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Education Nation

Emerging best practice standards relating to financial literacy of plan participants

THE AGING U.S. population and the accelerating shift from defined benefit plans to defined contribution plans has made the issue of financial literacy increasingly important in ensuring a secure retirement income. This has led policymakers to recommend measures that are evolving rapidly into a set of best practices that employers should consider adopting. These evolving standards regarding financial literacy could prove to be burdensome for plan sponsors and financial advisers alike, but also quite helpful to plan participants and, therefore, a net positive to plan sponsors and their advisers. It is important to stay abreast of change in this area to better fulfill your duties and expectations of plans and plan participants.

In 2007, the ERISA Advisory Council formed a Working Group on Financial Literacy which made a series of recommendations for consideration by the Secretary of Labor relating to participant education and advice. The group proposed the creation of a DoL-sanctioned best practices grid that would illustrate the core financial literacy skills needed for the successful retirement of differently situated employees, as well as updating Interpretive Bulletin 96-1, which sets out examples of the types of information, materials, and educational services that can be furnished to participants without constituting investment advice.

The primary concern driving the Working Group, as well as attentive employers, is that despite the ease and convenience of investing over the Internet, employees are doing poorly in handling responsibility for their own retirement. The Group concluded that plan participants must be given the tools to make sound investment decisions. The Group heard unanimous testimony that participants must have familiarity with concepts such as the time value of money, asset allocation, risk management and taxation, as well as knowledge about their plan's investment options. These matters generally fall within the investment education safe harbor.

Participants also need to have a working knowledge of particular plan design features, such as the ramifications of the plan's various distribution options, the calculation of minimum withdrawals, and the rules relating to rollovers. Furnishing information as to the benefits of plan participation and/or increasing plan contributions, the effect of preretirement withdrawals on retirement income, the terms of the plan, and how the plan operates are also matters that are within the investment education safe harbor.

The modern 401(k) plan demands active participant involvement. However, the Working Group discovered that participants had no idea how much money will be required to provide an income stream at retirement that will support their current standard of living. Furthermore, they frequently misunderstood concepts, such as life expectancy, investment returns, and other variables that are elements of a proper retirement income replacement calculation. Consequently, it urged the DoL to encourage the inclusion in plan communications of retirement income replacement calculations and final pay multiples on a per participant basis. As stated in the Group's report, "Plan communications should encourage participants to have a numerical goal....At the very least, participants should be able to determine and have access to an estimated account balance necessary for retirement." If adopted, the Working Group's recommendations would extend the investment education safe harbor from retirement income calculators to such matters as mandatory 20% tax withholding, the 10% penalty tax on early withdrawal, and calculations of guaranteed income for life.

The Working Group found that third-party education via the Internet is not being widely used. There was a consensus that several face-to-face financial counseling sessions over a lifetime work best for the purpose of learning financial topics and modifying participant behavior. Mandatory one-on-one counseling may be appropriate before certain events, such as retirement, making a lump-sum withdrawal, or electing the purchase of an annuity with plan assets. In order to minimize the inhibiting factor of cost, a standardized set of counseling and instructional materials should be developed to assist employee decisionmaking.

The available literature indicates that employee response to workplace financial education programs is generally favorable. Some employers have reported that the reaction to preretirement planning seminars has been that the seminar was one of the best benefits offered. Studies have shown that financial education is also effective in eliminating bad financial habits. This is critical because, in the end, training and communication must pave the way to employee action that results in retirement income adequacy.