America's Workers Need a Next-Generation DC Plan More Than Ever

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Introduction

The economic fallout from the COVID-19 pandemic is a wake-up call for defined contribution (DC) retirement savings plans.

The message is especially urgent as it relates to plan participants nearing or recently entered into retirement as the current situation has exposed how much risk has been shifted onto individuals when it comes to addressing their retirement income needs. They have watched financial markets turn volatile and interest rates tumble, keenly aware that any big losses in their DC accounts now, with little time to recover from them, could have potentially devastating consequences for their long-term financial security. Many have shortsightedly taken steps to try to minimize losses.

In those plans for which Prudential serves as recordkeeper, for example, the overwhelming amount of transfer activity out of equities into stable value and fixed-income accounts in the first quarter of 2020 was completed by individuals between the ages of 55 and 64.[1] If DC plans are going to continue to meet the needs of American workers, they must evolve to address the risks facing pre-retirees and retirees.

[1] Prudential data as of March 31, 2020.

We already know this kind of change is possible. Over the past decade and a half, we've seen DC plans automate themselves in a number of areas—via features such as automatic enrollment, automatic escalation of contributions, and default investing into Qualified Default Investment Alternatives (QDIAs) such as target-date funds—to make it easier for early-career plan participants to save and invest appropriately. Among this group, for whom the amount socked away each pay period is generally the most important determinant of success, it is not unreasonable to use auto features to treat all participants of the same age much the same way.

By the time participants are starting to transition toward retirement, however, their financial circumstances vary greatly and the investment-related risks they face are more numerous and complex. As these participants turn from accumulating assets to generating income for the remainder of their lives, one-size-fits-all solutions become less workable.

We hear it all the time, but it bears repeating: generating a sustainable and sufficient level of income for an unknowable length of time is the toughest financial problem we will ever face.

DC plans can and must do a better job of helping older plan participants create workable retirement income plans personalized to their individual retirement spending needs and wants.

Plan sponsors are well positioned to do this, thanks to:

- A friendlier regulatory environment (e.g., the SECURE Act)
- Their fiduciary oversight capabilities
- Their ability to leverage their size to receive favorable institutional pricing on products and services
- Their access to professional investment resources

Still, the task is not for plan sponsors alone. All stakeholders—plan sponsors, plan participants, plan providers and plan advisors—have a role to play. One way to advance the ball is to stop thinking about retirement savings in terms of account balances and start thinking about them in terms of their ability to generate retirement income. Congress drove home the importance of this idea last year with its passage of the SECURE Act.

SECURE ACT

The new law requires plan sponsors to include a lifetime income disclosure to at least one account statement during each 12-month period and also makes it easier for DC plans to offer retirement income products.

Whether the financial markets become less volatile or not in the near-term, now is the time to begin creating the next evolution of DC plans. The financial security of plan participants will likely depend on it.

Why Workers Need More Help Preparing for Successful Retirement Outcomes

There are many reasons DC plan participants need more help as they prepare for and enter retirement.

1 Many workers haven't saved enough and account balances will need to be stretched.

Even before the bear market of early 2020, researchers were finding that retirement savings balances of pre-retirees were below optimal levels. This may have been attributable in part to plan design features in decades past. For most of their careers, today's pre-retirees did not have an opportunity to benefit from plan features such as automatic enrollment, automatic escalation of contributions, or QDIAs. Timing also may have played a role. The Center for Retirement Research (CRR) has found, for example, that late-cycle baby boomers have acquired significantly less wealth in DC plans than baby boomers who were born earlier in that generation. Among households in the middle wealth quintile in 2016, CRR researchers discovered, late boomers between the ages of 51 and 56 had amassed only 54% of the wealth early boomers had when they were those ages.[2] The researchers called these findings "alarming" and said the poorer results for the late boomers were likely attributable in part to "high levels of unemployment during the Great Recession and more reliance on lower-paid jobs when they re-entered the labor market."[3] During the recent bear market in stocks, of course, many pre-retirees likely sustained losses in their DC account balances again, making matters even worse.

Looking ahead, the current economic turmoil will almost certainly have a negative impact on household savings rates, at least for a while, as some workers see their incomes stagnate or even disappear—and perhaps see their employer's matching contributions to their retirement accounts temporarily lowered as well.

[2] Center for Retirement Research at Boston College, "Why Do Late Boomers Have So Little Retirement Wealth?", March 2020, Number 20-4, p.3.

[3] Ibid, p.1.

The bottom line is that many workers will need tremendous help stretching their DC account balances to ensure that what they have saved provides as much retirement security as possible. Plan sponsors can help by offering both guaranteed and non-guaranteed solutions that can generate reliable income for participants in retirement. For example, plan sponsors can take advantage of changes brought by the SECURE Act to offer plan participants institutionally priced annuities within their DC plans. Annuities are financial contracts that pool the longevity risk of many participants. As a result, those who live longer benefit from mortality credits, which therefore lower the cost to individuals of generating sustainable lifetime income in retirement. Annuities also allow individuals to address the uncertainty of their retirement time horizon and the planning challenges associated with this uncertainty.

