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NOTES

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Executive Summary:

- ***RCS data used to gauge impact of auto-escalation:*** This report uses data from the 2007 Retirement Confidence Survey (RCS), fielded several months after the enactment of Pension Protection Act of 2006 (PPA), to ascertain how high workers are likely to allow their default 401(k) contributions to go in plans with an automatic escalation feature. The result is a first approximation for the expected impact of automatic escalation under the PPA safe harbors for a number of different assumptions about worker and employer reactions.
- ***Previous EBRI research:*** EBRI has done extensive modeling of the retirement income prospects for future generations of retirees, with results ranging from very bleak for substantial portions of the U.S. population to fairly positive for 401(k) participants with continuous coverage throughout their working careers.
- ***Replacement rate estimates for automatic enrollment:*** Assuming that *all* 401(k) plan sponsors would adopt automatic enrollment immediately (in 2005), the median replacement rates for the lowest-income quartile increased to 37 percent (from the 23 percent baseline) even under the conservative assumptions of a 3 percent default contribution rate and a money market default investment. When the default contribution rate was increased to 6 percent and the default investment was changed to a life-cycle fund, the median replacement rate for this group increased further to 52 percent.
- ***Auto-escalation is likely to result in major improvement for low-income workers:*** Results from the 2007 RCS suggest that the introduction of automatic escalation will result in a significant increase in 401(k) accumulations—especially for low-income workers—compared with estimates previously determined for automatic enrollment. Under the assumptions and scenarios modeled in this article, the automatic escalation feature is likely to increase overall 401(k) accumulations between 11–28 percent for participants in the lowest-income quartile, and between 5–12 percent for those in the highest-income quartile.

The Expected Impact of Automatic Escalation of 401(k) Contributions on Retirement Income

By Jack L. VanDerhei, Temple University and EBRI Fellow

Introduction

The retirement income prospects for future generations of retirees have been modeled by EBRI extensively in recent years, in an attempt to more accurately predict how various cohorts of Americans will likely fare in retirement. Results have ranged from very bleak for substantial portions of the U.S. population[1] to fairly positive for 401(k) participants with continuous coverage throughout their working careers: Results suggest a significant portion of these workers' pre-retirement income could be replaced by 401(k) accumulations when combined with Social Security (at least Social Security benefits projected under current statutory provisions).[2]

Assuming that 401(k) accumulations were used to purchase nominal annuities at age 65, the EBRI/ICI 401(k) Accumulation Projection Model predicts baseline median replacement rates at retirement ranging from 51–69 percent, by quartile, based on final five-year average salary ("replacement rate" meaning the percentage of a worker's final salary that is replaced in retirement by a nominal annuity purchased by 401(k) assets). However, these baseline results were predicated on the assumption that any worker currently participating in a 401(k) plan would continue to be offered a 401(k) plan for each future job. If it is assumed that the worker would have only an average chance of being offered a 401(k) plan at future jobs, the income replacement rates decrease to a range of 21–26 percent. While this scenario is certainly far too pessimistic to be correct, the disparity between the two sets of results demonstrates the importance of continued participation in a 401(k) plan throughout an employee's working career.

A year prior to the enactment of the Pension Protection Act of 2006 (PPA), the EBRI/ICI 401(k) Accumulation Projection Model was used to simulate the impact of universal adoption of automatic enrollment features under a combination of default contribution rates and default investment allocations.[3] In order that the beneficial effect of the expected increase in participation rates could be included in simulation results, "synthetic" employees were generated in the model to include eligible workers who chose *not to participate* in the 401(k). When these employees were added to the model, the median replacement rates under the baseline assumption mentioned above decreased significantly for the lowest-income quartile (23 percent, down from 51 percent) but only mildly for the highest-income quartile (56 percent, down from 67 percent).

