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Impact of the Pension Protection Act on Financial Advice: What Works and What Remains to be Done?

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Impact of the Pension Protection Act on Financial Advice: What Works and What Remains to be Done?

Abstract

In light of the challenges and complexity of managing income for retirees, and the lack of overall financial literacy of our workforce, advice and financial planning services must be effectively delivered to help more participants achieve financial security, today and in retirement. A challenge that emerged in the wake of the Pension Protection Act of 2006 is how to deliver such advice without compromising plan sponsors' fiduciary responsibilities, and without relying on participants to indirectly fund the cost of advice programs through their purchase of ancillary financial products.

Disciplines

Economics

Comments

The published version of this Working Paper may be found in the 2010 publication: *Reorienting Retirement Risk Management*.

Reorienting Retirement Risk Management

EDITED BY

Robert L. Clark
and Olivia S. Mitchell

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Chapter 5

Impact of the Pension Protection Act on Financial Advice: What Works and What Remains to Be Done?

Lynn Pettus and R. Hall Kesmodel, Jr.

The US Congress addressed several issues important to both defined benefit (DB) and defined contribution (DC) pension plans with the 2006 enactment of the Pension Protection Act (PPA). Certain aspects of the PPA are widely viewed as improvements to the existing system, including changes to certain funding rules for DB plans and the explicit endorsement of auto-enrollment in DC plans, while others are more controversial (Warshawsky 2007; Sirkin and Coffin 2008). One of the most hotly debated topics is a provision expanding the delivery of plan participant investment advice.

By including participant advice provisions under the PPA, Congress effectively took the position that existing fiduciary requirements for participant advice programs were too restrictive to allow widespread plan sponsor adoption. Accordingly, relief from the prohibited transaction restrictions of the Employee Retirement Income Security Act (ERISA) was needed. In January 2009, the United States Department of Labor (USDOL) issued final regulations outlining how to comply with PPA statutory exemptions, and at the same time it created a new class exemption seeking to increase the availability of participant advice while controlling potential conflicts of interest (USDOL 2009).

Prior to the passage of the PPA, a 401(k) benchmarking survey showed that about 40 percent of 401(k) plans had offered participant investment advice programs for many years; the remainder had not offered advice due to fiduciary concerns (Smith 2006). In early 2007, the number offering advice had risen to 51 percent. Nevertheless, fiduciary concerns are still a main reason that sponsors elect not to provide financial advice (Phoenix and Dzierzak 2008). Therefore, while the PPA was somewhat successful in increasing the availability of advice, it may have failed to fully address fiduciary concerns. The Labor Department suggests that its new class exemption will do much to alleviate these fiduciary concerns, ultimately

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resulting in 60 percent of plan participants having access to investment advice.

This chapter addresses three important questions related to the PPA advice provisions:

- How did advice programs operating prior to PPA deliver advice to plan participants?
- Have eligible advice arrangements put forth under PPA both expanded the availability of advice and better served plan sponsors and participants thus far?
- Particularly with respect to serving the needs of plan participants, what remains to be done?

Participant investment advice: a brief regulatory and legislative history*Interpretive Bulletin 96-1*

The transition to DC pension ‘self-directed’ plans has meant that more employees are now responsible for managing their own retirement saving. For this reason, in 1996, the USDOL released Interpretive Bulletin 96-1 to provide plan sponsors with clarifications regarding non-fiduciary participant *education* versus fiduciary investment *advice*. This release indicated that plan sponsors may educate participants on such concepts as diversification and historical return expectations for various asset classes and assist participants with estimating future retirement income needs and assessing risk tolerance. Such non-fiduciary education may go so far as to provide participants with hypothetical asset allocation models and interactive software built using ‘generally accepted investments theories’ and assumptions that identify a ‘specific investment alternative available under the plan.’ To comply, the model must identify the specific assumptions made, acknowledge the availability of other similar investment alternatives in the plan, and take into account (or ask participants to consider) individual circumstances and outside assets. Such models and related output materials are not considered a ‘recommendation’ and thus do not constitute fiduciary ‘investment advice’ under ERISA (USDOL 1996).

