**Topic Paper**
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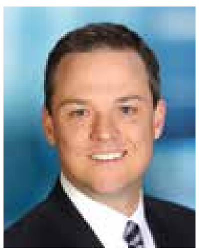
# BEYOND AUTOMATION:
## Lessons from behavioral finance to drive better outcomes



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If you are reading this paper, surely at some point you have heard the common industry notion that trying to communicate with Defined Contribution (DC) plan participants is a waste of time and money. In fact, it has become almost a default position that retirement outcomes can only be marginally impacted by participant communication programs. In a recent Cerulli survey, DC plan recordkeepers ranked “financial education” as the least effective strategy for encouraging retirement savings—behind auto-escalation, auto-enrollment, simplified enrollment process, adjusting the match formula, and even simplifying the investment menu.[1]

Particularly over the last decade, the industry has embraced a more paternalistic approach with automatic features such as auto-enrollment and auto-escalation, and there is certainly some evidence of success.[2] For individuals with coverage and access to a DC plan, participation rates are up, savings rates are up, and balances are up.[3] But as a result, we have largely de-emphasized the role of traditional plan communications as we have sought to streamline decision points for participants, if not eliminate them altogether.

While the days of trying to make participants into investment experts are behind us, we believe that finding ways to meaningfully engage participants to help them navigate important junctures in their DC plan journey is essential. Late-career participants in particular have unique financial contexts and important decisions to grapple with in their transition to retirement, from Social Security claiming strategies to replacing their paycheck in retirement. We believe that unilateral action by plan sponsors or one-size-fits-all solutions are ineffective ways to navigate this complexity and are unlikely to result in the best outcomes. Lessons from behavioral finance teach us that engaging participants in effective ways can help them overcome inertia and make them feel accountable and committed to saving for retirement.

In this paper, we explore an engagement strategy called ‘Enhanced Active Choice’—grounded in the behavioral finance concept known as active choice—which has promising applications in the DC space.

To help explain this choice mechanism and how it can potentially improve engagement and outcomes in DC plans, we recently spoke with two of the leading scholars in behavioral finance: **Dr. Punam A. Keller**, Professor of Management at the Tuck School of Business, Dartmouth College, and **Dr. Annamaria Lusardi**, Denit Trust Chair of Economics and Accountancy at The George Washington University School of Business.

# WHAT IS 'ACTIVE CHOICE?': THE ENROLLMENT EXAMPLE

Active choice is an alternative or complement to the types of default choice mechanisms common in DC plans—that is, the traditional "opt-in," as well as the "opt-out" mechanism (i.e., auto-enrollment) that is more prevalent today, particularly among larger DC plans.

In an "**opt-in**" scenario, the participant must actively choose to participate in the DC plan, usually by enrolling via a website or paper election. Alternatively, "**opt-out**" automatically enrolls an employee in the plan (at the preset rate), unless they proactively elect NOT to participate in the plan—again, usually through the website or via paper.

Active choice differs from the more traditional approaches to the participation decision in that it creates an explicit choice that the employee faces instead of a default or *"status quo"* option with some alternative. In other words, doing nothing is not positioned as an option to the employee. Professor Keller provides examples of each approach to the plan enrollment question below:

**Examples of opt-in, opt-out, and active choice**

Enrollment approaches for DC plan participants

| OPT-IN ENROLLMENT | OPT-OUT ENROLLMENT | ACTIVE CHOICE |
|---|---|---|
| ☐ Check the box if you choose to enroll in the firm's 401(k) plan. | ☐ Check the box if you do **not** choose to enroll in the firm's 401(k) plan. | **Check one box.**<br>☐ I will enroll in the firm's 401(k) plan.<br>☐ I will **not** enroll in the firm's 401(k) plan. |

Source: Franklin Templeton Retirement Innovation Summit, Toronto, November 2016, "Enhanced Active Choice: A new method to increase enrollment, participation, and reduce leakage," Punam A. Keller

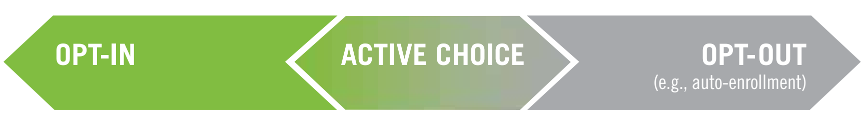
Importantly, auto-enrollment and active choice are not mutually exclusive options. The enrollment question can still be framed with active choice, even with an underlying default. However, should an employee not take action, they could still then be defaulted into the plan at a suitable rate and in the qualified default investment alternative (QDIA).

