PLANNING FOR RETIREMENT:
THE ROLE OF 401(K)S IN RETIREMENT INCOME

George Castineiras
Senior Vice President

James McInnes
Senior Vice President

Total Retirement Solutions
Prudential Retirement

Individuals have a realistic chance at a secure retirement when they augment Social Security with appropriate savings behavior. 401(k) and similar types of plans ("401(k) plans") are the most promising vehicles to foster good savings behavior, particularly when plans have automatic features that can help individuals make the right savings decisions.[1] The Pension Protection Act of 2006 (PPA) significantly improved the effectiveness of 401(k) plans by facilitating the adoption of features such as automatic enrollment and automatic contribution escalation, which help to increase participation and improve savings adequacy.

With fewer future retirees receiving retirement income from traditional pension plans, the role of 401(k) plans is becoming increasingly important. Social Security will continue to play a critical role, providing approximately 40 percent of the average retiree's income.[2] (Social Security represents a higher percentage of income for lower-income retirees, and a lower percentage for higher-income retirees.)[3] An important follow-up question thus becomes, "What percentage of retirement income should 401(k) plans provide?" New research by the Center for Retirement Research at Boston College (CRR) addresses this question.

The CRR produces the National Retirement Risk Index, or NRRI, which measures the share of American households at risk of being unable to maintain their standard of living in retirement. The NRRI calculates statistics for the average household across all income groups, as well as for three categories of household income groups – low income (under $41,500), middle income ($41,501–$ 76,500), and high income (over $76,500).[4] In the NRRI model, retirement income can be provided by Social Security, defined benefit plans, defined contribution plans, personal savings, and home equity. In the CRR's latest research, defined benefit, defined contribution, and other personal savings, including IRAs, were considered "401(k) wealth," as future retirees are unlikely to have defined benefit income, little personal savings occurs outside of 401(k) plans, and most IRA assets originated from defined contribution plan rollovers.

Findings

The CRR research finds that, on average, 35 percent of retirement income must come from 401(k) plans in order for households to maintain their pre-retirement standard of living. This translates to 25 percent for low-income households, 32 percent for middle-income households, and 47 percent for high-income households. (See Figure 1)

The research also established required 401(k) savings rates to achieve the targeted income amounts. Assuming retirement savings begins at age 35 and that retirement occurs at age 65, the average required savings rate to achieve the targeted income from a 401(k) plan is 14 percent of pre-tax household income per year. For low-income households the savings rate is 11 percent, for middle-income households it is 15 percent, and for high-income households it is 16 percent. (See Figure 1)

How much retirement income should a 401(k) provide? Figure 1

Income Group	Percentage of Retirement Income	Required Savings Rate
All	35%	14%
Low Income	25%	11%
Middle Income	32%	15%
High Income	47%	16%

Note: This example is based on savings beginning at age 35 and a retirement age of 65. The percentage of retirement income will vary based on retirement age. The required savings rate will vary based on the age at which savings begin.

In a simple exercise, the CRR researchers modeled an average wage earner in a single-person household retiring in 2040 at age 65.[5] They found that the required savings rate drops from 15 percent to 10 percent if the individual starts saving at age 25, instead of age 35. When the retirement age is changed to age 67 – the Full Retirement Age for Social Security for those born after 1959 – the required savings rate (starting at age 35) is lowered from 15 percent to 12 percent. When the retirement is further delayed to age 70, the required savings rate drops to 6 percent. If approaches are combined, with savings starting at age 25 and retirement occurring at age 70, the required savings rate drops to 4 percent. (See Figure 2)

Savings Rate Required for an Average Wage Earner to Attain a 70% Replacement Rate Figure 2

Retire at	Start saving at 25	Start saving at 35	Start saving at 45
65	10%	15%	27%
67	7%	12%	20%
70	4%	6%	10%

Note: The calculations assume a real rate of return of 4 percent and the purchase of an inflation-indexed annuity with the same rate as in the National Retirement Risk Index.