In defining fiduciary investment advice, USDOL stated that this would include specific recommendations to buy or sell securities, as well as discretionary control over assets or a mutual agreement that the advice will be the ‘primary basis for the participant’s or beneficiary’s investment decisions.’ The Bulletin also confirmed that providing either non-fiduciary education or fiduciary investment advice to participants would not cause

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the plan to violate ERISA Section 404(c), as the participant might choose to accept or disregard the investment education or advice.

SunAmerica

The next definitive action by the USDOL on investment advice came in December 2001 when USDOL issued Advisory Opinion 2001-09A to SunAmerica Retirement Markets. This advisory opinion concluded that a retirement plan services provider offering its own investment options to plan participants may also render participants investment advice and discretionary managed account services, provided that an ‘independent financial expert’ developed the recommendations for participants using objective criteria. In so doing, USDOL determined that SunAmerica would not be in violation of ERISA Section 406(b), which prohibits a plan’s investment advisor fiduciaries from receiving additional compensation resulting from participant investment advice. Some commentators (Ungurean 2004) have noted that the SunAmerica Advisory Opinion was significant, as it outlined a clear model under which retirement plan providers may now offer ‘independent’ investment advice and managed account programs, even with the presence of their own investment options in the plan (USDOL 2001).

Failed legislation

Over the period 2001–5, both Democratic and Republican members of Congress introduced competing legislation proposing investment advice models that would shield plan sponsors from liability related to participant advice. Notably, Rep. John Boehner (R-Ohio), Chairman of the House Committee on Education and the Workforce, introduced the Retirement Security Advice Act, which permitted advice from plan providers with disclosures. Largely in response to this legislation, Sen. Jeff Bingaman (D-New Mexico) later introduced the Independent Investment Advice Act, which required that participant advice come from independent firms not involved with the management of the plan’s investments. Neither Act was ever passed into law.

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Finally in 2006, PPA was enacted by Congress and signed into law by President Bush to address widespread pension funding issues and increase retirement security. Along with addressing certain DC plan design features such as auto-enrollment and creating Qualified Default Investment Alternatives

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(QDIA), the PPA added a statutory exemption to ERISA that, if followed, permits the plan's fiduciary investment advisor to provide participant investment advice under an 'eligible advice arrangement.' The advice provisions in PPA effectively represented a compromise between the Boehner and Bingaman proposals (but much closer to the Boehner approach) by permitting a conflicted party to offer participant advice with controls.

Field Assistance Bulletin

Shortly after the enactment of PPA, USDOL issued a Field Assistance Bulletin (FAB No. 2007-01) providing preliminary guidance on implementing eligible advice arrangements under which a 'fiduciary advisor' renders advice either by using a computer model certified to produce objective advice, or by using a 'fee-leveling' approach. It also affirmed that past guidance remained effective, and that plan sponsors need not operate under a PPA-eligible advice arrangement. Additionally, it also reiterated plan sponsors' fiduciary obligations in providing participant investment advice (USDOL 2007).

USDOL final rules

In 2009, USDOL issued proposed regulations that largely followed FAB No. 2007-01, but further liberalized investment advice rules by introducing a class exemption that goes beyond the statutory exemption defined under PPA. Most significantly, under the USDOL class exemption, the fee-leveling requirement applies only to the representative (person) providing the advice to participants. It does not apply to fees received by the fiduciary advisor (firm) responsible for the eligible advice arrangement. Consistent with FAB No. 2007-01, the fiduciary advisor providing the eligible advice arrangement is not required to be registered under the Investment Advisers Act of 1940 and may be a bank, insurance company, or broker-dealer. The class exemption also allows the fiduciary advisor's representative using a computer model to render additional subjective 'off-model' advice under certain circumstances, with documentation. While these liberalized rules might conceivably make advice more available, by removing certain barriers, they also potentially increase conflicts of interest within PPA-eligible advice arrangements by removing the requirement for representatives to follow the computer-model recommendations and the requirement for firms to receive level fees for the representative's recommendations (USDOL 2009).

