Defined Contribution Plan Success Factors

Framework for Plans with an Objective of Retirement Income Adequacy

Plan Administration Committee

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OVERVIEW

In the United States, more than 630,000 employer-sponsored defined contribution (DC) plans are in place to help nearly 90 million participants prepare for retirement.[1] How successful will these plans be? Traditional measures of success include factors based on a plan's inputs, such as participation rates, savings levels, and the performance of investment options relative to selected benchmarks. These metrics do not, however, accurately capture a plan's potential to provide its participants with retirement income adequacy: helping plan participants build sufficient savings to achieve their goals while working (accumulation) to support their income needs in retirement (distribution). The Defined Contribution Institutional Investment Association (DCIIA) believes retirement income adequacy should be the primary objective of most DC plans today.

Toward this end, DCIIA has developed this best practices framework to outline actions that plan sponsors and fiduciaries can take to build plans that have the greatest potential to help participants achieve retirement readiness. As we approach the ten-year anniversary of the Pension Protection Act of 2006, we recognize that many of the ideas in this framework have been facilitated by this important legislation. The framework further addresses specific factors related to Plan Design, Investment Structure, and Plan Monitoring. It can help plan sponsors and fiduciaries:

- Evaluate existing plans
- Develop thoughtfully designed plans
- Maximize the effectiveness of auto features programs
- Identify and address suboptimal plan participant behaviors

While the topic of communications and education is also integral to improving retirement outcomes, DCIIA has addressed this topic in a recently published paper entitled, "Rethinking Defined Contribution Communication and Education."

The decisions that plan sponsors and fiduciaries make today will impact the retirement readiness of future generations of retirees. This framework is intended to provide ideas for plan sponsors and fiduciaries to consider; it is not expected that every recommendation will apply to every plan. As always, plan sponsors and fiduciaries should design a plan and implement the practices that make the most sense for their participants.

1. PLAN DESIGN

These design features focus on how to structure DC plans to improve participant retirement readiness outcomes. Features such as automatic enrollment and automatic contribution escalation can significantly improve retirement readiness by helping to increase participant enrollment and contribution levels.[2] Other features, such as the presence and design of an employer match, can also enhance both participation and deferral rates. Plan sponsors can consider whether any one or a combination of the features described below may work best for their plan.

Features	Details	Impact
Immediate eligibility	Permit employees age 21 and older to enroll in the plan on "day one" or as soon as practicable based on employee demographics. The plan administrator should take care to comply with disclosure rules under 404(a)(5), as failure to timely provide necessary disclosures may necessitate a delay in enrollment.	If employee deferrals are not deducted from the start, beginning with the first paycheck, the likelihood of the employee enrolling may decrease (due to the perception that enrolling decreases their take-home pay and income).
Automatic enrollment	Auto-enroll employees at an initial deferral percentage designed to achieve the plan's savings and income replacement goals. Recent research shows that enrollment at a 6% salary deferral rate can result in improved retirement outcomes, compared to a baseline enrollment rate of 3%.[3]	Auto enrollment has proven to have a profound influence on participation rates, with an average rate of 81.4%, versus 63.5% if not using auto enrollment.[4] Not only does it establish a baseline savings rate for new participants, but it also is frequently implemented together with a default investment election, which is most often into a Qualified Default Investment Alternative (QDIA). Together, these features can work to place the participant on a path to achieving retirement readiness.
Automatic contribution escalation	In addition to auto enrollment, consider increasing participant contribution rates by 1% to 2% per year, so as to reach an ultimate rate that achieves the plan's goals. If default rates are less than 6%, the plan sponsor may wish to consider 2% annual automatic contribution escalation increases. Research has shown that auto escalation up to a 15% deferral rate may result in significantly improved retirement outcomes.[5]	If plan deferral rates are low, as can occur when automatic deferral rates start low, auto escalation becomes even more important. Tying increases to pay raise cycles, if a company has them, or to the beginning of the year, may lessen their impact on net take-home pay in participants' eyes. Auto enrollment alone, when not combined with automatic contribution escalation, may give participants a false sense that they are saving enough. Encouraging an increase in annual savings improves the likelihood of successful retirement outcomes.
Stretching employer match contributions	For non-safe harbor plans, consider stretching the match over a larger percentage of compensation to encourage participants to reach for higher levels of savings. For example, in lieu of a common match of 50% on the first 6% of deferrals, plan sponsors can influence savings rates by changing the employer match to 33% on the first 9% of deferrals.	This strategy can help motivate participants to reach higher savings rates, while remaining cost neutral for plan sponsors. Many participants elect to contribute the minimum amount to get the full company match, which typically results in a lower savings rate than may be required for a secure retirement.
Additional matching contributions for safe harbor plans	While most plan sponsors have not adopted safe harbor plans, those that do may consider further boosting retirement savings by providing an additional matching contribution, in addition to the mandatory employer safe harbor contribution, under Internal Revenue Code (IRC) Section 401(k)(12).	Plan sponsors that have adopted safe harbor plans can retain the benefits offered under a safe harbor plan, as long as additional matching contributions are not based on deferrals in excess of 6% of compensation and, if they are discretionary, do not exceed 4% of compensation.

