FRANKLIN TEMPLETON INVESTMENTS

Topic Paper
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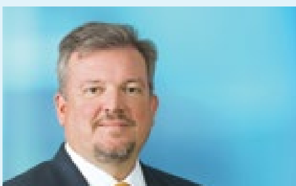
"EASY WINS" FOR DC PLAN DESIGN:
What we can do better now

Inertia is taking hold in some areas of the Defined Contribution (DC) industry today, and the reasons are clear. An active litigation environment has many plan sponsors on their heels, and the steady drumbeat of negative headlines about Americans' retirement readiness and the overall health of the DC system can breed defeatism.

While challenges certainly do exist in the system, we shouldn't let them impede meaningful progress. We believe there is plenty more that can be done today with the tools we already have to build upon the tremendous progress made in the 10 years since the Pension Protection Act of 2006 (PPA).

Some plan design proposals are challenging or controversial, but many are not. We believe that when it comes to plan design, there are a number of "easy wins"—actions that plan sponsors can take today to help their participants achieve retirement success. How do we define an "easy win"? Simply stated, they are plan design ideas that are not administratively complex, resource intensive or time consuming, but can be relatively impactful.



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In this paper based on a nationally-broadcast webcast for the DC plan community, **Drew Carrington,** Head of Institutional DC at Franklin Templeton Investments, is joined in a roundtable discussion by two distinguished industry peers to break down three potential "easy wins" for plan sponsors. **Christine Loughlin**, Partner at NEPC, speaks from her experience working with clients to address these types of challenges, and **Elizabeth Heffernan**, Vice President at Fidelity Investments, provides her perspective on potential administrative hurdles.

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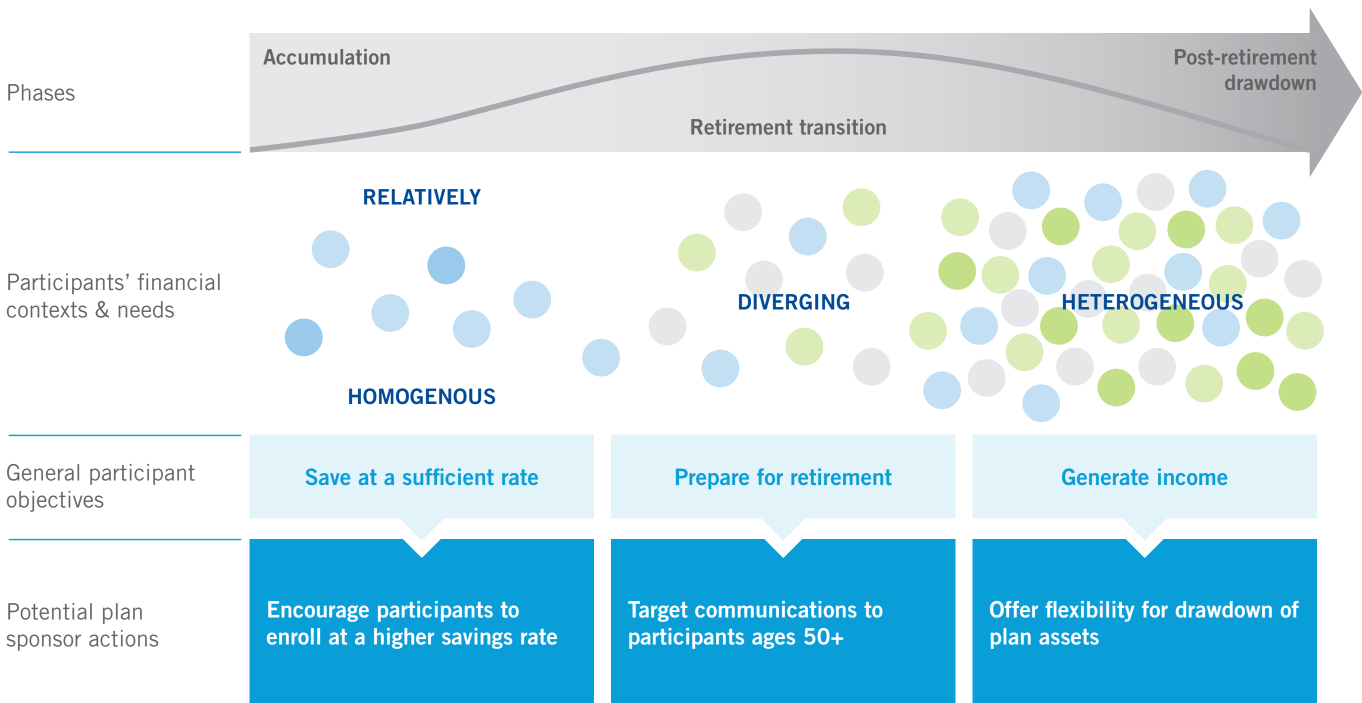
BREAKING DOWN THE PARTICIPANT POOL

