

Issues & Considerations Around Facilitating Lifetime Plan Participation

**Department of Labor
Employee Benefits Security Administration
Advisory Council**

The 401(k) As A Lifetime Financial Instrument

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Prepared Remarks to Accompany Powerpoint Presentation

Thanks for the opportunity to present.

My presentation focuses on what we accomplished in the plan sponsor role at a former Fortune 100 insurance and financial services employer in terms of facilitating lifetime plan participation. It is based on a concept that was triggered by changes that were part of the Tax Reform Act of 1986.

I have previously presented this material in a number of plan sponsor seminar settings – Employee Benefits Research Institute/American Savings Education Council, World at Work, Council on Employee Benefits, International Foundation of Employee Benefit Plans Symposium, Benefits Expo, Society for Human Resources Management, and the Corporation for Enterprise Development.

I mention this only because after all that effort, I have yet to see another plan sponsor embrace the concept – that lifetime plan participation should be a priority for plan sponsors.

So, to provide a high level overview of all the changes involved in my 401(k) plan's 25+ year journey to convert a typical employer-sponsored 401(k) into a lifetime financial instrument, I will have to move pretty quickly.

Here we go.

These are the takeaways: I will focus on the 401(k) plan; however, my last employer also sponsored defined benefit, retiree medical and retiree life coverage. Objectives in those plans also changed over the twenty five year period.

The “401(k) As A Lifetime Financial Instrument” concept was not a formal Human Resources or Benefits or Corporate policy at my prior employer; but it became a specific consideration in a 25+ year series of compliance/design changes – changes first triggered by provisions in the Tax Reform Act of 1986.

The concept is essentially one of meeting workers where they are – most are focused on today, not on planning for retirement. Most are focused on accumulated debt, not on saving or investments. Many are simply overmatched, overwhelmed, and time-starved – when it comes to managing finances.

So, the “lifetime focus” is a two part solution – one prong is, to quote Einstein, to make it as simple as possible, and to make it ubiquitous or prevalent or an expectation, and the other is to nudge people in the right direction – to force them to make decisions, over and over, if they decide not to pursue wealth accumulation. Remember that workers are on a journey; however, most are on a path where retirement is not a specific destination.

Lifetime here means an attempt to serve workers for their entire working career, including periods prior to the date of hire at your employer, and throughout life - serving the worker and her family until the last to die. Again, that is, to build up the asset base throughout working career, including assets from prior employer plans, contributory and rollover IRA assets, accumulate, aggregate, consolidate, maintain, throughout the entire period of service, serve at and after separation – encouraging rollovers from other IRAs, and subsequent employer plans, throughout retirement and for survivors – until the last to die.

The concept anticipates that workers have many diversions in their financial behaviors. For example, Thaler and Sunstein in their book *Nudge* contrasted the difference between *homo sapiens* and *homo economicus* – that most of us are often not rational in our economic and financial behavior, but biased. Another challenge comes from all the marketing for current consumption as well as the marketing by IRA vendors, life/annuity firms to challenge a plan sponsor's attempts to consolidate/aggregate savings.

For me, the plan I inherited at my last employer, over 25 years ago, that plan design actually discouraged participation at hire, actually encouraged distribution/payout at separation. That 1985 plan had no focus on asset retention, and in 1984-1985, prospectively terminated the in-plan annuity.

A major component of our approach to changes over the 25 years that followed was a change in focus – dropping all retirement themed communications and marketing to focus solely on wealth accumulation. We focused on wealth accumulation – a theme we sometimes called “middle class millionaires” – demonstrating how a lifetime of savings activity might accumulate. We did not focus on retirement or income replacement – deeming those concepts too remote and too complex for new hires. We also dropped most references to the employer and the fact that this was a tax-qualified, employer-sponsored, profit sharing plan. Instead, our messaging favored an account ownership theme – that participants owned their own accounts – even after separation from service.

