



Recommended Practice

Essential Design Elements of Defined Contribution Plans as the Primary Retirement Plan (2008) **(CORBA)**

Background. In its Recommended Practice, *Developing a Policy for Retirement Plan Design Options (2007)*, the Government Finance Officers Association (GFOA) recommends that public sector employers or plan sponsors have a policy statement that will guide their plan design decisions. Once a pension plan design decision has been made, GFOA members can refer to this RP on *Essential Design Elements of Defined Contribution Retirement Plans* to review the essential elements of offering a defined contribution plan to employees.

Separate recommended practices have been adopted in the *Essential Design Elements of Defined Benefit Retirement Plans* and the *Essential Design Elements of Hybrid Retirement Plans*. These recommended practices should be consulted accordingly.

A defined contribution plan provides funds for retirement based solely on the assets available in an employee's individual account and all investment related risk is borne by the employee. Defined contribution plans can be offered as the primary retirement plan or as a supplemental retirement plan. Some of the following plan design recommendations only apply to defined contribution plans which are the primary plan.

Recommendation. Should an employer choose to provide a defined contribution (DC) plan, GFOA recommends that retirement administrators and finance professionals consider the following essential elements in their plan design:

1. A fundamental aspect of plan design is to determine the adequacy of the retirement plan in meeting the needs of employees. Key factors to consider include:
 - a. Conducting a full actuarial analysis based on workforce demographics and the desired level of replacement income to determine the related cost of providing the benefit.
 - b. Providing a tax deferral to the employee through the use of mandatory employee contributions (employer pick-ups).
 - c. Evaluating possible employer matching to promote voluntary savings. Determine if an employer match will be offered, and if so, the formula needed to accomplish the desired level of contributions.
 - d. Establishing a system for automatic enrollment and default investment options that may be available pursuant to state law¹.
 - e. Consider adding an automatic escalator to employee contributions, which could be tied to pay increases.

¹ The automatic enrollment and default investment options under ERISA **do not** apply to governmental plans. However, for governmental plans residing in states that do permit automatic enrollment, ERISA may provide an existing framework, see sections 902 and 624 of the Pension Protection Act of 2006 or sections 514(e) and 404 (c)(5) of ERISA.

2. Design a sound investment structure and policy. See GFOA's recommended practices, *Investment Policies Governing Assets in a Deferred Compensation Plan (2004)* and the associated *Investment Policy Checklist for Assets in a Deferred Compensation Plan (2005)*, as well as *Asset Allocation – Guidance for Defined Contribution Plans (1999)* for further information. A sound investment structure and policy should offer investment products that:
 - a. Cover a risk and return spectrum of appropriate investment classes, preferably with the advice of an investment professional.
 - b. Consider including diversified life cycle (target-date) strategies or other related multi-asset strategies for employees who do not, or prefer not to, select their own investment options.
 - c. Are distinguishable and have distinct risk and return characteristics.
 - d. Are well diversified and professionally managed.
 - e. Assure that fees are reasonable for the asset class, investment style and services provided.
 - f. Maximize return within reasonable and prudent levels of risk.
3. Other plan design considerations should be examined, including:
 - a. Whether employees are eligible for Social Security.
 - b. Disability and survivor coverage in place of benefits typically offered by defined benefit plans.
 - c. The advantages and disadvantages of lump sum payments, roll-over options, annuity purchase options and periodic payment options.
 - d. The potential utilization and liability of offering investment advice.
 - e. A plan for effective communication and reporting to participants. Investment disclosures (e.g. fees and risks) should be comprehensive and transparent.
 - f. Issues related to Board Governance as discussed in GFOA's Recommended Practice, *Essential Design Elements of Defined Benefit Retirement Plans (2008)*.
4. Develop a participant education program using all available methods, which assists in providing the required knowledge related to:
 - a. Information regarding the defined contribution plan, especially for plans that offer employer matches, automatic enrollment and default investment options.
 - b. On-going education regarding the features of the plan.
 - c. On-going financial planning education.
 - d. Retirement planning services. See GFOA's recommended practice *Retirement and Financial Planning Services (2003)*.

References

- *Choosing Between (Traditional DB and DC--Decisions Points; CCA Strategies)*, J.P. Morgan Retirement Plan Services, March 23, 2007.

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- *Retirement Security in the United States – Current Sources, Future Prospects, and Likely Outcomes of Current Trends*, Employee Benefit Research Institute, 2006.
- *Defined Benefit and Defined Contribution Plans: A History, Market Overview and Comparative Analysis*, Stephen P. McCourt, International Foundation of Employee Benefit Plans, February 2006.
- *An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans*, David Rajnes, Employee Benefit Research Institute, Issue Brief, no. 249, Sept. 2002.
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- *An Elected Officials Guide to Public Retirement Plans*, Cathie G. Eitelberg, Government Finance Officers Association, 1997.
- *Can We Save Enough to Retire? Participant Education in Defined Contribution Plans*. Employee Benefit Research Institute, Issue Brief, no. 160, April 1995.
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