Refreshing Your Defined Contribution Plan: How to Make the Most of the Latest in Plan Features and Technology

Lori Lucas
Defined Contribution Practice Leader
Callan Associates
Chicago, Illinois

What Type of DC Plan?

- Auto enrollment
- Retirement income adequacy calculators/statements
- Plan Goal
- Cashout interventions
- DB-ized/Paternalistic
- Contribution escalation
- Collective trusts
- Advice
- Separate accounts
- Low Effort/Communication
- Target date funds
- Auto Rebalancing
- High Effort/Communication
- Streamlined fund lineup
- Retail mutual funds
- Extensive fund lineup
- Retail/Accumulation
- Target date funds
- Self-directed brokerage account
- Multiple loans
- Base level termination support
- Roth 401(k)
- Voluntary enrollment
- Separate accounts
- Streamlined fund lineup
How Do DC Plan Sponsors Measure Success?

<table>
<thead>
<tr>
<th>Importance of Plan Success Measures</th>
<th>5 = Very Important</th>
<th>4</th>
<th>3</th>
<th>2</th>
<th>1 = Least important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adequate performance of investments</td>
<td>71%</td>
<td>25%</td>
<td>4%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Facilitates adequate retirement income security</td>
<td>80%</td>
<td>34%</td>
<td>14%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Valued and appreciated by employees</td>
<td>47%</td>
<td>42%</td>
<td>10%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost effective</td>
<td>46%</td>
<td>39%</td>
<td>12%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>High participation rate</td>
<td>42%</td>
<td>38%</td>
<td>18%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Attracts retains employees</td>
<td>40%</td>
<td>37%</td>
<td>20%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Easy accessibility of plan and information</td>
<td>24%</td>
<td>47%</td>
<td>18%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>High salvage rate</td>
<td>27%</td>
<td>46%</td>
<td>24%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: AonHewitt’s 2011 Trends and Experience in DC Plans

What Type of DC Plan: Social Versus Market Norms

- **Social Norms**
  - Having family over for Thanksgiving dinner.
  - Moving a couch.
  - Helping to change a flat tire.

- **Market Norms**
  - Wages
  - Prices
  - Rents
**Circle/Square Experiment**

How many circles can be dragged over the squares in five minutes?

Source: Dan Ariely, Alfred P. Sloan Professor of Behavioral Economics at MIT

---

**Outcomes**

- Group 1 → Paid $5
- Group 2 → Paid 50 cents
- Group 3 → No money, favor
- Group 4 → Small Snickers bar
- Group 5 → Box of Godiva chocolates

Source: Dan Ariely, Alfred P. Sloan Professor of Behavioral Economics at MIT
Outcomes

- Group 1 → Paid $5 → 159 circles
- Group 2 → Paid 50 cents → 101 circles
- Group 3 → No money, favor → 168 circles
- Group 4 → Small Snickers bar → 162 circles
- Group 5 → Box of Godiva chocolates → 169 circles

Source: Dan Ariely, Alfred P. Sloan Professor of Behavioral Economics at MIT

Social Norms and Corporations

If corporations started thinking in terms of social norms, they would realize that these norms build loyalty—more important—make people want to extend themselves to the degree that corporations need today: to be flexible, concerned, and willing to pitch in.

Source: Dan Ariely, Alfred P. Sloan Professor of Behavioral Economics at MIT
## Do Employers (Plan Fiduciaries) Have a Responsibility to Help Employees Achieve Retirement Security?

### One Plan Sponsor’s View

### Traditional View: No

- **Why:** ERISA fiduciary duties are focused on process.
- **Best way to minimize risk/liability is to make yourself a small target.**
- **Place all the responsibility (for accumulation and “decumulation”) on the plan participants.**
- **Key questions/benchmarks:**
  - Are plan benefits competitive with our peer group?
  - Am I complying with statutory safe harbors: 404(c), QDIA, etc.?
  - Are NHCEs contributing enough to avoid ADP/ACP testing issues?
  - How do I avoid undue fiduciary exposure (i.e., walking the line between “education” and “advice”)?

### Alternative View: Yes

- **Why:** Outcomes matter.
- **Companies/fiduciaries should create a model that maximizes the probability of good outcomes (retirement security).**
- **Focus is on lifetime accumulation and “decumulation.”**
- **Key questions/benchmarks:**
  - Is my plan design/operation delivering outcomes that lead to meaningful retirement benefits for my employees?
  - Does the plan design minimize any risks (investment, accumulation, inflation, etc.) for less sophisticated participants?
  - How prepared are my employees for retirement?
  - What steps can help employees save more, and use those dollars more effectively in retirement?

