

Defined contribution plan design: why income should be the outcome

A new retirement paradigm appears to be emerging — one that reframes defined contribution (DC) plans from savings plans to retirement income programs. A decade in the making, this paradigm shift, which is being driven by a range of demographic and market forces, is an acknowledgement that today's DC plans not only need to provide more effective outcomes for participants...lifelong income should be the outcome of these plans.

As plan sponsors seek to reframe their DC plans as retirement income programs, the creation and introduction of an educational program — one that extends beyond investment-focused topics and puts retirement income front and center — can be an important first step in underscoring for participants the need to think about their DC plan assets in terms of the monthly income they can expect those assets to generate in retirement.

American workers face a tremendous retirement challenge

There are a number of forces that are leading to the emergence of this new retirement income paradigm. Countless news stories have pointed out that many American workers have not saved enough for retirement to maintain their pre-retirement lifestyles and, for many workers who have diligently amassed a nest egg, trying to make their savings last throughout their retirement won't come without significant challenges. Although the Dow Jones Industrial Average has rebounded from the economic crisis, investment market volatility over the last few years had eroded a significant portion of Americans' retirement assets.

Beyond market performance, there are other forces that are shining a spotlight on the inadequate savings problem. First, Americans can expect to live longer than at any time in our nation's history.¹ Second, a well-documented development over the last decade has been the steady decline in the prevalence of defined benefit (DB) pension plans.² In addition, an increasing number of the DB plans that do remain in place have been converted to DC benefit formulas or offer benefit payments in the form of one-time payments, rather than provide the security of a fixed level of guaranteed lifetime income afforded by traditional formula pension plans.

The fact that many of the causes of this dynamic were not intended to make affording retirement more difficult for Americans does not make the problem any less compelling. The result, however, is that many retirees run the risk of outliving their retirement assets or, perhaps as concerning for both retirees and the overall economy, unnecessarily being forced to adjust their lifestyles and standards of living in an attempt to ensure that they do not.

From supplemental savings to primary source of retirement income

When the first DC plans were introduced in the 1980s under section 401(k) of the Internal Revenue Code, they were originally intended, designed and sold as supplementary savings vehicles — often as a way to encourage workers to supplement the guaranteed income they could expect from Social Security and their DB plans and/or as a way for companies to encourage employee investment in company stock. And, unlike their DB counterparts, which typically do not require or allow employee contributions, DC plans were set up as optional, contributory plans. In DC plans, participants have an individual account within the plan and the balance is a combination of a participant’s salary deferral contributions, investment gains or losses, and in some cases employer-matching contributions.* According to the Investment Company Institute, Americans held \$7.0 trillion in all employer-based DC retirement plans in 2016, of which \$4.8 trillion was held in 401(k) plans.

As the incidence of DB plans has decreased, only individual account DC plans will remain for an increasing proportion of private sector workers, and many of the more than 50 million American workers who are active 401(k) participants** will be relying on these plans as their primary source of retirement income to supplement Social Security. DC plans do not provide any inherent guarantee of benefits as DB plans do. In a DB plan, each employee’s future benefit is determined by a specific formula, and the plan provides a nominal level of benefits during retirement. Usually, the promised benefit, which is designed to facilitate retirement, is tied to the employee’s earnings, length of service, or both.*** For DC plans to have a similar effect, workers need to replicate the security previously provided by DB plans — security that was created by teams of actuaries, pension experts, investment professionals, benefit consultants, accountants, attorneys and by the government through the protection offered by the Pension Benefit Guaranty Corporation.

* Bureau of Labor Statistics, “Changing Landscape of Employment-based Retirement Benefits,” by William J. Wiatrowski, September 29, 2011

** Investment Company Institute

*** EBRI’s Fundamentals of Employee Benefit Programs — 6th Edition (2009)

Most workers don't know what their savings are worth

Many workers accumulate money for retirement but, unfortunately, most of them don't know what those savings translate into in terms of income nor do they know how long that income will last. While most experts believe workers will need 65 to 85 percent of their pre-retirement income³ just to maintain their standard of living in retirement, figuring out how to generate sufficient monthly income in retirement becomes critical. Yet, this is a daunting challenge. Individuals are tasked with first figuring out how much to save, then diligently investing their retirement savings over their working careers and then, finally, figuring out how to manage their savings — often over a 20-year period or longer⁴ — so their accounts are not prematurely depleted. And, since the standard form of payment provided to most DC participants is a single sum rather than all or a portion as guaranteed income, the challenge of making their retirement savings last becomes even more arduous. We believe that plan sponsors, acting in the best interests of their participants, have a critical role to play in enabling more effective outcomes from the plans they sponsor, as is outlined in more detail below.

