Retirement Saving Policy

That Was Easy: The Importance of Auto Features in Promoting Retirement Savings

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A state-sponsored retirement savings plan could help millions of private-sector workers who are not covered by an employer plan build financial security. Several features will help a plan become more effective and produce more secure retirements. This report discusses how automatic enrollment and escalation can increase both participation and savings.

Ensuring that individuals and their families are financially prepared for retirement is an important policy objective. That is no easy task. The Center for Retirement Research at Boston College estimates that 53 percent of US households are at risk of not having enough savings to maintain their current living standard in retirement.[1] In addition, rising life expectancy and the shift from traditional defined benefit (DB) pensions to defined contribution (DC) retirement savings accounts have made increasing personal retirement savings imperative.

Over the past 40 years, we have witnessed a sea change in the structure of retirement income provision in the United States as DC retirement savings accounts (e.g., 401[k]s and IRAs) have gradually displaced DB pensions as the primary privately sponsored source of retirement income. At year-end 2012, the assets in private employer–sponsored DC plans and individual retirement accounts totaled $10.5 trillion, relative to $2.6 trillion in privately sponsored DB plans.[2]

The growing importance of DC savings plans has been accompanied by concerns about the capability of individuals to make savings and asset allocation decisions that will lead to a financially secure retirement—concerns that have been compounded during the financial turmoil of the most recent recession. In DB plans, employers make the complicated decisions about how much money to set aside for their employees' retirement and how to invest their pension assets. In contrast, DC plans place the burden of ensuring adequate retirement income on individuals who must choose how much to save and how to invest even though they may have little or no expertise in financial decision making. Indeed, a growing body of research documents low levels of financial literacy and a litany of investor biases that contribute to financial mistakes both large and small.[3]

The good news is that simple changes to the design of DC savings plans can dramatically change the retirement savings outlook by (a) increasing the fraction of individuals who are saving for retirement, (b) increasing the amount that

individuals are saving for retirement, and (c) ensuring that retirement assets are appropriately diversified.

Automatic Enrollment as a Tool to Increase Retirement Savings

By far, the most effective method to increase participation in a savings plan is through automatic enrollment. Under automatic enrollment, employees are defaulted into savings plan participation unless they actively choose to opt out, that is, choose not to save. That approach stands in contrast to the once-prevailing norm that employees had to actively opt in to participate in their employer's savings plan. Changing the default from nonparticipation (opt in if you want to participate) to participation (opt out if you don't) substantially raises savings plan participation rates. A recent Aon Hewitt study finds that those firms that have adopted automatic enrollment have savings plan participation rates of approximately 83 percent, a full 18 percentage points higher than in firms that have not adopted automatic enrollment.[4] Automatic enrollment not only increases savings plan participation rates on average but also equalizes the disparities in participation rates across demographic subgroups. In plans without automatic enrollment, savings plan participation rates tend to be very low for young, lower-income, and minority employees. In plans with automatic enrollment, the savings plan participation rates for those employees are much closer to the rates of other employees (figure 1).[5]

