The power of plan wellness

RETIREMENT PERSPECTIVES

How can individuals be expected to achieve financial wellness if the primary retirement savings vehicle, the defined contribution plan, is either poorly designed or inefficient?

Financial wellness is top of mind for many defined contribution plan sponsors who recognize that having participants who are financially secure benefits sponsors and participants alike. In fact, 82% of financial executives believe that their companies benefit from having workforces that are financially secure.[1] There are several aspects of financial wellness, including the ability to manage day-to-day finances, protect against key financial risks, and achieve important financial goals. One of the most important financial goals that many individuals struggle to achieve is retirement readiness.

This paper explores the relationship between plan wellness and retirement readiness and provides a framework for sponsors and their advisors to evaluate their plan wellness with a focus on balancing participant outcomes and cost efficiency.

KEY TAKEAWAYS

- Heightened fiduciary standards and regulatory scrutiny along with the shift from DB to DC put even more importance on good plan design and ongoing plan health.
- Industry trends, plan design, and investment menu are three core elements of plan wellness.
- Initial evaluation of plan wellness can be accomplished at a high level without requiring detailed participant data.
- DC plan features can serve as levers to encourage positive participant behavior and improve outcomes.

[1]CFO Research/Prudential, “The Value of Employees’ Financial Wellness,” 2016.

The decline in defined benefit (DB) plans has shifted most of the burden of saving for retirement from sponsors to participants—in essence, creating a "do-it-yourself" model to achieve retirement readiness. Defined contribution (DC) plans, originally designed to supplement DB retirement income, have become the primary vehicle for retirement savings for most Americans.

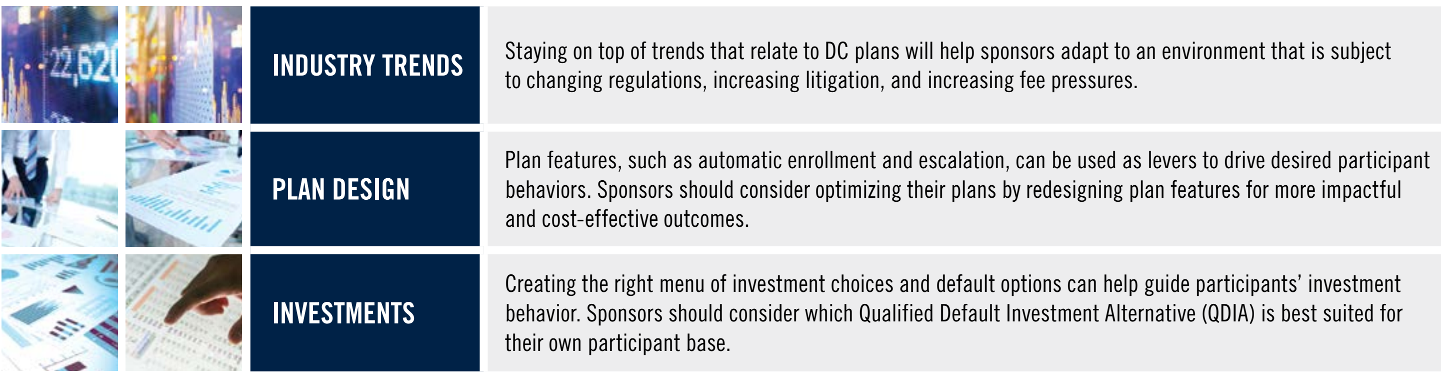
In this new reality, DC plans are not being used to their fullest potential, and still have several challenges. Individuals are not saving enough to prepare for retirement. Alarmingly, over half (52%) of households are currently at risk of not being able to maintain their standard of living in retirement,[2] and the average household approaching retirement had only $111,000 in DC plans and IRA accounts in 2013.[3] To help participants achieve retirement readiness, sponsors have historically evaluated and managed their plans based on current plan statistics, as opposed to the drivers of participant behavior, which may not be as relevant to future outcomes. As a result, many sponsors have not optimized their plan design in a way that produces the best retirement outcomes for participants while maximizing the efficiency of their investment in the plan.

