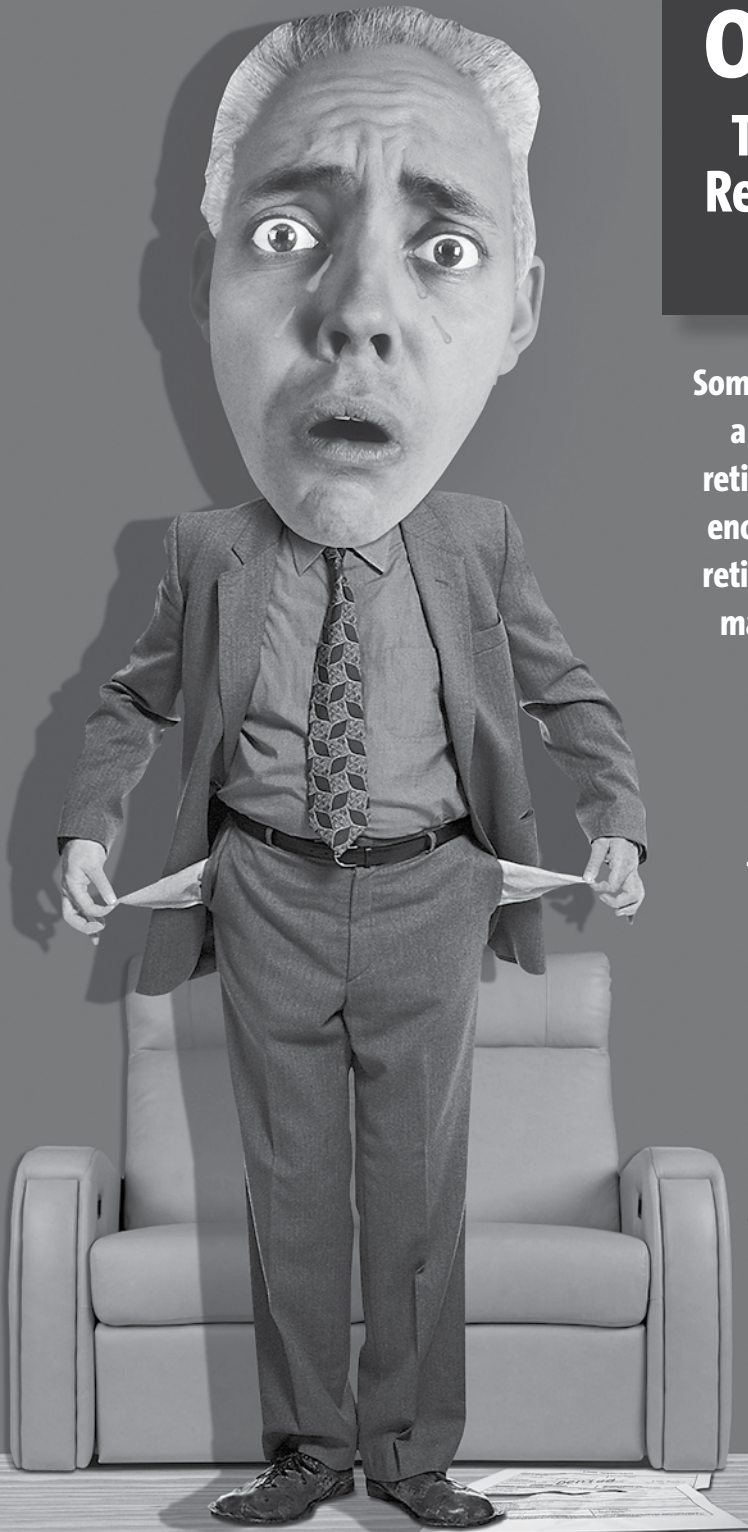


# Ready or Not...

## The Impact of Retirement-Plan Design

Some 10,000 baby boomers  
a day are heading into  
retirement. Will they have  
enough income to finance  
retirements that, for some,  
may last as long as their  
working careers?

BY  
NEVIN ADAMS  
AND  
JACK VANDERHEI



## What factors influence retirement readiness? How can the way retirement plans are designed and regulated help (or hurt) households seeking to fill their nest eggs?

The Employee Benefit Research Institute has been focusing on the adequacy of retirement income for some time, beginning a major project to measure it in the late 1990s at the request of several state governments. Building on that work, the EBRI developed a national model for simulating retirement income adequacy (the Retirement Security Projection Model) in 2003.