Assuming that *all* 401(k) plan sponsors would adopt automatic enrollment immediately (in 2005), the median replacement rates for the lowest-income quartile increased to 37 percent (from the 23 percent baseline) even under the conservative assumptions of a 3 percent default contribution rate and a money market default investment (Figure 1). When the default contribution rate was increased to 6 percent and the default investment was changed to a life-cycle fund, the median replacement rate for this group increased further to 52 percent.[4]

These results illustrate the very strong improvements that can result from automatic enrollment of workers in a 401(k) plan—especially for the lowest-income workers.

This report uses data from the 2007 Retirement Confidence Survey (RCS), fielded several months after the enactment of PPA, which asked workers how high they would allow their default 401(k) contributions to go. The result is a first approximation for the expected impact of automatic escalation under the PPA safe harbors for a number of different assumptions about worker and employer reactions.

Pension Protection Act of 2006

One of the extremely important plan design decisions a 401(k) plan sponsor must make because of PPA is whether to introduce automatic enrollment features. There is extensive literature on the potential benefits of automatic enrollment on participation rates, especially for young employees and those with low incomes.[5] However, there is also a recognition that the introduction of these programs has a tendency

to "anchor" participants' contribution rates and asset allocation to the defaults chosen by the sponsor;[6] hence, the overall increase in expected account balances from adopting these plans will be a function of both the employee's relative wage level and the employer's default decisions.

PPA provided a significant incentive for employers that had not already adopted automatic enrollment to reconsider their decisions. PPA pre-empts state laws that might affect plans adopting automatic enrollment provisions and provides additional nondiscrimination safe harbor protections for them. To qualify for the automatic enrollment safe harbor, the contribution rate for automatic enrollees must be at least 3 percent of salary during the first year of participation, 4 percent during the second year, 5 percent during the third year, and 6 percent thereafter. The plan may specify a higher contribution up to a maximum of 10 percent.[7]

Modeling the Impact of Automatic Escalation of 401(k) Contributions

Although the automatic escalation of 401(k) contributions described above has been shown to potentially increase employee contributions considerably in a limited number of test cases,[8] these experiments have simply been too recent to show how long and/or to what extent employees are likely to continue the periodic escalations before opting out of any additional increases. There has been detailed exploration of the impact of automatic enrollment on participation decisions, investment allocations, and the desired contribution rate in the pre-PPA environment; however, the inability to measure the employee's optimal stopping point in the automatic escalation process has made it difficult to simulate the impact of PPA on 401(k) accumulations.

Fortunately, as part of the 2007 Retirement Confidence Survey (RCS)[9] fielded several months after the enactment of PPA, this information could be elicited from 456 employees who were currently contributing to a 401(k) plan. Figure 2 shows the distribution of employee responses to the question:

> *Suppose your employer automatically increased the percentage of your salary contributed to the plan by 1% each time you received a raise. For example, your contribution might increase from 3% to 4% of your salary with your first raise, and from 4% to 5% with your next raise. You could choose to discontinue the automatic increase at any time. At about what percentage of your salary do you think you would discontinue the automatic increase?*

Three percent of the employees responded that they would discontinue the increase immediately or before the first raise. Twenty-five percent indicated a percentage between 1–5 percent, while another 44 percent estimated they would continue until some place in the 6 to 10 percent range. Thirteen percent chose a limit between 11 and 15 percent, while 14 percent indicated they would allow the increase to exceed 15 percent.

This information was added into the baseline assumptions from the EBRI/ICI 401(k) Accumulation Projection Model with a 3 percent contribution rate and life-cycle default investment; the result is a first approximation for the expected impact of automatic escalation under the PPA safe harbors for a number of different assumptions with respect to worker and employer reactions.

