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Taking Auto Enrollment and Auto Contribution Escalation to the Next Level

According to Employee Benefit Research Institute findings, the typical low-income worker, in particular, will need to save significantly more than he or she does today in order to achieve retirement income security.

By Lori Lucas

If the past few years of defined-contribution plan investing has taught us anything, it is that participants cannot rely on the stock market to make up for poor savings habits. In fact, according to Callan's DC Index, only 1 percent of the 4.34 percent annualized growth in DC plans since the mid-2000s has been due to total returns. The rest has come from cash inflows (participant and plan sponsor contributions).

However, according to Employee Benefit Research Institute findings, the typical low-income worker, in particular, will need to save significantly more than he or she does today in order to achieve retirement income security. Likewise, a T. Rowe Price study finds that the average employee/employer contribution to DC plans is 8.5 percent—well below the 15 percent of annual pay that many financial planners recommend investors save over a full career in order to replace pre-retirement income.

Finally, a Callan study shows that while a career plan participant with 9 percent annual employee and employer contributions replaced more than 70 percent of pre-retirement income about one-third of the time over 40-year rolling periods between 1926 and 2008 (investing in the typical target date fund), that participant replaced, on average, in excess of 70 percent of pre-retirement income most of the time when contributions totaled 12 percent of pay per year.

Statistics such as these have prompted many plan sponsors to offer automatic enrollment and automatic contribution escalation (where deferrals are periodically automatically increased) to boost plan savings. That's a good start. But even with these features available, participants in DC plans may not necessarily be well-positioned to reach retirement success. As with most things, the devil's in the details. In the case of automatic enrollment and automatic contribution escalation, it is all about implementation.

According to a recent Callan survey, the average default contribution rate for plans offering automatic enrollment is 3.6 percent. Many automatic contribution escalation arrangements increase deferrals by 1 percent a year, and cap deferral increases at 10 percent of pay. In fact, EBRI found that less than 20 percent of plans are structured to enable participants to automatically (through auto enrollment and auto contribution escalation) achieve a 9 percent deferral rate in less than six years of participation. Most plans, in fact, are structured so that employees would never achieve a 9 percent deferral rate, unless the employee took proactive action to do so (e.g., increasing the contribution on his or her own).

Plan sponsors often cite concerns about high opt-out rates if contribution defaults are too aggressive. After all, what good is it to default someone into the plan at such an aggressive level that they simply drop out right away? However, research finds that opt-out rates are similar regardless of whether the default deferral rate is a highly conservative 3 percent or a more aggressive 6 percent.

Plan sponsors also note that participants always have the abil-

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ity to increase their contribution levels at will. However, again research doesn't support this, finding that participants are apt to remain with defaults for years, no matter how inappropriate the defaults might be for their situation. This is especially true for lower-paid participants versus higher-paid ones.

Plan sponsors also worry about participant "noise" if deferrals are escalated too quickly (e.g., by 2 percent annually instead of by 1 percent, for example), or if they are escalated to a high level (e.g., past the match threshold). However, research has shown that when participants proactively elect the level at which they wish to cap their deferrals under automatic contribution escalation, the most common paycheck deferral cap is not 10 percent, but 15 percent or higher.

The reality is that unless more aggressive contribution defaults are used, participants may struggle to ever reach the target 15 percent annual contribution rate—unless a very significant company contribution is in place. Simple math bears this out. According to the Bureau of Labor Statistics, the median tenure of employees is 4.1 years.

Imagine the average employee moving from job to job every four years or so. Imagine now that this employee is defaulted into his or her new plan at 3 percent of pay each time they join a new company. After that, the employee's deferral is auto escalated by 1 percent a year with a 10 percent cap.

Unless the employee takes proactive action to increase his or her contributions (which we know often does not happen), paycheck deferrals into any of these plans will never exceed 6 or 7 percent (3 percent in year one; 4 percent in year two; 5 percent in year three; 6 percent in year four). Combine that with the typical employer contribution of 3 percent of pay and such an employee will fall well short of the target 15 percent annual savings rate, despite the presence of automatic enrollment and automatic contribution escalation.

Compare that with an employee who is defaulted into plans every four years or so at 6 percent and auto escalated at 2 percent per year with a cap of 15 percent. Now the employee's deferrals can automatically reach 12 to 14 percent of pay—even without counting in the employer contribution. This clearly places the employee in a dramatically better position to replace income in retirement.

Of course, there are other reasons for plan sponsors to favor conservative default contribution rates and modest auto escalation features. If there is a matching contribution, cost can clearly be a factor. If salaries have been frozen or reduced, plan sponsors may find the environment challenging to automatically increase plan contributions.

As such, some plan sponsors may prefer to keep their conservative defaults in place and instead step up communication programs, encouraging the use of retirement calculators, advice or managed account services to get employees to save more. Another increasingly popular means of encouraging increased savings is retirement income gap analysis that is pushed out to employees either through quarterly plan statements or on the benefits website.

By translating account accumulations into income in retirement, so the thinking goes, it is easier to help employees grasp how much more they need to defer now in order to live comfortably on their savings post-age 65. Such analysis is becoming standard fare among DC record keepers. Finally, postcard campaigns that allow participants to check the box in order to increase savings continue to show strong results, helping employees overcome their inertia by making it simple for them to proactively save more in their DC plan.

The fact that nearly half of plans have automatic enrollment—and that a third have contribution escalation—points to the success of this part of the 2006 Pension Protection Act, and to DC plan sponsors' commitment to helping employees meet their retirement savings goals—despite employee savings inertia.

With increasing reliance on DC plans as the only employer-sponsored retirement vehicle, however, it now may be time for some DC plan sponsors to up the ante and encourage even greater savings by tweaking the defaults of their plan's auto features. At a minimum, plan sponsors may wish to get the word out: If employees are going to be able to retire when they want to, they are going to have to save very aggressively in their plan.

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