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Regulation of Retirement Saving

Squam Lake Working Group on Financial Regulation
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The Squam Lake Working Group on Financial Regulation is a nonpartisan, nonaffiliated group of fifteen academics who have come together to offer guidance on the reform of financial regulation.

The group first convened in fall 2008, amid the deepening capital markets crisis. Although informed by this crisis—its events and the ongoing policy responses—the group is intentionally focused on longer-term issues. It aspires to help guide reform of capital markets—their structure, function, and regulation. This guidance is based on the group's collective academic, private sector, and public policy experience.

To achieve its goal, the Squam Lake Working Group is developing a set of principles and their implications that are aimed at different parts of the financial system: at individual firms, at financial firms collectively, and at the linkages that connect financial firms to the broader economy.

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THE CHANGING RETIREMENT SYSTEM

Retirement saving is undergoing a fundamental change as employers shift from defined benefit pension plans to defined contribution plans, such as 401(k) accounts. Defined contribution plans have important advantages: they allow households to customize their retirement saving to their own risk preferences and circumstances, they insulate pensioners from potential bankruptcies of their employers, and, although there may be a modest vesting period, they allow workers to move from job to job without risking their pensions.

These plans also place much greater burdens on consumers to make good financial decisions. There is widespread concern that many households are not up to the task. In this memo, we analyze this concern and recommend measures that will improve the performance of the nation's retirement saving system. Our discussion and recommendations are oriented toward U.S. defined contribution plans, which are offered by most American companies, but the concepts we develop are applicable around the world.

We recommend changes in disclosure requirements and investment options. To be eligible for defined contribution plan investments, a mutual fund should be required to provide a simple standardized disclosure of the costs and risks of investing in the fund. Our model is the nutrition label required for packaged foods in the United States. The investment label should emphasize tangible characteristics that are related to cost and risk. Expense ratios, for example, should be prominent.

When trying to forecast future investment returns, investors often overestimate the information in prior returns. Even five-year return histories are of almost no use in forecasting future relative performance. For this reason, we recommend that the standardized disclosure should not include information about prior returns. To help investors understand the limited value of prior returns, sponsors of investment products for defined contribution plans who report their average prior return in advertising or other disclosures should be required to report a standardized measure of the uncertainty associated with the average.

We also advocate improved default options for defined contribution plans. If employees do not select an alternative, they should be automatically enrolled in their employers' defined contribution plan. Many participants in defined contribution plans tend to anchor their investment decisions on the default options, as though those are optimal. To increase the amount employees save for retirement, we recommend an aggressive default withholding rate that increases over time. The default investment should be well diversified and have low fees.

Finally, there should be more restrictions on the investments employees can include in their defined contribution plans. There should be strict limits, for example, on investments in the stock of one's employer.

Our standardized disclosure is not meant to replace the standard investment prospectus, or even the Securities and Exchange Commission's new summary prospectus. Our goal is to communicate tangible and easily understood measures of cost and risk that can have first-order effects on an employee's investment experience. The uniform format of the disclosure label will facilitate comparisons across investments and help employees develop perspective as they compare alternatives over time. It is tempting to recommend the inclusion of many other measures that we know are important, but doing so would defeat the purpose of the label; few employees read required disclosures that are long and complicated, just as few home buyers study the many pages of disclosures in their mortgage

contracts before pledging to make years of payments. Motivated employees who want more detail can always find it in the prospectus and the statement of additional information.

Our recommendations about default options build on provisions of the Pension Protection Act of 2006. The Act gives employers the option to automatically enroll employees who do not explicitly opt out of defined contribution plans. We argue that automatic enrollment should be the default option for all defined contribution plans. The default withholding rates we recommend are also more aggressive than the safe harbor rates in the Pension Protection Act.

THE NEED FOR REGULATION OF RETIREMENT SAVING

A large body of research has found that many people make costly mistakes in retirement planning. They do not save enough, so their standard of living falls substantially on retirement. They hold insufficiently diversified portfolios, exposing themselves to needless risk. Many invest much of their retirement savings in company stock, which means that if their company fails, their savings disappear at the same time that they lose their jobs. Others hold high-fee funds that on average deliver poor long-term performance. Some change their allocations far too often, while many others never revisit an allocation made on the first day of the job.

There are several reasons why it is appropriate for public policy to help reduce such mistakes. First, people who reach old age with inadequate financial resources become eligible for public assistance, such as Medicaid. Taxpayers have a legitimate interest in preventing this outcome. It is also likely that, if many people lose substantial sums in their retirement accounts, there will be great pressure for the government to provide additional financial support.

Second, the possibility of social assistance creates what economists call moral hazard; people are less likely to save or to properly consider downside risks of their investment decisions if the government will support retirees who cannot support themselves. Provision of aid to the unfortunate should be accompanied by pressure not to become unfortunate in the first place.

Finally, it is difficult to make wise decisions about retirement savings and investment. The mistakes people make about their retirement savings have been attributed to a number of psychological biases: limited ability to make decisions about risks; procrastination; inadequate self-discipline; inertia; and overconfidence, which leads most active investors to the illogical conclusion that each can outsmart the others. The problem is compounded by poor self-knowledge of these limitations. Learning to invest well is difficult, and to the extent that the government can help people make good decisions—an important caveat—it can improve welfare by doing so.