The result was stunning. We went from negligible assets in the plan for term vested and retired participants (amounts so small we didn't measure them prior to the 21st Century), to \$1.643B in assets (including a lifetime of my own savings), which represents over 34% of plan assets. While averages can be deceiving, that's an average account balance of almost \$110,000.

My goal, since I've been publicly pushing this concept since 2008, is to ensure that all compliance actions and future statutes should be considerate of those plan sponsors who want to maximize value for both current and former employees – who see individuals (and their family members) as participants for life and who want to deliver superior value at every stage of the relationship – recognizing most have service prior to hire, serving them at hire, serving them while working for the plan sponsor, serving them at separation, serving them post-separation and throughout retirement or payout – including serving survivors.

That's the concept. On to the detail – very high level, very summarized.

Here's my agenda today. I'll focus on the 401(k) plan. Spend a minute on TRA '86. Talk about the concept of a "lifetime financial instrument" as I see it. Discuss the lifetime journey we experienced from 1986 through 2010. And, finish with a few items I believe the DOL might focus on to facilitate adoption of the lifetime participation focus.

Here is the 401(k) plan design in place in 1985. For the most part, it is pretty typical of the plans in place back then – shortly after the 401(k) regulations were issued - the dawn of 401(k) penetration. This plan had some notable differences, compared to typical plans, in terms of eligibility, vesting, and the limitations on changes to contributions and investments.

Limits on access to assets prior to separation (no loans, etc.) was also typical of the plan of that day – so, even though the plan had a competitive match, which was 100% vested, only 74% of eligible employees (people who had completed at least three years' service), elected to participate.

What was interesting to me was the payout provisions. I used to do a pre-retirement planning seminar. And, I also counseled workers who quit prior to retirement. It was clear that the lump sum design, coupled with the requirement to take at separation or defer to age 55, was intentionally put in place to push participants and assets out of the plan.

Here is my attempt to diagram what the forced leakage looked like. Not only did we open the leakage spigot, we added pressure through the pipes ... all but forcing money out.

We immediately sent distribution paperwork. We repeatedly followed up with notice after notice before closing off payout (and deferral to age 55). We highlighted the lack of withholding tax. Again, if you were under age 55, that you needed to get in and get your money or else you would have to wait until age 55. We also highlighted the favorable tax treatment at separation, and we demanded any loan be repaid, and finally, you didn't have any other payout options – it was lump sum only after separation. And, we wanted you to leave the plan. And, most did. I was never able to confirm why we had this structure. However, I would note that the same structure could still be in effect under current regulations - had we not changed the plan provisions.

So, an important place for plan sponsors to start is to examine their own plan provisions to see whether perhaps provisions prompt leakage – intentionally or unintentionally.

Then along came TRA '86 – which forced the plan to make changes in eligibility, prompted addition of a vesting schedule to counter earlier eligibility, added Minimum Required Distribution installment payout provisions and significantly curtailed the tax preferences for lump sum distributions.

It prompted a shift in focus – and, I took the hint. I decided I needed to pay just as much attention on getting the maximum out, after taxes, as I did on getting assets into the plan. And, now that we would likely have some people as participants until death (the later of the worker or her/his spouse), all of a sudden we were talking about periods of participation ranging from as little as a few months to five, six or seven decades, or more.

Concurrently, due to changes in retirement design, both DB and retiree medical, the 401(k) would no longer be positioned as a supplemental savings plan, but as an integral part of retirement benefits and retirement participation.

So, we could no longer afford to have one in four eligibles foregoing participation.

Post TRA'86, it was clear that the top issue we faced was the realization that people were not taking full advantage of the opportunity, they were not achieving optimal accumulations.

We did some focus groups and surveys and found that the 401(k) was the highest rated (in terms of employee satisfaction) of all the benefit plans we offered – even though just over 50% of employees were actively contributing to the plan in 1986 – the rest were in the 3 year eligibility cycle and the others had waived participation.