Final USDOL rules were filed in the Federal Register on January 21, 2009, and had an effective date of March 23, 2009. But the change in presidential administration prompted the USDOL to extend the effective

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date by an additional 60 days and request further comment. As of the writing of this chapter, part or all of the USDOL final rules are not expected to go into effect without substantial rewrite, due to Congressional disagreement over perceived conflicts of interest and liberalized rules that could go beyond the statutory compromise.

Participant investment advice today

Despite the availability of the new PPA statutory exemption, the market for participant investment advice today continues to be dominated by Internet-based computer models developed by independent firms registered under the Investment Advisers Act of 1940. Independent providers are distinguished in that they are not affiliated with the retirement plan's asset manager, and they do not sell financial products or provide brokerage services to plan participants.

Business and delivery models

These firms typically sell their Internet computer-model services through marketing alliances with retirement plan administrators, or directly to large DC plan sponsors. Smaller advisory firms sometimes sell services directly to individual plan participants, bypassing the plan sponsor. Some providers exclusively offer participant investment advice while others operate large diversified institutional investment advisory, research, and technology businesses.¹

Most large retirement plan services businesses have entered into alliance agreements with at least one independent advice provider to deliver Internet-based participant advice via a computer model. Some co-market with several advice providers to offer plan sponsors a choice of tools and advice methodologies. Others have branded a single advice platform as part of a 'bundled' service with an independent advice provider's computer model ('financial expert') delivering the participant advice behind the scenes, similar to the SunAmerica approach. Few businesses, if any, currently structure their computer-model platforms as PPA-eligible advice arrangements.²

While retirement plan services providers may be awaiting the fate of USDOL final rules before establishing new PPA-eligible computer-model arrangements, there are several reasons that providers might retain their existing platforms. These include the widespread availability of third-party computer models, the expense of creating new models, and the presence of certification and annual audit requirements under PPA compared to no such requirements for independent advice providers and SunAmerica arrangements.

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The lack of retirement plan services providers delivering participant investment advice programs via PPA-eligible fee-leveling arrangements might be due to the prevalence of mutual fund revenue-sharing agreements at the plan level, which include both the provider (fiduciary advisor) responsible for the advice arrangement, and the financial advisor intermediary (firm or representative who sold the 401(k) plan to the plan sponsor) responsible for providing investment advice to participants. Such agreements complicate the implementation of fee-leveling, particularly if the USDOL class exemption is not made effective.

Services and scope

Computer-model advice tools offer personalized asset allocation and investment recommendations based on a proprietary analysis of the retirement plan's investment options, coupled with an assessment of the participant's investment needs. These tools typically ask participants to input relevant information such as age, income, assets outside the retirement plan, and desired retirement age. The advice output includes educational materials and graphics designed to provide the participant with portfolio return and risk expectations as well as target saving levels. The output also may include a Monte Carlo analysis, which might show a range of returns representing 90–95 percent (approximately two standard deviations) of calculated possible future outcomes.³

In some cases, the plan provider, the advice provider, or the plan sponsor may offer telephone-based counseling related to the advice tool or managed account program. Managed account programs involve the advice provider taking the extra step of implementing ongoing investment decisions on a discretionary basis. Plan providers may also offer face-to-face meetings in conjunction with the computer model. While participants are more likely to use face-to-face advisors than any other delivery method (Helman, Copeland, and VanDerhei 2006) of advice delivery, there can be caveats to these interactions that we will explore further.

Fee structures

Independent computer-model advice providers, or plan providers operating a program similar to that of SunAmerica, collect fees from the plan sponsor, who may in turn pass through the cost of offering the advice program (and related telephone or face-to-face support) by charging a fee to each participant's account. The advice provider may charge fees on a per capita or assets-under-management basis. When an alliance relationship is involved, the retirement plan services provider may offer education and

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investment advice for no additional cost as part of its ‘bundled’ platform with an additional fee charged for managed account services. Generally, under pre-PPA delivery models, provider representatives supporting the computer model are salaried registered investment advisor representatives or employees who do not receive additional compensation or commissions from participants.

