

## How “Choice Architecture” Can Strengthen Defined Contribution Plans

Now that an increasing wave of employees armed only with Social Security and a defined contribution (DC) plan account is reaching retirement age — the result of employers shifting their focus from defined benefit plans (DB) to DC plans — some employers are starting to feel the pain of an unforeseen consequence. Put simply, many employees believe they cannot afford to retire. (See the [text box on the last page](#) for background information on this trend.) This is because many employees make less-than-optimal decisions when it comes to savings rates, asset allocations, in-service withdrawals and retirement distribution options. This has been exacerbated by the steep decline in the number of employers that offer subsidized post-retirement medical coverage. The result is that many employees are not retirement-ready or even on the path to retirement readiness.

When employees remain on the job longer than employers anticipated, they may create workforce-planning bottlenecks. While some employers may welcome any development that keeps seasoned professionals on the job as long as possible, others feel that if they cannot offer clear career paths to their best young and mid-career talent, they may soon lose them, with unfortunate consequences for profitability and productivity. In either case, retirement plans and retirement-readiness need to be a factor in any workforce planning process. Ironically, employers that thought empowering employees to provide for their own retirements through DC plans would enable the organization to take a step back from the responsibility of providing retirement income are now finding that they cannot ignore this development.

Although past decisions cannot be reversed, employers can begin to improve this gloomy outlook at relatively low cost or even no cost simply by altering their plans’ “choice architecture” — that is, how choices are presented to employees. Subtle changes in plan structure and participant communications can help counter certain natural tendencies participants have to making decisions that are sometimes not in their own interests because although people make these “sub-optimal” decisions due to these subconscious tendencies, they do so in highly predictable ways.

This *Spotlight* discusses three examples where understanding anticipated sub-optimal choices can help employers mitigate these choices and improve employees’ readiness for retirement.

### EXAMPLE #1: COMMUNICATE THE MATCH IN A NEW WAY

A typical §401(k) plan features a 50 percent employer match on as much as a 6 percent of pay employee deferral. If the employer’s objective in order for employees to achieve retirement readiness is through making a 12 percent contribution, Table 1 shows a typical way the various employee deferral options might be communicated.

Table 1: Total Contribution in a DC Plan with a 50 Percent Company Match Up to 6 Percent of Pay		
Employee Deferral	Company Match	Total Contribution
0%	0%	0%
2%	1%	3%
4%	2%	6%
6%	3%	9%
8%	3%	11%
10%	3%	13%
12%	3%	15%

What employers tend not to realize is that by structuring the match this way, they send the following three unspoken messages to plan participants all of which work against the 12 percent objective:

- Any contribution other than zero is good because there is a company match.
- The “right” amount for the employee to defer is 6 percent because the company caps its match at that level.
- A total contribution at 9 percent of pay will be sufficient for accumulating an adequate benefit.

Of course, none of these messages align with the messages the employer wishes to send.

If the objective is to have employees defer 12 percent, employers could impose a purely economic solution to this problem, phasing in the match so that the full match is realized only with a 12 percent deferral, as shown in Table 2 below.

<b>Table 2: Total Contribution in a DC Plan with Gradual Company Match Up to 50 Percent at 12 Percent of Pay</b>		
<b>Employee Deferral</b>	<b>Company Match</b>	<b>Total Contribution</b>
0%	0%	0%
2%	0.5%	2.5%
4%	1.0%	5.0%
6%	1.5%	7.5%
8%	2.0%	10.0%
10%	2.5%	12.5%
12%	3.0%	15.0%

However, this purely economic solution could be perceived as a benefit cutback and result in lower savings rates, especially among lower-paid employees who often cannot afford to contribute 12 percent of pay. Like the approach shown in Table 1, this approach also suffers from an “anchoring” problem: the zero employee deferral is the first option on the list and biases individuals toward deferring a lower amount. Anchoring refers to the fact that seemingly unrelated information that precedes the making of a decision can influence the decision.

Alternatively, employers could position the typical 50 percent company match up to 6 percent of pay shown in Table 3.

