

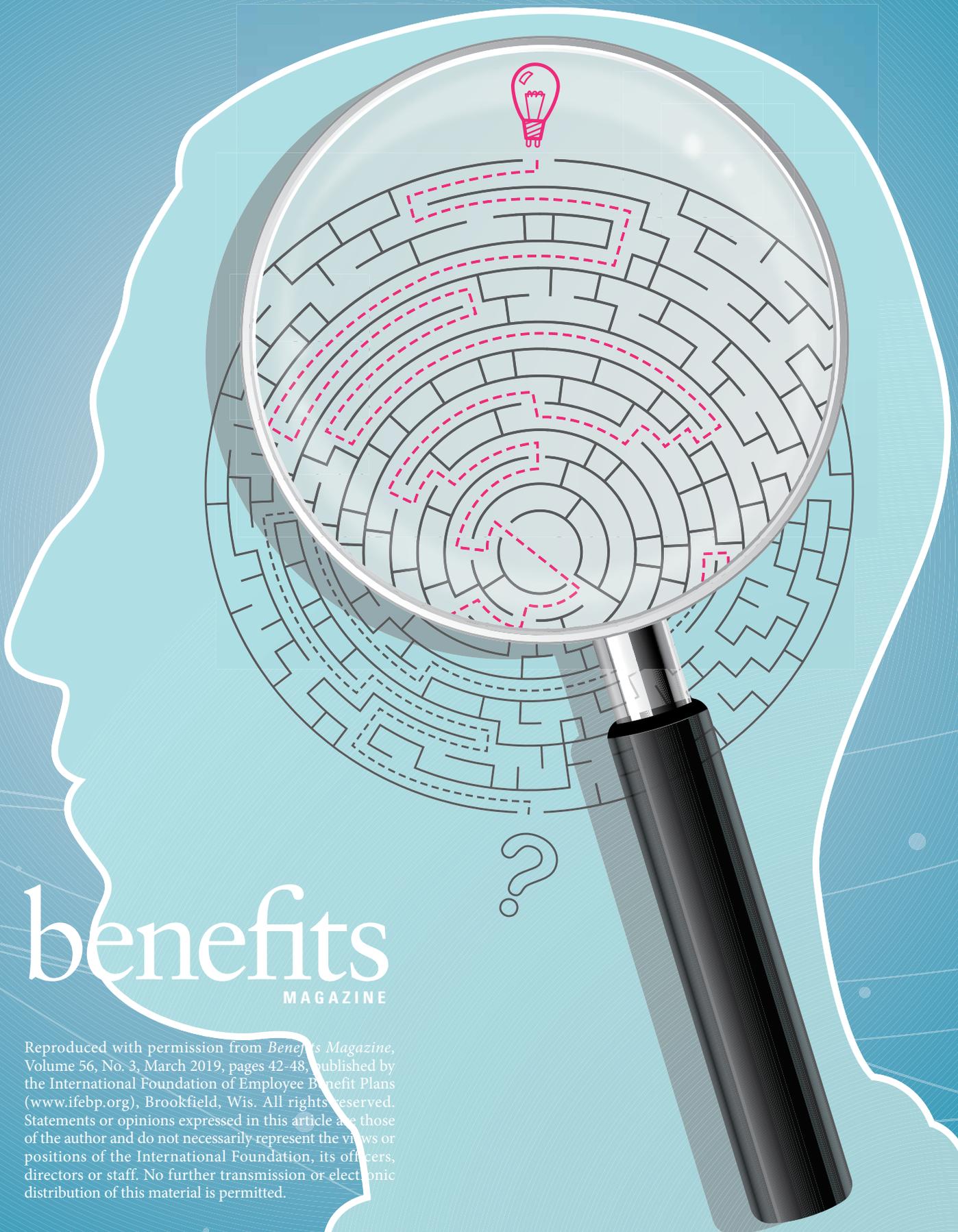
For retirement plans, the field of behavioral economics has demonstrated the power of autoenrollment features to increase plan participation. Plan sponsors can put other insights into action using research on plan participant behavior to help workers start saving earlier, determine how much to save and decide when to retire.