1. PLAN DESIGN (CONTINUED)

Features	Details	Impact
Re-enrollment	Expand the benefits of automatic features by implementing one or more of the following re-enrollment strategies on a periodic basis, when consistent with the plan's outcome goals and the plan's specific facts and circumstances: • Enroll non-participating active employees into the plan's QDIA/default fund at the default deferral rate. • Re-enroll current participants into the QDIA/default fund by reallocating existing participants' assets and future contributions into the default fund, unless participants re-affirm their present selections or make an alternative election. • Re-enroll current participants to a higher default deferral rate, unless participants re-affirm their present deferral rate or make another alternative election. Increasing the deferral rate increases the rate at which participants are saving. These re-enrollment strategies may be implemented separately or in combination.	Continued efforts to get non-participating employees enrolled, and existing participants appropriately diversified and saving at a robust level, can be the most important actions plan sponsors take to help employees achieve retirement readiness. Note, however, that plan sponsors may need to take special care when considering implementing re-enrollment — when, for instance, the re-enrollment affects certain investment options, such as stable value, company stock, managed accounts, and/or brokerage accounts.
Discourage early withdrawals and loans from retirement savings	**Plan loans:** When consistent with the plan's outcome goals and the plan's specific facts and circumstances, consider one or more of the following: • Limit to one outstanding loan at a time. • Establish and/or enforce waiting periods between loans. • Limit withdrawals to participant contributions only. • Charge loan initiation fees. • Ensure loan fee considerations are included in communications. • Allow employee contributions to continue while a loan is outstanding. • Educate participants on the long-term detriment of not contributing while a loan is outstanding. • Clearly communicate potential tax penalties and costs associated with withdrawals and loans. • Consider allowing loan repayment post-employment termination. **Post-termination distributions:** Encourage terminated pre-retirees to leave balances in the plan or to roll them over to an alternative retirement vehicle.	These strategies can minimize leakage, which continues to erode retirement savings by prematurely accessing assets earmarked for retirement. Research by DCIIA and the Employee Benefit Research Institute (EBRI) found that DC plan leakage in the form of cash-outs at separation of employment can materially reduce the probability of replacing a sufficient level of income in retirement.[6] There may, however, be circumstances where it is necessary to offer plan loans and hardship withdrawal provisions. In fact, being too restrictive may discourage plan participation.
Encourage consolidation of participants' retirement accounts	Establish a program for "roll-ins" to encourage both new and existing employees to roll prior employer DC plan or existing qualified IRA balances into the plan.	Consolidating eligible retirement accounts into one plan can help participants better manage their assets, gain economies of scale, and plan for retirement. The DC plan may also benefit from an increased level of assets.

2. INVESTMENT STRUCTURE

When it comes to investment menu offerings, less may be more. Two important objectives are to offer a comprehensive asset allocation solution that allows participants to alter their asset allocation and risk exposure over time, and to avoid overwhelming participants with too many menu options. Plan fiduciaries can consider whether any one or a combination of the features described below may work best for their plan.

