NORTHERN TRUST

HOW TO IMPROVE DC PLANS AS A VEHICLE FOR RETIREMENT SAVINGS

Northern Trust collaborated with Clear Path Analysis to sponsor a series of articles about the institutionalization of defined contribution plans.

Moderator:

HUBERT DANSO,
CEO and Vice Chairman,
Africa Investor SE

Panelists:

STEVE TOOLE
Director Retirement Systems,
North Carolina Department
of State Treasurer

CHRISTINE BRYAN
Benefits Manager,
TESSCO Technologies

CINDY CATTIN
Managing Director – Investment
Operations and Risk Management,
Exelon Corporation

Hubert Danso: Is the Defined Contributions model of today falling short of what it should be doing?

Christine Bryan: I believe the model is falling short with respect to average balances and level of participation that I have seen at a couple of different employers.

In general, many don't have the amount saved up for retirement that they really need. There is also easy access to money in the form of loans and hardship withdrawals so the accounts are often seen more as a savings account rather than as a retirement vehicle.

Cindy Cattin: What it should be doing varies from plan to plan and when I think of Exelon and whether it is failing I would say no because we still have an open Defined Benefit (DB) plan where most of our participants continue to accrue a benefit there and so our Defined Contribution (DC) plan is viewed as supplemental. We have 90%+ participation and healthy average balances so within the context of my company I don't see it as failing but that is because we are unique in what it should be doing and what it is intended to do for us.

Christine: I have worked in both nonprofit and for-profit, both with a wide variety of employees with different income levels and success within their retirement plans. The hospitals where I worked before had frozen DB plans. There was one that had an active DB that was likely moving towards freezing to be replaced by DC safe harbor. Where I am now there is no frozen DB but only DC 401(k) and the levels of participation are very unequal. At TESSCO we have an 85% participation rate with the 401(k) but that is likely due to automatic enrollment and automatic escalation and it would be much worse without that.

We have people at the top of the scale who are much better informed and who are participating and will be in much better shape than the people at the lower end of the pay scale. This is what I also saw at the hospitals. The staff members making ten dollars an hour are the big concern; these individuals will be wholly dependent on programs like social security benefits versus the staff who are making a lot more and who will be just fine with their DC benefits. Because the DC plans should meet the needs of everyone, if it is falling short for one group, it is not working as well as it should in general.

Hubert: You feel then that it works well for a certain class of contributor?

Christine: We certainly have quite a few people retiring who are very well prepared but the number of people I see who are ill prepared worries me.

Hubert: Steve, what are your thoughts?

Steve Toole: I don't feel it is falling short and the model is working the way it is supposed to. The issue is, how are people taking advantage of the model and the key is plan design which is driven by employer decisions. Too many times they are leaving these plans up to participant selection who aren't thinking long term, which is a problem. There are great examples where plan sponsors are taking advantage of "DB like" features in DC plans such as auto enrollment, auto contribution and escalation in order to drive participant outcomes but not enough.

If you look at the public sector participation, I have worked in the public sector for nearly 30 years and the rate of participation has been approximately 30% across the board and it hasn't changed so there is the issue that plan sponsors aren't doing enough to drive participant election.

In North Carolina (NC), we have 480,000 active public servants and our goals that every one of them will be able to replace 80% of their final annual income in retirement starting at age 62.

Each year, we issue an annual benefits statement that summarizes their DB, social security and their DC and we convert this to a monthly income projection. Since we are the DB administrator we know what their current income is and compare that to their current projected income at age 62 to determine if they are on track to replace 80% of their income in retirement. If they are short of the goal we offer ways to address the situation now before it's too late.

Currently over 60% of all active North Carolina public servants are on track to replace 80% of their income.

As we take a deeper dive into the numbers we learn some interesting results. 74.09% of our active public servants are exceeding 80% replacement income if they are participating in one of our state sponsored defined contribution plans. The number of members achieving 80% replacement income drops significantly if they are not participating in one of our defined contribution

PLAN SPONSORS CAN DO MORE TO ENCOURAGE HIGHER LEVELS OF PARTICIPATION.

85%

PARTICIPATION RATE AT TESSCO WITH THE 401(K) BUT THAT IS LIKELY DUE TO AUTOMATIC ENROLLMENT AND AUTOMATIC ESCALATION

plans. In 2013, 60.37% were retirement ready, compared to 55.42% in 2014 and 50.16% in 2015. Participation in one of the state sponsored defined contribution plans makes all the difference in the world for North Carolina's public servants.

We don't currently have auto enrollment and auto escalation in North Carolina as it requires legislative change but we will pursue this again, legislatively, in 2017.

Participation in one of the state-sponsored defined contribution plans makes all the difference in the world for North Carolina's public servants.

Hubert: Will giving employees access to alternative investments improve their returns?

