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Active vs Passive Choice in Retirement Savings

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A new economic landscape

Two major changes

Major changes that increase individuals' responsibility for their financial well-being

➤ Shift from DB to DC pensions

- Workers are in charge of making decisions about pensions

➤ Changes in consumer credit

- More opportunities to borrow & in large amounts
- Individuals are in charge of deciding how much to borrow



Some important features of DC pensions

Workers have to make many decisions

➤ Voluntary contributions

- Sometimes incentivized by employer matches

➤ Investment decisions

- Menu of options

➤ Borrowing opportunities (not much discussed)

- Loans and hardship withdrawals

➤ Withdrawals after retirement (discussed even less)

- Whether to take pensions as lump sum
- How to generate a stream of income after retirement



Two approaches

Dealing with DC pensions

- **You are on your own**
 - Workers make all decisions
 - Employers may offer incentives to save
- **We will do it for you**
 - Automatic enrollment into pension
 - Default workers into investment funds



Both approaches are extreme

Limitations of the “on your own” approach

- **Level of financial literacy is very low**
 - People know little about interest compounding, inflation, risk diversification, or basic asset pricing
- **Knowledge of pension, pension plan characteristics, and taxes and other incentives is also very low**
 - A lot of “do not know” answers
- **A lot of inertia**
 - People do not participate/contribute to pensions. It is not easy to support a 30-year retirement with a 40-year career

Both models are extreme (cont.)

Limitations of “we will do it for you” approach

- **One size does not fit all**
 - Workers are very different in terms of needs, preferences, and economic circumstances
- **Contributions are very low**
 - Targeting minimum contribution rates that make workers stay enrolled
- **A lot of borrowing against pensions**
 - Leakage due to loans and other withdrawals



More limitations

Limitations of “we will do it for you” approach

- **There are several sources of retirement savings**
 - Decisions about Social Security?
- **Changing jobs**
 - What to do with retirement savings
- **Decumulation phase**
 - Automatic enrollment into annuities?

Need to move away from these extremes

Active choice: Help people make decisions

- **Empower people to make decisions**
 - People make many financial decisions and these decisions influence retirement savings: e.g., financing children's education
- **Consider both sides of household balance sheet**
 - Help with debt management: Young people start their economic life in debt. Boomers carry debt into retirement
- **Consider decumulation part of life cycle**
 - Decisions are even more complex

Examples of active choice/financial education

Some examples

- **Helping people contribute to supplementary retirement accounts**
 - The Dartmouth Project

- **Helping people learn about fundamental financial concepts**
 - Five steps to planning success
 - Visual tools and narratives

- **Personal finance in college and high school**
 - Need to prepare for the future

How to help employees make financial decisions

The Dartmouth Project

- Simplify financial decisions
- Provide information when needed
- Target specific groups
- Use communication that does not rely on figures and numeracy

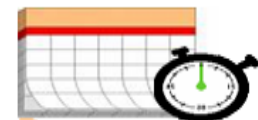


A planning aid

Punam Keller (Tuck School) and I designed a planning aid intended to help Dartmouth College employees enroll in supplementary retirement accounts (SRAs)

We have outlined 7 simple steps to help you complete the application.

1. **Select a 30 minute time slot** right now to complete the online contribution to your Supplemental Retirement Account (SRA) during the next week.
2. 3 minutes. **Check to see if you have the following materials:** a) worksheet in your benefits packet ✓, and b) the name and social security number of a beneficiary ✓.
3. **Select the amount you want to invest for 2006** (minimum: \$16/month, maximum: \$1,666.67/month), even if you don't know your take-home pay in your first month. If you want, you can change this amount at a later date. This voluntary contribution is tax-deferred, you will not pay taxes on it until you withdraw the funds.
4. 5 minutes. **Select a carrier.** if you do not select a carrier, Dartmouth will invest the non-voluntary portion of your college funds in a Fidelity Freedom Fund, a fund that automatically changes asset allocation as people age.
5. 5 minutes. Now you are **ready to complete your worksheet.** Complete the worksheet even though you may be unsure of some options. You can change the options in the future.
6. **Take your completed worksheet to a computer** that is available for 20 minutes. If you like, you can use the one in the Human Resources office at 7 Lebanon Street, Suite 203.
7. 15-20 minutes. **Log on to Flex Online and complete your online SRA registration** within the 20 assigned minutes. Be sure to click on the investment company (TIAA-CREF, Fidelity, or Calvert) to complete the application. You need to set up your account – otherwise your savings will not reach the carrier.



