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Defined Contribution Institutional Investment Association

Institutionalizing DC Plans: *Reasons Why and Methods How*

By Lew Minsky, DCIIA; Lori Lucas, Callan Associates; Suzanne van Staveren, Goldman Sachs Asset Management

This paper is the first in a series that will explore institutionalization in the defined contribution world. Subsequent papers will consider the fiduciary aspects of institutionalizing, provide actual examples of implemented changes through plan sponsor case studies, and examine institutional investment structures, fees and asset classes in more depth.

Introduction

The expanding role of defined contribution (DC) plans in providing retirement income to working Americans is adding urgency to the question: Are DC plans capable of filling this role effectively? If the answer is less than a resounding "yes," the follow-on question might be, how do we strengthen today's DC plans to deliver more robust income adequacy?

One answer that many in the retirement field are at least considering is "institutionalization." The term implies many things, and the approaches that institutional strategies encompass are also varied. In this paper, DCIIA examines what is meant by institutionalization, how plan sponsors might go about adopting institutional strategies in their DC plans, and possible benefits of doing so as well as potential barriers to overcome.

Research methodology

To obtain a broad industry view with the least amount of bias, DCIIA focused its research on the consultant community. Consultants bring a wide-angle perspective on the marketplace and are knowledgeable about the issues confronting plan sponsors today across plan design, administration, investment management and fiduciary concerns.

To gather consultant viewpoints, DCIIA sponsored two roundtable discussions—one in Chicago, one in New York—in which 20 consultants and attorneys participated. Their names and firms are listed at the back of this paper. DCIIA issued a pre-discussion questionnaire comprised of open-ended questions on institutionalization. Our primary objective was to obtain rich qualitative input and descriptions. To supplement these discussions, we gathered some quantitative data on current practices by plan sponsors from already-published studies conducted by DCIIA and its member organizations.

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Defining "institutionalizing"

> *"'Institutionalization' is a broad mindset that applies beyond investment options. It's how you get people into the plan; how you design it properly; how money moves out of the plan over time; what options are offered; how fees are structured; and what type of unbiased advice might be available for participants along the way."*

In the most narrow definition offered by consultants and attorneys, institutional investing describes the structures employed by institutional funds (not only within pension plans, but other large-scale funds like those within endowments or charitable foundations) that are characterized by low cost and unbundled services, as well as decision-making processes employed by those institutions to ensure appropriate governance.

As several consultants observed, if we look to defined benefit plans as an applicable model for institutional management in the retirement world, then we can further broaden the definition beyond investment management. DB plans are managed to yield a specific outcome: the retirement promise of the plan. This outcome relies not only on investment management but also funding—which, translated into the DC arena, expands the definition to take into account participant contribution strategies. Because DB plans also provide models for the decumulation phase, and specifically for the delivery of lifetime income, these practices can also be associated with "institutionalizing" the DC plan.

Using DB plans as the institutional model for retirement, institutionalization of DC plans can encompass a broad spectrum of practices, including:

- Managing toward a financial target (e.g., income replacement percentage)
- Recognizing the role of funding (in DC plans, funding equates to contribution levels) in achieving the financial target
- Use of institutional investment vehicles that enable scale pricing (separate accounts, collective trusts)
- Improving diversification by offering exposure to alternative asset classes
- Managing risk—specifically risk to achieve an income target through the DC account—and encompassing market risk, shortfall risk, and longevity risk (well beyond fiduciary risk)
- Engaging professionals hired for their expertise in asset management as consultants, focused on enabling achievement of the financial target
- Minimizing leakage—keeping money in the system

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While scale may be necessary for some of these practices, institutionalization does not necessarily need to be the exclusive province of a certain plan size or organizational size. Particularly when the definition is founded on a "mindset" or philosophy, institutionalization becomes accessible to virtually all plans and plan sponsors.

