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TOPIC #9: **Retirement Plan Design & Policy** *(ie., 401k's, 403b's, etc)*

PROMPT: **Explain how changes in retirement plan design and related public policy have impacted or can impact retirement savings and outcomes. *Included:* a discussion of unintended consequences related to plan design**

There has been increased interest in how defaults and plan design parameters affect savings outcome in the United States, spurred largely by a "relative low social security replacement rate" and a shift toward defined contribution plans and IRAs (BeShears, et. al., 2009, p. 170). Institutions, researchers and public policy have sought to better promote programs that positively impact retirement preparedness by angling for optimal retirement plan participation defaults, of which there are three different types (BeShears, et. al., 2009, p. 187):

i) **automatic enrollment** –best when there is a large degree of homogeneity within individual preferences, and low expertise levels (ie., a default level that is in line with the employer match level)

ii) **requiring an affirmative participation election (opt-in)—**best when individuals share a preference NOT to participate, or if there are very heterogeneous preferences and little tendency to procrastinate.

iii) **requiring employees actively make a decision** (no default, since you have to choose what to do) –p.188 … best when very heterogeneous preferences (not one choice is best for all) and individuals tend to procrastinate ….leads to HIGHER initial participation rates.

The first two options do help combat present-biased preferences & procrastination, but it is important to recognize there is no single optimal savings plan enrollment mechanism that will be optimal for all, as it will depend on parameters of the model, institutions and individuals.

Aside from participation, a second important default is the percentage of savings rates relative to an employee's income and retirement needs. Often, if at all, participants do not sufficiently increase their contributions over time. To curb behavior, plans have introduced auto-escalators options. Thaler and Benartzi (2004) show "with the 3 percent a year increases, employees would typically reach maximum tax-deferred contribution within four years" (p. 173).

A third important consideration is asset allocation. Important default solutions have been the introduction of age-based funds to provide average investors investment options or glide paths that may have more appropriate timing and risk elements. A 2002 survey referenced by BeShears (2009) revealed

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that 38% of respondents had little or no knowledge about deciding appropriate asset allocation, 40% believed a money market has stocks, and 66% believed government bonds could not lose money. Target-date and age-based funds directly combat this prevalent lack of financial literacy.

An unintended consequence of any plan default is the possibility that participants who lack financial sophistication may assume the defaults to be an endorsement, such as the firm looking after their best interest (BeShears, et. al., 2009, p. 184). The biggest endorsement effect is the default investment (such as a 100% money-market default allocation), and is especially important as seldom that plan participants go back and reallocate their portfolios away from poor performance, even at low costs.

Institutions like Fidelity and Principal are impacting public policy by engaging plan participants in an ongoing basis to ensure that employees stay informed and attentive. They work to improve engagement through email campaigns, innovative technology, personalized workshops, and a customized technology driven planning solution.

References:

Beshears, J., Choi, J.J., Laibson, D., & Madrian, B.C. (2009). The importance of default options for retirement saving outcomes: Evidence from the United States. In J. Brown, J. Liebman, & D.A. Wise (Eds.), *Social Security Policy in a Changing Environment* (167-195). Chicago: University of Chicago Press

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