Fidelity.com



Calvert



A planning aid

Don't give up! Contact the Benefits Office (6-3588) if for any reason you could not complete the online application.



It takes no time to prepare for your lifetime!

Most people plan on electing a supplemental retirement account, but feel they don't have the time or information right now. We have outlined 7 simple steps to help you complete the election process. It will take between 15 – 30 minutes, from start to finish. It will take less time for you to start to insure your future than it takes you to unload your dishwasher!

Program effectiveness

There was a large increase in savings enrollment within 30 and 60 days of hiring among participants exposed to the planning aid.

	30 days After Hire	60 days After Hire	Number of Observations
Control group	7.3%	28.9%	210
Planning aid	21.7%	44.7%	166

A program for the young

Five steps to planning success

- **Program targeted to young workers**
 - They are the ones with low financial literacy
- **Used new methods of communication**
 - Video and narratives
- **Kept the message free of economic/finance jargon**
 - Very important for women
- **Covered concepts, such as interest compounding and risk diversification, in a simple story**

Short video about risk

Risk diversification = don't put all your eggs in one basket



[Link to Video](http://gflec.org/education/) <http://gflec.org/education/>



We measured whether it worked

- Tested interventions using an Internet panel
- Baseline questions on knowledge of risk diversification
- Randomly assigned
 - Intervention group
 - ◆ Video only, narrative only, video & narrative
 - Control group
 - ◆ No intervention
- Repeated risk diversification questions

Findings

- After being exposed to the video, the performance on financial literacy questions (general knowledge and hypothetical choices) improved
- While young people were targeted, the video affected all age groups

Most recent project

Financial knowledge & 401(k) investment performance

- **Use administrative data from the Federal Reserve Board**
 - High quality data
- **Designed survey that had the 3 financial literacy questions + questions on pension literacy**
 - High financial literacy but low knowledge about pensions
- **Linked financial literacy to return on 401(k) investments**
 - Have data on portfolio allocation
- **Those who are more financially literate earn a lot more on their portfolio (adjusted for risk)**
 - Similar evidence is emerging in other papers

Personal finance

A new course at the George Washington University

Financial Decision-Making: Implications for the Consumer and the Professional

- **Cover personal finance with a rigorous approach**
 - A quantitative approach to personal finance
- **It incorporates some macro, accounting, and risk management**
- **Writing a textbook on personal finance**
 - Joint with a mathematician at Dartmouth College

