Setting Plan Defaults

When you set automatic enrollment and investment defaults for you 401(k) plan, you need to understand and satisfy pension and tax law requirements. But you also should be aware that the default choices you make could significantly impart how financially prepared your employees will be for retirement. Below we answer some questions plan sponsors may have about setting plan defaults.

How does a plan's automatic enrollment default deferral rate affect retirement readiness? Research shows that many plan participants who are automatically enrolled in their employer's plan at the default contribution rate don't question whether a different rate would be better for them—even though about 65% of plans have default contribution rates of 3% or less*, and many retirement advisors recommend significantly higher contribution rates. Consequently, an employee who contributes to an employer's plan at a low default rate for his or her entire career risks having a plan account balance at retirement that's far smaller than the employee will need to meet retirement expenses.

Is any particular group of employees more likely to stick with the default? Yes, according to the National Bureau of Economic Research (NBER), lower income employees are more apt to stay with the default rate than higher income employees. **

What can we do to get employees to move from the default rate to a deferral rate more appropriate for them? Employee communications encouraging participants to calculate how much money they may need in retirement can help. In addition, many plans are turning to automatic and voluntary contribution arte escalation features to encourage higher contribution rates. With automatic contribution, a plan participant's deferral increases gradually over time with no effort on the part of the employee. Employers must implement the increases according to a specified schedule. They also must notify employees of the amount of the deferral increases and when increases will occur. With voluntary contribution escalation, the participant opts into (and can opt out of) the employer's increase schedule.

We understand participants staying with a low default contribution rate, but when they see the effect of contribution escalation on their paychecks, don't they opt out? Interestingly, the NBER found that lower paid employees tend to stay with the default rate even if it's higher than they may need to replace their preretirement income in retirement. Higher paid employees are more likely to change their contribution rate if it isn't appropriate for their needs.

How does our default investment choice affect employees' retirement readiness? First, there's an inertia factor similar to that associated with default contribution rates. Employees automatically invested in the default investment often leave their money in that investment. In addition, NBER data seems to indicate that a plan's default investment choice influences how participants overall allocate their plan savings. In the study, when a plan changed its default investment choice from a more conservative (no stock) fund to balanced or target date fund with substantial stock exposure (classified as aggressive funds in the study), plan participants allocated more of their accounts to aggressive funds.

* *56th Annual Survey of Profit Sharing and 401(k) Plans*, Plan Sponsor Council of America, 2103 (2012 plan experience)

** *Financial Inertia Among Low-Income Individuals—Plan Carefully When Setting 401(k) Defaults*, National Bureau of Economic Research, 2013