Retirement Income Products: Will Employees Welcome or Resent This Form of Employer Activism?

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Introduction

There has been a proliferation of information regarding the pending crises faced by workers approaching retirement age. The March 2011 GAO Report on "Private Pensions" reflects ongoing concern over poor retirement savings rates on the part of low income workers.[1] Although many employers have made admirable efforts to encourage employees to save for retirement and have instituted programs to assist employees in understanding the investment alternatives available through the employer's Section 401(k) program, it would appear that no corresponding effort is typically made to educate the workforce on how to utilize or draw down retirement savings subsequent to retirement.

A number of insurance companies and other financial investment companies have already developed interesting retirement income products and the area continues to reflect a burst of creative evolution. The products may differ significantly as between companies. Some products guarantee a minimum payment for the life of the participant, usually by specifying that a fixed percentage of the accumulation invested in the product can be withdrawn annually throughout the life of the participant, frequently with an additional option that allows a lower percentage of the accumulated amount to be withdrawn through the combined lifetimes of the participant and his/her spouse. Other products do not offer a guaranty of a minimum payment for life but offer a diversified investment portfolio and draw-down schedule that significantly decreases the odds of the participant outliving his or her retirement savings.

Although these products are now available to plans, there has been some hesitation on the part of employers to consider the vehicles. The hesitation may stem from a number of sources including (i) the lack of experience in evaluating the relative merits of competing retirement income products, (ii) a concern over the fiduciary responsibility of selecting the product, and (iii) a concern that employees may view the introduction of a retirement income product as an inappropriate intrusion by the employer into the personal financial world of the employee. The first two areas of concern have been recently addressed in various articles including "Evaluation Scorecard for Retirement Income Products" by Mendel A. Melzer and Julie Leinenbach (http://iricouncil.org/thought).[2]

The purpose of this article is to touch upon the possible employer concern that participants may view the introduction of a retirement income product as a suspicious and unwarranted instance of "employer activism". This article presents examples of how other initiatives that employers have taken with the goal of influencing retirement outcomes have been very favorably perceived by employees. By extension, the concern about an adverse employee reaction in the context of a retirement income product seems unfounded.

Favorable Response to Employer Activism – Automatic Enrollment

A feature which has become increasingly popular in the Section 401(k) plan arena is a mechanism under which employees will automatically be enrolled at a specified contribution level in the employer's 401(k) plan, absent

[1] "Private Pensions: Some Key Features Lead to an Uneven Distribution of Benefits", General Accountability Office (March 2011).

[2] Melzer, Mendel and Julie Leinenbach, "Evaluation Scorecard for Retirement Income Products", Institutional Retirement Income Council (2011).

an affirmative decision on the part of the employee to elect out of participation. When the concept was first introduced, there was concern that employees would react in a resentful manner, perceiving that the employer was "forcing" them to behave in a certain manner. Studies have consistently found, however, that the reaction of employees has been positive and that the vast majority of employees who have been automatically enrolled in a program remain in the program. The GAO Report on "Retirement Savings" (October, 2009) indicated that approximately 40% of the plans with a large number of participants (defined as more than 5,000 participants) utilized an automatic enrollment feature. Approximately 58% of the surveyed plans that utilized automatic enrollment extended the feature only to new employees while 42% extended the automatic enrollment feature to all employees.[3] These are indications that the feature has increased in popularity in recent years, particularly with larger plans.

One study indicated that before the introduction of auto-enrollment, the participation rate among employees was 37% and the rate rose to 86% subsequent to the introduction.[4] Comparable studies have indicated increased rates of participation from 53% pre-introduction to 81% post-introduction and from 45% pre-introduction to 86% post-introduction.

The higher rates of participation through automatic enrollment often decrease slightly in the ensuing years but still remain at a level significantly higher than the pre-introduction rates.[5]

[3] "Retirement Savings: Automatic Enrollment Shows Promise for Some Workers, but Proposals to Broaden retirement Savings for other Workers Could Face Challenges", General Accountability Office (October 2009).
[4] Madrian, Brigitte C. and Dennis F. Shea. "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior." The Journal of Economics, Vol. CXVI, No. 4 (2001).
[5] "Evaluating Auto Solutions", Fidelity Investments (2009).

Proponents of the concept of "behavioral economics" find that the introduction of an employer initiative here has been a successful solution to a tendency to procrastination which will otherwise cause a participant to choose a path that does not require active decisions. Frequently, automatic enrollment effectively takes care of three choices that a participant would otherwise have to make (i) whether to participate in the plan, (ii) how much to contribute to the plan, and (iii) what product to invest in.

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Auto enrollment has seen a significant increase in popularity since the Pension Protection Act of 2006 which removed certain barriers, including the problem of state wage garnishment laws and the concern of plan fiduciaries as to potential liability for the investment of funds for which no specific instructions had been received.

Certainly, a form of employer activism but not one that has met with resistance!

