

How to auto-escalate your 401(k)

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Introduction

The modern retirement system has been transformed by the introduction and adoption of auto-enrollment and auto-escalation. These behavioral features have made it easy for workers to start saving earlier and to save more over time. They've also helped close longstanding gaps in retirement plan participation across gender, race, ethnicity, and income.

However, the world of “auto-everything” still leaves practical questions unanswered. While recent research by the Voya BeFi Institute¹ has identified key features to enhance auto-enrollment, such as the optimal initial default savings rate, it's less clear how plans might best implement auto-escalate features. Of course, getting the details of auto-escalation right is of critical importance, as escalator features are crucial for helping enrolled participants save for their retirement.

What happens if we increase the escalator from 1% to 2%?

In designing a successful auto-escalation plan, two questions are paramount. The first question is the size of the escalator increments. Nearly all plans currently feature a 1% annual escalator. But what happens if we increase the escalator from 1% to 2%? Does accelerating the pace of escalation lead some enrollees to save more, faster? Alternatively, does it lead to an increase in those declining enrollment? Or perhaps it boosts engagement and personalization, allowing people to customize their preferred level of escalation, with some staying at 2% and others opting for 1%?

A second question involves the timing of future escalation. Although research has demonstrated that employees are far more willing to increase their rate of saving in the future than they are in the present, it remains unclear when the “future” actually begins in the minds of enrollees. Put another way, would enrollees agree to escalate saving if such escalation were to occur sooner than one year? What is the ideal delay for increasing saving without significantly increasing opt-out rates?

These details are important to get right given current labor market trends. If workers stayed at the same job for decades, the pace of escalation would be less impactful, as even a slow escalator would still lead to many years of saving at a high rate. However, according to the Bureau of Labor Statistics, the median employee tenure was only 4.3 years for men and 3.8 years for women, as of January 2022.² This short tenure means that it's critical to get workers to the right savings rate sooner rather than later.

¹Beshears, John and Benartzi, Shlomo and Mason, Richard and Milkman, Katherine L., How Do Consumers Respond When Default Options Push the Envelope? (October 7, 2017). Available at SSRN: <https://ssrn.com/abstract=3050562> or <http://dx.doi.org/10.2139/ssrn.3050562>

²Bureau of Labor Statistics, Employee Tenure in 2022; <https://www.bls.gov/news.release/pdf/tenure.pdf>

The field study

To better understand the optimal settings for auto-escalators in retirement plans, researchers Saurabh Bhargava, Rick Mason and Mark Patterson at Carnegie Mellon and Shlomo Benartzi at UCLA conducted a field experiment in which they randomized the default auto-escalation options displayed to 22,170 new 401(k) enrollees across 398 plans. These plans used an opt-in enrollment process where employees had to choose whether they save and whether they want auto-escalation (this is different from automatic enrollment plans, where employees are often automatically assigned escalation features). The researchers then observed the escalation choices of enrollees at the time of enrollment and checked in on their savings several months later.³

How does a new employee typically enroll in auto-escalation? After an employee reaches the end of the 401(k) enrollment process, prior to confirming their enrollment, they are asked whether they want to also enroll in auto-escalation. While employees can specify their rate of escalation and even specify the date when such escalation will begin, nearly everyone who enrolls in auto-escalation sticks with the prominently displayed default parameters of a 1% escalator and a delay of one year.

Here's where the researchers stepped in. To understand the impact of different auto-escalator settings, they experimentally varied whether an enrollee would see a default escalator of 1% or 2% and whether the start date of escalation was a year, six months, or three months.

The results

What did the researchers find?

Defaults really matter.

First, they learned that defaults really matter. A majority of auto-escalation enrollees followed the default escalators and delays.

Second, the researchers found that faster default escalators can lead to faster escalation over time. Among the employees who were shown a 2% default escalator and decided to participate in auto escalation, roughly half ultimately stuck with the default 2%. The majority of the remainder switched back to 1%, but still chose to escalate. And critically, the higher default escalator did not meaningfully increase the share of employees initially declining auto-escalation. The combination of more aggressive default escalation increments and no corresponding drop in enrollment suggests that plans could increase saving by increasing the escalation increment to 2%.

³ Bhargava, S., Mason, R., Patterson, M., & Benartzi, S. (2022). When does the future begin? 401(k) auto-escalation over future time horizons. Working paper forthcoming.

Finally, among employees who decided to enroll in automatically escalating plans, a substantial share of employees were willing to escalate well before 12 months had elapsed. In fact, when prompted by the default, 54% of employees appear willing to escalate in 90 days, and 67% in 180 days. This suggests that, for the majority of employees, the “future” begins within a few months. However, the more aggressive default delays, which led to escalation beginning sooner, did modestly reduce escalation enrollment (from 23% to 18%).

Key takeaways

What do these findings teach us about how we can improve plan design and communication to help employees save more for retirement?

Plans can likely increase employee savings by adopting higher default escalators.

The main lesson is that plans can likely increase employee savings by adopting higher default escalators. Instead of setting default escalation increments at 1%, they may be able to set them at 2% without significantly decreasing participation. And, while plans can also accelerate the pace of saving by setting their auto-escalation defaults to begin sooner, they should address the potential for lower enrollment. For example, they could remind enrollees who decline escalation that they can auto-escalate with a year delay if they prefer.

Ultimately, these findings also highlight the need for additional research to help determine the optimal escalation default for different types of employees. By creating personalized defaults, we can help more employees boost their savings while further minimizing the share of employees who decline escalation. In striving to optimize the design of retirement savings products, plans should not overlook the importance of appropriately setting and personalizing auto-escalation defaults.

By helping workers get to the right savings rate in less time, we can design auto-escalation processes that help employees be more prepared for retirement, even in a modern labor market where people regularly change jobs.

This report is for educational purposes only. Each plan must consider the appropriateness of the investments and plan services offered to its participants.

Auto-enrollment and auto-escalation do not ensure a profit or guarantee against loss in declining markets. Investors should consider their financial ability to continue their purchases through periods of low price levels.

All investing involves risk, including the loss or principal. There is no guarantee an investment, investment strategy, or managed portfolio will meet its stated objective.

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