Sponsors can help improve participants' retirement readiness by maximizing their DC "plan wellness" through a holistic approach that focuses on the right design features, thoughtful investment solutions, and compelling participant engagement. Plan wellness can have a significant impact on financial wellness.

In addition to benefitting participants, a focus on plan wellness can help sponsors achieve strategic objectives, such as attracting and retaining talent, as well as helping prepare participants to retire when they wish. Delayed retirements typically mean higher costs for sponsors—new research estimates that a one-year delay in retirement may result in incremental workforce costs of 1%–1.5% annually.[4] By improving participants' retirement readiness, sponsors stand to benefit from lower workforce costs, lower turnover, and higher productivity.

PLAN WELLNESS FRAMEWORK

In evaluating their DC plans, sponsors and their advisors may consider a framework that includes three key elements of plan wellness—responsiveness to industry trends, optimization of plan design, and suitability of investment options.



INDUSTRY TRENDS	Staying on top of trends that relate to DC plans will help sponsors adapt to an environment that is subject to changing regulations, increasing litigation, and increasing fee pressures.
PLAN DESIGN	Plan features, such as automatic enrollment and escalation, can be used as levers to drive desired participant behaviors. Sponsors should consider optimizing their plans by redesigning plan features for more impactful and cost-effective outcomes.
INVESTMENTS	Creating the right menu of investment choices and default options can help guide participants' investment behavior. Sponsors should consider which Qualified Default Investment Alternative (QDIA) is best suited for their own participant base.

Using this framework, sponsors can work with their advisors to evaluate their plan wellness and explore how modifying their plan design, including the plan's investment options, may further boost participants' retirement readiness and financial wellness.

[2]Center for Retirement Research at Boston College. Prudential, "Planning for Retirement: The Growing Impact of Student Loan Debt on Retirement Security," 2016. [3]Center for Retirement Research at Boston College, "401(k)/IRA Holdings in 2013: An Update from the SCF," 2014. [4]Research by University of Connecticut Goldenson Center for Actuarial Research sponsored by Prudential 2015–16.

A NEW APPROACH TO EVALUATING PLAN WELLNESS

Current plan statistics, such as average participant account balances, level of contributions, and participation rates, are helpful in the plan wellness evaluation process, but may not be indicative of future savings behaviors that ultimately impact retirement readiness.

Prudential introduces a new tool that measures hypothetical future outcomes based on plan design features that are key to driving participant behaviors and can be controlled by the sponsor. This approach is more indicative of outcomes at retirement, and may provide actionable insights for sponsors to design plans in ways that help overcome participants' behavioral challenges to saving. Regardless of participants' account balances today, DC plans can be designed to drive positive participant behaviors that can help them achieve desired outcomes.

Prudential's new tool, Plan Power℠, generates a plan wellness score by measuring outcomes, which are based on how the plan design is expected to encourage positive participant behaviors and, ultimately, improve participants' retirement outcomes. Plan Power brings together Prudential's actuarial, investment, and data analytics expertise to predict how most participants will behave in response to various plan features, and uses these predictions to model the outcomes.

When optimizing their participants' retirement outcomes, most sponsors wish to do so in a cost-effective way. After all, sponsors have other priorities, such as health care costs, competing for limited resources, so they need to maximize outcomes to get the largest possible return for the investment they have made in their retirement plans. Plan Power marries these two objectives in its measurement of plan wellness by factoring in two outcomes that mirror sponsors' objectives:

- Successful retirement outcomes for participants
- Cost efficiencies for sponsors

Plan wellness is a balancing act

CASE STUDY: EVALUATING PLAN WELLNESS

The following hypothetical case study demonstrates how Plan Power evaluates a sponsor's plan wellness. Using plan features as input levers, the tool applies actuarial assumptions, capital markets assumptions, and data analysis to project outcomes, which are used to generate the plan wellness score. Along with the score, Plan Power provides an assessment of the plan features and suggests opportunities to improve the plan design at a high level. It also provides a revised plan wellness score to demonstrate how the suggested changes in plan design can improve plan wellness.

