From Saving to Income:
The Next Evolution of Defined Contribution Plans

Prudential

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Introduction

With a focus on lifetime income, employees could make confident decisions about when to leave the workforce.

The last two years have seen a surge in the adoption of financial wellness programs by employers eager to help employees improve their financial wellbeing. But many employers have yet to evolve one of their core employee benefits—their retirement savings plan—to help workers address their greatest financial wellness challenge: generating an adequate and sustainable amount of lifetime income in retirement. While retirement savings plans have undergone two significant evolutions over the last four decades, they still fall short in providing workers with lifetime retirement security. This is an important gap now that defined contribution (DC) plans generally are a primary source of participants' retirement income.

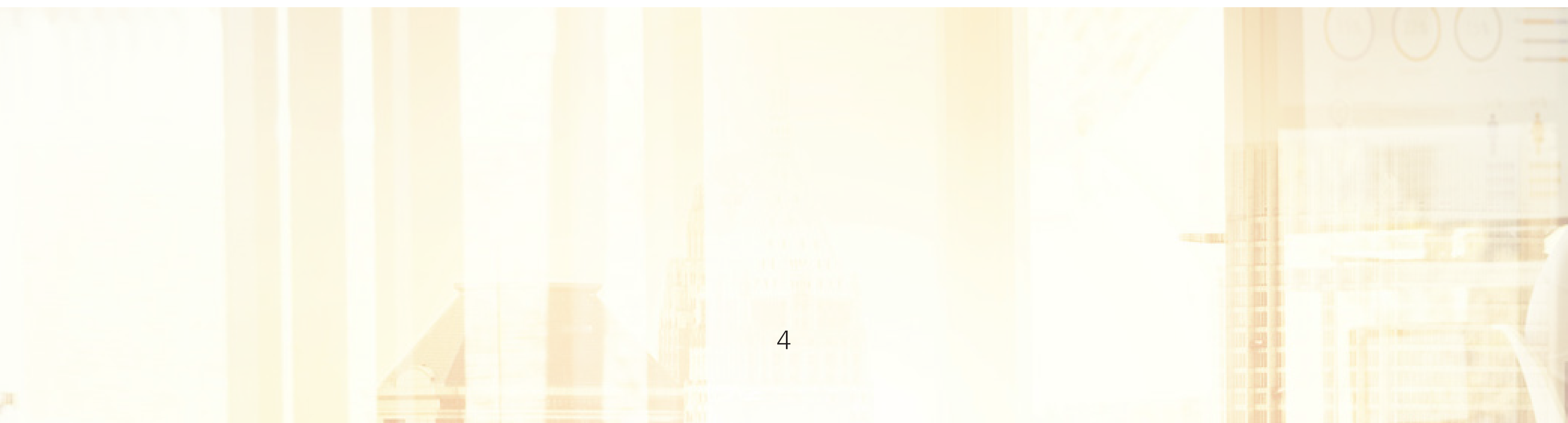
A Case for Evolution

Most retirement plans today are DC plans, such as 401(k)s, rather than the defined benefit (DB) pension plans that were more common through much of the 20th century. DC plans focus primarily on helping participants accumulate retirement savings, not on converting those savings into a steady stream of lifetime income. That's left workers vulnerable to a wide array of risks once managed by their DB plans—longevity risk, market risk, inflation risk, interest rate risk, and sequence of returns risk. Because most DC plans default retiring workers into a lump sum payout, this also leaves retirees exposed to drawdown risk. With so many variables to manage, many retirees end up spending their assets too quickly or hoarding them too conservatively.

A recent Prudential survey found that having enough savings to last through retirement is the financial goal Americans worry about most, with three out of four deeming it important[1].

Workers are understandably worried. To be sure, generating retirement income from a pool of 401(k) savings as long as it will be needed—without knowing how long that will be—is no easy trick. Nobel laureate William Sharpe calls it the "nastiest, hardest problem in retirement.[2]"

For all these reasons, it is critical that plan sponsors begin to evolve their DC plans once again, this time to focus not just on retirement saving but also on retirement outcomes. By embracing new technologies, customization opportunities, and risk-mitigation solutions, DC plans have the potential to help workers meet their retirement income challenges. They also have the potential to help employers, both by mitigating the costs associated with older workers staying on the job because they can't afford to retire, and by giving retirees an incentive to stay in their workplace plans. Their continued participation can boost a plan's size, giving it greater leverage in negotiating fees and services with providers. Further, a focus on retirement outcomes can help reduce employee stress, as worry and uncertainty about retirement preparedness can be reduced.



Policymakers in Washington have already indicated their support for a third evolution in DC plans with the overwhelming approval of the SECURE Act, which was passed by Congress and signed into law by President Trump in December 2019. Among other things, the act mandates that DC plans provide plan participants with individualized projections of how much retirement income their DC account balances will generate in the future. It also encourages plan sponsors to adopt and offer additional risk management products that can reduce participants' exposure to longevity and market risk.

Absent further evolution of DC plans, retirees will be left to cope with the hardest problem in retirement on their own. Many won't save enough, and many will stay on the job simply because they don't know whether they can afford to retire.