# THE CONTINUUM OF APPROACHES TO PARTICIPANT DECISIONS

Professor Keller describes active choice as "part of a continuum" of choice mechanisms. At one extreme is opt-in and at the other is opt-out, with active choice in the middle.

She contrasts the approaches by explaining that an "opt-in" approach assumes that participants are rational actors. It relies on the notion that education will be provided, read, and then people will make rational choices based on their unique circumstances and retirement goals. By contrast, she explains, "opt-out" approaches are highly paternalistic and assume that actors are not rational and cannot be trusted to make the decision that is in their best interest. Rather, they need an agent to make those decisions for them.

**The continuum of choice mechanisms***




Assumes participants are rational
Laissez faire,
**"YOU'RE-ON-YOUR-OWN"** approach

Assumes participants are NOT rational
Paternalistic,
**"WE'LL-DO-IT-FOR-YOU"** approach

*Source: Franklin Templeton Retirement Innovation Summit, Toronto, November 2016, "Enhanced Active Choice: A new method to increase enrollment, participation, and reduce leakage," Punam A. Keller.

Professor Lusardi points out the limitations of these two extremes. She explains that a "you're-on-your-own" approach does not work since many participants have a very low level of financial literacy, and it fails to address inertia. But a "we'll-do-it-for-you" approach also presents challenges. One size does not fit all in retirement savings, she explains, as workers are very different from each other in terms of needs, preferences, and economic circumstances. In the case of enrollment, this approach may have the effect of leaving contributions too low as participants generally do not elect to go above the minimum deferral rate.

An approach that employs active choice acknowledges some of the inherent nuances that exist and rests somewhere in between these extremes on the continuum.

# ENHANCED ACTIVE CHOICE

Building on the concept of active choice is Enhanced Active Choice. In this evolution, the agent (e.g., plan sponsor) explicitly highlights a benefit of the desired choice from the agent's perspective and a potential consequence of the undesirable choice.

Professor Keller provides the following example of a participant communication that employs Enhanced Active Choice:

**Example of Enhanced Active Choice**
An approach to increasing participation

| | | | |
|---|---|---|---|
| **YES** ☐ | I am enrolling in my company's retirement savings plan to help ensure that I will have enough money to retire comfortably and when I would like to. | **NO** ☐ | I do NOT want to enroll in my company's retirement savings plan even though it could have a significantly negative impact on my ability to retire on time and with enough money to meet my income needs. |

Source: Franklin Templeton Retirement Innovation Summit, Toronto, November 2016, "Enhanced Active Choice: A new method to increase enrollment, participation, and reduce leakage," Punam A. Keller

Professor Keller notes that these framing mechanisms only work well with "ought" behaviors, or things people know that they ought to do. Healthcare decisions, financial decisions, and living wills are good examples of "ought" choices that can be impacted by Enhanced Active Choice. This type of framing does not work well with a decision to buy a TV, for instance, or whether or not to go to the movies.

The key behavioral finance concept underpinning this notion is the idea of "regret aversion." Keller found that active choice is very effective in prompting a feeling of potential future regret for not doing something, which in turn leads to greater instances of compliance with the desired alternative. The expectation is that when people are forced to make a choice, rather than do nothing, and those choices are assigned benefits and consequences, more people will end up choosing the option that will likely yield the least amount of future regret—because they know they ought to.

This also leads to an interesting question: Do people remain more committed to their choices? According to Professor Keller's research, there is evidence to support the notion that commitment is similar to what is observed in traditional opt-in constructs.[4] She compares participants that enrolled using an Enhanced Active Choice construct with those who did so via a traditional opt-in mechanism—the group that would presumably be the most committed to participating in the plan.

According to Keller and her colleagues, the research found that "disenrollment percentages in the Enhanced Active Choice and opt-in condition are virtually identical."[5] This research suggests that by using Enhanced Active Choice, DC plans may expect to experience higher participation rates (or deferral rates) than with a traditional opt-in approach, but with equally high levels of commitment to participate (and save) as they would with opt-in. Enhanced Active Choice is evidently effective in making participants feel more accountable and committed to their decisions.

