Testimony

Of

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My name is Dana Muir, and I'm a professor at the Stephen M. Ross School of Business at the University of Michigan. I'm honored to address the Advisory Council on Employee Welfare and Pension Benefit Plans regarding Participant Plan Transfers and Account Consolidation for the Advancement of Lifetime Plan Participation. This is a topic that I believe is very important to the retirement security of American workers.

I have in process a research project that considers both why the defaults, which plans have developed based on behavioral economics theory and work so well to increase participation and contribution levels, fail to discourage participants from engaging in rollovers from their DC plans even when those rollovers do not appear to be in their best interest. It also considers what types of actions may be more effective in keeping DC plan assets in the DC plan system in appropriate cases.

My testimony will address three primary topics:
1. Briefly, whether and in what kinds of situations it might be in a plan participant's best interest to rollover an account to a new employer's DC plan; I'll spend most of my time on the next two topics.
2. Potential explanations for why default settings that would leave DC plan assets in an individual's prior plan are largely ineffective; and
3. Interventions that may be useful to retain DC plan assets in the DC plan system.

I understand that this Council is concentrating on the administrative obstacles that participants face when attempting to consolidate their retirement savings within employer-sponsored plans. I believe, however, that my testimony will show that behavioral research supports concerns the Council has identified based on anecdotal reports. Identifying the theoretical underpinnings for those anecdotal observations reinforces the importance of the concerns identified by the Council. And, understanding at least some of the reasons for why participants behave the way they do will be helpful to the Council as it develops recommendations on how to address the concerns it has identified.

<u>Making the "Right" Choice on DC Plan Assets</u>

As an initial matter my research addresses the factors that are relevant to a participant when deciding whether to remain in a prior employer's plan, rollover to a new employer's plan, rollover to an IRA, or take a distribution. For the record, I feel strongly that there is not a single correct choice that applies to all participants. Careful decisions would consider the fees associated with investments and plans, tax rates, estate planning, the number of and assets in retirement accounts, an individual's overall investment portfolio and level of sophistication, and alternative uses of the funds. Some participants will consider the relevant factors and should be permitted to make the choice that is best for them.

<u>The Failure of Default Settings in Retaining Plan Assets in the DC System</u>

Again, I understand that the focus of this Council is on enabling participants to consolidate accounts within the employer-sponsored DC plan eco system. But, I think that there is a preliminary question that is worth thinking about. If we want to change behavior, it is useful to understand the basis for that behavior. The default setting for plan accounts with assets of more than $5000 is that the participant's account will remain in a former employer's DC plan. Plans may rollover account balances of between $1,000 and $5,000 to an IRA (and it appears that more than half of all plans do that). For accounts of less than 1,000, plans have the additional option of cashing out the participants.

During the rest of my testimony I will refer to the statutorily-based default setting for accounts over $5000 as automatic retention. We know from the use of automatic enrollment and automatic escalation defaults that defaults can be tremendously powerful in encouraging particular participant behavior while still providing participants with the ability to make other choices. Why then do so many participants choose to rollover their plan assets, particularly, to IRAs, in spite of the statutory automatic retention default?

Behavioral economics research provided the impetus for automatic enrollment and automatic escalation default settings. Research on how and why defaults work helps us understand why default settings are so powerful. I study these from two perspectives. First, consistent with the overwhelming majority of the DC plan literature in both law and economics, I consider the explanations for why defaults work. Second, and perhaps of more importance for this Council, I think about why in some situations defaults lose their power.

<u>Success of Default Settings.</u> We can think of two categories of explanations for the success of default settings: (1) transaction barriers; and (2) various biases identified in the behavioral economics research.[1] The understanding that high costs, whether in terms of money, time, or

[1] *See* Lauren E. Willis, *Why Not Privacy by Default?,* 29 BERKELEY TECH. L.J. 61, 72-78 (2014) (Professor Willis subdivides the behavioral categories).

effort, change participant behavior, provides the foundation for the efforts of this Council and needs no more discussion for purposes of my testimony.