It won't just be employees who suffer, either. For employers, the costs could be monumental. A 2017 Prudential study estimated that carrying workers who can't afford to retire costs employers approximately $50,000 per person per year.[3] This wasn't as much of a problem in the past, when DB plans functioned in part as workforce management tools. With the certainty of guaranteed lifetime income, employees could make confident decisions about when to leave the workforce. DB plans also allowed for early retirement subsidies that encouraged veteran employees to stop working around traditional retirement ages or earlier. All these features kept the employee pipeline flowing, and allowed talented younger workers to move up in their careers at regular intervals.

The potential economic impact on retirement "insecurity" if DC plans don't evolve is not lost on policymakers in Washington. While consumer spending continues to drive the economy, the U.S. population is aging; by 2030, one in five U.S. citizens will be of retirement age.[4] If many of these older Americans lack sufficient income to fuel spending, the economy will suffer.

A Look Back at DC Plans: Versions 1.0 and 2.0

1980 The first 401(k) plan debuted in 1980. Initially, these tax-preferred savings vehicles were viewed as supplements to the DB plans many workers had access to at midsize and large firms. But over the course of the next two decades, private sector employers widely replaced their DB plans with 401(k)s, making them the main retirement plan for most of their employees. The first generation of 401(k) plans relied on employees to voluntarily enroll in them, determine the amount they would like to save, and choose their own investments, usually from an extensive menu of choices.

1990 While the bull market in equities during the 1990s helped drive modest participation in DC plans, many workers either did not enroll in their plans or saved very small percentages of their salaries, often using investment strategies inappropriate for their circumstances.

2000 In the early 2000s, behavioral economists began to look for ways to encourage greater DC plan participation and savings rates. Over time, their groundbreaking research found that defaulting workers into better decisions about participating in, contributing to, and investing in DC plans could significantly improve expected outcomes.[5]

2006 The Pension Protection Act of 2006 encouraged adoption of these defaults through various fiduciary and tax incentives.[6] The result was version 2.0 of DC plans, in which plans increasingly were enhanced with features such as automatic enrollment, automatic escalation of contributions, default investment options, streamlined investment menus, institutional investments, and professionally managed investment products like target-date funds.

2018 Today all of these features, including defaults into qualified default investment alternatives (QDIAs) such as target-date funds, are now widely embraced. Version 2.0 was a success in terms of helping participants accumulate assets, with the average 401(k) balance increasing to $103,700 in 2018 from $46,300 in 2009.[7]

2020 SECURE Act legislation goes into effect, which encourages plan sponsors to better help workers think about generating lifetime income with their retirement savings.

Employees Still Face Challenges

The shifting of these risks from employer to employee now that private employers have largely abandoned DB plans in favor of DC plans is at the heart of the challenge facing today's workers.

The goals of DC plan version 2.0 are largely to get workers to save adequately in their plans and invest their contributions appropriately for the long term. Plan design, including the types of investments offered, the tools made available to participants, and the communications aimed at promoting the plans, all point toward these objectives.

Under this approach, the default savings rates and investment options incorporated into most DC plans treat all workers of the same age the same way. But that's a problem. Especially as participants approach and enter their retirement years, their individual circumstances can vary greatly from one person to the next. Older plan participants have varying needs and goals, as well as levels of Social Security, DB income, and savings, both within and outside their DC plans. Their tolerance for risk also can vary, not only in terms of the investments they make, but also in how willing they are to risk having their retirement income run out. The shifting of these risks from employer to employee now that private employers have largely abandoned DB plans in favor of DC plans is at the heart of the challenge facing today's workers.

For a large percentage of workers, receiving a lump-sum distribution from their retirement savings plan when they stop working also is problematic. Many have low levels of financial literacy, a problem particularly common among vulnerable subgroups of the population, such as those with lower incomes, those with less education, and those who are divorced.[8] The bottom line is that the current model of defaulting individuals with little financial literacy into a lump sum distribution and expecting them to manage many different risks is simply not going to create good outcomes. Add in the chance of cognitive decline for many people at some point in retirement, and the picture becomes even bleaker.

How Version 3.0 of DC Plans Is Likely to Evolve

Version 2.0 of DC plans demonstrated that incorporating defaults into plans, such as automatic enrollment and default investment options, is effective in getting workers to save and invest. With DC plan version 3.0, plan sponsors will evolve their plans to have participants focus on a retirement outcome, namely helping participants reach their individual retirement income goal. Accordingly, plan sponsors will add personalization to their plan design toolkit. Using what have now become widely available technologies, plan recordkeepers can provide more customizable advice and investment solutions for participants as they approach and enter into retirement. These solutions may be offered in-plan or out-of-plan, and could include both guaranteed and non-guaranteed sources of income. Professionally managed solutions will become even more critical as the DC plan experience becomes more personalized.

Plan sponsors may find it helpful to approach this newest evolution of plan design by thinking about the retirement journey in four phases: accumulation, preparation, early retirement, and late retirement.