---

## Strategic Implementation of Automatic Enrollment

### Traditional View

- **Make defaults conservative so as to minimize opt-outs.**
- **Limit default contribution rate to a level at or below the company match threshold.**
- **Expect participants to increase salary deferral rate to desired level on their own.**

### Alternative View

- **Participants do not opt out of automatic enrollment even when defaults are aggressive.**
  - Opt out rates the same if 3% or 6% deferral default.
- **Participants do not move quickly away from defaults.**
  - Many can stick with defaults as long as 3-4 years.
  - Defaults should take into account long-term impact on retirement income replacement.
Strategic Implementation of Automatic Contribution Escalation

Traditional View
- Implement only as part of safe harbor or as opt-in.
- Limit deferral increases to 1% of pay per year.
- Stop increases at 6% of pay.

Alternative View
- Contribution escalation should be tied to automatic enrollment.
- 10% shouldn’t be the de facto upper limit on rate increases.
  - In a Hewitt study, the most common upper limit selected for automatic contribution escalation was 15 percent.
- Both should be designed based on retirement income adequacy goals.

Auto Features

Source: 2011 Callan DC Trends Survey.
Auto Feature Prevalence

- 66% of plans use a 3% or lower default contribution rate for auto enrollment.
- The average rate of annual contribution escalation increase is 1%.
- 45% of those offering automatic enrollment now combine contribution escalation with automatic enrollment.
- Regarding target-rates, half of these plans default to only 6% of pay; 34% default up to 10% of pay, while 12% default to 11% of pay or higher.

Sources: 2011 Callan DC Trends Survey; AonHewitt's 2011 Trends and Experience in DC Plans

Impact on Retirement Income Adequacy

- EBRI and DCIIA examined the impact of how auto features are implemented on the retirement income adequacy of workers using EBRI’s simulation model.
- The analysis defined a “successful outcome” as one in which a pre-retirement 401(k) balance, combined with the worker-specific benefits projected under Social Security, was projected to provide a total real replacement rate of at least 80%.
- The analysis was limited to younger employees (with 31-40 years of 401(k) eligibility) and provided separate results for employees in the highest- and lowest-income quartiles.
- In its analysis, EBRI and DCIIA compared the typical conservative implementation of auto features with a more robust implementation.
Conservative versus Robust Auto Features

Conservative Implementation:
- Capping automatic contribution escalation at 6% of compensation.
- Implementing 1% annual increases in contributions.
- Assuming participants opt out of contribution escalation at rates similar to past experience.
- Defaulting participants at current, generally low initial automatic enrollment contribution rates.
- No effort to encourage employees to make contributions at a level comparable to their participation in a prior employer’s 401(k) plan.

Robust Implementation:
- Capping automatic contribution escalation at 15% of compensation.
- Implementing a 2% annual increase in contributions.
- Successfully preventing participants from opting out of automatic contribution escalation.
- Where applicable, successfully encouraging employees to make contributions at a level comparable to their participation in a prior employer’s 401(k) plan.
Impact on Retirement Income Adequacy

In its baseline analysis of plan implementations of automatic enrollment and automatic contribution escalation, the EBRI/DCIIA analysis found that fewer than 45% of lower income workers could expect to successfully replace 4/5ths of their income in retirement given their plans’ current, generally conservative implementation of automatic enrollment—along with assumed low increase levels and caps on auto escalation.

However, when plans were assumed to implement automatic features more robustly—for example, with contributions escalating by 2% instead of 1% of pay annually and with contribution escalation capped at 15% of compensation instead of 6%—the probability of lower-wage workers replacing at least 80% of income in retirement soared 33.5 percentage points to 79.2%.
Strategic Use of Institutional Structures

Traditional View

- Mutual funds are worth the higher fees.
- Participants don’t like non-40 Act funds.
- Institutional structures aren’t worth the extra effort.

Alternative View

- High fees chip away at retirement security and must be managed.
- Institutional structures can make fees payment more equitable.
- Participant expectations can be a communication challenge—but not necessarily a reason to avoid institutional structures.

