PART One

DC Plan Evolution and Design Trends

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CHAPTER 1

DC Plans in the American Retirement System

Someone once called defined contribution (DC) plans one of the "great social experiments of our time." For many people, a DC plan is the *only* company-sponsored retirement plan they have, and for this reason, plan effectiveness needs to be more than merely an "experiment." People need these plans to function because most will depend on them to provide adequate retirement income. The plans should also be designed to realistically take into account factors such as inflation.

When we refer to DC as a social "experiment," we should recognize that "scientists" in the retirement-plan field have made significant contributions to the status of DC plans today. Two behavioral economists who have done so are Professor Richard Thaler from the University of Chicago and Professor Shlomo Benartzi of the University of California at Los Angeles. Perhaps their greatest DC contribution has been to support automatic programs within the Pension Protection Act (PPA). Working from the premise that inertia is one of the most powerful forces of nature, employee auto-enrollment, auto-contribution escalation, and auto-asset allocation all work together to help put Americans in a better position to retire more successfully.

We need to find better ways to make these retirement plans succeed. What is more, *each* participant must succeed in a retirement plan *individually*. In other words, it is not good enough for a group of employees to reach their retirement-income goals *on average*.

Some people will resort to anything to find a creative solution to retirement planning. We saw an extreme example in the 2007 *New York Times* article "A Financial Plan that Comes with Mug Shots."[1] The story involved "financial visionary" Timothy Bowers, who solved his retirement income shortfall by robbing a bank and immediately handing himself over to the police. Bowers figured that if he were sentenced to a minimum-security

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prison with "quality programming for an aging offender population" and remained in jail until Social Security and Medicare kicked in, he would be able to meet his retirement-income goal.

Few of us are desperate enough to go to that length. However, this story underscores the need for our retirement plans to succeed, again, not just for most people but for everyone individually. That is why we produced this book, covering key issues in today's retirement field. To gather a wide variety of experienced commentary on these issues, in 2006 we started the monthly *PIMCO DC Dialogue* series in which we interview various retirement experts, including consultants, academics, plan sponsors, financial advisors, attorneys, and others. This book discusses a number of points from conversations with them and covers key questions and proposed solutions discussed at the *Pensions & Investments* Custom Target-Date Summits held in both 2008 and 2009.

EVOLUTION OF DB AND DC PLANS

To see where you are going more clearly, it is helpful to understand where you are coming from. For that reason, we asked David Wray, president of the Profit Sharing/401(k) Council of America (PSCA), to share some historical background about the evolution of DC plans in America. Wray explained that while most people think that DC plans began with the invention of the 401(k) plan, the plans actually got their start in the late 1800s with the implementation of company profit sharing plans for employers "to build partnership in the workplace and manage labor relations."[2]

Procter & Gamble led the way with this type of plan in 1887, but then found that employees were spending the money instead of using it as a financial reserve or as money that could go toward their retirement. So in 1904, "to encourage saving, P&G introduced a stock-purchase and matching program in which they would match contributions made by the employee, with an additional amount based on the profitability of the company." This, Wray noted, was the genesis of company matching.

Then the Revenue Act of 1921 initiated tax advantages for employment-based retirement plans, allowing plan contributions to be tax free until the employee withdrew funds from the retirement account. "This law established the value of the DC plan from a tax perspective," Wray explained, "which remains the real advantage of these plans today."

These early DC plans flourished in the early part of the twentieth century, but when so many companies were forced out of business during the Great Depression, only about 300 plans remained at the beginning of the

1940s. However, World War II marked a rebirth of retirement plans and employee benefits. As Wray noted:

> *At the time, wages were frozen but there were no government limits on benefit plans. Competing for high-quality—and now scarce—workers, companies improved their benefit plans and started offering both health insurance and retirement programs. There was an increase in both traditional defined benefit plans, with which most people are familiar, as well as DC programs.*
>
> *By the 1950s, the DC system had grown and evolved into three kinds of tax-advantaged plans:* pure profit-sharing plans *where the employer contributed the entire amount;* cash and deferred profit-sharing plans *in which companies allocated a profit-sharing bonus to the employee, who could take all or part of it in cash or defer all or part of it into a profit-sharing trust; and* thrift savings profit-sharing plans, *into which the employee contributed a certain amount of his or her income on an after-tax basis and could receive a tax-deferred employer matching contribution.*

The year 1974 saw the creation of the Employee Retirement Income Security Act (ERISA), which focused on defined benefit (DB) funding issues, but also impacted DC programs. "Unfortunately," Wray pointed out, "ERISA failed to authorize the continuation of cash and deferred profit-sharing plans and, as a result, no new plans were formed and some companies withheld contributions waiting for a clarification."