That model has since been updated to incorporate changes in retirement plan design and regulation, among them the impact of freezes in traditional corporate pension plans (also known as defined-benefit plans), automatic-enrollment provisions for 401(k) plans, the consequences of the Great Recession, ongoing demographic trends and the evolving savings behavior of some 23 million 401(k) plan participants. The research institute uses the statistical computer model to simulate alternative retirement paths for each household to account for risks linked to investment returns, longevity and health care costs.

### MODEL PORTFOLIOS

The institute's model does not rely on simplistic retirement-income targets like a fixed replacement ratio. We developed a more sophisticated metric: the EBRI Retirement Readiness Rating, which measures the share of households that are at risk of not having enough retirement income by simulating 1,000 hypothetical life paths to retirement. A household's path to retirement is considered at-risk if its total financial resources will likely be insuffi-

cient to meet estimated expenditures.

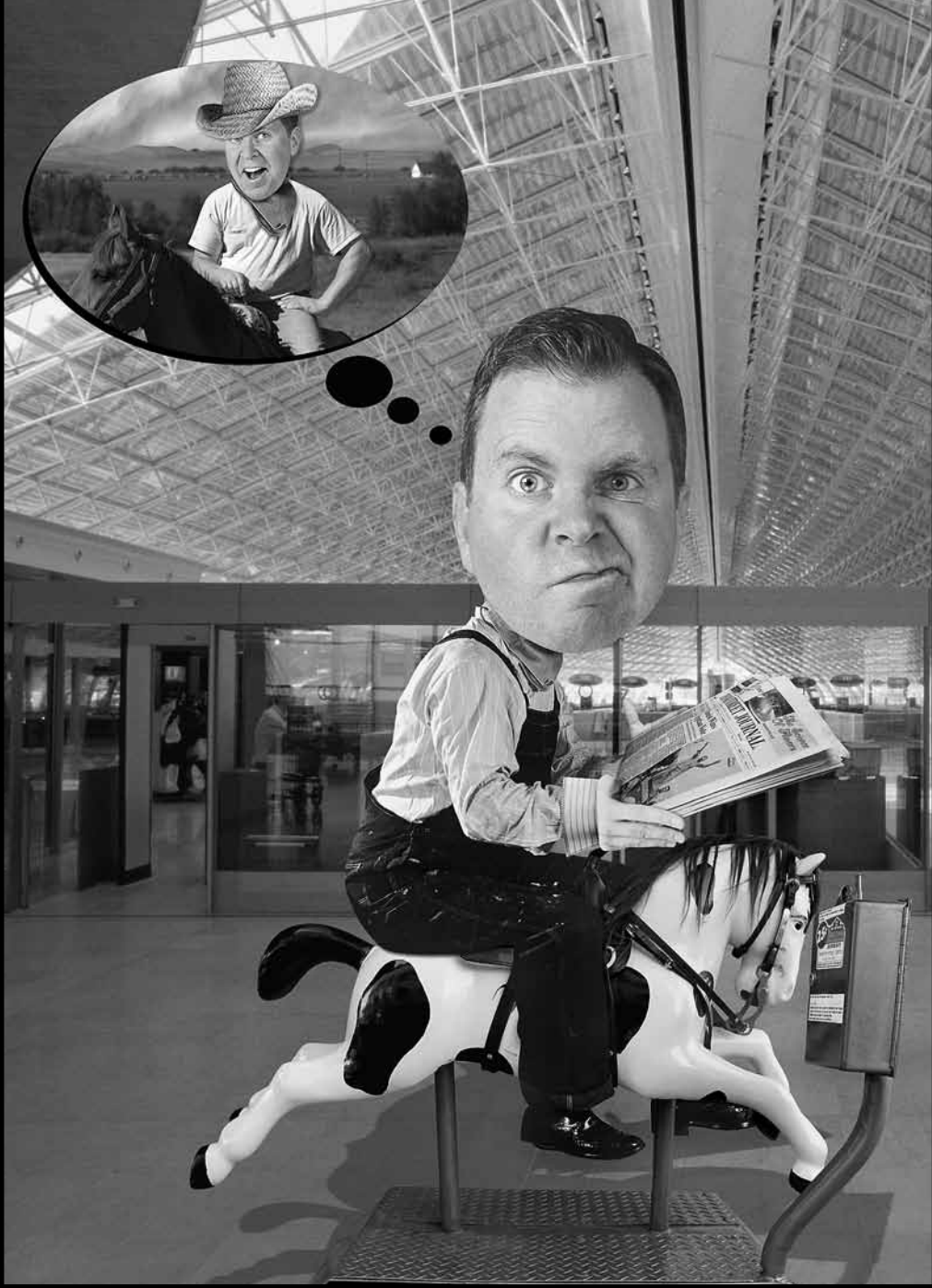
On the financial-resource side, we include Social Security, balances in retirement accounts, annuities or lump-sum distributions from defined-benefit pension plans and housing equity. On the expenditure side, we incorporate not only basic living expenses, but also long-term care and nursing expenses (adjusted for the statistical probability of needing them), which are overlooked by some models.

