
Improving Retirement Savings Choices Through Smart Defaults

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Question Posed

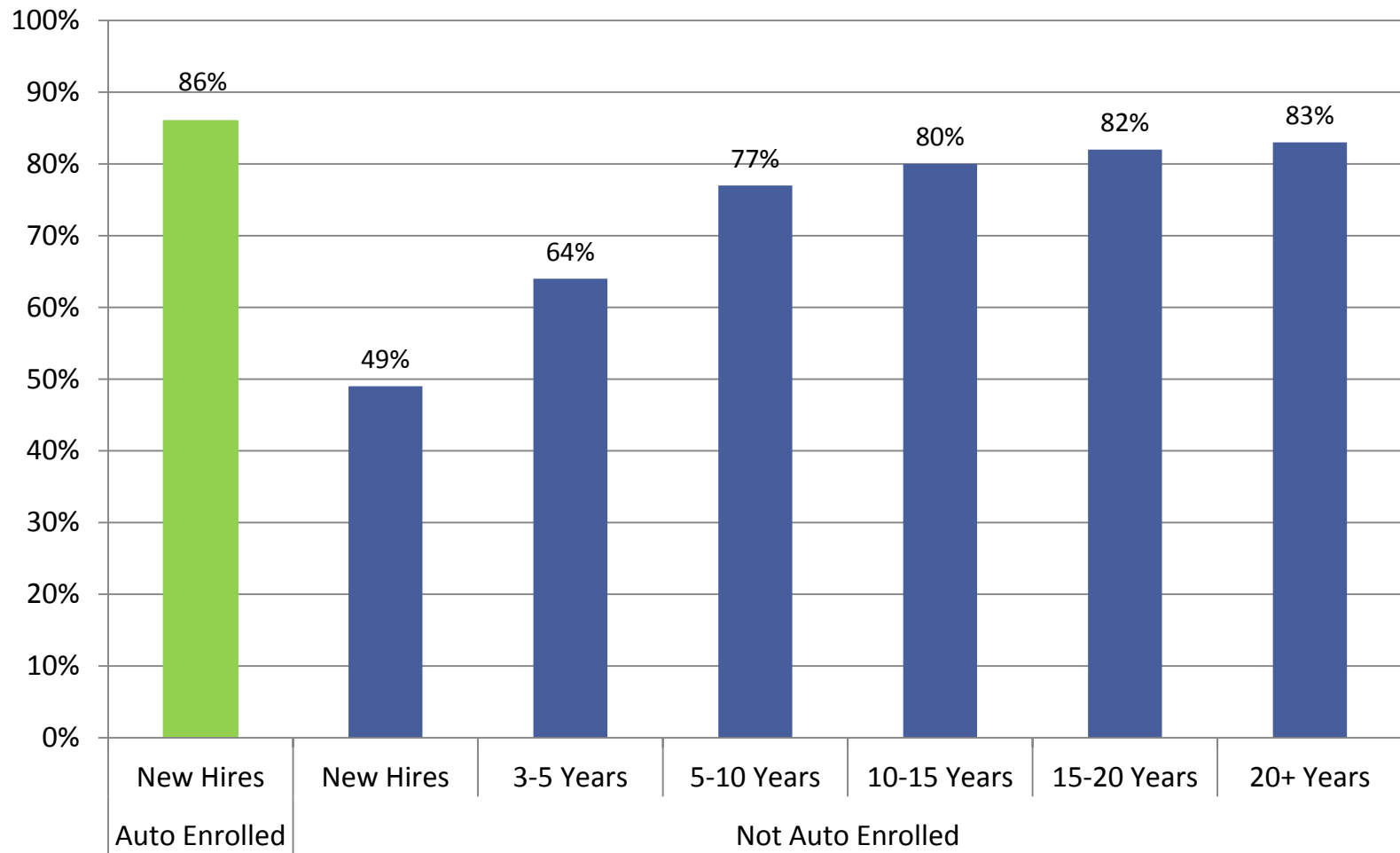
- **Question:** To the extent that we have voluntary retirement savings programs, how can we structure the embedded defaults to improve retirement security?
 - Paper sets aside other important questions:
 - What is optimal mix of voluntary vs. mandatory retirement savings programs?
 - How should we reform tax subsidies for retirement savings? Should we spend more or less on them? Should we make them more or less progressive?

