Willis Towers Watson

Perspectives

Improving retirement readiness

Start with defined contribution plan governance

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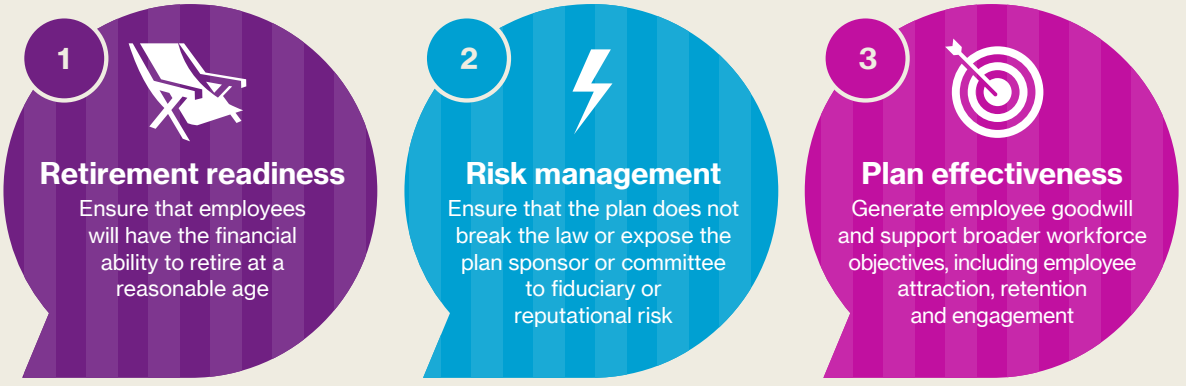
The role of defined contribution (DC) retirement plans, including 401(k) plans, has evolved in recent years. Instead of being a vehicle to allow employees to save their own money to supplement a monthly pension, DC plans are now the sole retirement source for millions of workers. In fact, many plan sponsors have frozen or even closed their traditional defined benefit (DB) pension plans. This evolution may leave some participants particularly vulnerable if they rely on Social Security as the only source of guaranteed income in retirement. This dilemma may force employees to work longer because they aren't prepared for retirement, which, in turn, could adversely impact plan sponsors faced with the incremental costs of an aging workforce.

Despite the shift to a more DC-centric world, **investment governance** structures and processes have been slow to adapt. Typically, DC investment governance mirrors the practices long used by DB plans. For example, DC committees have generally adopted the strategy used by pension plans, which focuses on the benchmark relative performance of their investments. However, investment performance is only a small part of what could ultimately lead to sustained success of DC plans, now that they are the primary retirement vehicle offered in the workplace. Instead, sponsors should focus more broadly on aligning plan design, communications and investment design to help ensure that participants are leveraging their DC benefit in the most efficient way. In our view, the end goal for the plan sponsor should be the creation of a fully funded retirement stream of income for participants.

The 2017 Willis Towers Watson U.S. Defined Contribution Survey indicates that retirement readiness is the top priority for large plan sponsors, yet committees spend a majority of their time discussing plan investments. As the first generation of workers to rely heavily on retirement savings from DC plans reaches retirement age, it's becoming increasingly clear that committees' current investment-centric approach to plan governance may not yield the best outcomes for participants. With more employees falling short of their retirement goals, there is a growing realization among plan sponsors that they need a more proactive and forward-looking approach to managing their DC plans.

Changing goals and changing governance

DC plan sponsors generally have three key goals for their plans:

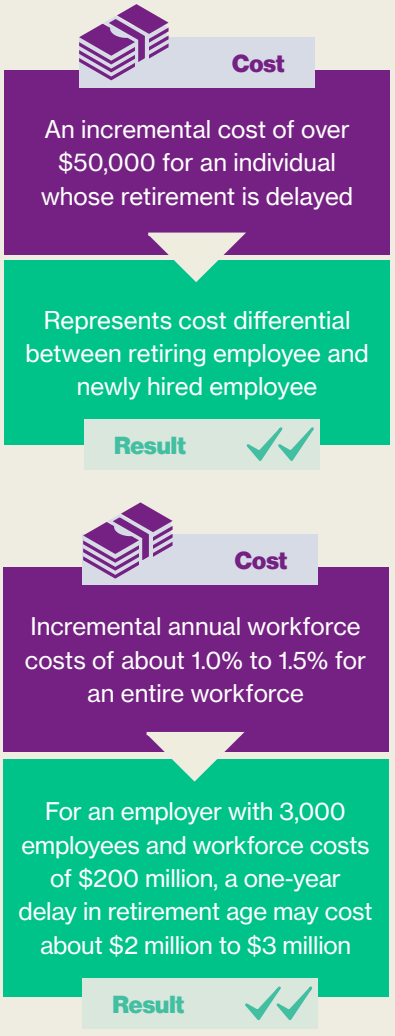


Investment governance *describes the system of decision making and oversight used to invest the assets — and generally achieve the desired retirement outcome — for a plan participant. A DC plan sponsor's governance budget is influenced by three factors that directly impact success: time, investment expertise and organizational effectiveness.*

These goals are not mutually exclusive and thus are not without conflict. We believe plan sponsors need to reassess how they spend their governance budget and realign their resources in a way that maximizes their impact on organizational goals and supports workforce and financial priorities.

