Defined Contribution Plans: Pitfalls and Potential

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Agenda: DC Pitfalls and Potential

- Retirement Trends
- DC Pitfalls
- Role of Education
- Role of Employers
- DC Plan Reforms
- Conclusion
Best Chance for a Secure Retirement: “3-Legged Stool”

- **Social Security**: Basic near-universal benefit; keeps retirees out of poverty

- **Pension**: Provides monthly income to supplement Social Security

- **Personal Savings**: 401(k) & other savings for “extras” beyond monthly bills
## Employer Legs of the Stool

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Traditional “Defined Benefit” Pension</th>
<th>“Defined Contribution” 401(k), 401(a), 457, 403(b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>How is the value of the benefit set?</td>
<td>Fixed formula</td>
<td>Depends on account balance at retirement</td>
</tr>
<tr>
<td>How is the benefit doled out?</td>
<td>Monthly income stream</td>
<td>Typically a lump sum</td>
</tr>
<tr>
<td>What is the benefit timeline?</td>
<td>Lifetime income</td>
<td>Lump sums are spent down at retiree’s discretion</td>
</tr>
<tr>
<td>Are investments pooled?</td>
<td>Pooled investments</td>
<td>Usually individually invested</td>
</tr>
<tr>
<td>Who makes investment decisions?</td>
<td>Professional asset management</td>
<td>Individuals choose from plan choices</td>
</tr>
<tr>
<td>Who bears the risk?</td>
<td>Employer(s) / plan sponsor(s)</td>
<td>Employees</td>
</tr>
<tr>
<td>Is there a guarantee?</td>
<td>Usually guaranteed</td>
<td>No guarantee</td>
</tr>
</tbody>
</table>
## DB and DC: Who Bears the Risk?

<table>
<thead>
<tr>
<th>Risk Type</th>
<th>Defined Benefit</th>
<th>Defined Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Funding Risk</strong></td>
<td><strong>Employer.</strong> If the plan becomes underfunded, employer must make up the difference.</td>
<td><strong>Employee.</strong> Employer bears no additional cost if account is “underfunded.”</td>
</tr>
<tr>
<td><strong>Investment Risk</strong></td>
<td><strong>Employer.</strong> Pension benefits are guaranteed despite investment performance.</td>
<td><strong>Employee.</strong> If investments perform well, account balance increases; if poorly, balance decreases.</td>
</tr>
<tr>
<td><strong>Inflation Risk</strong></td>
<td><strong>Employee, unless COLA is provided (rare).</strong></td>
<td><strong>Employee.</strong></td>
</tr>
<tr>
<td><strong>Longevity Risk</strong></td>
<td><strong>Employer, but may be shared if lump sum option is provided.</strong></td>
<td><strong>Employee.</strong></td>
</tr>
</tbody>
</table>
Private Sector Has Been Moving to 401(k)s Only

Percentage of Private-Sector Wage and Salary Workers Participating in an Employment-Based Retirement Plan, by Plan Type, 1979–2017

DC Pitfalls Abound

**Pitfalls Abound...**

- Not knowing how much to contribute / contributing enough
- Investment decisions and downturns
- Leakage
  - Forfeited unvested employer contributions
  - Not rolling over
  - Taking cash out upon termination
  - Needing cash for other emergencies
- How to spend down money in retirement
- Lack of spousal protections
In the absence of a pension, workers need FAR MORE saved in their 401(k) accounts than most realize.

<table>
<thead>
<tr>
<th></th>
<th>Average Worker <em>NEEDS</em>...</th>
<th>Workers Actually <em>HAVE</em>...</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Annual Savings Rate</strong></td>
<td>12-15% of pay for 30 years</td>
<td>5% <em>or less</em> if earning under $100,000</td>
</tr>
<tr>
<td><strong>Account Balance at Retirement</strong></td>
<td>10-12x annual pay</td>
<td>2-3x annual pay</td>
</tr>
</tbody>
</table>
20 Years Later... Workers Don’t Have Enough

### Median Balances by Income, 2022

<table>
<thead>
<tr>
<th>Income Range</th>
<th>401(k) Balance</th>
<th>Median Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>≤$15,000</td>
<td>$4,033</td>
<td>$8,000</td>
</tr>
<tr>
<td>$15,000 - $29,999</td>
<td>$4,568</td>
<td>$9,112</td>
</tr>
<tr>
<td>$30,000 - $49,999</td>
<td>$11,556</td>
<td>$18,278</td>
</tr>
<tr>
<td>$50,000 - $74,999</td>
<td>$31,064</td>
<td>$52,531</td>
</tr>
<tr>
<td>$75,000 - $99,999</td>
<td>$58,665</td>
<td>$97,902</td>
</tr>
<tr>
<td>$100,000 - $149,999</td>
<td>$104,155</td>
<td>$159,234</td>
</tr>
<tr>
<td>≥$150,000</td>
<td>$201,301</td>
<td></td>
</tr>
</tbody>
</table>

