The last few decades have seen dramatic shifts in employer-sponsored retirement plans in the United States. The number of defined benefit (DB) plans is declining at a rapid rate while defined contribution (DC) plans are increasingly used in place of them. Frozen or terminated DB plans rose from 5.4% to 41% between 2002 and 2011 among Fortune 1,000 firms and aggregate funding levels dropped from 124% to 83% over the 10-year period 2000–2010. DB plans now represent 39% of the total retirement asset pool.1

**REGIONAL SHIFTS**

This is not just a U.S. dynamic, but also a critical economic and social issue around the globe. Countries that historically depended on DB structures as cornerstones of retirement security for their populations are realizing that they are no longer economically viable. However, the shift to DC plans is not coming as quickly as it should, specifically in Europe.

**Europe’s Transition to DC**

The European Union (EU) is still predominantly a DB pension environment. Only 40% of total assets (US$1.3 trillion) are currently held in DC plans.2 A survey by the European Federation for Retirement Provision (EFRP) examines participation in DC plans by country (see chart 1).

**CHART 1: DC IN EUROPE**

<table>
<thead>
<tr>
<th>Assets of DC Plans in the Survey by Country (U.S. dollars, billions)</th>
<th>Active Members of DC Plans in the Survey by Country (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria 13.6</td>
<td>Austria 2.8</td>
</tr>
<tr>
<td>Belgium 30.0</td>
<td>Belgium 2.1</td>
</tr>
<tr>
<td>Bulgaria 0.9</td>
<td>Bulgaria 2.8</td>
</tr>
<tr>
<td>Denmark 228.5</td>
<td>Denmark 4.6</td>
</tr>
<tr>
<td>France 42.0</td>
<td>France 3.7</td>
</tr>
<tr>
<td>Germany 14.0</td>
<td>Germany 0.4</td>
</tr>
<tr>
<td>Hungary 7.2</td>
<td>Hungary 3.0</td>
</tr>
<tr>
<td>Iceland 13.7</td>
<td>Iceland 0.1</td>
</tr>
<tr>
<td>Ireland 22.8</td>
<td>Ireland 0.4</td>
</tr>
<tr>
<td>Italy 57.4</td>
<td>Italy 3.5</td>
</tr>
<tr>
<td>Netherlands 8.7</td>
<td>Netherlands 0.7</td>
</tr>
<tr>
<td>Poland 40.7</td>
<td>Poland 14.5</td>
</tr>
<tr>
<td>Portugal 0.3</td>
<td>Portugal 0.0</td>
</tr>
<tr>
<td>Romania 0.4</td>
<td>Romania 4.4</td>
</tr>
<tr>
<td>Spain 28.6</td>
<td>Spain 1.9</td>
</tr>
<tr>
<td>Sweden 31.2</td>
<td>Sweden 6.7</td>
</tr>
<tr>
<td>Switzerland 195.0</td>
<td>Switzerland 2.9</td>
</tr>
<tr>
<td>UK 562.5</td>
<td>UK 3.5</td>
</tr>
</tbody>
</table>

Source: EFRP, Workplace Pensions – Defined Contributions, March 2010

However, the historical practice of member states or occupational plans providing DB-style pensions is being replaced, and the trend toward DC is growing. There are now nearly 60 million active members.

Nearly all new plans being offered to employees are DC. Simple approaches to investment options are favored, including default options, guaranteed income savings funds and lifecycle funds. However, employers in many European countries are still struggling to convince their populations that DC is a viable approach.

**Trends in Asia-Pacific**

In the Asia-Pacific region, Australia has legislated the DC approach to retirement; here, the superannuation fund plays a dominant role in retirement security. Employees are mandated to participate at a 9% contribution rate. Moreover, retail and employer- or group-sponsored superannuation plans provide for professional investment management during active employment and into the retirement payout phase.

