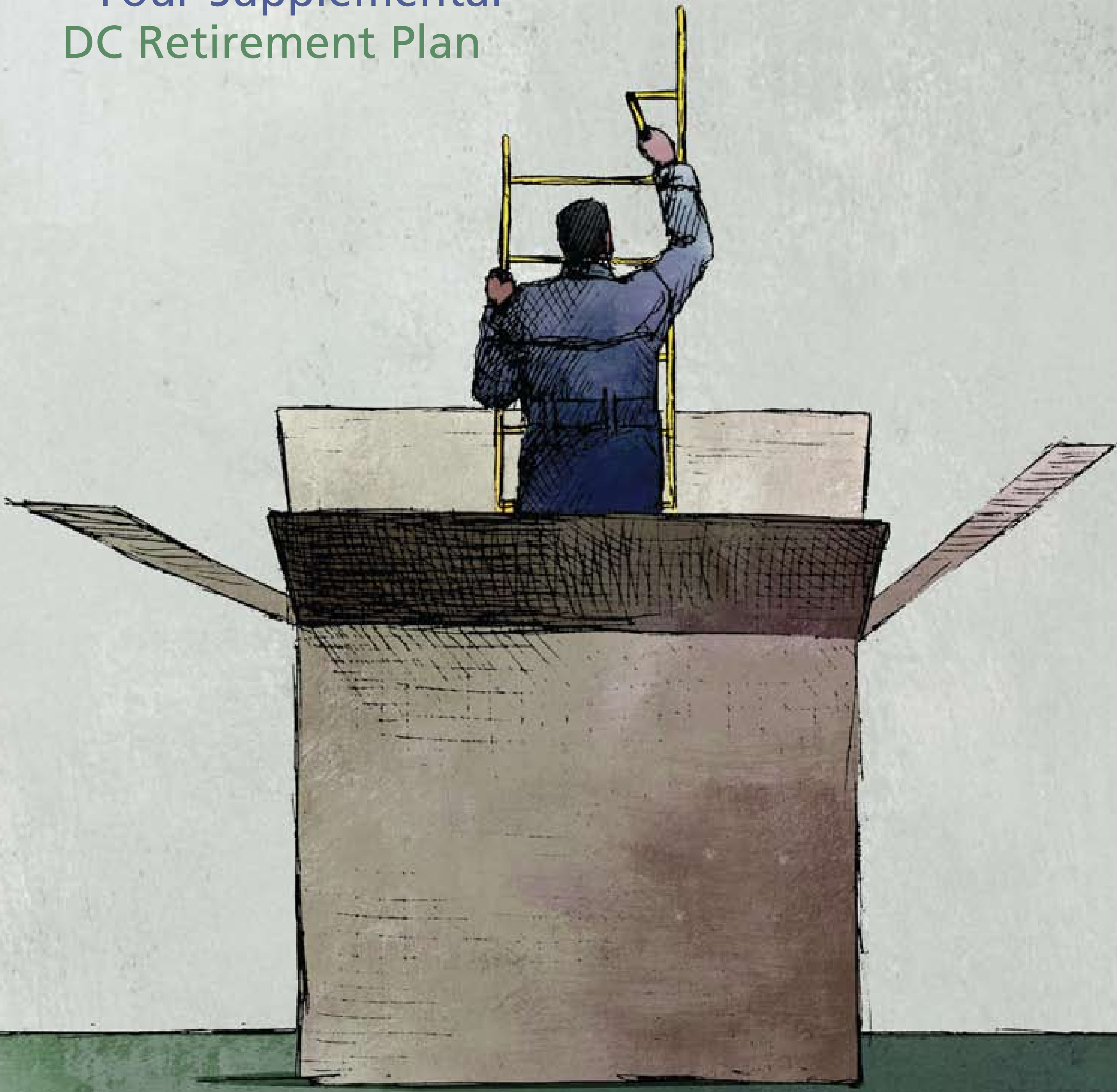
How to 'DB-ize' Your Supplemental DC Retirement Plan



