Retirement Income in DC Plans: What Our Experience with DB Plans Tells Us

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Introduction

Traditional pension benefits have been in steady retreat since corporate America began replacing defined benefit plans with defined contribution plans in the mid-1980's. Once a staple offered by most employers, accrual of benefits under defined benefit plans today is limited primarily to unions and governments. According to the Center for Retirement Research, there was a 65% drop in the number of private sector employees with pensions between 1975 and 2005 while the public sector held steady.[1]

In the private sector, employees' retirements depend heavily on income from savings they have managed to accumulate through a combination of their own contributions and that of their employers. Not only are these savings often woefully inadequate, retirees are generally ill-prepared to manage their nest egg so that it provides steady income for the remainder of their lives.

Employers, employees, and the federal government are becoming painfully aware of the shortcomings inherent with defined contribution plans:

- Retirement benefits are an important tool for employers trying to manage the demographics of their workforce; they are looking for ways to improve their employees' financial ability to retire without significantly increasing compensation costs.
- Employees are overwhelmed by the recent volatility of the stock market and low interest rates, and are seeking greater security during their retirement years.
- The federal government is looking to balance its budget while lessening demands on Social Security and other entitlement programs.

The potential for improvement in DC plans' ability to provide a steady stream of income has caught the eye of the financial services industry. While the marketplace races to deliver an array of possible solutions, employers and regulators are grappling with how these products fit within qualified retirement plans[2]. Unfortunately, the initial response from employees has been tepid, at best. Retirement income products – specifically, products embedded in retirement plans focused on generating secure retirement income – have only a 1% take up rate when the products are offered at the point of distribution. [3]

In this context, it is tempting to wish for a return to "the good ol' days" when defined benefit plans reigned. And yet many corporations phased out defined benefit plans for some very valid reasons. This includes volatile minimum required contributions, benefits which are not very tangible (especially to younger employees), and a byzantine regulatory environment. This article will examine our experience with defined benefit plans and identify some key lessons that can be applied to improve retirement outcomes for participants in the "next generation" of defined contribution plans.

The Importance of Certainty

Many hold the view that employers abandoned defined benefit plans because they were too *costly*. Yet any actuary will tell you that from the perspective of a full

[1] Munnell, Alicia, Kelly Haverstick, and Mauricio Soto, "Why Have Defined Benefit Plans Survived in the Public Sector?" The Center for Retirement Research, p. 2 (2007).

[2] Request for Information Regarding lifetime income, Department of the Treasury, Department of Labor, Federal Registry, vol. 75, No. 21, February 2, 2010.

[3] Survey Findings: Trends and Experience in 401(k) Plans 2009, p. 68, Hewitt Associates.

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employment career cycle, the defined benefit plan is mathematically the most efficient vehicle for providing retirement benefits for two reasons:

1. Investment and contribution strategies can take a long view and are aided by sophisticated asset liability modeling. This allows the pension fund to assume more strategic risk. Individuals cannot – and should not – take on the same level of investment risk since their investment horizon is necessarily much shorter.

2. Mortality risk pooling is efficient and results in lower costs overall. Individuals who attempt to self-insure for longevity must always assume that they will continue to live beyond the current year and therefore must never deplete their assets. This harsh reality forces them to either save more than they may need or live on less income than they might otherwise enjoy.

Employers have always had the ability to manage the *cost* of a defined benefit plan by managing the level of benefits promised. And because defined benefit plans are more efficient than defined contribution plans due to their long term investment horizons and ability to pool risk, it actually costs less to deliver the same level of retirement income through a defined benefit plan than through a defined contribution plan.

So what did kill the defined benefit plan, if not *cost*? The answer is the inability to reliably predict required minimum contributions from year to year. Funding regulations implemented in the 1980's [4] shortened the period over which investment gains and losses could be recognized, and the Federal Accounting Standards Board (FASB) required investments to be "marked to market". This meant greater volatility of asset valuations held by the pension funds, and any difference between the *expected* returns and *actual* returns had a much bigger impact on the immediate funding requirement.

