contribution	Max out at company match (if applicable)	Autoescalation
Policy statement	More applicable for pension plans	Becoming best practice

Source: Marquette Associates.

and the human tendency to make irrational decisions when faced with multiple choices, simply offering funds across the investment spectrum without much guidance can induce unhelpful behaviors such as procrastination and inertia. (See Figure 3.) The tiered investment structure was developed as a means of positively tackling some of the common behavioral biases that can impede a participant's efforts to build and adequately manage an investment portfolio.

A typical tier structure (Figure 4) will have three parts:

- **Tier I: A "one-stop shop" fund solution, typically a target-date or lifecycle fund**
  —Objective: To provide a "set-and-forget" fund option for reluctant investors
- **Tier II: A "core" set of actively and passively managed funds**
  —Objective: To provide a diversified set of "core" building blocks for more hands-on, "do-it-yourself" (DIY) investors
- **Tier III: Where applicable, specialty options or features (for example, a mutual fund window or a specialty standalone fund)**
  —Objective: To provide additional options for DIY investors who are the most hands-on.

Presenting a DC plan's investment options via the tiered structure can be a practical way to show a participant how certain options may be appropriate for him or her. For example, an employee who is fee-conscious and does not spend much time poring through prospectuses and quarterly statements would be a good fit for a target-date fund (Tier I) allocation versus maintaining self-managed exposure to Tiers II or III.

Greater Focus on Correlations Between Ethnicity, Gender and Savings Behavior

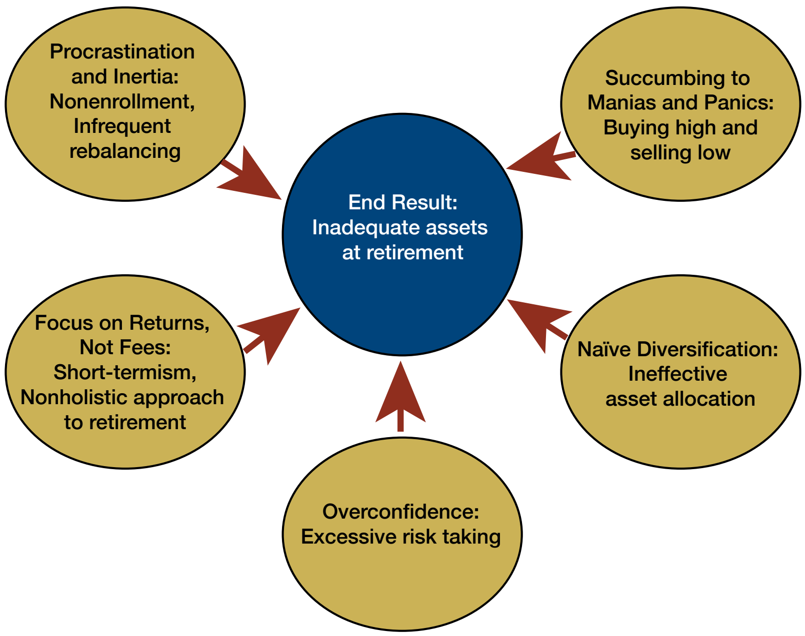
Volumes of data disaggregate the story on key themes such as *retirement readiness* and *employee engagement*.

takeaways >>

- U.S. workers have allocated $6.6 trillion to DC plans.
- Because of socioeconomic, political and macroeconomic factors, public DC plans in aggregate are projected to grow at a slightly faster rate than corporate plans.
- Regulatory organizations such as DOL are expected to provide more direction into DC plan best practices.
- Plan fiduciaries recognize they need to educate plan participants in making better saving and investment decisions and provide more help through plan design.
- DC plan balances show that retirement prospects of some demographic subgroups are bleak. Plan sponsors have tools available to help overcome these trends.

FIGURE 3

Destructive Tendencies Highlighted by Behavioral Finance



Source: Marquette Associates.

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Save More Tomorrow: Practical Behavioral Finance Solutions to Improve 401(k) Plans

Schlomo Benartzi. Penguin Random House. 2012.

Visit *www.ifebp.org/books.asp?9040* for more details.

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International Foundation. 2014.

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But there is still an alarming gap between the practicality and usefulness of some components of PPA as they relate to DC plans, the conclusions of behavioral finance and the retirement readiness of a material number of DC investors.

If nothing else, this detailed data reveals varying degrees of retirement readiness for different ethnicities and/or subgroups of the U.S. working population. It is clear that consultants and plan sponsors should not rest until the retirement readiness story is a positive one for all groups within our workforce.