If a financial advisor intermediary (i.e., a commissioned representative affiliated with a brokerage firm, wealth management firm, or life insurance agency) is involved, there may be an informal or personal advisory relationship formed between financial advisors and certain participants, such as the business owner or its executives. Financial advisors unaffiliated with the retirement plan provider may also find their way to the employer via informal networking contacts with human resources, corporate business leaders, or individuals at company locations to offer face-to-face financial planning and out-of-plan advice services.

In these circumstances, the financial advisor might offer select plan participants ancillary investment advisory services or insurance products for assets outside of the plan’s formal advice platform. The financial advisor intermediary’s affiliated financial institution will dictate the extent to which fees and commissions are charged outside the context of the plan (e.g., commissions from financial product sales, fees related to assets under management, and brokerage commissions).

Limitations

Both the independent, online computer model (formal program offered in the plan) and the financial advisor intermediary (informal program offered outside of plan) have some limitations in providing participant advice, irrespective of PPA.

Today’s sophisticated Monte Carlo computer models in both retirement and investment advice programs are essential for performing stochastic modeling that potentially could include all sources of retirement income (e.g., Social Security benefits, DB pensions) and invested assets (e.g., IRAs, taxable accounts). Aside from lacking Internet access at work, the issue for most participants continues to be their lack of desire or financial knowledge to accurately and confidently enter information into these tools or understand the outputs without the assistance of a trusted professional. Indeed, for most plan participants, the Internet is not the preferred method of obtaining advice (Helman, Copeland, and VanDerhei 2006). While most are comfortable seeking general information from web sites, relatively few trust the Internet for financial advice (Greenwald 2007). Fewer are inclined to input the required personal information (from all of their

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various accounts) to obtain investment advice, and even fewer understand advice tool outputs and investment concepts.

Such reluctance is further complicated by the behavioral tendencies of participants to trust their own investment decisions for delivering their retirement saving objectives (47 percent) over that of a professionally managed account (25 percent). In cases where participants do access advice, only 13 percent say they implement all of the advice (Helman, Copeland, and VanDerhei 2006). Finally, online advice programs are not designed to provide financial planning recommendations for participants who struggle with debt or for those near retirement who are focused on plan distribution options and long-term cash flow planning. Decisions facing today's plan participants approaching retirement include: when to commence DB pension benefits, whether to elect an annuity or a lump sum, when to begin Social Security benefits, determining the appropriate level of cash reserves versus invested assets, whether to pay off their mortgage, and ordering and timing account withdrawals to minimize taxes. Collectively, these decisions are difficult for plan participants to address without the assistance of a financial planning professional.

There are also limitations to financial advisor intermediary or commissioned representatives' roles in providing financial planning advice. Factors to be considered relate to objectivity, quality, and consistency of the advice delivered for each participant, as well as how wealth management firms compensate these financial advisors.

One major issue is that dialogue and recommendations rendered during face-to-face meetings between financial advisors and participants are seldom recorded or archived. Consequently there are few ways to control quality, consistency, or conflicts that may arise. For example, an insurance agent, acting on a suitability (non-fiduciary) standard in providing out-of-plan recommendations, might be trained by his or her field office to sell more life insurance by instructing clients (plan participants) to limit their plan contributions to the employer match level (e.g., 6 percent of salary). Whole life insurance premiums, rather than additional plan contributions, are then recommended as an alternative to additional plan contributions.

Issues also arise around the compensation structure of commission-based financial advisor intermediaries, which incents advisors to focus attention on executives and business owners rather than rank-and-file participants, who arguably need the most help and have the fewest assets. This compensation structure may therefore create inherent issues of uneven participant access as well as conflicts of interest, irrespective of the advice framework (i.e., SunAmerica or PPA).