Rethinking DC plan outcomes

In order for a new retirement income focus to take hold, DC plan design, as well as the manner in which the success of these plans is measured, must change. When the DC plan functioned primarily as a supplemental savings plan, traditional benchmarks for measuring success, such as plan participation and average deferral rates, made sense. Fast forward thirty years since the inception of DC plans and many plan sponsors are now beginning to recognize that if a DC plan is expected to play the same role in retirement that DB plans played for former generations of workers, traditional plan measurement metrics may need to be broadened and realigned to include income-oriented measures. Similarly, the nature of a plan sponsor's involvement and engagement should be expected to broaden and realign as well.

The good news is that the majority of plan sponsors already believe they have a role to play in helping their participants generate guaranteed income. In fact, a large majority of plan sponsors surveyed (85%) agree that the core purpose of a DC plan should be to serve as an income source during retirement.⁵

In order for income to become the primary retirement savings objective for DC plan participants, plan sponsors first need to create a culture of retirement income.

The need for a shift in focus for DC plans from a singular focus on asset accumulation to the inclusion of income generation is consistent with the thinking of the U.S. Department of Labor's (DOL's) ERISA Advisory Council, which believes "the changing role of DC plans to becoming the major (and in many cases the only) source of retirement income for many of today's workers has highlighted the need for DC plans to expand their focus to include providing workers with a secured retirement as one of their major goals. This will involve changing the plan's ultimate structure from solely the accumulation of retirement savings to distribution options that include replacing income over the participant's lifetime."⁶

Retirement income education is key

Before the DOL issued regulations under Section 404(c) of the Employee Retirement Income Security Act (ERISA) in 1992 that laid out the conditions required for protection from certain fiduciary risks for DC plans, most DC plan communications were oriented toward the need to save for retirement and the tax benefits of pre-tax contributions, which also helped to boost participation of lower-paid workers and better nondiscrimination testing results. Once the 404(c) regulations were issued in October of 1992 clarifying the requirements for investment choice diversification necessary for fiduciary protection, this set the stage for the next major advance in participant communications with the DOL's Interpretive Bulletin 96-1. This Bulletin provided an explicit safe harbor for investment educational information on which sponsors have relied in the years since. It clarified that educational investment information includes the basics of investing, and the importance of diversification, and was generally included along with information about the ongoing benefits of saving. Historically, most DC plan educational programs did extend beyond these investment-focused topics.

Sponsors and participants had little need to know how much participants' savings would translate to in terms of retirement income because income generation was not the purpose of these plans in the early days of their existence.

However, given the dynamic in place today where the guaranteed income provided by DB plans is no longer a reality for many Americans, creating and introducing a retirement income education program can be an important first step in reframing a DC plan from a savings to a retirement income program. Communicating DC plan account balances as lifetime income, in addition to the total account balance on annual benefits statements, is one of the most effective ways to begin to change participants' mindsets about the primary purpose of their retirement savings. Today, nearly all plan sponsors (96%) agree that it would be helpful for plan participants

if account balances were required to be communicated as lifetime income — in addition to the total account balance — on DC plan benefit statements, including 62% who believe it would be extremely or very helpful for plan participants.⁵

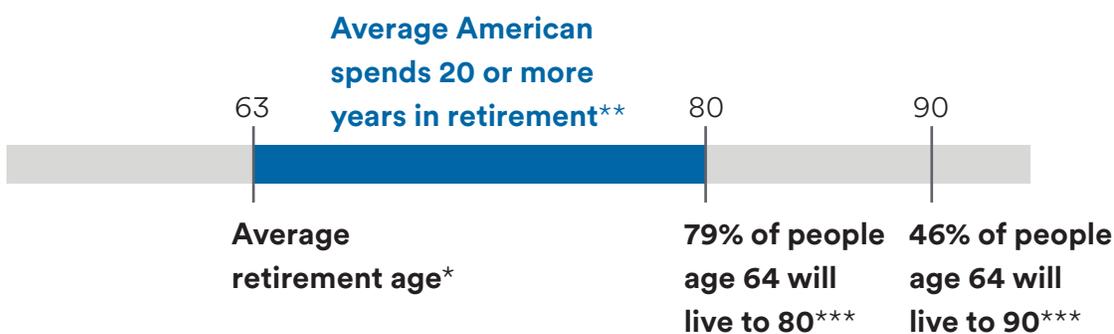
We also recommend that plan sponsors consider including information in plan communications about retirement income-related issues such as longer life spans (longevity risk), how to create retirement income, the pros and cons of taking a lump sum versus periodic payments, and when to begin taking Social Security benefits in a basic retirement income education program.