Finally, we can also define the term by what it is *not.* For example, institutional DC management can be contrasted with "retail" investing in terms of governance, bundling/unbundling of services, pricing, purpose and focus, and a reliance on individual participant decisions.

Why institutionalize?

> *"The pros for institutionalizing seem self-evident: clear options for participants, potentially better performance, lower fees, improved transparency, and the increased likelihood that participants will satisfy their retirement needs."*

The overarching reason for institutionalizing the DC plan is that these strategies, and the mindset behind them, are likely to produce better retirement outcomes for participants. The combination of lower fees, more efficient portfolios with more effective asset allocation, a more significant role for professional investment management and more targeted investment management practices, and greater use of "automatic" features that increase funding, generally are consistent with producing larger retirement accounts and greater retirement income adequacy.

Focusing solely on investment results, DB plans have outperformed DC plans over the past 15 years, as explored in several recent studies (see side bar).

Examining the Performance Gap: DC vs. DB Investment Performance

At least three recent studies have found that defined benefit plans have achieved better investment results than defined contribution plan accounts in most—but not necessarily all—conditions.

- **Callan Associates** includes over 70 plans in their DC Index, and reported in early 2011 that "since the beginning of 2006 the DC Index still trails the average DB plan by almost **140 basis** points (bps)."[1]
- **TowersWatson** analyzed performance for 90 of the largest DC plans compared to large DB plans. Between 1995 and 2008, asset-weighted median returns were **1.03% higher** in DB plans than in DC plans. Even after adding 10 bps to DC plan returns for implicit bundled admin costs, the study showed a net performance difference of an estimated 93bps. Additionally, the study found that DB plans consistently outperformed DC plans during the 2003 to 2007 bull market as well as the recent bear market through 2008. Only during the last half of the 1995 to1999 bull market did DC plans outperformed DB plans. [2]
- **The Center for Retirement Research** at Boston College focused on companies that sponsor both DC and DB plans, to minimize the effect of company or participant characteristics on the results. Looking at weighted returns by assets in the plans, DB plans appear to have outperformed DC plans by **1%** and IRAs by **2.8%**.[3]

What accounts for the performance gap? Higher investment fees for DC plans are identified as the primary factor in all three studies. Additionally, both Callan and TowersWatson recognize the impact of higher equity allocations in DC plans, and greater diversification and professional investment management in DB plans.

Could institutionalizing DC plans help close the performance gap?

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The difference has been attributed to various factors, including lower investment fees for DB plans, bundled administrative fees for DC plans, differing equity allocations, and the use of a broader array of asset classes by DB plans, resulting in lower volatility. Some of these advantages can be captured, at least in part, in a DC environment by adopting institutional strategies.

Additionally, an institutional model can deliver other benefits to both participants and plan sponsors. For example, the move away from bundled services and fees can result in greater transparency. The emphasis on utilizing a strong governance model in institutional plans is consistent with fiduciary responsibility, and mitigating fiduciary risk.

What's holding plan sponsors back?

> *"They'll never get a pat on the back [for these changes]. There's no real upside to them. For most plan sponsors, a common attitude is to just wrap it up, put a bow on it, and move on to my day job."*

If the pros are self-evident, why aren't more plan sponsors adopting institutional strategies and the mindset behind them at full speed? The fact is, there are some barriers—hard, and soft—to institutionalization.

Any change to an employee benefit plan is subject to common hurdles such as organizational inertia. In the DC environment, not only the plan sponsor but the investment committee may be reluctant to take on change. Plan sponsors typically have other (sometimes higher priority) duties, and participants seldom exert a cohesive demand for change. The plan sponsors who have overcome these barriers and pursued innovation in their DC plans have done so because they believe it is the right thing to do—for participants, for their company's talent strategies, and in some cases for their own career satisfaction.

