Defined Contribution Plans for Passive Investors

by James Choi, David Laibson, and Brigitte C. Madrian

July 5, 2004
Executive summary

• 401(k) savers follow the path of least resistance
  – Automatic enrollment dramatically increases 401(k) participation
  – Requiring employees to make an active decision about 401(k) participation leads to large enrollment increases
  – Mandatory cash distributions from 401(k) accounts tend to get consumed rather than rolled over into IRAs
  – And many other examples…

• Financial education doesn’t fix this problem

• These are big mistakes: low-saving employees leave hundreds of dollars in employer match money on the table each year

• Firms and governments shape our lives by framing our choices

• We list ten principles for good 401(k) design
Motivating the problem: A survey

Employees have a hard time carrying out the actions they say they want to take.

• Survey
  – Mailed to 590 employees (random sample)
  – 195 usable responses
  – Matched to administrative data on actual savings behavior

• Consider a population of 100 employees
  – 68 report saving too little
  – 24 of 68 plan to raise 401(k) contribution rate in next two months
  – Only 3 of 24 actually do so in the next four months
Standard enrollment

Most companies require employees to initiate 401(k) enrollment themselves.

- Welcome to the company
- If you want to enroll in the 401(k), call this phone number
- If you don’t do anything, you will not be enrolled in the 401(k)
Automatic enrollment

Automatic enrollment signs employees up for the 401(k) plan unless they opt out.

• Welcome to the company

• If you don’t do anything
  – You are automatically enrolled in the 401(k) at a 2% savings rate
  – Your contributions will go into a money market fund

• Call this phone number to opt out of enrollment or change your investment allocations
Automatic enrollment effect
Automatic enrollment dramatically increases participation.

401(k) participation by tenure at firm: Company B

Fraction of employees ever participated

Tenure at company (months)

- Hired before automatic enrollment
- Hired during automatic enrollment
- Hired after automatic enrollment ended
Automatic enrollment effect

Employees enrolled under automatic enrollment cluster at the default contribution rate.

**Distribution of contribution rates: Company B**

<table>
<thead>
<tr>
<th>Contribution rate</th>
<th>Fraction of participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>1%</td>
<td>3, 1, 6</td>
</tr>
<tr>
<td>2%</td>
<td>67, 20, 9</td>
</tr>
<tr>
<td>3-5%</td>
<td>17, 7, 31</td>
</tr>
<tr>
<td>6%</td>
<td>37, 14, 18</td>
</tr>
<tr>
<td>7-10%</td>
<td>14, 6, 9</td>
</tr>
<tr>
<td>11-16%</td>
<td>9, 4, 10</td>
</tr>
</tbody>
</table>

Default contribution rate under automatic enrollment:

- Hired before automatic enrollment
- Hired during automatic enrollment (2% default)
- Hired after automatic enrollment ended
The persistence of defaults
Participants stay at the automatic enrollment defaults for a long time.

Fraction of participants hired during automatic enrollment at both default contribution rate and asset allocation
Automatic enrollment: Conclusions

• Automatic enrollment dramatically increases 401(k) participation

• Participants hired under automatic enrollment tend to stay at the automatic enrollment defaults

• Bottom line: Employers need to choose defaults that facilitate retirement savings goals of employees who follow the path of least resistance. Possibilities:
  – Higher initial default contribution rates
  – Contribution rates that ratchet up with tenure by default
  – More aggressive default funds
  – Defaults tailored to each employee
  – Defaults that kick in with a delay
Active decisions

Active decision mechanisms require employees to make an active choice about 401(k) participation.

• Welcome to the company

• You are *required* to submit this form within 30 days of hire, *regardless* of your 401(k) participation choice

• If you don’t want to participate, indicate that decision on the form and submit it

• If you want to participate, indicate contribution rate and asset allocation on form and submit it

• Being passive is *not* an option
Active decision effect on participation

401(k) participation increases substantially when employees are not allowed to be passive about savings.

401(k) participation by tenure: Company E
Active decision effect on savings rates

Employees savings rates at 9 months after hire are what they would have otherwise chosen 3 years after hire.