Roadmap

- I. **Current Law**
- II. Theory of Optimal Defaults
- III. Potential Welfare Gains from Reforming Defaults
- IV. Barriers to Smart Defaults
- V. Sketch of Practical Approach to Adopting Smart Defaults (if time)

The Power of Retirement Savings Defaults

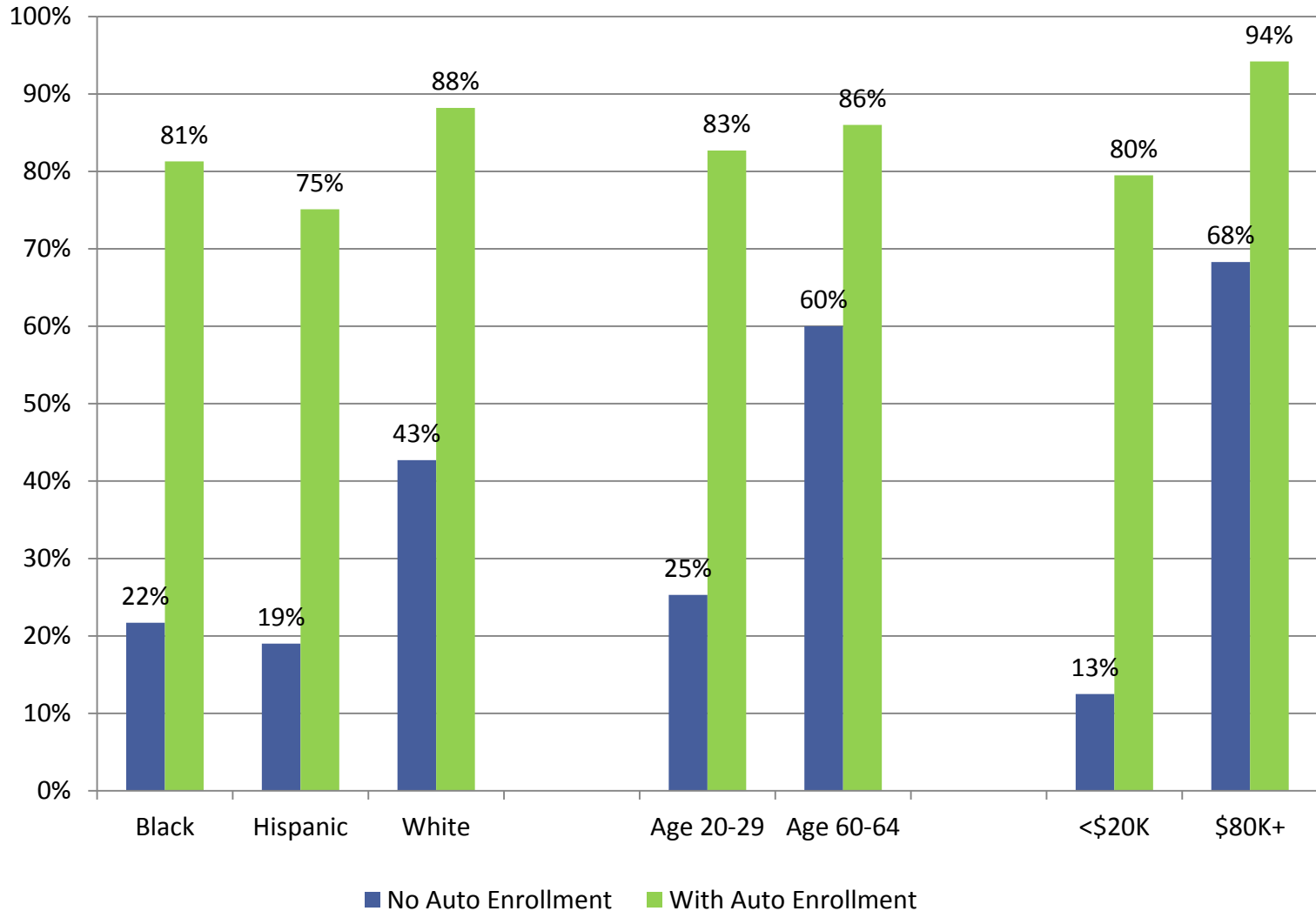
Participation Rate With and Without Auto Enrollment



Source: Madrian & Shea (2001).

Auto Enrollment Has Larger Effects on Low-SES Workers

Participation Rate



Source: Madrian & Shea (2001).