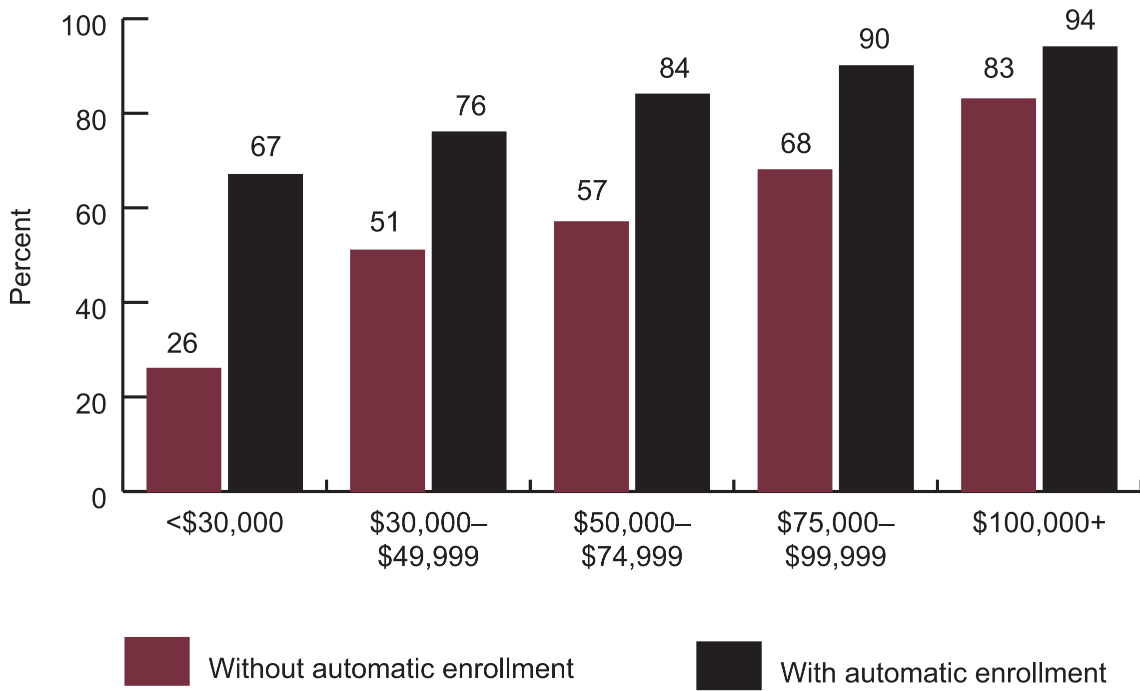
Although automatic enrollment is extremely successful at getting employees into a retirement savings plan, its success at setting up individuals for a secure retirement also depends on how much individuals are actually saving. Vanguard reports that in 2012, most employers using automatic enrollment had a default contribution rate of only 3 percent.[6] Such a low default contribution rate is problematic because many employees will persist at the default. Most employees will be better served by a higher initial default contribution rate or by a combination of automatic enrollment and automatic contribution escalation. With the latter, contribution rates increase automatically each year until a certain threshold is reached. That method can be very effective in increasing savings plan contribution rates over time.[7]

One concern some employers voice about increasing their default contribution rate is that more employees will opt out of savings plan participation altogether if the default contribution rate is too high. What research exists on that subject suggests that opt-out rates do not materially increase when employers increase their default, although it has been studied for only relatively small changes in the default contribution rate, such as going from a 3 percent default to a 6 percent default.[8] If that is a concern, a lower contribution rate combined with contribution escalation is unlikely to increase savings plan opt-out rates.

