Model Notices and Plan Sponsor Education on Lifetime Plan Participation

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Good afternoon. I am David C. John, testifying today in my role as Deputy Director of the Retirement Security Project (RSP) at the Brookings Institution. I appreciate this opportunity to share my thoughts about ways that retirement plans can provide clear, concise and objective information to participants that enables them to make appropriate decisions. However, I would go beyond that to provide information that also motivates employees towards actions that will prove to be in their long-term best interest.

General Thoughts about Participant Communications

The shift from traditional pensions to the current defined contribution system places most of the responsibility for making decisions on the participant. Automatic enrollment and similar features assist them by combining several formerly potentially complex decisions about whether to participate, how much to save and what investment vehicle to use into one question that the employee can effectively answer by doing nothing. While the result may not be optimal in all situations, it is certainly better for the saver than not saving at all or waiting until he or she has all of the answers – a day that for many may never come. For these reasons, automatic enrollment and escalation are extremely popular with both those who accept the automatic choices and those who opt out[1].

Unfortunately, at this time, automatic mechanisms are not available for every decision that an employee might need to make between starting to save and retirement. Over time, additional mechanisms that are in development will further simplify these plans, but they are not available yet. Today's automatic mechanisms also do not necessarily affect the attitudes that participants may have about their saving balances and how they might be used. To assist in these areas, effective participant communication is needed.

In order to be effective, communications and notices to employees must have a consistent message that regularly appears throughout an employee's career. No single notice, no matter how effectively worded or how timely it is provided, will be as effective as a regular series of

[1] http://www.retirementmadesimpler.org/Library/RMS_Styles_2008_Topline_Data_Public.pdf

messages. And in order to be effective, notices and statements need to be geared to the needs of the participant rather than to provide legal cover to the plan sponsor for any unanticipated situation. This requires that they be short, clear, simple and to the point.

This need for regular communication as opposed to a single notice or series of notices is especially true for withdrawal options. Whether the participant is leaving the employer or retiring, they need to have key information well in advance of when it is needed. Otherwise, the saver may be influenced by others who are not acting in their best interests or make a decision based on advice from well-meaning, but poorly informed family friends.

An effective participant education plan for lifetime plan participation and effective withdrawal options should have at least three separate parts, which are detailed below. These include effective information contained in the quarterly statement; notices at the time an employee leaves the plan due to a job change, and a pre-retirement education campaign.

While all three must have consistent messages, they should also be tailored for specific circumstances. What follows is a general discussion, as effective model forms require field-testing in focus groups and similar settings. Unfortunately, forms developed by financial professionals with a deep understanding of key issues often gloss over important background information or have technical wording that confuses non-professionals.

Another problem with many individual statements and notices is that they contain too much information. The professionals who developed them recognize the limitations of projection models and seek to compensate by providing a range of results using differing assumptions. Unfortunately, this either further confuses the reader or appears as a dense block of type that is usually completely skipped. It is far better to provide a simple illustration with clear warnings of its limitations than to flood the employee with complex information that will be ignored.

Improved Statements with Income Illustrations and Social Security Information

The most important participant education tool is the quarterly statement they receive. Properly structured, these statements can set the stage for more specific notices before an employee leaves the employer due to either a new job or retirement. Today’s statements are often too long and inadvertently cause the employee to focus on account balances rather than seeing the retirement plan as a source of future income. In many cases, they also fail to note that income from the plan should be added to Social Security for a better estimate of total retirement income. Two major innovations would be to add both income illustrations and to combine 401k statements with the existing Social Security statement.

Income illustrations:

Most of today's quarterly statements focus almost exclusively on the amount that an individual has saved and how much he or she has gained or lost in the previous quarter. This focus damages the ability of a participant to see the plan as anything other than a savings account. Faced with a lump sum of retirement savings that may be a much higher amount than an individual has ever had and little or no practical experience about how to translate that amount into an income stream, it would be very easy for a worker to assume that he or she is much better prepared for retirement than is actually the case. An income illustration would help savers to make earlier and better decisions about how much they may need to save and how best to manage their retirement assets.

The illustrations should also encourage participation both by including both current and projected balances and by showing the additional income that could be expected if the saver slightly increased his or her contributions.

Including income illustrations for both current and projected retirement savings balances would have a greater incentive effect than just including current balances. For younger employees, the very small amount of income that would be produced from their current retirement savings balances may discourage them from further savings and thus have the opposite effect of what is in their long-term best interest and the objective of this disclosure. Including an income illustration for projected balances that assumes continued participation provides a clearer picture of the extent to which the amount that the individual is saving will meet his or her retirement income needs.

Studies[2] show that an illustration of the additional income that can be derived from a higher level of saving is likely to stimulate the participant to increase his or her savings rate. Plan sponsors should be encouraged to also include balance projections and income illustrations that show how much retirement income an individual would have if they modestly increased the proportion of their income that they contributed to their retirement savings plan. For instance, in addition to the income illustrations based on their current balances and projected balances assuming their current savings rate, there might be an illustration based on saving an additional one percent of income and another three percent of income.

