

401(k)

Enhancing 401(k) Value and Participation

Taking the Automatic Approach



Executive Summary

With their growing prevalence over the last few decades, 401(k) and other defined contribution (DC) retirement plans have become a critical piece of the retirement puzzle for most private-sector employees today.

This is especially true in smaller companies and those of fairly recent vintage because 401(k)s are likely to be the only retirement program offered in these organizations. But, even in large and old-line businesses in which traditional defined benefit (DB) pension plans remain common, it's important for employees to take responsibility for their retirement planning and save for retirement in order to achieve targeted income replacement levels.

Because of the tax advantages of 401(k)s and the fact that many companies match employees' contributions in these plans up to certain limits, 401(k) plans represent an especially powerful way to save for retirement. Corporate America's ongoing shift in emphasis from DB to DC retirement plans

only heightens the need for employees to take maximum advantage of the 401(k) saving opportunity.

Having a 401(k) plan is a high value benefit for employees for a variety of reasons. The plans provide a tax-effective way to save for retirement efficiently via payroll deductions, provide a clear “account balance” of savings, provide a benefit that is “portable” and can be transferred as employees change jobs, and also in most cases enable the employee to manage their investments based on their needs.

Nevertheless, a sizable percentage of those eligible to invest in 401(k)s—on the order of three out of ten employees, according to some studies—do not choose to participate in these programs. Research also shows that many of those who do contribute to 401(k)s don’t save enough to meet their likely retirement income needs. When employers match employees’ contributions, employees who fail to participate are, in effect, leaving significant employer dollars on the table. As a result, many working Americans risk having insufficient savings for retirement in an era when people are living longer than ever before, and health care costs continue to increase at rates far in excess of overall levels of price inflation. As a result, these trends are creating increased challenges for government insurance programs including health care and Social Security. The need for enhancing retirement funding has never been greater.

Employers have plenty of reasons to be concerned about employee understanding of and participation in 401(k) plans. Research into employee attitudes shows that retirement benefits, including DC plans, can be a powerful factor in attracting people to an organization. With increased competition for skilled talent and the focus at companies on innovation and customer service, this is an issue that is top of mind. And, when employees are given the chance to tell their employers what rewards they value most, they often emphasize the importance of the DC plan employer match. But to leverage the value that employees see in 401(k) plans, employers must count on employees to take action; that is, to participate in the 401(k) and manage their DC investment portfolios with care.





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Concerns about low levels of 401(k) participation and the need to make these plans more valuable to support a range of key workforce and rewards goals have prompted some employers to begin adding automatic features to their plans in recent years. Automatic enrollment is one example. With this feature, the default option is for employees to be enrolled in the plan at a minimum contribution level when they first become eligible. Participation is automatic but not mandatory; employees who do not wish to participate may opt out of the program. Automatic enrollment—along with other “auto” features such as

automatic rebalancing of investments, “lifecycle” funds and automatic increases in employee contribution levels—are designed to overcome employees’ inertia or lack of knowledge about saving and investing for retirement. These are the common barriers that prevent some workers from getting into the 401(k) saving habit. In a sense, these features mimic the more “automatic” attributes of traditional DB pension plans to help employees make prudent financial choices today to prepare for tomorrow’s retirement. (See page 4 for an overview of some key differences between 401(k) plans and traditional DB pensions.)



The DB–DC Evolution and the Importance of ‘Automation’

The continuing shift from traditional defined benefit pension plans (DB) to 401(k)s and other defined contribution (DC) arrangements has been well documented over the years. The primary form of retirement benefits offered by U.S. companies as recently as 20 or 30 years ago, DB pension plans now cover only about half as many U.S. workers in private industry as 401(k)s, according to the Bureau of Labor Statistics’ National Compensation Survey.¹ National Compensation Survey data from 2006 shows 21% of private sector workers had access to DB plans, while 54% had access to DC plans. Recent instances of major U.S. companies closing their DB plans to new hires or terminating them altogether point to even lower levels of pension plan participation in coming years.

One of the primary differences between DB and DC plans is that DB plans are, in a sense, automatic. Employees in jobs covered by traditional pension plans participate in those plans automatically after working long enough to meet the plan’s eligibility requirements. Their

“pension money” is invested for them by the plan sponsor and typically paid out in equal installments when they retire according to an automatic benefit formula set by the plan.

In the typical 401(k) plan, by contrast, nothing is automatic and active employee involvement is critical. In fact, the employee usually has the option of whether to participate in the plan at all. The employee must make proactive choices about how much to save in the plan, how those savings are invested, and when and in what amounts payments are received. For employees who find these choices confusing, if not overwhelming, automating plan participation and putting ongoing investment decisions on auto-pilot via features like automatic re-balancing can mean the difference between a secure retirement and no retirement savings at all. The government continues to shape the future direction of retirement programs with new regulations implemented or being considered. This leaves a key open question as to what will be the best mix of employer action or new government rules to close the growing gaps.

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According to research by Deloitte Consulting, however, only about a quarter of large private employers in the United States offered automatic 401(k) enrollment as recently as 2006.² Concerns about added 401(k) costs and potential liability for participants' investment losses were among the considerations that have discouraged many employers from adding automatic features to their 401(k)s until recently. With the enactment of the Pension Protection Act (PPA) of 2006, Congress offered new encouragement to companies interested in taking the automatic approach by clarifying employers' fiduciary liability and providing some "safe harbors" that plan sponsors can follow in designing automatic enrollment features to limit their potential liability.

To help employers better understand recent trends in 401(k) design and the pros and cons of automating 401(k) participation, AARP asked Towers Perrin to review the published research on 401(k) prevalence, participation and design and to analyze Towers Perrin's own proprietary data on employer and employee views of 401(k)s and other reward components. The research team also conducted in-depth interviews with a number of U.S. companies to get an up-to-date view of employers' thinking and current approaches to enhancing 401(k) participation. Among the key research findings:

- Despite the continuing challenges involved in maximizing 401(k) participation, U.S. companies recognize the growing importance of 401(k) plans and are focusing increasing attention on boosting their 401(k) participation rates to address a range of key business and workforce objectives.
- U.S. employees, for their part, also show growing awareness of the pivotal role that 401(k) plans play in their total reward package. Indeed, according to data from Towers Perrin's latest *Global Workforce Study* involving more than 60,000 U.S. employees, competitive retirement benefits, including a 401(k) plan, are among the top 10 considerations for today's employees in choosing an employer—and are even more important to workers age 50+ and to employees in certain industries.
- Towers Perrin's research on behalf of individual employers suggests that employer contributions to 401(k)s typically offer a larger, positive return on investment (ROI) that can sometimes exceed the ROI for spending on other key reward elements, such as pay and bonuses. This high ROI is likely due to employees increasing focus on retirement savings and security.

To maximize the employer's return on 401(k) investments, however, it's critical for employees to participate in the plan at a meaningful level of individual savings and to manage their savings carefully over time. Adding automatic 401(k) features offers a solid payoff in this regard. In fact, one study by the Employee Benefit Research Institute, conducted in July 2005, projects that automating 401(k) participation can bring a significant increase in retirement savings at all income levels and more than double the income replacement rate for employees in the lowest income brackets.³

Here's a closer look at Towers Perrin's research findings.