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The future of defined contribution

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How we got here: A history of retirement in the United States

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FIDUCIARY PERSPECTIVES

How we got here

A history of retirement in the United States

THE DEFINED BENEFIT ERA

1898 **Nuveen founded** to underwrite public infrastructure projects

1918 **TIAA founded** to provide retirement benefits for teachers: TIAA now serves a wide range of individuals and institutions in the academic, medical, cultural and research fields.

1935 **The Social Security Act of 1935 established the Social Security program.** The Social Security Act has been amended and expanded over the years to include additional programs and benefits, and was amended in 1965 to create Medicare (for people 65 and older) and Medicaid (for low-income and vulnerable individuals and families). Social Security has become a crucial part of retirement planning for many Americans, providing a stable income stream in their later years.

1958 **The creation of 403(b) plans can be traced back to changes made to the Internal Revenue Code in 1958** A 403(b) plan is a retirement savings plan available to employees of certain tax-exempt organizations, such as schools, hospitals, religious organizations and nonprofit organizations.

1974 **The Employee Retirement Income Security Act (ERISA) became federal law.** ERISA sets standards and regulations for employee benefit plans offered by private employers. The law was enacted to protect the interests of employees participating in employer-sponsored retirement plans, such as pension plans, 401(k) plans and health insurance plans.

1978 **401(k) plans become law.** The plan originated as a provision in the Internal Revenue Code, more specifically section 401(k), which was added under the Revenue Act of 1978.

Our thoughts on defined benefit plans

It is shortly after 1978 that we see defined benefit plans start to fall away. In 1975, 70% of workers with a retirement plan had access to a defined benefit plan. Today, the number covered by DB plans is 12%. Companies wanted to push the liability management of full defined pension plans off their balance sheet, and to make the employee more responsible for their retirement assets.

What we like

Defined benefit pension plans were not without advantages, and some of these we would like to recreate within the modern 401(k) plan. The guaranteed lifetime income of a defined benefit pension provided participants with the certainty of income on top of their Social Security payments.

What we dislike

However, there were numerous drawbacks with the defined benefit plan. The portability of the assets was limited, with the plans often built on the assumption that the participant would remain with one company for a majority of their career. The defined benefit plans also only ever benefited a relatively small number of people. There were a lot of temporary workers and those who took breaks from employment who were not given access to defined benefit plans.

THE MODERN 401(K) ERA

1983 **At this point a series of legislative changes were made to Social Security to address its long-term financial sustainability.** The reform was prompted by concerns about the future solvency of the Social Security trust funds and the growing number of retirees relative to the working-age population.

1984 **The Retirement Equity Act signed into law** aimed to address gender-based disparities in retirement plans and enhance protections for spouses and beneficiaries. This Act worked to address fair treatment and financial security.

1996 **Assets in 401(k) plans pass $1T**

1997 **ROTH IRAs established**

2003 **HSAs created**

2006 **The Pension Protection Act creates QDIAs,** leading to a huge uptake in target date funds. Target date funds allow for automatic risk adjustment, albeit often based simply on a participants' target age of retirement. So, while they are relatively simple in overall portfolio rebalancing, they provide risk adjustment over time and allow for growth to transition to income over the life of the portfolio.

Our thoughts on 401(k) plans

What we like

The modern 401(k) era has many benefits for plan participants and sponsors alike. Shifting the burden of managing the assets onto the participant affords much more portability when employees change jobs and allows them to allocate the risk of the portfolio according to their needs. Having tax advantaged accumulation vehicles allows people to see much more clearly how well they are saving for retirement, how much of an asset base they have built up, and with projected returns how much they can expect to have in retirement. It encourages early savings, while allowing younger employees to move between companies and not lose what they have saved.

What we dislike

As much as the 401(k) is an ideal vehicle for accumulation, it does not have a set standard to assist with decumulation. Plan participants are often left confused as to their options when they reach the age of retirement, and there is no inherent guaranteed income within a 401(k).

THE SECURE ACT ERA

2017 **Target date funds pass $1T in AUM**

2020 **SECURE Act passed.** The SECURE Act was a significant step forward in retirement legislation. It also highlights that fixing America's retirement crisis is a growing area of concern for Congress, and it has wide bipartisan support. The Act made it much easier for part-time employees to get access to retirement plans, it changed RMD provisions, and opened up a greater use of annuities within 401(k) plans by adding safe harbor provisions.

2022 **SECURE Act 2.0 passed.** This follow-up piece of legislation continued to build on the SECURE Act. It continued to incentivize businesses to offer retirement plans, included automatic 401(k) enrollment, and further changed tax codes and RMDs to help encourage savings by participants.

Data source: TIAA Institute.

What the future holds

While there are elements from the defined benefit era that we want to see make a return to retirement plans, namely guaranteed lifetime income, the drawbacks of the defined benefit era are worth avoiding. Likewise, while the portability and accumulation benefits of the modern 401(k) plan are well-established and worth trying to retain, we feel that we need a solution that enables better decumulation from the basket of assets built during a long career.

We think that an in-plan annuity, that takes some of the accumulated assets built up in the 401(k) structure, and can transfer them into a guaranteed income stream, can present the option that blends the benefit of both solutions. These structures are relatively well established within the 403(b) space but bringing this to the larger 401(k) market can have wide-ranging benefits for a lot of plan participants, while not putting the burden back on plan sponsors.

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next

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Endnotes

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Annuity contracts and certificates are issued by Teachers Insurance and Annuity Association of America (TIAA).

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