Investment Menu

Source: 2011 Callan DC Trends Survey
Impact of Fees on Retirement Income Adequacy

- AonHewitt projected the impact on retirement income replacement of various fee structures.
- **Scenario 1**: The plan contains privately managed commingled funds with average weighted expenses of 0.58%.
- **Scenario 2**: The plan contains institutionally priced mutual funds across a broad range of asset classes with average weighted expenses of 1.02%.
- **Scenario 3**: The plan contains retail mutual funds outside of the 401(k) plan (e.g., rollover IRA accounts held through a broker or direct mutual fund investments) with average weighted expenses of 1.53%.

Fees and Retirement Security

Source: Hewitt Associates’ 2005 Total Retirement at Large Companies: The Real Deal
Fees Matter!

The AonHewitt study finds that:

- Over a career, projected income generated by the DC plan is reduced by nearly ten percentage points if the plans offer actively managed institutionally-priced mutual funds instead of actively-managed commingled funds.
- The difference is 88.7% in the institutionally priced scenario versus 98.1% replacement income generated in the privately-managed fund scenario.

Plan Leakage and Retirement Security

**Traditional View**

- The plan sponsor’s job is to get people in the DC plan and help them accumulate money within the plan.
- The relationship between employer and employees in DC plans ends at termination or retirement.

**Alternative View**

- When cash is removed from the retirement program through loans, withdrawals, cashouts, it can undermine the retirement income adequacy goals of the plan.
- Plan sponsors can find ways to actively encourage participants to keep money within the retirement system.
Retiree/Terminated Policies

The rationale for seeking asset retention is to maintain economies of scale that can benefit both active and terminated DC participants, while a common rationale for not seeking asset retention ranges from cost to perceived additional potential for litigation.

Source: 2011 Callan DC Trends Survey

Impact on Retirement Income Adequacy

- EBRI leveraged its auto features research to further determine the impact of leakage on the retirement income adequacy of workers using its simulation model.
- Leakage was defined as loans, hardship withdrawals, and cashouts.
- The analysis shown here focuses on the lowest wage quartile of workers.
Impact of Plan Leakage on Retirement Income Adequacy

**Probability of Replacing at Least 80% of Income in Retirement with Various Leakage Assumptions (Low Earners—Robust Auto Features Assumptions)**

- Without Cashouts: 82.9%
- With Cashouts: 67.4%

Source: EBRI.

---

Impact of Plan Leakage on Retirement Income Adequacy

**Probability of Replacing at Least 80% of Income in Retirement with Various Leakage Assumptions (Low Earners—Robust Auto Features Assumptions)**

- Without Cashouts: 82.8%
- With Cashouts: 67.4%
- Difference Between Cases: -15.4%

Source: EBRI.
Leakage Matters!

- When EBRI combined the projected impact of cashouts, delays in participation by job changers, and hardship withdrawals, results show that the projected probability of success under this worst case leakage scenario drops by more than 14 percentage points.
- This outcome amounts to a significant potential derailment of retirement income replacement.

Target Date Funds and Retirement Security

**Traditional View**
- Target date fund selection similar to selection of core funds.
- Often, target date fund of recordkeeper used.
- Little attention paid to glidepath.

**Alternative View**
- Target date fund glidepaths vary widely, and are a key source of performance variation.
- Target date fund selection can drive retirement income adequacy—and will increasingly do so as a Qualified Default Investment Alternative.
- Retirement income adequacy analysis should be used in target date fund selection.
QDIA—A Consensus?

Source: 2011 Callan DC Trends Survey

Target Date Funds

Source: 2011 Callan DC Trends Survey
The Bottom Line: Retirement Income Adequacy Measures Facilitate an Outcomes Based Approach

- Critical to evaluation of investments such as target date funds.
- Has implications in designing features of 401(k) plans—such as automatic enrollment and contribution escalation.
- Can facilitate better communication of the plan.

Variations in Target Date Fund Glidepaths

Source: 2011 Callan Target Date Funds Survey
### Sample Use of Retirement Income Adequacy Analysis

