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Defined Contribution Plans: The Way Forward

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Executive Summary

Today's reality is that increasingly, plan sponsors are trying to find practical ways to evolve the DC structure away from its original purpose as a supplementary savings plan to be more effective as a retirement plan for both sponsor and participant.

This article is designed as an ongoing working document, in which we seek to focus on learning from the experiences and insights of leading plan sponsors in the United States and around the world.

We examine the pros and cons of using a DB investment approach as the default option ("QDIA"[1]) in a DC plan menu, based on the experience of a pioneering public plan in the United States. We also look at new developments worldwide to include useful information for U.S. plan sponsors on what's working (and what's not).

Input from our readers is not only welcome, but is essential to meeting the objectives of this project: facilitating the spread of information and ideas on how to develop more effective retirement plan structures. To provide your feedback, please contact Barry Gillman, Research Director, Brandes Institute Advisory Board, at barry.gillman@brandes.com, 858-523-3670.

Introduction

The key issue for plan sponsors today no longer appears to be the debate over defined benefit ("DB") versus defined contribution ("DC") plans. Instead, the focus has moved to how best to improve a DC plan structure to be more effective for both sponsor and participant.

In our 2013 publication, "The Future of Retirement Plans"[2], we analyzed DB and DC plan structures, and suggested that the way forward could be pension plans incorporating features from both DB and DC. Subsequently, in our 2014 paper "Hybrid Retirement Plans: Acceptable Compromises and Long-Term Solutions"[3], we looked in detail at hybrid plan structures and the features that can address key gaps in the U.S. retirement system.

Today's reality is that increasingly, plan sponsors are trying to find practical ways to evolve the DC structure away from its original purpose as a supplementary savings plan to become an effective retirement plan that can meet the long-term needs of today's participants.

This article is designed as an ongoing working document, in which we seek to focus on learning from the experiences and insights of leading plan sponsors in the United States and around the world. Building on our previous research, our goal is to provide a framework for discussion, supported with updates and analysis of developments worldwide. This working document may eventually lead to a series of articles on several related pension topics, but in this article we start with a focus on two:

1. The pros and cons of using a DB investment approach as the default option ("QDIA"[4]) in a DC plan menu
2. New developments worldwide: useful information for U.S. plan sponsors on what's working (and what's not)

[1] QDIA: Qualified Default Investment Alternative
[2] https://www.brandes.com//docs/default-source/brandes-institute/the-future-of-retirement-plans
[3] https://www.brandes.com/docs/default-source/brandes-institute/hybrid-retirement-plans.pdf
[4] QDIA: Qualified Default Investment Alternative

The DB option within a DC plan

DC participants typically are given a wide range of investment choices in their plan menu. Whether such an extensive range of choices is a positive is debatable, and many sponsors have slimmed down their menus, often with a focus on target date funds. However, some participants might long for an even simpler option: the ability to invest their assets in the same way as a professionally managed DB plan. It's an interesting concept, but DB plans typically can't meet the liquidity or other operational requirements of DC.

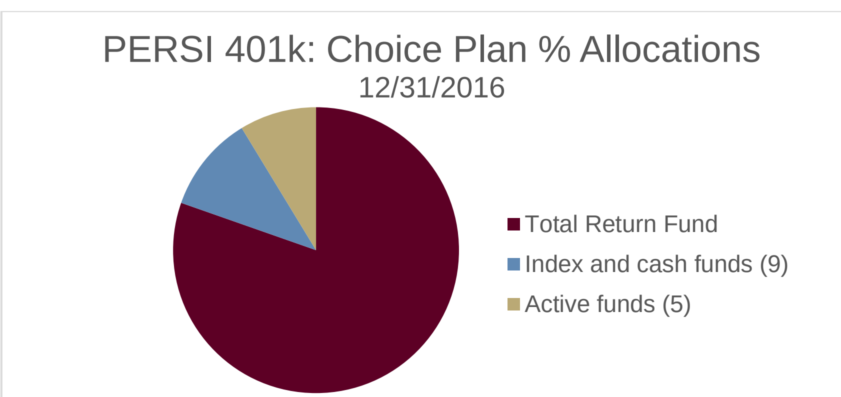
Yet a small number of DC plans do offer exactly that option to their participants: a fund in their investment menu that mirrors the investment strategy used in the DB plan offered by the same sponsor. One of the pioneers of this approach is the Public Employee Retirement System of Idaho ("PERSI"). Bob Maynard, CIO of PERSI, and a member of the Brandes Institute Advisory Board, explained the background to their Total Return Fund option within PERSI's 401k ("Choice Plan"), and how this fund has helped both DB and DC plans sponsored by PERSI.

Around the time of the peak of the investment bubble in 2000-2001, many public funds had high funding levels. Some increased benefits, essentially locking in promises that have proved expensive as time passed. PERSI's Board took a different approach, using some of its excess funding to make a voluntary distribution. As well as giving retirees an extra paycheck, and employers a month's contribution holiday, PERSI handed every active participant in its DB plan a new $1,000 DC account invested in the Total Return Fund, managed in parallel with the DB plan assets. At that time, the PERSI Choice 401k plan was relatively new, functioning as a savings plan supplement to the DB plan. At one stroke, the new Total Return Fund was over $100 million. This also solved the usual problem of a new fund: how to cover a high fixed cost with minimal assets at the outset.

