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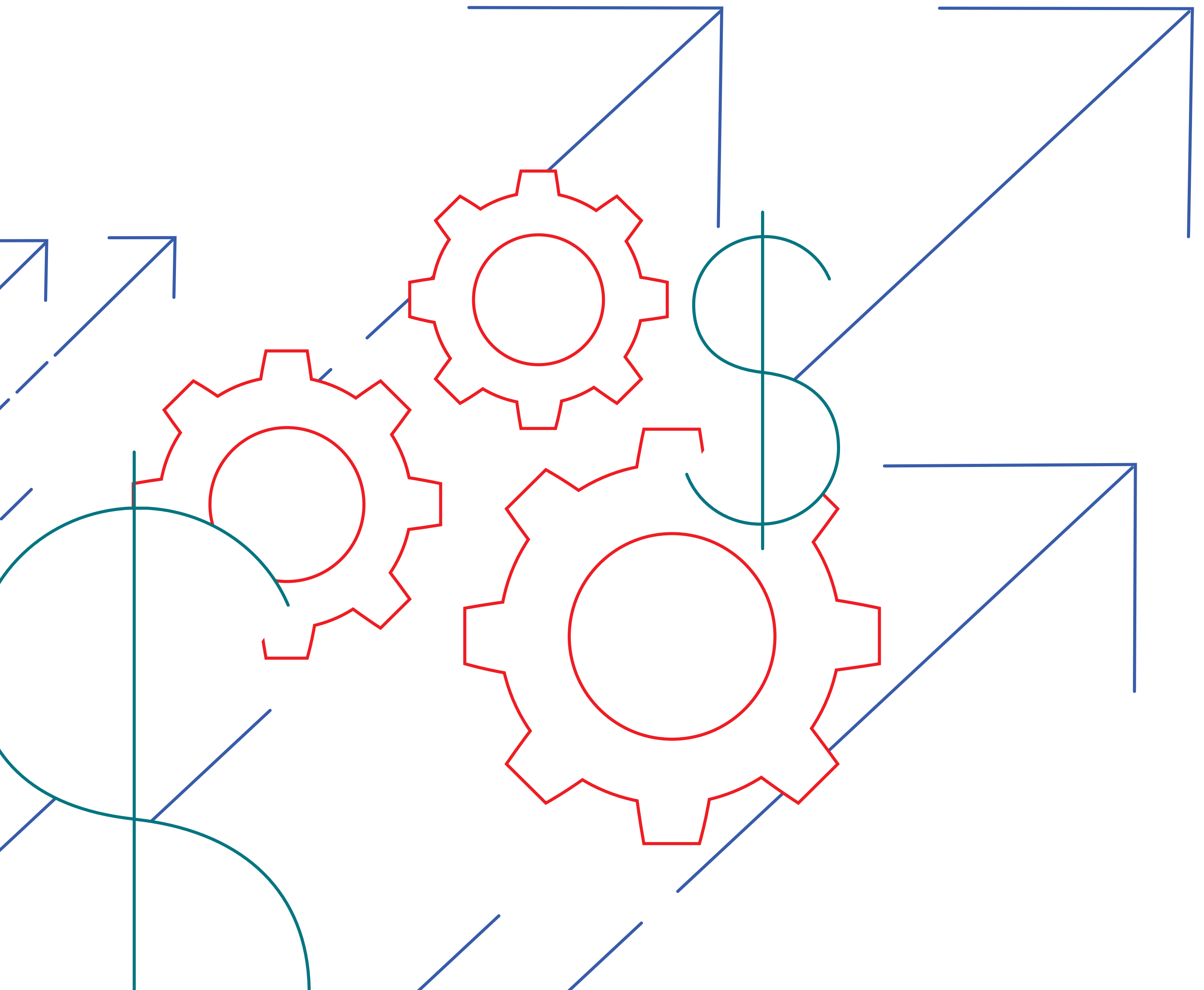
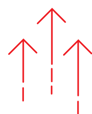
# Using Carrots, Sticks, and Nudges to Improve Retirement Savings Rates



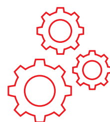
Too often, employers are focused on improving employee participation in defined-contribution plans and pay less attention to their workers' overall retirement readiness. This misplaced focus has led to inadequate default savings rates, which are the rates employees save automatically if they don't set their own. The expectation is that employees will save more later, but this "save more tomorrow" approach may prevent employees from reaching an appropriate savings rate. If we want a more immediate impact on retirement readiness, we shouldn't wait for tomorrow. Our research explores how to help employees save more today. The results strongly suggest that:

Employer match contribution impacts how much an employee saves.

Higher savings recommendations through in-plan financial advice result in higher implemented savings levels.



Increasing default savings rates could likely be the simplest and most effective way to boost retirement savings.



Automated features, such as automatic enrollment and automatic escalation, should be used and presented strategically to be effective.

## Shifting Course to Boost Savings

Despite initial promise, many defined-contribution plans have fallen short of providing a clear path to retirement readiness for many Americans.