Sponsor Profile	A small hospital ("ABC" Hospital) in the Midwest worked with an advisor to evaluate its DC plan wellness and better understand how it stacks up relative to its local health care competitors. ABC Hospital's DC plan includes the following key features: • Sponsor matching contribution formula of 50% of participants' contributions up to 4% • Profit-sharing contribution of 2% of income, consistently granted to all employees every year • Automatic enrollment of 2% for new employees, and no automatic escalation • A well-diversified QDIA option with low fees • No guaranteed income option	**Current Plan Wellness Score**	The Plan Power tool revealed a score of 44 on a scale of 0–100. The score indicates that ABC is spending its DC plan budget inefficiently—that is, the plan is not driving optimal employee savings behavior for the dollars spent. The relatively low matching formula, the low automatic enrollment rate, and the lack of an automatic escalation feature result in a participation rate of only 60% and an average employee deferral rate of only about 4%. In addition, the profit-sharing contribution, which provides funds to all employees, unintentionally signals that the sponsor will consistently provide funds without expecting employees to contribute. As a result, the plan is ineffective in preparing participants to save enough to retire when they want. The tool measures participants' likely replacement ratio, or how much of final pay participants could expect to replace in retirement. ABC's likely replacement ratio for career employees is about 60%—well below the industry rule of thumb of 80%.[5]	
Suggested Action Plan	ABC Hospital works with its advisor to explore various scenarios to improve retirement outcomes by modifying its DC plan features, while retaining its current level of funding. The suggested action plan includes redeploying ABC's profit-sharing contributions to fund a stronger matching contribution capped at 6% of participant contributions, an automatic escalation feature increasing by 1% per year up to 10%, and a retroactive automatic enrollment sweep that would bring current participants to a higher minimum rate of savings. The action plan also includes providing a guaranteed lifetime income option as a further enhancement to its plan.	**Revised Plan Wellness Score**	Reflecting the suggested action plan, the Plan Power score jumps to 98. The improved score reflects the: • Increased cost efficiencies of ABC's contributions. The reconfigured plan would drive positive behaviors, leading to higher participation rates and contribution levels, while keeping ABC's costs at the same level. • Increased effectiveness of participants' retirement outcomes. The redesigned plan is expected to generate a likely replacement ratio of 80%.	

This hypothetical case study is for illustrative purposes only. No two experiences may be alike.

[5] Many studies indicate that retirees who can replace 80% of their income in retirement are likely to be able to maintain their standard of living.

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PLAN DESIGN LEVERS: FEATURES THAT DRIVE PARTICIPANT BEHAVIORS AND OUTCOMES

Sponsors may use DC plan design features as levers to drive participant behaviors that, in turn, drive outcomes. Key features include automatic enrollment, automatic escalation, matching contributions, qualified default investment alternatives (QDIAs), and guaranteed lifetime income.

Automatic Enrollment and Automatic Escalation. To help participants overcome inertia in contributing a meaningful amount to their DC plans, sponsors can incorporate automatic enrollment and automatic contribution escalation, which increases income deferral rates over time.

Despite these design strategies, many plans with automatic features set the contribution bar too low for participants to attain a secure retirement. The most common default deferral is 3% of pay, and only 65% of plans with automatic enrollment also include an automatic contribution escalation feature.[6] For the 35% without contribution escalation, this may be interpreted as a tacit signal that a 3% contribution level is adequate to attain a secure retirement.