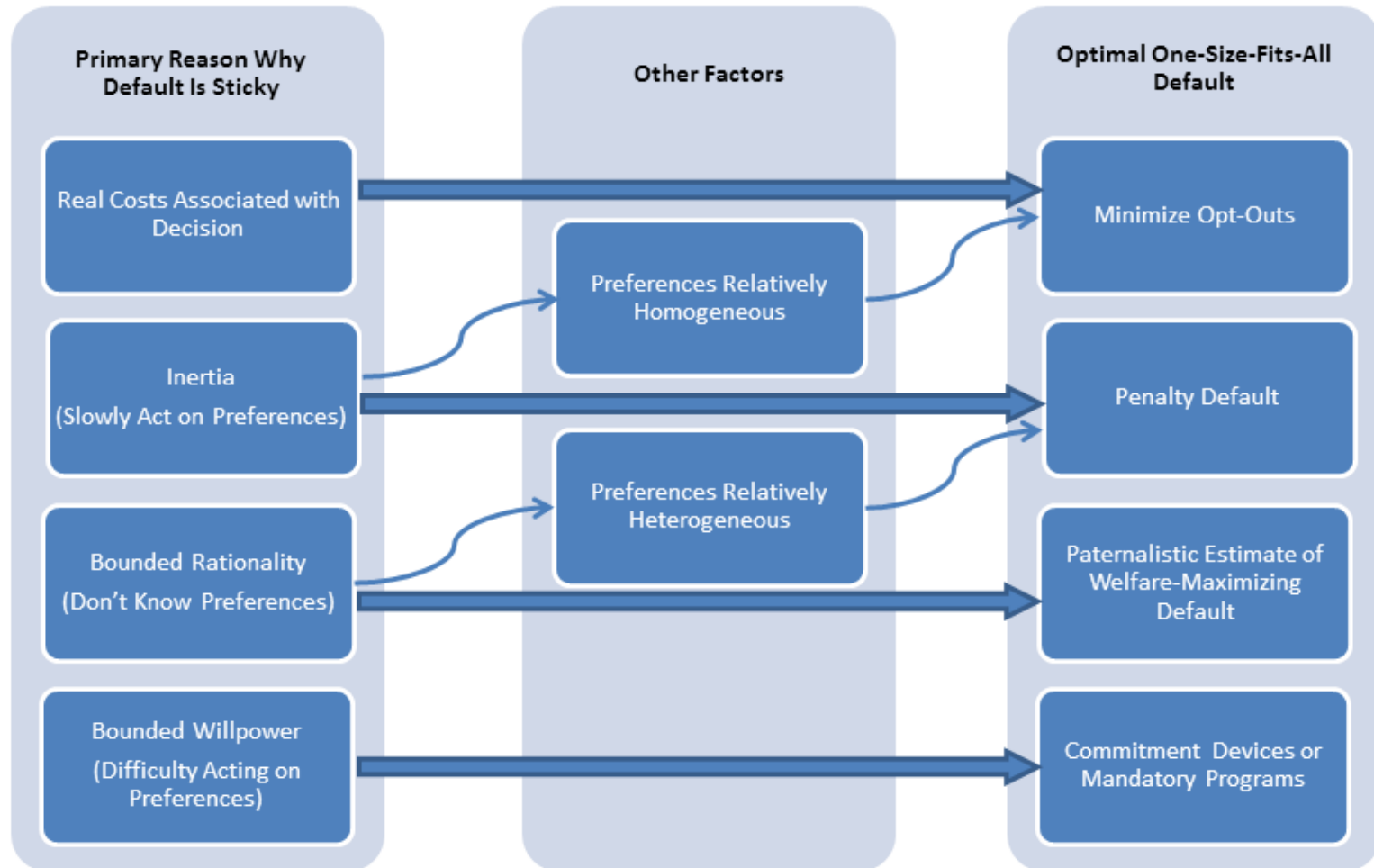
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Channels Through Which Defaults Influence Decisions

