FRANKLIN TEMPLETON INVESTMENTS

Topic Paper
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Optimizing Plan Design in Defined Contribution

KEY TAKEAWAYS

The Pension Landscape Is Evolving: Plan sponsors need to remain attuned to changes and the need to ensure their plans keep pace with the market.

Plan Design Is Critical: Plan sponsor decisions regarding eligibility, enrolment, escalation features, employer matching and withdrawal restrictions can have a significant impact on plan member retirement savings habits, accumulation and future income streams once in retirement.

Investment Options Matter: The design of investment menus should accommodate diverse needs ranging from employees best suited to default target date solutions to those with more nuanced requirements reflecting pre-existing or broader retirement planning factors. Active vs. passive investment styles can be complementary, not contradictory.

Harry Bertoia, the Italian-born American artist (1915–1978), once remarked that “the urge for good design is the same as the urge to go on living.” Bertoia likely was not considering pension plan design in his pronouncement, yet we feel the lesson applies. The design of a good defined contribution (DC) plan should be based on the primary goal of helping employees prepare for a successful retirement, so that they can go on living comfortably into their golden years.

The Canadian pension landscape is accelerating in both its pace of regulatory reform and scale, notably in the DC space and its proxies. Plan sponsors need to be acutely attuned to the need for their plan design to keep pace with the market. Decisions that plan sponsors make today about their plan design will undoubtedly affect future generations of retirees. Whether a plan is designed to maximize the average balance of participants, to minimize the number of participants that fall below a specific net replacement rate[1] or to meet another goal, this paper seeks to address important considerations and recommendations when designing, or in some cases redesigning, a DC pension plan at both the benefit and investment level. We will also discuss the notable implications of these design considerations.

Plan Benefit Design

We can begin by examining the issues from a plan benefit design perspective:

- **Immediate eligibility:** Allowing employees to enroll immediately upon the commencement of employment is optimal, with the notion being to capture employees’ participation prior to them receiving their first paycheque. Where there is a deferral of eligibility, the likelihood of not enrolling may increase. The Canadian trend for immediate eligibility is increasing in both DC and Group RRSP plans: 39% of DC plans and 55% of Group RRSP's now offer immediate eligibility.[2]

- **Automatic enrolment:** This feature is designed to deliver an initial default percentage contribution by employers. Automatic enrolment in countries where DC pension plans are non-mandatory in nature has often led to consequently high participation rates by employees. For example, average US participation rates are 86% (allowing for opt-outs), compared with 63% if automatic enrolment is not utilized.[3]

- **Automatic escalation:** Increasing participant contributions, often tied to pay raise cycles, improves the likelihood of better retirement outcomes, while lessening the impact of the net pay of the individual. In any DC pension plan, average contribution rates need to be purposeful and not just a token amount. OECD models have long cited minimum contribution rates of 10% to generate sufficient retirement capital over the full working life of an individual.[4]

- **Employer match:** Employer contributions that include a match to employee contributions provide an incentive for employees to save and can accelerate the rate of saving. A common match is 100% on the first 3% of employee contributions, but other contribution-matching designs are becoming more prevalent. One such idea is to stretch the match as the employee's contribution increases. For example, an employer may match the first 3% of employee's contributions at 100%, the next 2% at 125% and the next 2% at 150%. This would equate to a 15.5% contribution rate (when totaling employer and employee contributions).

- **Withdrawal restrictions:** When/if possible, restrict the ability of participants to withdraw their savings before retirement. Though the ability to withdraw can increase participation (in a non-mandatory environment), we believe contributions and investment income earned ought to be preserved until retirement, where possible. Plans that allow early withdrawal access to invested capital (as opposed to a loan) can defeat the very purpose for which the retirement savings are designed, in our view. This is often a policy issue and not a plan design issue, but we believe it merits mention nonetheless.

Investment Design

Solutions need to be selected based on the appropriateness of a participant's expected tenure in the plan, underscoring the need for reducing allocations to growth-oriented assets over time. We believe the more pertinent investment design issues are the following:

- **Default option:** "Active choice" is a design feature that requires participants to decide their investment choice. However, regardless of whether this choice is made, plan sponsors need to establish an appropriate default investment strategy, particularly where employees are unwilling or unable to choose investments. The selection of a target date solution as a default option, designed to reduce the equity exposure over time, should generally serve participants well. Target date funds are designed to also help protect participants close to retirement against extreme negative outcomes or drawdowns.