Earlier this year, we modeled the retirement readiness for early boomers yet to reach age 65 (those born between 1948 and 1954), late boomers (1955 to 1964) and Generation Xers (1965 to 1974), and estimated that approximately 56 percent of these American households were on track to have sufficient resources to cover basic retirement expenses and uninsured health care costs. While that means that 44 percent were not on track, the 2012 reading was an improvement of five to eight percentage points over the projections we did in 2003 – an improvement largely attributable to the expansion of automatic-enrollment provisions in 401(k) plans following the passage of the Pension Protection Act of 2006. Before that legislation, participation rates among lower-income employees (those most likely to be at risk), were relatively low because they had to “opt in” to workplace retirement-savings programs like 401(k)s – that is, to sign a document declaring they wished to set aside money from their paychecks.

The retirement-savings shortfall in the aggregate – the projected amount lacking to provide adequate retirement income for all baby boomers and Generation Xers when they reach 65 – is a staggering \$4.3 trillion. However, while a multi trillion dollar projection makes for eye-catching headlines, it does

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**NEVIN ADAMS** is the director of education at the Employee Benefit Research Institute, a nonpartisan, nonadvocacy group that focuses on health, savings, retirement and economic-security issues, and director of the American Savings Education Council. **JACK VANDERHEI** is the institute's director of research.



little to direct attention to the groups at greatest risk or to offer insight on ways to reduce that risk.

The retirement-savings shortfalls are based on individual retirement income deficits. On average, the additional savings required for those on the verge of retirement (early boomers) at age 65 ranges from approximately

\$22,000 (per individual) for married couples to \$34,000 for single men and \$65,000 for single women. The projected shortfall is larger for younger cohorts, primarily because we have assumed that health care-related costs not covered by Medicare, Medicaid or private insurance will increase faster than the general rate of inflation, as has been the trend.

## **RETIREMENT PLAN DESIGN**

If you include only those households projected to run short of funds, the average additional savings required for early boomers ranges from approximately \$70,000 (per individual) for married couples, to \$95,000 for single men and to \$105,000 for single women. Thus, when looking only at households calculated to be at risk, the average shortfall is larger – sometimes considerably so.

Lower-income households were found to be much more likely to be at risk, even though basic retirement expenses are assumed to be

the Pension Protection Act included provisions that have encouraged the adoption of certain automatic plan-design features by 401(k) plans, including automatic enrollment, automatic escalation of the amount of income deferred and the utilization of investments like target-date funds, as default choices. So, in contrast to the traditional type of 401(k) plans, where employees were required to opt in, 401(k)s with automatic-enrollment provisions automatically enroll the employees in the plan at predetermined contribution rates, but give them the ability to opt out at any time.

### **One of the most important factors contributing to retirement-income adequacy is eligibility to participate in employment-based defined-contribution plans.**

lower in our model for this group. Some 87 percent of early boomers in the lowest-income quartile fall into the at-risk category, compared with only 13 percent among the highest-income quartile. Similar trends were found for both the late boomers and Generation Xers.

#### **CLOSING THE GAP(S)**

Previous research by EBRI suggested that one of the most important factors contributing to retirement-income adequacy is eligibility to participate in employment-based defined-contribution plans. For example, Generation Xers with no future eligibility to participate in these plans would run short of money in retirement 61 percent of the time, compared with fewer than 20 percent of those with 20 or more years of future eligibility.

Of course, the reason that eligibility to participate has such a significant impact on retirement income adequacy is that most (though not all) of those who are eligible to participate choose to do so. As noted above,

Industry studies have found that this relatively simple plan-design change can increase participation rates substantially, overcoming the inertia that has traditionally hindered the participation of some workers – notably those who are younger and have smaller paychecks. In fact, a recent Aon Hewitt study found that just 23 percent of workers with less than a year of tenure voluntarily chose to participate in traditionally designed retirement plans, versus 78 percent of those eligible for plans with auto-enrollment provisions.

In 2010, the research institute simulated the impact that this automatic-enrollment plan design could make and found that the median 401(k) balances at retirement age for workers who are now 25 to 29 would increase from approximately 1.5 times final earnings under voluntary enrollment to more than 6 times final earnings in the auto-enrollment scenario. Additionally, we found that there is a much greater difference in median 401(k) accumulations in the alternative designs for low in-



come employees than for their higher-income counterparts.