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Reduced revenues and growing demands for services have led governments to examine the financial sustainability of their retirement plans, resulting in widespread pension reforms. According to the National Conference of State Legislatures, 43 states have implemented substantial changes to their pension plans in 2009-2011, as have numerous local governments. Many of these changes will reduce employees' pension income in retirement, and some employees with shorter tenures will no longer have access to the benefit. To offset these and other related impacts, many public employees will need to supplement their savings. As a result, supplemental defined contribution plans — plans that are not intended to be the primary retirement savings vehicle for employees — will be more prominent than previously, when they were used as extra spending money or to pay for a retirement dream like travel or a boat. In the future, supplemental plans will likely become a critical component to meeting basic needs such as rising health-care costs and housing, in addition to issues such as personal debt reduction.

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THE 'NEW FACE' OF RETIREMENT

The primary goals of recent pension reform legislation have typically been to reduce costs and employer risk, adjust to the needs of a more mobile workforce, and equalize benefits between the public and private sectors. Most of the reforms have focused on amending the defined benefit plan itself and have fallen into four primary categories:

- Increasing defined benefit contribution levels for current and/or new employees.
- Increasing the age and/or length of tenure required to be eligible for normal retirement.
- Reducing or eliminating cost-of-living adjustments for new and/or current employees.
- Changing the way pension formulas are calculated to reduce pension benefits.

Additionally, some states and local governments have begun offering hybrid[1] and primary defined contribution plans to replace the traditional defined benefit plan. For example, the states of Georgia, Utah, and Rhode Island have all adopted hybrid retirement plans for new employees within the last few years.

At the same time, the "new face" of retirement is adding to the importance of having additional retirement savings. The retiree who has paid off his or her mortgage, is an empty nester, and has limited medical expenses is not always an accurate portrait of today's workforce. More frequently, retirees are carrying debt into retirement, have children or grandchildren living with them, are facing rising health-care costs, and must plan for multiple decades in retirement. In these circumstances, what once was considered a very adequate defined benefit pension may simply be insufficient.

Acknowledging the growing importance of defined contribution plans, finance and human resources staff in the public sector have begun to analyze how to encourage greater participation in supplemental plans and to improve savings outcomes. They have looked at behavioral economic theories and the successes and failures of the private sector 401(k) world. Much of the effort centers around making defined contribution plans look more like defined benefit plans, referred to as "DB-ization." Under this approach, plan design takes into account the limited experience and interest many employees have in regards to their own retirement savings and incorporates several tools that can ease decision making for employees.

PLAN DESIGN

DB-ization is an outcomes-based approach to defined contribution plan design that attempts to achieve an adequate retirement income for workers through adoption of specific plan components, strong employee communication, and acceptance of participant behavior. Design features seek to increase savings during employment by investing a higher percentage of salary, selecting appropriate investment strategies, and limiting leakage from the plan. Some DB-ization tools may be more appropriate when defined contribution plans serve as the primary retirement income mechanism (i.e., core plans), while others are appropriate for both supplemental and core plans. We will discuss the most common tools and why they may or may not work for your organization's supplemental defined contribution plan.

Auto Enrollment. Under auto enrollment, employees are automatically enrolled in the employer's retirement plan and must opt out if they don't want to participate. This is the opposite of the traditional enrollment method, which has employees opt in. Generally speaking, the latter enrollment method has not been particularly effective at increasing participation rates, while the former can have a very strong impact. Research has shown that auto enrollment has increased participation rates for private-sector 401(k) and public-sector 401(a) plans to the range of 85 to 95 percent.[2] This success stems from the premise that people follow a path of least resistance.

Although the vast majority of research on auto enrollment participation rates looks at 401(k) and 401(a) plans, a strong argument can be made in support of auto enrollment for supplemental plans as well.[3] In an era of rising health-care costs, even those public employees with relatively generous defined benefit plans will likely need the extra money from a supplemental plan to meet basic expenses. This concern is further highlighted for governments that have been forced to reduce pension benefits such as cost-of-living increases.