Recognizing that there were at least 1,000 of these plans and that they "were excellent programs for workers to build retirement savings, as well as for companies to build a positive partnership in the workplace," legislation was passed in 1978 to change the tax code and correct this oversight. However, the language inadvertently went further, opening the door "to a new type of deferred compensation savings plan, the 401(k). . . . For the first time, workers were allowed to save not only bonus dollars, but also regular wages on a tax-deferred basis." Following further clarification by the IRS in 1981, the modern 401(k) plan was born.

In 1982, Wray explained, when companies began to allow "employees who were already making after-tax contributions to the plan to make their contributions on a tax-deferred basis . . . the 401(k) then took off like wildfire. Within years, literally millions of people were participating in these programs."

This full-speed-ahead rush to save a significant amount of tax-deferred wages in these plans was not to last. Concerned about lost tax revenues, Washington and the Internal Revenue Service (IRS) first tried to repeal the

law but, with the Tax Reform Act in 1986, succeeded only in adding "onerous discrimination tests" and putting a cap on how much employees could contribute annually to a 401(k) plan. "This change in legislation," Wray explained, "led to the termination of most cash and deferred profit-sharing plans, as the new government restrictions made them impractical."

The great irony of this legislation is that Section 401(k) was intended to reinstate cash and deferred profit-sharing plans, but the government's revenue concerns regarding the potential success of 401(k) led to changes that killed cash and deferred profit-sharing plans.

When we asked Wray if he agreed with the general consensus that the Pension Protection Act of 2006 had caused many companies to close or freeze their defined benefit plans more rapidly, he agreed. He also concurred with us that, with so few companies now offering DB plans to workers, 401(k) and other DC plans are more important than ever and are currently undergoing a complete transition. "While they were created initially for profit sharing," Wray explained, "today the employee deferral using the 401(k) has become the predominant form of DC plan. More companies every year are adding the opportunity to save in a 401(k) plan, even those that already offer very rich profit-sharing plans. We're approaching 50 million actively employed workers who have a balance in a 401(k) plan and 60 million in DC overall." Wray is confident that the DC system will continue to grow in the coming decades.

MAKING THE MOVE FROM A DB PLAN TO A DC PLAN

We asked a variety of experts and plan sponsors to comment on how switching from DB plans to DC had changed the face of retirement. Deena Katz, associate professor at Texas Tech University, Personal Financial Planning Division, speaks about how having more than one choice in terms of retirement accounts has changed the way that they communicate with clients regarding their responsibilities. Almost 30 years ago, Katz related, when she first began in the retirement-planning field, there were DB plans "that could take care of a good percentage of a person's retirement-income needs."[3] Some of the plans even included cost-of-living adjustments to help clients keep up with inflation. "Many of us," Katz remarked, "grew up with a three-legged retirement-income stool composed of our DB plan, our own investments including defined contribution, and Social Security. Today, the truth is, we don't know where Social Security is headed. And our company-provided retirement benefits are typically limited to DC." Even in the many cases where DC plans offer a company match, plan participants are still

responsible for deciding how much of their salary goes into those plans. "In essence, today we have a two-legged stool that tells us we're on our own in terms of investing for our future. As advisers, we need to help people understand that they must rely on themselves and how to plan, given the available programs and other resources."

However, Tom Idzorek, the chief investment officer at Ibbotson Associates, points out that the shift to DC as the primary retirement vehicle

> *doesn't necessarily reduce plan sponsors' responsibilities as they pertain to creating the best possible plan. Ultimately, as fiduciaries, plan sponsors still want to create a good lineup of options that enable employees to create their own diversified portfolios to meet their participant needs. In addition to designing a good lineup of single-asset-class fund options, these days we also see more plan sponsors adding a do-it-for-me option—either a target-date, target-risk, or perhaps a managed-account option.*[4]

Charlene Mims, vice president of benefits, HRIS and payroll at Dole Food Company, Inc. is creatively looking at the needs of the company's workforce, exploring a somewhat DB-like approach to the DC plan: "Basically we're exploring two directions. One is to give people an additional DC contribution based on years of service. A second is to offer a minimum or floor payout, again, based on years of service."[5] She feels that this somewhat "1970s approach" helps Dole to both attract and retain employees. Since over 50 percent of its workforce will be over the age of 55 within the next three to five years, this payout approach is a benefit that older employees who are nearing retirement find highly attractive.

David Wray of PSCA concurs that there is no such thing as a one-size-fits-all solution and that looking at the unique needs of the population is important in designing the DC plan. "I'd suggest the plan sponsor take a hard look at its workforce and what it's trying to accomplish. Often when companies transition from a DB to a DC-only system, they find very low DC participation. In this case, companies look for ways to make their DC arrangements more successful."[6]

Wray is looking for creative ways to achieve greater plan participation. One approach is auto-enrollment, not only of new hires but of current employees who are not participating. He explains: "While an educational process can work in some cases to raise participation, if you need to really jump-start the system and bring it up to a high level of participation right away, automatic enrollment makes a lot of sense. Auto-enrollment has gained ground rapidly, especially with the recent government support and incentives to add the feature to plans."