### **AUTOMATIC ESCALATION**

According to industry surveys, the most widely adopted default contribution rate for automatic enrollment plans is a relatively modest 3 percent of compensation. Realizing that (even with a common employer match) this is an insufficient amount of savings to generate adequate retirement income when combined only with Social Security benefits, some 401(k) sponsors have chosen to embrace a plan design feature called auto-escalation. This automatically increases the employee contribution rate each year (generally by 1 to 2 percent of compensation) until the rate reaches the plan maximum (usually 15 per cent, with a dollar cap); employees can always opt out of the automatic escalation. Plans with this feature have not been in widespread use very long, and it will therefore take several years to determine exactly how both plan sponsors and plan participants will respond.

In a joint 2010 study with the Defined Contribution Institutional Investment Association, we used the rule of thumb that retirees would need 80 percent of preretirement income (in real terms) to live adequately and then simulated the share of younger workers (those with three to four decades of retirement plan eligibility ahead) who would reach their adequacy targets by age 65. Success rates for the highest-income quartile employees ranged from 27 percent to 64 percent, the former based on the pessimistic assumptions that employees (a) do not remember their previous contribution rates when they change jobs and thus reset to the default deferral rate with a new employer, (b) at some point opt out of automatic escalation entirely, and (c) automatically increase the initial deferral rate by just 1 percent per year. The highest projected

rates of success came with all optimistic assumptions; that employees (a) did remember their previous contribution rates when they changed jobs, (b) never opted-out of automatic escalation and (c) allowed auto escalation to raise their contributions by two percentage points annually until they reached 15 percent of compensation.

In these projections, the lowest-income quartile employees fare better than their higher-income peers because Social Security replaces a higher portion of their preretirement income. Under similar scenarios, they succeed in reaching the 80 percent replacement rate 46 to 80 percent of the time.

### **DELAYING RETIREMENT**

One of the more recent alternatives proposed to closing the retirement savings gap is to delay retirement – an approach that would have the benefit of both deferring the spending of retirement savings and providing additional time to accumulate retirement funds. There are concerns as to whether this approach represents a realistic alternative for most people in view of current trends in retirement age. Setting those aside, in 2011, we modified our simulation model to consider retirement beyond age 65. Not surprisingly, participation status in a defined-contribution plan at age 65 for a worker is extremely important to the simulation results, because of the possibility of adding contributions to the account. In fact, when household outcomes were divided into those with a worker who remains a defined-contribution participant at age 65 versus those without someone in a plan, we found a substantially improved retirement readiness.

Even when households without a member participating in a defined-contribution plan were assumed to retire five years later (without the benefit of additional years of employee



or employer contributions), retirement readiness increases to 57 percent. In other words, 23 percent of those who would have been at risk if they retired at age 65 are ready to retire at age 70. Among households with an active 401(k) plan, the news is even better: 33 percent of those who would have been at risk if they retired at age 65 would be ready to retire at 70. Clearly, continuing to work until age 70 helps in enhancing retirement readiness, but continuing to work and participate in a defined-

contribution plan until age 70 produces an even more dramatic improvement.

#### **THE IMPACT OF TAX PREFERENCES**

Although the 2006 law encouraged a new wave of plan-design features, like automatic enrollment and auto-escalation, that should have a significant positive impact on retirement savings, a primary financial incentive for many in contributing to a 401(k) was (and remains) the benefit of deferring taxes

on that income until it is spent in retirement. Yet with deficit reduction high on Washington's agenda, these tax preferences are under intense scrutiny.

In September 2011, a Senate Finance Committee hearing explored the potential consequences of modifying current federal tax treatment of contributions to 401(k) accounts with an eye toward reducing the net cost in tax revenues. One possibility on the table was a plan offered by William Gale of the Brookings Institution under which employee and

the role of tax deferral as an incentive to save for retirement. One might have expected lower-income workers, who receive a proportionately smaller benefit from tax deferral, because they are in lower tax brackets, to care the least. In fact, the survey found just the opposite: 76 percent of those earning \$15,000 to \$25,000 (who are in the 10 or 15 percent tax brackets) said the deductibility of contributions was very important. Asked how they would likely respond if the current tax deferral were eliminated, 57 percent (more than any

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employer contributions to 401(k) accounts would no longer be excluded from taxable income. Instead, the government would provide a match of sorts – a flat-rate tax credit that would be deposited directly into the retirement saving account.

Gale acknowledged that the proposal “could conceivably affect incentives for firms to offer 401(k)s or pensions,” but concluded that this would be unlikely. He also gave short shrift to the concern that the government-match approach would discourage employers from providing their own matching contributions.