There are some important issues to consider in deciding to implement auto enrollment for a supplemental defined contribution plan. First is whether to limit the program to only new employees or to include all employees. If all employees will be auto enrolled, the jurisdiction may face some opposition, particularly if it has not been able to provide pay increases for a few years.

To overcome employee resistance, many governments use a low contribution amount, such as 1 or 2 percent, to minimize the impact on an employee's take home pay. This low rate might be counterproductive, as participants may think their employer is endorsing the initial rate as the best level for achieving a secure retirement. Contribution rates also tend to "stick," in that employees don't usually change their initial contribution rate, for the same reason that participation rates are high with auto enrollment — inertia. These are reasons why governments need to carefully assess the most appropriate initial contribution rate. With all of this noted, a low contribution level may be acceptable when the plan is not the employee's primary source of retirement income.

The "stickiness" of auto enrollment contribution rates should also sound a note of caution for hybrid plans because employees who participate in these plans may need to invest more income. Fortunately, research has found that opt-out rates remain low even when contribution levels are set relatively high for core defined contribution plans (i.e., 6 percent).[4]

Other issues with instituting auto enrollment may include the need for new legislation to allow for the withholding of wages, working with unions and employment contracts, impacts on administrative costs, and additional expenses for the government. Some governments may have employment contracts that preclude auto enrollment, in which case human resources and/or financial staff can work with union representatives to explain the benefits of auto enrollment for employees. And in general, regardless of investment activity, account management has a relatively set cost per account, such as covering the fund statements that are mailed to participants. To recoup these costs, plan administrators typically assess a percentage-based fee on account balances. However, when many participants' account balances are small due to low contribution levels, plan administrators may feel a pinch. This scenario could occur with auto enrollment in a supplemental plan, so governments would need to work with their plan administrators to determine the potential impact. Finally, as stated earlier, auto enrollment will likely increase plan participation, which is generally considered a good thing; however, if the government provides a financial match to employees for participating, auto enrollment could lead to a sizeable cost increase. Governments that

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provide a contribution match for their supplemental plans may decide that this benefit alone is sufficient incentive for employee participation.

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Auto Escalation. Under auto escalation, plan sponsors automatically increase employee contributions into the defined contribution plan up to a predetermined maximum. These adjustments might be pegged to a timeframe and/or increase in salary. Auto escalation for supplemental plans is essentially non-existent because only modest asset accumulation is expected and the concomitant high contribution rates are not considered necessary.

Portfolio Selection. One of the core responsibilities of defined contribution plan sponsors is fund selection because it represents the universe of potential investment gains for participants. With DB-ization, plan sponsors should limit the pool of funds from which participants can choose to invest to avoid overwhelming them. Research has not determined an ideal number of funds, but eight to 15 funds (plus target date funds) appears to be reasonable number.[5] With a limited number of funds, it can be challenging to ensure that all major asset classes are available for investment, while also accommodating investors varying ages and risk thresholds.[6] Furthermore, plan sponsors should be careful not to have substantially more of one risk/growth category of fund (i.e., low growth vs. high growth funds), as employees will think it is a preferred investment strategy regardless of whether it best suits their situation.

Default Fund Choice. Under auto enrollment, plan sponsors need to assign a default fund for those employees who don't elect to do so themselves. Overwhelmingly, the fund of choice is a target date fund. A target date fund is a mutual fund that resets the assets in its portfolio to a more conservative mix according to a selected time frame for a particular investor.[7] Target date funds have become very popular because of their simplicity for employees, asset diversification, and long-term focus. A common phrase applied to target date funds is "set it and forget it," making this a very attractive choice for busy employees with little time, interest, or expertise in managing investments.