Predicted standard enrollment savings rate at 3 years vs. actual active decision savings rate at 3 months

Active decision avoids herding employees into a one-size-fits-all default
Active decision: Conclusions

- Active decision significantly raises 401(k) participation, but not as much as automatic enrollment
- Active decision doesn’t induce clustering of choices around defaults
- Under active decision, employees quickly choose savings rates that they otherwise would have taken three years to get to
- Because active decision requires that passivity not be an option, it is important that the deadline for indicating a decision is enforced
- Extension: Can require employees to make an active decision about their 401(k) every year, rather than just at hire
- Bottom line: Active decision is an attractive alternative to defaults. At the end of this presentation, we will discuss when one is more appropriate than the other.
What happens to 401(k) balances when an employee leaves?

- Large balances (>\$5000)
  - Default: balances remain at former employer
  - Terminated employees can request a cash distribution into an IRA or other qualified plan
  - In practice, balances tend to remain at the former employer

- Small balances (<\$5000)
  - Employers can choose to retain small balances unless terminated employees choose otherwise
  - OR employers can choose to compel a cash distribution if the former employees do not request a rollover into an IRA or another 401(k)

  ➡️ Default is a cash distribution

  - In practice, cash distributions of small balances tend to be consumed rather than rolled over into another form of retirement savings
Likelihood of 401(k) distribution for terminated employees

The probability of a cash distribution that isn’t rolled over changes dramatically across the $5,000 balance threshold.

Balance size and the likelihood of a cash distribution for terminated 401(k) employees: Company D

Note: The probability of a distribution gradually rises as balances fall from $5,000 to $1,000, rather than jumping discretely at $5,000, because the balances on the horizontal axis are balances at the prior year-end. Hence, an account with $4,000 in it at the prior year-end has some probability of being above $5,000 at the time of termination.
Automatic cash distributions: Conclusions

• The default treatment of employers largely determines what happens to the 401(k) balances of terminated employees
  – Large balances (> $5,000) stay with the former employer
  – Small balances (< $5,000) that are subject to an automatic cash distribution are consumed

• Bottom line: Employers can further promote retirement savings by changing the default treatment of small balances
  – Maintain small balances instead of subjecting them to a cash distribution
  – Lower the threshold for an automatic cash distribution
  – Automatically roll over small balances into an IRA unless terminated employee actively elects otherwise
Employer match threshold and contribution rates

We present a case study of a company that changed its employer match threshold.

• Matching at Company G
  – Through 12/31/1996
    -50% match rate
    - Matched contributions up to 6% of salary (5% if unionized)
  – Increased match threshold on 1/1/1997
    -50% match rate
    - Matched contributions up to 8% of salary (7% if unionized)
Employer match threshold and contribution rates

Changing the match threshold caused employees to slowly move from the old threshold to the new threshold.

**401(k) contribution rate response to match threshold change: Company G**

![Graph showing the percentage of participants and contribution rates from March 1996 to September 1999.](image)

- **1-4%**
- **5-6%**
- **7-8%**
- **9-10%**
- **11-15%**
- **16-25%**

Jan-97
Employer match thresholds: Conclusions

• Changing the employer match threshold moves employees from old threshold to new threshold
  – Proportion of non-threshold contribution rates remains relatively unchanged

• Employee savings rates are sticky: adjustment to new savings rates takes years

• Bottom line: Increasing the match threshold increases employee savings rates, but slowly
  – Match threshold seems to serve as a focal savings rate for many employees
  – Conjecture: 50% match up to 6% threshold will induce higher savings than 100% match up to a 3% threshold
Other examples of passive decision-making

• Automatic savings escalators increase savings rates (Benartzi and Thaler)

• 401(k) participants often randomly pick mutual funds from their plan menu and allocate money equally among them (Benartzi and Thaler)

• Employer matches made into company stock tend not to get moved into other investments, even when there are no restrictions on diversification
Financial education

Can financial education help overcome passivity?

