No. 5 in a series of 5

Issue Brief

Retirement Policy: Aligning Plan Design With Effective Employee Engagement

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Key Points

- Some plan participants of defined contribution (DC) plans may lack the resources and/or knowledge needed to make informed choices during the retirement savings accumulation and decumulation phases.
- Well-designed plan features considering the demographic makeup of the workforce can lead to better participant decisions by providing either no choice or a range of options, including defaults and incentives.
- Legislators and regulators might consider changes that enable and encourage plan sponsors to use plan designs that could further improve participation and retirement security.

In July 2019, the American Academy of Actuaries (Academy) Retirement System Assessment and Policy (RSAP) Committee published an issue brief titled *National Retirement Policy & Principles*, which focused on the increasing need for a comprehensive national retirement policy based on certain guiding principles. This initial issue brief was followed up by three additional papers in the series. *Retirement Security Challenges: Portability and Retirement Income* addressed the challenges faced by workers in a mobile workforce who accumulate retirement benefits at multiple employers over their careers. This issue brief was followed by *New Retirement Plan Designs: Degrees of Risk Sharing*, which focused on where the risk lies under alternative retirement plan models as well as legislative changes needed to allow more innovative plan designs in the private sector. The next issue brief, *Retirement Policy: Potential for Changing Roles of Employers in Retirement Programs*, addressed how employers can provide retirement plans to their employees through models in which many of the responsibilities are decoupled from the employer.

This issue brief addresses how retirement program design can impact decisions that participants make with the goal of improving retirement security. The principle of individual choice—and the degree to which such choice might be permitted in a retirement system—is highlighted in the original *Policy & Principles* issue brief. Most defined contribution (DC) retirement plans, such as 401(k) plans, leave important and sometimes complex choices to the individual. These decisions include not only whether to contribute but also how much to contribute and how to invest contributions (employee and any employer contributions). In addition, employees have to decide when to withdraw the funds they have accumulated, as well as how to structure those withdrawals so they last for an unknown lifetime.

1850 M Street NW, Suite 300
Washington, DC 20036
202-223-8196 | www.actuary.org

Craig Hanna, Director of Public Policy
Linda K. Stone, Senior Pension Fellow

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Underlying the DC retirement plan structure is the assumption that individuals are equipped to make decisions in their own best interests, and that they will do so. However, this assumption might not always be accurate, especially if individuals lack the resources and/or knowledge needed to make informed choices. For example, access to easy-to-use quantitative tools may be helpful to assess expected outcomes based upon different scenarios and decisions such as when to commence Social Security benefits and employ various drawdown strategies.[1] Tools that use actuarial principles, reflecting future life expectancy and investment return, can be extremely helpful. One example of a tool for educating individuals about future life expectancies is the Actuaries Longevity Illustrator, developed by the American Academy of Actuaries and the Society of Actuaries.

This issue brief separates plan provisions or features that affect retirement plan outcomes into four categories. The first is where no choice is provided. The second is where some level of choice is provided and a range of options is offered. The third is the use of defaults, for which options exist but, if no action is taken, a selection is automatically made according to the terms of the plan. The last one is where incentives (or disincentives where penalties apply) are used, where certain decisions are encouraged or rewarded (or penalized). Note that these provisions or features may, and often do, overlap. Some may not be plan provisions but rather provisions under the law.

This issue brief will provide a brief overview of the concept of behavioral economics, followed by a discussion of alignment, one of the fundamental principles in the RSAP Committee's "Retirement for the AGES" (**A**lignment, **G**overnance, **E**fficiency and **S**ustainability) framework.[2] This will be followed by a look at the decisions that individuals may need to make in DC plans (and occasionally in defined benefit [DB] plans). Next will be a discussion of the four categories of plan provisions or features as noted above. The framing of options and how such framing may impact decision making will then also be addressed. This analysis is followed by a brief discussion of how plan provisions designed to impact behavior might influence different demographic groups in different ways. The issue brief will conclude with some suggestions for consideration by legislators and regulators of how retirement outcomes can be improved through provisions that focus on employee behavior.

1 See, for example, the Academy issue brief *Actuarial Perspectives on Determining a Retirement Income Budget*, July 2020.
2 See https://www.actuary.org/Retirement-for-the-AGES.

Members of the Retirement System Assessment and Policy Committee, which authored this issue brief, include Eric Keener, MAAA, FSA, FCA, EA—*Chairperson*; Claire Wolkoff, MAAA, FSA—*Vice Chairperson*; Kelly Coffing, MAAA, FSA, EA; David Driscoll, MAAA, FSA, FCA, EA; Lee Gold, MAAA, ASA, EA; Scott Hittner, MAAA, FSA, FCA, EA; Cynthia Levering, MAAA, ASA; Esther Peterson, MAAA, ASA, EA; Timothy Robson, MAAA, ASA, FIA; Andrea Sellars, MAAA, FSA; and Mark Shemtob, MAAA, FSA, FCA, EA.

