Employee Retirement Readiness

ITS IMPACT ON LONG-TERM ORGANIZATIONAL SUCCESS

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Nearly twice as many (35 percent) are “not too” or “not at all” optimistic about their retirement prospects – and with good reason. The same poll indicates only one-third of people covered by a retirement plan have liquid financial assets exceeding $100,000. That’s a very slim portion of the savings most Americans will need to accumulate so they can afford to retire. This savings gap poses serious financial challenges for employees and employers alike, both today and into the future.

There is encouraging news, however: Employers that recognize the seriousness of the challenge and are willing to take decisive steps to guide employees down the path to retirement affordability can turn the situation around.

For plan sponsors (employers who offer employer-sponsored retirement plans) it means engaging employees to have sufficient financial assets to retire on time. For participants (employees who are participating in employer-sponsored retirement plans), it requires replacing around 70-80 percent of their highest preretirement income with an adequate capital reserve and drawdown strategy to last them at least until age 90.

The consequences of a lack of retirement readiness are clear. For employees, it can mean being forced to continue working during a time in their lives when they would rather be doing other things. Also, some employees of retirement age that have inadequate retirement savings may be unable to continue working because of age-related health problems, a financial disaster.

Why Retirement Readiness Matters

For employers, the fallout of a broad retirement readiness shortfall can include all of the following:

- Older employees who don’t want to be working – but are forced to by financial necessity – are often less motivated, resulting in reduced productivity.
- When older, generally higher-paid employees retire, payroll costs decline. A higher concentration of senior employees keeps payroll costs at higher than desired levels.
- Employer-paid health benefit costs typically are higher for older employees.

When more senior positions are held by older employees who can’t afford to retire, promotion opportunities are more limited for younger workers, which may impact their engagement and motivation.

Finally, not being able to replace older employees limits employers’ ability to infuse the workforce with younger workers.

These adverse consequences appear to be high on employers’ list of concerns. In a recent Deloitte survey, employers identified “facilitating optimal retirement income replacement” as their retirement plan’s top objective.

Before seeking to address a retirement readiness shortfall within your employee population, it’s necessary to determine the nature and scope of the challenge. While every employee’s financial picture may be different, it’s possible to use some very basic rules of thumb to get a snapshot.

How Much Is Enough?

For example, widely available online are “income replacement” calculators that estimate the monthly income a retiree could draw, based on a percentage of his or her retirement portfolio, stipulating a number of years lived in retirement and how the retirement portfolio will be invested – conservatively, moderately or aggressively. For perspective, here are two illustrations:

1. Suppose an employee wants sufficient funds to live in retirement for 30 years and is comfortable with a middle-of-the-road asset allocation for his investment portfolio. Further suppose he wants to replace 80 percent of his $75,000 pre-retirement income and is expecting his initial annual Social Security benefit to be $22,000. He would need a $1 million portfolio at retirement to meet his goal, based on an assumed 3.8-percent annual portfolio withdrawal rate. Using that assumption, the employee would draw $38,000 annually from his portfolio. That figure, combined with a $22,000 annual Social Security benefit, equals $60,000, or 80 percent of his $75,000 annual salary.

2. A conservatively invested $500,000 nest egg intended to last 35 years, based on a 3-percent annual withdrawal rate, would only generate a $15,000 annual ($1,250 monthly) retirement income.

Suppose an employee needs to accumulate $500,000 more to fund a desired retirement income. If the employee had only 15 years to do it, assuming a 7-percent annual rate of return, it would take nearly $20,000 in annual savings to make it happen. If the employee is prepared to wait 20 years to retire, the number is closer to $12,000.

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3 Four percent has been a commonly used safe withdrawal rate benchmark based on a scenario such as this. In light of sustained low interest rates and somewhat diminished long-term stock market performance expectations, however, the 3.8-percent number was used in this illustration.
Chances are, a rough estimate of your employee population’s retirement readiness, even based on moderate retirement income expectations, will suggest there’s trouble ahead. According to the Deloitte survey, only 23 percent of employers have conducted a retirement readiness assessment in the last year, but 42 percent are considering doing so. (Note: BB&T’s retirement plan specialists can assist you to conduct a composite employee retirement readiness assessment.)