The findings of this study appear to bear out in the "real world" as well. See the Appendix for an interesting case study: The Ohio Deferred Compensation Plan.

# OPPORTUNITIES TO IMPLEMENT ENHANCED ACTIVE CHOICE THROUGHOUT THE PLAN

While the enrollment question is a simple example for Enhanced Active Choice, the principle can be applied in many facets of the plan to promote more optimal outcomes.

For example, as the industry increasingly shifts its focus from the accumulation phase to the decumulation phase, investment options and tools in the plan designed to help participants pay out their savings from the plan take center stage. Enhanced Active Choice can be used to nudge participants nearing retirement toward solutions specifically designed to help them solve this problem.

Other milestones that could potentially incorporate Enhanced Active Choice include:

**TARGETING**

- New employees to enroll in auto-escalation
- Mid-career hires to defer at a rate at least the same as they were at their previous employer
- Terminated employees to continue to pay back a loan post-termination (in order to prevent leakage)
- Employees 50 years and older to enroll in catch-up contributions
- Retirees drawing down assets post-retirement to meet required minimum distributions (RMD's) and household spending needs in retirement.

# CONCLUSION

The core of our message is simple: We can do more.

Enhancements in the DC system such as auto-enrollment have done well to increase the number of people saving. As we celebrate these significant improvements, we should continue to innovate and evolve.

Enhanced Active Choice is a simple tool that DC plans can implement right now—one that requires relatively few resources but can yield high value.

Professor Keller's research proves that using Enhanced Active Choice can improve outcomes over traditional opt-in measures, while simultaneously holding steady the commitment to said choice. The case of the Ohio Deferred Compensation Plan provides further evidence that this theory bears out in the real world of DC plans (see Appendix).

We believe that plan sponsors can best support their participants by providing the tools and guidance they need to navigate these critical decision points from the day they start working through their retirement. But particularly in light of the increased heterogeneity and complexity of circumstances as participants approach retirement, plan sponsors cannot solve their participants' retirement challenges alone. We believe that neither a "you're-on-your-own" approach nor a "we'll-do-it-for-you" solution will result in optimal outcomes for most participants. With some support, participants will need to play a role in making their plan assets work for them in retirement, and we believe that, by and large, they are both capable and willing to do so.

# APPENDIX—CASE STUDY: OHIO DEFERRED COMPENSATION PLAN

So, how effective is Enhanced Active Choice in a real DC plan? Let's look at a case study to make that assessment.

In 2014, the Ohio Deferred Compensation Plan implemented Enhanced Active Choice as well as some auto features to address the issue of inadequate savings. To provide context, the plan is a multi-employer plan, with about 1,800 employers, including the state of Ohio, city and county municipalities, and local schools. One of the primary challenges they consistently identified was a lack of savings. On average, pension income provides about 52.2% replacement income. However, most employees do not have access to Social Security income, and they identified "inertia and present bias" as keeping participation and savings rates down.

**New Enhanced Active Choice language for plan enrollment**
Ohio Deferred Compensation Plan

| | |
|---|---|
| **YES** | **I want to take this step toward enjoying a comfortable lifestyle for the rest of my life, even after I stop working** |
| **NO** | **I don't want to take this step toward a comfortable lifestyle** |

Source: NAGDCA 2015 Annual Conference, Leadership Award Winner Case Studies Presentation, Keith Overly, Ohio Deferred Compensation.

In response, the State of Ohio set upon a multifaceted program that combined auto features and Enhanced Active Choice. Isolating the Enhanced Active Choice component, the plan decided to change their "institutional" form to one that used "softer, conversational language," that "stress[ed] secure financial future," and that "use[d] principles of Motivate, Force an Action, and Plan."[6] They also removed the minimum $15 deferral requirement in favor of check boxes of $25, $50, $75, and other amounts. Finally, they changed the auto-escalation feature from opt-in to opt-out.

The results were, by any measure, largely successful. In just six months, the plan saw a 25% increase in new enrollments and a 680% increase in the use of auto-escalation. As a result of this success and willingness to innovate, the Ohio Deferred Compensation Program was awarded the NAGDCA Leadership Award for Plan Design in 2015.[7]

**25%** | **Increase in new enrollments**

**680%** | **Increase in auto-escalation usage**

Source: NAGDCA 2015 Annual Conference, Leadership Award Winner Case Studies Presentation, Keith Overly, Ohio Deferred Compensation.

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