The barriers specific to institutionalizing DC plans, according to the consultants, reflect concern over fiduciary liability. Will institutionalizing the plan shift more accountability for retirement outcomes to the plan sponsor and is it in conflict with the direction set by many companies to emphasize individual accountability for retirement? Importantly, is it "safe" from a fiduciary standpoint to move forward on changes that the government has not explicitly protected through legislation? We plan to explore fiduciary issues in more depth in a forthcoming paper in this series. This paper will explore approaches to institutionalization that can still support participant responsibility. And, as plan sponsors and consultants press for legislative protections, it is important to demonstrate the need for protection through already-implemented plan enhancements.

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Consultants and attorneys at the roundtables recognized several other barriers. Bundled service providers are reluctant to move away from the current approach which favors their proprietary investment options. Several consultants mentioned an unreceptive press. And, institutionally structured and managed DC plans may require more time and effort on the plan sponsor's part. The decision-making process, employee communication, potential administrative complexities, and the potential for disruption to participants add up to a perceived road block to change.

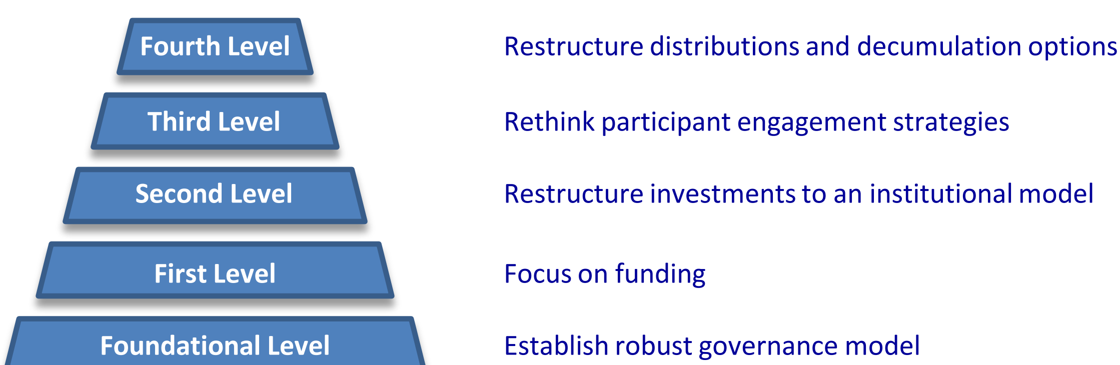
So, is DC institutionalization a viable path? When we consider the risks of maintaining the status quo, we believe the answer is "absolutely." A plan sponsor's fiduciary obligation is to act in the best interest of plan participants, and institutional strategies are undertaken specifically for that reason: to improve plan participant retirement outcomes. So the question changes from *whether* to institutionalize, to *how* to do so?

How to move forward: a suggested path

> *"While there are limitations imposed by size, we think of institutionalization as a process that comes out of being a fiduciary—i.e. it is a process that should be at least aspirational for everyone."*

Plan sponsors who recognize the obligation to act in participants' best interests…who are willing to take on the participant change management challenges… and who can lead rather than follow in the retirement plan world, will want to institutionalize their DC plans. The fact is, many plan sponsors have already taken preliminary steps, whether they did so under the "institutional" banner or not. The high rate of adoption of automatic features (such as automatic enrollment and automatic contribution escalation) is just one example.

Culling the perspectives of the consultants on effective approaches to institutionalization, an *evolutionary* transition, described below, is proposed.



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Foundational Level: Establish robust governance model

> *"Has the plan sponsor put a prudent structure in place, and a commitment to be disciplined in examining the elements of it periodically?"*

The first step to institutionalizing the DC plan is the establishment of a strong governance model. Ideally, it mirrors the DB plan's processes and decision criteria (in organizations that have a DB plan), and reflects the DC plan's purpose. The DC plan's Investment Policy Statement (IPS) also should reflect the governance model. Additionally, the governance model should be supported by a stated organizational commitment to examining its elements on a periodic basis, and updating it as both external and internal environments evolve. A prudent decision-making structure provides a foundation for all of the next steps.

