401(k) Pension Plans and Financial Advice: Should Companies Follow IBM's Initiative?

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All eyes (in the pension world, at least) were on IBM recently, as it announced a huge shift in how it handles employee pensions. Abandoning the defined benefit pensions it has traditionally relied on, the company will instead automatically enroll employees in its 401(k) pension plan, matching 100 percent of the first 6 percent employees defer (with additional matches that depend on tenure). All 127,000 U.S. employees will be offered financial advice—on a full range of financial topics, not just how to manage pension wealth. The shift from defined benefit to defined contribution pensions (placing the responsibility to save and invest onto workers' shoulders) is not news these days; it has become the norm. But the business world will be watching this particular transition, because IBM is going beyond the normal scope.

IBM's Initiative

There are two important features of this initiative that deserve consideration. First is the decision to combine automatic enrollment and financial advice: Contrary to what many—including part of the academic community—tend to assume, automatic enrollment and financial advice are not two alternatives companies face when trying to boost employees' pension contributions. In fact, they complement each other very well. Alone, each initiative has significant drawbacks, but combining them can go a long way toward overcoming those hurdles. The second innovative feature of the IBM plan is the decision to offer financial advice beyond pension wealth.

Combining Automatic Enrollment and Financial Advice

Automatic enrollment is an ingenious mechanism. Many behavioral economists have argued that inertia and high planning costs delay workers from contributing to pensions, which means programs can be designed that make inertia work for, rather than against, workers. Moreover, with automatic enrollment, nothing is taken away from the worker's choice set. Any employee can opt out of the plan at any time with the stroke of a pen. Best of all, automatic enrollment has proven effective at dramatically increasing participation to pensions.

Financial education alone has not been equally effective. If, as argued before, inertia is a factor in financial decision-making, it can take a long time for education and financial advice to have an effect. Besides, not all workers will choose to attend financial education sessions or look for financial advice. According to my research, though, those who are exposed to financial education are more financially savvy, accumulate higher amounts of wealth, and make better investment choices.

So why do we need both? There is no guarantee that workers will stay enrolled in the pension plan in the long run. And the same inertia that makes workers stay in the plan initially may also prevent workers from returning to the plan if they have opted out due, for example, to a temporary shock. There is also no guarantee that the contribution rates set by automatic enrollment in the pension plan will be enough to guarantee financial security after retirement. To maintain high enrollment, often contribution rates are set quite low, and pension wealth is invested in conservative assets. One of the lessons we have learned from the extensive literature on saving is that individuals cannot be served well by the one-size-fits-all rule. Automatic enrollment combined with financial advice could be a solution, providing the type of differentiation that will allow each worker to develop the plan he/she needs.

Financial Advice Beyond Pension Wealth

As mentioned above an innovative feature of the IBM plan is the decision to offer financial advice beyond pension wealth. Obviously pension wealth is only a component of total wealth, and most employees accumulate wealth beyond their pensions. There is no guarantee that the increase in pension saving is not simply offset by a decrease in private saving, especially if the new pension plan gives the worker a false sense of financial security. That means employers' contributions may end up increasing current consumption instead of enhancing employees' financial security. Moreover, workers are confronted with a wide, ever-changing array of choices and complex financial instruments for managing their non-pension wealth. Those who do not have good financial skills may end up with high-cost mortgages, carry high credit card balances, and invest in poorly diversified portfolios. Those choices may also eventually offset the wealth accumulated in 401(k) accounts.

Inadequate planning for other saving motives—college education for their children or an emergency savings account—may also result in quick opt out when children do go to college or an unexpected expense occurs. Eventually, that can limit the worker's ability to contribute to a pension and to exploit tax advantages and the employer's match. The risks are real: Financial literacy among workers should not be taken for granted. Some of my research shows that as few as one-third of respondents in a sample of people over the age of 50 understand three basic concepts of financial planning: Interest compounding, the effects of inflation, and risk diversification. In addition, lack of planning is very widespread. Just over 30 percent of older respondents have ever attempted to calculate how much their family needs to save for retirement and of those who tried many were not able to come up with a plan. Most workers also display little or no knowledge of critical variables for financial planning, like the age at which they can receive Social Security benefits, or basic characteristics of their pension plan. Another feature I noted in my research is that, even though they are not the main earner in the family, many financial decision makers are women. That means financial advice needs to be offered to those who make financial choices in the household, not just those who bring home the primary paycheck. It is again noteworthy that IBM has allowed spouses and partners to participate in education sessions and to access the company's financial advice initiative.

Concluding Remarks

Should companies follow IBM's lead? We do not know yet. The costs are hefty: IBM plans to spend $50 million over five years. There needs to be a rigorous evaluation of the effectiveness of this program—too many financial education initiatives go untested. But the odds are in IBM's (and its workers') favor, and every company should spare some thoughts to this large initiative.

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