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RETHINKING DEFINED CONTRIBUTION RETIREMENT PLAN DESIGN: PLAN SPONSOR PERSPECTIVES

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EXECUTIVE SUMMARY

The risks associated with providing retirement income have shifted from employers to employees over the past several decades as the number of defined contribution (DC) plans, particularly 401(k) plans, have increased while the number of defined benefit (DB) plans has decreased. These include investment risks associated with funding retirement and longevity risks associated with converting savings to income. The 2008-09 recession along with subsequent economic turbulence has had a dramatic impact on the account balances and retirement plans of many plan participants. This has lead to growing concerns about the ability of individuals to handle this responsibility. With the leading edge of the baby boom generation now entering retirement, increasing attention is being focused on potential changes in the DC model by plans sponsors, the financial services industry, public policy officials and the research community. There is also a growing focus on financial literacy levels in the population and initiatives to increase those levels.

On June 23, 2011, Roger W. Ferguson, Jr., President and Chief Executive Officer, TIAA-CREF, and the TIAA-CREF Institute hosted a forum focused on ways to enhance DC plan design to better meet the needs of today's workforce. Forum participants included senior human resource officials responsible for plan sponsorship at colleges, universities and nonprofit hospitals. Key themes emerging from the forum included:

- With individuals shouldering more responsibility for providing their retirement income and the risks associated with that responsibility, it is vital to examine ways to improve their financial choices.
- DC plan design can play a critical role in influencing the decisions individuals make and determining ultimate retirement income outcomes.
- However, plan design with a purpose or "choice architecture" is not enough; financial education efforts must be strengthened to increase financial literacy levels.

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- Individuals need to fundamentally shift their mindset about retirement savings from emphasizing wealth accumulation to an emphasis on securing income for life.
- Individuals do not understand annuities and how they can guarantee lifetime income.
- Employers are unsure about the appropriate level of their responsibility for helping employees make effective retirement savings decisions. Many are embracing automatic enrollment and weighing other more proactive approaches such as automatic escalation of contributions and holistic financial counseling.
- While plan sponsors in higher education have generally considered a contribution rate of 15% of salary (employer and employee combined) to be an appropriate target, that may need to increase in light of soaring healthcare costs.
- Financial counseling for employees must move beyond simple asset allocation choices and focus on the employee's complete financial health, from retirement savings to debt management to saving for their children's education and beyond.
- Financial education efforts should begin in school, so individuals learn and practice responsible financial habits before they enter the workforce.
- The sole recordkeeping model for DC plan administration can enable employers to meet their fiduciary, regulatory and compliance needs, while also providing a more effective, unified experience for employees.

INTRODUCTION

On June 23, 2011, Roger W. Ferguson, Jr., President and Chief Executive Officer, TIAA-CREF, and the TIAA-CREF Institute hosted a forum focused on ways to enhance defined contribution (DC) plan design to better secure the financial future of today's workforce. Forum participants included senior human resource officials responsible for plan sponsorship at colleges, universities and nonprofit hospitals (see Appendix for a list of forum participants). Discussion focused on creative approaches to optimizing plan features and choices, product design and participant services.

This was the second forum hosted by the TIAA-CREF Institute on the issue. On December 3, 2010, experts in behavioral economics, actuarial science, decision making, and financial education and advice gathered to examine creative uses and combinations of plan features, product designs and participant services to address the retirement income needs of a heterogeneous workforce.[1] The dialogue from the December forum formed a basis for the June forum discussions.

Many individuals who participate in DC plans, particularly 401(k) plans, make savings and investment decisions that will likely fail to produce adequate income throughout their retirement years. While many desire and intend to save, they do not take the steps necessary to put the appropriate funds aside for a variety of reasons, including being intimidated by the financial decision-making process and not properly prioritizing long-term savings. In addition, those who are saving for retirement often focus too heavily on wealth accumulation as opposed to ensuring an adequate level of retirement income for life. This failure to appropriately plan and save often reflects a lack of understanding about the retirement planning process and financial needs in retirement.