(Figure 1)

According to a paper from Prudential titled, "Why Employers Should Care About the Cost of Delayed Retirements," a one-year increase in average retirement age results in:



While fiduciary and litigation risks remain key concerns for DC plan sponsors, especially those related to plan fees, other risks are becoming equally pressing. A recent Willis Towers Watson survey found that 39% of employers now view retirement benefit adequacy as a risk, and 44% expect it to become a risk within two years, putting retirement readiness risks on par with regulatory compliance risks. Plan sponsors are concerned that a lack of retirement readiness among older employees could lead to a stagnant workforce as these individuals remain employed longer than expected, potentially leading to higher labor costs and workforce management issues *(Figure 1)*.

To address these concerns, committees should evaluate their priorities and how they spend their time, rather than simply taking on more responsibilities. Members are often senior-level employees who are already overstretched and have little time to prepare for meetings. The average committee member can dedicate only about 5% of his or her time to plan management issues – not enough time for even the most basic review of a DC plan, its operations and results. Therefore, it's unlikely that committee members will be able to expand their focus to include broader items of DC plan management.

Gaining focus: Delegate your investment decisions

A good first step toward more effective DC plan governance would be to reduce committee members' investment-related responsibilities. Currently, committees spend up to three-quarters of their already limited time on plan investments and results, including evaluating new and existing investment options. As the complexity of investments increases, it's becoming more difficult for committee members to manage them as a part-time job. With even less time to educate themselves on a range of evolving DC issues or even to prepare for committee meetings, these committee members – through no fault of their own – may not meet the "prudent expert" standard under ERISA required for this role.[1]

Of course, investment-related governance responsibilities are not going away. In fact, as DC plans have grown in size over the past few decades, the level of sophistication required for investment-related governance in managing DC plans has increased. Consequently, we believe sponsors should adopt one of two strategies to allow their committee to refocus their efforts on improving retirement outcomes:

1. Delegate investment decisions to an internal subcommittee.
2. Delegate investment decisions to an outsourced chief investment officer (OCIO).

Keeping investment decisions in-house

For sponsors that wish to keep activities in-house, consider the formation of a subcommittee to which the DC plan committee can effectively delegate decisions, such as the selection and termination of managers. A best practice for an in-house subcommittee is three representatives: a voting member from the primary committee, a person involved in the day-to-day management of the plans and a person with financial expertise. Using the subcommittee structure would require sponsors to free up senior resources to enable them to dedicate their time to overseeing plan investments or hire additional staff with investment expertise.

[1] ERISA's "prudent expert" standard requires that plan fiduciaries, including DC plan committee members, exercise the "care, skill, prudence and diligence" that a prudent expert would use in discharging their duties.

Outsourcing investment decisions

Alternatively, committees can rely on an OCIO to help ease their burden and more effectively manage their plan with limited resources. An OCIO is the next evolution in the process to enable committees to focus their time more fully on the strategic objectives, i.e., to ensure that participants use the plan to its fullest potential. In delegating the ongoing management of plan assets, the DC plan committee still retains control by setting appropriate investment constraints, but it can rely on the OCIO for the day-to-day portfolio management, implementation, monitoring and operational activities.

The OCIO model may offer a number of benefits for plan sponsors and participants, while ensuring a focus on improved retirement outcomes:

Speed

Investment decisions can be implemented substantially quicker.

Depth

The number and sophistication of investment asset classes can be expanded, as an outsourced governance structure leverages the delegated investment manager's research and oversight capabilities.

Potential savings

The OCIO provider will generally have global purchasing power in securing discounts from investment managers and other providers hired within a delegated investment management program.

Streamlined service model

Vendor management, investment execution and communication review will be outsourced to the OCIO.

Using an OCIO also helps enable the committee to change the way participant decisions are made. Today most plans offer numerous choices with the expectation that employees will design and manage a diversified portfolio themselves – including periodic rebalancing and ongoing shifts in allocation as they move through various phases of life. However, we have found offering a simplified and streamlined investment menu emphasizing professionally designed and managed portfolios will allow participants to focus on saving, rather than investment-related decisions that they are typically ill-equipped to make.