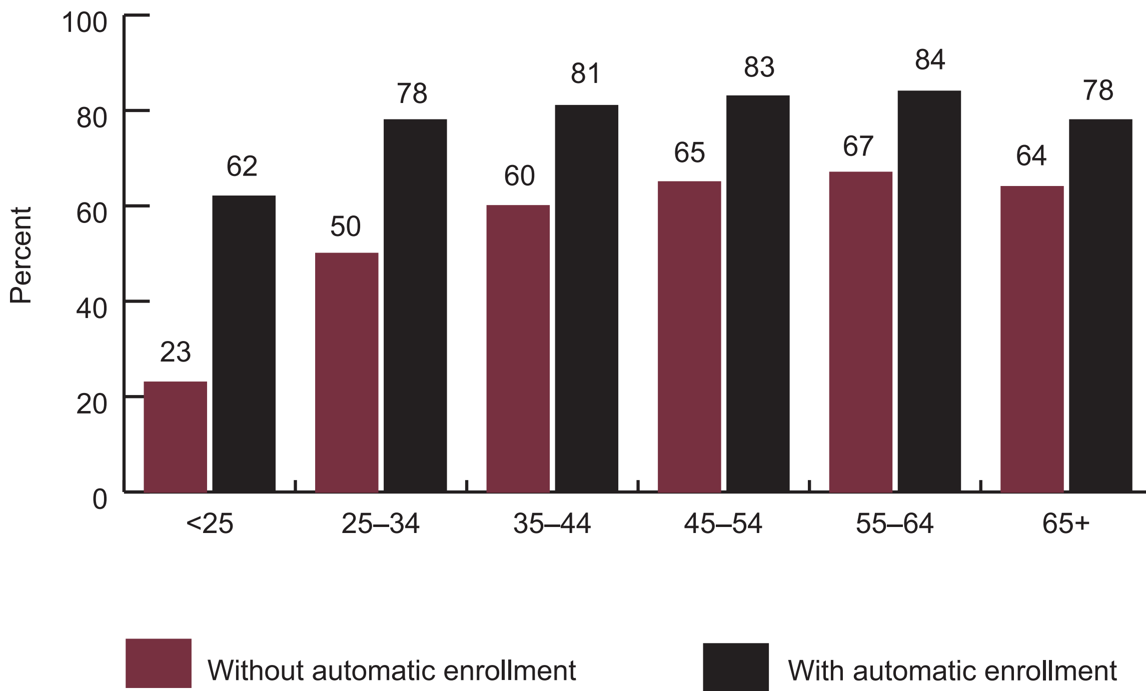
In addition to selecting a default contribution rate, automatic enrollment also requires that companies specify a default asset allocation. Most companies that have adopted automatic enrollment use target-date funds as their default investment option. Target-date funds are mutual funds that invest in a combination of stocks and bonds, with the allocation to stocks decreasing and that to bonds increasing over time as individuals get closer to their target retirement date. The funds come in different vintages, so the asset allocation for employees who are older and closer to retirement will be more conservative than that of employees who are younger. Although employees can opt out of the default investment option and choose an asset allocation of their own, many employees stick with the default asset allocation.

Figure 1. Savings Plan Participation Rates

a. By Income



b. By Age



Source: *How America Saves: 2013* (Valley Forge, PA: Vanguard, 2013).

Is Automatic Enrollment Too Paternalistic?

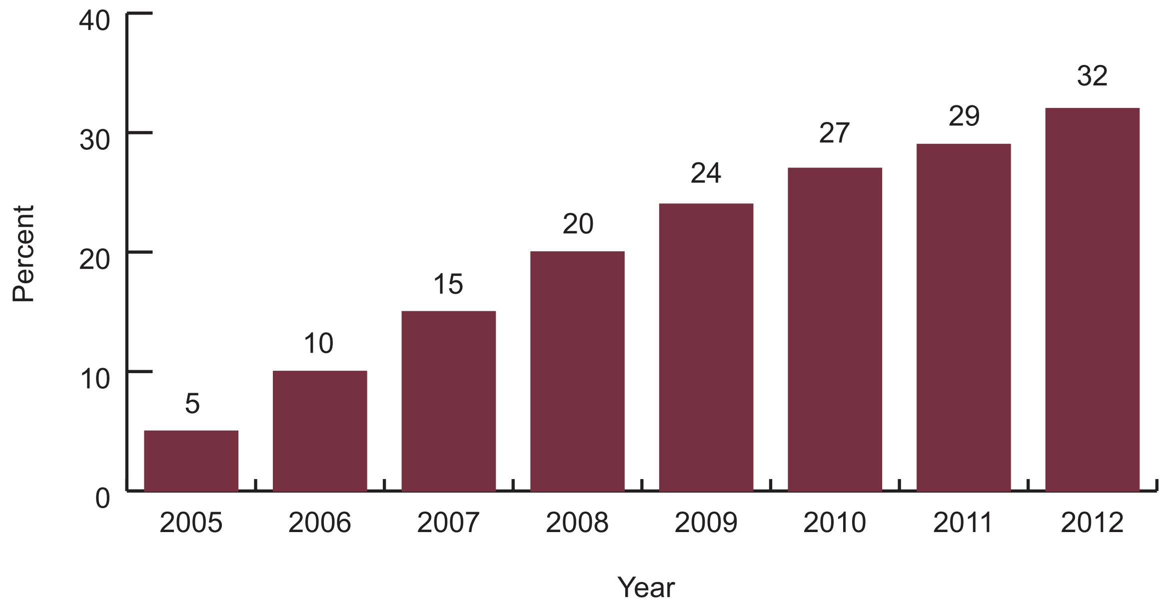
Some critics have objected to automatic enrollment on the grounds that it is too paternalistic and coerces employees into saving when they would prefer not to. Although the truth of that assertion is hard to measure, most of the evidence would suggest otherwise. The employees that opt out of automatic enrollment tend to do so almost immediately. Conditional on being enrolled in the savings plan at some point, the subsequent savings plan opt-out rates are very low and virtually identical for employees who are automatically enrolled and for employees who are not.[9] That fact suggests that the process of opting out of savings plan participation under automatic enrollment is easy and transparent so that the employees who don't want to (or can't) save opt out almost immediately. Further, employees are generally quite happy with automatic enrollment. In a Retirement Made Simpler survey of employee attitudes toward automatic enrollment, 98 percent of those who were automatically enrolled agree with the statement "You are glad your company offers automatic enrollment," as did 79 percent of those who opted out.[10]