As the responsibility for providing retirement income shifts from the employer to the individual, the disconnect between the need to save and actual savings is causing increasing concern. Professor Jeffrey R. Brown, University of Illinois at Urbana-Champaign, explained during the forum: "If one goes back 30 or 40 years ago, the typical plan in both the public and private sector was a defined benefit plan: mandatory and without many decisions to be made by the individual. When individuals reached retirement, they had a check written to them each month. Over the last 25 or 30 years, the world has dramatically changed towards placing a premium on choice. However, what we have come to learn is that people are not always making the best choices."

1 For a complete synthesis of the forum's discussions, see Yakoboski, Paul. "Rethinking Defined Contribution Retirement Plan Design," TIAA-CREF Institute *Trends and Issues* (March 2011).

Given a variety of factors such as continuing weakness in the macro-economy, funding pressures in Social Security and Medicare programs, and the number of baby boomers nearing retirement age, it is imperative to reconsider DC plan design. Many in the retirement planning community are now embracing the concept of "choice architecture" or "plan design with a purpose" to better guide participants to plan outcomes that secure their financial future and ensure income for life.

Specifically, retirement plan providers and sponsors are exploring methods to strengthen plan design, including the strategic use of plan defaults and a sharper focus on investment vehicles that provide a steady level of income throughout retirement. In addition, employers are examining ways to enhance financial education and advice to address disparities in the level of employee financial literacy and engagement.

This *Trends and Issues* report summarizes and synthesizes the June forum's presentations and dialogues.

THE STRATEGIC USE OF DEFAULTS

An employee with an organization sponsoring a DC plan is asked to make key decisions about participation in the plan, such as whether or not to enroll, how much to contribute and how to invest any contributions. But many choose to do nothing at all. They are often unsure and overwhelmed about what action to take. By not choosing, they default into whatever the plan sponsor decides in these cases.

Historically, the default result has been nonparticipation. However, more organizations are embracing auto enrollment, whereby an employee is automatically enrolled in a 401(k) plan (with a contribution rate and asset allocation specified by the plan sponsor) unless he or she chooses to opt out of the plan. Auto enrollment can increase participation in 401(k) plans by as much as 20 to 25 percentage points, according to Brown who discussed coordinating accumulation and distribution design with forum participants.

Why do so many individuals default on an issue of such critical importance? Brown cited three primary drivers–procrastination, employee paralysis resulting from the complexity of the decisions to be made, and what he referred to as the "endorsement effect."

"We have come to realize that whatever a plan sponsor chooses as the default has an enormous impact on how people behave," explained Brown. Many employees assume that if their employer has chosen something as a default option, it must be because the employer believes that it is probably best for most individuals. They view the default as advice even though it is not. Brown noted research indicating that such an endorsement phenomenon is not unique to retirement planning.

However, despite the need and demonstrated success of auto enrollment, some institutions remain wary of adopting this approach. One reason is the resulting necessity to choose one vendor over another to receive contributions in cases where multiple vendors serve a DC plan, as is commonly the case in higher education. Another factor is budgetary impact—greater participation means greater cost when the plan involves sponsor contributions.

Professor Annamaria Lusardi, The George Washington University, argued that it is not enough for employers to autoenroll employees; they should also autoescalate employee contributions to adequate levels and advise individuals how to invest their money. However, she also cautioned that auto enrollment is not appropriate for some employees, such as those carrying high-cost debt.

A forum participant also predicted plan sponsors may change the nomenclature in the future to help drive enrollment. By replacing the word "retirement" with a more holistic term such as "financial life management," the industry would underscore the immediacy and relevancy of retirement planning and saving.

ACHIEVING ADEQUATE CONTRIBUTIONS

What is an adequate contribution level (participant and sponsor contributions combined) in a DC plan? Participants noted that many colleges and universities target 15%. Contributions in the 12%-15% range over the course of a career can be expected to generate savings sufficient to replace at least 70% of preretirement income when combined with Social Security benefits.[2] Several forum participants questioned whether a combined contribution target of 15% would remain sufficient given factors such as longer life expectancy and skyrocketing healthcare and long-term care costs.