Fast forwarding to the present day, PERSI's Choice Plan has over $750 million in assets[5] and has a menu of 15 different options, including both active and passive strategies[6]. The popularity of the Total Return Fund is evidenced in the allocation selected by plan participants.

Over 80% of participant assets are invested in the Total Return Fund. The remainder is spread fairly evenly across the other 14 fund options (the next most popular fund choice has attracted just 3% of assets). That popularity may be helped by the familiarity of knowing that the fund is managed alongside the DB plan (all DC participants are also in the DB plan) but the returns and costs are a major factor, according to Mr. Maynard.

What they choose at PERSI



Source: PERSI Quarterly Report, December 31 2016, number of fund choices shown in ( ).

[5] Assets and percentages are as of December 31, 2016; source PERSI Quarterly Plan Review
[6] Full disclosure: one of the active strategies is Brandes International Equity

PERSI's DB return ranks in the top 20 state plans for the past decade, both in absolute and risk-adjusted terms. And the annual fee charged to DC participants is just 0.27%. "Financial advisors find it hard to compete with those returns, and at that fee" quips Mr. Maynard. Any participant who has money elsewhere in another 401k plan is able to roll it into PERSI's Total Return Fund, and many do so.

Having this DC fund has helped the DB plan considerably, notes Mr. Maynard. He points out that having a unitized, daily liquidity version of the DB plan is an excellent risk control device. The requirements for precision and timeliness in record-keeping and pricing are much more demanding for DC plans, so he notes this lifts the DB plan to the same high standard. Because 85% of the PERSI fund is invested in the public markets, daily pricing can be provided for the DC plan's Total Return Fund. As a result of these DC needs, the information provided for the identically-run DB fund on positions, liquidity and reconciliations is generally quicker and more accurate than typical for DB plans. Mr. Maynard explains that having this quality of information is very valuable in liquidity and risk management. For example, he notes the PERSI DB fund navigated the 2008-9 financial crisis "without a hiccup."

So, can or do other DC plans provide a seemingly ideal default option like this? PERSI is not alone: for example, Washington State Investment Board offers the Total Allocation Portfolio ("TAP"), which mirrors its DB strategy. However, with a higher proportion of illiquid assets than PERSI, the TAP offers only monthly liquidity.

Mr. Maynard suggests that others can pursue the PERSI approach, as long as they are able to address the important practical issues. Those include finding a way to keep start-up costs low, maintaining a high exposure to public markets for liquidity, and making sure there are no conflicts between the DB and DC plans.

It's not for every plan, but for those sponsors who can navigate the hurdles, it can bring significant advantages to both sponsor and participants.

New developments around the world

<u>Plan Sponsors make a pension contribution, but with a possibility of getting some or all of it back eventually.</u>

Two Canadian provinces, Alberta and British Columbia, are exploring an intriguing concept: the Solvency Reserve. The idea is simple. Instead of the plan sponsor making a contribution directly to their DB pension plan, they put the money into a separate reserve fund. Depending on actual experience over time in investment and plan demographics, these Solvency Reserve assets can either be moved into the pension fund as needed, or if the plan's experience is more favorable than expected, some assets can be returned to the sponsor. The legal and regulatory framework needs to be constructed carefully, but both provinces have already started on this path with enabling legislation.

<u>One of the world's best accumulation systems is getting serious about the decumulation phase.</u>

Australia has been widely heralded as having built a strong pension accumulation system, covering a broad segment of the population due to the requirement that a portion of employee income (currently 9.5%) be contributed into a superannuation (or 'super') fund. Member choice gives most the ability to select their fund provider and product, although many accept the default. While the system is some distance from maturity, Australians are nevertheless relatively well positioned at retirement age. One weakness of the Australian system has been a lack of focus on the retirement phase and lifetime income protection, relying almost totally on drawdown products in the decumulation phase. The Australian government is now seeking to address this, with a 2017 industry consultation study to develop a framework for Comprehensive Income Products for Retirement ("CIPR"). The goal is to provide a CIPR at retirement age, possibly as the default. CIPRs would likely comprise a mix of investment products that generate a lifetime stream of income. The consultation period ended in April and legislation is expected in due course to enable the launch of CIPRs.

One step forward, one step back in providing broader coverage in the United States?

In our 2013 publication, we highlighted the potential of "Secure Choice", a program initially advocated by NCPERS[7] that proposed new hybrid retirement plans at state level that would cover private sector workers not otherwise eligible for pension coverage at their employers. While varying in practical details, a number of states have since moved forward with this concept. California has been at the forefront, with its Secure Choice program being readied for a 2017 launch. Other states, including Oregon, Illinois, Ohio, Maryland, Vermont, also have their variations in process. In 2016, the Department of Labor published safe harbor rules for states (and cities) clarifying that Secure Choice plans would not fall under Federal jurisdiction including ERISA. However, in February, the new administration announced that those 2016 rules would be scrapped, putting Secure Choice into limbo. Some states (such as California) still plan to go ahead, while most others in the pipeline may take a "wait and see" approach. This story isn't over yet!