Wray also feels that adding "a hybrid, profit-sharing or other employer-funded program in which all employees are participants even if they don't make elective contributions like in a 401(k)" is a good strategy. "The idea . . . is for everyone who works at your company to have an account that accumulates money for retirement. There are a lot of different ways to do that. The advantage of the DC system is that you can have a single plan with all these features integrated into it."

Mark Ruloff, the director of asset allocation at Towers Watson, points out that while DB plans continue to be "a key component of retirement security, we see them playing less of a role than in the past."[7] Now DC plans are the primary source of most workers' retirement income, and he notes that recent changes under the PPA have given employers the ability to improve asset allocation and increase participant's savings rates via automatic programs. These default strategies play an important role in an individual's ability to retire. However, like Wray, he does not believe in one-size-fits-all retirement solutions.

> *When we looked at the different types of target-date funds, we discovered that there's no silver bullet that solves all problems. In working with plan sponsors, we encourage participants to save more and to use an appropriate investment approach. Employers need to educate people to save more rather than simply rely on investment performance to deliver the retirement income that they need in the future. As we know, target-date strategies are garnering a lot of attention and assets. We hope that these asset-allocation strategies, combined with higher savings rates, will help participants better meet their retirement income needs.*

HOW DO WE MEASURE DC PLAN SUCCESS?

With all this in mind, it is important to look in more detail at how DC plan objectives have changed in recent years and how plan sponsors are defining "success." Because, as we discussed, plan sponsors now rarely offer a defined benefit plan, creating an effective employee DC plan has become the primary issue. During this transition, the DC plan objective has shifted from wealth accumulation to creating adequate and sustainable retirement income for all participants.

Today only 21 percent of U.S. private workers participate in a DB plan; given this reality, most plan sponsors—about 64 percent—view their DC plans as the primary company-sponsored retirement-savings vehicle.[8] Given this shift, it is important for plan objectives to change.

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In one of our first *DC Dialogues*, we asked Josh Cohen, CFA, and Phil Enochs, CFA, of the Russell Investment Group, "How can a company measure its DC plan success?" Their answer: "A company should examine the retirement income-replacement ratio, a percentage of the pre-retirement income replaced by the accumulated DC savings."[9] They suggested that plan sponsors—especially those that use DC as primary retirement-savings vehicle—should evaluate the realistic likelihood that a plan will provide a sufficient level of income throughout retirement.

When we asked if there was a specific retirement-income replacement ratio that the DC plan should aim for, they said:

> *Financial advisors often suggest that a participant save enough to replace somewhere between 70 and 100 percent of pre-retirement income to enjoy the same standard of living after retirement. In the past, income replacement came from four primary sources: DC plans, DB plans, Social Security, and private savings. Today, a larger portion of that income needs to come from the DC plan.*

Dallas Salisbury, leader of the Employee Benefit Research Institute, concured that "most individuals should plan to replace approximately 70 percent of their incomes, on top of Social Security."[10] He suggested that plan participants save 15 to 20 percent of their salaries throughout their careers to help them reach this figure. Clearly the amount needed will be impacted by the number of years the person saves, their retirement age and income needs, market performance, inflation, and other factors.

Cohen and Enochs also pointed out that what was considered an appropriate retirement-income-replacement ratio varied with each individual and his or her particular lifestyle preference. "Life expectancy, which continues to grow longer, and healthcare costs, determined by overall health, affects the percentage to a large degree as well."[11]

Consequently we asked, "Can a DC plan actually provide the same income level as a DB plan?" Cohen and Enochs replied, "Yes, so long as (1) people participate, (2) each person contributes a sufficient amount, (3) the company allocates each contributor's assets across diverse classes, and (4) the plan uses institutional investment vehicles to tap into lower fees."

Currently, we are in a strong position to create successful DC plans. Because of the Pension Protection Act, legislation now supports much of what Cohen and Enochs say about successful DC plan requirements.

In a *DC Dialogue,* we asked Marla Kreindler, a partner at the legal firm of Winston & Strawn, to discuss how the PPA impacted the design of

retirement plans and paved the way to DC plans. Here are her main points, in summary:[12]

- The PPA cements the transition from DB plans to DC plans.
- It allows plan sponsors to add auto-enrollment to their plans easily by creating a "safe harbor" from fiduciary responsibility for auto-contribution arrangements.
- For plan sponsors that use Qualified Default Investment Alternatives (QDIA), it also provides a safe harbor from fiduciary responsibility.
- The auto-enrollment provision allows plan sponsors to transition from a wait-and-see position to more actively enrolling their participants in the QDIA.
- The PPA requires automatic escalation of contributions by plan sponsors. Auto-escalation must start from a 3 percent rate and go up by 1 percent a year to 6 percent. At that point, the plan sponsor can then choose to continue the automatic escalation all the way up to 10 percent.
- Firms that offer DC-bundled services, such as Fidelity, Vanguard, and the like, can now offer investment advice to their DC clients rather than use a third party.