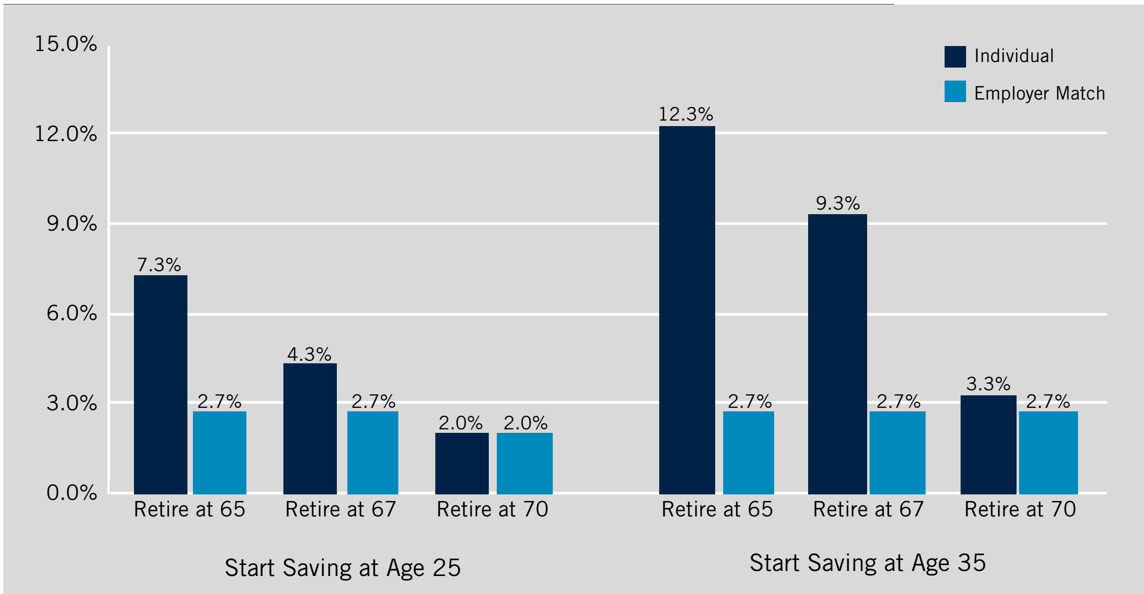
Source: CRR calculations.

More details can be found in the CRR Issue Brief, "How Much Should People Save?" by Alicia H. Munnell, Anthony Webb, and Wenliang Hou.

Prudential's Perspective

The findings of this latest NRRI research are encouraging. If savings start earlier and retirement is delayed by a few years, the required savings rate becomes even more achievable. Furthermore, many employers will match their employees' 401(k) contributions. The average employer match rate is 2.7 percent.[6] As shown in Figure 3, if a middle-income worker who starts saving at age 25 receives a 2.7 percent employer match and wishes to retire at age 67, the individual would need to save 4.3 percent annually, for a total savings rate of 7 percent. The same worker who begins saving at age 35 would need to save 9.3 percent annually, for a total savings rate of 12 percent.

Savings Rates for an Average Earner with 2.7% Employer Match Figure 3



Source: Prudential calculations based on CRR and Profit Sharing Council of America data.

Savings rate targets are within reach for many Americans, especially when savings start early and when 401(k) matching contributions are considered. The key is to get individuals started along a proper savings path and to improve savings behavior along the way. This is why access to 401(k) plans is so important, particularly plans with automatic features. Plans using Prudential as a recordkeeper have a 90 percent average participation rate for plans with automatic enrollment, vs. 62 percent for plans without.[7]

Providing participants with modeling tools that project future retirement income can improve savings behavior by increasing savings rates. As workers age, they need to shift from a focus on accumulation to a focus on retirement income. With the appropriate tools, 401(k) participants can see if they are behind in their retirement income objectives, and make appropriate adjustments. Nearly 20 percent of participants who complete Prudential's *Retirement Income Calculator* modeling tool immediately increase their 401(k) contribution rate, and do so by an average of 4.5 percent of pay.[8]

In-plan guaranteed retirement income options can also improve savings behavior by helping participants focus on retirement income as an end goal. Prudential found that participants who were investing at least a portion of their 401(k) savings in an in-plan guaranteed income option contributed 38 percent more than the average 401(k) participant.[9]

The bottom line is that a secure retirement for workers is possible. 401(k)s have been greatly enhanced since they were launched in 1978 as supplemental savings vehicles. With Social Security serving as a base, 401(k)s are an effective means to help achieve a secure retirement. 401(k)s provide tax-advantaged savings and the ease of saving through payroll deduction. Access to a 401(k) plan also brings investment education, advice, institutionally priced products, and employer-matching contributions to many American workers.