2 Workers shoulder a tremendous amount of risk during their pre-retirement years

2020 brought the second period of extreme market volatility DC participants have experienced in the last twelve years. While the bear market of 2020 was a stark reminder of the investment risk individuals carry, the DC world also forces pre-retirees and retirees to shoulder longevity risk, inflation risk, interest rate risk, and sequence of returns risk. It is hard for even seasoned investors to account for all of them.

Entering 2020, for example, it is doubtful that many investors viewed a global pandemic as a likely trigger to investment risk, yet here we are. And even as the stock market has plunged, so have interest rates—which now makes it more difficult for DC plan participants to generate sufficient income from their fixed-income investments. Moreover, if we think of a DC plan participant’s future retirement income needs the way the sponsor of a traditional defined benefit (DB) pension plan would—as a liability that must be funded—lower interest rates have substantially increased the cost for individuals to fund their retirement.

3 Mitigating suboptimal behavior during the pre-retirement and retirement years.

Beyond the risks outlined above, DC plan participants also run the risk of exhibiting suboptimal investment behavior. DC plans have addressed much of this risk during the accumulation phase of the retirement journey with auto features and default investment options. However, as participants enter their pre-retirement years, much more is at stake and a misstep can be the difference between a secure retirement and running out of money. The next generation of DC plans should be designed to drive the savings, investment, and spending behaviors that are needed in these years. This evolution will improve the likelihood that workers with DC plans achieve lifetime retirement security.

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For example, pre-retirees could benefit from similar guardrails as those adopted in the accumulation phase, including enhanced professional management of their accounts personalized to address the risks they face. Likewise, income solutions can provide individuals with peace of mind when markets become volatile, allowing them to stay the course rather than succumbing to fear and transferring into less risky assets at the wrong time of a market cycle. While solutions exist to head off suboptimal behaviors during the latter half of the retirement journey, they have not been widely adopted.

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4 Everyone's needs and wants are different.

Every person retiring with money in their DC plan does so with a unique set of financial circumstances. Each will have saved a different amount for retirement, and each will have different retirement liabilities to be met with the retirement income generated from their savings. These liabilities are often dynamic, changing over time for each individual. Ideally, participants' core non-discretionary needs, such as mortgage payments, utility bills, and food costs—will be covered by reliable sources of income, such as Social Security benefits, pension payouts, annuities, or fixed-income investments.

Core non-discretionary needs, such as mortgage payments, utility bills, and food costs

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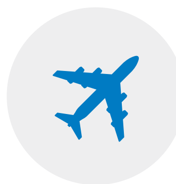

Vacations, travel, entertainment

To generate income to cover things retirees might want beyond their needs—vacations, travel, entertainment, bequests—retirees will likely gravitate toward investing in diversified risk assets, such as stocks. As we've already seen, determining how best to structure a retirement portfolio to meet all these various needs for an unknown period of time can be challenging. The next evolution of DC plans will have to leverage technology to efficiently help DC plan participants with this fraught exercise.

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5 Not everyone has access to professional financial advice.

With DB plans, which are less widespread, plan sponsors pick up all the costs for professional investment expertise and guidance. And because they pool all their participants' assets together, DB plans can negotiate favorable pricing for those services. In DC plans, by contrast, the cost of professional investment expertise and guidance is typically born individually by each participant, increasing the cost per dollar of assets. Worse still, professional advice from a financial advisor often is not even available to pre-retirees, since the majority of their financial wealth is in their DC plan and thus beyond the reach of advisors. Some DC plans offer managed account services that make professional advice available for an added fee, but this remains the exception rather than the norm. For DC plans to evolve, it is important to provide scalable, personalized advice and guidance to pre-retirees and retirees in an affordable manner to help them address the challenges they face. As with automatic enrollment and the use of QDIAs, plan sponsors should consider defaulting participants into these advice solutions to encourage their use.

The Next Generation of DC Plans

It is clear today that DC plans, for all their successes, still fall short of helping many participants with preserving assets in their pre-retirement years and generating lifetime income once they have stopped working. The economic and financial market fallout from the COVID-19 pandemic will likely compound the retirement income challenges for many of them, as substantial market losses just before or immediately after entering retirement may cripple an investor's ability to sustain adequate levels of retirement income throughout their lifetime. It is fair to wonder how many of today's workers will be forced to delay retirement because they lacked the tools needed to protect their savings.

Without exaggeration, the future retirement security of America's private-sector and not-for-profit workforce is at risk.

> To make DC plans work better for them, plan sponsors, plan providers, and plan consultants must prioritize providing personalized retirement income solutions for plan participants, coupled with professional investment management, all at institutional pricing.

The pieces to the puzzle are available. They just need to be put together to take DC plans to the next level to take them from savings plans to plans that help participants generate retirement income. As the market volatility of 2020 has shown, there is little time to waste.

To learn more about the evolution to Next-Generation DC Plans, contact your Prudential representative.

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