In short, plan sponsors can now auto-enroll employees, auto-escalate contributions, and default to professionally managed asset allocations. What is more, many plans are moving in this direction already. In fact, 40 percent of companies already have auto-enrollment; this includes 56 percent of plans with 5,000+ participants that offer auto-enrollment, while only 16 percent of plans under 50 participants make it available.[13] The same is true for contribution escalation: 36 percent of firms have it, and others are likely to add it in the future. As for the default fund, 60 percent offer target date, 18 percent offer target risk, and 3 percent use professionally managed accounts. Target-date strategies should grow rapidly in prevalence as more plan sponsors seek to have participants' assets managed for them over a set time horizon. Since participants often ignore the investment mixes of their DC plans, offering investment solutions that reallocate for people as they age is becoming more popular.

WHAT IS A QUALIFIED DEFAULT INVESTMENT ALTERNATIVE?

As summarized in a Department of Labor (DOL) fact sheet, the PPA directed the department to issue a regulation to assist employers in selecting default investments that best serve the retirement needs of workers who do not

direct their own investments. The final regulation provides these conditions that must be satisfied in order to obtain safe harbor relief from fiduciary liability for investment outcomes:

- Assets must be invested in a "qualified default investment alternative" (QDIA) as defined in the regulation.
- Participants and beneficiaries must have been given an opportunity to provide investment direction, but have not done so.
- A notice generally must be furnished to participants and beneficiaries in advance of the first investment in the QDIA and annually thereafter. The rule describes the information that must be included in the notice.
- Material, such as investment prospectuses, provided to the plan for the QDIA must be furnished to participants and beneficiaries.
- Participants and beneficiaries must have the opportunity to direct investments out of a QDIA as frequently as from other plan investments, but at least quarterly.
- The rule limits the fees that can be imposed on participants who opt out of participation in the plan or who decide to direct their investments.
- The plan must offer a "broad range of investment alternatives" as defined in the DOL's regulation under Section 404(c) of ERISA.

The final regulation does not absolve fiduciaries of the duty to prudently select and monitor QDIAs.

Qualified Default Investment Alternatives

The final regulation does not identify specific investment products; rather, it describes mechanisms for investing participant contributions. The intent is to ensure that an investment qualifying as a QDIA is appropriate as a single investment capable of meeting a worker's long-term retirement savings needs. The final regulation identifies two individually based mechanisms and one group-based mechanism; it also provides for a short-term investment for administrative convenience.

The final regulation provides for four types of QDIAs:

1. A product with a mix of investments that takes into account the individual's age or retirement date (e.g., a life-cycle or targeted-retirement-date fund)
2. An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (e.g., a professionally managed account)

3. A product with a mix of investments that takes into account the characteristics of the group of employees as a whole rather than each individual (e.g., a balanced fund)
4. A capital preservation product for only the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt out of participation before incurring an additional tax)

A QDIA must be managed by an investment manager, a plan trustee, a plan sponsor, or a committee comprised primarily of employees of the plan sponsor that is a named fiduciary, or be an investment company registered under the Investment Company Act of 1940.

A QDIA generally may not invest participant contributions in employer securities.

Other Significant QDIA Provisions

Recognizing that some plan sponsors adopted stable value products as their default investment prior to passage of the Pension Protection Act and this final Qualified Default Investment Alternative regulation, the regulation provides a transition rule. The regulation grandfathers these arrangements by providing relief for contributions invested in stable value products prior to the effective date of the final rule. The transition rule does not provide relief for future contributions to stable value products.

The final regulation clarifies that a QDIA may be offered through variable annuity contracts or other pooled investment funds.

The rule provides that ERISA supersedes any state law that would prohibit or restrict automatic contribution arrangements, regardless of whether such automatic contribution arrangements qualify for the safe harbor.

A summary of the legislation has been developed by the DOL. A copy of the QDIA regulation is available on the DOL's Web site at www.dol.gov/ebsa under "Laws and Regulations." We return to a broader discussion of safe harbors and legal issues in Chapter 4.

Understand Qualified Default Investment Alternatives

To help in our discussion of how to create a successful DC plan, it is important to clarify relevant terminology, as many different terms are used to describe various types of diversified investment strategies in DC plans. Over the last 25 years, we have seen the DC investment lineup evolve from plans offering a single balanced strategy, to those providing a set of target-risk strategies, to today's target retirement-date strategies. (Please note that the

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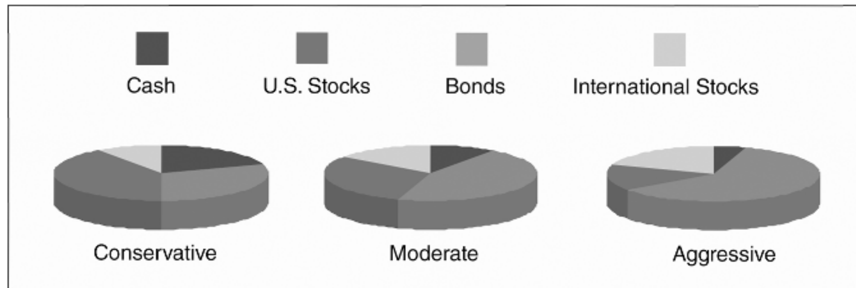