Other problems with exposing employees to commissioned representatives in the workplace include participants' lack of ability to select the lowest-cost option when it comes to investments (Choi, Laibson, and Madrian

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2010) and presumably other financial product decisions as well. Participants might also view the recommendations and products offered by financial advisors in the workplace as tacit plan sponsor recommendations. This can lead participants to believe that they should work with these advisors (Pessin 2008) even if this is not the employer's intent. Allowing commissioned representatives further access to the workplace under PPA-eligible advice arrangements will not change these dynamics, as PPA and USDOL only focus on the conflicts related specifically to plan investment advice, not financial product sales.

Participant issues

While retirement plan providers and sponsors continue to focus much attention on participant needs with respect to plan investment advice, significant problems for many participants exist outside the context of selecting investments in their 401(k) plans. One need only look at the current problems in the housing market to understand how severe resource allocation problems are relative to selecting investment options in 401(k) plans. Consider also that these serious financial problems can exist when the employee receives regular paychecks from an employer. With a lump-sum retirement benefit, the problem only worsens as these same individuals must now create their own paychecks for 30 years or more, juggling investment management, spending decisions, and unpredictable health-care expenses.

To put the relative importance of competing saving goals into perspective, the 2003 Employee Benefit Research Institute Retirement Confidence Survey showed that retirement saving was the most important long-term saving goal for only 45 percent of employees. When short-term goals are included, retirement was most important for only 30 percent of workers (EBRI and MGA 2003). Though this objective was mentioned more often than other saving goals, retirement is not considered to be the most important goal for a majority of employees. Along these lines, a recent survey conducted by The Federal Retirement Thrift Investment Board of 35,121 employees eligible for the Thrift Savings Plan found that 23 percent believe they 'do not have enough money' to contribute to the plan. However, only 4.3 percent were not contributing because of dissatisfaction with the investment options and only 2.2 percent were not contributing because the decision was 'too complex' (The Federal Retirement Thrift Investment Board 2009).

These findings suggest that, if participant education and advice is to be more effective, these must help participants understand how to allocate their limited financial resources across competing goals—rather than simply allocating their 401(k) investments.

Factors affecting 401(k) plan advice

Trust

Participant financial problems may also lead to a breakdown of trust in financial institutions, an important component in any participant's decision to participate in a plan (Agnew et al. 2007; Vanguard 2008). Participants may also question the presentation of potential investment outcomes due to recent financial shocks. As mentioned above, providers who show 90–95 percent probability calculations might not properly manage participant expectations when extreme market events become a reality, further confusing and disheartening those who relied on investment advice and stated return expectations in the past. Bodie (2003) illustrates this with a discussion of the 'fat tails' of the equity return distribution. Ironically, inertia has kept many from making changes to their allocations or contribution levels in response to recent market turmoil (Benartzi 2008), but trust in the system and in advice models may be further eroded nonetheless. In the present environment, advice programs funded in part by ancillary financial product sales could further erode participant trust in the plan sponsor and the plan provider's motives.

Automatic solutions

It is possible that participant investment advice in 401(k) plans is giving way to automatic solutions offered under the PPA, which are increasingly focused on helping participants save and diversify their investments passively.

MANAGED ACCOUNTS

For example, with the enactment of PPA, third-party advice providers won a major victory – not through the enactment of advice provisions, but through third-party advice providers' successful bid to include managed accounts as a Qualified Default Investment Alternative (QDIA) along with risk-based 'lifestyle' and age-based 'life-cycle' funds. QDIA status has given advice providers the opportunity to vastly increase the number of participants utilizing their advice through default investment managed account programs offered under auto-enrollment programs. Although managed accounts used as a plan's QDIA are still the exception rather than the rule, retirement plan services providers continue to expand their alliance relationships with third-party advice providers, delivering managed account services to more participants as a plan option and as QDIA default investments for auto-enrolled participants (Financial Engines 2008).