Collectively, the evidence on automatic enrollment suggests that most individuals want to save for retirement but many find the process difficult and overwhelming. As a result, they procrastinate. Automatic enrollment simplifies the process of saving for retirement by transforming a difficult multipronged decision (whether to save, how much to save, and how to invest) into a simple choice between whether the employer-specified default is better or worse than not saving at all.

Automatic Enrollment and Public Policy

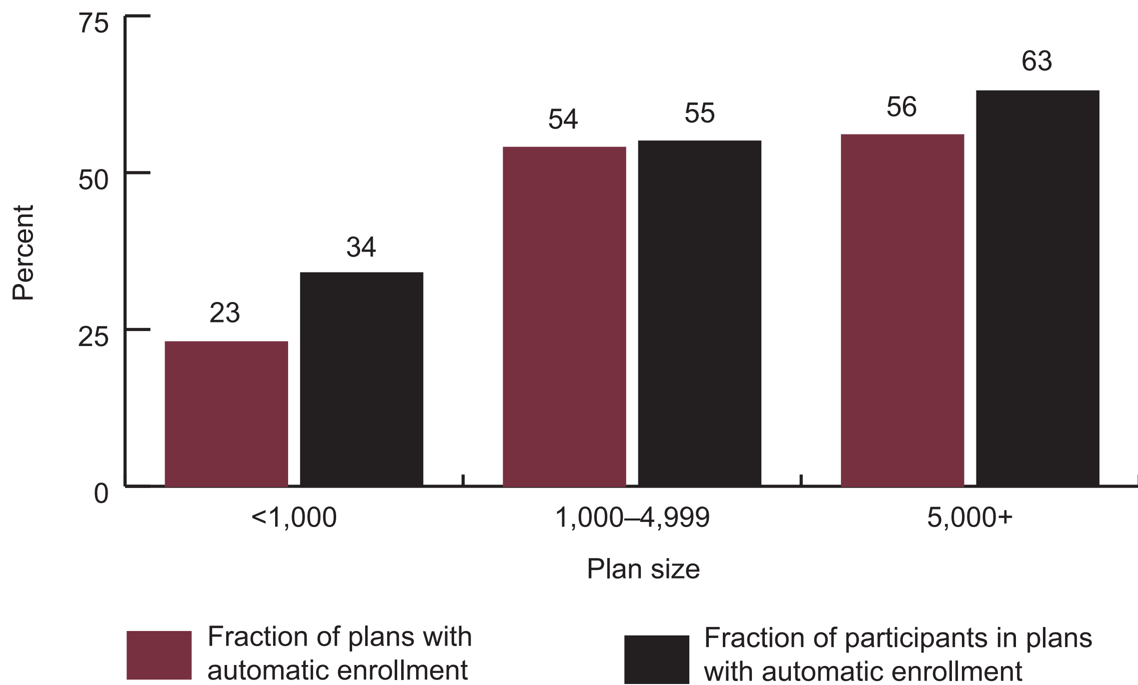
The research findings on the success of automatic enrollment at promoting savings plan participation provided the motivation for regulatory changes codified in the Pension Protection Act of 2006 to encourage employers to adopt both automatic enrollment and automatic contribution escalation. Those provisions of the act appear to have been successful. Vanguard reports that in 2012, 32 percent of employer savings plans had adopted automatic enrollment, up from 5 percent in 2005 (figure 2); among large employers plans, well over half had adopted automatic enrollment (figure 3).[11] Automatic enrollment is also being used to increase retirement savings in countries other than the United States. For example, automatic enrollment is a key feature of a national pension reform that is currently being rolled out in the United Kingdom.