Our (STAR) students

Undergraduates, graduate students and... athletes

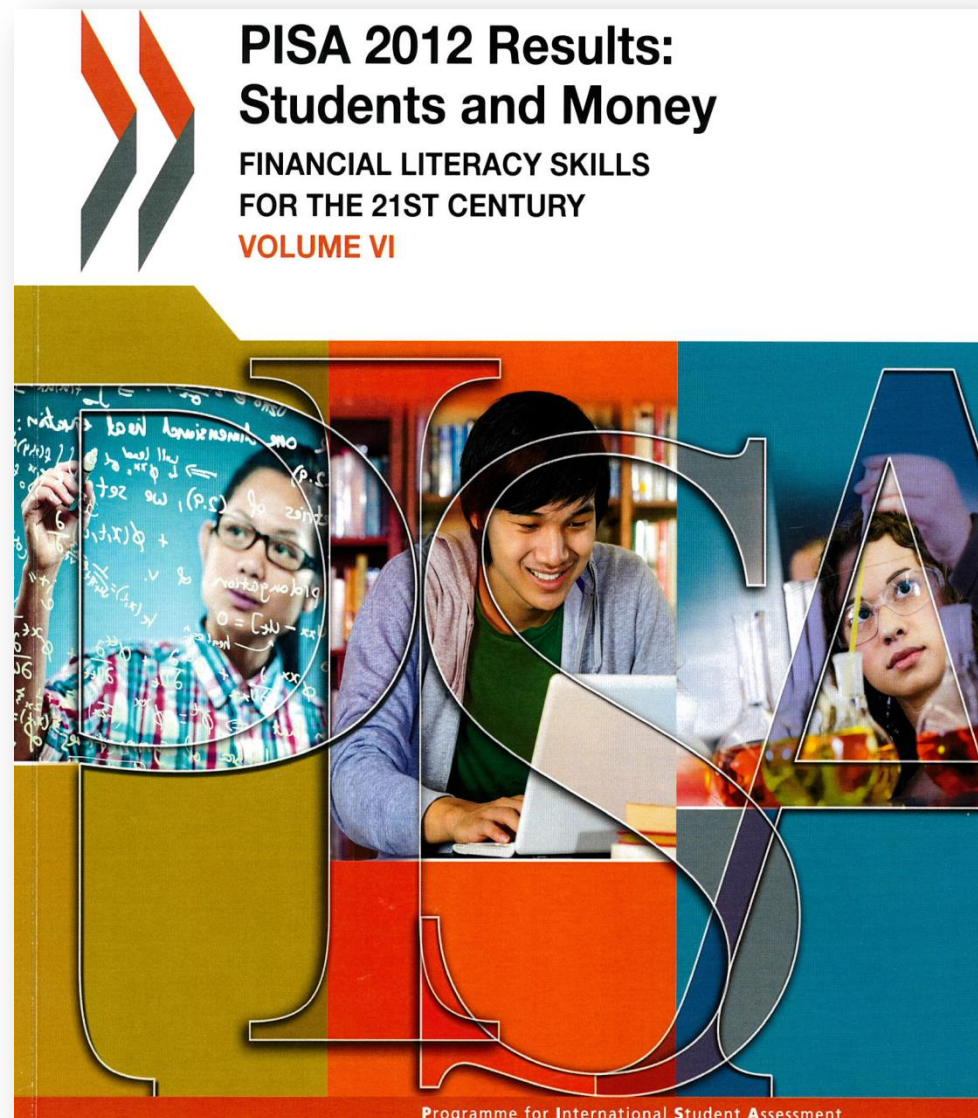
Our students in and out of the classroom



New data for 15-year-olds around the world

We have important new data

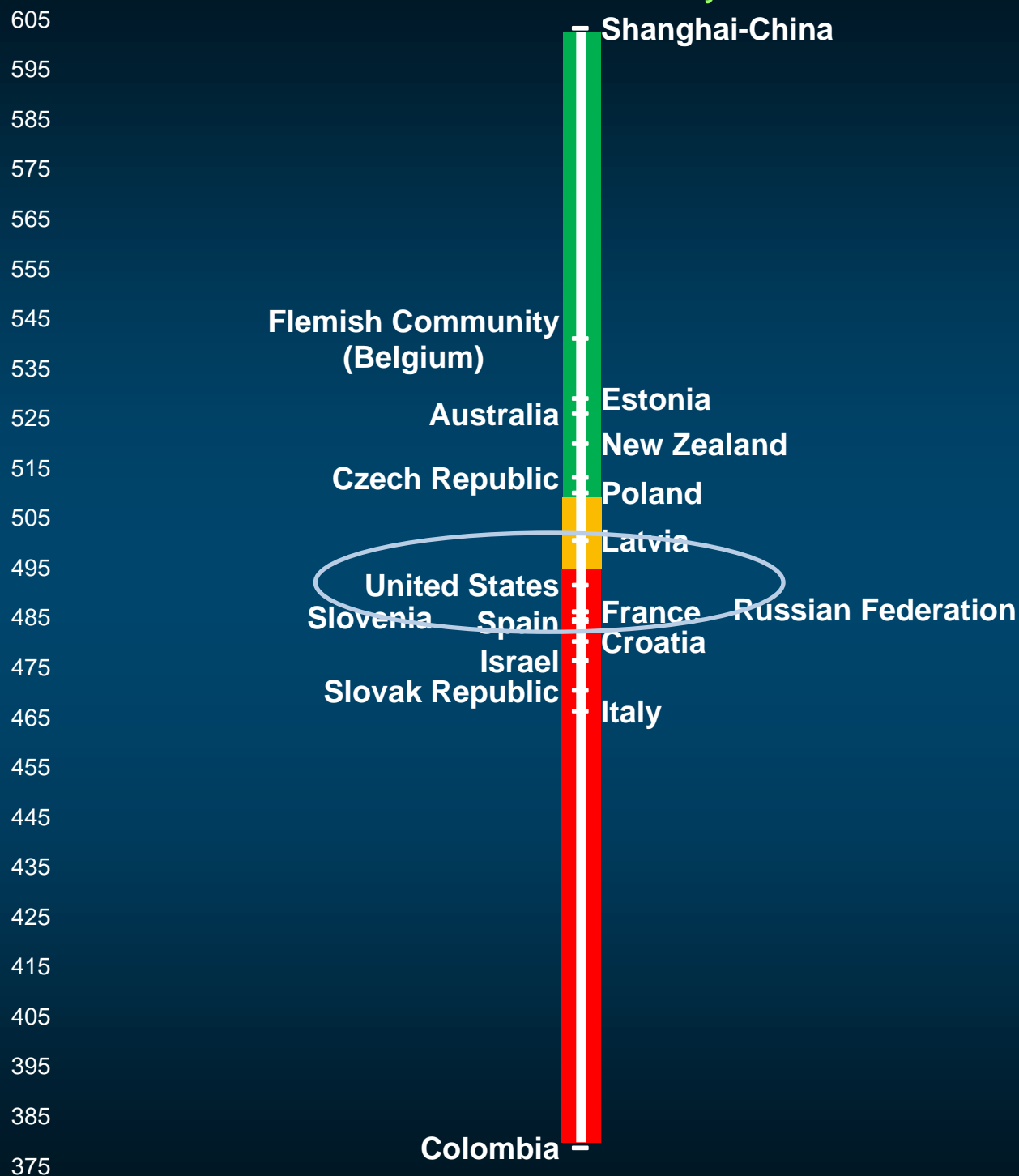
- 2012 Programme for International Student Assessment (PISA)
- Measuring financial literacy among high school students in many countries