As a practical matter, the proliferation of managed account platforms as a plan option tends to conflict with conventional lifestyle and life-cycle

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fund choices, as they steer participants away from these. A plan sponsor's communication efforts might also become unmanageably complex, if advice, managed accounts, and life-cycle funds are all offered. Plan sponsors might question whether the additional fees and communications challenges are necessary when low-cost life-cycle funds (or institutional life-cycle funds customized for the plan) might provide similar results with more streamlined communications.⁴

One reason for plan sponsors to consider offering managed accounts as a plan option or as a QDIA default investment comes from work by Benartzi and Thaler (2007) that suggests that participants are not necessarily comfortable 'putting all their eggs in one basket' via a single life-cycle fund. This propensity toward multiple funds is also demonstrated by the fact that only 13 percent of participants believe a life-cycle fund is the investment option most likely to achieve retirement saving objectives, and only 11 percent believe a balanced fund will attain this end (Helman, Copeland, and Van-Derhei 2006). That study, and Benartzi and Thaler (2007), help explain the misuse of life-cycle funds by over 70 percent of participants. Nevertheless, few participants can accurately explain what the various options are, or their differences. For this reason, enhancing financial literacy could help, though managed account programs may also produce better results.

Managed account programs have certain advantages and seem to yield positive results for participants (Charles Schwab 2007), but more research is needed to determine whether these programs yield superior overall results when compared to life-cycle funds. For instance, it would be useful to ask whether managed account programs adequately retain participants over the long-term and mitigate irrational investment behavior in times of extraordinary stock market losses when compared to life-cycle funds. This analysis is unfortunately complicated by the fact that aspects of managed account performance are dependent on the underlying funds available in each plan.

AUTOMATIC ENROLLMENT

Studies also show the potentially negative impact on providing 'tacit' advice to employees in areas such as plan saving levels. While some programs providing contribution auto-escalation may mitigate this issue, most employers offering auto-enrollment today continue to have a 3–4 percent fixed contribution rate (Phoenix 2008). This is often due to the significant increased match costs of automatically escalating contribution rates above these levels. Due to inertia, these 3–4 percent saving rates may prove to be a long-term challenge for employers in making sure their workforce retires with adequate replacement ratios through 401(k) plans alone—with or without investment advice.

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The need to address this problem is further evidenced by a recent study by Brady (2009) who suggests that employees may achieve acceptable retirement income replacement ratios, including Social Security benefits, by saving 4–10 percent of earnings. While this might be in line with participant trends in traditional ‘opt-in’ programs, these rates are well above the levels of most auto-enrollment programs. For example, if the employer’s match is 50 percent of the first 6 percent of contributions, total contributions for auto-enrollees are more likely 5–6 percent. The problem of inadequate retirement fund accumulations is exacerbated by the fact that auto-enrollment programs without auto-escalate features have tended to create lower overall saving rates in 401(k) plans when compared to participant saving rates in plans without auto-enrollment (Olsen and Whitman 2007).

Increasing complexity

As employers move beyond investment advice toward automated solutions, it is important to keep in mind the complexity involved in accumulating and distributing ‘lump-sum’ retirement assets as discussed above. Even a seemingly simple decision such as rolling over a 401(k) balance to an IRA carries with it potentially complex tax considerations, such as Net Unrealized Appreciation (NUA) on employer securities.

Another key consideration is creating a way for participants to automatically continue receiving asset allocation assistance even after leaving their employers. Since the median tenure for American workers is currently 4.1 years (USDOL 2008), the transfer of advice from one employer to the next, and for multiple accounts is a key challenge. A recent survey of Americans aged 55–75 with over \$50,000 in savings found that 43 percent held more than six accounts (including employer plans, IRAs, and transaction accounts such as checking; Mottola and Utkus 2008*b*). As more future workers rely on 401(k) plan assets for retirement, the number and complexity of account management will only continue to grow.