**United Kingdom Initiative**

The United Kingdom is currently working on an approach similar to Australia’s, for certain low-wage employees. The voluntary National Employee Savings Trust (NEST) DC program launched in early 2011.

**Predominant U.S. Solution**

In the United States, a voluntary corporate approach is in place, popularly known as the 401(k) – a tax-deferred DC retirement plan. The current U.S. private defined contribution market includes more than 637,000 plans with total assets of $3.5 trillion dollars and 62.4 million active participants. The corporate DC plan has grown at a rate of 4.9% CAGR from 2005–2010 and is expected to grow at a 6.9% CAGR from 2011–2016.3

DC plans have come to dominate the U.S. retirement market as the preferred corporate employee retirement benefit. Beyond the U.S., however, a consistent solution has yet to emerge, creating a puzzle for multinational corporations that wish to establish scalable retirement plan solutions across a global employee base.

**DC: A Global Model?**

Could the U.S. DC industry serve as a model for markets around the globe? In the past 30 years, the U.S. defined contribution market has become one of the most sophisticated in the world. It transformed retirement planning by transferring retirement savings responsibilities from the employer to the employee.

While significant challenges remain in finding effective ways to educate 401(k) participants about prudent saving and investing, the U.S. DC model can prove instructive to nations seeking viable alternatives to struggling DB plans. The global markets can also learn from what the U.S. hasn’t done as well, such as helping participants understand asset allocation, allowing borrowing against the plan, and other shortcomings.
Typical Plan Features
Most U.S. DC plans allow for daily access to information and processing of investment transactions. Additional plan offerings to participants include retirement planning, investment education and advice, and a broad array of investment options that span the risk/reward spectrum.

Typical Investment Vehicles
The U.S. DC investment industry infrastructure allows for open architecture of investment choices, trades that settle overnight, registered and unregistered funds, company stock, and brokerage accounts for the highly sophisticated investor. Opportunities are also available to allow for the combining of DB and DC investments for scalability and governance.

As a global financial services company, Northern Trust is a leader in both the DB and DC industries. Chart 2 displays DC plan assets that Northern Trust services today, based upon our global book of business.

Plan Administration
U.S. corporations with established DC plans have relationships with providers to integrate, process and support all that is required to successfully administer these plans, including servicing employees, participants and retirees. For U.S. employees, these DC plans – along with Social Security benefits and personal savings – can provide the complete financial support required for retirement, provided that employees have adequate education and make appropriate decisions. For DC plan sponsors, ongoing management of the plan typically revolves around:

- Increasing participation, education and use of advice so employees maximize the benefit of the DC plan
- Responding to annual regulatory reporting changes and updates
- Offering new investments options that deal with changing employee demographics (i.e., addressing distributions amid current market conditions)
- Adapting to population shifts (i.e., retiring Baby Boomers and demographic differences among younger participants)
TRENDS IN THE U.S. DC MARKET

In its annual U.S. Defined Contribution Investment Survey (August 2011), Mercer surveyed 233 plan sponsors to gather their views on investment trends, focusing on the use of:

- Inflation protection options as standalone investments
- Target date/target risk options
- Investment advice and managed accounts
- Fixed payout options inside or outside of the plans

Following are some of the Mercer survey’s key findings.

Inflation Protection Options

Protecting participants against inflation is a key focus. Forty six percent of plans in Mercer’s survey (see chart 3) offer or plan to offer standalone inflation protection. Treasury Inflation Protected Securities (TIPS) are a commonly used strategy.

Plans with more than $1 billion have the highest percentage of TIPS, at 31% versus an overall average of 24%. Nineteen percent of plans with more than $1 billion intend to offer these strategies within the next year.

Target Date and Target Risk Funds

Thirty eight percent of plan sponsors in Mercer’s survey indicated that 10% or less of their plans’ assets are allocated to target date funds. Plans with assets between $1 billion and $5 billion have the highest usage of custom funds: 17% use custom target date, 12% use custom target risk funds. Twenty percent of plans with assets of more than $5 billion use custom target date funds – triple the percentage of the broad group. Aggregate data on target date and target risk usage is shown in chart 4.