# Beyond Defaults:

## Using Behavioral Economics to Improve Retirement Outcomes

by | **Steve Vernon**

In March 2018, the International Foundation hosted a summit to explore how to deploy behavioral economics and psychological science in retirement and health plans. The summit, which gathered input from more than 200 Foundation member participants, featured behavioral economics researchers and was facilitated by Steve Vernon, FSA, MAAA, actuary, author and research scholar at the Stanford Center on Longevity. Vernon authored a white paper summarizing the main observations and conclusions from the summit. This article is based on Vernon's findings. A second article will address health plans. For a full copy of the white paper, visit [www.ifebp.org/pdf/whitepapers/beh-decision-summit-paper.pdf](http://www.ifebp.org/pdf/whitepapers/beh-decision-summit-paper.pdf).



# benefits

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**E**vidence is accumulating that financial literacy education programs are not successfully moving most participants to action when it comes to addressing the significant financial security challenges they face. Such programs may be successful at raising awareness about these challenges, but they have not been sufficient to improve retirement outcomes among a broad population.<sup>1</sup>

As a result, employers and plan sponsors are interested in learning how to move beyond merely providing information and educational programs to improving participants' financial security.

This article discusses the reasons for considering behavioral economics in the design and communication of retirement programs, key behavioral considerations and a research-based design that practitioners can use to integrate various principles of behavioral economics. The article discusses key action steps, participant decisions that plan sponsors may want to positively influence and how behavioral interventions might help. It ends with a summary of key takeaways and a call to action for plan sponsors to consider deploying behavioral economics to improve outcomes with their participants.

### Why Consider Behavioral Economics?

For many years, the retirement world consciously or unconsciously agreed with the assumption that workers and consumers made rational decisions—for example, plan

sponsors often assumed that when their participants faced a challenge, the participants recognized that they faced an important decision that needed their attention, spent the time to learn about and study their options, calculated the financial consequences of each option, made their decisions solely on the economic advantages they would enjoy and had the discipline to implement their decisions. Often the response to seeing mistakes and poor decisions made by participants was simply to provide more education or develop more sophisticated calculators or online tools. And this may have worked for the small part of the population that was already motivated to focus on their retirement security.

But research is showing that while education programs help raise awareness, they often don't lead to people changing their habits and behaviors. For example, one meta-analysis of 188 research studies found a 0.1% variance in financial behaviors that is explained by content-based, financial interventions.<sup>2</sup>

Starting in the latter part of the 20th century, there's been a growing recognition by economists, employers and the financial industry that workers and consumers don't always make decisions that appear to be rational or in their best interests. This has inspired the rise of a new field, commonly called *behavioral economics*.

Indeed, the importance of this new field is evidenced by Nobel Prizes being awarded to prominent behavioral economists Daniel Kahneman in 2002 and Richard Thaler in 2017.

Now retirement plans can utilize a robust field of research on how people make decisions.<sup>3</sup>

### Key Considerations for Behavioral Engineering Design

The practical application of this research is to design interventions that go beyond pure education and help influence participants to make more effective decisions. It's important to recognize that the level of precision with behavioral interventions isn't the same as with the physical sciences such as physics and chemistry. Often, the best we can do is influence more participants to make better decisions, and it's unrealistic to expect that the interventions will help all participants.

To deploy behavioral engineering, employers and plan sponsors will need to debate a few important considerations.

- What are the *right* decisions that they want to influence? Or, at least, what is the *right direction* of decisions?

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## key takeaways

### Action Step No. 1: Convince younger workers to save for retirement.

- Implement automatic enrollment in the retirement plan.
- Select a default rate that results in meaningful contributions, such as 6% of pay.
- Deploy a precommitment strategy with automatic escalation of contributions.
- Look for visible ways to reward or recognize saving.

### Action Step No. 2: Help plan participants determine how much to save.

- Show a recommended savings rate on election forms.
- For nonparticipants, project estimated employer matching contributions and future balances, and state the amounts that will be lost due to nonparticipation.
- Illustrate annual contribution amounts instead of hourly amounts.
- Simplify the investment lineup with a default investment option and a small initial lineup of funds—for example, five to seven funds.
- Encourage older workers to learn about Social Security and pension benefits by asking: Are you OK living on half of your paycheck?