Behavioral Economics

Behavioral economics is the study of psychology as it relates to self-interest in decision-making when applied to economic choices. Employee decision-making with respect to retirement plans can be a daunting task for many individuals. Plan sponsors can help address this by making appropriate options available. Even when the appropriate options are available, some individuals may not have sufficient knowledge and quantitative skills to make informed choices, and research shows that individuals are prone to behaviors that may not lead to desired results. For example, individuals:

- Can exhibit risk aversion tendencies by applying greater weighting to potential losses than potential gains. In accumulating retirement savings, avoiding investments such as equities could actually increase the risk that accumulations will not be sufficient.
- Tend to discount the value of future needs when compared to near-term needs.
- Generally use "rules of thumb" or other "educated guesses" as substitutes for a more rigorous quantitative analysis.

Another factor influencing economic decision-making is how options are presented, also known as framing. The early work in this area stemmed primarily from the writings of Daniel Kahneman and Amos Tversky that were published over four decades ago in *Prospect Theory: An Analysis of Decision Under Risk*. Since then, much additional research has been performed in this area. While a discussion of this broad topic is well beyond the scope of this brief, an understanding of decision-making by individuals can be crucial in the development of sound retirement policy and plan design. This concept is more important today than in the past because most individuals rely on DC plans that pose multiple, complex options and decisions to achieve their retirement security. In contrast, many traditional DB plans, which are now less prevalent than DC plans among private-sector employers, provide only limited choices to individuals.

Consideration of the impact of "behavioral economics" in retirement plan designs and the public policies that support them is recommended.

Alignment

The Academy's "Retirement for the AGES" framework is intended to assist policymakers and other key stakeholders in formulating policy, structure, operational practices, and plan designs that improve employer-based retirement programs. The Alignment principle states that retirement income systems work best when stakeholders' roles are aligned with their skills. Important tasks—such as financial analysis, investment management, and retirement plan administration—should be the responsibility of those who have the knowledge and experience to perform them well. As many private-sector retirement programs have transitioned from DB to DC plans, participants are being asked (and required) to make more choices, both in terms of investing their accounts during employment and in planning for decumulation during retirement. Plan design should be structured to facilitate desired outcomes, and, where choice is provided, it is important that employees have the education and skills to understand and make the choices and decisions to improve their long-term outcomes.

Plan Decisions

Among the major decisions DC plans might require plan participants to make are the following:

Whether to participate in the plan: It is difficult for individuals to decide on the trade-off of the utility of current income versus saving for a more secure retirement, especially when retirement is decades in the future. Receipt of current income tends to be valued more than future income. In addition, the benefits of tax deferral may not be adequately understood and appreciated. It could be that a decision not to participate fully (or at all) is rational based on near-term financial needs.

How much to contribute to the plan: Once individuals have committed to participating in a plan, they must determine how much to contribute. Often the contribution elected is based upon an employer match, but this level of contribution might not provide sufficient accumulations for a successful retirement. And again, in certain cases, not contributing enough to maximize the employer match may be a decision based on near-term financial needs.

How to invest accounts: Plan participants might have limited experience with investing. Understanding how to assess the amount of risk to assume can be challenging for many, and the appropriate amount of risk will vary over time. Individuals might deal with investment gains and losses reactively, behaving in a manner that is inconsistent with their long-term goals. In addition, individuals could fail to properly account for the impact of fees and expenses on their investment choices.

Whether to withdraw funds before retirement: DC plans generally provide an option to take distributions upon the occurrence of a hardship, or to borrow from the plan up to certain limits. While for many individuals this might not be their only source of available funds, it might be the one that is the most readily accessible. Penalties and taxes may apply if these funds are not repaid to the plan. In addition, individuals are generally provided access to their funds when they change jobs. Though the option exists to roll over funds to an individual retirement account (IRA) or possibly a new employer's plan, there may be technical obstacles to an easy rollover as well as temptation to use those funds for other purposes, even though penalties and taxes might apply (as with loans or hardship distributions that are not repaid to the plan).[3] Consuming these funds prior to retirement could result in significant loss of retirement savings.