FIGURE 1.1 Sample Target Risk Strategies
Source: PIMCO. Hypothetical example for illustrative purposes only.

term "strategy" or "option" is used more frequently throughout this book than "fund," as a plan sponsor can create the asset-allocation options within its plan without the need to establish a fund as a separate legal entity and without registering the option as an investment company or "mutual fund" with the Securities and Exchange Commission.)

You can think of a balanced strategy as a single option, which is typically a blend of equity and fixed-income assets (e.g., 60 percent Standard & Poor's 500 and 40 percent Barclay's Capital Aggregate). By comparison, think of target strategies as a series of premixed investment options that focus either on risk or on maturity (in other words, "time until retirement"). Target-risk funds started in the 1990s and commonly are labeled "conservative," "moderate," or "aggressive." These funds rebalance to a target-risk level and have a static asset allocation. Many investment companies offer these strategies, as shown in Figure 1.1.

Gaining in prevalence, target retirement-date strategies are geared to the participant's time horizon rather than their risk tolerance and adjust their asset allocations automatically to become more conservative as the targeted retirement date approaches. The participant expects the year of his or her retirement to coincide with the strategy's maturity date. These strategies are offered in a series, such as a "today" or "income" fund, 2010, 2020, 2030, 2040, and 2050, and so on. However, investors should be warned that some investment companies manage their asset allocation to a target "retirement" date while others are focused on a "mortality date"; the latter funds typically take on far more risk, given an additional 20- to 30-year investment horizon. Many investment companies also offer target date funds. Target retirement-date funds, which have come later to the market than target-risk funds, have a shorter investment track record yet are already far more prevalent in plans than target risk.

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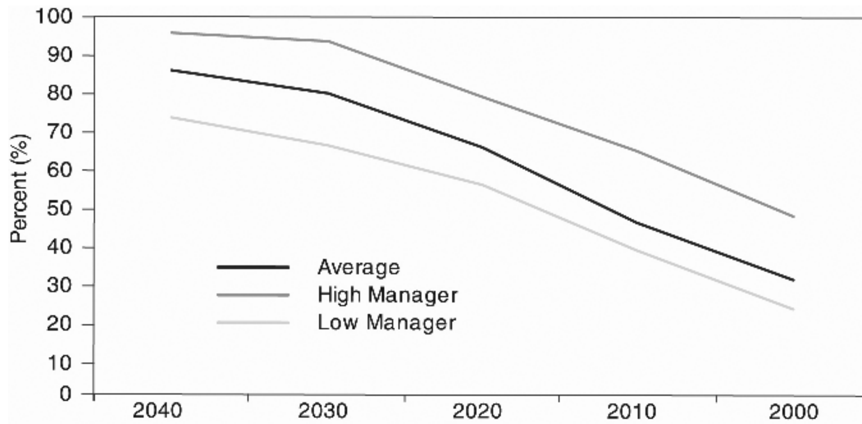

FIGURE 1.2 Equity Allocation Glide Paths Vary
Source: PIMCO.

Today, 83 percent of companies offer premixed strategies in their DC plans; among that group, 15 percent offer target-risk strategies, while 78 percent offer a target retirement-date approach, and 7 percent offer both. Target retirement-date strategies are gaining ground rapidly, as plan sponsors favor their simplicity from a communication and investor-behavior standpoint. Research by Benartzi and Thaler demonstrates plan participants' struggles in defining their own risk tolerances. Participants find it easier to state a likely retirement date. Target retirement-date strategies not only allow participants to focus on their retirement dates, they also provide automatic asset-allocation migration in the form of a changing "glide path" to the retirement-date target. (Note: As illustrated in Figure 1.2, glide paths vary significantly among retirement-date managers.)

Target retirement-date strategies rebalance on an ongoing basis and adjust allocations as a participant ages, so participants' inertia or lack of attention to their investments is likely to move them to a more favorable time horizon or age-appropriate asset allocation over time.

As mentioned, with the passage of the Pension Protection Act, we are likely to see even more interest in target retirement-date strategies as sponsors add auto-enrollment and default alternatives to their plans. No doubt the qualified default-investment alternatives regulations as drafted by the Department of Labor are designed to leverage inertia in participants' best interests.