Healthcare costs are of particular concern to individuals approaching retirement. Such concern is understandable given the magnitude of the dollars involved. A man with median drug expenditures would need $124,000 in savings, and a woman would need $152,000, for a 90% likelihood of having enough money to cover healthcare expenses in retirement. A couple with median drug expenses would need $271,000 for a 90% chance of having enough. At the highest (90th percentile) level of drug spending, a man would need $187,000 and a woman $213,000 for a 90% chance of having enough money to cover healthcare expenses in retirement.[3]

The issue of employer contribution rates is critical to recruitment, retention and morale, as well as to ensure an adequate retirement income, so many institutions use some form of benchmarking to ensure they are in line with their peers. However, forum participants noted that more comprehensive research and stronger leadership are needed to develop a truly systematic way to determine optimal contribution rates and best practices. One forum participant noted that reaching appropriate contribution levels through employer and employee dollars can be problematic, specifically noting instances where employer contributions differed between sponsored DB and DC plans or between faculty and staff in the context of plans offered each group, resulting in tensions within the institution.

Several forum participants argued for automatic escalation to drive individual contributions to adequate levels. This design element has been adopted less frequently than auto enrollment. “If you automatically escalate contributions over time, people will end up with a much higher level of savings than they would if they just chose one rate and left it there,” said Brown. However, one forum participant expressed concern that auto escalation could be intrusive and possibly interfere with plan participants’ vision for themselves and their savings. Brown noted that plans with auto escalation allow participants to adjust their contributions as they deem appropriate.

Financial planning education and advice is also vital to ensuring that employees save an adequate amount for retirement. Forum participants argued that counseling sessions through work should prompt individuals to consider increasing their contribution rates, in addition to focusing on asset allocation. One forum participant proposed that institutions consider paying any one-time salary supplements to employees in the form of contributions to Supplementary Retirement Accounts (SRAs) as opposed to cash “bonus” payments.

The framing of information presented to employees can also play a critical role in determining contribution rates. For example, a forum participant suggested that sponsors communicate how much potential retirement income an employee would forfeit by not participating in a plan that involves an employer match.

Forum participants also touched on the larger issue of balancing employer versus employee versus government responsibility for funding retirement, with one individual predicting significant changes in the next 10-20 years given the $14 trillion federal deficit: “There is an anti-public, anti-government movement taking place in this country and the notion of what the taxpayer and the government are going to give the workforce of the future will be vastly different than the way it is now.” The same forum participant also argued that the notion of an implicit employer-employee contract will also go away.

2 See Crane, Roderick B., Michael Heller and Paul Yakoboski, “Best-Practice Benchmarks for Public-Sector Core Defined Contribution Plans,” TIAA-CREF Institute *Trends and Issues* (July 2008).

3 See Fronstin, Paul, Dallas Salisbury and Jack VanDerhei. “Funding Savings Needed for Health Expenses for Persons Eligible for Medicare.” EBRI *Issue Brief* no. 351 (May 2010).

CHANGING THE FOCUS TO INCOME

The focus in DC plans in terms of design and participant messaging, particularly with 401(k) plans, has been on wealth accumulation as opposed to ensuring an adequate and secure income throughout retirement. This would be somewhat understandable if DC plans were strictly supplemental to defined benefit (DB) plans, but this is obviously not the case. Furthermore, when an individual is covered by both a DB plan and a DC plan, both may be necessary to produce an adequate retirement income. So, there is a growing sense that the focus with DC plans must change. "Individuals have to think both about the accumulation of wealth and the smart decumulation of wealth, or how to make sure that the resources you have last for life," said Brown.

Forum participants noted that shifting the public mindset will be challenging after "years and years of advertising all focused on the accumulation phase." One individual suggested it will "require a seismic shift in thinking." The group also discussed the challenge of conveying the importance of lifetime income to younger workers who have never had an expensive health issue, are decades away from "retirement age" and assume they will be able to work well into their senior years if they need to.

