
Application 1

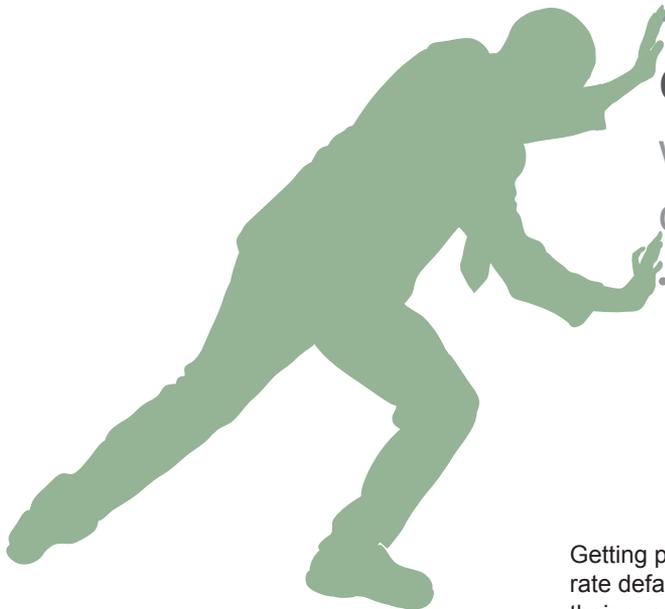
SETTING CONTRIBUTION RATES FOR RETIREMENT SAVINGS

Defaults can prove to be useful tools in setting contribution rates. Experts are likely to have better insight than individuals into what an appropriate contribution rate is to maximise the probability of reaching the target. We talk about targets in **Part 2, Chapter 2**.

Given the current low return environment, funds may find that the default contribution rate ends up being more than many members can stomach. In fact, Alexander Forbes Research & Product Development

found that a 25-year-old new fund entrant, who plans to retire at the age of 65 with a replacement ratio of 75%, will need to contribute 17% of his pay towards retirement savings. This rate may be more than many individuals are comfortable with. This means that maximising the probability of meeting the target (Principle 3) may clash with either meeting an individual's other needs (Principle 1) or maximising the number of individuals using the default (Principle 4).

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Getting people to choose the contribution rate default when it starts to infringe on their expectations of their take-home pay is a key challenge. When rates are set too high, individuals are likely to opt out⁶. When they are too low, individuals are unlikely to meet their targets⁷. A key concern for the UK's auto-enrolment programme is that all employees are enrolled at a 3% contribution rate, which is unlikely to make a significant difference in increasing retirement incomes. Because defaults are so often seen as advice, setting a low default can result in individuals saving less than they would otherwise have done⁸.

But there is an alternative called auto-escalation, which academics originally proposed as the Save More Tomorrow (SMarT) programme that could provide a less painful way of achieving what is required⁹.

Auto-escalation slowly adjusts contribution rates to the level required as individuals receive salary increases. This means

it improves their chances of a decent retirement outcome without disrupting consumption.

We can implement auto-escalation in a few ways. In its original conception in the SMarT programme, contribution increases were linked to annual increases. Each year when an individual receives their salary increase, some percentage of the increase (say 1–2% of a 7% increase) would be redirected towards saving. This means that while contributions toward retirement are increasing, so is take-home pay, making a smaller negative impact on members.

Since it has been rolled out more broadly, it has often been used as a default where all new employees start at a defined contribution rate, with a predetermined increment applied to increase the rate each year, until they reach a cap. In this case, the increase in rate is not related to the annual salary increase as such, but applied at a specific increment for all employees.

6 Beshears, Choi, Laibson and Madrian (2010)

7 Choi, Laibson, Madrian & Metrick (2004)

8 Choi et al (2004)

9 Thaler and Benartzi (2004)

If we consider a fund in which individuals committed that part of their salary increase that was above inflation to their retirement fund contribution for three years and then held that contribution rate constant until retirement, we would see the average replacement ratio increase from 40% to 82% at the end of that three-year period.

A final way in which we can apply auto-escalation is on an age basis, where we set default contribution rates for different age bands, with older ages having higher default contribution rates.