1. Real costs associated with making decisions
2. Inertia and inattention
3. Bounded rationality
4. Bounded willpower

Optimal Defaults Under Different Scenarios



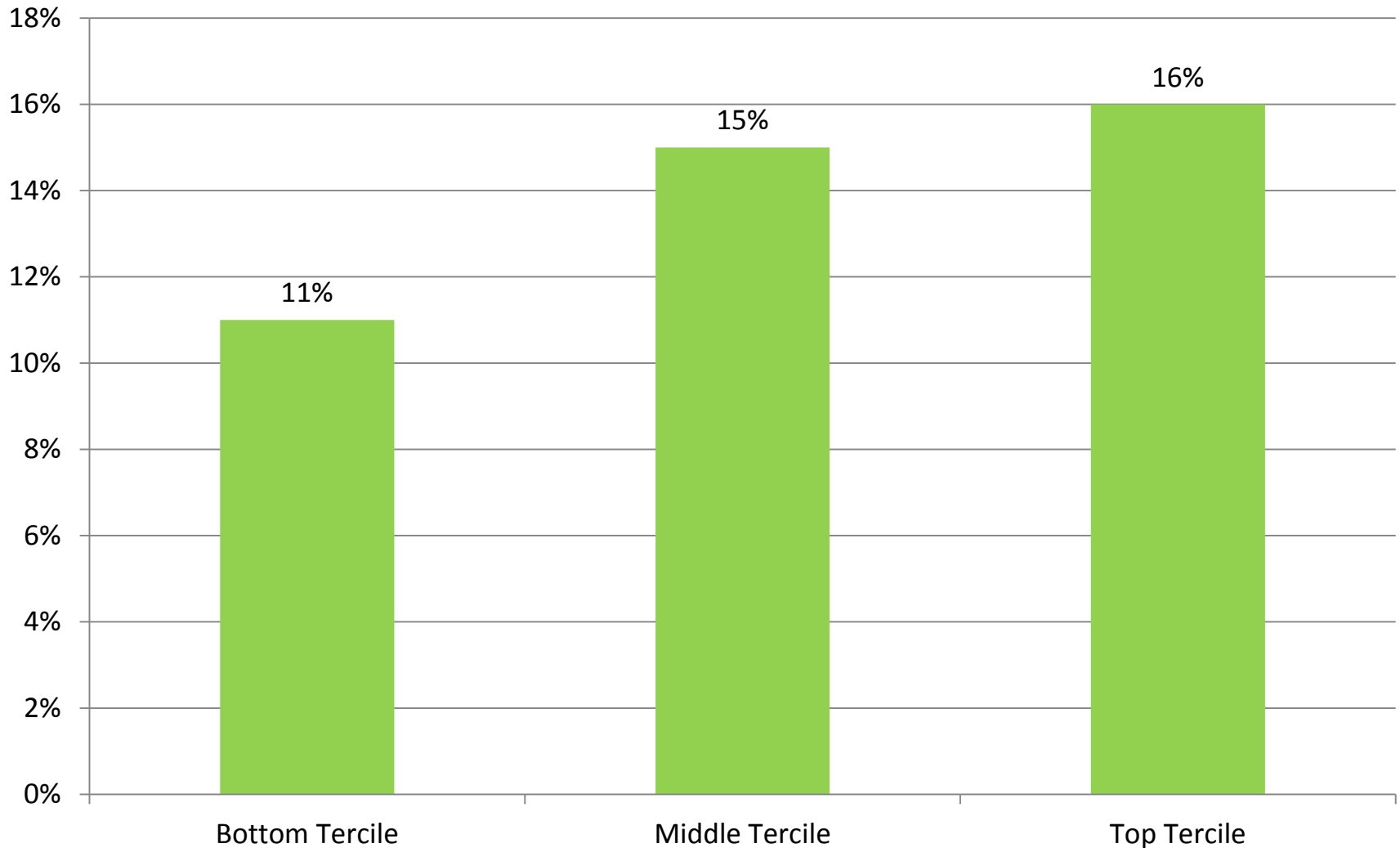
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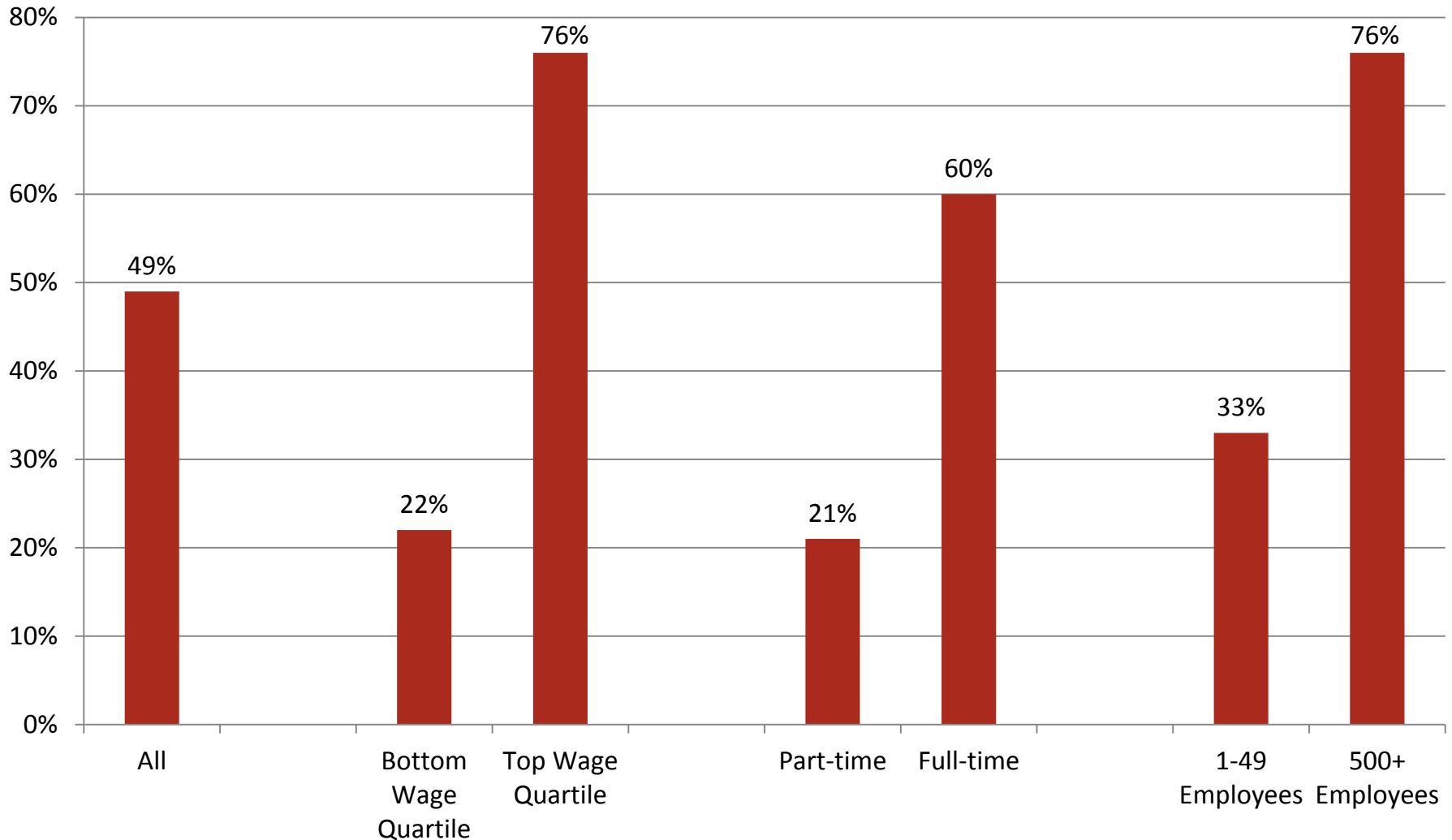
Defining the Objective