Exacerbating the issue was the fact that as pension funds grew in size relative to the business enterprise supporting them even a small deviation in investment returns could materially affect the firm's bottom line.

This situation was unacceptable to most CFO's, who found the certainty of defined contribution plans much more palatable. Under a defined contribution plan, the amount required to be funded each year is either a function of 1) the business's payroll, or 2) their profit, or 3) a combination of both. Because payroll levels are not as volatile as investment returns, funding levels are much more predictable. And profit sharing plans give even more control, allowing for funding levels to be determined after profits, if any, have been booked.

Employers who continue to sponsor defined benefit plans are desperate to find a way to inject greater *certainty* in the required funding levels, even if it means higher overall *costs*. One solution is liability driven investing, which is a strategy that seeks to match fixed income vehicles with a term that aligns with the timing of expected pension payments.

While this has the potential to achieve the desired effect of dampening the volatility of required funding, it reduces exposure to equities and their historically higher returns, therefore increasing pension costs. The cost of moving from a portfolio holding 70% equities/30% fixed income to one holding 20% equities/80% fixed income can lower expected investment returns by approximately 200 basis points. The only way to make up this loss of foregone investment income is for the employer to make larger contributions. Or, they can reduce the level of benefits granted on future service (benefits earned on service already completed are protected and cannot be reduced).

[4] Financial Accounting Standards Board (FASB) Statement 87

If certainty is of such great consequence to employers – so much so that they would consider foregoing up to 200 basis points in investment returns - would certainty not also be of similar importance to individuals? Defined contribution plans have offered employers the certainty they sought by shifting the investment risk and mortality (longevity) risk to individuals. But individuals are even less able to absorb risk and uncertainty. Retirees are faced with two equally unacceptable choices:

1) support current consumption and ignore the risk of living 20, 30, or 40 years after retirement, or

2) significantly lower their living standards to make their savings last until their death. And since no one can predict the exact moment of their death, this means living on even less than they might otherwise and dying with money still in the bank.

In fact, AARP found most retirees choose the first option. 54% of those who took one-time cash payments from their retirement plan had exhausted their savings within 3 years of retirement[5].

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The next generation of defined contribution plans should seek to address this fundamental flaw of leaving retirees with no attractive options for mitigating the uncertainty they face as to the level of retirement income the account balances can sustain. Defined contribution plans need to provide investment options that offer certainty and the ability to pay a predictable retirement income for life. Yes, there will be an additional cost to mitigate these risks. But faced with similar uncertainty, employers were willing to incur the *cost* of a less efficient retirement program or a less volatile investment strategy. Employees should be given a similar opportunity to protect themselves.

[5] AARP Public Policy Institute Report, 2006

Benefits Need to Be Tangible to Employees

If defined benefit pensions are such a good deal for employees --- after all, employees bear no risk, their retirement income is predictable, and it even comes with a federal guarantee through the PBGC that it will be paid for the life the employee --- why do employees tend to favor defined contribution plans? Even for those fortunate enough to have earned a traditional pension, the choice of receiving a large sum of cash today versus a small monthly payment is surprisingly tempting.

What employees are saying, both directly and indirectly, is that their retirement benefits need to be tangible to them. They need to be easily understood, and the fewer the strings attached, or caveats and necessary explanations, the better. This manifests in several key ways:

<u>Simplicity sells</u> - Employees prefer simplicity. For example, defined contribution plans can be explained simply as "Your balance is $x." Or "We contributed $x to your account."

Compare this with an explanation for a defined benefit pension: "If you continue to work for us at your current rate of pay for the next 30 years you will receive a monthly payment of $x if you are married, or $x if you are single, beginning at age 65. Your spouse will continue to receive $x if you should die before her/him."

Or, employers who quantify the total wage/benefit/paid-time-off package through a comprehensive benefit statement may attempt to explain the cost of providing a pension benefit, for example: "The value of your pension benefit when you

retire is estimated to be $x. The cost of providing this benefit to you varies from year to year. Last year the company contributed $x to the pension fund, or x% of covered payroll."

