Overcoming Obstacles to Retirement Plan Success: Inertia, Myopia, and Loss Aversion

By Michael M. Kane

Under Sections 404(a)(1)(A) and (B) of the Employee Retirement Income Security Act of 1974 (ERISA), plan fiduciaries are required to act prudently and solely in the interest of plan participants and beneficiaries in the selection and monitoring of the plan investments. In addition, regulations and other guidance issued by the Department of Labor (DOL) relating to participant-directed investments are designed to ensure that the participants are "made aware of their rights and responsibilities" with respect to the investment of their plan accounts and to ensure that they have "sufficient information" regarding the plan and the plan's investment alternatives. A failure to satisfy the DOL's requirements may result in the responsible plan fiduciaries becoming subject to personal liability for any related losses incurred by the plan's participants, as well as additional civil penalties.

Given the severity of the penalties for the failure to comply with the IRS's or DOL's rules, plan sponsors have a legal incentive to ensure their plans are managed in compliance with their requirements. Plan sponsors should have a desire to provide as excellent a retirement plan as practical for their employees.

Typically, a plan sponsor's overall vision for a successful plan includes its benefitting as many employees as practical and helping each participant to save appropriately for his or her retirement years. Many plan sponsors are interested in promoting participation and improving the contribution rates of their plan participants.

Employees who are satisfied with the level of retirement savings in their plan may be less likely to file legal claims against the plan sponsor and the plan's other fiduciaries. In addition, participants, who find it easier to become fully invested in one-stop professionally managed ("Do-it-For-Me") vehicles, such as target date investments or actively managed accounts, may be less inclined to file legal claims relating to any short-term volatility or having too few asset classes necessary for real asset allocation or diversification. Thus, when a plan sponsor promotes the success of its plan in this manner, it may be able to significantly reduce the likelihood of any plan-related litigation and mitigate the risk of potential plan-related liability.

The good news, according to a 2013 Annual Deloitte 401(k) Benchmarking Survey, is that 78 percent of employers either care or take great interest in their participants' retirement readiness. [Deloitte, 2013 401(k) Benchmarking Survey] The bad news is the state of retirement readiness: The 3rd Annual Putnam study of 4,089 adults between ages 18-65, in conjunction with Brightwork Partners, indicates that working Americans are on track to replace 61 percent of their household income in retirement. [Putnam, 2013 Lifetime Income Score study] According to the National Retirement Risk Index, developed by the Center for Retirement Research at Boston College, half of today's households are ready to retire at age 65. When it was updated for 2012, the index showed the number of "at risk" households NRRI measures the share of American households "at risk" of being

Michael M. Kane, ChFC, AIFA, CBFA is the Founder and Managing Director of Plan Sponsor Consultants, an independent retirement plan consulting firm. For more information, *see http://www.plansponsorconsultants.com*. Securities and Advisory Services provided through LPL member FINRA/SIPC and Registered Investment Advisory.

unable to maintain their pre-retirement standard of living in retirement had increased by nine percentage points—from 44 percent to 53 percent—between 2007 and 2010. According to the 2013 report by Vanguard Center for Retirement Research, one-third of participants contributed less than 4 percent themselves. {Vanguard, 2013: How American Saves, *available at https://pressroom.vanguard.com/non-indexed/2013.06.03_How_America_Saves_2013.pdf*} The average participant deferral rate was 7 percent in 2012, down slightly from the peak of 7.3 percent in 2007. Professor Shlomo Benartzi, Co-Chair of the Behavioral Decision Making Group at UCLA, in his book *Save More Tomorrow*, says that participants need to save 10 percent, assuming a generous employer match. In the absence of generous match, the savings rate needs to be even higher. {Shlomo Benartzi, Save More Tomorrow: Practical Behavioral Finance Solutions to Improve 401(k) Plans (Portfolio/Penquin, 2012)}

Behavioral Impediments to Employee Savings

In his book, Benartzi identifies three main behavioral impediments that plan sponsors face when dealing with participants' retirement readiness: participant inertia, loss aversion, and myopia. Benartzi proposes some behavioral solutions to these challenges, which will be discussed further below.

- *Inertia*—also known as "status quo bias."