### Action Step No. 3: Help older workers decide when to retire.

- Look for alternative career paths and other ways to accommodate older workers to postpone retirement, even just for a year or two.
- Consider implementing retirement readiness programs that motivate older workers to learn about their options, and then provide the tools to help them consider the financial consequences of retiring at various ages.
- Review the terms used by retirement plans to see how they can influence more effective decisions.
- Consider offering a 75% joint and survivor annuity as the default payment option for married participants in pension plans.

- How directive do they want to be? How much flexibility and judgment do they want to give to participants?

For example, defined benefit (DB) plans usually fulfill the responsibility of how much to save and how to invest, saving participants from making these decisions. In other words, these plans do it for the employee. The only flexibility these plans typically provide is the form of payment at retirement.

Plan sponsors and trusts will want to keep in mind three approaches to this flexibility and consider the most appropriate approach for their participants.

1. Do it for me.
2. Help me do it.
3. I'll do it myself.

The answers can be different for various groups of participants. Also, individuals may desire different approaches for the various financial decisions they need to make.

Much of the initial research on behavioral economics examined methods of influencing people to save more money or invest more effectively. It was relatively simple to define the problem and measure whether the intervention improved results. These findings also can be applied to more complex de-

isions, such as when to retire, when to start Social Security benefits and how to deploy savings in retirement.

### Avoid DB Plan Complacency

There's a natural tendency to think participants who are covered by DB pension plans may not need to pay attention to saving and investing. However, there are four problems with this notion.

1. For most plan participants, Social Security benefits will be more valuable than benefits from a pension plan.<sup>4</sup> Participants' decisions regarding when to claim Social Security will significantly impact their financial security in retirement.
2. Not all participants will earn a significant DB pension. Many participants may not have enough service, or a DB plan may not be enough to replace a substantial percentage of income. Many DB plans are designed to provide a basic level of benefits, and many participants will still need savings to retire comfortably.
3. There are still important decisions with a pension plan that are subject to behavioral factors, such as selecting

a joint and survivor benefit to cover a spouse or whether to elect a lump-sum equivalent, if offered.

4. Most participants have spouses and other family members who do not participate in DB plans, and it will be important for them to make effective financial decisions.

Following are three key action steps for plan sponsors looking to positively influence the retirement decisions of their participants.

### Action Step No. 1: Convince Younger Workers to Save for Retirement

Deploying automatic enrollment in retirement savings plans is a very effective way to boost participation in these plans. Automatic enrollment takes advantage of the following behavioral economics phenomena.

- **Inertia:** Participants often have a strong tendency to do nothing. If they are automatically enrolled to participate in a savings plan, they do nothing and allow their participation to remain effective.
- **Social norms:** If most or all co-workers are saving for retirement, it encourages people to save for retirement.
- **Endorsement effect:** Automatic enrollment sends a message from an influential source (the employer or plan sponsor) that it's important to save for retirement.

Studies demonstrate the power of automatic enrollment. For example, results from a few studies showed a 40% participation rate for *opt-in enrollment* that required positive election to participate and a 90% participation rate for *opt-out enrollment* that automatically enrolled participants and required a positive election to stop participating.

There also is evidence that for savings plans with automatic enrollment, participation rates were virtually identical for plans with a default contribution rate of 3% of pay vs. 6% of pay. Participants chose the default, regardless of the amount. This should encourage plan sponsors to design higher default contribution rates with automatic enrollment.

Precommitment strategies can also influence participants to save or increase their savings. For example, a savings plan could take advantage of autoescalation features, which could save a portion of future salary increases or simply automatically increase the annual contribution rate each year.

One more idea: One challenge with saving is that it's easy to observe friends and family spending their money, while saving is invisible—People don't see their friends saving

money. Plan sponsors could look for ways to make saving more visible by rewarding and recognizing those who save money.

### Action Step No. 2: Help Plan Participants Determine How Much to Save

Most plan participants do not use online calculators to help them determine how much to save for retirement. Possible reasons include lack of confidence or sophistication with using online modeling tools and low motivation.