- **"Managed" architecture:** Standalone asset classes such as global equities and cash should be considered for participants who wish to adjust their investment risk exposure or for those who are contemplating their overall pension arrangements. This is important as the reality for most plan members is that their current employer plan is not the sole source, and sometimes not even the chief source of future income in retirement. Many plan members may well have a varied collection of retirement assets, accumulated from one employer to the next over their careers, and so a degree of investment choice becomes even more essential in these circumstances.

- The level of sophistication and knowledge regarding personal finance varies considerably from one participant to another, as do their respective financial needs, priorities, level of engagement and ability to save. For these reasons investment choice is important, but keeping the number of investment options limited to a target date fund solution plus approximately 10 other investment options is adequate and manageable, in our view. While some DC plan sponsors are considering more sophisticated and esoteric investments—such as emerging market equities, global high yield and alternative solutions—we believe that these options should only be included in pre-mixed asset portfolios developed by suitably qualified investment professionals, rather than as standalone investment options for participants.

- **Active and passive investing:** There are two distinct approaches to investing. Active management exists where investment professionals explicitly believe that markets are inefficient and can be exploited. Passive investing is where a manager simply replicates the index; there is no chance of outperformance in rising or falling markets. By their very nature, passive investments do not even attempt to differentiate themselves from the market, and will essentially replicate any broad losses. Active managers, however, aim to identify and invest in opportunities that passive investments overlook, often utilizing disciplined and proprietary security selection strategies to try and outperform the market. Sometimes DC plans approach their decision as a binary choice, choosing either active or passive management. Of course, these decisions are not mutually exclusive, and often the best route is for plan sponsors to focus on creating the best performance outcomes net of fees while managing risk, which can be achieved by blending both approaches.

  Therefore, the discussion needs to be more nuanced than simply a black-or-white approach of active versus passive. Plan sponsors need to select active investment solutions based on, among other factors, whether they have conviction in the asset class in question - such as a Canadian equity or global fixed income strategy, for example. It is crucial to note that investing in passive investments does not lessen the fiduciary responsibility for plan sponsors.

- **Retirement income options:** As the shift towards DC plans from defined benefit plans (particularly in the private sector) continues at pace due to a confluence of factors, the need for retirement income solutions becomes increasingly critical. Once an employee reaches retirement, they must choose a retirement vehicle to convert their accumulated savings into a future income stream. There are presently two options for members. One is to outsource the management of the income portfolio by purchasing an annuity with automatic indexing, the second is to self-manage and assume the risks. Often the decision to self-manage leads to a preponderance of lump-sum benefit withdrawals, which may not represent the optimal solution for plan members. A better approach may be to consider blending an annuity with a self-management option. Within this structure, access to capital is retained, a portion of capital is allocated to an account-based pension, and a guaranteed income stream flows from the annuity. The Canadian market still has significant product development to undertake to strengthen retirement income options both inside and outside of DC plan design, in our view.

Conclusions

In Canada, the concept of DC plans is still relatively young when compared with other countries with DC systems. Many challenges remain to secure the retirement of Canadians, including higher participation, adequacy, financial literacy and the development of retirement income strategies.

Furthermore, while participation in DC plans requires employees to make several extremely difficult forecasts and decisions about their future, the DC plan sponsors who use some of the recommendations previously discussed can help make these decisions easier for employees, in our view. Experience and observation tell us employees making these important decisions on their own run the risk of contributing at insufficient levels, using overly aggressive asset allocations and taking lump-sum benefit withdrawals without considering possibly better solutions. We believe an approach of making larger contributions—ostensibly by maximizing employer matching arrangements—plus aligning asset allocations to better match plan members' risk tolerances and delivering retirees at least a portion of their accrued benefits as an annuity, should deliver better outcomes. Better outcomes, as a result of good plan design, should help retirees go on living comfortably.

1. The net replacement rate is defined as the individual net pension entitlement divided by net pre-retirement earnings, taking account of personal income taxes and social security contributions.
2. Source: Great West Life Assurance Company, *2017 CAP benchmark report: Context Is Everything*, Canadian Institutional Investment Network.
3. Source: Aon Hewitt, *2016 Universe Benchmarks: Measuring Employee Savings and Investing Behavior in Defined Contribution Plans*.
4. Source: OECD, *Design and Delivery of Defined Contribution (DC) Pension Schemes: Policy challenges and recommendations*, 5 March 2013.

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