

TRENDS AND ISSUES

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SUMMARY: Putting It All Together

Researchers Alicia Munnell and Annika Sunden, in their recent report, “401(k) Plans Are Still Coming up Short,” summarized the retirement challenge as follows:

Policymakers and the business community have come to recognize that (defined contribution—editor’s insertion) plans must be easier and more automatic if they are to serve as an effective vehicle for retirement saving.A significant percent of eligible employees fail to join the plan, few contribute the maximum, most do not diversify their investments or re-balance their accounts over time.....Automatic enrollment, automatic increases in the deferral rate and automatic rollovers will all help workers accumulate larger balances...^{xxxiii}

Employers who want broad participation and adequate retirement savings for their employees are expected to adopt automation increasingly in their plan design. In PLANSPONSOR’ s “2005 Defined Contribution Survey,” about 14% of responding employers said they have “embraced” automatic enrollment.^{xxxiv} Observers believe that percentage will rise significantly once Congress and the Department of Labor provide certain clarifications, as expected this year. Critics of automation have referred to highly automated plans as paternalistic, and defenders have countered with the term “libertarian paternalism” since participants maintain their right to opt out of the defaults they do not want and make their own choices.^{xxxv}

Given the fact that employers’ previous hands-off experiment with traditional DC plans has left many workers ill-prepared for retirement, it appears as though a degree of paternalism may be in order, as long as individual decision-making remains an option. As discussed earlier, employees frequently make passive decisions by doing nothing. As described by researchers Choi, Laibson, Madrian and Metrick, many employees “are likely to do whatever requires the least current effort”...following “the path of least resistance.”^{xxxvi}

Before implementing automatic features, employers need to have a clear understanding about their goals and objectives, as well as projections about the costs of adopting automatic features. Automatic enrollment, automatic deferrals, and contribution escalators are powerful tools but may become counterproductive if deferral rates are set too low (insufficient savings) or too high (significant opting-out). The employer match rate and match threshold need to be considered carefully so that they provide incentives for higher savings rates. Lastly, the investment default is a critical factor since participants typically will not rebalance or reallocate; therefore, managed portfolios such as life-cycle or target-

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maturity funds make a lot of sense for many employees lacking investment understanding or discipline to make appropriate allocation decisions.

In sum, the trend toward defaults in DC plans is turning employees' former behavioral liabilities—namely procrastination and inertia—into assets. Employers concerned about their employees' welfare in retirement will help them capitalize on these behavioral tendencies by implementing plans with thoughtful automatic components.

About the Author

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Endnotes

ⁱ Olivia S. Mitchell and Stephen Utkus (eds), 2004, Oxford University Press, *Pension Design and Structure*, p. 32.

ⁱⁱ James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "Saving for Retirement on the Path of Least Resistance," original version in *Tax Policy and the Economy 2001*. Updated version in E. McCaffrey and J. Slemrod (eds.), *Behavioral Public Finance*, Russell Sage, 2006.

ⁱⁱⁱ Olivia S. Mitchell, Stephen P. Utkus and Tongxuan (Stella) Yang, October 2005, "Turning Workers into Savers? Incentives, Liquidity and Choice in 401(k) Plan Design," National Bureau of Economic Research, NBER Working Paper Series, Working Paper 11726, <http://www.nber.org/papers/w11726>, p.19.

^{iv} Mitchell, Utkus, and Yang, pp. 13-14.

^v Mitchell, Utkus, and Yang, pp. 13-14.

^{vi} Mitchell, Utkus, and Yang, pp. 16-17.

^{vii} Choi, Laibson, Madrian and Metrick, p. 5.

^{viii} Mitchell, Utkus, and Yang, p.3.

^{ix} Gur Huberman and Wei Jiang, April 2006, *The Journal of Finance*, "Offering versus Choice in 401(k) Plans: Equity Exposure and Number of Funds," <http://www0.gsb.columbia.edu/faculty/ghuberman/offering%20versus%20choice.pdf>.

^x Sheena S. Iyengar, Wei Jiang and Gur Huberman, "How Much Choice is Too Much? Contributions to 401(k) Retirement Plans, in *Pension Design and Structure*, edited by Olivia Mitchell and Stephen Utkus, Oxford University Press, 2004, http://www.columbia.edu/~ss957/articles/How_Much_Choice_Is_Too_Much.pdf.

^{xi} Mitchell, Utkus, and Yang, p.15. Note that the research referenced here was conducted with non-highly compensated employees (NHCEs).

^{xii} Julie Agnew and Lisa Szykman, May 2004, "Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice and Investor Experience," Center for Retirement Research, working paper CRR WP 2004-15, http://www.bc.edu/centers/crr/wp_2004-15.shtml.

^{xiii} John Beshears, James J. Choi, David Laibson, and Brigitte Madrian, "The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States," presentation at Federal Reserve Bank of Atlanta, March 2-3, 2006 conference, "Lessons from Pension Reform in the Americas," <http://www.frbatlanta.org/invoke.cfm?objectId=55633E7A-5056-9F06-990F6128EC116B71&method=display>.