The DC System: Successful for Many, Potentially for All

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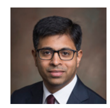

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KEY INSIGHTS

- In the private sector, defined contribution (DC) plans, especially 401(k) plans, have replaced defined benefit (DB) plans as the dominant retirement benefit.
- Retirees who were able to take advantage of 401(k)s while they were working are highly satisfied and financially stable in retirement.
- With 43% of workers facing a retirement savings shortfall,[1] more work is needed to improve the 401(k) system.

For private sector American workers, funding retirement is now largely dependent on workplace-provided 401(k) plans and Social Security. New T. Rowe Price research shows that it is a system that can be successful if people have access to it and use it.

In this paper, we offer insights into where and why the system has worked and explore factors that drive retiree satisfaction and success. We also provide insights into how the system can be more equitable for all.

Historical Perspective

401(k) plans were first offered to employees in 1981 as a tax-advantaged way to save for retirement. Initially offered primarily as a supplement to DB plans, they gained in popularity with tax law changes and changes to workplace and labor force dynamics, including deindustrialization, declining ranks of organized labor, and increased workforce mobility. These factors coupled with the unpredictability of defined benefit funding and rising Pension Benefit Guaranty Corporation premiums also led to many companies freezing or terminating their DB plans.

As a result, in less than 20 years, 401(k) plans became the dominant workplace retirement benefit, and as a consequence the onus to save for retirement effectively shifted from the employer to the employee. As a result, today, only 17% of private sector workers have access to defined benefit plans, while 64% have access to defined contribution plans (mainly 401(k) plans).[2] All along, pundits have posited that this transition from DB to DC could lead to individuals not adequately

[1] VanDerhei, Jack, EBRI Retirement Security Projection Model® (RSPM)–Analyzing Policy and Design Proposals, ©2018
[2] US Dept. of Labor Bureau of Labor Statistics National Compensation Survey, 2018

(Fig. 1) Retirement Expectations of Current Workers vs. Retirees

	Current Workers	Retirees
I will work at least part time in retirement	52%	16%
I will have enough money to pay for health care	46%	77%
I will have to reduce my standard of living	41%	20%
I will live as well or better as I did when I was working	39%	69%
I will be able to leave money to family members or charities	32%	59%
I will run out of money	25%	9%
I will be able to help out younger family members with tuition or housing expenses	25%	27%

preparing for retirement on their own, precipitating a national crisis. Our research suggests otherwise.

In fact, our research suggests that the current system of 401(k) savings coupled with Social Security can, in fact, work for those employees who have access to 401(k) plans and use them effectively. The challenge is not to find a new retirement savings system or bring back an old system, but rather find ways to increase access to 401(k) plans for those who do not have access and increase savings and usage by all workers.

Defining Success

Endemic to any retirement program is the measurement of success. Employers commonly measure the success of their DC plans by using a variety of means to calculate "retirement readiness." Simply put, retirement readiness is the measure of employees' ability to fund their retirement (i.e., the percentage of current employees on track to have accumulated sufficient funds at retirement to provide them with enough income). While employers can measure success for those saving for retirement, it is the actual savers who must measure it for themselves once retired.

So, what is a successful retirement? In July and August, 2018, T. Rowe Price conducted a survey[3] of over 3,000 active 401(k) savers and 1,000 currently retired workers to better understand their attitudes and behaviors about retirement. This paper examines data from the survey, including a comparison of the expectations of active employees with the experiences of retirees.

Experience Exceeds Expectations

According to our 2018 survey, current workers are generally pessimistic about their future retirement, with the majority not expecting to live as well or better than they are now or to have sufficient funds to pay for health care; but is their pessimism warranted?

Interestingly, the actual experience of retired workers is remarkably better than they anticipated. They're faring better than current workers expect (Figure 1), and more importantly, better than what they expected themselves, as shown in the following sections. Part of a successful retirement can be attributed to significantly

[3] T. Rowe Price engaged NMG Consulting to conduct a national study of 3,005 adults aged 21 and older who have never retired and are currently contributing to a 401(k) plan or are eligible to contribute and have a balance of at least $1,000. We also included an oversample of 1,005 adults who have retired with a rollover IRA or left-in-plan 401(k) balance. The online survey was conducted from July 24 to August 14, 2018.

85%

of retirees indicated that their retirement turned out to be as good or better than expected.

(Fig. 2) Financial Practices of Current Workers vs. Retirees

"The following statements are always true of me and my household."