Behavioral economics at work in plan decisions

An article from behavioral economists Shlomo Benartzi and Richard Thaler provides some important insights on how behavioral forces impact employees' decisions in regard to retirement savings.[2]

A few key findings from the study are:

- Behavioral economists have uncovered the predictable but irrational ways that human beings make decisions – many of which are evident in our saving and investment behavior.
- The shift from DB plans to DC plans, in which employees make retirement planning decisions, means that these behavioral shortcomings could have a pervasive impact on our national retirement security.
- Without programs to overcome these behavioral issues, many American workers will be unable to retire comfortably.

Their article references a study[3] by Sheena Iyengar and Wei Jiang from Columbia Business School on the impact of choice overload. Their research indicated that employees will often delay a decision or decide not to choose, rather than run the risk of regretting the choice they actively made. Using records from nearly 800,000 participants from Vanguard, Iyengar and Jiang found that for every 10 funds added to the choice menu:

- The average employee's participation probability is lowered by 2%.
- The contribution allocation to safe funds (money markets and bonds) is 5.4 percentage points higher.
- The contribution allocation to stock funds is seven to nine percentage points lower.

Iyengar and Jiang's research effectively counters the presumption that more choices provide greater autonomy and self-determination, and lead to higher participation.

[2] "Shlomo Benartzi and Richard H. Thaler (2005)
[3] "How more choices are demotivating: Impact of more options on 401(k) investment," Sheena Iyengar and Wei Jiang.

Measuring the impact of delegating

Once a new governance structure is in place, committees can identify the best way to measure success against the DC plan's new goals. When DC plan goals were focused on maintaining a strong array of plan investments, committees relied heavily on investment returns to measure plan success. When committees start focusing plan goals on retirement readiness and participant outcomes, the committee will need to identify the tools and metrics to evaluate the plan's success relative to each goal, and then monitor plan performance.

Studies by Willis Towers Watson in June 2017 point to a number of successes among plan sponsors that have increased their focus on participant retirement outcomes.

Goal	Solution	Outcomes
Global chemical company: Enhance employees' financial acumen and ability to retire with confidence	Companywide educational effort, including online retirement readiness portal for employees	In the first five months, employees lowered the age at which they could expect to retire
Large telecommunications: Improve financial well-being among low- and middle-income workers	Education campaign, including $50 reward for using retirement readiness tools	Among participants who hadn't been getting the full company 401(k) match, increased their savings level to get the full match
Large hospital system: Improve financial well-being tool usage and employee retirement planning decisions	Embed retirement readiness concept into both automated and customized communications	Over a five-year period, those considered at financial risk decreased the age at which they could expect to retire

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Moving forward

Based on a study conducted by Ambachtsheer, Capelle and Scheibelhut, there is ample evidence to support a committee's decision to reexamine its DC plan governance.[4] The research suggests that the longer-term investment performance gap between good and bad governance is 1% to 2% per year. Further, changing DC plan governance structures and goals to support greater retirement readiness is becoming more essential every day as current and future generations of employees face retirement without access to pension benefits.

While investments are undoubtedly an extremely important part of DC plans, they are not the only element in need of attention. By delegating investment decisions, to either an internal or an external resource, committees will be freed up to spend more time on levers – such as plan design and communication – that will likely have significant impact on participant outcomes and retirement readiness. For example, with a more holistic mandate, committees could be having robust discussions about how to leverage breakthroughs in behavioral economics to improve how participants interact with their DC plans and make these important investment decisions.

As DC plan committees shift their focus to improving retirement readiness within this new model of governance, the mission and agenda of the committee should be updated to focus on driving stronger retirement outcomes for plan participants. This mandate can include: revising the overall plan strategy, plan design and investment structure; improving participation levels; and examining the trajectory of outcomes participants are likely to achieve given their current behavior. As the first wave of DC-only participants gets ready to retire over the next few years, these committees can also help manage the spend-down phase as a complement to their existing focus on accumulation of funds.

Historical measures of evaluating the success of a DC plan – strong investment returns and basic plan statistics – should be reevaluated in the context of increased reliance on these plans for the full retirement income of plan participants. In today's environment, participants need DC plans that are designed to help them maximize their retirement savings. Now, it's up to plan sponsors and DC plan committees to find ways not only to provide but also to optimize the effectiveness of these plans for their employees.

[4] Keith Ambachtsheer, Ronald Capelle and Tom Scheibelhut (1998). Improving Pension Fund Performance. Financial Analysts Journal - FINANC ANAL J. 54. 15-21. 10.2469/faj.v54.n6.2221.

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