These "easy wins" are not uniform changes that will benefit every plan participant. They are *demographically targeted* and *objective-driven*. We believe it's important to avoid viewing plan participants monolithically. Our thinking is informed by the work of Harvard University professor Todd Rose, author of *The End of Average* (2016), who warns that "when it comes to understanding individuals, the average is most likely to give incorrect or misleading results."[1] We ought to acknowledge that the "average" participant often doesn't really exist, and that each participant has their own goals, and lives within a uniquely individual financial context—particularly for participants approaching or in retirement.

While the ideal is to structure solutions to address participants' individual needs, it is helpful to recognize that participants enter distinct phases in the plan in which they have some shared demographic characteristics, goals and challenges. The investment and plan design solutions we implement should seek to address those shared challenges to maximize the utility of our efforts.

For the purposes of this discussion, we identify three general phases through which participants evolve as they (1) start making contributions and accumulate balances; (2) transition into retirement; and then (3) complete their drawdown.



In our framework, **"accumulation"** participants are new entrants into the plan with relatively modest balances and (hopefully) long saving horizons in front of them. While every participant's financial context is unique, as a group, their investment needs are functionally relatively homogenous. In our view, they would be best served by a plan that provides an appropriate qualified default investment alternative (QDIA) paired with auto-enrollment, auto-escalation and an effective communication strategy to encourage positive behaviors that could result in savings rates exceeding the often modest initial default contribution rates.

As participants reach catch-up contribution eligibility at age 50 and enter the **"retirement transition"** phase, they start to demonstrate different characteristics. With larger plan balances, many of them begin to think about generating income in retirement—sometimes years before they make the retirement leap. Their financial contexts and needs are generally more divergent at this time, and we often see higher levels of engagement (measured in terms of rebalancing and other plan activity) and a trend of diversification away from QDIAs such as target-date funds.[2] Regardless of whether their allocation choices are always optimal, we should recognize the message writ large: Participants approaching retirement may no longer perceive the plan QDIA to be meeting their needs as a standalone investment.

Finally, as participants retire and enter the **"payout"** phase, we see maximum heterogeneity among DC plan participants. Great variance exists with regard to retirement expenses, Social Security claiming strategies, other household financial assets, and bequest plans, to name only a few variables. Two retirees with the same plan balance may need very different things from their DC plan.

The investment options we provide to participants should allow them to fit their plan assets into their broader financial context and help meet their retirement needs, however divergent they may be. In our view, a proactive, targeted approach that seeks to address the changing needs of participants in each stage of the plan is the best strategy to improve retirement outcomes overall.

"The investment options we provide to participants should allow them to fit their plan assets into their broader financial context and help meet their retirement needs, however divergent they may be."