Even if all the "x" variables have an equivalent value, employees will prefer the defined contribution plan over the defined benefit plan because the benefit is much more easily understood, making it more tangible to them. Similarly, retirement income products need to present their value in a way that is simple and easily understood to make the benefit tangible to employees.

Mobility needs to be protected – A vibrant workforce is a mobile workforce. It allows talent to flow to the highest use. And just as there is a healthy level of unemployment – the economy suffers when it is both too high and too low – there is also a healthy level of turnover.

Yet defined benefit plans were intended to act as "golden handcuffs". They were designed to reward people for staying in one place. They provide the greatest benefits to long term employees. But they had the unintended consequence of discouraging the hiring of older workers by making it more expensive to do so.

Defined benefit plans also make it challenging to manage older workers seeking a reduced schedule, e.g. phased retirement, by imposing seemingly arbitrary rules around minimum hours worked, "double dipping", and how to determine when employment has officially ended or terminated.

Many have assumed the workforce has become significantly more mobile in recent years, with shrinking loyalty from employees and employers alike. However, the reality is since the industrial revolution the American workforce has been highly mobile and loyalty quite fragile. Average tenure has decreased only modestly over the past three decades[6].

Employees of the past, present, and future expect to work with several employers over their lifetimes. Today's workers expect to take their accumulated retirement savings with them to the next job. And both employers and employees have incentives to ensure the workplace is attractive to older workers. Employers need the experience and stabilizing influence of older workers, and quite frankly, older workers are going to need to continue to work to help pay their bills.

Therefore, the next generation of defined contribution plans needs to continue to support portability through all phases of employment. Employees need to be able to take their retirement savings with them from job to job, employer to employer. And the cost of providing benefits to older workers needs to be comparable to the costs for younger workers so older workers are not priced out of the labor market.

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Retirement income products that offer guarantees need to be able to move with the employee to the next job. And it needs to be done in a simple, seamless way. While many see this as a daunting challenge, the financial services industry has the ability to address this, just as they did the demand from employers for an open investment platform from their recordkeepers. It is the author's view the financial services industry will rise to the challenge once it is convinced the demand

[6] Huff Stevens, Ann, "The More Things Change, The More They Stay the Same: Trends in Long-term Employment in the United States". 1969-2002, NBER Working Paper No. 11878 (2005)

from employers and their employees will make the investment pay off.

Make it easy – Employees will always migrate to the "easy" solution. In one sense, defined benefit plans worked because nothing was required of employees. They did not have to sign up, decide how much to save, or manage their investments. Defined contribution plans are the opposite: employees must decide whether to save, and if so, how much. Then they have to determine their "risk profile" (a term requiring some degree of financial literacy) and based on that, allocate their savings among a dizzying array of investment options. To make matters worse, government regulations discouraged employers from being too hands-on in helping employees develop their investment strategy, and so employers threw choices at them with little or no real guidance.

The situation improved with the advent of automatic features after the passage of the Pension Protection Act. Employers began adopting automatic enrollment, automatic escalation, and diversified investment options that rebalanced over time (e.g. target date funds). Like defined benefit plans, this combination of "automatic" features set employees on the right path to achieve retirement readiness. Employers also were given more regulatory guidance on how they could offer investment guidance to those who wanted it.

To be considered successful, a retirement income option must be *utilized* by employees. This will require employers to take an active role in helping employees achieve retirement security. For some, it may mean ensuring the retirement income option is integrated into the participant experience and education is appropriately and effectively targeted. For others, it may mean setting employees on the right track toward generating sufficient and secure retirement income (via a default election), while preserving the right of employees to opt out.

The converse is also true: the retirement income option should *not* be presented as an after-the-fact, just-in-case-you-might-want-it, off-to-the-side option. If handled in this manner, retirement income will see very low utilization and will therefore be doomed to fail.

Regulations Should Encourage Employers to Facilitate Better Outcomes

Government regulations, no matter how well intentioned, can have unintended and perverse outcomes. In its efforts to shore up the funding status of traditional pension funds, regulations made contribution levels more volatile and unpredictable. The unintended consequence of this, as explained above, was to discourage employers from sponsoring defined benefit plans at all.

