The Evolution of Defined Contribution Plans

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As has been well documented, defined contribution plans increasingly serve as the primary retirement savings vehicle for most Americans. Evidence clearly shows that assets in defined contributions plans are growing quickly, while the number of ongoing defined benefit plans continues to shrink.

It appears likely that the share of assets in defined contribution plans will continue its rapid growth in coming years. Companies are responding to mounting pension costs and tougher accounting rules by closing their defined benefit plans. In addition, public plan sponsors are struggling with the structure of their current defined benefit plan model.

With the critical role that defined contributions plans will play in meeting basic income needs for all employees in coming years, it would be reassuring to know that the current model is prepared to provide a comfortable retirement for these employees. Unfortunately, we know this is not the case. While improvements are occurring within the defined contribution field, we know well that numerous flaws exist within the system.

As many Americans have moved into their retirement years, it has become apparent that the most significant flaw within the system is that in many cases leaving the decision making process in the hands of employees has not adequately funded a dignified retirement.

The biggest challenge of the current system is its underlying assumption that every participant in America is going to figure out his or her own several crucial factors: the amount of income he or she will need during retirement; the size of the defined contribution plan account at retirement which will create this amount of income; the level of contributions needed over their working years to create this size account over time; and, finally, how to invest the assets in their account in order to maximize the return and minimize the risk appropriate for their personal circumstances. These factors are easily more complex than those faced by a defined benefit plan sponsor.

As well-intentioned as it might be, one of the cornerstones of the defined contribution concept--providing employees with choice and flexibility--is setting employees up to fail.

“DBizing” DC plans

As recent industry legislative and product changes reflect, one of the methods used to offset these flaws is the idea of applying the best of defined benefit plan practices to defined contribution plans, or what is being called “DBizing” DC plans. This process is one way that

defined contribution plans are embracing a more methodical and institutional approach to improving retirement outcomes for all plan participants. There are several strategies which defined contribution plan sponsors and providers have leveraged from defined benefit plan plans in order to assist plan participants.

Automatic Enrollment

The reasons for failing to contribute to an employer sponsored define contribution plan are numerous: “The financial commitment is just too big”, “A retirement account is not a priority”, “I don’t understand how it works” and “I forget about it” are just a few of the excuses. Ultimately, most of these excuses relate to inertia and our tendency as humans not to create change.

However, the evidence is clear that it is effective to opt employees into plans with the option to opt out. Many studies have shown that defined contribution plans which have automatic enrollment (where employees are automatically enrolled into the plan upon eligibility, thereby ensuring immediate savings) have higher participation and savings rates. Clearly, plans should allow workers opt out if they don’t wish to participate. Further evidence shows that higher initial default rates, such as starting employee contributions at 5% or 6% of salary, do not have a significant impact on the opt-out rate.

Automatic Deferral Escalation

Related to employees failing to contribute to employer sponsored define contribution plan is the issue that many employees may get into the plan, but fail to do so at high enough a level of contributions to accumulate sufficient assets for retirement.

To offset this issue, many plans which utilize automatic enrollment and require employees to opt out of their plan now also require automatic deferral escalation. This design feature automatically increases employees’ contribution rates 1% to 2% annually. These yearly increases continue until reaching the final rate determined by the plan sponsor, typically from 10% to 15% of salary, which is the contribution level commonly recommended for retirement security.

Improved Investment Results

While participant self-direction of investments is a common and distinct feature of defined contribution plans, time has shown it has not worked as well as initially envisioned. Employees frequently fail to diversify their investments or rebalance their portfolios over time. Given the prevalence of defined contribution plans, the demonstrated inability or unwillingness of many workers to make sound investment choices is a significant concern. Better investment

performance could increase plan account balances and reduce the risk level of participants' accounts.

The retirement industry has focused on providing pre-diversified, professionally managed, multi-asset class products, such as target date funds or target risk funds as the default investment for plan participants. Whether formally specified as the Qualified Default Investment Alternative (QDIA) or simply available for employee investment, the belief is that these products can lead to enhanced results by leaving investment decisions, such as asset allocation and rebalancing, in the hands of professional investment managers.

In an uncertain market and economic environment, defined contribution plan participants need a more robust framework with which to invest for their future. Fortunately, much of that framework already exists within the world of defined benefit plans, including using alternative investments and a more institutional approach. For plan sponsors, the challenge is how to overcome technical barriers and internal roadblocks to bring the institutional defined benefit approach to their defined contribution plan participants. Sponsors need to ensure that the participant population is insulated from making the decision about these products, but exposing them to what may asset classes which can be non-correlated to traditional asset classes and additive to portfolios.

Despite a relatively short history, studies show that "DBizing" DC plans, using these features is having a positive impact on workers' retirement savings.

What's Missing?

When discussing the main differences between defined benefit and defined contribution plans, the shift of risk from the employer to the employee should be a key portion of the comparison.

Employers view defined contributions plans as a way of reducing their exposure to certain risks in defined benefit plans. With a defined benefit plan, the employer takes on the risk that assets may not produce sufficient investment returns to support the promised level of retirement benefits over the lifetime of their employees. With a defined benefit plan, the employer bears both market risk, should the plan investments fail to meet their required rate of return, as well as the longevity risk, should their pool of retirees outlive the actuarial assumptions for the plan.

Within defined contributions plans, both the market risk and longevity risk is transferred to the employee. Employees bear a significant burden over the risk of living longer than expected and running out of assets. In addition, it is difficult for participants to recover from losses in bad markets, such as 2001 and 2008. Until we find a way to immunize employees from these risks, we are not truly "DBizing" DC plans.

While the retirement industry is taking steps to address these risks, evolution has been slow. Hard questions remain as to who best understands these risks, whether they can or even should assume these risks, and at what cost. Defined contribution plans have the capability to provide advantages to employers, employees and even our broad economy if their effectiveness can be increased. Helping employees deal with market and longevity risk would be a big step forward in improving the effectiveness of participant outcomes.