This is shown in Figure 3: The set of numbers on the left side shows that the baseline (before introduction of automatic escalation) under these sets of assumptions produces a median replacement rate of 43 percent for the lowest-income quartile, 46 percent for the second income quartile, 50 percent for third, and 58 percent for the highest-income quartile.[10]

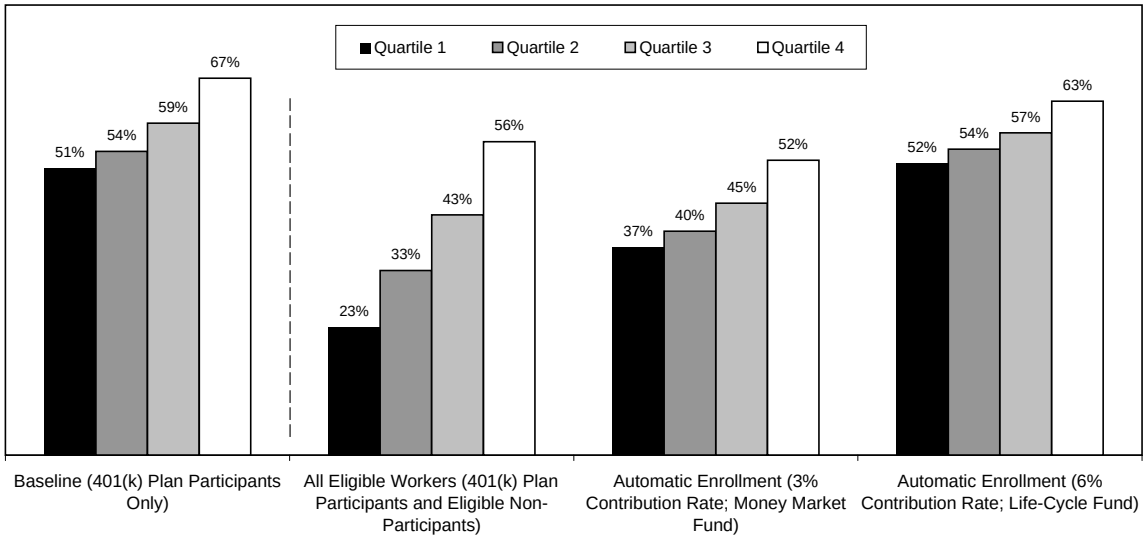
The first attempt to gauge the importance of automatic escalation assumes that employees are willing to go as high as the distribution of responses in the Retirement Confidence Survey would suggest. This is undoubtedly an optimistic estimate, considering the various limits on how high employers will be allowed to set the caps in a safe harbor plan. Still, the results are useful in determining an upper bound on the impact of automatic escalation, to the extent that the RCS results are representative of future experience.

But before running the simulations, it is important to deal with the question of whether employees are likely to maintain their higher contribution rate from a prior job when it comes to setting the initial contribution rate with a new employer. For example, if employees start at a 3 percent contribution rate with the first employer and leave when they have already increased the contribution rate to 6 percent, will they *maintain their contribution rate* when they move to the second employer? Or would they *start over,* and drop back down to 3 percent?

Figure 1

Median Replacement Rates[1] From 401(k) Accumulations[2] for Workers Turning 65 Between 2030 and 2039, by Income Quartile at Age 65

(percentage of final five-year average salary)



Source: EBRI/ICI 401(k) Accumulation Projection Model.