“EASY WIN” 1

Encourage participants to enroll at prior savings rate

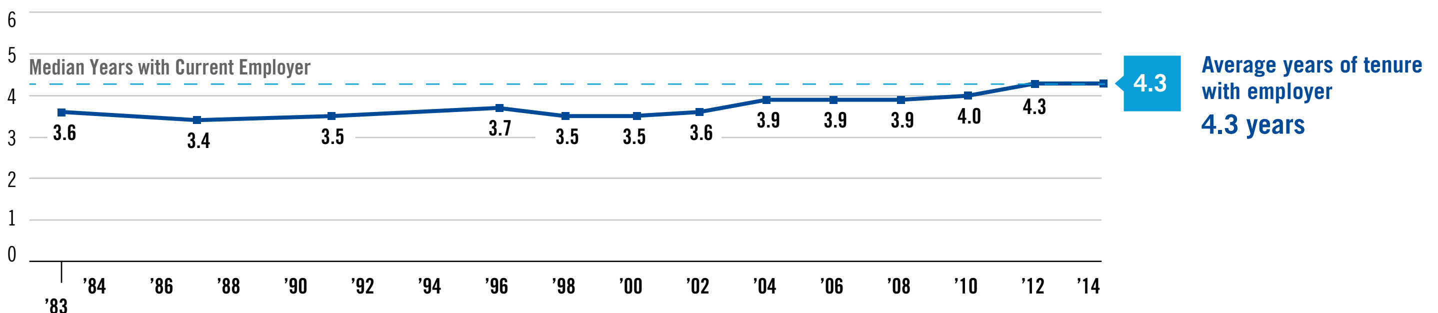
Our first “easy win” for plan sponsors is to encourage newly hired employees to enroll at the deferral rate used with their prior employer.

We believe that this action can help increase average deferral rates and keep participants on track toward a financially secure retirement while saving at levels they can afford.

To understand the problem, it’s important to recognize that participants change jobs in the American workforce quite regularly. The median job tenure in the American private sector workforce is just 4.3 years as of 2014, and that is the highest level it’s been over the last 30 years.[3] Frequent job changes are not a new phenomenon.

Median tenure levels for private sector wage and salary workers

Ages 20 and older, 1983–2014



Source: Franklin Templeton Investments based on Craig Copeland, “Employee Tenure Trends, 1983–2014” EBRI Notes, Vol. 36, No. 2 (Employee Benefit Research Institute, February 2015).

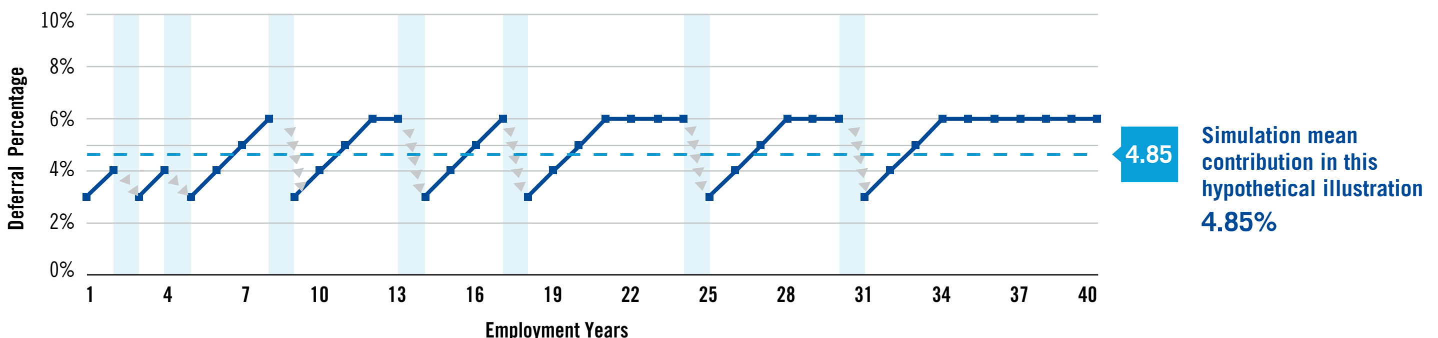
Furthermore, the prevalence of auto-enrollment and auto-escalation in DC plans has skyrocketed in the last decade since the PPA. Larger plans with over $25 million in assets, which include nearly two-thirds of the DC plan participant population, in particular have seen significant uptake of auto features.[4] Auto-enrollment and auto-escalation are now more of the rule than the exception. Therefore, as employees change jobs they are increasingly likely to have been enrolled in a plan at a previous job with auto features.