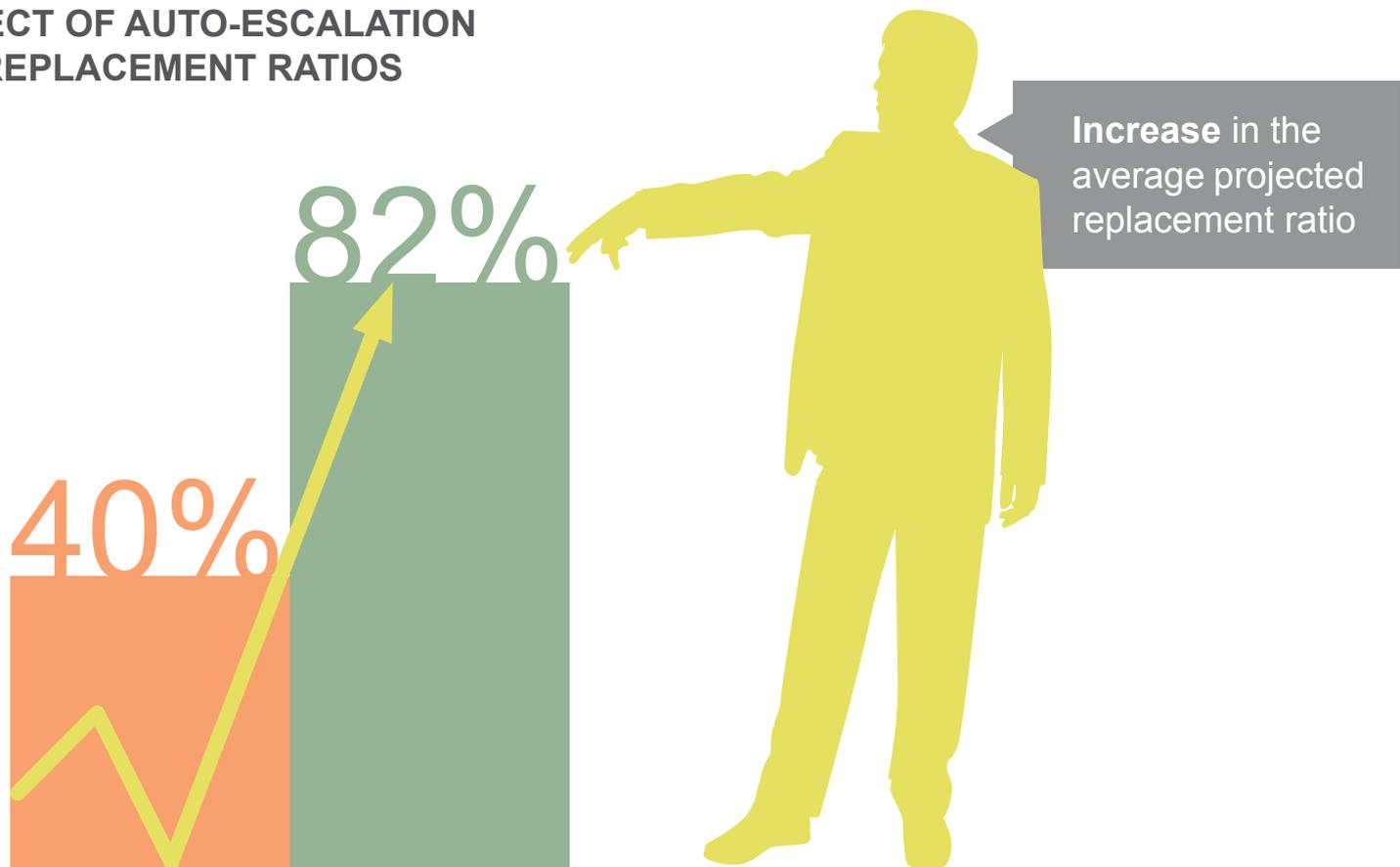
In this final route where all new employees follow the same step-wise increases in

contributions based on their age, a few potential pitfalls have been identified. Extensive US experience suggests that we should be wary of¹⁰:

- Setting the starting contribution level too low.
- Setting the increment between contribution levels too low.
- Stopping the auto-escalation increases before an adequate rate is reached.

Any of these could result in individuals saving less than is necessary or even less than they would have without auto-escalation.

EFFECT OF AUTO-ESCALATION ON REPLACEMENT RATIOS



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The **starting contribution rate** under an **auto-escalation** structure could be **set by age**. In **standard auto-escalation**, any new employee, whether **25 or 40 years old**, would start at the **minimum contribution rate**.

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CAN AUTO-ESCALATION WORK IN SOUTH AFRICA?

In South Africa, inflation complicates the setting of the increment. An aggressive increment, such as 2%, increases the chances of real take-home pay falling, while small increments may fall short of the contributions required.

In the case of individual need, research suggests that individuals with lower incomes tend to be less likely to opt out of a default – in other words, make a choice different from the default¹¹. Yet, it could be these very individuals who can least afford higher contribution rates, and have the greatest need for take-home pay. So we need to ensure that individuals receive proper advice and communication around the impact of such defaults before they are implemented.

Another challenge with auto-escalation is in industries or companies with **high employee turnover**. If employees change

jobs frequently and the firms that they join all use auto-escalation, they may be perpetually enrolled at the minimum contribution rate. Or worse, they may transfer into a fund without auto-escalation and the net effect of a low starting contribution rate with one employer together with an only average contribution rate with the next employer could also result in the individual being underfunded.

To avoid this, the starting contribution rate under an auto-escalation structure could be set by age. In **standard** auto-escalation, any new employee, whether 25 or 40 years old, would start at the minimum contribution rate. If the strategy is set around age, then a 25-year-old would start at the same rate as a model 25-year-old enrolled in the strategy, say 10%, while the 40-year-old would start at the same rate as a model 40-year-old, say 18%.

Given that as people age, their salaries tend to rise in real terms (up to a point), this still retains the benefits of auto-escalation. If the increase in contribution rate is structured to be a fixed annual increment, it does raise significant risk of take-home pay falling at some point. Because it is a default, individuals could choose to opt out of the structure at this point. However, as this is more likely at older ages when individuals become more aware of retirement, employees may be willing to stick with the strategy.

Despite its shortcomings, auto-escalation may work well in bargaining council funds, where members may remain within a single fund over their lifetime even though they may not always have the same employer.