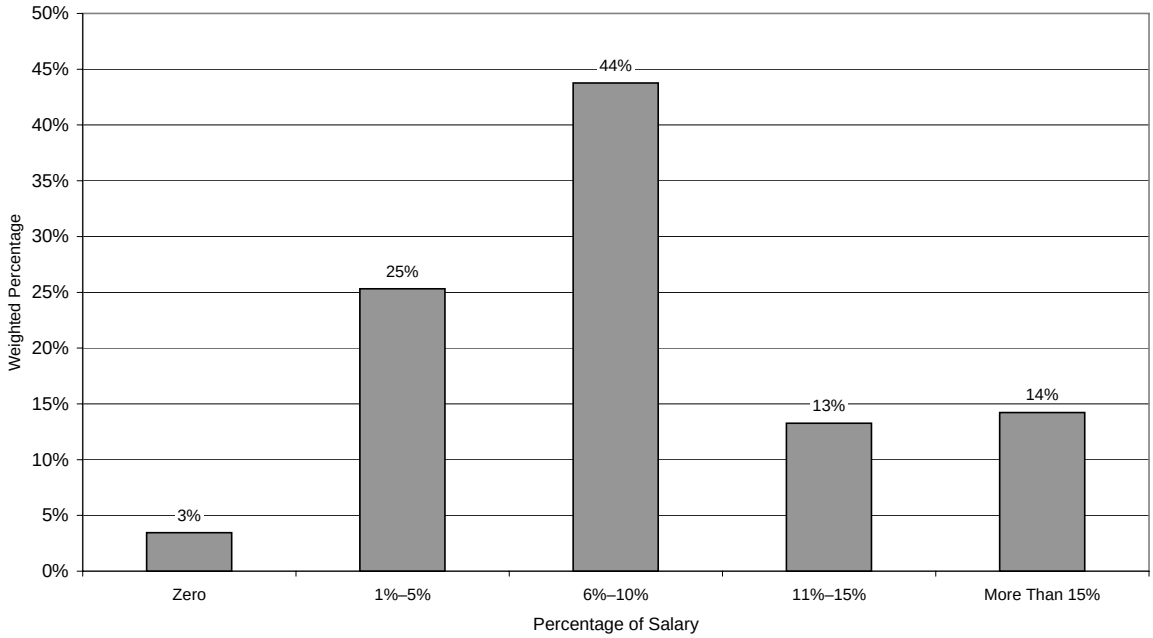
[1] In all four simulations presented in this figure, workers experience continuous employment, continuous 401(k) plan coverage, and investment returns based on historical returns from 1926 to 2001. In the baseline, only 401(k) participants with account balances at year-end 2000 are considered. In the other three scenarios, all eligible workers are considered.

[2] The 401(k) accumulation includes 401(k) balances at employer(s) and rollover IRA balances.

Figure 2

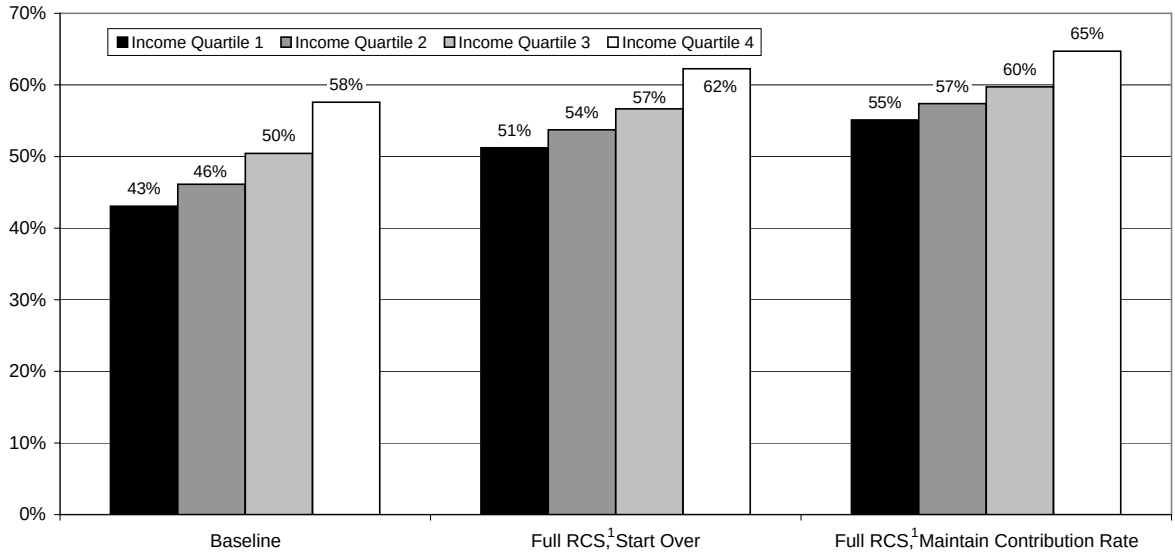
Range of Maximum 401(k) Deferral Rates Under Auto-Escalation