Automatic Escalation

Another design feature that is often considered with an automatic enrollment feature has been a procedure under which the original default rate of contribution of a participant is increased on a periodic basis from an initial level of, for example, 3% of compensation to a target of 6% to 10% of compensation or more. Employers have not been as quick to introduce automatic escalation as they have been to introduce automatic enrollment. However, where it has been introduced, automatic escalation seems to be very well received by participants. The above-referenced study done by Fidelity Investments indicates that while 79% of the plans surveyed in the study offered some form of annual increase program on an opt-in basis, only 8.3% of the plans used an annual escalation approach where employees were automatically enrolled but could opt-out. However, of the 8.3% offering automatic escalation, the study also showed that 71% of the participants who were automatically enrolled in a contribution escalation system chose to remain in the program.[6] Again, the studies indicated that the contribution rates reached through auto-escalation tend to "stick" and the employees tend not to affirmatively elect out of the concept.

Automatic Investment Solutions

Automatic investment solutions are integrated retirement investment vehicles, such as target-date funds, designed to relieve a participant from having to make periodic investment decisions. Instead, the participant chooses a set of retirement targets and a typical target-date fund automatically adjusts the proportions in which it holds various mutual fund interests as the participant grows closer to retirement. The Vanguard Center for Retirement Research issued a study entitled "Measuring Effectiveness of Automatic Enrollment" in 2007 in which over 87% of the surveyed plans offered target-date funds or other automatic investment solutions.[7] A more recent study by Vanguard entitled "How America Saves 2010" indicated that 42% of the participants who were offered automatic investment solutions tend to use them, and 46% of participants who invested any portion of their assets in an automatic investment solution in fact invested 100% of their account in the vehicle.[8] Participants given a choice of multiple investment vehicles have indicated a general level of acceptance and indeed preference for vehicles which made the choices for the participant and avoided the consequences of investment inertia.

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Number of Investment Options

Some employers have approached their 401(k) plans with the theory that participants would respond favorably to having a large number of investment options and would appreciate having the employer step back and not limit investment choices. Such employers may have assumed that a lack of "activism" on their part would enhance employee enthusiasm for the plan. Several studies, however, have indicated that some employer control over the number of available options, which indeed is a subtle form of employer activism, has a positive effect on contribution levels. For example, in the study done by Iyengar, Jiang and Huberman in "How Much Choice is Too Much? Contributions to 401(k) Retirement Plans", an average participation rate of 70% was reached with respect to plans that offered 10 to 12 options and the rate of participation actually declined to 60% when up to 60 options were offered. The study indicated a generally linear relationship such that for every 10 funds that were added for the consideration of the participants, a drop in participation of 1.5% to 2% resulted.[9]

This would suggest that employees felt a bit more comfortable with the notion that the employer was making careful selections of investments within specific sectors rather than offering very large numbers of

[6] Ibid.

[7] "Measuring the Effectiveness of Automatic Enrollment", Vanguard (2007).

[8] "How America Saves 2010", Vanguard (2010).

[9] Ivenger, Sheena S. and Gur Huberman, and Wei Jiang, "How Much Choice is Too Much? Contributions to 401(k) Retirement Plans", Pension Research Council (2003).

alternatives with the implication of a “figure it out for yourself” attitude towards the participants.

Another study illustrating the possibility of information overload was performed by Mitchell, Utkus & Yang “Turning Workers into Savers? Incentives, Liquidity and Choice in 401(k) Plan Design”. Here the study indicated the possibility of “equity fund overload”. In situations where 30 funds or more were offered and the proportion of equity funds to total funds was increased, participation rates began to fall. When the percentage of the total funds offered that constituted equity funds increased by 10%, the participation rate for the non-highly compensated employees fell by 1.6%, suggesting again that “choice overload” can have a detrimental effect on participants and that indeed some level of employer involvement is appropriate. [10]

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Retirement Income Products

In the area of retirement income products, there is every reason to assume that a similar level of participant acceptance would be extended to the introduction of a retirement income product. In fact, such activism might actually be welcomed. The inertia that can otherwise hinder decisions on whether or not to participate, the level of investment and how to invest, even in the context of a friendly, supportive employer-assisted environment, can become even more crippling when participants are left on their own to consider (or simply ignore) the confusing world of private annuities and retirement budgets.

An employer initiative may not only assist in overcoming the tendency to inertia but may also reinforce the importance of the area that is the focus of “activism”.

The nervousness over personal investment management decisions that has led participants to embrace automatic enrollment, to shy away from excessive investment choices, and to gravitate towards automatic investment alternatives, should result in a sense of appreciation of an investment option that addresses the complexities of post-retirement years.

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[10] Mitchell, Olivia S. and Stephen P. Utkus, Tongxuan (Stella) Yang, “Turning Workers into Savers? Incentives, Liquidity, and Choice in 401(k) Plan Design”, The Pension Research Council (2005).

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Institutional Retirement Income Council (IRIC)

As the burden of funding retirement has shifted from employer to employee, defined contribution plans, such as 401(k)s, have become the primary source of retirement savings for an increasing number of Americans. Yet DC plans were originally designed as supplemental retirement savings vehicles and were generally never intended to provide guaranteed lifetime income.

The mission of the Institutional Retirement Income Council (IRIC®) is to facilitate the culture shift of defined contribution plans from supplemental savings programs to programs that provide retirement security. By providing a forum for insightful, solutions-oriented thought leadership on institutional retirement income, IRIC is promoting the need for retirement income adequacy for defined contribution plan participants.

A membership-based organization, IRIC is supported by sponsors, and a panel of industry advisors, who are dedicated to sharing best practices, informing about legislative and regulatory issues, and facilitating solutions for plan sponsors and their participants.

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