	Current Workers	Retirees
I pay my/our credit card balances in full when due	39%	72%
I am able to stick to my/our monthly budget, if I/we have one	26%	52%
I make some after-tax savings after taking care of all my/our expenses	21%	25%
I carry a balance on my/our credit card and pay interest	19%	5%
I use a fixed budget for my/our spending	16%	14%
I have problems paying my/our required monthly bills	7%	1%

better financial practices exhibited by retirees vs. current workers (Figure 2).

Satisfaction Builds in Retirement

Retirees with savings from DC plans are generally satisfied with their financial situation in retirement (Figure 3). For people who've been retired for more than ten years, the level of satisfaction increases (Figure 4). There are distinct differences in attitudes and expectations based on how long an individual has been retired. Recently retired workers tend to spend more, with spending expectations and practices stabilizing as retirees progress through retirement. This is not unlike the significant differences that exist among active workers at various stages of their careers, as found in extensive T. Rowe Price research on workers in different generations.

Drivers of Retiree Satisfaction

Of the total population of retirees we surveyed, 85% indicated that their retirement turned out to be as good or better than expected, with 80% saying that their retirement years are more enjoyable than their working years. By contrast, 14% indicated that retirement was worse than expected. We can gain valuable insights into potential drivers of satisfaction by examining the differences between satisfied and unsatisfied retirees.

Financial matters—both income and assets, and both current and anticipated expenses—are the primary drivers of retiree satisfaction. Satisfied retirees have more assets, greater incomes, less debt, and fewer concerns about future expenses (Figure 5). Clearly, public policy, plan design, and participant education that encourage early, adequate, and steady savings will go far to mitigate the shortfalls that contribute to retiree dissatisfaction.

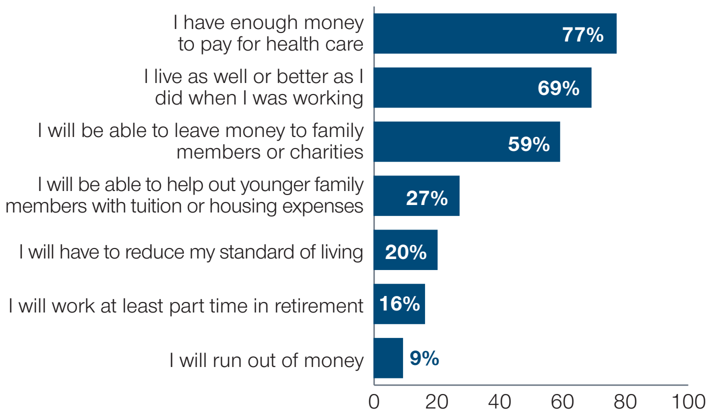
A key financial concern among retirees is the ability to pay for health care. Over three-quarters (77%) of all retirees we surveyed indicate that they have enough to pay for health care: 81% of satisfied retirees and 59% of unsatisfied retirees.

Also critical for individuals is their ability to maintain a standard of living in retirement that is similar to their working years. This affirms our belief that finances play an important role in retiree satisfaction:

- 76% of satisfied retirees report that they live as well or better in retirement as they did while working, compared with only 37% of unsatisfied retirees.
- 15% of satisfied retirees expect to have to reduce their standard of living, compared with 48% of unsatisfied retirees.

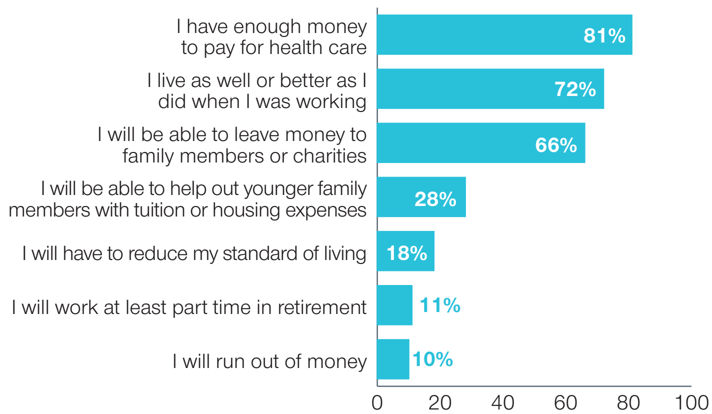
(Fig. 3) Retiree Satisfaction

"Given your savings, income and expenditures, which of the following statements are true of your retirement?"



(Fig. 4) Retiree Satisfaction After 10+ Years in Retirement

"Given your savings, income and expenditures, which of the following statements are true of your retirement?"