(Self-reported among those providing a response)



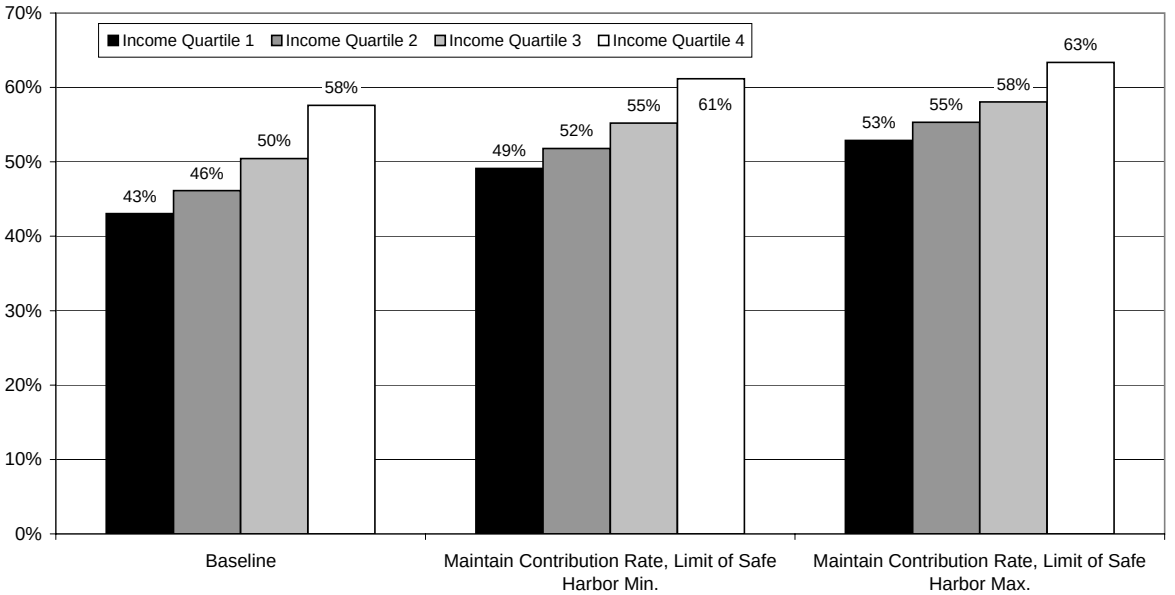
Source: EBRI/MGA 2007 Retirement Confidence Survey.

Figure 3
Impact of Automatic Escalation:
Median Replacement Rates From 401(k) Accumulations for Workers Turning 65 Between 2030–2039, by Income Quartile at Age 65, Assuming No Employer-Imposed Contraints
(percentage of final five-year average salary)



Source: Author's simulations from the EBRI/ICI 401(k) Accumulation Projection Model.
[1] Retirement Confidence Survey.

Figure 4
Impact of Automatic Escalation: *Maintain Contribution Rate* Scenario
Median Replacement Rates From 401(k) Accumulations for Workers Turning 65 Between 2030–2039, by Income Quartile at Age 65
(percentage of final five-year average salary)



Source: Author's simulations from the EBRI/ICI 401(k) Accumulation Projection Model.

Since it will likely be years before researchers have sufficient information to determine which of these scenarios is more likely, and for whom, Figure 3 shows the results under both scenarios. The middle set of numbers assumes that workers *start over* at the minimum contribution with each job change.

The set of numbers on the right side of the chart assumes that employees retain their current contribution rate when they change jobs and continue to allow annual increases until they hit the limit stochastically selected according to the RCS distribution. Under the *start over* scenario, the median replacement rate for the low-income quartile increases from 43 percent to 51 percent, while the high-income quartile increases from 58 percent to 62 percent. Under the *maintain contribution rate* scenario, both numbers continue to increase: The low-income quartile increases to 55 percent, while the high-income quartile increases to 65 percent.