#### Range of Industry Solutions vs. Various Metrics

<table>
<thead>
<tr>
<th>Expected Replacement Ratio</th>
<th>Probability RR &gt;=65%</th>
<th>Probability Assets Last &gt;=95%</th>
<th>Worst % $ Decline at 65</th>
</tr>
</thead>
<tbody>
<tr>
<td>80%</td>
<td>9%</td>
<td>8%</td>
<td>7%</td>
</tr>
<tr>
<td>75%</td>
<td>8%</td>
<td>7%</td>
<td>6%</td>
</tr>
<tr>
<td>70%</td>
<td>7%</td>
<td>6%</td>
<td>5%</td>
</tr>
<tr>
<td>65%</td>
<td>6%</td>
<td>5%</td>
<td>4%</td>
</tr>
<tr>
<td>60%</td>
<td>5%</td>
<td>4%</td>
<td>3%</td>
</tr>
<tr>
<td>55%</td>
<td>4%</td>
<td>3%</td>
<td>2%</td>
</tr>
<tr>
<td>50%</td>
<td>3%</td>
<td>2%</td>
<td>1%</td>
</tr>
<tr>
<td>45%</td>
<td>2%</td>
<td>1%</td>
<td></td>
</tr>
<tr>
<td>40%</td>
<td>1%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>35%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Industry glidepaths differ significantly across all the forward-looking risk/return metrics.

---

### Strategic Approach to Foolproofing DC Plans

#### Traditional View
- Certain risks are benign, such as securities lending.
- Worry about today’s problems today and tomorrow’s problems tomorrow.

#### Alternative View
- Securities lending may not be worth the risk in DC.
- Nothing is benign—even principal preservation funds.
Will Structural Changes Eliminate Stable Value’s Advantage over Money Markets?

Historic Stable Value Premium 1.5%

Impact on Stable Value Premium:
- Higher Wrap Costs 10 to 15 bps
- Shorter Durations 10 to 30 bps
- Higher Treasury Allocations 10 to 40 bps
- Ownership of Collateral
- Deterioration of Wrap coverage

Other Considerations:
- Increases in lengths of put options
- Widening of definition of “competing options”
- Less willingness to assume risk

Strategic Investment Menu Nudges

Traditional View
- The investment menu should be complete and offer good diversification opportunities.
- Communication can guide participants through the investment menu.

Alternative View
- Participants can derive unintended signals from the investment menu.
- Care should be given to everything from number of funds to how funds are weighted according to asset class.
- Communication and advice should be used to offset unintended signals.
Advice Environment

Do you offer investment guidance or advice today?^a

- Online advice (e.g., Financial Engines, Morningstar) 52.8%
- On-site seminars 38.9%
- None 29.2%
- One-on-one advisory services 19.4%
- Managed accounts 6.8%
- Full financial planning (e.g., Ayco, EY) 6.8%
- Other

68.1% of plan sponsors offer some sort of investment advice or guidance

^a Multiple responses were allowed.

Source: Callan 2011 DC Trends Survey

Advice Environment

Are you satisfied with participant utilization of investment guidance or advice?

- Very Satisfied
- Somewhat Satisfied
- Somewhat Dissatisfied
- Very Dissatisfied

^a Multiple responses were allowed.

Source: Callan 2011 DC Trends Survey
Reasons for Not Offering Advice

Source: Callan 2011 DC Trends Survey

Addressing the Needs of a Diverse Participant Base

Traditional View
- The plan must be one size fits all—often geared for the middle of the road participant.
- Trying to do too much will confuse people.
- Common concerns:
  - Designated Roth 401(k) Accounts are confusing and difficult to explain to participants.
  - No one will understand automatic rebalancing—it’s confusing.
  - Self-directed brokerage accounts will result in participants doing crazy things with their retirement money.

Alternative View
- Participants come in many shapes and sizes.
- The plan can be geared to meet the needs of everyone from do-it-yourselfers to do-it-for-mes.
- Common realities:
  - The pretax/after-tax message can be greatly simplified.
  - Auto rebalancing isn’t for the rank and file—it is for the do-it-yourselfers.
  - Self-directed brokerage accounts are commonly used by the highest salary and highest balance workers, not the average participant.
Roth Contributions

Of those not offering Roth, 9% will offer Roth next year; 25% are considering it.

Source: Callan 2011 DC Trends Survey

Automatic Rebalancing Prevalence

Source: AonHewitt's 2011 Trends and Experience in DC Plans
Conclusions

- There are numerous factors that drive plan sponsors to retail approach: cost, concerns about participant objections, fiduciary considerations, inertia.
- Many times these factors are either over-blown or can be countered.
  - Example 1: There is no evidence that opt outs of automatic enrollment increase with default levels as high as 6% of pay.
  - Example 2: Matching features can be redesigned to neutralize added cost of implementing features such as automatic contribution escalation.
  - Example 3: Participants rarely look up their plan funds’ performance in the newspaper using ticker symbols.
- Decision-making in the framework of retirement income adequacy and an outcomes based approach can help plan sponsors gear their DC plans for the future.
- The plan doesn’t have to be one-size-fits-all. It can accommodate many investor types.