<b>Table 3: Total Contribution in a DC Plan with a 50 Percent Company Match Up to 6 Percent of Pay — Restructured and Reframed</b>			
<b>Employee Savings</b>	<b>Company Contribution</b>	<b>Total Contribution</b>	<b>Lost Company Match</b>
12%	3.0%	15.0%	0%
10%	3.0%	13.0%	0%
8%	3.0%	11.0%	0%
6%	3.0%	9.0%	0%
4%	2.0%	6.0%	1%
2%	1.0%	3.0%	2%
0%	0%	0%	3%

This match structure is identical to the one in the typical §401(k) plan described on page 1, but reframes it to accomplish the following:

- Leads with the employer’s 12 percent objective to encourage participants to think first about a high contribution rate.
- Emphasizes the loss associated with lower contribution rates (the red percentages at the bottom of the last column), which plays into individuals’ strong preference for avoiding losses over acquiring gains, and
- Uses ordering and yellow-highlighted blue text as a decision-making guide because, when faced with complex decisions, people look for clues that they hope will be relevant to rational decision making.

Restructuring the communication of the match to require greater employee contributions gives employees a clue that their employer thinks they need to save more. Reframing the information in terms of lost opportunities may lead participants to save more to avoid “losing out.” One such message related to the above example might be: “You lose valuable tax benefits by saving less than 12 percent.”

**EXAMPLE #2:  
ADD AN ESCALATOR**

A common mistake among DC plan participants is to start with a low contribution rate and to stay there. “Behavioral economics,” a blend of psychology and microeconomics that seeks to explain why people make irrational decisions with their consumer and lifestyle choices, describes two phenomenon that explain this behavior: (1) the status quo often paralyzes decision making and (2) the likelihood of favorable outcomes tends to be overestimated.

Plan sponsors can put both inertia and optimism to work by placing a new participant into a contribution arrangement that automatically increases over time unless the participant elects otherwise, or one that automatically devotes some portion of future pay increases to DC plan contributions (for example, plan sponsors can set the increasing contribution to coincide with pay increases, so a contribution increase does not result in a drop in take-home pay). Making a contribution escalator the default option is an even more powerful use of behavioral economic principles. By adding a contribution escalator in which employee contributions increase automatically, employees may be more willing to “stretch” when it comes to future contributions because they are convinced they will be able to afford them.

There is, however, a behavioral economics concept already introduced above that comes into play when considering auto-escalation: the tendency for a participant to look for clues when looking at an array of choices to determine the *right* choice. (This is called “clue-seeking bias.”) On the other hand, by auto-enrolling at a 6 percent deferral, and auto-escalating to a 12 percent deferral, some employees might view 6 percent with auto-escalation as preferable to the 12 percent employer objective to promote retirement readiness. Although some employees will elect to scale down the 12 percent, inertia will work to keep the majority in place.

**EXAMPLE #3:  
STREAMLINE THE LIST  
OF INVESTMENT  
OPTIONS**

Few Americans are experts at personal investing. This fact, together with a tendency to procrastinate or avoid making decisions requiring knowledge and experience outside of one’s comfort zone, has adverse consequences for DC plan choices.

Plan materials often present lengthy lists of investment options to plan participants in some manner that attempts to be “unbiased” or convey a neutral point of view. For example:

- Some service providers arrange investment options alphabetically by name.
- Default investment options (*i.e.*, target-date funds) are frequently presented at the bottom of the list. Balanced fund options may be buried in the middle of the list.

When the options multiply and plan participants recognize that they are far less competent in personal finance than in other matters, they simply give up and often choose irrationally — like exhibiting “clue-seeking bias” and choosing the first item of the list.

Plan sponsors may wish to take advantage of “clue-seeking bias” and restructure their investment options to make it simple for participants to “leave the investment decisions to experts.” This might consist of adding a best-in-class lineup that offers one high-performance fund in each asset class, selected by an unbiased third-party expert. Or, it may take the form of highlighting best-in-class fund choices or placing these choices at the top of the list.<sup>1</sup>

Although participants will still make their own investment elections, plan sponsors that take behavioral economics into account when displaying and describing their investment lineup are likely to improve the results of the decisions.