Figure 2. Fraction of Plans with Automatic Enrollment



Source: *How America Saves: 2013* (Valley Forge, PA: Vanguard, 2013).

Figure 3. Automatic Enrollment by Plan Size



Source: *How America Saves: 2013* (Valley Forge, PA: Vanguard, 2013).

Endnotes

[1] Alicia Munnell, Anthony Webb, and Francesca Golus-Sass, "The National Retirement Risk Index: An Update," Working Paper 12-20, Center for Retirement Research at Boston College, 2012.

[2] *2013 Investment Company Fact Book*, 53rd ed. (Washington, DC: Investment Company Institute, 2013), http://www.ici.org/pdf/2013_factbook.pdf.

[3] For a review of the literature, see Justine S. Hastings, Brigitte C. Madrian, and William L. Skimmyhorn, "Financial Literacy, Financial Education and Economic Outcomes," *Annual Review of Economics* 5 (2013): 347–73.

[4] *2012 Universe Benchmark Highlights: Measuring Employee Savings and Investing Behavior in Defined Contribution Plans* (London: Aon Hewitt, 2012), http://www.aon.com/attachments/human-capital-consulting/2012_Universe_Benchmarks_Highlights.pdf.

[5] Brigitte C. Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," *Quarterly Journal of Economics* 116, no. 4 (2001): 1149–87.

[6] *How America Saves: 2013* (Valley Forge, PA: Vanguard, 2013), https://institutional.vanguard.com/iam/pdf/HAS13.pdf?cbdForceDomain=false.

[7] Richard H. Thaler and Shlomo Benartzi, "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving," *Journal of Political Economy* 112, no. S1 (2004): S164–S187.

[8] John Beshears, James J. Choi, David Laibson, and Brigitte C. Madrian, "The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States," in *Lessons from Pension Reform in the Americas*, edited by Stephen J. Kay and Tapen Sinha (New York: Oxford University Press, 2008), 59–87.

[9] James J. Choi, David Laibson, Brigitte C Madrian, and Andrew Metrick, "Saving for Retirement on the Path of Least Resistance," in *Behavioral Public Finance: Toward a New Agenda*, edited by Edward J. McCaffrey and Joel Slemrod (New York: Russell Sage Foundation, 2006), 304–51.

[10] Harris Interactive, "Retirement Made Simpler," survey prepared for AARP, FINRA, and Retirement Security Project, 2007, http://www.retirementmadesimpler.org/Library/FINAL%20RMS%20Topline%20Report%2011-5-07.pdf.

[11] *How America Saves: 2013*.

Spotlight 12, October 2014

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