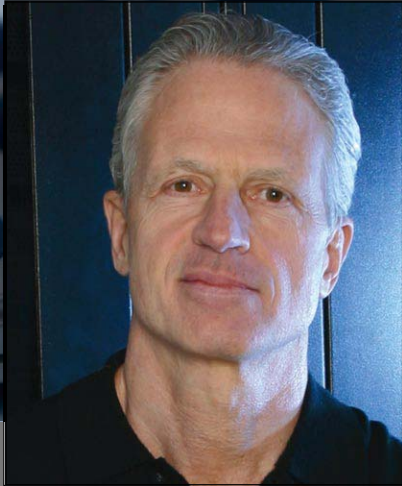


Gaps in Participant Gap Analyses



Pete Newkirk
President, Newkirk Products, Inc.

Gap analyses are receiving increasing attention among plan sponsors and the providers of DC services. Understandably so. Gap analyses are an effective way to encourage participants to defer more – and, depending on the sophistication of the analyses, better allocate their balances.

Even Congress may be getting into the act. While the Lifetime Income Disclosure Act recently introduced in the Senate only requires an annual projection of the retirement income an annuity purchased with the amount a worker has saved would provide – and does not tell the employee whether that income is sufficient for retirement – the intent is clear: Plan participants need a better understanding of just how adequate their retirement savings are.

When considering a gap analysis tool or communication, however, plan sponsors and their providers need to be aware of the limitations as well as the benefits. Here are some questions sponsors and vendors should address in addition to “How does it work?”

How accurate is the gap projection?

The answer depends on the available data. What do you know about the participant? At Newkirk, we can create a gap analysis if we have a participant’s birthdate, compensation, current deferral rate, and current account balance. But that analysis does not take into account such information as the value of a family home or a spouse’s income or retirement assets.

The advantage of such a bare-bones gap analysis is that the information required is readily available for most

participants. The disadvantage is that the analysis may not be particularly accurate. Arguably, that doesn’t matter. Getting a participant to pay attention to his or her retirement income needs is a desirable result, and overstating the gap because of insufficient information regarding a participant’s other resources isn’t a bad thing, is it?

There are, of course, better options. Web-based programs (the guidance and advice tools found on many provider participant sites) generally allow participants to supplement information secured from the provider’s record keeping system. The participant is given the opportunity to provide additional information about a spouse’s or partner’s income and retirement account balances, for example, or the value of the family home or other investments. The result is a more accurate assessment of a participant’s retirement income needs and the resources available to meet those needs.

The problem with these tools, however, is that few participants use them. They’re reactive. That’s the reality that has led many providers and sponsors to adopt a more proactive approach and to pursue such options as printed gap statements, year-end security reports, website pop-ups, and statement messages. The picture being painted may be broad brush, but at least it tells a story.

The lesson with respect to a proactive participant gap analysis – one based solely on record keeping data – is that it should be accompanied by an explanation of the analysis’ assumptions and limitations. It’s okay to present a partial picture as long as the participant is informed of that fact. Of course, that may lead to communication issues and off-

putting “fine print,” but that’s why God created graphic designers.

What suggestions should be presented when a gap exists?

Many printed gap analyses not only determine whether a gap exists, but also make suggestions for closing the gap. The obvious suggestion in such communications is for the participant to defer more. A good gap analysis, though, will place a limit on this suggestion. There are two factors in determining what deferral percentage the gap analysis might propose: the plan’s contribution limit and common sense. Proposing to a \$30,000-a-year participant with a family that he or she contribute 20% of income to a retirement account simply isn’t realistic. At least, not in the typical situation.

Other suggestions might include working longer, allocating differently, and reducing retirement income expectations (i.e., living with a 70% replacement income assumption instead of 80%). The “allocating differently” suggestion is tricky. In our printed communications, we simply suggest that a participant review his or her allocation. While a more aggressive allocation might help deal with the size of the gap, suggesting such a course to a 60-year-old participant is not advisable. Recommending that participants use an Internet-based guidance or advice tool to get a better picture of the options available may be the most prudent course.

Are there risks to including the employer’s match?

Obviously, without the match, many more participants will have a gap. And, certainly, communicating the fact that the employer provides this benefit/incentive is highly desirable. Recently, though, we’ve seen numerous employers discontinue their matches. Does an employee who receives a gap analysis that indicates either (a) no gap exists or (b) a modest gap exists and who then sees a significant gap upon retirement because the employer has discontinued its match have grounds for complaint?

More work for the graphic designers. If you include the employer’s match, make sure you include a disclaimer that the match may be discontinued or not continued at its current level.

There’s a secondary consideration, too. DC providers who are facilitating the use of a gap analysis for a sponsor should make certain the sponsor understands the ramifications of including the sponsor’s match – and other discretionary items like profit sharing contributions.

What is reasonable replacement income?

Replacement income is generally defined as the percentage of working income that an individual needs to maintain the same standard of living in retirement. Is that 75%? 80%?

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100%? Do you adjust for inflation? What’s the inflation assumption?

One 2003 study indicated that a typical retiree in 2013 could expect to pay \$223,000 in health-care costs during retirement, even with Medicare. How does that number fit into the replacement income calculation?

As a practical matter, replacement income percentages should probably vary depending on the participant’s compensation. The assumption that lower paid participants may need only 80% of their working income upon retirement seems unlikely, particularly in light of the health-care cost consideration mentioned above.

Web tools that provide gap analysis information to participants frequently pass the buck to the participant by requiring the participant to specify the replacement income percentage he/she thinks is appropriate (possibly after providing some general guidelines attributable to “many advisors”). Printed gap analyses don’t have that luxury. A replacement income assumption needs to be made.

What’s a reasonable return assumption?

Our system – like many on the market – allows a user to specify a return assumption, both for the accumulation phase and for the distribution phase. What number would you suggest? A few years back, a 6% return assumption wasn’t uncommon. Does such an assumption seem reasonable today? True, there may be some historical basis for it, but tell that to participants who have seen their account balances wither over the past year or so.

Ideally, the return assumption would vary with the participant’s age. Older participants would have one assumption (a lower one). And younger participants would have another assumption.

Conclusion

Printed gap analyses, statement messages, and Internet reminders that pop up when a participant accesses his or her account all help to draw participants’ attention to their retirement income requirements. Despite their limitations, and the need for appropriate disclaimers and explanations, the proactive nature of such communications makes them a desirable participant communication option. ■