First Level: Focus on funding

> *"Savings rates are so important, so whether you have auto-features or auto-escalation—those can be the single most important factors."*

If a key element of the institutional mindset is managing toward an outcome—i.e., greater retirement income adequacy—then contributions are the most powerful lever to exercise. The PPA provided protections for plan sponsors who implement auto-enrollment and auto-escalation features for exactly this reason.

According to the most recent AonHewitt biennial publication, *Trends and Experience in Defined Contribution Plans*, 56% of DC plans have an automatic enrollment feature (as of Q1 2011); the adoption of auto-escalation increased from 44% in 2009 to 51% in 2011[4].

But there is opportunity to do more, and the impact of doing more could be significant. AonHewitt also reports that two-thirds of the plans with auto-enrollment use a 1% to 3% default contribution rate. A 2010 study conducted jointly by DCIIA and the Employee Benefit Research Institute (EBRI) found that higher levels of automatic contributions and steeper automatic escalations can improve the "success" of DC plans enormously[5] *(see side bar summary).*

Plan sponsors who are institutionalizing the DC plan to improve participant outcomes would therefore want to implement automatic contribution features at the highest possible levels. In addition, these organizations should look to provide communication that not only notifies participants of their options, but also demonstrates the significant impact of saving—and not saving—on their futures.

Finally, plan sponsors can take steps to limit the impact of "leakage" associated with plan withdrawals and cashouts. The recent DCIIA paper, ***Plug the Drain: 401(k) Leakage and the Impact on Retirement*** explores this issue in detail and provides guidance for plan sponsors[6] *(see side bar summary).*

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Automating Retirement Success

DCIIA and the Employee Benefit Research Institute (EBRI) have joined forces to explore the impact of automated participation on the "success" of defined contribution plans in delivering retirement security. The most recent study, published in 2010 examines how success changes with higher levels of employee contributions; faster increases in contributions (1% vs. 2% of compensation); and assumptions regarding employee behaviors when transitioning into a new plan. The study defined "success" as achievement of 80% income replacement in combination with Social Security[5].

Focusing on younger employees with over 30 years of potential plan participation—who are also the participants least likely to have a DB plan to rely on—the analysis revealed large differences in success rates, depending on these plan design factors and employee behaviors:

- The probability of success for the lowest-income quartile increases from the baseline probability of 45.7% to 79.2% when all four factors are applied.
- The impact on the highest-income quartile is even more impressive, with an increase in the probability of success from 27.0% to 64.0%.

The implications are clear: Not only is automation important in helping employees achieve success, but utilizing these features to their fullest potential has significant consequences for each employee's future.

Reducing Plan Leakage

Building on its work with respect to automating plan features, EBRI examined the impact of DC leakage factors—such as loans, hardship withdrawals, distributions and cashouts (including delays in rejoining the plan)—on workers' retirement income adequacy.

- The analysis finds that 401(k) plan cashouts reduce the probability of successfully replacing the majority of income in retirement within the 401(k) environment by more than 5 percentage points (78% with cashouts versus 83% without cashouts).
- When EBRI combined the projected impact of cashouts, delays in participation by job changers, and hardship withdrawals, results show that the projected probability of success under this worst case leakage scenario drops by more than 14 percentage points.
- When modeling loans as the final leakage factor, EBRI's analysis finds that the impact of loan taking on retirement income replacement generally is negligible.

In its Plug the Drain white paper, DCIIA recommended that plan sponsors take the following steps to reduce the impact of plan leakage:

- Actively promote the benefits to new employees of rolling over existing balances from former employer's plans into their new employers' plan, possibly as part of the new hire orientation; encourage ways to simplify and automate this process.
- Encourage retired employees to leave assets in the plan through communication efforts and through plan design (e.g., by allowing more flexibility around partial distributions).
- Facilitate rollovers by offering streamlined, online rollover options.
- Automatically restart contributions after the statutory six-month suspension period.
- Target communication messages to employees' with hardship withdrawals to encourage restarting contributions in the plan.
- Reduce the number of loans allowed and/or restrict the available loan balance.