Much work remains to be done. Data on the share of working-age households with a retirement account balance of less than $10,000 (by race) provides a very sobering picture of the retirement readiness story for some individuals and subgroups. Simply put, these numbers suggest a worrisome number of U.S households are not at all prepared for retirement. (See Figure 5.)

A look at savings behavior by gender tells different stories. For example, we have seen a material dip in the retirement plan participation of both single men and single women since the turn of the century. Around the turn of the century, single and married women had similar participation rates in retirement plans; however, in recent years, single women have seen their participation rates erode while those of married women have increased. (See Figure 6.)

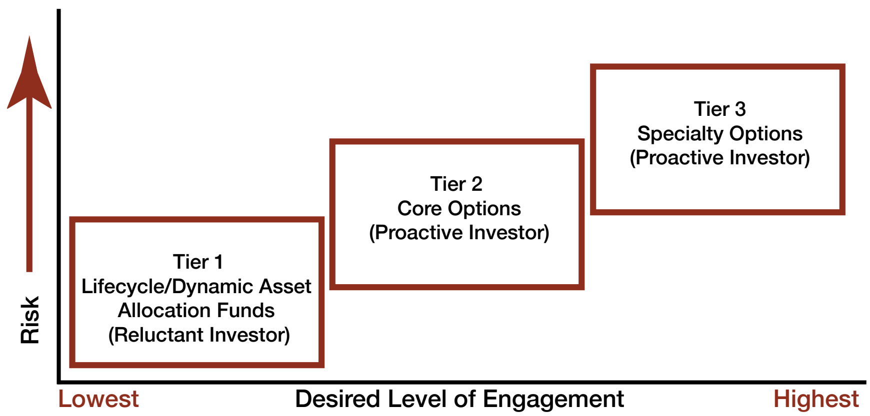
The myriad of socioeconomic, historical and cultural reasons that account for these savings disparities and changes in participation rates are outside the scope of this article. Instead, these examples highlight the importance of practices that should become a permanent part of the discussions between plan sponsors, recordkeepers, fund managers and consultants during their regular interactions with one another. Some of the proposed practices highlighted below have been effective in bolstering participation and adequate savings rates in DC plans:

- **Automatic enrollment** has been shown to increase plan participation among low-income workers, young workers and minorities. A recent study revealed that employees who joined their plan through automatic enrollment had an overall participation rate of 82%, compared with a participation rate of 65% for employees who joined through voluntary enrollment.[4]

- **Autoescalation.** While autoenrollment influences the number of participants who are in a DC plan, improving the retirement readiness of these participants is also critical. The more a participant saves over his or her working life, the better the chances of having sufficient assets at retirement. Plans with autoescalation features (where contribution rates are automatically increased at predetermined intervals) should help participants who currently are not setting aside sufficient assets for retirement.
- **Recordkeeper reporting.** Many of the top recordkeepers are able to "slice and dice" demographic data and report these statistics at both the highest and the most granular levels. In order to establish trends of positive or destructive behaviors that may be prevalent in groups and subgroups, consultants and DC plan sponsors—with the aid of their recordkeepers—should review plan-specific demographic and utilization statistics at least annually, as well as after any fund lineup changes.
- **Customized participant communications.** In reviewing plan-specific trends or in conjunction with any plan lineup changes, as examples, DC plan sponsors should work with their recordkeepers and, where applicable, their consultants on the production of targeted communications. If used effectively, targeted communications can help to educate participants on key areas such as the tier structure and act as a deterrent for the inappropriate use of some funds.

FIGURE 4

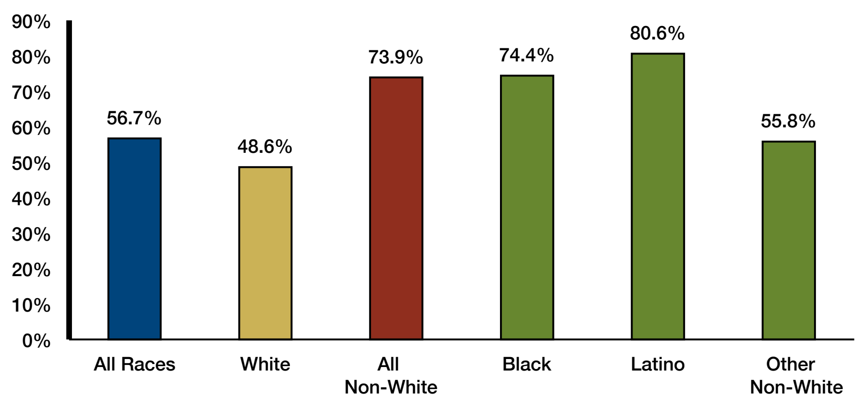
Tiered Investment Structure



Source: Marquette Associates.