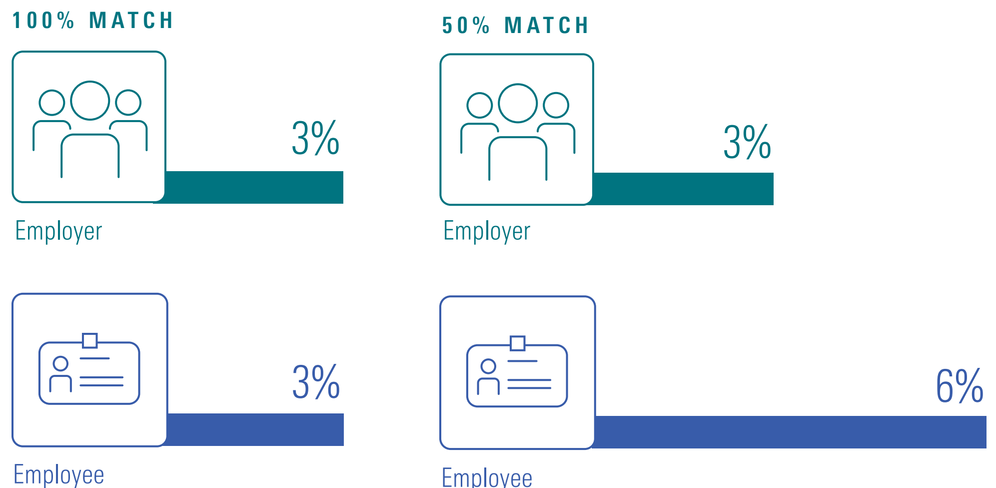
Using empirical participant data and the results of an online survey, we looked at three broad approaches to potentially improve participant savings rates: the carrot (stretching the employer matching contribution), the stick (in-plan financial advice), and the nudge (raising savings rate expectations with higher defaults and larger increases in features such as automatic enrollment and automatic escalation). We break them down below:

## The Carrot: Stretching the Employer Match Contribution

In the case of defined-contribution plans, the employer match is the so-called carrot that can help encourage higher savings. Like the mule driver who uses a carrot for motivation, the match acts as the reward for making progress toward benchmarks or goals.

Employer match is often cited as a leading reason why employees choose to participate in a defined-contribution plan, but it doesn't conclusively improve participation. However, the results of our study strongly suggest that the match impacts how much an employee saves. This means an employer could get more from its match by stretching it.

For example, instead of offering a 100% match on the first 3% saved—which is the most common rate—an employer could offer a 50% match on the first 6% saved. The employer would still be contributing 3% in both scenarios, but the employee may be incentivized to save twice as much to get the entire match.



## The Stick: In-Plan Financial Advice

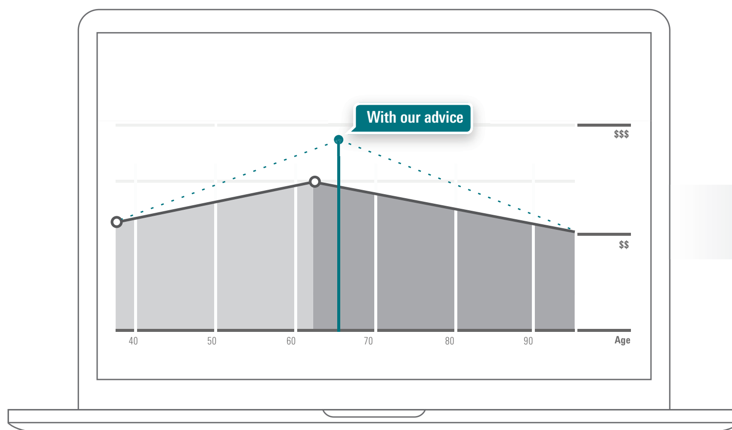
Many participants may feel that the default savings level is all that's required for them to reach their retirement goals. But for most people, the savings level required is significantly higher.

Informing participants how much they should save to meet their retirement goals can potentially improve retirement savings rates. This can be done through financial planning or advice that's offered within defined-contribution plans. Such advice might be thought of as a behavioral "stick"—a threat of punishment of one's own making in the form of an underfunded retirement.

Recent research suggests that total pretax savings, including employee deferrals and employer match, should exceed 15% for most workers.[1]

Our study shows that 90% of participants who received some form of in-plan guidance increased savings rates, by about 2 percentage points on average.

When participants received higher savings recommendations in our study, they tended to save more. That suggests that advice solution providers also should consider being aggressive when providing savings guidance to participants.

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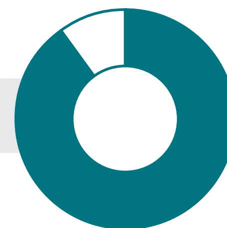

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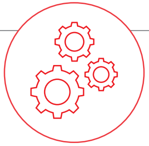
1. Blanchett, D., Finke, M., & Pfau, W. 2017. "Planning for a More Expensive Retirement." Working Paper.