Behavioral economics explanations for the power of defaults that I consider include: (1) anchoring and (2) prospect theory, sometimes referred to as framing. Anchoring tells us that an example or initial information about a topic can affect an individual's preferences.[2] The other principle, prospect theory or framing, tells us that how information is presented matters. Many of the framing studies show that individuals are loss averse. If a choice or outcome is framed in a way that highlights risk of loss, an individual is less likely to choose that option. This might help us understand the messaging by entities that encouraging participants to rollover to IRAs, when that messaging casts at least gentle aspersions on a prior employer's DC plan. The tone in those communications seems to be: "You've moved on from that old employer; why would you leave your money behind?" The effect of the communications may be to alter the participant's implicit bias that the low risk choice is to stay in the prior plan.

Endorsement effects also seem to be important in DC plan decision making. An endorsement effect occurs when an individual views a default, option, or example as implicit advice that the option or example is optimal. For example, in prior work I observed that an endorsement effect may contribute to the frequency with which participants invest disproportionately in employer stock. They may believe that an employer that chooses to offer employee stock in its DC plan sees that stock as a good investment choice. Similarly, this may help explain why individuals leave their assets in forced rollover IRAs, even when the effect of relatively high fees and use of conservative investment products means that balances in those types of IRAs may decrease over time.

Failure of Default Settings. The opposite perspective asks why so many participants actively choose something other than the default, particularly when they choose to roll over their DC accounts to an IRA. Professor Lauren Willis has written on why some defaults are "slippery" in that they are not particularly effective in keeping people in the default setting, compared to defaults that are "sticky," which are those like auto enrollment and auto escalation that are effective. Professor Willis's work is set in the contexts of (a) bank overdraft protection, where banks are successful in causing the default setting to be slippery; (b) in sharing of financial information that is permitted unless customers opt out, where financial institutions are successful in making the default sticky; and (c) in digital tracking where policy makers have discussed whether a "Track-Me" or "Don't-Track-Me" default is preferable.

[2] The Behavioral Economics Guide 2014, 13 (ed. Alain Samson).

Professor Willis establishes that four conditions bound the effectiveness of default settings. Those are:
1. Self-interested entities oppose the default;
2. Entities have access to the participant;
3. The decision environment is confusing to participants; and
4. Participant preferences are uncertain.

In the rest of this part of my testimony I discuss conditions two and three.

Access to Participants. Obviously, both a new employer and IRA providers have access to plan participants. In practice, though, IRA providers have been more aggressive than new employers in seeking rollovers from prior plan accounts. And, in the absence of contractual provisions with the plan that ban such practices, a plan service provider has a unique path to communicating with the participant. The participant is already familiar with that firm and may have an increased tendency to pay attention to communications from that firm. A GAO report even provides an example where the plan service provider promoted a "one-click" IRA option in the distribution materials distributed to plan participants.[3]

The combination of early and unique participant access enables plan service providers to take advantage to both anchoring and endorsement effects. And the data support the theory. In one set of surveyed 401(k) plans, forty percent of assets rolled over went to IRAs maintained by the recordkeeper for the plan where the account originated.

Confusing Decision Environment. Prior testimony to this Council, the reports of prior Councils, and many other sources establish that a complex set of rules, alternatives, and processes interact when an individual leaves employment with assets in the prior employer's DC plan. Recognition of those rules, alternatives, and processes as confusing almost certainly understates the nature of the beast. That is the type of environment in which participants can most easily be persuaded to make decisions that are not in their interest and that are inconsistent with the default setting.

Interventions to Retain DC Assets in the DC System

Now we have some ideas about the various factors that influence participant behavior, the question becomes how the Council can leverage that information in pursuit of its goals.

Confusing Decision Environment. The confusing decision environment is the problem that this Council has been focused on-removing speed bumps and facilitating the ease with which participants are able to make plan-to-plan rollovers and account consolidations. Many of the

[3] GAO-13-30, at 24.