A better approach may be automatic enrollment at a rate of at least 6% of pay, along with automatic escalation up to at least 10%, in annual 1% increments. Participants would, of course, be eligible to opt out.[7]

For sponsors, automatic escalation maximum rates that exceed a plan's matching contributions rate may drive positive behavior without increasing plan costs beyond the maximum level of matching contributions. Also, these features may better position plans to pass non-discrimination testing.[8]

Many plans with automatic features set the contribution bar too low; the most common default deferral is 3% of pay

Sponsor Matching Contributions. To encourage participants to contribute, sponsors can match participants' contributions according to a pre-determined formula. The average company contribution in 401(k) plans is 3% of pay.[9] The most common sponsor match rate (42% of sponsors) is dollar for dollar.[10] The majority of plans (57%) require workers to save 6% or more in order to receive the full sponsor-matching contribution.[11]

Although participants should contribute to DC plans at least enough to take full advantage of a sponsor's matching contribution, one in four participants does not save enough to receive their full sponsor match, leaving $24 billion on the table each year.[12] Prudential's experience indicates that a matching formula must be generous enough in matching percentage and maximum contribution matched to effectively motivate participants to contribute. For example, a matching percentage below 50% has been shown to have a disproportionately lesser impact on encouraging participants to maximize their sponsor match, versus more generous matching formulas.

__1__ in __4__ participants does not save enough to receive their full sponsor match, leaving $24 billion on the table each year

[6]Plan Sponsor Council of America, "58th Annual Survey of Profit Sharing and 401(k) Plans," 2015, p. 66. [7]Prudential, "Insights for Optimizing Your Employee Benefit Program," 2016. [8]The Employee Retirement Income Security Act (ERISA) requires several tests each year to prove 401(k) plans do not discriminate in favor of employees with higher incomes. [9]Plan Sponsor Council of America, "58th Annual Survey of Profit Sharing and 401(k) Plans," 2015, p. 27. [10]Aon Hewitt, "2015 Trends and Experiences in Defined Contribution Plans." [11]Aon Hewitt, "2015 Trends and Experiences in Defined Contribution Plans." [12]Financial Engines, "American Employees: Are You Leaving Money on the Table?" May 12, 2015.

QDIA decisions should align with the demographics of the plan

QDIAs. Providing a QDIA that offers asset diversification can help improve participants' investment returns. Sponsors may choose from three types of QDIAs approved by the Department of Labor: lifecycle or targeted retirement date funds, professionally managed accounts, and balanced funds.[13]

The decision about which QDIA is best suited for a participant base may depend on the participants' demographics. For example, sponsors should consider how well a target date fund's characteristics align with the demographics of the plan. The glide path design should address the right risks at the right time—target date funds need to be aggressive enough to address longevity challenges while not over-exposing participants to market risk near retirement.

Seventy percent of plans offer a target date fund as an investment option,[14] and target date funds receive the majority of new plan contributions.[15] More than half (53%) of surveyed financial executives say that participants are apt to make better investment decisions when presented with prepackaged diversified investments like target date funds.[16]

Guaranteed Lifetime Income (GLI). Guaranteed lifetime income products help to improve retirement outcomes by protecting participants from outliving their assets—no matter how long they might live.

From an investment perspective, GLI may help mitigate the risk that severe downturns in the financial markets will impede retirement readiness. Fifty-three percent of surveyed financial executives believe DC plan participants will make better behavioral decisions (e.g., not getting out of investments at the wrong time) if they are invested in an option that includes a GLI feature.[17]

In addition to the features described above, several other features may impact behaviors and outcomes. These include, but are not limited to, auto escalation cap, dollar cap on match, and profit sharing.

[13]Sponsors may also choose stable value funds, a capital preservation product, for only the first 120 days of participation. (This option is for plan sponsors wishing to simplify administration if participants opt-out of participation before incurring an additional tax.)

[14]Plan Sponsor Council of America, "58th Annual Survey of Profit Sharing and 401(k) Plans," 2015, p. 39.

[15]Aon Hewitt, "2015 Trends and Experiences in Defined Contribution Plans."

[16]CFO Research/Prudential, "Helping Employees Achieve Secure—and Timely—Retirements," 2016.