Clearly, most of us would argue that it is best to engage a participant in determining his or her own asset allocation based on overall risk tolerance, time horizon, and financial profile rather than simply defaulting to a strategy. Yet in the absence of such engagement (and given participants'

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	1999	2001	2003	2005	2007	2009
Money Market or Stable Value	68	68	67	56	17	5
Balanced or Premixed Fund	28	31	30	39	13	12
Unspecified	3	1	3	5	1	1
Target Date Fund	0	0	0	0	50	69
Target Risk Fund	0	0	0	0	15	10
Managed Accounts	0	0	0	0	4	4

FIGURE 1.3 Default Fund Used by DC Plans
Source: Hewitt Associates, 2005.

typical lack of investment knowledge), a default to a target strategy is more likely to diversify DC portfolios (and take participants through retirement) better than other often-ignored approaches, such as investment-education and advice models, which have been relatively unsuccessful in the market to date. Given the typical time horizon for DC participants, defaulting to a target strategy is an improvement over the strategies that dominated in the past. As Zvi Bodie of Boston University told us in the March 2007 *PIMCO DC Dialogue*, "As you know, in the past the default alternative typically was a money market or stable-value fund. Or, in some cases, company stock was used as a default or match. Neither of them works. Money markets are highly liquid, but not appropriate for long-term saving and, on the other end of the spectrum, receiving company stock doubles participants' exposure to company-specific risk."[14] Thus, it is not surprising that DC experts believe target strategies will continue to grow at a rapid pace.

Figure 1.3 shows a continued increase over the past few years in the use of asset allocation strategies (including balanced, target-date and target-risk) as the default investment for automatic enrollment. Given the DOL's qualified default-investment alternative regulations, we anticipate a continued and more rapid shift away from money-market or stable-value default alternatives and toward alternatives such as target retirement-date strategies and managed accounts.

IS AUTOMATIC ENROLLMENT ENOUGH?

As we said, behavioral scientists have documented participant inertia within plans, showing that participants tend not to reallocate investments once they

are in a particular plan.[15] However, while automatic enrollment is a good strategy to get people into a plan, according to Thaler, this is not enough. Auto-enrollment must be accompanied by auto-escalation of savings. Applying what he calls "simple principles of behavioral finance," Thaler and Benartzi have written an article entitled "Save More Tomorrow," in which they have outlined the three primary components in auto-escalation. In the June 2007 *PIMCO DC Dialogue*, they outlined the steps in this strategy: "First, we invite people to sign up for auto-escalation a few months before it takes effect. Second, we link contribution increases to pay raises and, third, we leave things alone until the person opts out or reaches an IRS or plan savings cap."[16]

According to Thaler and Benartzi's research, people can be persuaded to sign up for this type of auto-escalation because

> *they're more willing to entertain ideas of self-control if that control occurs in the future. As St. Augustine prayed, "Oh, Lord, make me chaste. But not yet!" People don't think they can afford to save more right now. Rather, they think they can later, perhaps. Linking savings increases to raises mitigates what we call "loss aversion"; people hate to see their pay go down, but they can imagine taking some of their raise and contributing it to the defined contribution plan.*

In this way, Thaler explained, the power of inertia can work *for* the plan participants rather than against him or her. Once people sign up for a plan, they usually stay where they are. Additionally, participants "almost never reduce their escalating contribution rates. A small percentage drops out of auto-escalation, but typically that's to stop future escalation. It's rare for anyone to set his or her saving rate back to a lower percentage. All these factors together lead us to think that auto-programs help the vast majority of people save more. We don't hear complaints."

Lori Lucas, defined contribution practice leader at Callan Associates, supports Thaler's finding that inertia can be made to serve the plan participant. She points out that when participants are auto-enrolled into a plan, they will be likely stay at the default contribution rate of 2 to 3 percent. But just getting them into the default plan then enables plan sponsors to use "auto-escalation to counter the contribution-rate inertia. In other words, plan sponsors not only auto-enroll employees, they also automatically increase the contribution rates over time. So, for instance, they may default in at the match percentage—say, 6 percent—and then increase it by 1 percent each year up to a maximum. This is another way to make inertia work in the participant's favor."[17]

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AUTO-ESCALATION: HOW MUCH IS ENOUGH?

In terms of the Pension Protection Act of 2006, the safe harbor on auto-enrollment requires auto-contribution to start at 3 percent, then rise 1 percentage point each year until it reaches 6 percent, with the stipulation that it can go no higher than 10 percent. Most companies start at a 3 percent contribution level and stop at 6 percent. When we asked Thaler what he thought of those numbers, he stated that 6 percent should be considered a minimum escalation, in terms of qualifying for the safe harbor.

He also pointed out that the auto-escalation percentage rate also depended on the context of the plan. "If you also have a defined benefit plan, then 6 percent may be fine. If you have no DB plan, then that percentage is low and I suggest running it longer."[18] Thaler also suggested that plan sponsors could notify participants when their automatic contribution raises have leveled off at the 10 percent ceiling in order to give them the option of continuing to increase their savings contributions.

