

The Changing Face of Employer Sponsored Retirement Plans

Mike Dulaney, FSA, EA, MAAA

Senior Consulting Actuary, Retirement Actuarial Services
Principal Financial Group

Subject: Actuarial Science

Article type: Retirement Readiness Roundtable presentation

Over the past 40 years, there has been tremendous change in employer sponsored retirement programs. These changes, and future changes, have altered the way employees plan, save, and retire. Defined benefit plans used to be the norm but have gradually been replaced with mostly defined contribution plans by most non-public sector employers. Why has this happened? and more importantly, what does it mean for the retirement behavior of employees?

Employer Sponsored Plans

Everyone is familiar with the “3-legged stool” of retirement income. Most people will retire with three sources of income; Social Security, personal savings, and benefits through an employer sponsored retirement program. Benefits from an employer sponsored retirement program have always been an important and critical source of retirement income.

Employers voluntarily offer these retirement programs, and they usually come in one of two broad plan types:

- Defined Benefit Plans (DB plans) – Sometimes referred to as a “pension plan”, these plans typically are paid for entirely by the employer and provide lifetime income after retirement for an employee and their spouse based on factors such as their salary and years of service with the company.
- Defined Contribution Plans (DC plans) – Often called the “401(k) plan”, these plans are typically funded with a combination of employee savings and employer contributions. The participant then manages their investments both up to and during retirement.

From an employee perspective, the largest difference is an employee’s personal responsibilities. In a defined benefit plan, they did very little but continue to work for the company and were guaranteed steady income after retirement. In a defined contribution plan, their responsibilities have drastically increased to include savings, investing, and managing the wind-down of their investments through retirement.

The Shift from DB to DC

You only need to do an Internet search, and you can easily find articles and statistics on the decline in DB plans and increased importance of DC plans. Here are a few I found easily:

- The number of single employer DB plans covered by the PBGC (government agency insuring private sector DB plans) has dropped from over 112, 200 in 1985 to 43,900 in 1997, and less than 24,000 in 2013¹
- Nearly 50% of plans are frozen in some form². This means they either do not allow new employees when hired to participate in the DB plan, or they are completely frozen and existing employees do not receive future increases in their benefit for continuing to work.
- The number of employers in the Fortune 100 offering a DB plan to new employees has declined from 90 in 1985 to 30 in 2013.³
- I personally have not been involved in creating a new defined benefit plan for a company in my 20+ year career.

There are obviously still employers committed to providing a defined benefit plan for their employees. Most employers with a defined benefit plan also offer a defined contribution plan as well. However, there has been a broad shift in our voluntary employer sponsored system from offering a DB plan (or DB and DC plan) to only offering a DC plan for their employees.

Why has this happened? There are a number of factors and reasons, but the main reasons are:

- Lack of appreciation by employees. The defined benefit is often not valued by employees until they are close to retirement and is ineffective and competing for talent when hiring. Many employees change employers multiple times in a career, and the lack of portability is also a detriment. In a DC plan, they often “roll over” their 401(k) balance from one employer to the next.
- Herd mentality is another reason. One of the first questions an employer asks when analyzing their overall retirement program design is “What do my competitors offer?” To the extent one plan freezes, this often leads to a domino effect as others jump on the bandwagon.
- Increased cost of employer health insurance has competed for company’s budget for employee benefits.
- Regulatory changes have altered how employers view the risks of having a DB plan. Changes to accounting and funding rules to a more “mark to market” value have made employer’s financial statements extremely sensitive to changes in interest rates and fair value of assets. With these changes, low interest rates create financial challenges as liabilities increase. Longer life expectancies and increases in PBGC premiums are also viewed negatively by employers with DB plans.

Of these reasons, the last is perhaps the largest. It is also one of the biggest differences in requirements on employers in the private sector vs. employers in the public sector. Every employer who sponsors a DB plan has identical risks to an insurance company selling annuities, and the changes in rules have made them more fully realize this.