When we asked, they told us their reasons why they didn't join the plan when solicited – can't afford it, too complicated, not planning on staying here until retirement age.

It was also clear that once people made up their mind, they frequently stuck with that initial decision – even though the plan changed, times changed and the worker herself changed.

My most painful example was an individual who retired in 2006. She terminated employment and retired on her 50th anniversary. 50 years! However, she had rejected all post-1986 overtures to join the plan – leaving perhaps more than a quarter of a million dollars of employer contributions and earnings on the table.

She rejected a number of specific re-solicitations – such as the re-solicitation we conducted in 1989 (when eligibility was reduced from 3 years to 1 year). She even failed to join in 1991, after being solicited to join upon reaching age 59 ½, where she could have contributed, gotten the match and requested a distribution – every payday.

Simply, despite our best efforts of that time period, our results were not optimal. Our survey and focus group matched what was known elsewhere, in other studies.

Surveys show about 2/3rds of American workers live paycheck to paycheck – focused on daily or weekly needs, not saving, and certainly not retirement. Many lack access to commercial credit to meet day to day needs. A few adopt the envelope process, here depicted as food jars, save a little for each of various needs, or I'll save whatever is left at the end of the month after I pay my bills. Unfortunately, what is usually left at the end of each month is more bills, not money.

This prioritization challenge shows up in all kinds of surveys (many are documented in my white paper on this topic, which I hope to finish updating in a week or so) – where people give priority for other needs over retirement – that retirement is remote in time, of less priority, perhaps even futile or impossible or unattainable. Then, when a need arises, or a financial shock occurs, they raid any

available savings ... and if their savings are limited to the 401(k), they will look to the plan for access via a hardship withdrawal, loan and/or worse, perhaps suspend their contributions.

Simply, we found that retirement requires people to be a retirement funds saver for 20 or 30 or more years, so that they can be a retirement funds spender for 20 or hopefully 30 or more years. That said, workers will always be a retirement funds manager and investor. But, we also found that layering retirement planning over day to day activities was simply too complex for many workers. I mean, in September of 1986, who cared about how to calculate 10 year forward tax averaging other than those who were retiring at that time?

We found that retirement preparation success in a “DC” environment requires a lifetime of savings and accumulations and investing – not a lifetime of focus on retirement planning. We used to talk about all the complex issues in retirement preparation – all the risks, and all the issues people face. We still offer information and education on those topics - we just stopped talking about them with participants and especially new hires.

In my white paper and here, I included a citation to one of my favorite studies about financial literacy – it is an eye opener study – where the majority of surveyed individuals are not able to correctly answer three relatively simple financial/investment questions.

There are two parts to operationalizing the 401(k) lifetime concept – what I sometimes call morphing the 401(k) or repurposing the 401(k) to become a lifetime financial instrument – the first is simplification, the second is deploying various “soft paternalism” or “libertarian paternalism” concepts.

Simplify means, in large part, to focus on one goal – for us wealth accumulation - the opportunity presented by a lifetime of savings and accumulations and investment in the plan.

We also decided to focus individuals on their relationship with the plan – that the plan was a separate legal entity from the employer, and that participation could accommodate savings from other plans and that participation could continue long after employment ended.

But perhaps most importantly, we removed all mention in our push communications and marketing materials of the word ...

Retirement.

We found that people interested in retirement preparation knew what the plan was for, and others need not bother themselves.

We certainly continued to provide access to tools, projection capability, education, professional investment management, financial/account statements, fee disclosures, SPD's, plan documents, SMM's, everything you would expect... we just stopped marketing that stuff at hire in favor of talking about wealth accumulation, talking about the opportunity, talking about becoming a “middle class millionaire”

Two examples – of our solicitation materials for the newly eligible

In 1988, we updated our materials, with permission from Milton Bradley, using their game to encourage people to “Be a winner in the game of life”.