Target funds have some disadvantages that should be considered before assigning them as a default fund. They require effort on the behalf of the plan sponsor and involve some fiduciary responsibility in researching and choosing a sound fund and regularly reviewing it against performance benchmarks. There is no universal formula for setting the allocation mix of these funds, which can result in significant differences in returns among them; therefore, staff need to consider the impact of these differences on the potential income and security of employees' assets. Likewise, plan sponsors should evaluate and monitor management costs to ensure employees are receiving a good value. Because of concerns with target date funds, some plan administrators prefer using stable value funds (which guarantee a specific minimum return) as their default investment.

Brokerage Windows. A brokerage window allows employees to direct their investments beyond the portfolio selected by the plan sponsor. According to a 2012 survey from the National Association of Government Defined Contribution Administrators, 57 percent of governmental plans provide this option for their defined contribution plans. However, the percentage of employees who actually use the window

is quite small — just a few percentage points, on average. This may because employees are reluctant to venture full force into the investing world.

Under the DB-ization model, employers may find it appropriate to place limits on brokerage windows to protect employees' account balances. The justification is often to prevent employees from "playing the stock market," as this is not the purpose of retirement accounts. For example, governments can place a limit on the amount invested through a brokerage window as a set dollar amount or as a percent of the account. Governments may also want to limit investments to mutual funds rather than allowing employees to purchase individual companies' stocks or bonds.

'DB-ization' attempts to achieve an adequate retirement income for workers by adopting specific plan components, strong employee communication, and acceptance of participant behavior.

Loans and Withdrawals. Allowing employees to take loans and withdrawals from their supplemental retirement accounts is quite common in public plans and this prerogative is often viewed as an incentive for participating in the plan. However, taking loans and/or withdrawals works against the very purpose of the plan, to save for retirement. In order to promote savings, plan administrators typically discourage these actions, and many plans set limits on the amount of loans or withdrawals that can be made. With the growing importance of supplemental plans, instituting limits may become even more important. Examples include:

- Allowing loans only in case of financial hardship.
- Limiting the amount of the loan, either as a dollar amount or a percentage of the account's value.
- Limiting how often loans can be made and eliminating an employee's future ability to borrow money from the account if he or she defaults.
- Prohibiting withdrawals until the employee separates from the government.

Additionally, plan sponsors can work with employees to limit leakage, such as extending loan repayment periods and allowing loan repayment even if the employee leaves the government. Plan sponsors can also increase educational efforts to teach participants about the potentially negative impacts of loans and/or withdrawals on retirement income.

Annuities and Lifetime Income. Generally speaking, career public employees in a relatively generous defined benefit plan will not need to annuitize their supplemental defined contribution plan, as they should have a sufficient percentage of their income as a guaranteed payment. In fact, the money in the supplemental defined contribution account can be an important hedge against inflation. However, those employees who participate in hybrid plans and have less guaranteed income may want to consider annuitizing a portion of their defined contribution assets. Annuities are complex financial instruments and the financial industry has developed several new products to increase their flexibility for buyers. Governments can provide employees who are nearing retirement with a tremendous benefit by giving them straightforward and unbiased information about annuities. This service should involve little fiduciary risk and at most a moderate level of effort.[8]

FINANCIAL LITERACY

A key component of the DB-ization model for defined contribution plans includes effective financial education for employees. As employees rely more on defined contribution plans, their need for financial literacy increases. Research on financial literacy has demonstrated a myriad of benefits including greater comprehension of financial markets, risk-return tradeoffs with investing, and the savings needed to achieve retirement goals.[9] Likewise, financial literacy is positively correlated with wealth, pension contributions, and retirement planning.[10] Finally, financial education can help overcome factors that have been previously associated with a deficit in financial knowledge, including income, sex, and education.[11]

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Though the benefits of financial literacy are generally acknowledged, the best way to achieve it is still open to debate. There is some movement toward greater automation, as a way to reach a larger audience and to reduce costs. State and local governments are beginning to allow online enrollment for supplemental defined contribution plans and they are posting instructional videos, slide shows, worksheets, and finance calculators on their websites. These online tutorials allow busy employees to learn at their own pace and allow governments to post a wide array of financial information on topics such as on budgeting, debt management, and investing without breaking the proverbial bank. Posting this important information online can also enable retirees to access it, assisting them with their financial management.

