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Perspectives from Anna: Getting Better Results in a DC plan

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Defined contribution (DC) plans are increasingly becoming the predominant form of employer supported retirement arrangements in the United States. At the same time, there is extensive documentation from the Society of Actuaries and many other sources of continuing financial literacy problems and gaps in planning. Some of the financial and retirement literacy problems are very basic and some are specific to retirement. While some Americans have large balances in their 401(k) accounts and IRAs, there are many others whose balances are very modest as they reach retirement ages. Such balances will not even come close to replacing most of their income in retirement. In addition, most individuals have difficulty translating their lump sum into a lifetime retirement income.

This emerging environment leaves plan sponsors with questions about what they should do with their DC plans and about what success means for them when they consider their support for their employees' retirement. While the idea of a DC plan is quite simple, the plans themselves can be quite complex. There are a number of design options, legal issues and administrative complexities involved in establishing plans and the default options that go with them. For actuaries who are working with retirement security and whose training and background was more focused on pensions and the financing of defined benefit (DB) plans, the mosaic of DC issues to think about has radically expanded. Some of these issues include:

- What decisions are best made by the plan sponsor vs. the participant?
- What support needs to be put in place to enhance participant decision making?
- What are the plan sponsor's fiduciary responsibility and litigation risks?
- What default options should be considered and implemented at the various decision points?
- How can the plan sponsor get more employees enrolled and encourage higher levels of savings?
- How can the plan sponsor help participants achieve good investment results?
- How can the plan sponsor educate participants about the risk of leakage and appropriate use of plan funds?
- How can the plan sponsor help participants understand how to best utilize assets in the post-employment period?

For pension actuaries, this means continually learning more about different areas of business practice and the underlying technical issues. As with everything else, this is an area of change.

A GOOD LEARNING OPPORTUNITY: THE 2015 DIMENSIONAL DEFINED CONTRIBUTION CONFERENCE

In July 2015, I learned more about some of the options and issues when I attended the 2015 Dimensional Defined Contribution Conference, and was very interested in several ideas that made me think. Some come from the presentations and some from the discussion with others. The conference provided thought leadership applicable to both large and small DC plans. For me, these are some of the things that feel worth thinking more about. I want to encourage others who are thinking about retirement system issues to focus on these issues.

(1) Technical requirements. There are many technical issues involved in the structuring of DC plans. It serves those of us who are focused on the retirement system to try to learn more about those issues, and the options for structuring plans.

(2) Timing of retirement. Sequence of returns risk is enormously important and can make a huge difference in retirement income adequacy. There was very interesting quantitative modeling presented by Michael Drew from Australia. He presented historical scenarios where participant wealth was greatly impacted based solely on when they retired. Put simply, when you retire can impact how much income in retirement you will have. This is a familiar idea, but looking at modeling results strongly reminded me that decision-making about strategies should take this into account.

(3) Policy impact by gender. Policy in most countries is supported by research based on predominantly male life paths. Stated this way, this is a very powerful statement. It reminds us to be sure to recognize gender issues and differences, and life paths, in considering retirement program structures. While I have long thought about gender issues, I had not focused on this link between research and policy. One set of policy issues that is particularly important to women are requirements with regard to offering payout options. Lifetime income options are more valuable to women because they live longer. Spousal consent requirements, which may be linked to payout options, affect women more than men.

(4) Enrollment process. There are a variety of ways to frame and set-up the process and decisions involved in plan enrollment as well as participant choices of savings rates. Punam Keller from Dartmouth spoke at the Dimensional conference, and she presented some very different ideas about enrollment. She focused on four types of enrollment. This is discussed more below.

(5) Matching plan strategies with plan goals. There was discussion about framing the goals for DC plans and a lot of discussion about income and the post-retirement period. There was emphasis on the difference between goals that are focused on producing a stable and adequate income during retirement vs. accumulating as much money as possible. Plan strategies are likely to be quite different for these two types of goals. Dimensional has had a lot of client interest and thus has created a new DC solution designed to reduce the income volatility of participant retirement income, regardless of how well or poorly the employee makes decisions. I was impressed at the amount of emphasis on this topic. This has been a major area of emphasis for actuaries, but there were different viewpoints presented in these discussions.

(6) Considerations for post-retirement period. The discussion about income has several components: investment strategy including post-retirement strategy, the issue of whether the money stays in the plan or goes elsewhere, and the question of whether to buy an annuity with some of the DC balance. But of course for the plan sponsor, the first question is "Should we even focus on the post-retirement period and why?"

(7) Understand the importance of and differences in Target-Date options. Target-Date funds have become very popular and they are often used for the post-retirement as well as the pre-retirement period. Many go to age 90. There are numerous variations in how they are structured. For people who want to learn more about Target-Date funds, the Investment Company Institute's question and answer document is a good place to start. Morningstar's 2014 Target-Date Research Paper offers an overview of Target-Date funds. Some of the variations reviewed included target strategies that go to retirement age vs. those that go to higher ages, use of indexed vs. actively managed component funds, and open architecture vs. use of the company's funds only. There are also funds customized for individual participants. There are often significant cost advantages for an individual to remain with an employer plan vs. rolling assets into an IRA. The difference in costs depends on both plans. My big take-away was the large variation in Target-Date funds and the importance of thinking about these variations.

