Getting the Horse to Drink

Most employers understand the frustration of seeing their employees pass up retirement savings opportunities. This article reviews the problem of insufficient retirement savings and describes simple plan design features that can make it easier for employees to do what’s best for their financial futures. The author provides a case example showing what impact such changes can have on participation, deferral rates and account balances.

by Jerry Patterson | Principal Financial Group®

Your organization’s retirement plan is a big investment—in terms of both benefit dollars and staff resources. It’s also an important factor in your organization’s ability to attract and keep top employees.

But is it actually working?

Will your employees be financially prepared to retire on time? Or will they keep working past their planned retirement date just to pay the bills? Do they have the knowledge (and the confidence) to make smart decisions about their retirement savings? Or are they frozen by confusion and fear?

The answers to these questions affect not only your employees’ financial futures but also your organization’s bottom line—beyond what’s invested in the retirement plan itself. In fact, experts estimate that for every employee who delays retirement beyond normal retirement age, the employer pays $5,000 more in health care costs each year.¹

A National Dilemma

If you think your organization’s retirement plan isn’t as effective as it should be, you’re not alone. Studies show that retirement plans across the country could do a better job of preparing participants for retirement.

For instance, well over half (56%) of U.S. workers don’t think they’ll be financially prepared for a comfortable retirement, according to the Principal Financial Well-Being Index (Fourth quarter, 2014). And just 22% of workers are very confident they’ll have enough money to live comfortably throughout their retirement years.²

Workers are right to be concerned. The retirement industry generally uses a target income replacement ratio of 85% of projected salary prior to transitioning to retirement as the way to measure if a participant is on track. Our analysis indicates a savings rate of at least 10% plus employer contributions may be needed over a 40-year working career to reach this target income replacement ratio.

But currently, very few participants save at this level. Nationally, the average 401(k) deferral rate is just 6.7%.³

What’s the Problem?

For the most part, the issue in the United States isn’t access to employer-sponsored retirement plans. Seven out of ten workers (71%) report having access to a retirement savings plan at work, and 83% of those eligible workers contribute.⁴

But clearly, employees aren’t taking full advantage of the retirement plans available to them. Why?

It all comes down to human psychology and behavioral finance. There are some very powerful behavioral barriers
How One Company Encouraged Higher Employee Savings

Company: A leading construction firm with regional scope and national recognition, ranked yearly on the Engineering News-Record Top 400 Contractors list and as a Top Ten employer in its home state.

Challenge: The firm wanted to encourage savings behavior within its workforce to help ensure better retirement outcomes. Its retirement plan design already included automatic enrollment and a discretionary matching contribution. But an analysis indicated the organization and its employees were not getting the most out of the retirement plan.

Motivated by a strong desire to make sure employees had opportunities to meet their retirement savings goals, the firm consulted with its plan advisor and created a game plan to improve participant outcomes.

Action: The firm adopted the following automatic features to encourage better savings behavior:

- Increased the automatic enrollment elective deferral default from 2% to 6% to foster higher savings rates
- Automatically swept all eligible employees deferring less than the automatic enrollment default (those deferring 0-5%) to a 6% deferral percentage. This approach ensured that longer term employees also benefited from the plan design changes by starting or improving their savings activity.
- Implemented a default automatic escalation feature to help make sure employees’ contributions increase by about 1% each year.

Result: By implementing the suggested approach to plan design, the firm achieved the following:

- Participation: Automatic enrollment and a sweep of eligible employees increased participation by nearly ten percentage points.
- Average deferral rate: Average deferral percentage increased by about one percentage point with the use of automatic escalation.
- Average account balance: Automatically escalating the deferral rate increased the average account balance for this firm’s participants by more than $12,000.

(Figure 1: Impacts of Automatic Plan Features)

Automatic enrollment and sweep of eligible employees INCREASED PARTICIPATION BY ABOUT 10 PERCENTAGE POINTS

Average deferral percentage INCREASED BY ABOUT 1 PERCENTAGE POINT with use of AUTOMATIC ESCALATION.

Automatically escalating the deferral rate INCREASED THE AVERAGE ACCOUNT BALANCE for this client’s participants BY MORE THAN $12,000.

(Before, as of April 30, 2013: participation 85.92% and average deferral 7.52%; after, as of March 31 2014: participation 95.20% and average deferral 8.38%. Average account balance before, as of March 31, 2013: $140,743.86; after, as of March 31, 2014: $152,752.77.)
that make it hard for human beings to actually save, even though we express the desire and intent to do so. We know we should.

Essentially, we don’t care enough about our future selves to make saving for retirement a priority. This is as true for Millennials in a state of delayed adulthood as it is for retiring baby boomers who believe they will live forever and can always go back to work.

Make Saving Easier Than Not Saving

It’s clear you can lead this horse to water, but you can’t make it drink. However, you can make taking a drink the easier of two alternatives.

Specific plan design features make it possible to do just that within your organization’s retirement benefit. Automatic enrollment is a great example.

With automatic enrollment, workers don’t have to make a decision. That means inertia simply isn’t an issue. And industry experience shows that workers recognize the value of automatic plan features and overwhelmingly do not opt out when automatically enrolled.

Proven Plan Design Features

How can you adapt your retirement plan to make it easier for employees to save—and save enough—for retirement? We suggest:

• Automatic enrollment with at least a 6% elective deferral
• Automatic escalation of at least 1% per year up to 10%
• Sweeping all existing employees into the plan at least one time at the default deferral rate
• Stretching the match by using a formula that gives employees an incentive to defer at higher levels in order to get the full employer match—without costing the employer anything extra in matching funds
• Using an asset allocation option—such as a target-date investment option—as the qualified default investment alternative (QDIA).

Widespread Acceptance Among Participants

Participants have shown overwhelming acceptance of automatic plan design features. Among the retirement plans we service, 91% of participants who are automatically enrolled choose to stay in the plan. And 88% of participants whose contributions are automatically escalated accept the increase.

What’s more, instead of opting out of automated features, many participants choose to contribute even more. Of the 91% who accept participation, 44% remain at the default deferral rate. But 41% choose to raise their deferral rate above the default. Just 6% decide to reduce their deferral rate below the default.

Our data is supported by research on the industry as a whole. According to the Employee Benefit Research Institute (EBRI) 2015 Retirement Confidence Survey, 30% of workers would raise their contribution to their workplace retirement plan if automatically enrolled at 6%. Well over 40% would continue the contribution at 6%, and only 3% would stop contributing altogether.

In terms of automatic escalation, the EBRI study showed that nearly a quarter of participants would allow their employer to increase their salary contribution 1% each year until their contribution reached 10-14%. Nearly another quarter would let their employer increase their salary contribution 1% per year until their contribution reached 5-9%.

Make It Easier for the Horse to Drink

 Retirement plan participants need help to make the progress that’s clearly needed. Plan sponsors can provide that help by adopting certain plan design features. (See sidebar.) For example, most matching formulas phase out at 3-4%.

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Unfortunately, that doesn’t get savers to an adequate level. That’s where plan design comes into play (again). Tactics like stretching the match can help employees save more without costing the employer anything extra. For example, instead of offering a 100% match for employee contributions of up to 3% of salary, the employer could offer a 50% match of employee contributions of up to 6% of salary.

We continue to see organizations that adopt these plan features have tremendous success in better preparing their employees for retirement. At the same time, plan sponsors can get more out of their investments in retirement benefits and help employees retire successfully—and on time.

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Endnotes

1. EBRI estimate, October 2013.
2. 2015 Retirement Confidence Survey, EBRI.
4. 2015 Retirement Confidence Survey, EBRI.