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Second Level: Restructure investments to an institutional model

> *"I think, in a perfect world, you would take revenue sharing completely off the table."*

Institutional investment managers utilize structures such as collective investment trusts (CITs) or separate accounts that enable scale pricing efficiencies. By separating the investments from the recordkeeping and therefore eliminating revenue sharing, these structures also create greater transparency of all fees (direct and indirect) and greater flexibility in manager selection and design of the plan's investment options.

Another element within this level is the adoption of open architecture for both the Qualified Default Investment Alternative (QDIA) —a.k.a. the default—as well as the core fund line-up. For the QDIA this could mean moving away from off-the-shelf type target date or target rate products to a more customized approach. The core fund line-up options could offer the same funds that make up the QDIA, in a tier that allows participants to "mix" their own portfolio and make changes to allocations over time. With this approach, both tiers are made up of low-priced, best in class "building block" asset classes—or "white label funds"—rather than branded mutual funds. The plan can also add asset classes that have historically proven difficult to incorporate in DC plans, such as commodities, real estate, and others. Institutionalizing the investments in this way increases the flexibility of holdings, enhances diversification, and lowers fees. Often, these steps allow for leverage of the DB fiduciary process, offering potential for significant purchasing scale. Again, all of these factors contribute to better participant outcomes.

By moving to "unitized" asset class funds for the plan's core menu, the plan sponsor can also simplify the menu and offer fewer options. Behavioral economics has shown that "less is more" when it comes to making choices for purchase. Rather than offering a random selection of funds favored by the recordkeeper or the most vocal plan participants, plans can focus instead on adequate diversification of asset classes and style without unnecessary overlap and inadvertent complexity. Condensing the core menu also builds scale—a further factor in reducing fees.

Finally, institutionalization points to unbundling all fees and replacing revenue sharing arrangements with a flat per participant fee for recordkeeping, investment management, consulting, and participant advisory services. This strategy removes any potential conflicts of interest and furthers the transparency of the plan's fees.

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Third Level: Rethink participant engagement strategies

> *"DC plans have been built historically on the premise that participants are engaged and qualified to build their own investment portfolios after careful consideration of their individual retirement needs. Recent behavioral research indicates this idealized vision is far from reality."*

There is consensus that participant education has not created an engaged, informed workforce capable of making optimal decisions. The debate is whether to work to change this, or accept it as an unchangeable factor and design around it. Should plan sponsors accept that participant education is a losing battle, and simply take the participant out of the action as much as possible? Or, in the interest of limiting fiduciary risk and increasing employees' acceptance of their own responsibility for retirement adequacy, should plan sponsors find new and more effective ways to connect?

Most of the consultants in our discussions advocated the latter strategy—finding new ways to engage participants—while recognizing that a segment of the population may not respond, and will continue to need the safety net of protective defaults. Specific directions for improved communication and engagement include:

- Start with an outcome focus: retirement income. Help participants understand what they need to accumulate to achieve the retirement they want, and translate that goal into strategies for today.
- Offer planning tools aligned with the outcome focus, rather than general education (e.g., tax-saving calculators) for more personalized targeted messages
- Model the impact of higher savings as well as different investment strategies to inform participants of projected income adequacy
- Explain fees—including the fact that call centers, advisors, and planning tools deliver value and therefore carry a cost
- Create mechanisms to re-engage participants at key opportunities: pay increases, relocations, status changes, age milestones, market changes.

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Fourth Level – Restructure distributions and decumulation options

"I think we need to entertain the notion of not allowing people, when they terminate, to cash out. I think encouraging them not to is great, but you might need to go further."