It is very difficult to determine how many workers not participating in 401(k)s would join if tax policy were altered as Gale proposes. The research institute has, however, made an attempt to estimate the likely costs or benefits in terms of reduced or increased retirement savings for those currently participating in the 401(k) system.

As part of the institute's 2011 Retirement Confidence Survey, workers were asked about

other income group) said they would reduce the amount they would save in these plans.

Following the Finance Committee hearing, we took defined-contribution participant responses to the specific elements of the Gale proposal from the 2012 retirement-confidence survey, as well as plan-sponsor responses to the same elements in a survey fielded by Alliance-Bernstein. Based on those responses, the average percentage reductions in projected savings accumulations for the youngest group (those 26 to 35) were actually largest for those in the lowest-income quartile (22 percent).

Employers, particularly small businesses, are not indifferent to the tax preferences associated with these programs. In response to the same set of questions about the Gale proposal, significant numbers of plan sponsors indicated that they would be less inclined to offer these programs – and that, in turn, would result in fewer workers with an opportunity to save in them. For those in the lowest-income quartile, the average reductions in retirement

## **RETIREMENT PLAN DESIGN**

savings accumulations by participants, both as a result of employer and participant response to the changes, in the two smallest plan-size categories, exceeded one-third.

### **OTHER ISSUES**

#### **Leakage**

In recent months, regulators have raised the profile of the “leakage” issue – distributions from 401(k) plans by means of loans or hardship withdrawals prior to retirement. Some have called for more restrictive policies on access to these funds.

Loans are, of course, widely available in 401(k) plans; 87 percent of participants in the 2010 database of 401(k) plans maintained by the research institute and the Investment Company Institute were in plans offering loans. However, use of the loan option is limited. From 1996 through 2008, on average, less than one-fifth of 401(k) participants with access to loans had outstanding balances, though this figure did tick up in the wake of the financial crisis to 21 percent in 2009 and 2010.

Loans and hardship withdrawals (not to mention taxable cash-outs) can, of course, put a dent in retirements savings. We simulated the impact of the current rate of leakage on younger workers, ages 25 to 29, who have decades of savings opportunity ahead. Leakage – and here we’re talking about the combination of cash-outs, hardship withdrawals, loans and loan defaults – reduces the portion of this group that will meet an 80 percent income-replacement-rate goal by just seven percentage points. Putting it another way, more than three-fifths of those in the lowest-income quartile with more than 30 years of remaining 401(k) eligibility would still be able to retire at age 65 – with savings and Social Security equal to 80 percent of their real preretirement income levels.

What’s more, the option to borrow is a positive attribute for many workers. We don’t know how many workers would save less in 401(k) plans, or simply choose not to participate, if they were told they would not be able to access these funds prior to retirement.

#### **Starting Points**

While the Pension Protection Act of 2006 did much to encourage wider participation and, in some cases, larger contributions to 401(k)s, *Plansponsor* magazine’s 2011 Defined Contribution Survey of nearly 7,000 plans found that only about one-third of them had adopted automatic enrollment. Moreover, adoption rates were closely related to plan size; more than half of the plans with more than \$50 million in assets had done so, compared with fewer than one in five of those with less than \$5 million. Additionally, even among plans with automatic enrollment, more than half chose a default deferral rate of just 3 percent – consistent with the safe-harbor provisions of the law, but a rate unlikely to produce adequate retirement income.

Consider as well that less than half of the largest plans, and fewer than 1 in 10 of those with less than \$5 million in assets, adopted the auto-escalation feature. And, even among plans that have adopted both automatic enrollment and escalation, most of those in the *Plansponsor* survey extended those provisions only to new employees.

While there is no proscription against setting a default contribution rate higher than 3 percent, most sponsors have gravitated toward that level. One policy option: encourage sponsors to increase the default deferral rate, perhaps to 6 percent. It is too early to tell if this would result in a change in opt-out rates. But we recently simulated the impact and found that it would, indeed, sharply increase savings success, as defined above.





### WHAT'S AHEAD?

The data makes it clear that purely voluntary employer-based plans are, in fact, generating a great deal of savings to supplement Social Security. The data also makes it clear that automatic enrollment can have a significant positive impact on retirement readiness, and that starting to save early makes a huge difference in likely outcomes. And while fiscal concerns are likely to sharpen the debate around the size and structure of tax preferences for

these programs, it is clear that they have a powerful impact on both participation in them and the amount of savings accumulated for retirement.

Much, it seems, comes down to a truism: starting times and contribution rates are both important. The longer the issue of retirement-income security remains on the back burner – both for individuals and for policy-makers – the fewer options they have to make up for a slow start. **M**