Cindy: It would depend on how you are giving them access as access through a target date fund could be beneficial but from a core menu perspective could be more problematic. In the context of target date funds, alternatives are broad and can be defined in many ways so something like real estate is easy to slide into a target date fund and a relatively modest allocation can not only help with returns but also give some additional diversification. If you consider assets like private equity, which could absolutely help you with your returns if it is the right fund, there is huge disparity between top tier private equity funds and middle or bottom tier funds. It would be hard to get some of the top tier funds to want to participate in the DC space as many of them tend to be over-subscribed as it is and there are many complexities that they would need to sort through to get that into a DC daily valuation space.

60%

CURRENTLY OVER 60% OF ALL ACTIVE NORTH CAROLINA PUBLIC SERVANTS ARE ON TRACK TO REPLACE 80% OF THEIR INCOME.

Christine: There are many ways to define this and no particular investment is going to guarantee an improvement in returns, as it is all about what the individual does with that investment and how it is utilized in the plan to begin with. If an alternative investment was within a target date fund, it would make more sense. Personally, I am more a fan of the custom target date funds than the off-the-shelves, and it would be reasonable to build it into a custom target date fund. However, for someone who doesn't know what they are doing and might be easily influenced by talk show investment advice, they may vastly decrease their returns by adding in alternative investments by trying to time the market and landing wrong.

Hubert: Why are you a fan of the custom target date rather than off-the-shelf solution?

Christine: Investment committees in my experience can be challenged by off-the-shelf target date funds, and often they are somewhat glossed over during the review process. Because they are composed of a large number of underlying investments that are under the control of the fund managers, an underperforming fund in a target date fund that would otherwise be switched if it existed as a standalone option in the retirement plan, has to stay put. Also, sometimes a particular fund (like the Target Date 2045 fund) is performing poorly, but unless the entire suite is changed, there is not much that can be done.

By using custom target date funds that are comprised of other funds already in the plan, an employer can easily switch out that single fund.

The fiduciary responsibility is easier to handle with the custom line up, because if there is one underlying fund that is underperforming, that one fund can be switched out as would be done with any other underperforming fund in the plan.

Steve: In North Carolina, we offer a customized asset allocation model and what I like about it is that it allows the board and staff to create a custom glide path based on the plan features, including the availability of a strong pension and social security.

All North Carolina public servants have access to a very strong pension fund which should influence the glide path very specifically and it does. Typically, with the off-the-shelf solution, you are really trying to find something that best fits your needs.

A key significant difference between DB and DC is the active investment management by knowledgeable professionals, which includes a robust asset allocation model for the entire portfolio. On the DC side, most plan participants have access to a robust lineup but sometimes they are not leveraging proper asset allocation to reduce risk and maximize returns.

Plan sponsors have to be very mindful about how market swings can play havoc with participants. We have all heard the horror stories of participants buying high and selling low.

Plan sponsors have to think through the line up and provide value to participants but in an effective and risk controlled manner. Offering more riskier investments in the core menu where participants can elect to put 100% of their investments in is a very risky proposition and one that has to be thought through very carefully. Some exposure to alternative asset classes can certainly make some sense.

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60.37%

WERE RETIREMENT READY IN 2013, COMPARED TO 55.42% IN 2014 AND 50.16% IN 2015.

One of the things we are doing in North Carolina is leveraging our recordkeepers' custom portfolio models, GoalMaker, effectively in our plans. Currently, over 90% of all new enrollees and over 50% of all active participants use Prudential's proprietary product called GoalMaker.

The participant usage rate of our custom portfolio models is great and we find that participants do not make asset allocation changes as the markets shift. Our participants are staying the course. We are currently in discussions to alter our Glidepath and, ultimately, our asset allocation custom models to move from a "to retirement" to a "through retirement" and include nontraditional asset classes for improved asset allocation for the models only.

The biggest hurdle is to just get employees started on savings and investing on a routine basis.

Hubert: The number of employers' matching contributions is decreasing year on year. What impact does this have on participation and accumulation?

Cindy: From a participation and accumulation perspective, with accumulation, obviously this is being far less contributed to because you are missing the match and with participation a lot of our employees participate strictly to get that match, so it can definitely have a negative consequence.

This is where some of the auto features come in and are really helpful as with auto enrollment and auto escalation, as long as you are getting people in the plan. A lot of times they will tend to not make many changes. With those who we auto enroll into the plan, very few of them actually opt out once they are in so, while it obviously does have negative consequences, there are some tools we can use such as auto enrollment to mitigate this as much as possible.

Steve: Obviously, this will have a huge impact on the retirement readiness for those employees. Employers need to consider how attractive they are as an employer from a benefits perspective and if this may reduce the overall attractiveness of those employers to current and future employees, ultimately posing a potential retention and recruiting issue down the road in attracting talent. The biggest hurdle is to just get employees started on saving and investing on a routine basis. I worry that this action by employers is really sending the wrong message to the employees that it isn't that important to save now.