#### APPLYING CHOICE ARCHITECTURE TO DC PLAN COMMUNICATIONS

Choice architecture is a technique from behavioral economics. To apply choice architecture to a DC plan, consider the following steps:

- **Mine your data.** By looking carefully at employee contribution elections, investment decisions and other DC plan reports, it is likely that most employers will find their DC plans awash in sub-optimal decisions. Data-mining will enable plan sponsors to answer such questions as “What percentage of employees are not adequately saving for retirement?” and “Are lump-sum DC plan distribution elections much more prevalent than annuity elections?” and “Do participants combine lifestyle funds with investments in other asset classes not possessing a similar risk/return profile?” Once these questions are answered, plan sponsors can then take steps to “nudge” participants to make better DC plan decisions.
- **Identify the confusions at play.** Poor decisions can appear in all aspects of DC plan participation, from contributions to investments to distributions. Participants fall prey to different behavioral shortcuts for all of them. For example, the fact that when people are presented with too many and/or complex options they procrastinate, give up or default, may contribute to poor investment choices. The fact that viewpoints and decisions are heavily influenced by emotionally impactful events may lead participants to shy away from choosing an annuity for their DC plan distribution if they learn of the early death of a popular retiree. Plan sponsors that can identify through surveys or focus groups the most common behavioral shortcuts affecting their plans can take steps to combat them.
- **Develop a strategy.** Employers that know where their DC plan’s poor decisions are clustered, and why, can begin to address them, using a behavioral economics perspective to adjust the DC plan design, communications and administration.

Whether your goals are to raise elective deferral rates by non-highly compensated employees, help participants make better investment choices, assist those about to retire in making better choices among retirement plan distribution options, or just improve perceptions about the value of employee benefits, your chances of reaching them will be greatly improved with effective choice architecture. This *Spotlight* focused on three examples, but there are many others.<sup>2</sup>

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<sup>1</sup> Because participant communications are heavily regulated, they should be reviewed with counsel. Any deliberate ordering of investment options, even one with an intended neutral point of view, could be construed as some form of “steering.”

<sup>2</sup> Other examples were discussed in “Using Behavioral Economics to Encourage Employees to Make Better Decisions about their §401(k) Plans,” an article that was published in the December 2012 issue of Sibson Consulting’s e-magazine *Perspectives*: [http://www.sibson.com/publications/perspectives/Volume\\_20\\_Issue\\_3/using-behavioral-economics.html](http://www.sibson.com/publications/perspectives/Volume_20_Issue_3/using-behavioral-economics.html)

Organizations that deepen their understanding of how individuals make decisions, behavioral biases and choice architecture will be more effective in structuring, communicating and administering their defined contributions plans and, consequently, be better prepared to avoid the adverse workforce outcomes that they otherwise would face.



To explore how you can effectively use behavioral economics principles in your organization's defined contribution plan, contact your Sibson consultant, the nearest Sibson office or one of the following experts:

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### The Retirement Dilemma

According to the 2013 Retirement Confidence Survey published by the Employee Benefit Research Institute (EBRI), only 13 percent of workers said they are very confident about having enough money for a comfortable retirement. Higher percentages of workers indicated that they are somewhat confident (38 percent), not too confident (21 percent) and not at all confident (28 percent).\*

Another 2013 study found that, on average, pre-retirees said they will retire at age 68. More than 40 percent expect to work until at least age 70 and 10 percent expect to work into their 80s.\*\*

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\* That survey, which was published in March 2013, is available on the following page of EBRI's website: [http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content\\_id=5175](http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=5175)

\*\* That study, *Planning & Progress 2013 – Retirement and Longevity* is available on the website of The Northwestern Mutual Life Insurance Company: [http://www.northwesternmutual.com/media-center/Documents/2013%20Planning%20and%20Progress\\_RetirementLongevity\\_Final.pdf](http://www.northwesternmutual.com/media-center/Documents/2013%20Planning%20and%20Progress_RetirementLongevity_Final.pdf)