Northern Trust Client Target Date and Target Risk Usage

By way of comparison to Mercer’s study, use of target date and target risk products among Northern Trust clients with daily valued DC plans is shown in charts 5 and 6. Twenty two percent of Northern Trust clients that include target date investments in their DC plans use custom solutions while 73% use off the shelf products. The remainder use custom target risk funds (3%) or a combination of all (2%).
**Investment Advice/Managed Accounts**

Mercer’s 2011 survey also focused on investment advice, managed accounts, and fixed income and payout options. Aggregate data is shown in chart 7; the survey revealed the following findings.

- Among plan sponsors that offer advice, 68% indicated that 10% or less of participants actually enrolled in the program.
- Among plan sponsors that offer a managed account program, 71% indicated that 10% or less of participants actually enrolled in the program.
- Among plans that offer managed accounts:
  - In 78% the participant pays the fees;
  - In 11% the plan sponsor pays the fees; and
  - In 11% there are shared sponsor/participant fee arrangements.

The Mercer survey also provided data on retirement income/spend-down trends by asking plan sponsors what options they offer that are designed to provide fixed payouts during retirement. The vast majority (80%) offer participant annuity purchases outside the plan at retirement. Other options are depicted in chart 8.

**Fixed Payout Options**

Of Mercer’s respondents that offer fixed payout options, 59% offer them as standalone investment options. Twenty six percent don’t currently offer but expect to offer fixed payout options, and 15% include them as components of their target fund dates.

**NORTHERN TRUST RESEARCH: THE PATH FORWARD**

Northern Trust is one of the largest providers in the U.S. DC market, with $225 billion in assets under custody or management. In 2010, Northern Trust’s Defined Contribution Solutions Group launched a multi-year study with Greenwich Associates entitled *The Path Forward*. The study compiled input from major U.S. plan sponsors and consultants who were asked to envision the ideal DC plan. Its findings could prove instructive to non-U.S. plan sponsors interested in optimal plan design.

**Number of Investment Options**

Participating plan sponsors were asked to specify the ideal number of investment options in a DC plan.

- 10% preferred 5 or fewer
- 30% preferred 6 to 10
- 45% preferred 11 to 15
- 15% preferred more than 16
Target Date and Target Risk Funds
- Slightly more than half of plan sponsors indicated that participants should be free to invest in multiple target date funds.
- Seventy percent of plan sponsors opposed requiring participants to remain invested in target date funds through maturity.
- For auto-enrolled participants, only about one in five plan sponsors indicated they would be open to using target risk funds, managed accounts and stable value funds as default options.

Investment Advice
Between two-thirds and 85% of participating plan sponsors agreed that the ideal DC plan would offer the following consultative services.
- Product-related advice
- Specific investment strategy advice
- General retirement planning advice
- Broad-based financial planning

To learn more about Northern Trust’s multi-year study, The Path Forward, visit northerntrust.com/dc_solutions.

EVOLVING SOLUTIONS, CONTINUING CHALLENGES
The U.S. has been growing, changing and modernizing DC plans for more than 30 years. This is mainly due to a focused effort to reduce dependence on and cost in DB plans while maintaining solid retirement benefits. Though U.S. DC plans will continue to evolve – and are certainly not yet perfected – they have grown in sophistication and can provide an informative model for other nations whose DB systems face mounting pressures.

Building off of the U.S. DC model could also streamline retirement plan design for corporations who wish to establish solutions across a global employee base. We will continue our exploration of the global retirement plan puzzle in Part Two of this series.

FOR MORE INFORMATION
To learn more about Northern Trust’s asset servicing capabilities for defined benefit and defined contribution plans, please contact your relationship manager.

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