Three major risks in retirement

When a plan sponsor reframes the purpose of a DC plan as a retirement income plan, one of the most important topics that plan participants need to understand is the risks they will face in retirement. These are market risk, inflation risk and longevity risk.

Stock market experience has shown how quickly and how adversely savings can be affected when exposed to a bear market. When faced with **market risk**, retirees and those nearing retirement have a shorter time horizon in which to recover from market downturns. Workers who are still saving for retirement have the benefit of time on their side but, for retirees, market downturns, especially early on in their retirement years, can significantly and permanently reduce how long accumulated savings will last.

With **inflation risk**, income may need to double over a twenty-year period just to stay even with average rates of inflation.⁷



* Analysis of Labor Force Participation from the Census Bureau's American Community Survey for 2010 to 2014 by SmartAssets™, 2016

** U.S. Department of Labor, Top 10 Ways to Prepare For Retirement, 2015

*** Society of Actuaries Annuity 2000 Mortality Table with 100% AA projection to 2016 and 150% projection thereafter, with mortality blended 50% Male and 50% Female at age 60*

Longevity risk is the risk of living longer than average life expectancy, and the consequence is outliving retirement savings. Individuals who spend down their retirement assets based on their life expectancy will run out of savings if they live longer than expected, which half the population will do. Longevity risk is arguably the biggest risk a retiree faces because it is the only one an individual cannot manage on his or her own. Market risk can be reduced through asset allocation and inflation risk can be addressed by investing in growth equities. But longevity risk only serves to exacerbate these other two risks by increasing the length of time an individual is exposed to them.

Longevity risk is growing in significance because people are living longer, meaning that compared to a generation ago, they spend more time in retirement. According to current actuarial projections, 79% of people aged 64 will live beyond age 80, and 46% of people aged 64 will live beyond age 90.⁸

Keeping it simple for plan participants

Adopting simplicity as the key guiding principle for developing a basic retirement income education program is compelling for several reasons. First, participant behavior has consistently shown that complexity leads to inertia rather than increased engagement. Second, a simple approach whose messages are clear may lay a helpful foundation for participants, ultimately resulting in more savings and more income for more participants.

Simplicity characterizes plan sponsors' current philosophy toward retirement plan design. Nine in ten plan sponsors (90%) believe that it is in the best interests of plan participants to keep plan design changes simple since complexity, such as too many choices and features, often leads to participant inertia (i.e., avoiding taking any action).⁹

Key thoughts for plan sponsors

Developing a foundational retirement income education program is an action sponsors can take now, well before decisions need to be made about whether and how to add the ability to convert some or all of accumulated DC account balances to an income benefit form within the plan or not.

A retirement income education program can help with all of the following:

- reposition the plan from one viewed as an optional savings plan to a core retirement income plan without triggering fiduciary concerns;
- help increase employee understanding of their needs for income and the new risks they will face as they approach retirement;
- help enable participants to be more receptive to the calculators and modeling tools many sponsors provide; and
- help participants make more informed decisions for better outcomes.

Deciding which income solution is best for plan participants starts with a review of the overall objectives of the plan and an understanding of plan participants' needs in retirement, as well as a level of familiarity with the retirement income products that are available to address those objectives and needs. In a future paper, MetLife will explore the retirement income solutions available in the institutional marketplace, which are designed to address retirement-related risks and help plan participants secure guaranteed income that they can't outlive.

Please contact your MetLife representative or call [1-877-638-2862](tel:1-877-638-2862) if you would like to discuss these ideas in greater depth.

¹ Social Security Administration, Period Life Table, 2009

² Social Security Administration, The Disappearing Defined Benefit Pension and Its Potential Impact on the Retirement Incomes of Baby Boomers, Social Security Bulletin, Vol. 69 No. 3, 2009

³ The Retirement Crisis and a Plan to Solve it, US Senate Help Committee, 2012

⁴ Department of Labor, Top 10 Ways to Prepare For Retirement, 2014

⁵ MetLife 2016 Lifetime Income Poll

⁶ Advisory Council on Employee Welfare and Pension Benefit Plans (ERISA Advisory Council), "Examining Income Replacement During Retirement Years in a Defined Contribution Plan System," 2012

⁷ Society of Actuaries, 2006

⁸ Society of Actuaries Annuity 2000 Mortality Table with 100% AA projection to 2016 and 150% projection thereafter, with mortality blended 50% Male and 50% Female at age 60.

⁹ MetLife 2016 Lifetime Income Poll

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