Another example of the unintended consequence of regulations is the required disclosures related to optional forms of payment from a defined benefit plan. Government regulations are very prescriptive about the information defined benefit plans are required to provide to employees when it is time to elect the form of payment from their pension plan.[7] Detailed descriptions of 1) the different forms of payment available, 2) who can be a joint annuitant or beneficiary (which requires understanding the difference between the two), 3) how long the benefit is guaranteed to be paid and to whom, and 4) the relative value of different forms of payments are all required to be provided in a chart filled with lots of relatively small numbers and confusing terminology.

But complexity drops away when explaining to the employee that they can take a one-time cash payment. And the amount is staggeringly large compared to the other options presented. Regulations do not require the plan sponsor to explain in any detail what is required to manage the lump sum payment so that it

[7] United States Treasury Department, Internal Revenue Code Section 417(a)(3)

has a likelihood of providing a stream of income for the life of the employee. The only caveat is for the employee to consult their advisor.

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The effect is that the one time, cash payment is falsely presented as the "simple" and "easy" choice. Faced with having to decide between a complex array of small amounts or a seemingly simple-to-understand and large amount, it is no wonder so many employees elect the lump sum.

Government regulations should encourage employers to do the right thing for employees. Unfortunately, the two examples above --- more strict funding requirements and requiring confusing and frequently incomprehensible disclosures to employees – are examples of regulations that *discourage* employers from doing the right thing for employees.

In contrast, the Pension Protection Act is an example of a regulation that *encouraged* employers to do the right thing for employees by incorporating automatic features into their defined contribution plans. According to Cerulli Associates and the Plan Sponsor Council of America, the percentage of plans offering automatic enrollment increased from 40% to 66% between 2008 and 2010.

If the government wants to increase the likelihood that employees will enjoy a secure retirement with less need for taxpayer subsidies, they will pursue regulations that encourage employers to adopt retirement income solutions in a manner that will result in healthy utilization by employees.

Conclusion

In an effort to attract and retain talent, employers strive to provide a competitive compensation package to their employees. In today's difficult business environment, this can mean offering options and features that increase the value of the benefits to employees but not the direct costs to the employers. Retirement income options have the potential to increase the value of retirement savings to employees by providing retirement income for life at a greater level of predictability and security.

If retirement income options are structured in a way that provides tangible benefits to employees – they emphasize simplicity, portability, and ease of understanding– and regulations are adopted that encourage employers to offer the options in a way that maximizes utilization, it will result in positive outcomes for all parties involved:

1) ***Employers*** will improve the value of the benefits they are able to provide without significantly increasing their cost;
2) ***Employees*** will achieve a greater degree of retirement security; and
3) ***Government*** will be less compelled to expand entitlements for the old.

Institutional Retirement Income Council (IRIC)

As the burden of funding retirement has shifted from employer to employee, defined contribution plans, such as 401(k)s, have become the primary source of retirement savings for an increasing number of Americans. Yet DC plans were originally designed as supplemental retirement savings vehicles and were generally never intended to provide guaranteed lifetime income.

The mission of the Institutional Retirement Income Council (IRIC®) is to facilitate the culture shift of defined contribution plans from supplemental savings programs to programs that provide retirement security. By providing a forum for insightful, solutions-oriented thought leadership on institutional retirement income, IRIC is promoting the need for retirement income adequacy for defined contribution plan participants.

A membership-based organization, IRIC is supported by sponsors, and a panel of industry advisors, who are dedicated to sharing best practices, informing about legislative and regulatory issues, and facilitating solutions for plan sponsors and their participants.

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A former Principal with Mercer, Martha specialized in helping plan sponsors develop processes to improve their fiduciary oversight, manage vendor service levels and fees, and improve the overall value provided by their defined contribution retirement plans, while simultaneously managing costs. Martha's experience also includes managing defined contribution recordkeeping teams for Mercer, Watson Wyatt, and in-house for Weyerhaeuser.

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