Combining Social Security Statements with Quarterly Statements:

As a further way of moving the focus of quarterly statements away from lump sums and investment returns and towards retirement income, an accurate estimate of projected Social Security benefits could be added to at least one annual quarterly statement containing an income illustration. Some 401(k) providers already simulate Social Security benefits and provide this information to account owners, but these providers lack the income and work history data to

[2] Goda, Gopi Shah, Colleen Flaherty Manchester and Aaron Sojourner. What Will My Account Really Be Worth? An Experiment on Exponential Growth Bias and Retirement Saving. Santa Monica, CA: RAND Corporation, 2012. http://www.rand.org/pubs/working_papers/WR873-2

make a truly accurate projection. Collaboration between SSA and 401(k) plan administrators could result in adding information from the once annual Social Security statement to at least one 401(k) quarterly report each year.

Two sets of concerns about using Social Security information would need to be addressed: concerns about privacy and concerns about accuracy. Previous discussions of similar proposals failed because of privacy concerns, as many individuals do not want employers to have access to their Social Security information. Account holders' privacy is a concern for 401(k) providers too, and providers go to great lengths to protect the confidential data in the quarterly statements. To assuage concerns about the data from SSA, Social Security data could be provided directly to 401(k) administrators rather than employers and included on an annual 401(k) statement only if the administrators meet certain SSA-developed privacy standards. Individuals could have control over this decision through the ability to opt in to the service or to opt out, if the service were automatic. This should preserve individual choice and satisfy persons especially concerned about privacy.

To ensure accuracy and consistency, income illustrations of balances in the 401(k) and SSA projections would need to be produced using compatible methodologies that allow the projected monthly income estimates to be combined for a complete picture of estimated retirement income. This is not a terribly difficult problem. This reform will give people important information about how to plan their futures. They desperately need this information, and providing it should be fairly simple and cost-effective.

Using an Enhanced Statement as a Base for Additional Guidance and Education

An enhanced quarterly statement with a consistent message that retirement plan participation is intended as retirement income will set the stage for more effective education when the participant leaves the employer. The current statement format that focuses on aggregate savings amount and the performance of investments sends the message that the balances could be used for other purposes. This encourage leakage when employees change jobs and may leave the impression that the savers has sufficient resources to use part or all of that money for other purposes.

While the information on investment returns is important and should remain on the statement, it should be de-emphasized, with the focus moving to retirement income that it can provide. As an aside, let me be clear that I do not favor eliminating the ability to withdraw savings before retirement in the event of an emergency. For one thing, doing so would reduce participation, and could hurt vulnerable populations that have no other major source of savings. However, the purpose of the quarterly statement should be to inform savers of their future retirement income, and its orientation should be towards that goal.

Encouraging Participants to Preserve Savings When They Move to a New Job

Several studies show that the biggest source of leakage occurs when employees change jobs.[3] Part of the reason for this loss of savings may be the way that employers handle the discussion about retirement assets upon separation. A discussion that is centered on the open question of what should we do with your money may encourage savers to simply ask for their money as a lump sum. This is especially true if the participant is not informed of the tax consequences of an early withdrawal and the potential effect on future retirement income.

On the other hand, if the participant has received a consistent message that the account is for retirement income, and is informed of the potential consequences of withdrawing the money, they would be less likely to take the funds and more likely to leave the money in the current employer's plan or to roll it into a plan offered by the new employer or an IRA. Of course, part of this decision would be determined by whether the current employer is willing to allow the money to remain in their plan or if they would prefer it to be moved to another location.

As a side note, the process of combining retirement savings from one employer to another would be much easier if there is a simple mechanism that can be used to make such transfers. As I can testify from personal experience, it can be extremely complex to roll retirement money from one employers' plan to another's even for those of us who work in this field. Plan administrators from both the sending and receiving plans make this process overly difficult in part because one party needs to know if it is a legitimate transfer as opposed to a withdrawal, and the other needs to know that the money it is receiving has the proper tax status. While it is beyond the scope of today's hearing, it is definitely worth the effort for regulators and if necessary legislators to simplify the process and encourage automatic rollovers between employers.

Contents of Model Notices for Participants Changing Employers:

Given this background, a disclosure notice provided to employees who are moving to another employer should include specific information about several topics. However, a one-shot notice will be far less effective than an educational campaign that includes information about how poor decisions when changing jobs can adversely affect retirement security. This information should not be limited to when an employee departs; it should also be included in regular communications.