### Median Balances by Age, 2022

<table>
<thead>
<tr>
<th>Age Group</th>
<th>401(k) Balance</th>
<th>Median Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-34</td>
<td>$30,017</td>
<td>$11,357</td>
</tr>
<tr>
<td>35-44</td>
<td>$76,354</td>
<td>$28,318</td>
</tr>
<tr>
<td>45-54</td>
<td>$142,069</td>
<td>$48,301</td>
</tr>
<tr>
<td>55-64</td>
<td>$207,874</td>
<td>$71,168</td>
</tr>
<tr>
<td>65+</td>
<td>$232,710</td>
<td>$70,620</td>
</tr>
</tbody>
</table>

Source: Vanguard
Education Alone Will Not Save Us!

<table>
<thead>
<tr>
<th>Problem</th>
<th>Education Solution</th>
<th>However...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not knowing how much to contribute</td>
<td>Learn the benchmarks!</td>
<td>...but what if you don’t have the financial means to put away 15% per year every year?</td>
</tr>
<tr>
<td>Not knowing what to invest in</td>
<td>Learn about diversification, fee structures!</td>
<td>... but what about another “historic” investment downturn... or two or three?</td>
</tr>
<tr>
<td>Leakage</td>
<td>Understand the importance of rolling over, and keep track of your accounts!</td>
<td>... but what if it’s needed for an emergency? (And could still get lost)</td>
</tr>
<tr>
<td>Spending down money in retirement</td>
<td>Purchase an annuity!</td>
<td>... but they’re expensive (and the market is sketchy)</td>
</tr>
<tr>
<td>Lack of spousal protections</td>
<td>??</td>
<td>...More annuities?</td>
</tr>
</tbody>
</table>
...Will Good Quality Jobs / CBAs?

**Low Contribution Rates / Emergency Cash**
- Increase employer contributions
- Increase wages!

**Vesting Rules**
- Immediate vesting of employer contributions

**Leakage Issues**
- Increase retention?

**Large Market Downturns**
- Realistic for employers to commit to make up losses?

**Investment Issues**
- Employee say in investment menu

**Spousal protections**
- Hire the spouse?
What About DC Plan Improvements?

**Automatic Enrollment**
- Safe harbor created to default workers into participating
  - But 3% is not enough!
  - If employer willing to match more = money left on the table

**Target Date Funds**
- Safe harbor created to default workers into a fund balanced to their retirement age
  - But is that appropriate for 100% of assets; for all workers?
  - What about the fees charged?

**Automatic Escalation**
- Safe harbor to increase in 1% increments, up to a cap
  - Cap (8%) is often far lower than what’s necessary
What About More DC Plan Improvements?

Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019:
- Eases rules for “multiple employer plans”
- Increases safe harbor for auto enrollment & escalation
- Eases rules for part-time workers
- Delays mandatory distributions
- Makes lifetime income options easier

Securing a Strong Retirement Act (“SECURE 2.0”) of 2022:
- Mandatory auto enrollment & escalation
- Further eases rules for part-time workers
- Further delays mandatory distributions
- Allow Roth matching contributions and “match” for student loan payments
- Further makes lifetime income options easier
- Create national database for lost accounts

“Bipartisan retirement proposals are mostly just more tax cuts for the wealthy.”
What About *Even More* Improvements?

**DC Plan Reforms Can Address Issues Like:**
- Vesting Rules
- Fee transparency / disclosure; Target Date Fund standardization
- Leakage: DOL’s Lost Accounts initiative; adding emergency savings features; automatic rollovers
- Annuity Market Improvements

**But These Are Extremely Limited; Cannot Address:**
- Low Contribution Rates
- Large Market Downturns
- Needing additional cash for life’s emergencies
- Annuities are likely to remain expensive; Workers don’t trust them
- Lack of spousal protections
Even an “Ideal” DC Cannot Replicate a Pension

Cost of DB and DC Plan as Percentage of Payroll

- 49% savings
- 22.6% lower returns/higher fees
- 3.8% less balanced portfolios
- 3.8% no longevity pooling
- 16.5% DB cost

Source: The National Institute on Retirement Security
Conclusion: The Three-Legged Stool (Still) Is Where It’s At!

DC Plans were created as a supplement to traditional pensions. They still work very well in that regard.

As the main retirement vehicle, they are extremely problematic. Participants bear most of the cost, and all of the risk. Many of which are extremely difficult to resolve.