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Default Options - Failure To Choose

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The passing of the **Pension** Protection Act of 2006 (PPA) is being heralded as a significant new phase in the U.S. **retirement** industry. Its impact on Canada has been to heighten our awareness of some of the issues in our **retirement** system as they pertain to **Defined Contribution plans**. In particular, Canadian stakeholders have become increasingly concerned about default options in **DC plans**.

Default options not only include the choice of **investment** strategy, but can also pertain to the option of joining the plan and to the level of contributions. For those plan members who do not make these choices, the default will define their plan participation and activity.

The concern about default options is not new, but the passing of the PPA has acted as the catalyst to focus Canadian attention on this aspect of plan design. The PPA allows for automatic enrolment and auto escalation of contribution levels in 401(k) plans. In addition, regulators have indicated the preferred choice of default **investment** strategies (such as life cycle funds). In Canada, sponsors are wrestling with questions such as:

- What role should employer sponsored plans play in individual **retirement** planning?
- Can participants make informed, sensible choices?
- Will participants have enough savings with which to **retire**?
- What **legal** liability do sponsors face in the setting of default options?
- What fiduciary responsibilities do sponsors have in setting default options?

Minimum Requirement

Default characteristics have tended to be viewed as the minimum requirement for an unengaged plan participant while the default investment strategy was designed to ensure preservation of capital. Plan sponsors expected that the default choices would be a temporary situation for a member as they formulated their retirement saving strategy.

That assumption did not turn out to be accurate. Default positions have tended to remain static unless the sponsor engaged in a time-consuming and often costly campaign (typically through their human resources department or their service provider) to contact defaulted members and attempt to engage them in a decision-making process.

The typical default positions described above (minimum requirements) are contrary to the purpose of a retirement savings plan – to provide a structure for employees to save through regular contributions for an event (retirement) that will occur at some time in the future. The time horizon is typically long term in nature and few, if any, of these plans are designed to be the sole source of retirement savings. In addition, in today's transitory labour market, sponsors should assume that a new member has been participating in some form of retirement savings plan (unless they are new to the job market). This is an important assumption to keep in mind as it means that the retirement plan is not making up for a lack of savings in the past.

Historically, the decision-making process for determining default characteristics has been driven by the wrong factors – minimum requirements and preservation of capital.

What if, instead, stakeholders created an environment where the default options were tied specifically to the purpose of the plan?

Let's assume that the plan is a registered pension plan (participation is compulsory). Assume that the sponsor has decided that the benefit they wish to provide through the pension plan is the replacement of approximately 40 per cent of pre-retirement income. The

level of contributions (employer, employee, and/or both) would be determined to support this goal given assumptions about length of tenure in the plan and a long-term rate of return.

If a member does not make an investment strategy choice, should the default option not provide the possibility of achieving the purpose of the plan regardless of the member's engagement? The traditional choice of a money market or guaranteed type investment is probably not going to provide this opportunity. The potential for long-term growth and inflation protection are not characteristics of these types of investments.

This should lead the sponsor to the choice of a well-managed, diversified portfolio that has a balance of investments across asset classes (equities and fixed income). Growth potential and inflation protection are achieved and the investment strategy fits into the long-term nature of retirement savings. Currently, life cycle type funds offer this solution. Perhaps as the investment industry turns more of its attention to the dilemma of retirement savings, additional strategies will be developed.

Regulate Defaults?

One consequence of the default option choice that sponsors should recognize is that it can send a signal to plan participants about a preferred or 'better' investment strategy. Regardless of how much communication sponsors do, some members cannot, or will not, make a well thought out choice when it comes to their investment strategy. It has been observed that often they take their lead from the default option available in the plan. Although not the purpose of the default option, and certainly not the primary reason for choosing a particular default strategy, sponsors should be conscious of this behavioural tendency amongst some plan members.

One potential solution to the default option dilemma is to regulate the situation. This could result in consistency across all retirement plans with respect to the default – a potentially better outcome for the plan member – and perhaps offer a 'safe harbour' like environment for plan sponsors. If the regulators determine what the default should be, it stands to reason that a sponsor could not be liable for inadequacy of retirement savings for an unengaged plan participant.

However, best practices in determining default options offer a greater potential for a more palatable solution for plan sponsors in that they can determine the default options based on their goals for the retirement plan. In addition, best practices can evolve over time in order to meet the changing needs of plan sponsors and employees, and the potential change to available investment strategies. Regulation does not offer this type of flexibility, as regulatory change tends to lag new developments.

Measure The Success With all the recent focus on default options, there is one thing that should be considered – how do you measure the success of default options? The challenge in measuring success is that the ultimate indication of accomplishment is a member achieves the goals the plan was designed to deliver.

Unfortunately, this is a future event and the consequences of not achieving success cannot be reversed. What if there were ways to measure interim success – something that could indicate that the purpose of the plan was being met regardless of the fact that the member is not engaged in the process? Questions as to whether sponsors would, or should, assume this responsibility do arise when this is considered. However, what is the point of a strategy if one does not measure its effectiveness?

One way might be to periodically track the replacement income ratio generated for the defaulted member's account. This would allow some benchmarking of the success of the default strategy. Of course, the question of what action to take if the strategy is not on track would need to be considered. Should a sponsor change the default strategy? What liability exists if a sponsor takes this action? A strong governance and decision-making process can assist the sponsor in dealing with these issues. The rationale for the default options and the appropriate actions to be taken in the circumstances described above will provide the framework for the sponsor in which to operate.

Potential Solutions

As DC plans continue their prominence in the retirement system in Canada, the dilemma of default options and the potential solutions will continue to present challenges for plan sponsors. If one considers where this could take the industry in the future, one can speculate that new products will be developed or existing ones will be enhanced that will assist sponsors with this challenge. For example, we have seen guaranteed typed products with capital market participation developed in the life cycle space. Some may consider the cost prohibitive, but the combination of guarantees and growth come with a price. Inevitably, the market will determine if the features are worth the cost.

Target date type life cycle funds have also risen in number recently as they allow the default option to be tied to at least one of the factors in considering an investment strategy – time horizon. The current criticism of most of these products is the lack of consideration of risk tolerance – an argument that is moot given that the default is designed for an unengaged investor. Risk tolerance is a personal consideration and cannot be determined for an investor. An investor must determine it – tough to do when the investor is not engaged in the decision-making process.

Whatever the future solutions, the goal is to provide an investment strategy that has a high probability of meeting the objective of the plan.

A final consideration for the whole issue of default options is the elimination of the need for them. This will have more to do with changing current behaviour than any product development discussion. If members of retirement plans can come to understand the value of their plan and the role it can play in their retirement savings strategy, one assumes that they will become engaged. What is probably a bigger challenge is focusing plan participants on the importance of retirement savings overall. The Canadian education system could provide the means to this end by teaching financial literacy in the formative years. Retirement savings would form part of that curriculum.

Stakeholders in the Canadian retirement system need to change how they view default options. At the very least, default options should be designed so that the objectives of the plan can be met. Measurement of the success of the default options should also be tied to these objectives. Regulation of default options is not a desirable situation as customizing to the purpose of the plan and to the sponsor's circumstances may be hampered. Instead, best practices and a robust decision-making process will better enable sponsors to choose the most appropriate defaults for their plan.

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