Even if the participant’s current 401(k) plan is the only retirement saving vehicle, the complexity of managing a lump sum to create a stream of retirement payments is extremely challenging given inflation and longevity risks. Relatively few elderly today rely on lump sums from employer-sponsored plans as their primary means of retirement income (Ernst & Young LLP 2008; Mottola and Utkus 2008*a*), but this will not be the case for future retirees. The transition poses significant challenges from an educational and resource perspective, going beyond what computer-model investment advice offerings can effectively achieve for participants. Consider, for example, that future advice might need to include income product selection (e.g., managed payout mutual funds versus annuities). Employers will also confront a decision

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on how (or if) to automate this payment process and whether to provide employees with payout options inside or outside the plan, and/or educate participants on the universe of options beyond the plan for managing retirement income derived from their 401(k).

Where do we go from here?

Several open questions still remain. For one, it is not yet clear whether programs are delivering the right kind of advice and guidance to participants given their increasingly complex financial needs, which impact their plan participation and saving levels. Investment advice programs focused on accumulating assets are only part of the picture. While there is a need for relevant financial planning assistance beyond what is delivered by investment advice tools geared toward 401(k)s, how should plan sponsors deliver these programs? Should plan sponsors be comfortable with the PPA-eligible advice arrangements and USDOL class exemption, which, if implemented, will increase the presence of commissioned financial service representatives in the workplace? Face-to-face meetings with financial advisors might help certain participants make broader financial decisions beyond their 401(k) accounts, yet plan sponsors lack oversight over their recommendations, the kinds of financial products offered, the uniformity of participant access, and the methodology of the education or advice provided.

Expanding financial planning while addressing broader conflicts

Clearly 401(k) plan automation will continue to grow in scope and popularity. In the process, employers and plan sponsors may consider whether money spent on providing investment advice could be better deployed aiding participants in understanding broader personal finance issues including guidance on allocating the paycheck to coordinate long-term goals like retirement, immediate needs such as paying bills, and mid-term goals like buying a home. Related education might include making efforts to proactively assist with coordinating W-4 withholding calculations and 401(k) contributions, so employees decrease taxes withheld from their paycheck while simultaneously increasing plan contributions, thus keeping their paycheck levels unchanged. Such calculations can be easily performed by a financial planner via an Internet calculator.

If plan sponsors demand an increased spectrum of education and advice for participants, retirement plan services providers and other independent providers might deliver these expanded financial planning services through fee-only (salaried) professionals, without relying on the USDOL

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class exemption for their representatives. This model might combine a high-touch approach of a professional financial planner with an independent computer model subject to fiduciary advice requirements. If delivered over recorded telephone calls, this approach would limit sponsor and participant costs, assist in quality control, and reduce both real and perceived conflicts associated with commissioned representatives. The scope of permitted financial planning might address immediate needs (e.g., how do I find money to save in the 401(k), pay off debt, how much house can I afford, etc.) in order to better assist participants with meeting their retirement saving goals.

To offer these services, financial institutions would need to train fee-only (salaried) professionals to serve their workplace or plan sponsor clients, in lieu of commissioned representatives. Such a holistic workplace financial planning model might better comport with plan sponsors' fiduciary responsibilities and sensibilities, while allowing participants to receive unbiased (or less conflicted) financial planning from a trusted source without the reliance on ancillary financial product sales to indirectly fund these arrangements. Some financial institutions have already implemented a similar model that complies with pre-PPA regulations and does not rely on the USDOL class exemption for its representatives (Tyson and Palumbo 2008). Though certain conflicts might continue to exist at the plan provider level, the most troubling conflicts, including the incentive to recommend certain financial products in lieu of additional plan contributions, could be mitigated if provider representatives are not financially motivated to market these products to participants in the workplace.

Reevaluating the relative costs of participant education and advice programs

Many plan sponsors, when seeking to move beyond traditional 401(k) education and investment advice, may be concerned about the efficacy, cost, and potentially uncertain fiduciary questions associated with these new approaches. Given the mixed results in studies on the efficacy of certain employer education programs (Hira and Loibl 2005; Benartzi and Thaler 2007; Olsen and Whitman 2007), employers will continue to ask where their resources should be allocated in these areas. In this connection, a recent study suggests employee financial stress might cost more than \$15,000 per affected employee (Financial Literacy Partners LLC 2008).