Features	Details	Impact
Include professionally managed investment options in the form of managed account, target date and/or balanced options	Many participants do not have the knowledge or desire to make investment decisions and may benefit from professional management, either through the use of a target date, balanced or managed account offering.	Comprehensive asset allocation solutions promote professionally recommended investment decisions and ease the enrollment process. Initial and emerging research suggests that those whose deferrals are invested 100% in a QDIA outperform those who select investment strategies on their own, by 3% or more.[7]
Develop and document the rationale for the DC plan's core investment lineup and QDIA	Document the reasoning behind the strategies selected for the plan's core investment lineup and QDIA. Revisit this decision periodically to assess the ongoing fit. Consider whether, and document how, the glide path, asset allocation and underlying investment strategies for a QDIA make sense for the plan.	Plan fiduciaries who can document procedural prudence in their decision-making process for selecting their QDIA and core investment options may be better protected from fiduciary liability.
Open architecture	Consider adopting an **open architecture** framework so that the plan fiduciaries can designate, if they so choose, an investment lineup with multiple underlying investment managers and gain exposure to diverse investment offerings.	Open architecture can accommodate a broad range of investment needs, so that fiduciaries can construct plan investment menus that are consistent with their investment policy statement.
Low number of core investment options	Plan fiduciaries can effectively offer participants the ability to build prudent, diversified portfolios by offering a limited number of investment options - for example, 10 or fewer - with the QDIA being one of those options. Consider offering fewer overall options, while representing a thoughtful mix of asset classes. Using **multi-managed white label** investment options expands the range of asset class exposures, even if the actual number of overall options is decreased.	The average DC plan offers 18 investment choices. More is not always better, however, when it comes to providing investment options for DC participants. Behavioral research studies have shown that participants may feel overwhelmed by too many investment choices, which may hamper diversification, as well as their ability or inclination to engage with the plan.[8]
Offer a mix of active and passive investment options	Consider whether the plan should include both actively managed and index-based options in an investment menu. While this may, on the surface, seem to be contrary to the advice to limit the number of investment options, it doesn't have to be. Filling traditional style boxes is not the objective - giving participants an ability to build a diversified portfolio is.	Instead of selecting an investment lineup that is all actively managed or all passively managed, DC plan fiduciaries may see certain asset classes as efficient, and therefore good indexing candidates, while other asset classes may be better served through active management. Additionally, actively managed funds in a single asset class may compliment passive peers.

2. INVESTMENT STRUCTURE (CONTINUED)

Features	Details	Impact
Exclude or limit company stock	For DC plans that have a company stock fund, consider eliminating company stock or discouraging concentrated positions in company stock by imposing restrictions on contributions and/or exchanges to the company stock fund. Ensure that there are effective participation and communication initiatives about the company stock option and potential risks. Continue to receive and update legal and investment advice with regard to offering company stock as an investment option.	Survey results show that 18.2% of plans allow company stock as an investment option for both employee and employer contributions, and that 30.5% of those plans limit the amount of plan assets that can be invested in company stock.[9] Significant investment in company stock can pose diversification risk.
Investment vehicles	While many DC plans use registered mutual funds in their investment lineup, plan fiduciaries can also consider non-registered vehicles, such as collective trust funds and separate accounts, if available to their plan. Plan fiduciaries may also wish to consider multi-managed white label strategies, as these can offer the dual benefit of reducing the number of investment options while also expanding the available asset classes..	Some key considerations in choosing an **investment vehicle** include cost, transparency, frequency of pricing, and disclosures. Collective funds and separate accounts available to DC plans are generally valued daily, offer holdings transparency, and may have a cost advantage (after consideration of both investment and administration fees) over mutual funds. Yet, mutual funds can offer many similar features and are generally expected to provide a higher level of investor disclosures. When utilizing a mix of vehicles within a plan, another consideration is whether the amount and type of information provided by the different vehicles will be similar or different, which can impact both the plan fiduciary's due diligence review and participant communications.
Retirement income options	A large proportion of DC savers approach retirement without a savings program designed to address the decumulation phase of retirement, such as one that would produce a reliable monthly income. Plan sponsors should evaluate the wide variety of available options and choose the arrangement or combination of arrangements that best suits plan participants. Recent regulatory changes suggest that policy makers are seeking ways to make it simpler to offer a broader set of tools to participants as they approach retirement.	Having a retirement income option signals to plan participants the need to consider income sources post-employment, and extends their planning time horizon beyond the point of retirement. Research has shown that many American workers - even those approaching retirement - lack a financial retirement plan. Of those who do have a plan, most look a mere 5 years out, rather than the far more likely 20-30 years they may live in retirement.[10]