- Problems with most studies of financial education effects:
  - Education is not randomly assigned. So maybe observed effect arises because people who show up to seminars were going to make good decisions anyway.
  - Effect measured by asking people what they remember doing, or what they plan on doing
    - People have very bad memories
    - We have seen that people are not very good at following through on their savings plans
Financial education

Company E offered financial education to its employees.

- Seminars presented by a financial education company
- Curriculum: Setting savings goals, asset allocation, managing credit and debt, insurance against financial risks
- Seminars offered throughout 2000
- Linked data on individual employees’ seminar attendance to administrative data on actual savings behavior before and after seminar
Financial education results

The difference in behavior between attendees and non-attendees is positive but small.

<table>
<thead>
<tr>
<th></th>
<th>Seminar attendees % planning to make change</th>
<th>Seminar attendees % actually made change</th>
<th>Non-attendees % actually made change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Those who are not in 401(k) plan</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enroll in 401(k) Plan</td>
<td>100%</td>
<td>14%</td>
<td>7%</td>
</tr>
<tr>
<td>Those who are already in 401(k) plan</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase contribution rate</td>
<td>28%</td>
<td>8%</td>
<td>5%</td>
</tr>
<tr>
<td>Change fund selection</td>
<td>47%</td>
<td>15%</td>
<td>10%</td>
</tr>
<tr>
<td>Change asset allocation</td>
<td>36%</td>
<td>10%</td>
<td>6%</td>
</tr>
</tbody>
</table>
Financial education: Conclusions

- Financial education does affect 401(k) savings behavior
- BUT the effects are not large
- Seminar attendees have good intentions to change their 401(k) savings behavior, but most do not follow through
- Bottom line: financial education alone will not dramatically improve the quality of 401(k) savings outcomes
- We have also studied the effect of the Enron/Worldcom/Global Crossing scandals on employer stock holdings
  - We find minimal diversification out of employer stock in reaction to these news stories
The scope of employees’ mistakes

Many employees fail to pick up large amounts of free money in their 401(k).

- Reaping employer match is a high, instantaneous, and risk-free return on investment

- Therefore, not contributing up to employer match threshold is almost as bad as walking away from free money lying on the sidewalk

- Loss is especially egregious if you are over 59½ years old
  - Have the most experience, so should be savviest
  - Retirement is close, so should be thinking about saving
  - Can withdraw money from 401(k) without penalty, so contributing is riskless

- We study seven companies and find that on average, 39% of employees over 59½ years old are not fully exploiting their employer match
  - Average loss is $460 every year, or 1.6% of salary
Implications of passive decision making

• For employers
  – Employers have a large measure of control over their employees’ savings choices simply by how they structure their 401(k) plans

• For policymakers
  – Government laws and regulations can be used to promote the socially optimal use of defaults
Ten principles for defined contribution design

1) If an employee decision is not very important, then set a default (e.g. issue cash distributions for balances <$1,000)

2) If employee preferences are nearly homogeneous, set a default

3) If employee preferences are heterogeneous and employees know enough to make good decisions for themselves, require an active decision (e.g. 401(k) participation, 401(k) contribution rate)

4) If employee preferences are heterogeneous and employees don’t know enough to make good decisions for themselves, set a default (e.g. asset allocation)

5) Automatically update decisions (e.g. default rebalancing, default lifecycle portfolio adjustment, default diversification out of employer stock, default contribution rate escalators) or regularly require updated active decisions
Ten principles for defined contribution design (continued)

6) Replace the employer match with automatic enrollment (or active decision enrollment) and make non-contingent employer contributions to the plan.

7) Only offer mutual funds with low fees (e.g., <50 basis points)

8) Make mutual fund fees salient and easy to understand

9) Don’t offer a large menu of funds or exotic funds

10) Don’t expect financial education alone to solve your employees’ problems
Government’s role

• Require all companies to use either automatic enrollment or active decision enrollment

• Discourage company stock holding…
  – Require all companies to implement default rebalancing out of employer stock
  – Restrict matching in company stock
  – Or ban company stock outright from 401(k)

• Create new regulations encouraging individualized defaults
Further reading

This presentation is based on the following papers.