Eight years later, we updated the marketing/solicitation materials to a theme of “Drive to your dreams”. In that 1996 version, I personally removed the word retirement every time it was used.

That is, winner here is not “retirement” but the winner over the entire journey, in the game of life. And, both themes involve car travel – a journey.

The Dream theme is also obviously a journey ... here; the destination is not supplied by the plan sponsor, but by the participant, the worker. That is, again, the current destination, the current focus for many, perhaps most workers may not be retirement.

Simplify, simplify, simplify.

When it came to investments, we followed the crowd, expanded available options, in terms of number and complexity, then examined allocations by participants and recognized that too many thought diversification meant allocating 25% to each of the four large cap growth funds.

So, we woke up in 2006, scaled back the choices – and made sure there was considerable difference in style among the 15 now 13 core options, so as to improve individual’s ability to construct a portfolio of varied assets classes.

To digress for a second, just want to mention that I include myself in the group that has difficulty in investing – despite the A in modern portfolio management which I received in my MBA program.

FYI, less than 1% of participants were in the directed brokerage account the last time I looked.

Finally, one of the more transparent and effective options introduced in 2006 were the target maturity models, a no cost electronic investment allocation process designed by professionals using Modern Portfolio Theory – much the same strategy and historical data as investment houses use in creating Target Date Funds - almost all the value, at no cost, and with optimal transparency. A description of the 2050 Target Maturity Model is on page 27.

Long before mandated fee disclosure, it was clear that people with a lifetime of savings were shouldering a disproportionate share of administrative fees ... because of the use of basis point charges - disproportionate that is, relative to the cost to actually maintain their individual accounts.

We took action wherever possible to moderate fees, to create a significant added value available only to those who maintained assets in the plan – especially for those with a lifetime of savings.

In 2006, we invested considerable money to create an investment structure of separate accounts

And, in 2008, we ushered in a change to administrative fees changing from basis points to per-capita fees – so that we could provide some relief to those with a lifetime of savings in the plan and so that a

greater portion of the administrative burden would be allocated based on the actual cost of administration

Here's a simple example. For our average term vested/retired employee (no one is really average), a person with an account balance of \$100,000 or so, that's a \$585 reduction in fees or 90% - comparing the cost in 1996 to today.

And, while there aren't many in the plan with million dollar account balances today, there are a few and the number is growing rapidly now that the plan is fully mature – now in its 46th year. For comparison, for an individual with \$1,000,000 in assets, the reduction in fees would be from \$6,500 to \$245 or a \$6,255 a year reduction, or a 96% reduction in fees.

Lifetime means lifetime. Of course, we weren't just hiring new college grads and folks out of high school. So, we did everything we could to position the plan as a consolidator of retirement assets, as an aggregator. We added provisions designed to encourage people to roll over funds into the plan whenever possible – even if they were not yet eligible to contribute to the plan. We wanted to capture any retirement assets we could from prior employment – if only to help the participant – reducing individual administration, perhaps giving them an opportunity to improve asset allocation and investment selection (with reduced fees) and of course, to build up the account so as to reduce the potential for pre-retirement leakage.

We created solicitation materials concerning rollovers from prior employer plans, and individual retirement accounts (other than Roth IRAs, of course).

We only had modest success – typically attracting a million or two each year in new hire rollovers. We also re-solicited existing participants from time to time – we believed the plan provided a result superior to that offered by IRA vendors.

Simply, we believed the benefit consulting firm and academic studies that show that the larger the account balance at separation, the less likely the participant will be to take a distribution / trigger leakage.

On to part two of operationalizing the 401(k), or morphing the 401(k), or repurposing the 401(k) as a lifetime financial instrument – the deployment of various “soft paternalism” or “libertarian paternalism” concepts.

Essentially, this was an opportunity to deploy various behavioral economics concepts in a 401(k) environment.