Forum participants noted the importance of illustrating for plan participants how their savings translates into likely ranges of monthly or annual retirement income. Most individuals simply have no idea how much income a given amount of savings can be expected to generate, especially given the impact of decades of inflation until retirement and then in retirement. Brown commented that many plan sponsors would like to do more for their participants in this regard, but feel that they need more guidance from the Department of Labor because of the complexities involved. "Plan sponsors would have to make clear that this is not an implicit guarantee or a promise," said Brown. "This is an illustration."

One forum participant argued that the overall process of reporting projections needs to be simplified or in some instances changed because of current regulatory requirements. Forum participants agreed that including a visual dashboard with key metrics in quarterly statements sent to plan participants could be highly effective in shifting their focus to generating adequate income.

Another approach discussed to help shift the participant mindset is to focus retirement advice on lifestyle in retirement and how the participant envisions living during their retirement. And, as discussed below, payout options offered as part of a DC plan should include the ability to annuitize savings with clear communications regarding the benefits of guaranteeing a level of income for life.

INVESTMENT MENU DESIGN

The objective of investment menu design in DC plans over of the years has been on giving participants more options. It is now recognized that at some point more choices prove to be an obstacle to decision making for many individuals, especially given generally low levels of financial literacy where many do not know the difference between a stock and a bond. Brown discussed research in this area and noted an emerging consensus that plans should offer 10 to 20 investment options; offering more options risks creating "choice overload" for participants. For sponsors that want to offer a larger menu, a tiered approach can present participants who want a wider selection with a second level of investment choices beyond the basic menu.

In some cases, sponsors may want to help participants to narrow down the choice set, especially for those who feel overwhelmed by the process. This can be done by asking individuals a series of questions to guide them down a path. Such a process is an element of "choice architecture" which focuses on creating a structure that leads to more appropriate investment outcomes for plan participants. Another element would be the investment default. Target date funds result in "automatic diversification" and have become increasingly popular as the default option. Alternatively, a plan sponsor could impose constraints on asset allocation to ensure that a participant's holdings maintain a proper risk balance; for example, the sponsor could control the investment of sponsor contributions.

PAYOUTS AND ANNUITIZATION

Many forum participants agreed that more individuals should use annuities to ensure that accumulated wealth translates into a constant, guaranteed level of income throughout retirement. As noted by Brown, "No matter how much you have saved, you can provide a higher level of sustainable retirement income by annuitizing than by not annuitizing. Annuitizing helps you maximize the value of your money."

However, there was a general consensus that the typical individual does not understand how annuities work and, as a result, is reluctant to convert a lump sum of savings they view as "liquid" into something that is not. Forum participants noted a difference in psyche between individuals in DB plans and those in DC plans. The former view the plan as "taking care of my retirement finances for me," while the latter generally bristle at the thought of losing control over the wealth they have accumulated. One forum participant noted that it will be particularly difficult to move younger workers away from a mantra of "it's my money and it's my choice."

Concern about needing significant savings to cover catastrophic medical costs in retirement is another reason that individuals resist annuitization. Others erroneously believe that annuitization will necessarily preclude them from leaving money behind for their heirs. However, one forum participant noted that he is seeing an increase in the number of people who want to consider annuities because of volatility in financial markets.

In response to those concerns, Brown emphasized that individuals need to understand the full range of annuitization-related options available to them, especially if they are not adequately insured against risks such as exorbitant medical costs. For example, annuitization is not an all or nothing decision with regards to accumulations in DC accounts; in fact, partial annuitization of assets will often be the appropriate choice for individuals. One forum participant suggested that employees should be guided to annuitize assets gradually over time beginning when they turn 65 and are transitioning into retirement.

The idea of some level of automatic or mandatory annuitization was raised. A concern with mandatory annuitization is that there will be plan participants for whom it is not appropriate, for example, individuals who are reaching retirement in very poor health. An alternative is designing DC plans to make some level of annuitization the default outcome. Brown suggested that annuitants could be given a look back period to assuage any concerns they might have. Brown also suggested that it would be desirable for the financial services industry to develop metrics demonstrating the powerful impact annuities can have on ensuring lifetime income.