Another consideration is to put the cost of providing participants with financial planning into context. According to Kopcke, Vitagiano, and Muldoon (2009), asset management fees and trading costs make up 80–90 percent of a typical large employer's plan costs. This is particularly

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significant given that decisions on saving levels, when to retire, and when to collect Social Security benefits – rather than asset allocation or investment selection – are often the most important factors in determining participant retirement incomes (Mottola and Utkus 2008a; T. Rowe Price 2009). Yet plan sponsors spend little time or money counseling participants on these key decisions. Unfortunately, commissioned representatives again may be ill-suited to provide participants with unbiased recommendations on these issues, when ancillary (out-of-plan) financial product sales weigh heavily.

In the end, the overall cost of providing broader education and advice programs through commissioned representatives might prove to be much higher than fee-only programs delivered by the plan sponsor, if we include the external commissions and fees paid by participants purchasing ancillary financial products.

Leveraging automatic solutions to reduce the need for traditional 401(k) investment advice

As plan sponsors continue to focus on automatic plan designs and QDIA default investments, this will also reduce the need for traditional 401(k) investment advice. This is because more participants will find themselves automatically invested in diversified portfolios. In this event, education programs could then focus on helping participants understand the QDIA default investments and addressing important financial planning and saving issues, rather than expending efforts to help each participant select plan investments. Only engaged participants who choose to opt out of the QDIA would require traditional investment advice, thus reducing overall costs for delivering these services to the plan.

Conclusion

The Pension Protection Act led to a modest increase in plan sponsors offering participant investment advice and managed account programs. But to date, PPA-eligible advice arrangements have yet to take hold with plan providers or sponsors, as the final rules remain in flux. Therefore, formal participant investment advice programs today, while somewhat more available than in the past, are not materially different than programs offered prior to the PPA (notwithstanding the advent of QDIA managed accounts). For this reason, advice providers seek to ensure that pre-PPA SunAmerica arrangements continue to be permitted under any future rulings.

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The complexity and interconnectedness of participants' financial obligations—both immediate and long term—require effective participant education and advice programs to move beyond the narrow focus on 401(k) investment recommendations. If financial advisors can assist participants in the workplace with these broader considerations, beyond the 401(k), the regulators and plan sponsors will be able to consider the presence of broader conflicts of interest as well as the plan's ability to pay for services beyond the context of traditional plan education and investment advice.⁵ More needs to be done to deliver better education and advice to participants and retirees without compromising plan sponsors' fiduciary responsibilities and sensibilities, or relying on certain participants to indirectly fund the cost of advice programs through their purchase of ancillary financial products.

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Notes

- ¹ Examples of large independent providers who market directly to plan sponsors or partner with retirement plan service providers under SunAmerica arrangements include: Financial Engines, GuidedChoice, Ibbotson, Morningstar, and 401kToolbox. Examples of smaller independent providers marketing directly to participants include: StraightLine and Smart401k.
- ² The following retirement plan services providers who collectively serve an estimated 43,400,000 plan participants (PlanSponsor.com 2008; Financial Engines 2009) currently partner with an independent advice provider to offer plan sponsor clients access to participant investment advice under a pre-PPA or SunAmerica model: ACS, ADP, Charles Schwab, Fidelity, Hewitt, ING, J.P. Morgan, Mercer, Principal, T. Rowe Price, and Vanguard.
- ³ The authors have reviewed advice tool disclosure statements from several providers. However, the description of Monte Carlo analysis is not meant to represent any specific provider's tool.
- ⁴ Managed accounts programs typically charge 0.2 to 0.5 percent of assets under management. Retail life-cycle funds might include similar, or even higher, implicit asset allocation costs. Plan sponsors, particularly those with DB pension plans, might negotiate fees with asset managers to pool assets under management

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reducing the cost of offering customized or institutional life-cycle funds to participants.

⁵ USDOL final rules do not address these broader conflicts that directly affect plan participants who receive advice from commissioned representatives (USDOL 2009).

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Part II
The Environment for Retirement
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