With the all the potential plusses increased automation provides, keep in mind that one size does not fit all. Research on effectiveness is tending toward a more targeted approach, recognizing that different groups seek out information in different formats.[12] For example, seminars may remain more effective for older employees who like personal contact, while electronic information may be best for younger employees who feel more comfortable with online resources. Because most governments can devote only limited funds to financial literacy, it will likely be worthwhile to assess the jurisdiction's priorities in this arena and what types of information employees most need and desire.

CONCLUSIONS

States and localities face many financial and human resource challenges, including the need to find a balance between providing retirement benefits to employees that are both fiscally manageable and yet substantial enough to provide adequate financial security in retirement. Many of the traditional pension plans state and local governments sponsor have been reformed over the past few years, and these changes have, among other things, reduced the generosity of the benefit and shifted more savings responsibly and risk onto employees. Given this transition, the time is ripe for government employers to consider a range of design and information policies that make supplemental defined contribution plans more like traditional pensions.

Notes

1. Hybrid pension plans offer a typically reduced defined benefit plan (a 1-1.5 percent multiplier) and a defined contribution component. The defined contribution may or may not have an employer match.
2. For example, James Choi, David Laibson, Bridgette Madrian, and Andrew Metrick, "Defined Contribution Plans: Plan Rules, Participant Decisions, and the Path of Least Resistance," NBER Working Paper 8655, 2001; Paula Sanford and Joshua Franzel, "The Evolving Role of Defined Contribution Plans in the Public Sector," 2012; and John Beshears, James Choi, David Laisbon, and Brigitte Madrian, "Defined Contribution Plans in the Public Sector: Lessons from Behavioral Economics," NBER State and Local Pensions Conference, August 19-20, 2010. Please note that little auto enrollment research has been done for supplemental DC plans.
3. See Robert Clark and Joshua Franzel, "Adopting Auto Enrollment in the Public Sector," Retirement Made Simpler, 2010.
4. James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "Saving for Retirement on the Path of Least Resistance," *Behavioral Public Finance: Toward a New Agenda* (New York: Russell Sage Foundation), 2006.
5. A few governments allow employees to invest through the DC plan in their DB fund or a mirror of it. The benefits of this option include professionally managed funds with low administrative costs and access to a diverse investment portfolio. However, there are many considerations for those considering this course, including the need for authorizing legislation; the inherent risk for participants, as the investment horizon is long term; and the need to establish a fair market price for fund shares.
6. *Asset Allocation Guidance for Defined Contribution Plans*, best practice, Government Finance Officers Association. Available at gfoa.org.
7. Definition from Investopedia.com.

8. For information about annuities, please read "The Evolving Role of Defined Contribution Plans in the Public Sector."
9. Robert Clark and Madeleine d'Ambrosio, "Financial Education and Retirement Savings," a paper presented at the Retirement Implications of Demographic and Family Changes Symposium. San Francisco, California, June 2002.
10. Jere Behrman, Olivia Mitchell, Cindy Soo, and David Bravo, *Financial Literacy, Schooling, and Wealth Accumulation*, NBER Working Paper 16452, 2010.
11. Annamaria Lusaridi and Olivia Mitchell, "Financial Literacy and Planning: Implications for Retirement Well-being," in *Financial Literacy: Implications for Retirement Security in the Marketplace* (New York: Oxford University Press, 2011).
12. For example, Annamaria Lusardi and Olivia Mitchell, "Financial Literacy and Retirement Preparedness: Evidence and Implications for Financial Education," *Business Economics*, 42:1, 2007.

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Information for this article draws heavily from "The Evolving Role of Defined Contribution Plans in the Public Sector," a report by Paula Sanford and Joshua Franzel for the Arthur N. Caple Foundation, the National Association for Government Defined Contribution Administrators, and the Center for State and Local Government Excellence, available at http://slge.org. For more in depth information about plan design and employee education for defined contribution plans, we invite you to read this report.