Responding to the Challenge

Addressing the challenge of maximizing employee retirement readiness requires the creation of a clear strategy, with effective steps on two fronts: participant communication and plan design. A retirement plan services professional can work with plan sponsors to build and implement such a strategy.

The key to the communication component is participant engagement. When employees take advantage of retirement-savings calculators and translate general principles to specific dollar amounts applicable to their situation, they become engaged. Effective retirement modeling tools can incorporate existing retirement savings along with hypothetical future actions and translate it all to projected monthly income at retirement.

When such tools are offered in the context of a sustained, demographically targeted, retirement planning educational campaign using multiple communications media, they prompt employees to adjust their savings pattern to achieve their goals (see story at right for an example).

Depending on the audience, jumping immediately into the topic of retirement saving could be counterproductive if a basic financial education foundation has not first been laid. For example, a “financial wellness” program aimed at helping employees to manage debt, and establish and live within a budget, is a good starting point.

The Role of Plan Design

Plan design works hand in hand with effective participant communication and education to keep employees on the path to retirement readiness. In recent years, most plan sponsors – 62 percent in the Deloitte survey – have come to accept the importance of giving employees a firm nudge to take full advantage of their retirement plan through auto-enrollment features. Concern for employee retirement readiness has generally overtaken worries about being overly aggressive in inducing particular employee behaviors and the added cost in employer-matching contributions of maximizing participation rates.

The Deloitte survey found auto-enrollment, as an instigator of plan participation, was only surpassed by the motivations of “personal desire to save for retirement” and “take advantage of company match.” According to the survey, following auto-enrollment in importance was “proactive communication.”

Few participants reject auto-enrollment by opting out. The Deloitte survey reports that for 68 percent of plan sponsors with auto-enrollment features, no more than 5
percent of employees did so. Only 23 percent had opt-out rates as high as 10 percent, indicating broad employee acceptance of the practice.

The most common initial default auto-enrollment deferral rate is 3 percent (used by 47 percent of plan sponsors). However, the proportion of employers getting auto-enrolled employees off to a stronger start with a 6-percent deferral rate has grown to 22 percent from only 9 percent in 2012.

Another important plan design element that can enhance employee retirement readiness is the automatic contribution step-up, which is also becoming more commonly accepted as a default feature. Specifically, 57 percent of plans in the Deloitte survey have automatic step-up provisions; two years ago, the total was 52 percent. Three-quarters of plans defaulting participants into an annual automatic contribution step-up do so in 1-percent increments.

When employees are making their own decisions about deferral rates, contribution-matching formulas can be optimized to encourage high contribution levels. For example, a 50-percent match on up to a 6-percent deferral is more effective than a 100-percent match on up to a 3-percent deferral. The former supports a maximum deferral of 9 percent, while the latter only supports a maximum deferral of 6 percent.

Keeping It Simple

Simplifying participant decision-making with suitable plan investments is also a key driver of retirement readiness. The popularity of target-date retirement funds, offered by 83 percent of sponsors in the Deloitte survey, reflects that principle. Similarly, target-date funds were the overwhelming favorite (85 percent) choice as the default investment option for employers that auto-enrolled participants.

When employees are on the threshold of retirement, they are more willing to take that decisive step if they have confidence their accumulated retirement assets can become an income stream that will last them for the rest of their lives.

Although few employers today are incorporating insurance company-issued annuities into their defined contribution plans, they still can educate employees about the range of income solutions that are available to them – whether in the form of sustainable withdrawal strategies or external solutions.

The job of putting employees on a steady path to retirement readiness is a dynamic and multidimensional process. It is also crucial to your organization’s future. The task can be made easier with the support of a retirement plan service provider that can offer employees a host of complementary services supporting their financial needs – as strengthening overall financial wellness is a key requirement of retirement readiness.

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