So, with that in mind, we’re increasingly likely to see participants experience what we call “auto-decrease.” They start working at a firm, are automatically enrolled at the default contribution rate and are automatically escalated over time; but when they change jobs, they may start over at a lower default contribution rate in the new plan as a result of auto-enrollment.

In a classic safe harbor design—wherein defaulted participants start at 3% and escalate to 6%—many participants may not actually save around 6% over their career as you might assume. If they were a typical worker averaging the median tenure over their working career, their average deferral rate would be much lower. In the hypothetical scenario shown above, the participant would actually end up saving only 4.85% over his or her career—far below the intended 6%.

Hypothetical illustration: The “auto-decrease” zig-zag

Consequences of variable tenure



The scenario depicted is hypothetical and is intended for illustrative purposes only.

In our view, this instance provides an opportunity for plan sponsors to enact the behavioral finance concept of “active choice.” That is, instead of a traditional “opt-out” scenario, they can provide a simple decision point that elicits some engagement from the participant.[5] Plan sponsors can maintain the safety net of auto-enrollment at the standard deferral rate, but communicate directly with participants to give them an opportunity to increase their deferral rate, so that as they enter the plan, they at least have the opportunity to avoid a potential drop in their savings rate.

Example of “Active choice”

☐ I would like to contribute to my 401(k) at the same rate as I contributed to a former retirement plan (please provide: ____%)	☐ I would like to contribute to my 401(k) at the default contribution rate of X%.*	☐ I would like to opt-out of making contributions to my 401(k), understanding that this may have an adverse effect on future retirement readiness.

*If no selection is made, you will be enrolled at the default contribution rate.

ROUNDTABLE DISCUSSION

Q: How could a plan sponsor integrate this concept into their plan design with *quick enroll*?

Christine: This would be an item to put forward to the administrative or benefits committee. For context, *quick enroll* generally looks like a donation card you might receive from a charity, or it could be a website that a new hire is directed to. It would say, “Yes, enroll me,” and instead of just using the percent that you may have always used—3% or 5% on that card—you could put in 3%, 5%, 7%, 10% or some other easy amount for a participant to write in or click on. This could help them start saving at the rate they might have saved at before at their prior employer. So with *quick enroll*, it’s very easy, and I think the nice thing about it is the paper you send is very simple and to the point. What we’re trying to do is get people engaged.

Elizabeth: What we’ve seen is that if you give folks multiple choices, they will definitely react to that, and it is a very simple set of steps to get enrolled. One of the interesting things that [Fidelity’s] research found was that plan sponsors were sometimes concerned about making those choices fairly high—like 8, 10 and 12%. But what we found is that whether you put 3/5/7 or 8/10/12, the higher amounts did not necessarily dissuade folks from enrolling at all or seeking a lower amount. What ended up happening was that people, no matter what the choices were, tended to go for the lower numbers. So I think it reinforces this idea that participants want to be led and given good direction.

Q: How else could this idea be implemented?

Elizabeth: Another idea that could get those savings rates up is to pair *quick enroll* with auto-enrollment. So if somebody doesn’t use the *quick enroll*, you still have the auto-enrollment as a backup. But you can get them to higher deferral percentages by giving them a few choices, and making those choices higher than you might be comfortable with as your auto-enrollment default.

Christine: I think that’d be a new concept for most committees or plan sponsors we work with; most think of the two as separate. Roughly 50% of employers don’t auto-enroll at all, so they haven’t really had that conversation about the cost of it or the amount they’re comfortable with. And then for those that do auto-enroll, I think they are very much less concerned with any paper aspects, because they’ve bought into the fact there’s inertia in their plan. So I think in our experience, folks aren’t as concerned about using both concurrently, though it certainly could be interesting.

Q: For plan sponsors that use auto-enrollment with newly hired employees, how could you get new enrollees saving at higher rates?