When we asked him what percentage of automatic escalation was considered tolerable, given his experience, Thaler reported that he had seen little resistance to 2 percent and that plan sponsors could even give participants the option of moving it down to a 1 percent if that figure was not within their comfort level. However, he did report that the first company to adopt Save More Tomorrow put their escalation increase at 3 percent, with a 14 percent ceiling, and that very few employees had dropped out.

According to Thaler, getting people to an adequate retirement income level—particularly if they do not have a DB plan—depends on where they start and whether they have a spouse who's saving, but a 10 percent savings rate was rarely too high.

HOW MUCH SHOULD WE SAVE TO BEAT INFLATION?

Olivia S. Mitchell, the executive director of the Pension Research Council and director of the Boettner Center on Pensions and Retirement Research at The Wharton School, also advocates savings, but at an even higher rate if participants want to have sufficient resources to cope with inflation during retirement years. The picture she paints is not an optimistic one:

> *Our nation has no coherent retirement policy and we see it in many ways. Social Security is facing insolvency. Medicare is running short. Other institutions on which we've come to rely such as the Pension Benefit Guaranty Corporation also are falling short. Across the board, we haven't taken a hard look at the fact that we need to encourage people to save more and work longer in the face of ever-rising longevity.*[19]

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When we asked Mitchell what we needed to do to make that happen, she said that while DC plans were a powerful tool for diligent savers, the number-one challenge was getting people "to understand the need to save, to comprehend investment opportunities, and to keep money in a plan, so that assets don't leak out of the system early." She felt it was also vitally important "to help baby boomers realize they need to manage their assets sensibly during the de-accumulation or payout phase."

Like Thaler, Mitchell felt that auto-enrollment alone was not the answer to reducing future retirement shortfall. People who were automatically enrolled into a DC plan with a very low contribution rate and defaulted into a very low-return investment portfolio might "lull themselves into thinking they're doing the right thing. But then they may find at age 65 or 75 that they didn't make adequate contributions over the years." Contributing the minimum amount to one's plan is a formula for facing shortfall down the road.

When we asked Mitchell how much she felt people really needed to save, and at what rate plan sponsors should set auto-escalation, she spoke about the tension she was observing among plan sponsors between encouraging people to save more now so that they could live a better life during retirement or worrying that if they set the contribution rate too high, people would pull out altogether. She also pointed out that many other countries are having this same debate. "In Chile, a country where I work a great deal, the mandatory contribution rate is 10 percent of salary. In Australia they tried to get the mandatory rate up to 12 percent. They got as high as 9 percent, but then the tide turned and the politicians stopped there." While it is fair to say that Australia does not have a social security system, that does not negate the fact that higher mandatory contribution rates would significantly improve having enough money to meet retirement needs in the United States.

For Mitchell, the bottom line was that starting at 3 percent and escalating to 6 percent was a good start but much too low. As a solution she suggested "more education to help people understand that this isn't even a floor. It's a basement, and they should move up to a higher target saving rate." She also said that even contributions as high as 15 to 20 percent might still leave people falling short.

The challenge facing baby boomers today—which will become greater with each new generation coming into the labor force—is being aware of how much they actually need in retirement. According to Mitchell:

> *My parent's generation was relatively secure when it came to retirement. They expected a strong Social Security system, they could lean on a fairly reliable Medicare program, and many had retiree health benefits from their companies. The baby boomers' story has changed dramatically. As a generation, we must be much less*

complacent about all these institutions since many face insolvency in our lifetimes. Sadly, our children face even more serious risks.

This uncertainty suggests that we need substantially higher target saving rates. Each successive generation is likely to live longer and therefore need far more in retirement than one might extrapolate from looking at today's retirees.

PREPARING FOR RETIREMENT IN AN ECONOMIC DOWNTURN

In the June 2009 *DC Dialogue*, Anna Rappaport, president of Anna Rappaport Consulting and chairperson of the Society of Actuaries Committee on Post-Retirement Needs and Risks, agrees with Mitchell that 15 to 20 percent of salary should be considered as a basic savings rate for retirement. Referring to research in a TIAA-CREF paper recently presented at the Pension Research Council, Rappaport states that employees retiring at age 65 or later who have employer support for their health benefits in addition to their DC plan need "six or seven times [their] yearly income as an asset in addition to Social Security to provide a reasonable amount of retirement income.[20]

However, Rappaport also points out that there is a significant correlation between when people retire and what they actually need to supply them with inflation-adjusted income for the rest of their lives. If people can work longer, they can accumulate more savings as well as get significantly higher Social Security benefits. According to Rappaport:

People can claim retirement benefits as early as age 62 and as late as 70. If a person opts to start receiving Social Security at age 70 rather than age 62, she'll get much more money—often about 75 percent more income. In addition, if someone retires at 70 versus 62, she'll need the money for eight fewer years and she'll have eight more years to save and earn investment income before she starts using her savings. Also, at that age, she's covered by Medicare already.