  We all have things we need to do that we just cannot get around to for one reason or another. Most of us dislike change and cling to the familiar. We especially dislike change if it requires mental or physical effort. How many of us have said, "I'll get around to it later," or "I'll do it tomorrow" with regard to these perceived unpleasant tasks?

To illustrate inertia and its effects, let's look at a 2003 study, "Do Defaults Save Lives?" published in *Science Magazine*. {Johnson, Eric J., and Daniel G. Goldstein, "Do Defaults Save Lives?" Science 302: 1338–1339 (Nov. 21, 2003)} This study is about saving lives, versus saving for retirement. It is about organ donation, specifically in Germany and Austria. One would expect these two countries, with similar cultures, to be similar when it comes to organ donation. But they have slightly different systems that produce very different results. In Germany, if you want to donate, you have to check a box on a form to affirmatively opt in. In Austria, you still make the decision as to whether to donate, but you have to check a box on a form if you do *not* want to donate—in other words, you have to opt *out*. In both cases, because of inertia, most people do not check the box. In Germany, 12 percent check the box (to opt-in). In Austria, 1 percent check the box (to opt-out). What does this mean in terms of saving lives? In Germany, 12 percent of people are organ donors. In Austria, 99 percent are donors.

In their 2009 book, *Nudge: Improving Decisions About Health, Wealth and Happiness*, Richard Thaler and Cass Sunstein show how different choice architecture language yields drastically different results. {Thaler, Richard H., and Cass R. Sunstein, Nudge: Improving Decisions About Health, Wealth and Happiness (New York: Penquin 2009)}

The lesson for retirement plans: how you set up a system has a big impact on the results.

- *Loss Aversion*—Behavioral Principal Number 2.

Loss aversion is a very powerful and common psychological factor in human financial decision making. In fact, according to Professor Benartzi, loss aversion is one of the most powerful psychological factors at work in the field of behavioral economics and finance. Loss aversion implies that losses loom larger in our minds than equal gains. That applies to even small losses. In a 2006 study, *How Basic are Behavioral Biases: Evidence From the Capuchin Monkey Trading Behavior*, by Professor M. Keith Chen of Yale, the monkeys get one apple in one of two ways:

- They either just get one apple
- Or they get two apples and then one is taken away

In the second case, where an apple is taken away, the monkeys grow to hate the server. The monkeys are loss averse. Emotionally, one apple is *not* equal to two apples minus one apple. {Chen, Keith M, and Venkat Lakshminarayanan and Laurie R. Santos, 2006, Yale University)}

Loss aversion is a very general and powerful phenomenon, and it has major implications for retirement plans, because saving is perceived as a form of loss. A saver is losing his or her ability to spend. People do not want to cut spending. It feels like losing.

- *Myopia*, also known as "present bias," reflects that it is hard for us to do today what will be in our best interest tomorrow.

This is about not connecting to the future. Another study illustrates the point. It was conducted in 1998 by Read and van Leeuwen and titled, *Predicting Hunger: The Effects of Appetite and Delay on Choice* and appeared in the Organization of Behavioral Human Decision Process Journal {Read, D. and van Leeuven, B., "Predicting Hunger: The Effects of Appetite Delay on Choice," Organization of Behavioral Human Decision Process Journal, 76(2): 189-205 (Nov. 1998).} Suppose that it is one week before a planned business meeting. We say we are going to have snacks available there. If offered a choice one week beforehand of bananas or chocolates, 74 percent say they want bananas. When the week passes, however, and the day arrives, 70 percent of the people actually select the chocolate.

What does this have to do with retirement plans? A lot. We say we are going to save, but when the time comes, we spend instead. We tell ourselves that we will save next week and have fun today. It is easy for us to imagine doing the right things, but it is very difficult for us to follow up on our good intentions.

Overcoming Behavioral Impediments

It is important for those of us in the retirement industry to realize these behavioral realities and understand how we can use this knowledge to design better retirement plans and to make it *easy* for people to prepare properly for retirement.

The solution to overcoming these psychological biases is to help the employer or plan sponsor to become a wise behavioral architect in the design of their retirement plans. The Pension Protection Act of 2006 (PPA 2006) created safe harbors for the application of behavioral tools to retirement plan design to assist plan sponsors in increasing participation and increased deferrals rates. One of the objections to the behavioral approach, which advisors commonly hear in mid-sized or small 401(k) plans, is the argument of paternalism. The counterpoint to this argument is there is no neutral choice or plan design. When people are faced with a choice, the environment around that choice will inevitably influence their behavior.