When to retire: Plan participants are in many cases unaware of the value of their account balance in terms of the potential lifetime income it will provide. While the *Setting Every Community Up for Retirement Enhancement (SECURE) Act* requires annual lifetime income disclosures in DC plans effective Sept. 18, 2021, those disclosures might not provide sufficient information for a participant to understand whether they are on track for retirement.[4] Insufficiencies could be rooted in one's uncertainty of longevity and future capital market returns as well as a misunderstanding of how working longer potentially impacts retirement security. Certain decisions regarding the form and timing of retirement benefits could be irrevocable. Economic and business changes can result in an earlier retirement than planned.[5] As a result, the decision-making process as to when to retire can be complex, and individuals might not have the information they need to make decisions.

3 A similar decision may also come into play for DB plans that offer lump sums.
4 The Academy's comment letter to the Department of Labor regarding lifetime income disclosures regulation pursuant to the SECURE Act can be found here.
5 When to stop working and when to commence receiving retirement benefits are decisions that are also applicable to DB plans and Social Security; in some cases, DB plans may offer early retirement subsidies, further complicating the decision-making process.

How to create reliable income during retirement: There is no one "right" way to turn retirement accumulations into predictable lifetime income. Decisions are driven by health, lifestyle choices, desire to leave funds to heirs, risk tolerance, integration with other income sources such as Social Security, as well as access to education, advice, and easy-to-use strategies. In addition, ongoing evaluation is needed, and prior decisions might need to be revisited during retirement as actual returns, inflation, health status, life expectancy, and other factors change over time.

Plan Design Elements That Influence Behavior

As discussed, the various decisions to be made under DC plans can be challenging to many participants. Directing individuals toward better decision-making can be achieved through legislation and plan design. The strategic inclusion of plan design elements by plan sponsors can improve retirement outcomes, as discussed below.

No Choice: Not all aspects of plan design allow individual choice. For example, a plan could require that all contributions be invested in a single investment portfolio. Though this is not common with 401(k) plans, it is not unusual in DC plans where the participants make no contributions. Another example of offering no choice would be a requirement that a portion of one's account balance be used to provide lifetime income. Though this is not common in DC plans subject to the *Employee Retirement Income Security Act of 1974* (ERISA), it is a possible approach to improving lifetime income. Individual circumstances differ for each person (e.g., age, health, marital status, desire to bequeath an inheritance, level of financial literacy). Consequently, plan provisions that do not allow for choice could provide favorable outcomes for most participants but may lead to less favorable outcomes for some participants.

Range of Options: While a wide range of options can add tremendous flexibility and customization of plan benefits to fit employee preferences and circumstances, the inclusion of too many options can potentially confuse some plan participants. More choices could increase the need for education to assist individuals in making selections that are appropriate for them. The use of only low-cost, well-designed target date funds is an example of a restriction of investment choices that can benefit some plan participants.

Defaults: When plans offer choices, it is common to include a default selection that becomes effective in the absence of a plan participant's election. This approach is the cornerstone of autoenrollment and default automatic contribution arrangements. Examples include plan designs where, absent an affirmative election, the participant is deemed to have elected to participate and contribute to the plan at a predetermined level.

Default contribution arrangements can also provide automatic escalation of participant contributions up to a specified maximum level. This approach is also used for default investment choices when participants fail to select an investment option. For instance, the use of a well-designed target date fund as a Qualified Default Investment Alternative, or QDIA, in a 401(k) plan has the potential to improve retirement outcomes.

Incentives: Participant decisions can be influenced by incentives. An example is the use of matching contributions to encourage plan participation. Another incentive (though not one established by the plan) is the favorable tax treatment for those who participate. A penalty tax on early withdrawals also discourages the use of retirement savings for non-retirement purposes.

The Impact of Framing the Design Elements

Framing is not an element of plan design, *per se*, but the manner in which plan design and associated options are communicated to participants is extremely important. Framing can have a significant impact on individual decision-making. How an option is presented can influence the actions one might take. For instance, consider a plan that offers target date funds as well as funds that invest in specific market sectors. The target date fund, which is associated with a target retirement year designation, is presented as an all-in-one option that is designed specifically for someone planning on retiring in or near that year. Plan participants who find portfolio creation challenging could be drawn to this simple-to-use alternative, although they still should "do their homework" with regard to investment style, fees, and expenses to align with the individual participant's investment objectives.

The Impact of Plan Design Elements on Different Demographic Groups

It would be ideal if all plan design elements that are based on improving individual outcomes were appropriate for all participants. However, this is not always the case. For example, consider a plan with automatic enrollment in which salaries are reduced at a default percentage and those amounts are contributed to the plan. If a participant in such a plan has a financial emergency and needs to take a hardship withdrawal from the plan, that withdrawal could be subject to taxes and a penalty, which may not be a desired outcome.[6]

6 Participants have the ability to change the default election, including opting out completely.

Younger individuals may be interested in different types of investment options than older individuals (e.g., cryptocurrencies and environmental, social, and governance [ESG] funds). Plan designs that offer these alternatives may thereby increase plan participation. The plan sponsor must satisfy the fiduciary obligation when adding certain options, and including such nonstandard types of investments would likely necessitate additional education regarding risk.