Christine: I think for those 50% or so of employers that do auto enroll, they could use differentiated auto-enrollment rates. So you could set up an age-based auto-enrollment schedule where new hires ages 20–25 could auto-enroll at 3%, 25–30 could go in at 5% and 30–35 at 7%. I think it’s an easy way to improve your plan tomorrow in a fairly straight-forward way.

Drew: Not everyone knows this, but it is indeed legal for plan sponsors to design their plans with different initial default contribution rates for different groups of employees. Of course, they’ll need to satisfy nondiscrimination requirements, but they do have the ability to auto-enroll and auto-escalate different subgroups as they see fit.

“EASY WIN” 2

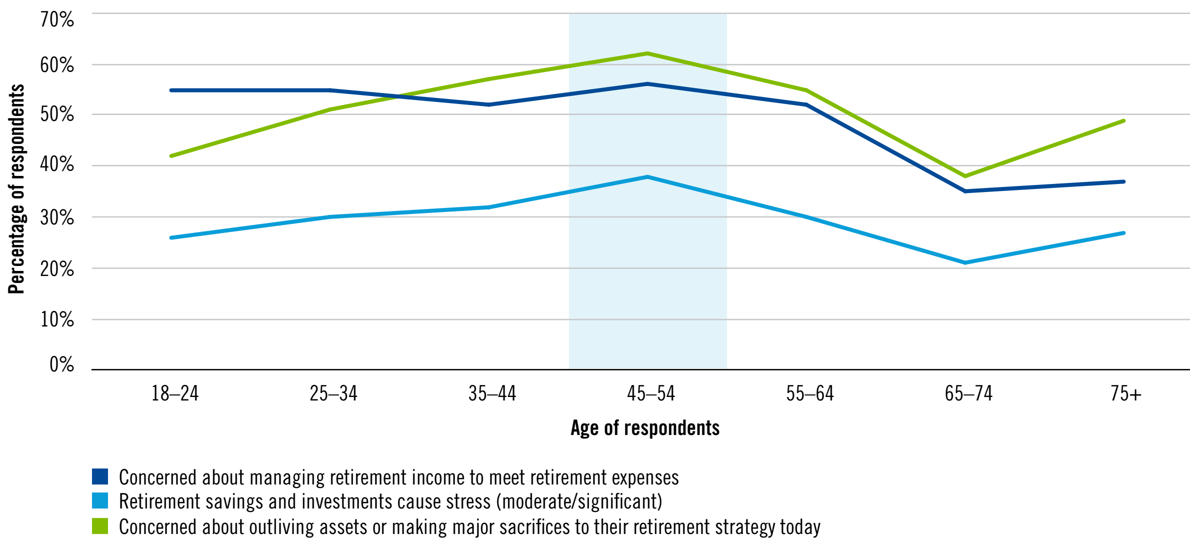
Target communications to participants ages 50+

For our second “easy win,” we suggest that plan sponsors focus on specific demographics within their plan and target communications to help those participants plan for retirement.

Increasingly, we’ve seen a decline in the percentage of plan sponsors reporting the use of general communications and broad-based education as a primary means of communication with plan participants, while targeted or even personalized communications have increased.[6] Instead of trying to target communications to an “average” participant or thinking about participants as a homogenous population, we see plan sponsors slicing and dicing their participant population data to target specific demographics within plans.

We believe that one subgroup of plan participants is particularly well-suited for targeted communications: participants ages 50 and over. According to the 2016 Franklin Templeton Retirement Income Strategies and Expectations (RISE) Survey, stress about financial issues related to retirement peaks among Americans ages 45–54.[7]

Retirement-related stress peaks long before retirement



Source: Franklin Templeton Retirement Income Strategies and Expectations (RISE) Survey, 2016.

Study results suggest that financial stress can be a productivity killer at work, and one of the biggest financial stresses among employees is preparing for retirement.[8] Targeting communications to participant populations most prone to that anxiety can turn this area of concern into an opportunity, since they have more of a reason to pay attention.