In the recent past, individuals on average were retiring at the age of 62, but in our current economic downturn, people are expressing a desire to keep working longer. Rappaport points out, however, that plan participants cannot *count* on working until, say, age 68 or 70. In fact, there is often of gap between when people *hope* to retire and when they actually *do* retire.

More than four out of 10 people retire earlier than expected, often not by choice. So a person needs to ask, "What are the implications

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of different retirement ages and do I have contingency plans?" For people who want to work longer, it's important to keep their skills up to date. If they don't invest part of their time and some of their resources in keeping those skills up to date, working longer may be difficult or impossible.

Rappaport also mentions other factors that can affect one's ability to work past the median retirement age. Health issues are an issue since some people become disabled or face major medical challenges that force them to stop working. Also, in terms of retirement adequacy, in today's market crisis many retirement models fail to take important factors into consideration, such as the value of one's house. "The market crisis has affected people whose houses are a huge part of their assets—many models don't handle housing well. Some of them don't do it at all. At the other end of the extreme, there's a model that assumes that home value is an asset that will be used gradually." While some people plan to stay in their homes, others assume that their house is one of their main retirement assets and count on being able to sell it if they need to downsize. But as the recent economic downturn has shown, using home equity to finance one's retirement is sometimes not a reliable plan. Rappaport cites "a new 2009 study [that] reminds us what a major part of the total retirement picture it is for many. People have diverse views about how retirees should tap into housing equity. Some retirees think, 'I'll stay in my house and if I have a big emergency, like long-term care, I can sell it.' Of course, that's not a reliable strategy because the housing market might be bad right when you need to sell your house."

In the wake of the current economic crisis, Rappaport feels that even fewer companies are offering DB plans—the number is now at about 20 percent, so DC plans are fast becoming the primary retirement vehicle for many.

Hard economic times are also affecting employer contributions to DC plans.

Some employers have suspended or talked about suspending the match to employee savings. Different surveys tend to look at different employment universes, and there's a lot of disparity in what they indicate. For example, The American Benefits Council published a survey at the end of 2008 reporting that 74 percent of employers offering matching funds hadn't changed their matches, 15 percent had increased or were considering an increase, 8 percent had decreased or were considering a decrease, and 3 percent had dropped the match.

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Since plan participants and sponsors are now living in "a different [economic] environment," Rappaport suggests that it may take two to three years to get a "better idea as to what extent employers are helping people save for retirement effectively." In the meantime, she suggests that people should try to consider working "until the economy recovers somewhat," that they should keep their skills up to date, and that they should make sure they work diligently to pay off credit card debt.

WHAT THE FUTURE MAY HOLD FOR DC PLANS

The 2008–2009 economic downturn has also drawn the eyes of Washington to DC plans. In the September 2008 *DC Dialogue*, James Delaplane, Jr., a partner in the law firm of Davis & Harman, LLP, talked about the changes in regulations that might be up ahead for DC plans. He states that there have been many hearings on retirement plan issues and reports from the Government Accountability Office, which is an investigative branch of Congress. Many questions have arisen during this process, Delaplane points out:

> *For example, now that the 401(k) is the dominant plan for many American workers, is it functioning well for the average employee? What do the plans' investment menus look like? What are the investment choices' fee levels? How do we handle disclosure practices regarding investment options and fees, and should we change the legal standards governing these topics? Many Democrats in Congress are making the case that we do, indeed, need legal change regarding fee disclosure.*[21]

The DOL is also examining the regulations regarding fee transparency in DC plans.

Delaplane points out that Pension Protection Act of 2006 is under scrutiny and that Washington has been implementing "technical corrections to the PPA" that will have an impact on the DC plans. This scrutiny has resulted in many regulatory projects, which are keeping agencies such as the Treasury, the Internal Revenue Service, and the DOL very busy. "For example, the DOL worked through the PPA investment advice provisions and implemented regulatory guidance on qualified default investment alternatives. The Treasury and IRS also worked on all the defined benefit plans' funding regulations and auto-enrollment safe harbor regulations."

When we asked Delaplane what issues he felt would be rising to the top during the current presidential administration, he stated that there would be greater emphasis on encouraging Americans to save more in their retirement

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plans and to invest more in Individual Retirement Accounts (IRAs). There will also be greater emphasis on "how we can reach people who don't have a plan or IRA coverage and how we can reconfigure tax incentives for retirement savings." We look at legal and fiduciary issues in greater detail in later chapters, especially Chapter 4.

IN CLOSING

DC plans continue to evolve and have been helped by the passage of the Pension Protection Act of 2006, given its support of automatic enrollment, contribution increases, and asset allocation. Despite these advancements, DC plans are not out of the laboratory yet. No doubt the emergence of target date strategies provides a springboard for more successful plans in the future. In the next chapter, we take a close look at how the investment structures in DC plans have evolved as well as what is on the horizon in design change. It was not long ago that defined contribution plans were considered "something extra" with investment offerings that were simple. As we know, times are a-changing.