Christine: It is going to impact accumulation because you do have less money going in and it is a demotivator for participation, as many people look at the employer match to determine if and how much they will contribute to a retirement plan.

With auto enrollment you are still going to get people initially into the plan, but in some plans, including TESSCO's autoescalation, it's only applicable for those with deferral rates of 1% or more. This means that if a participant has stopped contributing altogether they won't benefit from the inertia of autoescalation, and getting them back into the plan can be challenging without the added sweetener of the employer match.

In terms of the match level, if you have a 50% match up to 6% then you will get a lot of people up to 6%. If you have 50% match up to 2% then you will get a bunch of people at 2% so setting a match is essentially setting a benchmark for what you feel is a reasonable amount for someone to start saving.

The removal of the employer match creates the additional issue of not having vesting as a motivator for retention.

Hubert: Do you foresee that DC plans will ever be able to replicate the effectiveness of DB?

Steve: The single largest benefit of a DB plan is that the employer assumes the risk and not the employee and this will never be replicated in a DC.

Tremendous progress does continue to be made with DC in making them look and feel more like a DB plan. There are product features such as auto enrollment, auto escalation and there are more lifetime income products.

We have a unique product in North Carolina that we call the transfer benefit where we allow participants in our 457 and 401(k) to transfer assets back into their pension fund for a onetime fee of a hundred dollars and they get guaranteed lifetime income.

Plan sponsors continue to educate employees on the importance of long-term savings and not using DC accounts as a short-term investment vehicle. To that end, some plan sponsors are starting to remove the loan feature within their plans.

More does need to be done on DC plans but this has to be done at the employer level as they are the ones who have to make the tough decisions. The more that can be done at the employer policy level, and less at the participant level, will improve retirement outcomes.

The private sector is way ahead of the public sector on making these tough decisions and as an industry we need to catch up.

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Christine: I agree with adding lifetime income features to the plan as being a game changer.

I have had experience hand holding people through the retirement process and selecting their options under DB and DC plans. There is a noticeable difference in approach.

I see many people electing lump sum benefits on their DC despite heavy (but not specific) encouragement not to do so. Again, it is going to come down to getting people into the plan in the beginning and educating people on how best to use the money that they have accumulated.

There isn't any reason to go back to DB models because people don't stay with employers for 30 years anymore. The portability of a DC plan is good and necessary in the current world we live in, but it is about education, getting participants to utilize the plans correctly, getting the employers to design the plans correctly and then having a solution on the back end that is really going to make that money last for the rest of their lives.

Cindy: Automation definitely needs to play a role to drive participants in and encourage their behavior to become more DB like. We need to address leakage so keep the money from coming out whether that is through loans, hardship withdrawals etc. We also need to focus on the decumulation phase and educating participants around those choices as, similar to what Christine was saying, we typically see lump sums and even within our pension benefit, if a lump sum is offered versus an annuity we will typically see a lump sum as the predominant choice.

Automation definitely needs to play a role to drive participants in and encourage their behavior to become more DB like. .

Hubert: What key message would you say on this topic?

Christine: Defined contribution plans are here to stay, but they are evolving. We haven't quite gotten to the point where they are working as well as defined benefit plans worked for our parents and grandparents, but we will get there. Auto enrollment and escalation are big motivators to drive participation, but it is hugely important to educate participants on the importance of portability and how/why to roll over their funds when they are moving to the next employer. This all comes down to how employers communicate and get the message out to each and every one of their participants. Figuring out how to get that message through is going to be the key that makes DC plans successful by helping all participants make their accumulated savings last them through retirement.

Cindy: It is about simplifying the experience for the participant, whether that is through the auto features or from an investment perspective, streamlining the menu and in so doing perhaps creating some custom multi-manager funds that are going to increase diversification and help with the asset allocation decision or modelling to the extent that we can really simplify and help drive participants to do the right thing.

Steve: From a plan sponsor perspective, the North Carolina public employees don't have a choice to be part of the DB plan. Similarly, plan sponsors need to use plan design and make the tough decisions to make DC plans look and feel more like DB plans. We are constantly encouraging our employees to enroll and increase their contributions in the DC plans.

Often, I hear from our retirees and they tell me thanks for encouraging me to get into the DC plans, or they will say thanks for encouraging me to increase my contributions, and sometimes they will say I wish I had listened to you and joined the DC plans. No one has ever come up to me and said that I made them save too much for retirement and they wish they hadn't. I just don't believe it will ever happen. Plan sponsors have to step up, make the tough policy decisions and drive the right participant behaviors, which result in successful participant outcomes.

Plan sponsors have to step up, make the tough policy decisions and drive the right participant behaviors, which result in successful participant outcomes.

Hubert: Thank you all for sharing your views on this topic.

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