- 5% of satisfied retirees expect to run out of money, compared with 28% of unsatisfied retirees.

Retiring on My Own Terms

Another predictor of satisfaction in retirement is the actual catalyst for retirement. Our research shows that retiring in an orderly fashion, when the individual is ready and has saved enough, is much more likely to produce post-retirement satisfaction than when the individual must retire unexpectedly:

- 62% of satisfied retirees reported retiring when they were ready or at the point they had planned to, compared with 51% of unsatisfied retirees.
- 52% of satisfied retirees report that they had attained their desired level of assets, age, and savings, compared with only 31% of unsatisfied retirees.
- And nearly half (46%) of unsatisfied retirees report being forced out or having lost their jobs due to changing company circumstances or health reasons, compared with only 23% satisfied retirees.

Working in Retirement: Often for Social Engagement

As workplace and career norms have shifted in recent years, so has the notion of working in retirement. Increased longevity means that 30-year retirements are no longer unusual, and healthier lifestyles enable older adults to remain active longer than once thought. Working in retirement is correlated with retiree satisfaction, but the impetus for working plays a key role. "I work because I have to" is very different from "I work because I want to."

Only 15% of respondents report working or looking for work, but among this group, the reasons for working are telling. For unsatisfied retirees, 70% of those still working report that they are doing so because they need the money compared with only 42% of working satisfied retirees. Conversely, 32% of unsatisfied retirees report liking the mental stimulation provided by their current work, whereas 52% of satisfied retirees do.

Even with Planning, Health Care Concerns Persist

The top three concerns of all retirees in some way involve health. For most retirees, spending items such as housing, day-to-day expenditures,

(Fig. 5) Financial Data

	Satisfied Retirees[4]	Unsatisfied Retirees[5]
Median household income	$90,000	$65,000
Average household debt[6]	$15,000	$24,000
Money held in retirement accounts[7]	$370,000	$281,000

transportation, and loan repayment are not a concern at all (see Figure 6).

For unsatisfied retirees, the picture is different. For the health-related issues, a significantly higher number report them being a major concern. Long-term care is a major concern for 42% of unsatisfied retirees versus 28% for all retirees. Health insurance premiums are a major concern for 33% of unsatisfied retirees (up from 23% for all retirees), and out-of-pocket health care expenses are a major concern for 37% of unsatisfied retirees (just 20% for all retirees).

Non-health-related expenses are major concerns for unsatisfied retirees, too, including:

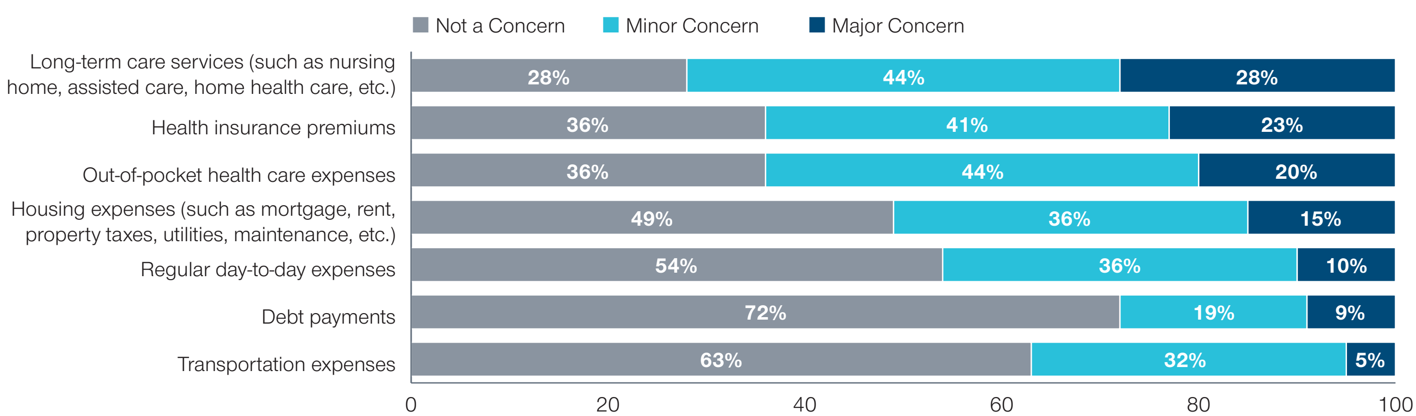
- Housing expenses (38% of unsatisfied retirees)
- Regular day-to-day expenses (28%)
- Transportation expenses (13%)

401(k)s Work—If You Have One

Our research finds that a 401(k) plan can make the difference between a satisfied retirement and an unsatisfied one. The Employee Benefits Research Institute (EBRI) appears to agree. In a 2018 report,[8] EBRI found that, "the probability of a successful retirement depends to a great

(Fig. 6) Spending Concerns

"Which of the following spending items are currently a major, minor, or not a concern for your household?"



