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New EBRI/ICI Research:

Automatic Enrollment Could Have a Significant Impact On Raising 401(k) Balances at Retirement, Study Finds

WASHINGTON—Automatically enrolling new workers appears to be a significant factor in increasing account balances in 401(k) plans, with lower-income individuals benefiting the most, a study released today shows.

The finding is important because employment-based 401(k) plans have become the dominant retirement savings option for millions of American workers. Beyond Social Security, the amount of retirement income many Americans will have when they reach 65 will depend to a large degree on how long they participate in a 401(k) plan, how much they contribute to the plan, and how they invest their 401(k) assets.

The study is based on a model constructed by the nonpartisan Employee Benefit Research Institute (EBRI) and the Investment Company Institute (ICI), using their 401(k) Accumulation Projection Model. It is being published simultaneously in the July *EBRI Issue Brief* and *ICI Perspective*, and is available at both organizations' Web sites at www.ebri.org and www.ici.org.

Automatic enrollment changes a worker's decision from having to choose *to participate* in a 401(k) plan when starting a new job to having to choose *not* to participate. If the worker does nothing, he or she is automatically enrolled. Typically with automatic enrollment, an employer notifies new workers that a certain percentage of their salary will be contributed to a 401(k) plan unless the worker takes the initiative to opt out within a specified period. The employer sets the initial contribution rate and allocates the contribution into a predetermined option (typically either a money market or "life-cycle" fund); these are known as default options.

Not all employers offer their workers a 401(k) retirement savings plan, or have an automatic enrollment feature. The report notes that without automatic enrollment 401(k) participation depends strongly on age and income, and ranges from a low of 37 percent among the young, lowest-income workers who are eligible to a high of 90 percent among the older, highest-income eligible workers.

"The effects of automatic enrollment on [income] replacement rates at retirement depend heavily on the default contribution rate and default investment option that the plan sponsor selects," the study says. "Everything else being equal, the higher the default contribution, the higher the replacement rates at retirement."

The study also finds that the median income replacement rate from 401(k) accumulations depends primarily on whether current participants will continue to work for employers that sponsor a 401(k) plan. For example, the lowest-income participants currently between ages 26–35 are estimated to have a median income replacement rate of 25 percent when they turn 65 if future 401(k) coverage is random; however, they would have a 51 percent replacement rate if each subsequent job is covered by a 401(k)

plan. The trend also holds for the highest-income participants of that age group, who would have a 30 percent replacement ratio under random coverage and 67 percent if 401(k) coverage is continuous.

The study makes these additional points on automatic enrollment:

- Automatic enrollment has the greatest impact on lower-income workers because members of this group are least likely to participate in a 401(k) plan on their own volition. Among eligible workers currently between 26–35, the median salary replacement from 401(k) accumulations would more than double from 23 percent without automatic enrollment to 52 percent of salary when the default contribution rate is 6 percent of salary invested in a life-cycle fund. “Adding automatic enrollment creates a larger percentage of new participants from this group,” the study says.
- The impact of automatic enrollment on higher-income groups is less dramatic and, in some cases, is reversed because workers in this group tend to have higher 401(k) participation rates. In addition, higher-income workers tend to contribute more of their income in a 401(k) retirement savings plan and place it in more aggressive investments than is typically the case through automatic enrollment, the study notes.
- Given the historical tendency of equity securities to generate higher returns than fixed-income securities, 401(k) plans that set a life-cycle fund as the default investment option have higher forecasted income replacement rates than plans that have a money market fund as the default investment option, the study reports. Life-cycle funds invest more aggressively in stocks (equities) when a worker is young and gradually shift to more conservative and fixed-income investments as a worker ages.

The EBRI/ICI study indicates that 401(k) catch-up contributions—available to participants who are age 50 and older and are already contributing the limit—primarily increase higher income participants’ projected income replacement rates.

In addition, the study looks at whether IRAs can make up for missed 401(k) contributions and finds significant differences based on income levels. For instance, if employees contribute to IRAs during lapses in 401(k) coverage, lower-income participants are not likely to fall as far behind in retirement savings as are higher-income workers, because contributions from low-income workers to 401(k) accounts tend to be close to IRA limits. But higher-income workers who are not offered a 401(k) plan at work will not be able to duplicate through IRAs the amounts they tend to contribute to a 401(k) plan.

EBRI and ICI have worked together on 401(k) research in the past in the creation of the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project, the largest analytical resource of its kind in the nation. The EBRI/ICI 401(k) Accumulation Projection Model was developed to examine the extent to which 401(k) assets will contribute to retirement income for future retirees who had these plans available to them for their entire careers. Sarah Holden, senior economist at ICI, and Jack VanDerhei, Temple University, and research director of the EBRI fellows program, are co-authors of the study.

A close examination of 401(k) plans is central to understanding a shift that has occurred in the retirement landscape in the United States. A quarter-century ago, 401(k)s had just come into existence and defined contribution plans held assets of \$184.5 billion. By the end of 2004, about 43 million 401(k) participants had accumulated \$2.1 trillion in assets.

The Investment Company Institute, founded in 1940, is the national association of U.S. investment companies, with a membership of more than 9,300 mutual funds, closed-end funds, and exchange-traded funds. Established in 1978, EBRI is an independent nonprofit organization committed exclusively to data dissemination, policy research, and education on economic security and employee benefits. EBRI does not lobby and does not take positions on policy questions.

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