Moreover, the widespread notion of the “disengaged participant” is not as applicable with this group. In Franklin Templeton’s recent survey of plan participants aged 50 and over, more than 9 in 10 reported reviewing in-plan investments at least once per year.[9] Nearly two-thirds of them also reported rebalancing or making changes in their plan once per year.[10] The behaviors of this particular subgroup challenge many of the assumptions commonly made about the so-called “average” plan participant.

Participants over 50 are often more engaged with their plans

91%
review in-plan investments at least once per year

62%
rebalance or make changes at least once per year

Source: Franklin Templeton IRIS Web Survey. The IRIS Web Survey was a 15-minute online survey administered during March 2015. All respondents were working (full-time or part-time) or previously worked for a large employer (1,000 employees or more), with at least $100,000 in DC plan balances (including current or former plans). The survey included 455 DC plan participants, ages 50-80.

As a specific idea, we propose engaging participants near their 50th birthday about their eligibility for catch-up contributions (if allowed under plan) and also using this milestone birthday as an opportunity to re-engage participants and encourage additional savings.

For participants who have already reached the top of the auto-escalation ladder, this may nudge them to save more. For participants saving well below the 402(g) deferral limit, this can serve as a signal that additional savings may be a good idea.

This idea is only one example of targeting communication to specific participants around a "milestone" event. These moments can serve as effective opportunities to connect with participants and begin a conversation about saving to support retirement outcomes.

ROUNDTABLE DISCUSSION

Q: What should plan sponsors consider as they plan targeted communications around something like catch-up contributions?

Christine: I think a lot of employers focus on a catch-up communication mailing, but it's the milestone that's important to highlight. It's like driving at 16 or drinking at 21. By age 50, we know people are thinking about retirement, so it's a natural connection point.

Elizabeth: I think that the reference point to the milestone is important, but perhaps more important is making sure that you're really addressing the right people with the right message. So as you think about your population, if you have employees that, even at 50, are still not contributing to the match level, that's really where you would still want to start. You can use the milestone as a reminder, but for that group you should really be focused on getting them up to the maximum match level. To me, the important thing is that it's not just a single message. You can carve people into several groups, and then keep that cadence of messaging growing. Plan sponsors can take advantage of the technology that's available to send different messages to different people based on their actual behavior.

Q: What are some of the specific subgroups of participants in their 50s plan sponsors should consider, and what would be the appropriate messaging for them?

Christine: I think the easy ones are the two ends of the spectrum. You always want to make sure people are maxing out to their match eligibility, so that's a message that continues. And then at the other end of the spectrum, if they are near or at the 402(g) deferral limit, it's good to reinforce their eligibility for catch-up contributions.

Drew: Beyond the two groups Christine mentioned, there are a couple of other categories of participants that the milestone birthday is a chance to reach out to. One would be people who have reached the top of the auto-escalation ladder. If you're a plan with auto-enrollment and auto-escalation features, you can look at people who have enough tenure, have stayed on the escalation ladder and have topped out at the plan's maximum, and then communicate with that cohort and invite them to save beyond the top of the escalation ladder. Similarly, target the potentially overlooked participants. Many plans have added auto features since the PPA, but some employees who were auto-enrolled when the plan added auto-enrollment were not auto-escalated. And some employees actually predate both auto-features in the plan. And many plans have been reluctant to do a re-enrollment or sweep, so that's a category where sponsors can reach out to their participants and invite them to participate at higher levels as well.

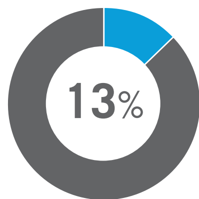
“EASY WIN” 3

Offer flexible payout options for participants in retirement

Our third “easy win” for plan sponsors suggests structuring the plan in a way that provides flexibility for drawing down plan assets to meet retirement expenses.

If necessary, the plan document can be amended to permit terminated participants—particularly those who are retired—to take ad hoc partial distributions. This would enable participants who are over 59½ and separated from service to choose the amount, timing and source of any plan distributions.