[4] Agreed "somewhat" or "completely" that "so far, my retirement has turned out to be just as good or better than expected."
[5] Agreed "somewhat" or "completely" that "so far my retirement has turned out to be worse than expected."
[6] All types of debt, self or other adult. 51% of satisfied retirees report no debt, versus 43% of unsatisfied retirees.
[7] Market value of accounts of self and other adult, including traditional or Roth IRAs, 401(k), Roth 401(k), 403(b), 457, profit sharing or other DC accounts at current or former employers.

72%

of workers who've had access to a DC system for 20 or more years are likely to achieve retirement readiness.

extent on whether employees are eligible to participate in a [DC] plan." The report projects that 43% of households will run short of money in retirement. A retirement savings shortfall of $90,000 on average is projected for workers aged 35–39 who don't currently have access to, and are not projected to gain access to, the DC system.

EBRI also found that retirement readiness is low (48%) for people with no projected future access to a DC plan. But with just one to nine years of future eligibility, that percentage increases to 55%. And when access to the defined contribution system increases to 20 years or more, the likelihood of retiring ready increases to a full 72%.[9]

Public Policy Implications

With DB plans largely having disappeared in the private sector, individuals are relying on 401(k) and other DC plans as their primary vehicle for retirement saving. And they work; many have retired successfully and are living happily thanks in part to a DC plan.

However, 36% of workers in the private sector still don't have access to a plan.[10] T. Rowe Price supports efforts to expand the DC system to all working Americans, either via incentives for companies to establish plans or through the elimination of unnecessary barriers that prevent them from doing so.

In addition, improvements are needed to increase workers' participation in the plans. Features such as automatic enrollment and contribution escalation can help plans overcome concerns about low participation levels. Recordkeepers also continue to make strides in the development of education and financial planning tools that enable plan participants to better build and maintain financial well-being. Access to proper advice and planning tools are critical ingredients to any 401(k) plan's design to motivate participants to keep participating and contribute at sufficient levels.

Implications for Consultants, Plan Sponsors, and Participants

Understanding the drivers of retiree satisfaction can help plan sponsors and their consultants create better communications plans for active employees. First, and most importantly, the overall level of a retiree's assets plays the biggest role in satisfaction. Plan design initiatives that push early, steady, higher rates of saving can have significant impact. These include increasing the initial automatic deferral rate to at least 6% and adding automatic escalation so that participants reach a savings rate of at least 15% (including employer contributions) as early as possible in their careers.

Second, other factors (health care costs, how someone retires, and the need to augment retirement income with employment) can make the difference between retiree satisfaction and dissatisfaction.

Many traditional approaches for educating participants ignore these factors, primarily because they tend to focus on a targeted savings goal. A better way may be to start with communicating about what makes a retirement successful or unsuccessful so that participants connect the value of saving and their ability to retire on their own terms. For example, a contribution rate calculator could be tied to retirement success factors to make the illustration more tangible for participants. If participants can more clearly see how their actions today could affect their control of when and how they retire, they might be more likely to make positive behavioral changes.

[8] VanDerhei, Jack, EBRI Retirement Security Projection Model®(RSPM)–Analyzing Policy and Design Proposals, ©2018
[9] Ibid.
[10] US Dept. of Labor Bureau of Labor Statistics National Compensation Survey, 2018

ABOUT OUR STUDY

T. Rowe Price engaged NMG Consulting to conduct a national study of 3,005 adults aged 21 and older who have never retired and are currently contributing to a 401(k) plan or are eligible to contribute and have a balance of at least $1,000. We also included an oversample of 1,005 adults who have retired with a rollover IRA or left-in-plan 401(k) balance. The online survey was conducted from July 24 to August 14, 2018. This is the fourth in a series of participant surveys, and data from prior surveys is used in this report for comparison purposes.

For more information on this and our other extensive research on retirement savings and spending, please contact your T. Rowe Price representative.

FINAL THOUGHTS

When coupled with Social Security, DC plans have delivered retirement satisfaction to those who have adequately contributed to them. A key to making the current system successful for all is to make DC plans available to more U.S. workers and design them in a way that gets workers saving early and regularly.

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