## The Nudge: Higher Defaults and Automated Features

How choices are presented or designed can influence, or "nudge," certain decisions and outcomes. For example, if the goal is to increase employee participation in a retirement plan, a plan sponsor could automatically enroll employees instead of making them choose to be a part of it. This way, employees would have to opt out instead of opting in. A plan sponsor could also "nudge" participants by using a higher default savings rate, automatic enrollment, and automatic escalation. Here's a look at how these approaches may work:

### Higher Default Savings Rate

The most popular default savings rate is 3%, which is selected by about 50% of defined-contribution plans.[2] Our study shows that increasing the default savings rate is likely the simplest and most effective way to get participants to save more for retirement.

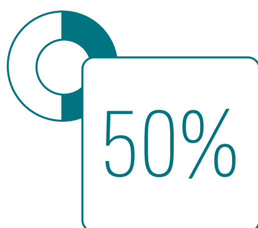
#### The Endorsement Effect

In defined-contribution plans, a participant may see the default savings rate as an endorsement of a course of action and accept it without considering why it was selected. Our study shows that participants tend to accept the default savings rate, regardless of the level.

#### The Default as an "Anchor"

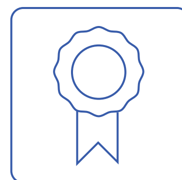
Even if the participant rejects a higher default savings rate, it still may serve as a psychological anchor. In our study, those who didn't accept the default rate tended to save more as the rejected default rate increased. This finding suggests that the default rate plays a valuable role in setting expectations for a participant's savings decision and driving savings.

Whether participants accept or reject a higher default savings rate, the results suggest that plan sponsors could, and should, be aiming higher than the popular 3% savings rate to help nudge their employees to save more.




of defined-contribution plans select 3% as their default deferral rate.

**Automated Features**



ENDORSEMENT

A participant may see the default savings rate as an endorsement of a course of action and accept it.

ANCHOR

Those who didn't accept the default rate tended to save more as the rejected default rate increased.

2. BrightScope/ICI (2014), Vanguard (2016), and T Rowe Price (2016) noted 59%, 48%, and 38% of participants, respectively.

### Automatic Enrollment

Defined-contribution plans have increasingly adopted automatic enrollment, in which employees are enrolled in the plan unless they choose not to join. Plan sponsors who have adopted automatic enrollment generally see an increase in participation. However, the relatively low default savings rates typically used result in decreases in average savings. We found that because of the acceptance of low default savings rates, participants who are automatically enrolled are saving less than participants who voluntarily enroll.

Our findings suggest that plan sponsors interested in improving initial employee savings levels should adopt automatic enrollment and select an aggressive default savings level to help increase retirement savings.

### Automatic Escalation

With automatic escalation, savings rates increase each year unless the participant opts out of the feature. This can be offered with automatic enrollment. But despite its promise of getting participants to commit to future higher savings rates, automatic escalation has not been widely adopted. Adding this service would help increase retirement savings, but its potential success is dependent on overcoming a couple of strategic obstacles.

"...plan sponsors interested in improving initial employee savings levels should adopt automatic enrollment and select an aggressive default savings level to help increase retirement savings."

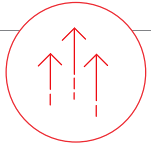
#### Opting In vs. Opting Out

Automatic escalation shows significantly different results when participants must opt in to the service. In our study, 68% of T. Rowe Price plans offer automatic escalation, and 62% do so on an opt-in basis. For these opt-in plans, only 11% of participants remained in the plan compared to 68% of participants who stayed after being automatically enrolled as part of an opt-out model. This study suggests that to help participants save more, they should be defaulted into automatic escalation.

#### Employee Turnover

A problem with relying on higher future savings is employee turnover. The median employee tenure today is about four years for all American workers and less than three years for workers under the age of 34.[3] This could result in perpetually low savings rates, because people rarely carry their escalated rate to a new job. For example, if an employee is automatically enrolled at a 3% savings rate and receives 1% increases for three years, his or her savings rate would likely revert to 3% after leaving for a new job. For someone changing jobs every three years, the rate would never exceed 6%. Setting a higher default savings rate would help overcome this obstacle—and keep in mind that participants tend to accept a default rate up to 6%.

3. https://www.bls.gov/news.release/tenure.t01.html



## Funding for the Future Today

Given chronically low savings levels for individuals at and near retirement, the issue of retirement readiness is urgent. This lack of readiness shows that designing a retirement plan with a low default rate, with the hope of increased participation and "saving more tomorrow," isn't enough. Fortunately, there is a relatively painless path plan sponsors can take to improve savings rates for participants. This path focuses on the carrot (stretching the employer match), the stick (higher recommended savings rates from a financial planner), and the nudge (more intelligent defaults). Our research suggests that plan sponsors need to continue using nudges such as higher defaults and automated features to help participants not only save more tomorrow, but more importantly, to save more today.

The research and study in this paper refers to David Blanchett's "Save More Today: Improving Retirement Savings Rates with Carrots, Sticks, and Nudges" (2017) research paper. To read the full research paper, download it here.

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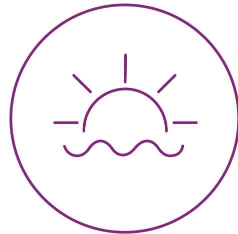

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