One forum participant raised the issue of the 403(b) Roth and the impact that tax-free withdrawals can play in supporting individuals in their retirement. Brown said, "there is a benefit to having a Roth option available in a plan if the employee fully understands the vehicle and carefully considers his or her current tax rates versus expected future tax rates." He noted that a downside of including a Roth option is that it adds one more layer of complexity to participant decision making.

Overall, forum participants felt that the lack of understanding about how annuities and annuitization work and the broad range of choices available underscore the critical role that financial literacy and education play in retirement savings decision making. A tool suggested to address this challenge is the use of storytelling to convey how annuities have actually enhanced retirement income security for people.

THE NECESSITY OF FINANCIAL LITERACY

A recurrent theme throughout the forum was the increasing necessity for individuals to have a working level of financial literacy and a better understanding regarding the consequences of their financial choices (and nonchoices) as they shoulder more responsibility and risk in planning and saving for their retirement. Professor Annamaria Lusardi, The George Washington University, provided important context on the challenge of increasing the financial savvy of the workforce, noting research documenting the low level of financial knowledge among the U.S. population. For example, a 2009 national survey by the Financial Industry Regulatory Authority (FINRA) found that less than a third of respondents could correctly answer three basic questions about interest rates, inflation and risk diversification. In addition, research using the *Health and Retirement Survey* has found that many workers do not know what type of retirement plan they have at work and do not understand the basic rules of Social Security.

Why is enhancing financial literacy critical? Lusardi documented the link between financial knowledge and a variety of positive behaviors in terms of retirement planning, debt management and investing practices. She noted that one of the key characteristics of an individual who plans for retirement versus one who does not is that the planner is more likely to be financially literate. This matters because people who plan for retirement have three times the amount of wealth than people who do not plan.

However, as Lusardi underscored, the challenge is that many individuals don't know where to start when it comes to planning. She noted the problem is widespread, with many people not only failing to plan for their retirement, but also failing to put money aside for precautionary savings and for their children's education.

Institutions looking for ways to combat this problem should consider simple, well-timed approaches. Lusardi cited an effort by Dartmouth College to give new hires a basic one page planning aid during employee orientation. The initiative resulted in a significant increase in participation in Dartmouth's supplemental retirement plan.

One forum participant noted that his institution has created a 360 degree personal financial health assessment in which the employer counsels individuals on their entire financial lives, from assets to debts to retirement and beyond, helping the employee develop a holistic financial plan.

However, the group noted that the retirement industry and plan sponsors need to carefully consider how the cost of enhanced educational efforts is borne by employers and employees. One forum member focused attention on smaller institutions with understaffed human resources departments, noting their particular need for support from plan providers in order to educate and advise their employees.

Forum participants also focused on the national need to teach financial literacy at an early age, noting that waiting until individuals enter the workforce is somewhat too late given that many young adults graduate from college carrying significant student debt and not knowing how to create a household budget. There was a call among forum participants for basic financial education to be part of the k-12 curriculum beginning in elementary school. At the same time, participants also stressed the value of financial education as part of the college curriculum; in addition, it was suggested that improving financial literacy among students could be an initiative of the financial aid office on campus.

Lusardi argued that plan design alone, including strategic use of defaults, framing and choice architecture, is not enough to improve the current state of employee retirement saving: "We cannot put people in charge of their financial well-being without really equipping them with the tools to make decisions." She explained that better plan design and financial education must be viewed as complements, not substitutes.

Forum participants also underscored the general need for financial education and advice to take the individual's entire financial life into account, or what one speaker called a "whole person" approach to employee financial health.