DB Risk Management Trends

Even for employees who have a benefit in a DB plan, the shift to DC is increasing speed due to employer's reactions to the risks they now have. Many employers have looked to plan design changes that lower the overall DB benefit provided (prospectively) and shift retirement benefits to DC plans. Lump sums are also increasingly becoming available in defined benefit plans. Lump sums are being added to give participants either the permanent ability (or even temporary window) to take a single lump sum payment in lieu of future lifetime income. This gives participants the responsibility of managing their lump sum through retirement, but also the ability to not use this money towards retirement.

Employers are also using annuities to transfer responsibility for lifetime income payments to insurance companies. This, arguably, transfers the risk to the industry best equipped to manage these insurance risks, but some retirees have expressed displeasure with losing PBGC guarantees.

Frozen defined benefits typically use a combination of these approaches, paying lump sums and buying annuities to fully terminate the plan.

The Retirement "Trip"

If we view preparing and retiring as going on a trip, we have switched from employees getting on a plane piloted by professionals (where they had no responsibility but to get on and stay on!), to where each employee has now been given their own plane and we expect them to pilot it to their destination.

Are employees adequately prepared and trained to fly? These numbers would say generally "no":

- As few as 18% of workers are confident that they will have enough money to live comfortably throughout their retirement.⁴
- 48% of American workers have less than \$10,000 in retirement savings.⁵
- 70% of American workers say they are behind in planning for retirement.⁶

Improvements are needed in many areas for employees to be more successful. This includes increased and earlier saving, managing investment risk, stopping loans and other leakage, and managing retirement income during the retirement period.

New Trends in DC Plan Design

Defined contribution plans are up for the challenge and recognize the need for improved savings and outcomes. Many companies are undertaking review and action to improve the outcomes in their defined contribution plans. The typical changes include one or all of the following:

- Auto enrollment – Instead of participants electing to save in a retirement plan, the company automatically begins deducting at a prescribed rate. The participant must then elect to stop or reduce savings. For plans that have auto enrollment, typically at 3%, many are contemplating increasing the auto savings amount.

- Auto escalation – A participant can chose an auto escalate feature where savings would automatically increase annually to get to the desired savings rate.
- Auto sweep – Annually, or more frequently, re completing the auto enrollment process and make participants (again) elect not to save.
- Stretching the match – Most plans have a matching feature where employer contributions are tied to the employees savings level (for example, 50% of the first 4% of pay). An employer can make the same contribution, but make the employee save more to receive it (for example, 25% of first 8% of pay).
- Diversified investment options – Investment allocations are being developed that help employees manage investment risk. These investment options typically become more conservative as a participant gets closer to retirement age. This utilizes professional investment managers to help allocate your investment risks through diversification.
- Technology and education – Technology has improved the ability for participants to become educated on their plans. Tools are available to model whether they are on track to meet their retirement objectives, and what actions they can take to improve outcomes.
- Lifetime Income options – many DC plans are looking at solutions to provide lifetime income throughout the retirement period. This could include buying an annuity at retirement (which has always been an option), or buying pieces of lifetime income with contributions throughout an employees working career.

It is exciting that employers are looking for ways to improve outcomes within defined contribution plans. Many sponsors have these options and many more are looking at changes to improve participant outcomes.

The Future

I think there is a bright future for employer sponsored retirement plans. Whether a company continues to offer a defined benefit or only a defined contribution plan, we are beginning to give employees the tools and understanding to be able fly through retirement.

Mike Dulaney, FSA, EA, MAAA. Mike is a senior consulting actuary at the Principal Financial Group in Des Moines, Iowa.

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¹ PBGC data book 2013

² PBGC data book 2013

³ PBGC data book 2013

⁴ Employee Benefits Research Institute (EBRI) Retirement Confidence Survey, 2014

⁵ EBRI Confidence Survey, 2013

⁶ EBRI Confidence Survey, 2013