(8) Stay abreast of DC litigation. There is currently important litigation affecting DC plans. This influences the strategies used by DC plan sponsors. Litigation has increased in recent years. Fees and fiduciary duties are two focuses of recent ligitation.

(9) Lifetime income illustration accuracy and responsibility. A question was raised in one of the sessions with regard to lifetime income illustrations. The question was "Who owns the risk that projections are wrong-- the employer, the plan administrator or the DOL?" Given the amount of other litigation, this is an important question. I have long supported the idea of illustrations and have my own ideas about them, but this question raises a new aspect of the issues.

FOUR TYPES OF ENROLLMENT

Before this discussion, I thought about traditional vs. auto-enrollment, but there are more options than that. The four types of enrollment are opt-in, automatic enrollment (opt-out), active enrollment and enhanced active enrollment. Opt-in is traditional enrollment which often does not get the desired participation. Active enrollment requires you to respond yes or no. Enhanced active enrollment is yes or no, but with statements attached to the yes and no. I had not really thought about active enrollment or enhanced active enrollment. Note that these concepts can be used for annual enrollments as well as one-time enrollments.

Here are examples of enhanced active enrollment from the Punam Keller presentation:

Example linked to retirement plan: "*I choose to remain in the Employer Sponsored Retirement Plan knowing that I have other options because I want to pay lower fees and enjoy more protection.*" The other choice is: "*I choose to leave the Employer Sponsored Retirement Plan, even though I know I will pay higher fees and may not be as protected.*"

Example linked to a request to increase savings percentage: "*I prefer to increase my participation because the minimum level will not cover my retirement needs.*" The other response is: "*I* *want to remain at the lowest level because I will get more money from somewhere else to cover my retirement needs.*"

Example linked to auto-increases: "*I would like to join the auto-escalation plan because I like the no-hassle automatic increases in my retirement account.*" The other response is: "*I don't want to join the auto-escalation plan even if I end up with more anxiety and hassle to manage the sporadic boosts in my retirement plan.*"

The presentation included data showing case examples where active enrollment increased participants selecting the desired action. I discussed the presentation later with other people at the conference. The first reaction was that it was fascinating. However, I also discussed it with a very senior ERISA lawyer, and he expressed great concern about the legal issues and potential for litigation from some of the statements. My impression is that while enhanced active enrollment can improve election of a desired choice, plan sponsors would need to be very careful and discuss the risks with legal counsel before they decide to use this option. In addition, they would need to work with legal counsel on the specific language of the options. While there be may be situations where it is a great idea, there are probably others where it would be too dangerous. My take-away from this discussion is to be open to new ideas and also to be careful when thinking about them.

MAKING THE SYSTEM BETTER

An entirely different set of ideas is presented in a July, 2015 viewpoint from Russell Research "The Future of Retirement: Three big ideas that could reshape the U.S. retirement system. Bob Collie presents a survey exploring three ideas:

- What if neither the benefit (DB) nor the contribution (DC) were fixed, but we made both vary according to plan experience?
- Should workers be required to participate in the retirement system?
- Should there be multiple DC plans available, allowing employers to participate in a plan without sponsoring or running it?

The survey was administered to their clients at a client conference.

The results showed a lot of interest in risk sharing ideas, and that is encouraging for those of us who think this is an important idea for the future. The survey also showed a lot of support for requiring that some money be saved for retirement. It also showed support for letting people opt-out. One of the big issues facing the retirement system is the coverage issue, with a question for the United States about what should be required beyond Social Security. My view is that for many of the people without additional coverage, mandates are the only way to get more saved for retirement.

The responses to the third question indicated interest in multiple plan options as long as fiduciary protections and the right regulatory frameworks are in place. The US Multiple Employer Plans (MEPs) can be used to cover the employees of a number of entities. At present, there is a requirement that the groups be related in some way, but there have been proposals to remove that restriction. In my view, it is important that such proposals not afford a route to pension coverage without appropriate oversight and participant protection. Prototype plans and simplified plans are already offered in the marketplace. I think the respondents to the survey, when they focused on appropriate regulatory oversight, are "right on" but that does not set forth exactly what that might mean. This is an area likely to stay in the limelight.

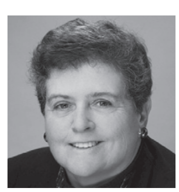
THE ROLE OF THE ACTUARIAL PROFESSION IN EXPLORING THESE ISSUES

The Society of Actuaries set up a multidisciplinary team to look at retirement system issues broadly when it set up *Retirement 20/20* about 10 years ago. The project established some principles for the future of the retirement system, but did not focus on specific issues related to the structure of DC plans, except to the extent that part of the project looked at models for the future. All of the *Retirement 20/20* solutions included consideration of the post-retirement periods, and I believe that generally the people involved in *Retirement 20/20* strongly support post-retirement solutions.

The Retirement for the AGES project sponsored by the American Academy of Actuaries builds on *Retirement 20/20* by establishing principles which represent a broad framework for the future but does not deal with specific DC trends. It does assess existing DB, DC and hybrid retirement systems and proposals.

The Society of Actuaries' Pension Section had a call for essays in 2013 on improving DC plans. The essays were published in the January 2014 issue of *Pension Section News*. There have been several Calls for Papers that included DC issues over the last decade or more, as well as a variety of meeting sessions.

A personal discovery for me was that I have a lot to learn with regard to many of the detailed DC issues and their variations. I hope that more actuaries will focus on these issues and participate in the discussions about them. ■



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