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WHAT DO YOU CALL A GLASS THAT IS 60-85% FULL?

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In the July 7 *Wall Street Journal*, the headline of an article assessing the Pension Protection Act of 2006 (PPA) provision that encourages automatic enrollment (AE) in 401(k) plans suggests that it is actually reducing savings for some people. What it failed to mention is that it's increasing savings for many more–especially the lowest-income 401(k) participants.

EBRI has been publishing studies on the likely impact of AE for six years. In a joint 2005 study with ICI, [1] we looked at the potential change in 401(k)/IRA[2] accumulations as a result of changing the traditional voluntary enrollment (VE) 401(k) plans to AE plans. Although we had the advantage of using a database of tens of millions of 401(k) participants going back in some cases to 1996, we were limited in knowing how workers would react to AE provisions, and thus simulated the likely response using the results of academic studies.[3]What we found was that the overall expected improvement in retirement accumulations—especially for the lower-income quartiles—were nothing less than spectacular.

However, one point that had already been made clear in the academic literature, and was corroborated by our simulation results, was that some workers placed in a 401(k) AE plan (without automatic escalation provisions–more on that later) would continue to contribute at the *default contribution rate* that the plan sponsor had chosen (typically in the range of 3 percent of compensation). Given that many workers who chose to participate in a VE plan would start contributing at a 6 percent rate (largely in response to the matching contribution incentive provided by the employer), some workers in AE plans were likely contributing at a lower

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rate than they would have had they been working for a plan sponsor offering a VE 401(k) plan AND had chosen to participate.

This anchoring effect can be seen by looking at the top-income quartile in the 2005 results, where the median replacement rate for the top-income quartile decreased by 4 percentage points for the scenario with a 3 percent contribution rate and default investments in a money market fund (Figure 1 of the July 2005 *Issue Brief*). However, from a public policy standpoint, it would appear that this was more than offset by the increase in participation for the lower-income quartiles due to auto-enrollment, resulting in substantial increases in their retirement accumulations (for the same scenario as mentioned above, the third-income quartile's median replacement rate increased 2 percentage points, the second-income quartile increased 7 percentage points, and the lowest-income quartile increased 14 percentage points).

A year after this study was released, Congress passed the PPA, which eased some of the administrative barriers to providing AE and for the first time setting up safe harbor provisions for automatic escalation. Although it was too soon to know how plan sponsors would react to this new legislation, EBRI published a study in 2007[4] that showed how automatic escalation would make the AE results even more favorable under a number of different scenarios for both plan sponsor and worker behavior.

In 2008, EBRI included all the new PPA provisions in a study[5]that compared potential accumulations under AE and VE for several different age groups. Again, we found certain (high-income) groups that were likely to do better under VE than AE, but overall, the AE results dominated (see Figures 6 and 7 of the June 2008 *Issue Brief* for details).

By 2009, many of the 401(k) sponsors who previously had VE plans had shifted to AE plans and EBRI was able to track the changes in plan provisions for hundreds of the largest 401(k) plans. This information was used in an April 2010 *EBRI Issue Brief* to show, once again, the significant impact of moving to AE plans (for those currently ages 25–29, the difference in the median accumulations would be approximately 2.39 times final salary in an AE plan relative to a VE plan).

Later in 2010, EBRI and DCIIA[6] teamed up to do an analysis that focused not on a comparison of VE and AE, but rather how to improve plan design and worker education to optimize the results under AE plans with automatic escalation of contributions. While it is difficult to determine the correct "target" for retirement savings, we tried to demonstrate what, by most financial planning standards, appears to be quite generous: an 80 percent REAL income replacement rate in retirement when 401(k) accumulations are combined with Social Security. We demonstrated that if only the most pessimistic combination of plan design and worker behavioral assumptions were used in the AE plans studied, only 45.7 percent of the lowest-income quartile would obtain this threshold,[7] and given the way in which Social Security benefits are designed, an even lower percentage of the highest-income quartile (27 percent) would reach the 80 percent threshold.

However, the entire point of the analysis was to determine how valuable the proper choice of plan design and worker education can be. The study found that with the all-optimistic assumptions, the percentage of lowest-income quartile workers achieving the 80 percent threshold increased to 79.2 percent, and that of the highest-income quartile workers increased to 64 percent.

The Wall Street Journal article reported only the most pessimistic set of assumptions and did not cite any of the other 15 combinations of assumptions reported in the study. The article reported only results under the threshold of a real replacement rate of 80 percent. Figure 5 of the November 2010 *EBRI Issue Brief* shows that even decreasing the threshold to a 70 percent real replacement rate would increase the percentage of "successful" retirement events by 19 percentage points for the lowest-income quartile and 12 percentage points for the highest-income quartile.

The other statistic attributed to EBRI dealt with the percentage of AE-eligible workers who would be expected to have larger tenure-specific worker contribution rates had they been VE-eligible instead. The simulation results we provided showed that approximately 60 percent of the AE-eligible workers would immediately be better off in an AE plan than in a VE plan, and that over time (as automatic escalation provisions took effect for some of the workers) that number would increase to 85 percent.

The *Wall Street Journal* did not report the positive impact of auto-enrollment 401(k) plans on many workers who began to participate due to AE. As with any change, some people will not have the desired results; but if the focus of auto-enrollment is to increase participation among lower-income participants (and, as a result, their retirement financial preparedness), objective analysis suggests auto-enrollment does obtain that goal.

ENDNOTES

[1] Holden, S., VanDerhei, J., "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement" (Employee Benefit Research Institute and Investment Company Institute, 2005).

[2]IRA rollovers that originated from 401(k) plans are included in the projected accumulations.

[3]Choi, James J., David Laibson, Brigitte C. Madrian, and Andrew Metrick, "Saving For Retirement on the Path of Least Resistance," originally prepared for Tax Policy and the Economy 2001, updated draft: July 19, 2004; and "For Better or For Worse: Default Effects and 401(k) Savings Behavior," Pension Research Council Working Paper, PRC WP 2002-2 (Philadelphia, PA: Pension Research Council, The Wharton School, University of Pennsylvania, November 9, 2001).

[4]VanDerhei, J., "The Expected Impact of Automatic Escalation of 401(k) Contributions on Retirement Income," *EBRI Notes* no. 9 (Employee Benefit Research Institute, September 2007): 1?8.

[5] VanDerhei, J., Copeland, C., "The Impact of PPA on Retirement Income for 401(k) Participants," *EBRI Issue Brief*, no. 318 (Employee Benefit Research Institute, June 2008).

[6]VanDerhei, Jack and Lori Lucas, "The Impact of Auto-enrollment and Automatic Contribution Escalation on Retirement Income Adequacy," *EBRI Issue Brief*, no. 349 (Employee Benefit Research Institute, November 2010).

[7]Results are limited to employees currently ages 25–29 and assumed to have 31–40 years of eligibility.

See also:

VanDerhei, J. "The Impact of Automatic Enrollment in 401(k) Plans on Future Retirement Accumulations: A Simulation Study Based on Plan Design Modifications of Large Plan Sponsors". *EBRI Issue Brief*, no. 341 (Employee Benefit Research Institute, April 2010).

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