Following are a few strategies that can help improve savings plan contribution rates.

- Help potential participants make a decision. If a plan does not offer automatic enrollment, it can still identify a specific contribution rate as *recommended*, taking advantage of the *endorsement effect*.
- Take advantage of *loss aversion* by adding statements to nonparticipants showing the amount of the employer match that they are losing by not participating. Another idea is to estimate potential participants' account balance at some future date to show how much would be lost if they do not contribute to the plan.
- With *framing*, show estimated savings amounts tied to annual salary, rather than the hourly rate. This can increase the amounts that participants save.
- Simplify the investment lineup. Too many investment funds can cause confusion with plan participants, leading to lower participation rates.

One idea to motivate older workers to learn about their retirement income is to ask them: Are you OK living on half of your paycheck? That might encourage them to save more to boost their retirement income.

### Action Step No. 3: Help Older Workers Decide When to Retire

Older workers who are contemplating retirement face a series of very important decisions that will impact their financial security and personal enjoyment for the rest of their lives. For example, many participants retire as soon as possible, forgoing significant increases in their total retirement income that they might earn if they postpone retirement, even for only a year or two.

A recent analysis by Stanford professor John Shoven demonstrates the power of working longer.<sup>5</sup> Workers who are age 62 can increase their annual retirement income by one-third

if they work four more years to age 66 and by roughly three-fourths if they work eight more years until age 70. These increases result from:

- Significant increases in Social Security benefits due to postponing benefits
- Additional service earned under traditional pension plans and waiting to eliminate early retirement reduction factors
- Additional investment income earned on retirement savings.

Working longer is a natural response to the longer lives that many people are living today. Retirement can get very expensive if we keep adding extra years of life to the retirement period.

As a result, employers and plan sponsors might consider making accommodations that allow older workers to postpone full retirement, even if for a few years. Such accommodations could be considered part of their overall retirement program.

The following key decisions facing older workers can be influenced by behavioral economics interventions:

- When to retire
- Whether to work part-time for a period
- When to start Social Security
- When to start DB pension distributions
- Whether to elect a joint and survivor pension if they are married
- When and how to start drawing down retirement savings.

To make the best possible decisions, participants will need to spend time learning about their options and the advantages and disadvantages of the choices they face. One technique that can enhance motivation is for people to see a picture of what they might look like in

bio



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ten, 20 or 30 years. Research shows that seeing a future self can motivate people to take steps now to improve life in the future.<sup>6</sup> Apps and computer programs can easily prepare these photos.<sup>7</sup>

The words that pension plans use to describe benefits also can influence the decision to retire. Consider that *normal retirement benefits* could instead be described with the emotionally neutral term *unreduced retirement benefits*. Similarly, *early retirement* has positive connotations in our society, implying that early retirees are perhaps more successful. A more accurate term could describe early retirement benefits as *reduced retirement benefits*.

On the other hand, *late retirement* implies that somehow a person has failed and is getting penalized. In actuality, most participants receive increased benefits if they delay retirement, so a plan could describe these benefits as *increased retirement benefits*.

As mentioned previously, carefully designed *defaults* can have a powerful influence. With many pension plans,

the default payment option for married couples is a 50% joint and survivor annuity. However, widows/widowers typically have living expenses that are about 80% of the expenses when both spouses were alive.<sup>8</sup> As a result, DB plan sponsors might consider designating a 75% joint and survivor annuity as the default payment option.

### Final Thoughts

Much of the research in behavioral economics has been conducted in labs. Indeed, we've gained useful insights from this research about interventions that can improve retirement and health outcomes. The next phase in behavioral economics research, however, is to test behavioral interventions with workforces and customer bases, helping people who are making real-world decisions. This will help enhance our understanding of the principles and refine the appropriate interventions. Employers and plan sponsors can play a significant role in facilitating this research.

Workers of all ages will want to take steps so that they arrive at their later years financially secure. The retirement plans offered by employers and plan sponsors are critical tools that can help participants achieve these goals. The next frontier is to design and communicate these plans, taking into consideration the behavioral factors described in this article, to help improve retirement outcomes. 6

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