June speakers focused on various technical and procedural ways to address those issues. All of the research into behavior, biases, and nudges indicates that is a worthwhile effort. If the environment is less confusing, participants are less likely to make decisions that are not in their best interest. But, that's hardly a surprise to this Council.

Timing of communications and access to participants matters. I encourage the Council, though, to consider the import of the research on communication timing and access to participants. Depending on the approach the Council takes, the cooperation of plan sponsors, and the level of intervention that occurs, making it easy to rollover to a new employer's DC plan may not be enough to change participant behavior and encourage higher levels of lifelong DC plan participation.

The research shows that timing of communications matter and the unique access to participants enjoyed by current plan service providers give those service providers an advantage. If the first information that a participant receives is about an opportunity to rollover to an IRA then the participant may lock in, at least psychologically, to that IRA rollover. We would expect to see similar effects if the first communication is about a forced rollover of a small account balance to an IRA. At that point participants may be so anchored on the early decision that it becomes very difficult to get them to revisit the decision even if a plan-to-plan rollover is a better choice for the participant and just as easy to execute as a rollover to an IRA.

The Council may be entirely successful in addressing the second boundary condition. Its recommendations could make it as easy to engage in a plan-to-plan rollover as it is to take a distribution or rollover to an IRA. But, if the new plan does not have access to participants at the time they first begin thinking about what to do with the plan assets, I would expect that the Council's efforts will be less successful than they otherwise could be. The question is how to reach a participant at the right point in time with the right information.

There are two ways to think about alternative approaches. First, the Council can focus on approaches that can be undertaken by plan sponsors and encouraged by the Employee Benefits Security Administration and the other is that the Council can seek regulatory change. Second, the Council can call for a mandate without participant choice (such as: "A participant's account always will be rolled over to a new DC plan if [constraints based on employment where a DC plan is offered]," a mandate with a participant opt out, or a softer nudge. My own bias is that it is most efficient and appropriate to provide participants with a choice but to use relatively firm nudges (we might even call them shoves). And, I believe that if progress can be made through voluntary and regulatory change, while perhaps not optimal, such an approach can establish the basis for later Congressional action and make progress in the meantime.

One practical approach that would not require legislation to decrease the advantage enjoyed by plan service providers is to leverage the existing power of plan sponsors. They could preclude plan service providers, preferably through contractual provisions, from initiating direct communications about rollovers and distributions with plan participants until after a participant receives a simple and salient disclosure outlining each of the participant's options. This could be accomplished with language that would accompany model notices and forms.

An even more effective approach would be to preclude any distributions or rollovers for a reasonable minimum time period after the participant leaves employment. The timing delay would have to be sufficient to ensure that participants do not make a decision without understanding all of their options. And, to be most effective there could not be an option for participants to waive the waiting period as they now are able to do with the 30-day notice requirement for rollovers. This could be accomplished with regulatory guidance.

Alternatively, a statutory change could require plans to automatically rollover assets to the next employer's DC plan unless the participant opted otherwise within a particular time period. This default should be more effective than the current automatic retention default for accounts of over $5,000 because it would leverage the principle of anchoring. For smaller accounts, if the new employer's plan is a low-fee plan then such a transfer would typically be better for participants than forced transfers to an IRA. If rollover to a new employer's DC plan is automatic and a participant must take action in order to have account assets distributed or rolled over to an IRA, it should become necessary to convince the participant that one of those alternatives is a better choice. And, if an alternative is a better choice for that participant, so be it.

Another approach, also requiring a statutory amendment, would be to automatically roll DC account assets into a new employer plan unless the participant meets a specific requirement, such as having written advice from a fiduciary advisor or passing a financial literacy test.

Exceptions from any of these measures could be made in situations of hardship or where the participant does not engage in full-time employment within a short period of leaving the employer in question.

In sum, if the Council can discourage participants from taking actions that probably are not in their long term interest at the same time it removes the barriers that currently discourage participants from keeping their DC account assets in the DC plan system, it will make an important contribution to increased retirement security for many participants.

Thank you for the opportunity to testify today.