Implications

For Plan Sponsors

- Adopt automatic enrollment and automatic escalation features in 401(k) plans to help workers to save early, and at the appropriate amounts.
- Help workers to shift their focus from accumulation to retirement income as they get older.
- Provide planning tools to help individuals set and gauge progress against retirement income planning objectives.
- Add guaranteed lifetime income options to 401(k) plans, if such options are not already available.

For Individuals

- Have confidence that a secure retirement is achievable with proper 401(k) savings behavior combined with Social Security.
- Start saving early, commit to the automatic escalation of contributions in a 401(k) plan, and, at a minimum, contribute at a rate that maximizes the company's match.
- Consider working a few years longer and take advantage of catch-up contributions (if over age 50), especially if behind in a savings goal.
- Use guaranteed income products to help protect against the risk of outliving assets in retirement.
- Maximize Social Security claiming options. Prudential's white paper, *Innovative Strategies to Help Maximize Social Security Benefits,* provides some guidance.

For Financial Advisors

- Assist individual clients in determining an appropriate target retirement age, retirement income needs, and adequate retirement savings rates.
- Help individual clients create appropriate amounts of guaranteed lifetime income for retirement.
- Work with plan sponsor clients to add automatic features and guaranteed lifetime income options to 401(k) plans.

For Policymakers

- Build on the success of the PPA through regulation and/or legislation that:
  - Makes it more feasible for small employers to offer a 401(k) plan in the workplace.
  - Creates safe harbors that address potential employer concerns regarding the addition of guaranteed lifetime income products to 401(k) plans.

Recent Prudential Financial Papers That Touch on These Topics:

Innovative Strategies to Help Maximize Social Security Benefits, November 2012

Should Americans Be Insuring Their Retirement Income?, December 2012

Meeting the U.S. Retirement Challenge, June 2013

To find these papers or for more easy-to-reference information, visit research.prudential.com, a Prudential website containing original research that provides insights into important issues for our clients, financial professionals, policymakers, and the general public.

Prudential is the exclusive sponsor of the National Retirement Risk Index.

[1] This includes the various types of defined contribution or deferred compensation plans, such as 401(a), 403(b) and 457 plans, that provide similar savings benefits as 401(k) plans.

[2] Employee Benefit Research Institute, "EBRI Notes," p. 1, June 2010.

[3] Ibid, p. 2.

[4] These income thresholds are for households headed by 33- to 35-year-olds. The thresholds vary by age bracket.

[5] Based on Social Security Administration data, 2014.

[6] Profit Sharing Council of America, "PSCA's 56th Annual Survey of Profit Sharing and 401(k) Plans," p. 23, 2013.

[7] Prudential Financial, "Overcoming Inertia: Automatic Features That Improve Outcomes While Improving Your Plan's Bottom Line," 2013.

[8] Prudential calculation through May 2014.

[9] Industry average contribution rate 7.30% versus 10.13% for Prudential IncomeFlex participants, Aon Hewitt, 2010, Prudential Retirement, 2011. Study of nearly 20,000 Prudential Retirement full-service Defined Contribution participants, age 50 and older, researched during the period December 2007 through April 2011. Statistic is inclusive of IncomeFlex Select due to the start date of the research. IncomeFlex Select is no longer available for new clients. Prudential Retirement, "Better Participant Outcomes Through In-Plan Guaranteed Retirement Income," p. 8, July 2012.

The Prudential Insurance Company of America, Newark, NJ.
0264657-00001-00

RTLI-D5661