- **Objective:** Maximize welfare-weighted likelihood of people being able to maintain pre-retirement, wage-indexed consumption level, after paying for expenses necessitated by work, health needs, and child rearing.
 - *Optimal replacement rate or retirement preparedness*
- Rests on several normative assumptions:
 - Identical utility functions with declining marginal utility of money
 - No externalities
 - People actually prefer to smooth their consumption in this way

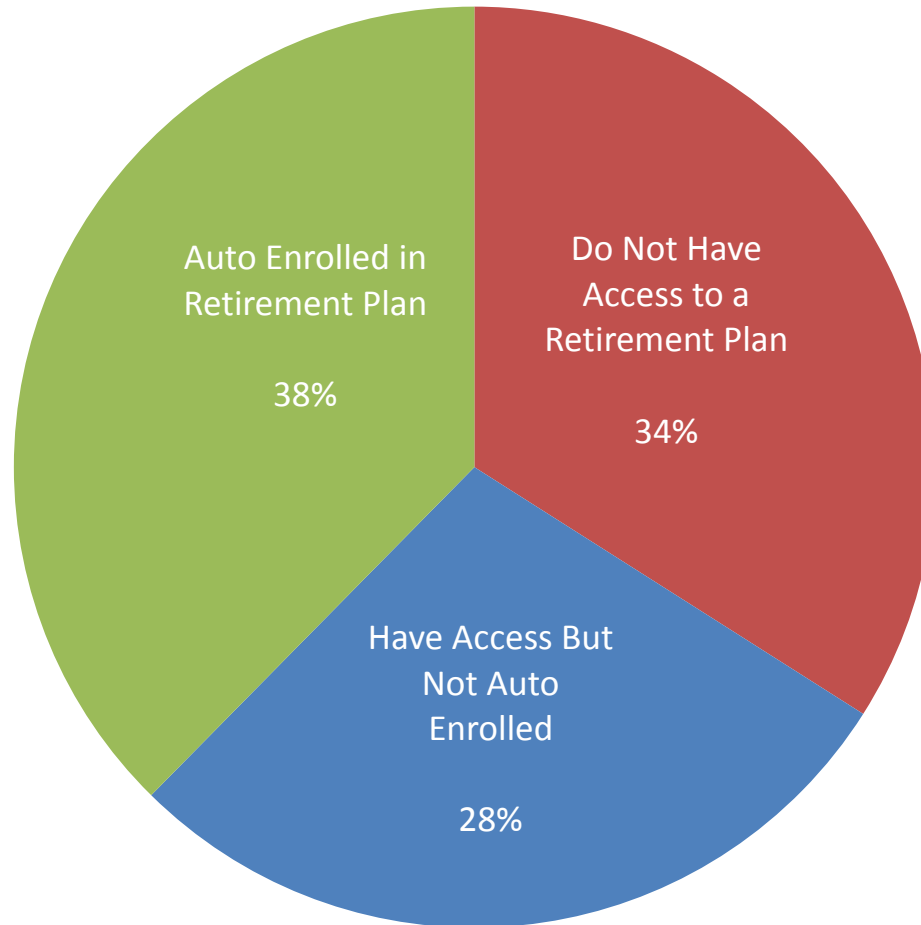
Target Savings Rates in National Retirement Risk Index



Participation in Retirement Plans Among Private Sector Workers, 2016



Share of Workers with Default to Save for Retirement



Current vs. Optimal One-Size-Fits-All Defaults

Decision	Current One-Size-Fits-All Default	Optimal One-Size-Fits-All Default
Savings Rate	0% for ~62% of workers ~5% for 38% of workers	Greater than zero and potentially higher than 5%
Traditional vs. Roth Contributions	Traditional	Mix of traditional and Roth
Investment	Typically actively managed target date fund No annuitization No long-term care insurance	Low-fee, indexed, target date fund that gradually annuitizes No long-term care insurance
Distributions	Typically lump sum	Installments

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Barriers to Smart Defaults

- Distributional effects
- Effects on privacy and bargaining power
- Stereotyping and expressive concerns
- Restricting choice and diminishing learning
- Practical and administrative barriers

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Potential Approach to Adopting Smart Defaults

- Require employers to auto enroll new and current employees either in a qualified retirement plans or auto-IRA
- Mandate following “smart defaults” for auto-IRAs and establish a new safe harbor from the nondiscrimination rules for retirement plans that adopt them
 - SSA/IRS calculate a set of defaults for each employee based household income, age, marital status, number of minor children, expected Social Security benefits, and total tax-preferred retirement assets
 - SSA/IRS communicate these personalized defaults, but not the underlying data, to employer/plan administrator (for retirement plans) or state/financial institutions (when administering auto-IRAs)
 - Personalized defaults include (a) contribution rate including employer contributions and matches, (b) share contributed on Roth vs. traditional basis, (c) share annuitized
 - More cautious alternative for employer plans:
 - Employer bases default just on pay, age, and worker’s assets in employer’s plan
 - Employee can elect have IRS/SSA use other data to calculate better default and have that shared with employer (similar to FAFSA authorization)

Potential Approach to Adopting Smart Defaults, cont.

- Other components of smart defaults
 - Default investments cannot carry fees that are >[25] bps higher than similar investments
 - All new hires defaulted into a risk-free product for first 90 days
 - Any funds that are not annuitized are distributed in installments upon retirement
- To qualify for safe harbor, employer plans must adopt smart defaults and offer a specified employer contribution or match (which is fully tapped under default savings rate)
- Retain nondiscrimination rules but repeal all other safe harbors.
 - Thus, employer plans have to auto enroll employees either in smart defaults or in an alternative set of defaults that satisfies nondiscrimination testing.
- Direct FIO to establish list of annuity providers that satisfy fiduciary duties of plan sponsor.