Plan sponsors might consider the impact their plan design can have on different demographic groups covered by the plan and whether there are specific features or communications that may be appropriate. For example, while encouraging positive saving behavior, employer contributions that rely on matching employee contributions negatively impact those who do not contribute. Each employee has unique financial circumstances that may inhibit their ability or willingness to contribute to the plan and obtain the full match. While matching contributions provide a strong incentive for first-dollar savings to go to the retirement plan, other uses may be a higher priority for any particular individual. In contrast, non-matching contributions do not provide a direct incentive for employee contributions but guarantee some level of contribution to all participants, regardless of an individual's circumstances.

Suggestions for Consideration by Legislators and Regulators

Legislators and regulators might consider changes to enable and encourage plan sponsors to use plan designs that would be beneficial to some groups of people who are not currently fully participating in retirement plans.[7]

Link emergency funds with retirement benefits: There are groups of people who are unable—whether due to age, salary level, or other financial obligations—to save enough to produce an adequate retirement income. From a financial viewpoint, it could be more important for some to address near-term needs and start saving to build an emergency fund. Under current law, savings for retirement are distinct from savings for emergencies and paying off existing debt. Linking these savings to some extent could produce better outcomes. For example, having access to an emergency fund without a tax penalty might encourage some individuals to participate in a retirement plan, especially if there is an employer match. Such linkage has been included in recent proposed legislation.[8]

7 *Gaps in Retirement Savings Based on Race, Ethnicity and Gender*; Advisory Council on Employee Welfare and Pension Benefit Plans; December 2021.
8 *Enhancing Emergency and Retirement Savings Act of 2021.*

Student loan considerations: Many employees are repaying college or other student loans and may not be able to start saving for retirement while they are paying off the loans. One approach in certain legislative proposals is to allow employers to make matching contributions to a defined contribution plan, such as a 401(k) plan, based on the employee's student loan payments.[9] The employee would then have retirement savings and might be more likely to start contributing when financially able. Such a provision could help those with lower incomes.

Tax and other incentives: Legislative changes can include expanded tax incentives to encourage small employers to provide retirement benefits for their employees. These employer incentives could cover some of the start-up costs for such plans. Credits can also be provided to low-income employees to help them start saving for retirement (for example, the Saver's Credit under current law). Matching contributions are a long-term incentive to encourage plan participation. Employers could also be allowed to offer small immediate, short-term incentives (e.g., gift cards in small amounts) to encourage plan participation.[10]

Plan-provided retirement income options: Changes to the law, such as expanded safe harbors that would encourage plan sponsors to offer more than insured annuities to retirees, could be of value. Many employees could benefit from plan alternatives that seamlessly transition to providing income in retirement as opposed to requiring the purchase of an insured irrevocable annuity contract.

Increase use of target date funds: The use of target date funds has become very popular and has helped millions of participants by relieving them of the complexities of selecting and adjusting asset allocations over time and rebalancing when appropriate.[11] Regulations to encourage the expanded use of target date funds, including appropriate disclosure of potential risks, may further benefit participants.[12]

Disincentives: Increased penalties for premature non-hardship withdrawals might be considered. This could discourage more individuals from consuming retirement savings when changing jobs.

9 *Securing a Strong Retirement Act of 2021* ("SECURE 2.0"), Section 109.
10 Short-term incentives unrelated to matching contributions are generally not allowed under current law.
11 In addition to traditional equity and fixed income investments, insured lifetime income options recently have become a feature of some target date funds.
12 Members of Congress have requested that the Government Accountability Office study the use of target date funds and associated risks.

Conclusion

It can be difficult for individuals to recover from delays in starting sufficient retirement saving and from insufficient investment performance. In addition, many workers might not be adequately engaged with their retirement plans, nor have the education and expertise needed to make decisions in this area. Targeted and effective plan designs can facilitate favorable outcomes despite these realities. Financial education is of value in helping individuals to make savings and investment decisions. However, not all individuals will have access to proper education or know how best to use it. Therefore, it is important to consider how plans can be designed to help retirees achieve the goal of securing their retirement.

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Taken together, these issue briefs lay out guiding principles that policymakers can look to as they consider the establishment of a comprehensive national retirement policy.

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