Mean score

Strong performance in
financial literacy

Average performance
of 15-year-olds in
financial literacy



Low performance in financial literacy

The end of pensions?

The old pension scheme is unlikely to survive

- **Many people want to continue working**
 - Retirement will not mean stopping work
- **Shift to self-employment, in particular late in life**
 - Different needs
- **Accumulation and decumulation phases?**
 - Different retirement products
- **Changes in Social Security and Medicare**
 - They will affect changes in private pensions

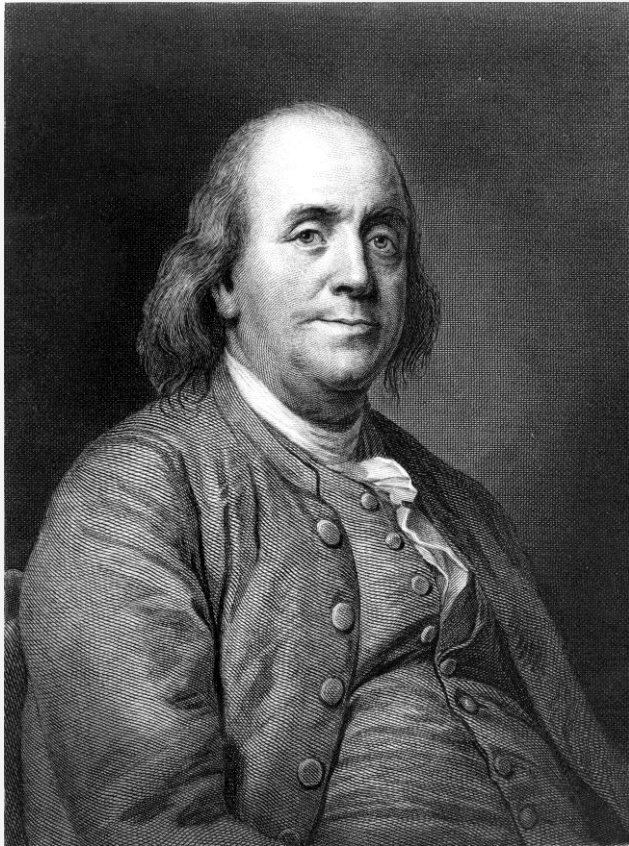
Concluding remarks

Shifting paradigm

- **Equipping people to make saving and retirement decisions**
 - Financial literacy is an essential skill
- **Need to start early**
 - The importance of financial literacy in school. Pension providers should speak to Department of Education
- **Need targeted approach**
 - Workers are very different
- **Cannot focus on retirement savings only**
 - Other decisions are important and affect retirement security

An earlier thinker on these topics

“An investment in knowledge pays the best interest.”



Benjamin Franklin, *The Way to Wealth*, 1758

Contact and sources of information

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