Figure 4 shows the estimated effect of automatic escalation when it is assumed that employees have grown from the experience on the previous job regarding their current level of contributions; however, it also assumes that the employee escalation is constrained by the employer response to the safe harbor minimum (6 percent of compensation) or the safe harbor maximum (10 percent of compensation). In the first case, the median replacement rate for the low-income quartile is 49 percent and the high-income quartile is 61 percent (compared with 55–65 percent for the *maintain contribution rate* scenario in Figure 3, without the safe harbor minimum cap). In the second case, the median replacement rate for the low-income quartile is 53 percent and the high-income quartile is 63 percent.

Figure 5 is similar to Figure 4, but assumes that the employee *starts over* from the previous job with respect to contribution rate levels. Similar to the previous figure, it also assumes that the employee escalation is constrained by the employer response to the safe harbor minimum (6 percent of compensation) or the safe harbor maximum (10 percent of compensation). In the first case, the median replacement rate for the low-income quartile is 48 percent and the high-income quartile is 60 percent. In the second case, the median replacement rate for the low-income quartile is 50 percent and the high-income quartile is 62 percent.

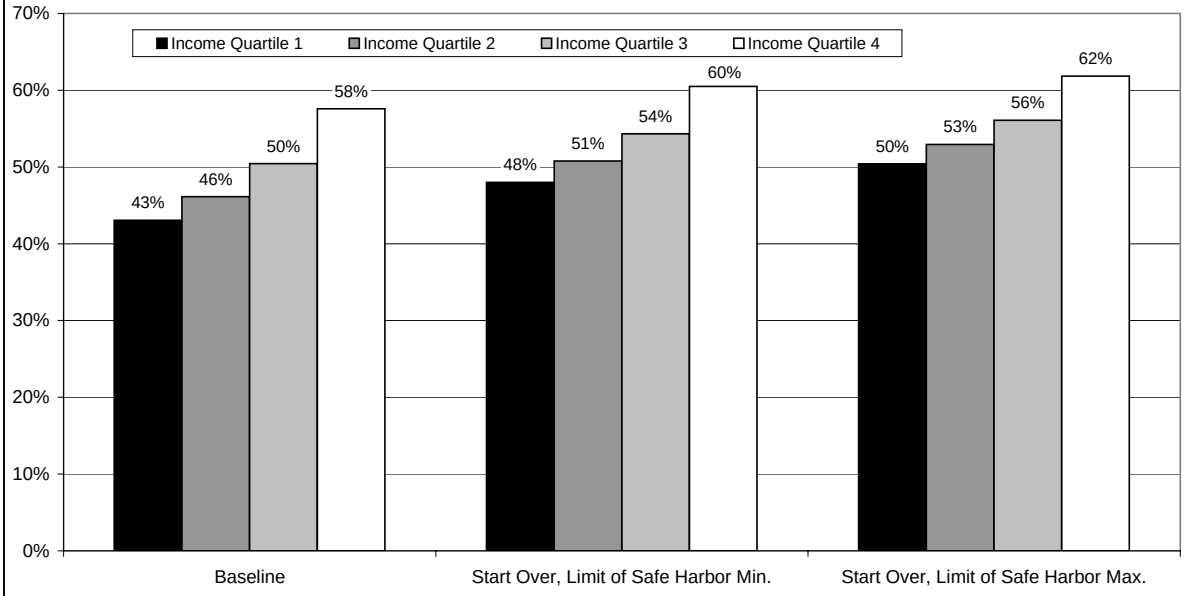
Figure 6 summarizes the results in Figures 3 though 5 by comparing the median replacement rates against the baseline in each of the six combinations of *maintain contribution rate*/*start over* scenarios by whether the contribution is constrained by the safe harbor minimum or maximum, or whether the full RCS distribution can be used. Not surprisingly, the maximum impact is seen when the full RCS distribution is used (without constraints) and the *maintain contribution rate* scenario is assumed. In that case, the median replacement rate for the lowest-income quartile increases by 28 percent, while the rate for the highest-income quartile increases by 12 percent. Even for the scenario with the smallest expected impact (*start over* and limited by the safe harbor minimum), the lowest-income quartile still experiences an income replacement rate increase of 11 percent and the highest-income quartile increases by 5 percent.