In the case of 401(k) plans, setting the default option design is one of the easiest tools. The organ study comparing the Austrian opt-out design with its 99 percent enrollment rate to Germany's 12 percent participation in the opt-in design, shows the way. With auto enrollment, participants have to affirmatively opt out of the plan to avoid doing the "right" thing. (Under PPA 2006, employers are required to provide notices and procedures permitting them to do so.) Repeated studies have shown that this results in an enrollment or participation rate of between 86 and 96 percent after six months. This is well above the results for plans that permit the employee to enroll on their own (*i.e.*, opt in). If our objective is to have as many employees enrolled in their retirement plan as possible, auto enrollment wins every time. After a couple of years, some plans may see a decline in the participation rate for the initial group of employees. PPA 2006 provides an additional safe harbor for employers through a re-enrollment of those employees, again utilizing an auto-enrollment process. A default rate of at least 6 percent should be implemented with the auto-enrollment. Auto-escalation (*i.e.*, automatically increasing the rate of deferral for participants) should be considered at either 1 percent or 2 percent annually. The higher the rate, the faster the participants will achieve Professor Bernartzi's defined optimum savings of 10 percent. In his 2006 book, Professor Benartzi demonstrated that employees are agnostic on which auto-escalation rate is selected, either 1 percent or 2 percent. However, any escalation rate above 2 percent will result in varying degrees of participation push-back.

How Does an Employer Match Affect Participation in Retirement Plans?

Employer match studies show a positive but small impact of the match on participation in the range of 3 to 10 percent, while auto-enrollment almost universally boosts participation by 15 to 25 percent. In plans with no matching contribution (we saw quite a few choose this following the stock market drop of 2008), participants generally selected a heuristic, or rule of thumb rate, that clustered around large round numbers like 5 percent, 10 percent, or 15 percent. These are large round numbers.

The one aspect of employer matching contributions that yields clear results is the match cap—*i.e.*, the rate of deferral at which the matching contribution no longer applies. With a match, another behavioral "given" comes into play—go for the deferral rate that equals the match cap. In 2000, a company that had no match introduced one that capped at deferrals of 4 percent. Prior to the introduction of the 4 percent match, the distribution of employee savings rates clustered around round numbers. Six months following the introduction of the match, 30 percent of the participants had adjusted their match to the 4 percent. {Choi, James J, David Laibson, Brigitte C. Madrian, and Andrew Metrick, "Defined Contribution Pensions: Plan Rules, Participant Decisions and the Path of Least Resistance," Tax Policy and The Economy, Vol. 16, edited by James Poterba (Cambridge: MIT Press 2006)]

What Are the Takeaways from This?

(1) The existence of a match does not increase participation as much as auto-enrollment.
(2) The match rate has little impact on participant behavior.
(3) Match caps tend to define the amount at which many of the participants save.

What about the CFO who wants to improve his participation and savings rates, but is worried about breaking his budget for retirement plan expenditures by incorporating automatic enrollment?

This is where the match optimizer comes into play. The match optimizer is based on a reduced match rate, tied to an increased match cap. For example, let's say a 401(k) plan has a traditional match of 50 percent of deferrals up to a maximum of 6 percent of compensation, and the participation rate is 70 percent. By introducing auto-enrollment, let's assume that the participation rate climbs 20 percent up to 90 percent. Simultaneously, we reduce the match rate to 25 percent of deferrals, but raise the match cap to 10 percent. What is the financial impact? The old formula for calculating the estimated cost would be 6% × 50% × 70%, producing an effective average match of 2.1 percent of total eligible payroll. Using the new plan design and participation numbers, the formula is: 10% × 25% × 90%. This assumes the unlikely scenario that all the participants stay at the match cap, increasing their deferrals to 10 percent. The result is a cost of 2.25 percent of total eligible payroll—a likely ma×imum increase of only .15 percent of eligible payroll. Providing the CFO with an analysis similar to this should help eliminate the fear that the improvements to participation will increase employer costs in an unpalatable way, which should improve the acceptance level. There are industry tools available that can provide more detailed financial modeling.

