The Language of Employees Savings: Encouraging Employees to Capture the 402(g) Limit

Michael J. Malone, CPC, AIFA

How do you respond when an employee asks you "how much should I be contributing to my 401(k) plan?" If you are like most plan sponsors, providers or advisors, you will typically respond by beginning a dialogue about how employees should be deferring at least a certain "percentage" of pay, that this "percentage" should be high enough to capture the employer match and that this "percentage" should be increased annually. But if you ask us, our answer is simply this: "$17,000...the maximum the law allows."

There is no doubt that 401(k) plans have come under increasing criticism over the past several years, with Washington, academia and the popular press all questioning the ability of 401(k) plans to help participants achieve financially dignified retirements. These criticisms focus primarily on the losses suffered by target date funds in the wake of the 2008 market crash as well as the excessive fees paid by some 401(k) plans. Some of these criticisms do have merit, but the fact is that 401(k) plans are an excellent vehicle to facilitate retirement savings. Unfortunately, they are not perfect and even the best designed plans have their limitations. However, it is not the investment options or fees that are the big problem with 401(k) plans – it is that they are undercapitalized because participants are simply not saving sufficient amounts to reach their retirement plan goals. It is not stretching the truth to say that nearly *everyone* needs to be contributing more to their 401(k) plan.

MJM401k

www.mjm401k.com

Phoenix, AZ 602.224.5599

Santa Monica, CA 310.899.3942

We believe that as an industry, we have unwittingly contributed to this problem by creating unrealistically low expectations for employees when it comes to helping them set their savings goals. Employees look to us as experts, and despite our good intentions, we have failed to set the bar high enough. Since we do not want to make employees feel bad if they cannot afford to save a higher amount, we have tended to approach this issue too cautiously. When we were designing our first 401(k) plans in the early 1980s, we simply encouraged people to participate in the plan at any level. I remember telling people to just put in 1% of pay if they could – that it was better than not participating at all. As time went by, and it became clear that participation at negligible levels would not lead to adequate retirement savings, we began to emphasize contributing enough to take full advantage of the company match. While this has been an improvement, it still does not lead participants to a level of savings that will be sufficient for the majority of them. It is now clear to us that it is time to move onto the next logical step in the progression – to encourage all participants to reach what we call the *"402(g) Capture".*

The 402(g) reference is to the section of the Internal Revenue Code which defines the maximum permissible amount that an employee may defer under a 401(k) plan and which may be increased year to year by the IRS based upon cost of living adjustments. For 2012, the maximum amount allowed under 402(g) is $17,000. In addition, employees who are age 50 or older may defer an additional $5,500 "catch up" contribution each year - for a total of $22,500. These are the amounts that all employees should be encouraged to capture each year. While there is no question that an annual deferral of $17,000 (or $22,500) is a high bar for some and may be unrealistic for others, it is a lofty goal that all employees should aspire to even it may take a few years to get there. However, we are convinced that employees will not get there as quickly if we continue to speak in terms of "percentages".

Employee communications have always been challenging, and we believe that speaking in percentages does not make this challenge any easier. Whether it is the amount that an employee should be saving, or the amount of income they will need at retirement, we believe that dealing in dollars with employees is far more helpful to many of them. Why? Because most people by nature tend to think in dollars rather than in percentages. Encouraging employees to capture the 402(g) limit of $17,000 paints a very clear picture to them of where they should be headed as a savings goal. In addition, behavioral finance suggests that using the maximum amount as *the starting point* in participant communications could be one way to significantly increase contribution rates. People tend to do their own internal benchmarking when making financial decisions – they measure against something they already have in mind. Someone from Los Angeles who is heading to a vacation in Miami might think of a side trip into Georgia as convenient. After all, you have already traveled nearly 3,000 miles - why not travel a few more? But someone who lives in Miami is more likely to think of a trip to Georgia as a bigger commitment. The same is true of money. If employee communications consistently present $17,000 as the standard, participants tend to measure their own contributions from that figure, rather than from the 2%, 6%, or even 0% that may have been suggested in past communications. It doesn't seem like such a long trip to increase your contribution to $12,000, for example, when the goal figure you have in mind is $17,000.

Advancing the concept through benchmarking

So how do we start the movement of speaking in dollars and 402(g) Capture? One way might be through plan benchmarking. Using 401(k) plan benchmarking as a tool to help improve participant outcomes has grown significantly in popularity over the last several years. 401(k) plan providers are increasingly supplying their clients with a host of benchmarking data as are a number of independent firms that have emerged in this growing market.

Benchmarking a plan generally consists of documenting various aspects of the company's 401(k) and then comparing it with the results for a designated peer group (same industry, same plan size, geographical location, etc.). A number of attributes of the plan can be measured. Some of these are based on the plan design choices made by the employer (such as eligibility, company match, Roth deferral opportunity, vesting, loans, etc.). Others measure the results of these choices. The idea is that if a plan lags its peers in one or more areas, then plan design changes can be made or participant communications efforts can be enhanced to achieve better results.

Savings – the most important benchmark

Of the various plan benchmarking factors, we would argue that those related to employee savings are the most important. As we previously noted, while much of the 401(k) discussion these days tends towards investments and plan fees, undercapitalization (participants not saving enough) is our industry's biggest challenge. As defined benefit pensions have faded in existence, and with continued concern about the long-term viability of social security, individual savings in 401(k) plans becomes even more important to achieving favorable retirement outcomes.