Of course, the fact that people make poor decisions does not, by itself, justify regulation. Regulation is a blunt instrument. It has costs and unintended consequences, even when implemented as intended, and the costs and unintended consequences tend to be magnified by real-world political pressures.

What are the costs? First, rules intended to protect consumers in financial markets can end up simply excluding poor and less creditworthy people from the benefits of financial market participation. Second, even apparently benign disclosure rules can create the unhealthy expectation that the government is responsible for identifying the risks people might encounter in life. Third, the disclosure and regulatory process can be captured by industry.

Finally, we note that government policy itself has contributed to the problem of inadequate retirement savings. One prominent reason for low savings rates in the United States is the high taxation

of savings. Tax-advantaged defined contribution plans, such as individual retirement accounts and 401(k) plans, reduce but do not eliminate the problem. A general overhaul of the U.S. tax code to address this issue is far beyond the scope of our paper. Instead, we take the current tax code as a given and offer suggestions to make defined contribution plans more effective.

Because the benefits from the regulation of retirement saving must be balanced against the potential costs, we recommend relatively mild regulations that are less open to capture and other unintended consequences. We do not advocate more aggressive policies, such as a legislated move away from defined contribution back toward defined benefit plans, severe limitations on eligible investments, or government takeover of pensions.

RECOMMENDATIONS

Disclosure

Recommendation 1. *Investment products offered to defined contribution plans should include a simple standardized disclosure label to encourage comparison shopping on important attributes. Although we offer some recommendations about what should and should not be on the label, the form and technical specifications should be developed by a committee of academics, regulators, and industry experts.* Our model is the nutrition label on food products. The standardized disclosure label should emphasize tangible characteristics that will provide meaningful information about the cost and risk of the investment. It will be tempting to include a wide range of information that a motivated employee might consider when comparing investment alternatives. These details, however, will continue to be available in the investment prospectus and the statement of additional information. The standardized disclosure label is a tool to help employees who are less motivated or less prepared to make better investment choices. The Appendix offers a preliminary version of the label for a generic S&P 500 index fund.

Recommendation 2. *Investment costs, including the expense ratio (annual cost), front-end load (initial cost), and back-end load (final cost), should be prominent in the standardized disclosure label.* Fees above a threshold should trigger a warning about the long-term consequences of high fees, analogous to the surgeon general's warning on a package of cigarettes. High-fee funds argue that their fees are justified by superior performance. A large body of academic research challenges that argument. On average, high fees are simply a net drain to investors. While some investors might gain by selecting successful high-fee funds, the negative-sum nature of the process implies that other investors must lose even more. Most employees saving for retirement are poorly placed to compete in this game. They should not be forbidden from doing so, but disclosure of high fees and a "surgeon general's warning" are appropriate.

High turnover is also a drag on average returns because it creates high transactions costs. Some funds may be able to profit at the expense of others by high turnover, but again, identifying future winners is very difficult. Turnover should also be included in disclosure for this reason.

Recommendation 3. *The standardized disclosure should present simple but meaningful measures of long-term risk.* Our analysis suggests the label should report two complementary measures. The first is the annualized volatility of the inflation-adjusted ten-year return. The other is the range of inflation-

adjusted payoffs a $1,000 investment might produce in ten years, including the average and the fifth, fiftieth, and ninety-fifth percentiles.

It is not a trivial task to calculate these measures of long-term risk correctly. One important difficulty is that the relation between short-term and long-term volatility varies across investments. Stock returns are roughly independent through time; a high return this year does not imply much about the return next year. In contrast, the annual real returns on Treasury Inflation Protected Securities (TIPS) are mean reverting; a high annual real return on two-year TIPS, for example, must be followed by an offsetting low return. Thus, although the variance of the payoff on a stock portfolio grows roughly linearly with time, the variance of the payoff on a fixed income portfolio grows less quickly (and may even decline). For this reason we recommend that standardized procedures for calculating long-term risk should be developed by a committee of experts on financial market returns and asset allocation.[1]

Recommendation 4. *Past returns should not be reported in the standardized disclosure label.* A large body of research finds that past returns in general, and short-term returns in particular, are almost useless in forecasting subsequent investment performance. We expect that some vendors of investment products will push hard to include past returns in the standardized disclosure label. The label, however, is intended to warn of the costs and risks of investments, not to help firms market their products.