Phase 1: *Accumulation*

The accumulation phase, which covers the typical worker's early and mid-career years, has been the focus of DC plans through the first two generations of plans. With DC plan version 2.0, target-date funds became the most common investment products offered to plan participants, and they still have an important role to play, especially for younger workers just starting their retirement journey when the most important thing is saving while individual circumstances likely wouldn't require different investment strategies. Automatic enrollment and automatic escalation will play an increasingly important role to ensure adequate savings as the maximum contribution cap for defaulting participants has been increased under the SECURE Act.

Phase 2: *Preparation*

The preparation phase begins around the time participants reach the age of 45 or 50. In this pre-retirement stage of life, protecting assets from a significant market downturn becomes increasingly important, and participants can benefit from investment portfolios customized to their individual needs, goals, and tolerance for risk using technology. Beyond accumulating assets, the conversation must now turn to projecting future retirement income, helping participants identify their retirement income needs, and educating them on what they can expect after they retire. Taking a page from DB plans, DC plans can help individuals manage their risk in this and future phases of the retirement journey by introducing liability-driven investing strategies and annuity products that can guarantee lifetime income.

Given the proper tools, individuals in the preparation phase can start to calculate with some rigor how much income will likely be available to them from guaranteed sources like Social Security, annuities, and any DB plans, as well as fixed income investments—and then compare how this matches up with their needs and wants. A well-designed DC plan with helpful tools and calculators also can help individuals decide how and when to claim Social Security benefits, which will play an increasingly important role in providing lifetime income now that a relatively small percentage of the population can look forward to receiving a pension.

Phase 3: *Early Retirement*

Once DC plan participants leave the workforce, they enter the early retirement phase of their retirement journey, which lasts from the initial moment of retirement until age 85. In this phase, retirees are spending down their assets and need to manage market risk as well as interest rate and inflation risk. Annuities and other guaranteed income products can be useful at this time. Where these sorts of products are offered in-plan, they should be structured to be "rollover-ready" and available as an IRA option should a participant wish to exit the plan and take the products with them.

Phase 4: *Late Retirement*

At age 85, retirees enter the late retirement phase, which lasts for an unknown period and largely deals with longevity risk and bequest considerations. Providing plan participants with access to longevity risk protection, whether that income starts early in retirement or at an advanced age, can make retirees more comfortable with spending their hard-earned savings in the early, active years of their retirement.

While the DC industry has successfully addressed the accumulation phase of the retirement journey, it needs to more effectively address the other three. Doing so may encourage participants to stay in their plans even after they stop working, where they may benefit from continued access to institutionally priced investments and related products, professional investment management, and the fiduciary oversight of a plan sponsor. Fortunately, many employers are now open to keeping retirees in their DC plans, recognizing that it can increase their plan's size and provide it with more negotiating power with service providers.

Conclusion

The second generation of DC plans improved upon the first. Aided by a decade-long bull market in equities, DC plan version 2.0 proved effective in helping workers save for retirement, with default plan features playing a key role in improving outcomes. Now it is time for plan sponsors to take their DC plans to the next level, and the enactment of the SECURE Act encourages plan sponsors to do so. DC plan version 3.0 will do more to help bring true financial security to workers in retirement, benefiting not only them and their families, but also their employers and the U.S. economy.

Steps Plan Sponsors Can Take to Evolve Their DC Plans to Version 3.0.

- Set retirement readiness objectives and measure results.
- Allow for systematic withdrawals from plans in addition to lump-sum withdrawals.
- Offer default-driven and professionally managed retirement solutions aimed at both pre- and post-retirement needs.
- Communicate account balances to participants in terms of the projected retirement income they will generate.
- Offer tools and advice on how to meet retirement readiness goals and spend down assets in retirement.
- Ensure target-date glidepaths are designed with retirement readiness objectives
- Leverage the power of technology to provide more tailored advice and investment solutions.
- Utilize an institutional investment philosophy that incorporates asset-liability management, active and passive investment options, and alternative asset classes.
- Offer non-guaranteed investment options designed to hedge retirement spending and duration risk.
- Offer guaranteed income products that can be used to hedge unique risks, particularly longevity.

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[1] Prudential Financial Wellness Census, 2018.

[2] Barron's, "Nobel Prize-Winning Economist on How to Solve the Nastiest, Hardest Problem in Retirement," November 15, 2019.

[3] Prudential, "Why Employers Should Care About the Cost of Delayed Retirements," April 2017.

[4] Business Insider, "The Aging Population in the U.S. is Causing Problems for our Healthcare Costs," July 18, 2019, https://www.businessinsider.com/aging-population-healthcare.

[5] James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "For Better or For Worse: Default Effects and 401(k) Savings Behavior," 2001 and Richard Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," 2004.

[6] Barbara Butrica and Keenan Dworak-Fisher, and Pamela Perun, "Pension Plan Structures Before and After the Pension Protection Act of 2006," p. 13, September 2015.

[7] Fidelity (from deck)

[8] Jill Fish, Annamaria Lusardi, and Andrea Hasler, "Defined Contribution Plans and the Challenge of Financial Literacy," University of Pennsylvania Law School, Institute for Law and Economics, p. 17.

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