When an employee moves to another employer, he or she needs to know:

- *Ability to retain fund in the account or roll them into another account:* The employee should be informed that moving the money to another retirement account, ideally that of

[3] http://www.ebri.org/pdf/FF.290.Leakage.17July14.pdf

the new employer, is the best option. He or she should also be informed if the current plan is willing to continue to hold the money. Information about how to effect the rollover and/or a third party willing to assist with the transaction can be provided on a separate sheet.

- *Tax consequences of withdrawing the money:* An early withdrawal from a traditional account is usually subject to both income taxes and a penalty. The employer should be informed of both the combined marginal rate and the total amount of retirement money that will be lost by taking the money out of the system.
- *Effect on retirement security of withdrawing the money:* Using an income projection, the participant should be shown that a withdrawal will potentially reduce their income at retirement by a certain dollar amount. They should also be shown how long it will take to replace that amount of saving.
- *Potential costs of moving to the wrong IRA provider:* Moving from a relatively low administrative cost employer plan into an IRA with higher fees could have a major effect on the eventual retirement income. Participants should be informed of this and offered a separate sheet discussing how to tell if an IRA provider has appropriate fee levels. This can ge general information rather than tailored to the specific employee.
- *Continuing to save at the same rate in the new employer's plan:* Finally, the employee should be encourage to start saving in the new employer's plan at least at the same level that they have been contributing to the plan of the current employer.

These disclosures do not need to be extremely detailed or presented in legal terms. If the participant cannot immediately understand what is being said, the information is essentially useless. To relieve employers' worry about legal liability, a model form that protects them from liability would be worth creating. However, this information is important, and could have a major effect on whether the money leaks out of the retirement system or remains in it.

Finally, the term "model form" does not need to mean a single form. In cases where a great deal of information needs to be available, one form could summarize the situation, while others provide more detailed information about certain subjects. However, this does not mean that these other forms should be written in long, legalistic language. Both the summary form and others should be in clear, concise language with appropriate graphics.

Assisting Participants to Make Appropriate Decisions When They Retire

Decisions about how to translate retirement savings into an appropriate income strategy can be among the most complex that an individual faces. Even those of us who work in the field can find the decision about whether to use an annuity or longevity insurance to supplement other strategies daunting. This confusion is only made worse by the focus of today's quarterly statements on lump sums and investment performance.

Ideally, retirement income disclosures would be combined with an automatic enrollment-like withdrawal strategy that the employee could adopt simply by not opting out. Unfortunately, while this is the subject of much research by both many groups and companies, it is not currently available.

To be most effective, education on retirement income strategies should not be delayed until the participant reaches a specific age. Rather, it should begin with the design of the quarterly statement and continue with regular discussions of how to create a retirement strategy throughout an employee's career. Even if the participant does not pay much attention for many years, the information will form a backdrop that will be recalled when he or she starts to think about retirement.

Because retirement income strategies are complex, the notices should include both a short summary sheet and individual longer notices on specific topics. Covered information should include:

- *An overview sheet with general information:* A general discussion of how to think of retirement income as well as the general elements that can be combined to provide an appropriate amount of secure income.
- *The role of Social Security:* Social Security pays an inflation-indexed annuity that serves as the basis for retirement income strategies. Employees should be given information about how much they can expect, how to apply for benefits, and the value of delaying their benefits.
- *What income options are in the employer plan:* If the employer plan offers any income options, they should be disclosed and explained. If not, the employee should be informed that they would need to go outside the plan and given advice on how to select a provider (see below). This would include the potential problems of turning the money over to a broker to manage.
- *How long an individual is likely to live:* Most people have no idea how long they could live in retirement. A brief discussion of the average longevity for their specific gender and birth cohort along with a notation that average longevity means that half of them will live longer would be helpful.
- *Longevity insurance and how to use it:* Longevity insurance can be a valuable part of a retirement income plan. How to think about it and choose a policy would be valuable.
- *Using immediate annuities and how to buy one:* This is a separate discussion from longevity insurance. While few of today's retirees may be interested in immediate annuities, information on how to select one should be included.
- *Positives and negatives of a phased-withdrawal system:* Most retirees will use a phased-withdrawal system for at least some of their retirement income. This would briefly explain the value of one, the drawbacks of withdrawing a set percentage of savings each year, and how to choose a plan.

- *How to choose a financial advisor:* Hopefully, may employees will seek the advice of a professional. If the employer does not provide access to an adviser, tips on how to select one and what questions to ask would be useful.

Again, this is complex information, and employers should also be encouraged to sponsor seminars and counseling sessions for retiring employees. As mentioned repeatedly, the value of this information and the employee's receptivity to it would be much greater if it has been part of a regular communications strategy that is simple and accessible.

A Consistent Message Will Enhance Retirement Security

The contents of individual notices are important, but they will be much more effective if they are placed in the context of a communications strategy with a consistent message. Making the focus of participant education the fact that the purpose of saving in the plan is to produce retirement income rather than lump sums will help participants understand the importance of rolling over their money when changing employers and of developing a sound income strategy when they retire.