One of the most powerful features of the traditional DB plan is the delivery of guaranteed lifetime income. For DC plans, this is an important opportunity in the institutionalization process—but currently a challenge, given the lack of government safe-harbor protections. Plan sponsors have been slow to adopt lifetime income solutions, given the availability of retail options. However, more and more plan sponsors are recognizing the advantages of retaining assets in the plan after participants retire, as they contribute to scale and therefore contribute to pricing leverage. For participants, continuing utilization of the DC plan rather than retail options associated with IRA rollovers are likely to offer fee advantages as well. A number of institutionally-aligned approaches to managing this final phase in the plan/participant relationship are possible.

For example, plan sponsors can undertake an interim step described as "retirement income stream planning," rather than adopting an annuitization model. Participants can benefit from simple education and tools on how a DC account plan can be managed to provide income, and the various strategies and products available to help them do that.

Additionally, plan sponsors can offer participants who are at or close to retirement investment options that are tailored to the specific needs of this cohort. For example, just as pension plans recognize short-term payment obligations in their investment strategies, defined contribution plans can offer retired participants an asset management strategy that emphasizes asset preservation, effective payout options, and risk management. Even a simple design change toward more balance between the number of core equity and fixed income options offered would reflect an increase in the importance of income.

Ultimately, institutionalized DC plans may want to discourage lump sum payouts, as attractive as they may be to participants. As one consultant observed, "You spend a career helping people accumulate assets in funds that are reasonably priced, and then you give it away at the end [by rolling over to retail investments]." Given the increasing proportion of DC assets in the accounts of "baby boomers" who are at or near the retirement threshold, it is likely that new and better options for decumulation will emerge in the near term.

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Forging the path forward

> *"It's the idea of leveraging your position to improve outcomes. Are you paying attention to your status as a plan and not letting participants do what they will with their money? Are you taking advantage of your size and ability to do good as a fiduciary in order to affect outcomes?"*

Institutionalizing DC plans represents a significant change—particularly if viewed as a change in mindset driving new strategies, practices and outcomes rather than as simply the adoption of select plan features. But many plan sponsors have already started down the path, and the challenges are not insurmountable.

To make the process of institutionalizing DC plans easier and more feasible, plan sponsors can take steps that go beyond the boundaries of their plans, or even their companies. Plan sponsors can join DC consultants, recordkeepers, asset managers, policy makers, and other industry influencers in taking action:

- Calling for legislated protections for institutional plan changes undertaken in the best interests of plan participants
- Contributing to the dialogue that takes place in the business media on effective management of DC plans and, more broadly, retirement benefits
- Educating participants on the objectives of the DC plan, and on their responsibilities, opportunities, and resources
- Engaging other plan sponsors in discussion of approaches to institutionalizing, which can lead to the emergence of best practices

We are in the early stages of redefining retirement in the United States. We can help Americans create financially secure retirements, utilizing the proven strategies of our defined benefit experience. DC plans offer powerful opportunities for individuals to create their own future financial security. We have the capability to make them even more effective: why not use it?

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Consultants and attorneys who contributed to this paper through participation in surveys and roundtable discussions:

Rod Bare, Russell

Felicia Bennett, Wilshire

Linda Delivorias, Mercer

Phil Edwards, Curico Webb

Winfield Evens, Aon Hewitt

Terrance Geenty, Morningstar

Mary Beth Glotzbach, Morningstar

Tammy Hughes, Mercer

Hall Kesmodel, HelloWallet

Marla Kreindler, Winston & Strawn

David Levine, Groom Law Group

Amy Labanowski, Mercer

Lori Lucas, Callan

Diya Luke, Towers Watson

Stephen McCaffrey, National Grid

Lew Minsky, DCIIA

David OMeara, Towers Watson

Joe Parlavecchio Financial Engines

Phil Seuss, Mercer

Jeremy Stempien, Ibbotson

Endnotes

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[6]Lori Lucas, "Plug the Drain: 401(k) Leakage and the Impact on Retirement, DCIIA Research Report (August 2011)