First, we stopped talking about payouts at separation – until specifically requested.

We started shaping communications to confirm that continued participation was just that – the only change was that contributions would stop – that the plan continued to offer all the same advantages those workers had come to know.

Second, we became more sensitive to the savings plan at turnover. One action we took was to document the opportunity rehire would offer to those who were less than 100% vested at separation. In fact, we once measured rehire activity, in 2006, and found that 1 in 12 workers, just over 8%, had worked for the enterprise, left and returned. Not sure it was due to the vesting overture, but maybe it had an impact.

We also highlighted the opportunity the plan provided, on the date of hire, and how separation would curtail access to future contributions.

Finally, we took advantage to individual's aversion to loss – most people are more concerned about avoiding losses than achieving gains – and we made specific changes to the annual benefits statement, to confirm the unvested portion of the account, as if the individual had terminated on the last day of the plan year.

We pushed hard to make the 401(k) ubiquitous, to leverage another Behavioral Economics concept, social norming. We created a new version of the ISP acronym – not only would it mean Incentive Savings Plan, it now also meant “I should participate” ... everyone should have a 401(k) account.

Finally, we fully embraced automatic features ... beyond any other employer's initiative that I know of. Mark Iwry once called this plan the 1st 2nd generation automatic 401(k).

We deployed automatic features perennially. We phased in the process – starting in 2007 and completing the implementation to the current design in 2011. The default auto enrollment is 6% of pay – every year if you are not participating, or contributing less than 6% of pay. The default auto escalation is 1% of pay – every year, if you are contributing 6% but not 12% of pay.

And, here are the results for the first 7 years ... Simply, we have consistently achieved 97% participation in the plan. And, almost all employees are now receiving the maximum available company matching contribution.

Essential to the process was adopting 21st century loan functionality/processing. (Rhetorically) how many of you pay even one bill electronically? Okay, so why haven't 401(k) vendors embraced such processing – it would be less costly than payroll deduction and separation would generally leave the repayment process unchanged.

I call this the “Bank of Jack” concept – again, focusing the materials on personal account ownership. Join, save, get match, invest, accumulate, access to meet immediate need, continue to save, rebalance investments, repay loan with interest, rebuild account for future need – repeat as needed up to/thru retirement.

My white paper discusses the opportunity loans present in detail. For plans that embrace the “lifetime” concept, loans are not leakage. Loans allow people to save more than they might otherwise earmark for retirement. And, those who would curtail access via loans, while allowing hardship withdrawals, likely don't have leakage in proper perspective. That is, almost all loans are repaid. There is almost no leakage from loans prior to separation. That is, almost all leakage from unpaid loans occurs at

separation where, in fact, much of the same leakage would have occurred anyway as part of the regular separation process.

And, after separation, the value of maintaining participation seems obvious ... as demonstrated by our ability to retain assets.

One item we have not focused on is the maintenance of ERISA fiduciary protections. Fact is, as the baby boomers age, concurrent with the massive expansion in individual account plans, as cognitive functionality declines, fiduciary protection may become a much larger factor in favor of lifetime participation.

And, certainly, if the 401(k) account is an aggregator or consolidator, you're talking about most if not all the accumulated assets for many Americans – which only adds to the value of creditor protection.

But, we don't focus on that so much. The messaging at separation is – we expect you to leave your money in the plan until you know what you want to do.

To finish, I think plan sponsors can achieve 80% of the journey using current statutes and regulatory guidance. That is, I believe there are a number of actions, statutory and regulatory, by the department, the IRS and combined, which are necessary to truly re-purpose the 401(k).

At this point, I will stop and open it up for questions, about any of the materials or any of these concepts concerning the last 20% of the journey, or the other items in Appendix B of my slide deck.

Thank you again for the opportunity to share one plan sponsor's journey in re-purposing the 401(k) from an employer-sponsored retirement savings plan into a "Lifetime Financial Instrument".