Conclusion

The Pension Protection Act is expected to have a significant impact on the plan design process for both defined benefit (pension) and defined contribution (401(k)) plans.[11] EBRI is currently working to update its simulation models to determine how PPA is likely to affect retirement income security. However, one of the issues that will be extremely problematic is predicting employees' responses to plan design features that have not been in existence long enough to determine how they will ultimately affect contribution behavior.

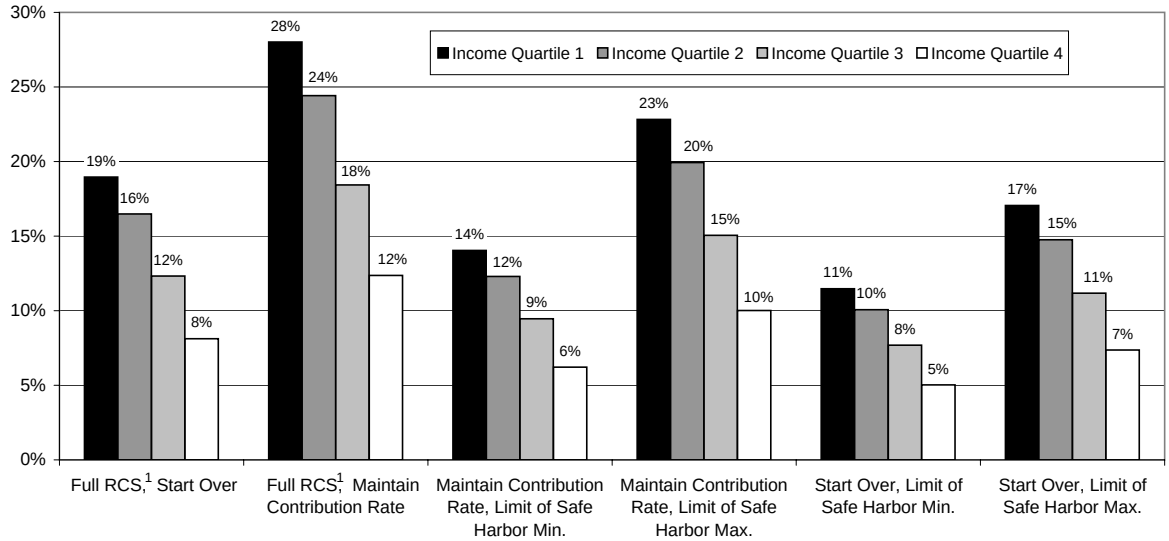
It will be several years until researchers know how 401(k) participants react to automatic escalation of contributions in general, and the plan design of 401(k) plans as a result of PPA in particular. However, results from the 2007 Retirement Confidence Survey suggest that the introduction of automatic escalation will result in a significant increase of 401(k) accumulations—especially for low-income workers—compared with estimates previously determined for automatic enrollment. Under the assumptions and scenarios modeled in this article, the automatic escalation feature is likely to increase overall 401(k) accumulations between 11–28 percent for participants in the lowest-income quartile, and between 5–12 percent for those in the highest-income quartile.

Figure 5
Impact of Automatic Escalation: *Start Over* Scenario
Median Replacement Rates From 401(k) Accumulations for Workers Turning 65 Between 2030–2039, by Income Quartile at Age 65
(percentage of final five-year average salary)



Source: Author's simulations from the EBRI/ICI 401(k) Accumulation Projection Model.

Figure 6
Impact of Automatic Escalation:
Percentage Increase in Median Replacement Rates From 401(k) Accumulations for Workers Turning 65 Between 2030–2039, by Income Quartile at Age 65
(compared to baseline of PPA matching without automatic escalation)



Source: Author's simulations from the EBRI/ICI 401(k) Accumulation Projection Model.
[1] Retirement Confidence Survey.