2. INVESTMENT STRUCTURE (CONTINUED)

Features	Details	Impact
Alternative investment strategies	Non-DC plan institutional investors have long used **alternative investments** in their investment portfolios. Some studies have shown that the use of alternatives has contributed to outperformance of defined benefit (DB) plans against typical DC plans. While useful as part of a multi-manager strategy – such as target date funds or white label/diversified core options – unique risks may deter plan sponsors from selecting alternatives as stand-alone investment options.	Alternative assets are often less liquid than traditional investments – and so alternatives may not meet the daily liquidity needs of most DC plans. Product development among alternative investment providers has, however, expanded the scope of available liquid vehicles.

Investment Structure: Commonly Used Terms

Open architecture In this context, open architecture refers to a fund and technology platform used by a financial services provider; the platform allows a plan sponsor to offer investment products managed by various investment managers, and multiple investment vehicles such as registered funds, separately managed accounts, and collective investment trusts, to the plan's participants.

Multi-managed white label solutions A multi-managed white label solution refers to a core menu option that is managed by two or more investment managers. The option's mandate may be limited to a specific asset class (e.g., US equities), or may include a variety of asset classes, such as equities, bonds, and commodities, in order to achieve a specific goal (e.g., inflation protection). The "white label" moniker refers to the fact that the option is not branded to a specific investment manager or record keeper; it might instead be called US Stock Portfolio or Inflation Protection Portfolio.

Alternative investment strategies Alternatives can encompass a broad range of "nontraditional" asset classes, such as commodities, real estate, hedge fund-like strategies, private equity, etc. Plan sponsors looking to incorporate alternatives in their plans need to weigh both the benefits and risks. Alternatives may complement traditional investment options and potentially enhance portfolio returns. They may also provide more consistent returns, enhance portfolio diversification and lower volatility. Plan sponsors also need to consider potential risks, including higher fees, liquidity and limited track records.

Investment vehicle options

	Separate Accounts	CITs	Mutual Funds
Investor types	Single Plan	Qualified Retirement Plans	Retail, Institutional, Retirement Plans, Endowment and Foundations
Daily Valuation	Yes	Yes	Yes
Daily Trading	Yes, via custodian	Yes, via NSCC	Yes, via NSCC
Fees	Customizable	Customizable	Fixed Schedule
Regulatory	DOL	OCC, IRS, DOL	SEC
Industry Analysis/ Screening Tools Available	Case by case	Yes	Yes

3. PLAN MONITORING

Evaluation methods for monitoring a plan's success should include metrics based on a plan's "inputs" (participation rates, savings rates, investment performance and fees) as well as those based on its "output", or ability to achieve the plan's desired objective. Plan sponsors and fiduciaries can consider whether any one or a combination of the features described below may work best for their plan.