[17]CFO Research/Prudential, "Helping Employees Achieve Secure—and Timely—Retirements," 2016.

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OVERCOMING BEHAVIOR CHALLENGES

How do these plan features drive behaviors and outcomes?

The table below illustrates how plan features help participants overcome key behavior challenges to saving for retirement—underestimating longevity, procrastinating, underestimating risks, and giving in to impulses.

BEHAVIOR CHALLENGE		PLAN DESIGN FEATURES
LONGEVITY	Underestimating how long retirement might last	• **Matching contributions** help increase retirement income for a given level of participant contributions. • **Guaranteed lifetime income** reduces worries about outliving assets.
PROCRASTINATION	Waiting until later to start saving or increase savings	• **Automatic enrollment** overcomes inertia, as no action is needed to enroll. • **Automatic escalation** gradually increases savings rates over time.
RISKS	Underestimating the impact of risks	• **QDIAs,** such as target date funds and **guaranteed lifetime income** may help mitigate the risk that severe market downturns cause people to sell at the wrong time impeding retirement readiness.
IMPULSES	Prioritizing short-term wants over long-term needs	• **Automatic enrollment, automatic escalation, and matching contributions** encourage participants to contribute to the plan instead of impulse buying. • **DC plans** do not provide easy access to funds; penalties are incurred for early withdrawals, except in the event of a hardship.

TRANSLATING PLAN WELLNESS INTO PARTICIPANT FINANCIAL WELLNESS

Overcoming behavior challenges can significantly improve participants' retirement outcomes, and, in turn, their financial wellness. In addition, there is a broad range of tools and capabilities sponsors can leverage to further improve participants' financial wellness. For example, to further improve retirement outcomes, sponsors can supplement their redesigned DC plans with education and additional customization, and do both in a cost-effective manner.

Providing saving and investment education may help participants proactively make informed financial decisions, such as contributing enough to receive their sponsors' full matching contribution. Even the best plan design may not yield expected outcomes if it is not communicated in a way that drives participant engagement, so the right education and communication can help ensure sponsors get the most out of their investment in their DC plan.

Overcoming behavior challenges can significantly improve participants' retirement outcomes

In conclusion, plan wellness can have a significant impact on participants' retirement readiness, an important goal of financial wellness. Together with their advisors, sponsors should consider using a comprehensive suite of tools and capabilities to help improve participants' financial wellness. Taking a holistic approach to plan wellness begins with an evaluation of plan design, potentially using a diagnostic tool such as Prudential's Plan Power. Supported by actuarial, investment, and data analytics expertise, this evaluation should enable sponsors to optimize retirement outcomes while making the most efficient use of their benefits budget.

FOR MORE INFORMATION ABOUT PRUDENTIAL'S APPROACH TO PLAN WELLNESS OR THE PLAN POWER TOOL, CALL YOUR RETIREMENT PLAN SPECIALIST AT (877) 275-9786.

Auto Enrollment: An automatic contribution arrangement that can be used as a feature in a retirement plan allowing employers to enroll employees in the company's plan automatically upon meeting eligibility requirements.

Auto Escalation: A plan design option that allows a plan sponsor to increase participant deferrals annually by a set increment.

Qualified Default Investment Alternative (QDIA): An investment vehicle to which a fund manager may direct retirement plan contributions in the absence of direction from the plan participant.

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Diversification does not assure a profit or protect against a loss in declining markets.

The target date is the approximate date when investors plan to retire and may begin withdrawing their money. The asset allocation of the target date funds will become more conservative as the target date approaches and for 10 years after the target date by lessening the equity exposure and increasing the exposure in fixed income investments. The principal value of an investment in a target date fund is not guaranteed at any time, including the target date. There is no guarantee that the fund will provide adequate retirement income.

A target date fund should not be selected solely based on age or retirement date. Before investing, participants should carefully consider the fund's investment objectives, risks, charges, and expenses, as well as their age, anticipated retirement date, risk tolerance, other investments owned, and planned withdrawals.

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