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Work Sample

Six-point plan can help workers to achieve a solvent retirement

When President Bush signed the Pension Protection Act (PPA) in August, he eliminated any doubts about the federal government's approval of automatic enrollment features as a tool to help employees reap the benefits of 401(k) plans.

The PPA stipulates that 401(k) plan sponsors will receive the same relief from liability as traditional affirmative enrollment plans under 404(c) rules governing investment options for default fund selections under automatic enrollment plans. And in late September, the Labor Department proposed, for public comment, a set of detailed regulations spelling out the particulars.

But even before the PPA's enactment, surveys and anecdotal evidence made it clear that a coordinated set of automated services for 401(k) plans, resting on a foundation of automatic enrollment, holds the key to helping the vast majority of plan participants achieve financial security in retirement.

Education tools not sufficient

"We have known for some time that simply providing the best educational tools and investment choices isn't enough to put most employees on the right path to a financially sound retirement," says Charles E. (Charlie) Vieth, president of T. Rowe Price Retirement Plan Services, Inc.

"According to our experience and survey data from the Employee Benefit Research Institute, a large percent of employees don't have the time, interest or motivation to take an active role in planning for their retirement." Vieth points to the fact that although overall 401(k) *participation* rates have remained steady in the mid- to high-70's percentage range, average *deferral* rates among non-highly compensated employees have stagnated at a 5% average for the past decade, according to the Profit Sharing Council of America.

"A 5% deferral rate is not even close to what most employees need to be setting aside," he says. "The good news," Vieth adds, "is that we now have a very good idea of what it takes to turn this trend around." Specifically, Vieth outlines a six-point best practices model that is "both realistic and achievable." These are the components:

1. Enroll employees in the plans automatically.
2. Set the initial deferral rate at 6%.
3. Automatically ratchet up participants' deferral rates by 2% annually, to a maximum of 20%.
4. Put the onus on employees to opt *out*, rather than opt *in*, of these plan design features.

5. Use “target-date” funds as the default investment.
6. Re-enroll non-participants and every year.

Over time, the impact of implementing this integrated set of recommendations can be very significant (see chart).

The basic concept of auto-enrollment is now widely accepted among plan sponsors, but starting off with a 6% default deferral rate may strike some as overly aggressive.

Redefining “safe”

“Historically, sponsors have gone with a 3% rate, considering it ‘safe’ and assuming that if they went any higher, employees would opt out,” Vieth says. “Our research shows that a 6% rate is acceptable to most participants.” (He also urges sponsors to align their matching contribution formulas to that 6% initial rate. For example, use a 50% match on up to 6% of the employee deferral, instead of a 100% match on up to 3% of deferred salary to encourage higher employee deferral rates.)

Vieth also notes that many employers starting off with low default deferral rates expect to coax participants to raise their deferral rates after they’ve taken that initial small step. “Unfortunately, once enrolled, most participants remain at their default deferral rate – which is often far too low for effective long-term retirement savings.”

Indeed, financial advisors say the typical employee needs to save at least 15% each year just to replace 50% of their salary at retirement. That’s the basis of recommendation number three -- automatically bumping up deferrals by two points each year. Given the inertia that generally governs employee retirement savings behavior, even starting with a healthy 6% deferral rate will doom most employees to inadequate savings without this auto-bump-up feature.

And, as with the “aggressive” 6% initial minimum deferral rate, most employees are willing to step up in 2% increments, despite the common view that anything above 1% would trigger a participant revolt.

“Employers can mitigate the pain of the increase by having it coincide with annual salary increases,” Vieth says.

How far can this principle be extended? “Our research indicates that participants will agree to invest their savings up to 20% when increased over time,” Vieth adds.

The PPA and the proposed Labor Department regulations provide some relief for fiduciaries who prudently selected default investment choices for auto-enrollment plans. Prior employer concerns about default investments led many sponsors to choose “stable value” investments that, ironically, pose a high risk that participants won’t achieve their savings goals.

Now sponsors can confidently set diversified, asset allocated “target-date” funds as their default investment, because such funds are specifically listed in the proposed Labor Department regulations’ set of “qualified default investment alternatives.” Target-date funds adjust asset allocations as the target retirement date advances, and are expected to generate potentially higher returns than stable value funds.

Finally, some employees will overcome inertia and opt out of participating in an auto-enrollment plan, or will participate but opt out of default deferral rates and investment funds. “That’s why it’s important to treat retirement plans just like a health care plan, which employees must revisit every year,” says Vieth.

During this annual cycle, all eligible non-participating employees should automatically be re-enrolled in the 401(k), he says.

At a minimum, requiring annual re-enrollment, along with all the other elements of the best practices model, will help to assure that the 401(k) serves as a vital component of employee compensation. Beyond that, by adopting this model, “sponsors will know they’ve made every effort to encourage all their employees to confront the challenges of saving for retirement,” Vieth says.

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