How Will Employees React to a Reduction in the Match?

When the motivation for the change is carefully explained to the employees, for example, to help them and their teammates save more, usually benefiting the lower income, young, and less educated employees, it can result in a big win.

While acknowledging the benefits of auto-enrollment, how does the human resource department contend with high or recurring turnover? Two different examples can illustrate this. One is a casino with employees who have been hired and rehired up to 25 times; the other is a media company with an employee who had been hired or rehired 15 times. The solution is easy enrollment.

A pre-filled easy enrollment form, utilizing the same information as auto-enrollment, including default savings rate and a default professionally managed investment such as a target date investment or actively managed account, requires only the participant signature. (Of course, the form must also permit participants to opt an alternate savings rate and investments. But we know from our inertia analysis that many people will opt for what is easy and quick.) Many recordkeepers are more than happy to work with the HR department to develop these forms. These easy enrollment forms can be distributed during the annual open enrollment period.

Two separate surveys of 401(k) experts in 2011 by Professor Shlomo Benartzi resulted in the development of a success metric for the investments. Based on their observation of retirement plan participants' behavior over many years, these experts recommended that 90 percent of participants place their savings in a one-stop, professionally managed account, such as target date investments or managed accounts. Why? Most participants lack the investment knowledge, experience, or time to be making investment decisions. Too many follow the herd to buy when they should sell, and sell when they should be buying, with the result being that they "buy high, and sell low," in many cases, the polar opposite of what large institutional managers are doing. The author's own experience in evaluating hundreds of 401(k) and 403(b) plans has revealed an average of two asset classes, and an average of five investments per participant. This personal observation aligns with the numbers reflected in annual plan reviews from many large recordkeepers.

Recordkeeper Involvement in Increasing Participation

Large recordkeepers are making great strides on their Web site design and their educational deliverables to improve participant retirement readiness. For example, Great West recently revamped its Web site, so that the participant landing page reflects the amount of monthly income the participant will need to replace, and how on target they are for achieving it. Buttons can be used to change participant deferrals percentages, as well as their asset allocation. In the first four months of operation in 2012, the Great West Web site experienced a 13.5 percent improvement in participant deferrals—a significant change. Many other recordkeepers have developed this type of technology on their Web sites. Recordkeepers also have developed extremely well targeted communication/educational campaigns that are designed to encourage positive participation, increased savings, and diversification. They can target a group, for example, employees in their 20s, which has an extraordinarily low savings rate, with positive emails and mail campaigns.

Recordkeepers are adapting new technologies to help participants save more. Digital age progression technology, which takes a participant picture (JPEG), uploads it and through a virtual reality "Time Travel" lets participants see what they will look like at retirement age. Once people make the acquaintance of their aged "selves," they may become significantly more willing to save for retirement. "Imagine" exercises are being conducted by knowledgeable advisors as part of their education deliverables. The imagine exercises enable a participant to make vivid the circumstances of their retirement and these images are, by their nature, "customized" to each individual because they are products of each individual's mind.

Advisors are critical to assisting their plan sponsor clients in helping their participants achieve retirement readiness. In the 2013 Putnam Study, 39 percent of those plans that scored a 100 or better on their life income score had an advisor.

Studies conducted by Professor Benartzi for the Allianz Global Investors Center for Behavioral Research, have developed three metrics that will signify Retirement Plan Readiness or Success: 90 percent participation rate, 10 percent average deferral savings rate, and 90 percent investment in a one-stop professionally managed portfolio solution. {Benartzi, Shlomo, and Lewin, Roger, 2012, Save More Tomorrow: Practical Behavioral Finance Solutions to Improve 401(k) Plans, Allianz Global Investors, Center for Behavioral Finance} These plan goals are not always achievable because of plan demographics. High turnover, low income, and lack of employer match are some of the factors that will impact the achievement of these goals.

Employers should want to know how their plans measure up to these plan success goals. In the 2013 Deloitte Study, 32 percent of plan sponsors indicated that they conducted some type of retirement readiness assessment for their plan within the past 12 months, while 45 percent said that they are considering having one completed. All plans should have one of these retirement readiness assessments conducted. It forms a basis for assisting plan sponsors in developing plan communication, design, and targeted educational deliverables to improve retirement outcomes for their participants. ■