Measuring the savings behavior in their plans, then, is absolutely critical for plan sponsors. Most employers direct their focus on two fundamental metrics. The first, *employee participation*, tells the company how many of its employees are saving at any level by dividing the total number of employees who made contributions for the period by the total number of employees who were eligible to do so. Nationally, various studies show that average participation is around 75% - meaning that 3 out of every 4 employees who are eligible to participate in the plan are actually contributing.

Once we know who is contributing under the plan, the next question becomes measuring how much they are contributing. The *average deferral rate* is the generally accepted measurement for determining the extent to which the plan's participants are saving, expressed as a percentage of their pay. The rate is calculated by first dividing each employee's individual 401(k) deferrals for the period by their compensation, and then taking an average of those percentages for all employees who are deferring under the plan. Various studies show that on a national basis, the average deferral or savings rate for employees who are participating in 401(k) plans is somewhere between 6% and 8%. Stated another way: even after three decades of encouraging employees to save for retirement, the average deferral rate for 75% of plan-eligible employees is just 6-8% of pay – and 0% for the remaining 25%. What can be done to improve on the savings rate?

Capturing the maximum under Section 402(g)

Within the last several years, we have begun looking at an alternative savings success metric based on the concept of "402(g) Capture" as described above Using a 402(g) Capture plan wide benchmark, we are able to measure how many participants are succeeding in their 402(g) Capture, and how the total dollars deferred compared to the theoretical maximum amount that could have been contributed based on the limits of the law. Here is a recent client example illustrating this calculation:

Participant Age Group	Number of Participants	IRC § 402(g) Limit	Total Deferral Possibility
Age 49 and Under	2,634	$ 16,500	$ 43,461,000
Age 50 and Older	849	$ 22,000	$ 18,678,000
Total	**3,483**		**$ 62,139,000**

The table above shows that the total possible deferrals under the plan for 2011 as $62,139,000. This is simply the number of participants in the age category multiplied by the applicable limit. To determine the percentage of the 402(g) limit that was actually "captured" by the plan's participants, we divide the total amount that participants actually deferred in 2011 by $62,139,000. In this case, their 2011 deferrals were $28,583,940, so the *402(g) Capture* ratio for the plan was 46% ($28,583,940/$62,139,000). This plan captured nearly half of all of the permissible deferral amounts available under the IRS limits. So is that good, meaning, how does this compare to other plans, particularly those in the same industry? The answer is that the industry does not have enough meaningful data yet, but if plan benchmarking firms and plan providers began to routinely measure this outcome each year, perhaps we could make this a prominent measure of plan success. And by routinely reviewing this and other plan metrics each year, plan committees could continue to use this data in their plan design and plan communication strategic decisions.

A Good First Step

Changing the language of employee savings, not only from percentages to dollars, but to the dollar limits, is a good first step in helping to solve the problem of undercapitalization. By calculating and comparing a plan's *402(g) Capture Ratio* each year, plan committees can find ways to get more and more employees to capture their share of the maximum limit.

Michael J. Malone, CPC, AIFA

Mr. Malone is the founder and managing director of MJM401k, an independent consultancy serving 401k plan sponsors and committees. Prior to MJM401k, Mr. Malone served as a director and retirement plan consultant with both a regional and a national consulting and advisory firm.

Mr. Malone is a Certified Pension Consultant (CPC) with the American Society of Pension Professionals & Actuaries, and is an Accredited Investment Fiduciary Analyst™ (AIFA). Mr. Malone was honored with the 2011 401(k) Advisor Leadership Award, a national award sponsored by Morningstar, Inc. and the American Society of Pension Professionals & Actuaries (ASPPA). He is a Past-President and a past board member of the Western Pension & Benefits Conference, and was awarded a Lifetime Achievement Award by that organization in 2008. He is also a member of various other employee benefits professional groups, including the Arizona Employee Benefits Forum, Profit Sharing Council of America (PSCA), and previous memberships in World-at-Work and the New England Employee Benefits Committee. In addition, he is a past-member of ASPPA's Government Affairs Committee and past-Chairman of its Committee on IRS Enforcement. For over twenty-five years, Mr. Malone has been a frequent author and lecturer throughout the US at industry conferences on the various plan design and plan investment aspects of pension and 401k arrangements, and has provided expert testimony to the ERISA Advisory Council at the Department of Labor. His 401k plan consulting experience began with work on some of the first plans in the country, and has continued since then covering hundreds of corporate clients and tens of thousands of plan participants.

About MJM401k

MJM401k was founded by Michael J. Malone, a thirty-year veteran of the 401(k) industry, as a response to the need for employers to have access to objective, non-conflicted, and expert advice for their 401(k) plans. With offices in Phoenix and Santa Monica, MJM401k's only business is serving as a trusted consultant to retirement plan sponsors. In addition to its ongoing investment consulting engagements, MJM401k assists its clients with various projects, such as fee benchmarking, RFP provider searches and negotiations, investment analysis, investment policy statements, plan design, and employee communications. Please visit www.mjm401k.com for more information or call 602.224.5599.