Recommendation 5. *Whenever an advertisement or other disclosure about an investment product offered to defined contribution plans reports an average prior return, it must also include a standardized measure of the uncertainty associated with the average.* Our goal is not to provide a precise statistical statement about future expected returns, but rather to give investors perspective about what an average prior return implies about the future. For example, sponsors of investment products might be required to report the "margin of error," which we define as twice the standard error of the average return, whenever they report an average prior return. Speaking loosely, the difference between the historical average and the true expected return during the prior period is within the margin of error about 95 percent of the time.[2]

Investment Options

The default options for defined contribution plans should encourage an aggressive savings rate and they should nudge employees toward low-fee, diversified investments. In our recommendations, we split defined contribution savings into a standard account and a supplemental account. The supplemental account is accumulated through investments made with savings in excess of perhaps 10 percent of compensation each year, plus any employer match on this part of the employee's savings. The standard account is accumulated through savings below 10 percent of annual compensation, plus employer contributions not specifically linked to savings in excess of 10 percent of compensation. Although employees should face only limited restrictions when investing the supplemental portion of their defined contribution savings, investment choices for the standard portion should be more constrained.

Recommendation 6. *Eligible employees who do not explicitly opt out should be automatically enrolled in their firm's defined contribution plan and the default savings rate should be a substantial portion of the employee's compensation. For example, the default withholding rate (the fraction of annual compensation with-*

held) might start at 5 percent in the first year, then grow by 0.5 percent per year to a maximum of 10 percent (subject to IRS limits). The default investment should be a portfolio of low-fee, diversified products. Many employees select the default options when they enroll in a defined contribution plan and others anchor their choices on the default options. A high default contribution rate will increase the retirement savings of those employees. Academic research provides compelling evidence that higher fees and expenses reduce the returns to investors. Thus, default investments should include only low-fee, diversified products.

Recommendation 7. *The standard part of an employee's defined contribution savings should be invested only in diversified products, and the fees on these products should not be excessive.* Investments in the standard account should be restricted to well-diversified products with annual fees below a specific limit, such as 2.5 percent.

Recommendation 8. *There should be strict limits on the amount of their own company's stock employees can hold in the standard part of their defined contribution accounts.* Although compensation linked to equity can be a useful tool for aligning the interests of management and shareholders, employees should not hold their retirement savings in their employer's stock. First, a concentrated position in any company creates unnecessary investment risk. Second, and probably more important, employees who invest in their employer's stock may lose both their pension and their job if their employer falls on hard times. Company stock may be included in a diversified investment product held in an employee's standard retirement account, but only as an "incidental" result of the investment manager's overall strategy.

APPENDIX: STANDARDIZED DISCLOSURE LABEL

Fund Name	Classic Market Index
Fund Type	U.S. Equity

	Annual	**Buy**	**Sell**	**10-Year**
Fees and Expenses	0.30%	0.00%	0.00%	4.67%

Possible 10-year	**5%**	**50%**	**Average**	**95%**
Payoffs (per $100)	$49.54	$132.27	$158.07	$353.16

Turnover	4.00%
Annual Volatility	20.00%

Fees and Expenses and **Possible Payoffs** assume that, after making an initial investment, you reinvest all distributions and then sell the fund in ten years.

Fees and Expenses

Annual	The percentage of your fund holdings that you pay for fees and expenses each year.
Buy	The percentage of your investment that the manager takes when you buy this fund.
Sell	The percentage of your fund holdings that the manager takes when you sell this fund.
10-Year	The percentage of your investment that you will pay for fees and expenses (including buy and sell charges), on average, if you invest for ten years.

Possible 10-Year Payoffs

If you invest $100 for ten years, the final (inflation-adjusted) value of your savings will be below the **5%** payoff roughly 5% of the time, below the **50%** payoff roughly half the time, and below the **95%** payoff roughly 95% of the time. Payoffs that are even more extreme than the 5% and 95% payoffs are possible. **Average** is the average of all possible payoffs.

Turnover	The percentage of the investment portfolio bought and sold each year.
Annual Volatility	A measure of risk. In a typical year, the return will fluctuate up or down by this much.

Endnotes

1. One promising approach to this problem starts by allocating securities to five asset classes: stock, cash (such as money market accounts), Treasury bonds, corporate bonds, and inflation-protected securities. We then split the return on each investment into the return on its asset class (or mix of asset classes) and an investment-specific component. We assume any mean reversion happens at the asset class level. Thus, an investment's ten-year variance is the historical ten-year variance of its asset class (or mix of asset classes) plus ten times the annual variance of its investment-specific return. This simple approach ignores issues that might be important in other applications, such as risk management, but it offers a standardized and robust way to compare long-term investments. Finally, to prevent employees from drawing inappropriate inferences from past returns, when calculating the range of ten-year outcomes we would use the same expected return for all investments in a particular asset class. For example, the calculations might assume the expected real return on all stocks is 5 percent.

2. For example, the long-term standard deviation on the U.S. stock market is around 20 percent per year. If a mutual fund invested in U.S. stocks has the same 20 percent volatility, the margin of error is 40 percent for the one-year average return, 17.9 percent for the five-year average, and 12.6 percent for the ten-year average return. Again speaking loosely, if the true expected return is 10 percent, the one-year average return will be between -30 percent and 50 percent, the five-year average return will be between -7.9 percent and 27.9 percent, and the ten-year average return will be between -2.6 percent and 22.6 percent about 95 percent of the time. These calculations are based on the standard formula that assumes returns are independently distributed in successive years. Margins of error for the difference between a fund and market performance are typically smaller, and can be reported when a fund chooses to report that difference.

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