The innovative national pension plan in the UK hits a speedbump

The UK's Pension Act 2008 created a new national DC retirement plan mandatory for all employers not providing pension coverage for their workers. The National Employment Savings Trust, widely known as NEST, has been innovative in its design and marketing approach. Auto-enrollment at minimum contribution rates is mandatory, and has been gradually phased in across UK employers (largest ones first, starting in 2012). NEST has been a pioneer in the use of behavioral "nudges" and consumer-friendly marketing. Assets are approaching $2bn and are expected to grow fast, on the way to NEST likely becoming one of the largest pension plans in the UK. While the current focus is on the accumulation phase for its members, NEST had been exploring ways to provide retirement income, including immediate and deferred income annuities ("DIAs" or longevity insurance). No longer! The UK government announced in March 2017 that NEST will not be allowed to provide decumulation products. The life insurance marketplace is deemed adequate to do that job, at least for now, even though no longevity insurance DIAs are currently offered. The government is looking for innovation but instead has provided a speedbump for the one entity that has shown the ability to challenge the "status quo."

Risk-sharing pension plans continue to attract attention

As many plan sponsors continue to struggle with the constraints and costs of traditional DB plans, variations of risk-sharing plans are seeing more support, both in terms of investigation and implementation. In such plans, generally the sponsor retains the longevity risk, but participants share in the investment risk. Eventual benefits will vary depending on actual returns. These plans go by various names: Defined Ambition in Europe, Target Benefit in Canada, hybrid plans in the United States, and (prosaically) risk-sharing plans in Japan. The Netherlands is perhaps the most advanced along this path, with a number of established Defined Ambition plans, so that information is now increasingly available on the practical pros and cons of this approach. There are lessons here for pension professionals worldwide.

Solving the solvency issue in Canada?

Concerns over funding deficits had led to Canadian provinces enforcing mandatory mark-to-market solvency valuations for DB plans. While this aimed to reduce the short-term risk of plan failure by forcing sponsors to contribute more, the (perhaps) unintended consequence was pressure on plan sponsors to close their defined benefit plans as too expensive to maintain.

In 2016, we saw the first reversal of this focus on the short-term. The province of Quebec passed a bill eliminating its pension mark-to-market solvency test, replacing it with a long-term "going concern" test. It's possible this will give Quebec a competitive advantage with sponsors regarding their DB plans. Later that year,

[7] National Conference on Public Employee Retirement Systems

Ontario announced it is expediting its study of a similar measure. If both these large provinces move away from mark-to-market, others may need to consider this seriously, as well.

Separately, two provinces, Alberta and British Columbia, are exploring an intriguing concept: the Solvency Reserve. The idea is simple. Instead of the plan sponsor making a contribution directly to their DB pension plan, they put the money into a separate reserve fund. Depending on actual experience over time in investment and plan demographics, these Solvency Reserve assets can either be moved into the pension fund as needed, or if the plan's experience is more favorable than expected, some assets can be returned to the sponsor. The legal and regulatory framework needs to be constructed carefully, but both provinces have already started on this path with enabling legislation.

Future Topics

We would be pleased to receive comments or feedback from our readers on the topics in this article. If you have a view on these issues, if you are involved in any of these initiatives, or if you have questions about how this could impact your plan, our contact details are at the end of this article. Depending on future developments and the focus of our readers' interests, we may go into more detail on some of these topics in a future article in this series.

We are not however limited only to the topics already mentioned in this piece. We expect to research and publish on a number of other topics impacting the future of DC plans. Here's a partial list, and we'd be interested in our readers' views on any or all of these.

1. CUSTOM FUNDS: How helpful is the move towards customizing some or all of the DC plan's menu of funds by creating "white label" funds to meet the plan's specific needs and demographics.
2. TARGET DATE FUNDS: Target date funds ("TDFs") have evolved significantly in recent years with a broad range of offerings and the ability of sponsors to tailor TDFs to their needs. Is the increasing dominance of TDFs a positive for both sponsors and participants?
3. THE PATH OF LEAST RESISTANCE: Low fees and passive management have become more popular with sponsors and consultants concerned about lawsuits (or just being second-guessed) for approving active strategies or higher fee funds. What should sponsors consider when making these decisions?
4. BEHAVIORAL INFLUENCES: How participants can most effectively be encouraged to participate in their DC plan.
5. RETIREMENT INCOME: How a DC plan can best provide participants with lifetime income, and the pros and cons of accomplishing this within the plan, or outside it.
6. HYBRID UPDATE: Some hybrid structures have gained traction in the past five years; others have stalled. What has driven the changes and what do the "plans of the future" look like now?

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