Endnotes

[1] See Jack VanDerhei and Craig Copeland, "Can America Afford Tomorrow's Retirees: Results From the EBRI-ERF Retirement Security Projection Model," *EBRI Issue Brief,* no. 263 (Employee Benefit Research Institute, November 2003).

[2] See Sarah Holden and Jack VanDerhei, "Can 401(k) Accumulations Generate Significant Income for Future Retirees?" *EBRI Issue Brief,* no. 251; and *ICI Perspective,* Vol. 8, No. 3 (Employee Benefit Research Institute and Investment Company Institute, November 2002).

[3] See Sarah Holden and Jack VanDerhei, "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," *EBRI Issue Brief,* no. 283; and *ICI Perspective,* Vol. 11, No. 2 (Employee Benefit Research Institute and Investment Company Institute, July 2005).

[4] Similar figures for the high-income quartile were 52 percent under the 3 percent contribution rate and money market investment, and 63 percent for the 6 percent contribution rate and the life-cycle investment.

[5] Jodi DeCenzo, "Behavioral Finance and Retirement Plan Contributions: How Participants Behave, and Prescriptive Solutions," *EBRI Issue Brief,* no. 301 (Employee Benefit Research Institute, January 2007).

[6] See James J. Choi, David Laibson, Brigette C. Madrian, and Andrew Metrick, "Saving for Retirement on the Path of Least Resistance," in Ed McCaffrey and Joel Slemrod, eds., *Behavioral Public Finance: Toward a New Agenda* (New York: Russell Sage Foundation, 2006), pp. 304–351; and James J. Choi, David Laibson, Brigette C. Madrian, and Andrew Metrick, "Optimal Defaults and Active Decisions," *NBER Working Paper,* No. 11074 (Cambridge, MA: National Bureau of Economic Research, January 2005).

[7] Patrick Purcell, "Summary of the Pension Protection Act of 2006," *CRS Report for Congress.* (Washington, DC: Library of Congress, Congressional Research Service, October 23, 2006).

[8] See Shlomo Benartzi and Richard H. Thaler, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy,* Vol. 112, no. 1 (February 2004): pp. S164–S187.

[9] Ruth Helman, Jack VanDerhei, and Craig Copeland, "The Retirement System in Transition: The 2007 Retirement Confidence Survey," *EBRI Issue Brief,* no. 304 (Employee Benefit Research Institute, April 2007).

[10] All four figures are within 1 percentage point of the corresponding (pre-PPA) estimates from Figure 10 of Sarah Holden and Jack VanDerhei, "The Influence of Automatic Enrollment, Catch-up, and IRA Contributions on 401(k) Accumulations at Retirement." *EBRI Issue Brief,* no. 283; and *ICI Perspective,* Vol. 11, no. 2 (Employee Benefit Research Institute and Investment Company Institute, July 2005).

[11] See Jack VanDerhei, "Retirement Income Adequacy After PPA and FAS 158: Part One—Plan Sponsors' Reactions," *EBRI Issue Brief,* no. 307 (Employee Benefit Research Institute, July 2007).

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Building Futures VIII: Highlights of Findings
http://personal.fidelity.com/myfidelity/InsideFidelity/NewsCenter/mediadocs/BF_VIII_Highlights_of_Finding.pdf

Change in Percentage of Families Offered Coverage at Work, 1998–2005
www.kff.org/insurance/upload/7667.pdf

Characteristics of Large Public Education Pension Plans
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Description of the "Pension Protection Technical Corrections Act of 2007" [JCX 60-07]
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www.alliancebernstein.com/CmsObjectABD/emails/pdfs/CranchNotto_070627.pdf

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National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2007
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Projections of Economic Well-Being for Social Security Beneficiaries in 2022 and 2062
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Reinsuring Health: A Proposal to Make Health Insurance More Affordable
www.rwjf.org/files/publications/other/Research%20Highlight%2021[6].pdf

SCHIP Reauthorization: Key Questions in the Debate
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