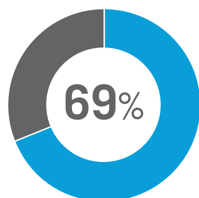
According to one data set, a mere 13% of plans allow for ad hoc partial distributions.[11] That means that the vast majority of plans may be pushing participants—particularly those early in retirement—to make suboptimal decisions about how they manage their retirement assets to meet retirement expenses. For instance, limited distribution options may complicate the process of using DC plan assets to meet early retirement expenses and delay filing for Social Security benefits. A lack of flexibility in distributions may also be a significant factor in the high rates of rollovers and “cash outs” soon after separation from service.



Only 13% of plans allow terminated participants to take ad hoc partial distributions[11]

Source: “Retirement distribution decisions among DC participants—An update,” Vanguard, September 2015.

We consider this issue to be highly important due to the apparent disconnect between plan sponsor intentions and plan realities. Surveys suggest that most plan sponsors believe their plan should continue to serve the needs of retirees. According to a Cerulli survey, 69% of plan sponsors intend for participants to leave assets in the plan and draw down over time.[12] Another study reflects a major shift among plan sponsor views over the last few years, as they increasingly believe the core purpose of their plan should be to serve as an income source during retirement.[13]



Most plan sponsors agree that participants should leave assets in the plan at retirement and draw down over time[12]

Source: The Cerulli Report, “U.S. Retirement Markets 2014: Sizing Opportunities in Private and Public Retirement Plans,” Cerulli Associates. Only plan sponsors to plans with over $100 million in DC assets were surveyed.

Survey results suggest that plan participants generally, but especially those closer to retirement, are looking to their employer for tools and advice on payout strategies.[14] As was referenced earlier, a majority of survey respondents in their 50s were concerned about managing retirement income to meet retirement expenses.[15]

A great deal of complexity exists for participants approaching and in retirement, from managing investment risk to Social Security filing strategies to fitting the plan into their combined household retirement income plan. No one solution will be right for everyone, and selecting and implementing in-plan retirement income products is a separate matter. But plan sponsors can take action today and address the plan rules that may unnecessarily limit the options of participants entering the payout phase.

ROUNDTABLE DISCUSSION

Q: How can plan sponsors approach plan changes to allow for more flexible distributions?

Christine: This is generally something that would fall to a benefits committee. It could be quite simple, or it could be a little trickier if it involves amending the plan rules. There are still a fairly significant number of plans today that, in their plan rules, say the distributions from the plan are either lump sum or installment only. So you can make a plan participant-friendly if you have more flexible language in your plan document. We've made enrollment easy. We've made investment transfers easy. We've made loans easy. But the distribution is that last part that is still too hard for participants in too many plans.

Elizabeth: We would suggest a dialogue within your committee and a review of the plan's rules, because I see that often plan sponsors want the money to stay in the plan, but they often don't realize they have a disconnect in their plan rules. And then you can make incremental steps. You don't have to be perfect. The solutions in this space, as in other parts of the DC marketplace, will evolve. And you can just simply make additions as they become available.

Q: What are the fiduciary implications of helping participants take distributions?

Drew: Our focus here is not on advising participants or telling them what the right answer is. We're talking about adjusting the plan structure to administratively accommodate a variety of payout strategies, which should not result in any increase in fiduciary responsibility.

Elizabeth: I agree with Drew. Making the plan as flexible as possible is not necessarily taking on fiduciary duties. With that said, any specific conversations that start happening with participants about money-out transactions and advising on what they should do will become a fiduciary transaction.

Q: How should plan sponsors think about retired participants and keeping their assets in the plan?

Elizabeth: Today we see plans that have the mindset of participants either staying in the plan or rolling over. But a perfectly appropriate situation for many people might be to do a partial rollover—for instance, if they want to use some of their assets to purchase an annuity but leave the rest in the plan. So those that retire early and need access to this money may also be pigeonholed by a plan that's too inflexible with distributions.

Christine: As a consultant, we think participants are better off leaving their assets in the plan than rolling it over because of the benefit of institutional pricing and investment oversight.