LEVERAGING RECORDKEEPING TO SUPPORT PLAN OUTCOMES

Ed Moslander, Senior Vice President for Institutional Development and Sales, TIAA-CREF, led the forum's final session focused on developing and managing recordkeeping models to meet fiduciary responsibilities and support plan outcomes. "Recent legislation and regulatory change have driven a lot of discussion on what is the best recordkeeping model to help sponsors meet their fiduciary, regulatory, compliance and auditing needs and requirements," said Moslander. "While that is an important consideration, it is also crucial to focus on the impact of the model that you choose on the retirement planning and readiness of your employees."

In higher education, it is not uncommon for multiple vendors to provide participant services within a single plan at a given college or university. Moslander noted that in the traditional multivendor model, participants get multiple statements and have to go to multiple sources for information if they invest assets with more than one provider. It takes longer to transfer assets between vendors than between options with one vendor. The multivendor model also makes it more complicated for employees to obtain advice regarding asset allocation given that each vendor will offer a range of options.

A coordinating vendor model is an alternative structure within a multivendor framework. Moslander explained that this model is less complicated for plan sponsors because the coordinating vendor, not the sponsor, is responsible for managing enrollment and coordinating contributions across vendors. However, given the continued presence of multiple vendors in the plan, the data aggregation process required for financial reporting and disclosure remains relatively inefficient and expensive. The coordinating vendor model does tend to provide participants with a somewhat better experience.

The final option within a multivendor framework is the sole recordkeeper model. In this model, the vendor functioning as recordkeeper maintains all participant-related information for the plan. Moslander noted that given today's open investment architecture, the sole recordkeeper model allows vast investment management diversity on a single platform. For plan participants, this means the same amount of choice with a much simpler and more cohesive experience – one set of statements, one website, one set of fees, one advice provider. Moslander argued that the sole recordkeeper model offers "a better opportunity for stronger retiree outcomes."

Roger Ferguson, President and Chief Executive Officer of TIAA-CREFF, noted that "the ability to coordinate and execute against the goals and objectives of the plan is another reason why the integration of recordkeeping and communication can be so effective."

CONCLUSION

Defined contribution plan design significantly impacts the outcomes experienced by a plan sponsor's employees; this can be in unintended as well as intended ways. Therefore, it is critical that the industry and employers carefully consider how to architect plans to better ensure an adequate and secure retirement income for workers. A key component of this is shifting the focus of design from wealth accumulation to providing income throughout retirement. But plan design alone cannot solve the challenge of helping employees achieve better plan outcomes. Definitive action is needed to improve financial literacy; this can happen through both education and advice. As one forum participant noted, "Employers need to help employees lay out a path to success."

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APPENDIX—PARTICIPANT LIST

TIAA-CREF Institute President's Forum (June 23, 2011)

Rethinking Defined Contribution Retirement Plan Design

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Paul Yakoboski is a Senior Economist with the TIAA-CREF Institute. He conducts, manages and communicates research on issues such as defined contribution plan design, income and asset management in retirement, individual decision making and preparation for retirement, managing faculty retirement patterns, and topics relevant to strategic management in higher education. He is responsible for the development and execution of Institute symposiums on such issues. Yakoboski serves as director of the Institute's Fellows Program and editor of the Institute's *Trends and Issues* and *Advancing Higher Education* publication series.

Prior to joining the TIAA-CREF Institute, he held positions as Director of Research for the American Council of Life Insurers (2000 to 2004), Senior Research Associate with the Employee Benefit Research Institute (1991 to 2000) and Senior Economist with the U.S. Government Accountability Office (1989 to 1991). Yakoboski previously served as Director of Research for the American Savings Education Council (1995 to 2000). He served as an adjunct faculty member at Nazareth College (Rochester, NY) between 1986 and 1988.

Yakoboski is a member of the American Economic Association, the Gerontological Association of America, the Association for the Study of Higher Education and the National Academy of Social Insurance. He also serves on the editorial advisory board of *Benefits Quarterly*. Yakoboski earned his Ph.D. (1990) and M.A. (1987) in economics from the University of Rochester (Rochester, NY) and his B.S. (1984) in economics from Virginia Tech (Blacksburg, VA).