FIGURE 5

Households With Less Than $10,000 in Retirement Savings*



*Universe is households with heads aged 25-64. Race is primary race reported for head of household.

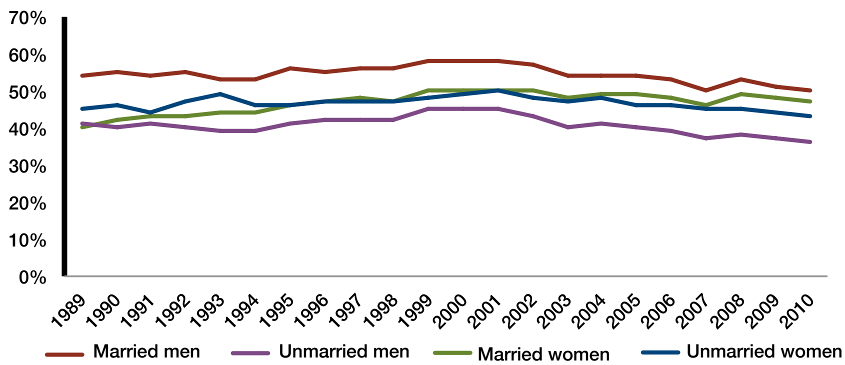
Source: National Institute on Retirement Security, *Race and Retirement Insecurity in the United States.*

Conclusion

Without a doubt, over the past few decades, DC plans have become a key

FIGURE 6

Share of Workers Aged 26-61 Participating in Employer-Based Retirement Plan, by Gender/Marital Status, 1989-2010



Source: Economic Policy Institute.

component of the U.S. retirement story. In concert with the increased growth of DC plan assets, there have been many key developments in the areas of plan design and investment structure. At this point in the evolution of the DC story, it is important that consultants, plan fiduciaries, investment managers and recordkeepers continue the trends and innovations in today's market.

As providers of advice and stewards of assets, it is our moral obligation to raise important questions around retirement readiness, financial literacy, cost savings and the like. Millions of DC plan participants are relying on us to guide them on a better path to retirement readiness. And, while we have seen stellar growth in the number of DC plans, there is sufficient evidence that highlights the need for DC participants to increase how much they save, invest more prudently and allocate more resources to planning their retirement journeys.

Prudent DC consulting, solutions and fiduciary frameworks of the future should focus on the typical plan participant, i.e., someone who is still trying to figure things out from a retirement perspective. Depending on their age, gender, ethnicity, economic status, location and industry, one plan participant may exhibit completely different savings behavior from the next plan participant. Therefore, while consultants can design the best investment lineup and plan sponsors can adopt these lineups on behalf of their DC participants, if savings rates are inadequate and fiduciaries shy away from explicitly addressing how different subgroups of their workforce (broken down by gender, ethnicity, age and location, for example) are preparing for retirement, we will be missing the unique opportunities that we have to place more individuals on a prudent path to retirement readiness.

<< bio

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Endnotes

1. Investment Company Institute, Federal Reserve Board, NAGDCA, American Council of Life Insurers and Internal Revenue Service Statistics of Income Division.
2. The Public Employees' Pension Reform Act (PEPRA) of 2013 is a good example of this trend. PEPRA has changed defined pension benefits for new public employees in the state of California. New members earn less in defined benefits than their predecessors ("classic" employees). To retire with benefits comparable to classic employees, PEPRA employees can either work longer or save to augment the income from the amended DB plan.
3. PPA represented the most comprehensive reform of U.S. pension laws in over 30 years. Congress passed the act as a means of ensuring more stable retirement outcomes for U.S. workers. A key provision in the act was the endorsement of autoenrollment (which previously had been prohibited). *Automatic enrollment* describes an administrative process where eligible employees are automatically enrolled to participate in a DC plan unless they opt out. Through organizations like Employee Benefit Research Institute (EBRI) and the Defined Contribution Institutional Investment Association (DCIIA), autoenrollment has been shown to be an effective method to increase both participation and savings.
4. Vanguard.