Drew: Making your plan friendlier to partial withdrawals doesn't mean you're stuck with the participant forever. It's not automatically the case that you've entered into some sort of permanent relationship with that participant. Yes, it might make sense for participants to stay in the plan initially, and then at some point they may want to consolidate assets. But we shouldn't force them into that decision just because they need a partial withdrawal in the early phase of retirement, particularly if our intent is to allow them to be able to retain some assets in the plan.

CONCLUSION

Todd Rose makes a bold claim in *The End of Average*: “Any system designed around the average person is doomed to fail.”[16] The increasingly targeted approach we are taking to plan design and participant communications indicates that we are far from doomed. But as he explains, it is ingrained in us to think that the average “represents some kind of objective reality about people.”[1] In the DC world, it can perpetuate unhelpful assumptions about participants that cloud our approach to them—such as that they are disengaged; unable to save more; or incapable of handling any complexity. And it masks the reality that no two participants are identical, and perhaps not a single participant is truly “average.”

Late-career participants in particular have highly individualized retirement challenges and sources of retirement savings. No circumstance is “typical.” The solutions we offer should be flexible enough to account for this variability, while seeking to address particular shared goals and challenges among participants.

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1. Todd Rose, *The End of Average* (New York: HarperOne, 2016), 10.
2. Source: Franklin Templeton IRIS Web Survey. The IRIS Web Survey was a 15-minute online survey administered during March 2015. All respondents were working (full-time or part-time) or previously worked for a large employer (1,000 employees or more), with at least $100,000 in DC plan balances (including current or former plans). The survey included 455 DC plan participants, ages 50–80.
3. Source: Franklin Templeton Investments based on Craig Copeland, "Employee Tenure Trends, 1983–2014" EBRI Notes, Vol. 36, No. 2 (Employee Benefit Research Institute, February 2015).
4. Source: Franklin Templeton Investments based on PLANSPONSOR Defined Contribution (DC) Survey, prepared in February 2016. The PLANSPONSOR Defined Contribution (DC) Survey results incorporate the responses of 5,109 plan sponsors from a broad variety of U.S. industries. Of the 5,109 respondents, 4,406 completed sufficient asset level and plan design information to be included.
5. For further reference: Carroll, G., Choi, J., Laibson, D., Madrian, B., & Metrick, A. (2009). Optimal defaults and active decisions. Quarterly Journal of Economics, 124, 1639-1676. Available at: https://dash.harvard.edu/bitstream/handle/1/4686776/Laibson_OptimalDefaults.pdf?sequence=2
6. Source: J.P. Morgan Plan Sponsor Research 2013, 2015. Note: 2015 Total n=756; 2013 Total n=796. Survey response to the question: "Which of the following best describes your plan's approach to participant communications?" (multiple responses accepted)
7. Source: Franklin Templeton Retirement Income Strategies and Expectations (RISE) Survey, 2016. The 2016 Franklin Templeton RISE survey was conducted online among a sample of 2,019 adults comprising 1,011 men and 1,008 women 18 years of age or older. The survey was administered between January 4 and 18, 2016 by ORC International's Online CARAVAN®, which is not affiliated with Franklin Templeton Investments.
8. Source: PwC. "2016 Employee Financial Wellness Survey." http://www.pwc.com/us/en/press-releases/2016/pwc-financial-wellness-survey-press-release.html
9. Source: Franklin Templeton IRIS Web Survey.
10. Source: Franklin Templeton IRIS Web Survey.
11. Source: "Retirement distribution decisions among DC participants—An update," Vanguard, September 2015.
12. The Cerulli Report, "U.S. Retirement Markets 2014: Sizing Opportunities in Private and Public Retirement Plans," Cerulli Associates. Only plan sponsors to plans with over $100 million in DC assets were surveyed.

1.3 Source: "Metlife 2016 Lifetime Income Poll," Metlife, September 2016.

14. Source: Franklin Templeton IRIS Web Survey.
15. Source: Franklin Templeton Retirement Income Strategies and Expectations (RISE) Survey, 2016.
16. Rose, *The End of Average*, 234.

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