Features	Details	Impact
Participation rate	If appropriate, target a participation rate of 90% to 100%. When a high participation rate is not realistic, focus on increases over time. For example, target a 20% increase over a three-year period.	Continue to educate non-participants on the benefits of joining the plan and the importance of saving for retirement. Consider re-enrollment strategies to sweep existing non-participating employees into the plan.
Deferral rate	Strive for optimal average total deferral rates of 10% to 15%.[11]	Encouraging employees through education and plan design – with strategies that include stretching the employer match and automatic escalation – can help them achieve a more financially secure retirement.
Asset allocation/ diversification	Identify participants who may not be efficiently utilizing the investment options and consider developing targeted communications. Target participants who lack diversification as a result of investing in a single core option (e.g., company stock or stable value) or participants who may be over-diversified as a result of investing in the QDIA and core options at the same time.	Non-diversified portfolios can be adversely impacted in times of market volatility. Promoting diversification through targeted communications or by re-enrolling existing participant account balances into the QDIA can help these participants better diversify.
Plan fees	Fees erode participant balances over time, and plan fiduciaries can periodically evaluate whether the fees paid for the services received are reasonable, via peer-based benchmarking or other market-based analyses. Consider including fee benchmark information on participant statements.	The 408(b)(2) service provider disclosures are intended to provide plan fiduciaries with ample information to determine whether the services are necessary and appropriate for the operation of the plan, and whether the arrangement and fees are reasonable for the features selected and provided. Peer-benchmarking tools may be available from a specialty firm or the DC plan's record keeper or investment consultant.
Income Replacement ratio	Leverage plan-design strategies and participant education to help employees think of the plan as a retirement income program rather than a savings account. Identify a target income replacement goal that takes into consideration employee demographics, and focus on contribution rates needed to meet that goal. Express plan balances in income equivalents in employee communications.	This can be a difficult concept for younger employees to grasp. Focus on high deferral rates that will have a better probability of meeting a high replacement ratio target. A traditional income replacement goal is 80%, but this varies by individual, and is based on supplemental sources of income, including those from DB plans and Social Security payments.

3. PLAN MONITORING (CONTINUED)

Features	Details	Impact
Retirement readiness	The drivers of accumulating assets – contribution rates, company contributions, personal investment returns – have historically been the primary focus of plan sponsors. However, the philosophy of a successful plan goes beyond the accumulation of savings and focuses on retirement readiness – helping participants become financially prepared for retirement. This includes meeting targeted income replacement goals so that participants can maintain a comfortable retirement, and helping them meet those goals through plan design and education. Take advantage of the many tools available from service providers to assist with this analysis.	It can be important for sponsors to incorporate additional sources of income, including DB and Social Security payment estimates, to obtain a full picture of participants' sources of retirement income. Measuring retirement readiness will not only gauge the effectiveness of the plan, but also identify at-risk employee populations that may require further attention to help them increase the likelihood of adequate retirement savings. Additional resources on retirement readiness can be found at EBRI.org.

SUMMARY

This guide provides a framework that plan sponsors and fiduciaries can consider to help improve DC plan participants' retirement outcomes. As with any benefits program, plan sponsors and fiduciaries should carefully consider which approach, and which individual actions, will prove most valuable and appropriate for their participants. DCIIA is committed to pursuing practical research that informs better decision-making and offers meaningful and actionable steps toward improving retirement outcomes, and is engaged in several research initiatives that seek to identify new insights into defined contribution plan design. DCIIA will update this paper to include the results of these efforts as they become available.

ENDNOTES

[1] U.S. Department of Labor Employee Benefits Security Administration, "Private Pension Plan Bulletin – Abstract of Form 5500 Annual Reports," October 2014.

[2] Jack VanDerhei and Lori Lucas, "The Impact of Auto-enrollment and Automatic Contribution Escalation on Retirement Income Adequacy," EBRI Issue Brief, no. 349, November 2010.

[3] DCIIA Auto Features Town Hall, Brigitte Madrian, Harvard Kennedy School, April 2, 2014.

[4] Aon Hewitt, "2013 Universe Benchmarks Measuring Employee Savings and Investing Behavior in Defined Contribution Plans."

[5] DCIIA, "Best Practices When Implementing Auto Features in DC Plans," June 23, 2013.

[6] DCIIA, "Plug the Drain: 401k Leakage and the Impact on Retirement," August 2011.

[7] Financial Engines and Aon Hewitt, "Help in Defined Contribution Plans: 2006 to 2012," May 2014.

[8] Schlomo Benartzi and Richard H. Thaler, "Naive Diversification Strategies in Defined Contribution Saving Plans," The American Economic Review: Vol. 91 No. 1, March 2001.

[9] Plan Sponsor Council of America (PSCA), "56th Annual Survey of Profit Sharing and 401(k) Plans," October 17, 2013.

[10] Society of Actuaries, "2011 Risks and Process of Retirement Survey Report of Findings," March 2012.

[11] Fidelity Viewpoints, "How much do you need to retire?", January 30, 2014.

ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of American workers. Toward this end, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution outcomes. DCIIA members include investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants.

For more information, visit: **www.dciia.org**.

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