Many plan sponsors recognize the benefits of automatic plan features such as automatic enrollment and automatic savings rate increases. These programs are very effective in overcoming the negative impact of participant inertia. With automatic programs, when participants are inert, they’ll be better prepared for retirement than they would be otherwise.

While automatic enrollment has been around for many years, automatic savings increase programs (sometimes referred to as automatic contribution increase, automatic deferral escalation, or automatic salary deferral increase programs) are relatively new, and many plan sponsors are increasingly interested in figuring out how these programs can help their participants.

WHY SAVINGS INCREASES ARE IMPORTANT

Our national annual savings rate is reportedly at its lowest level since 1934. Inertia looms large, and motivating Americans to save anything at all is challenging. Yet many financial experts suggest that we should be saving 15% to 20% of our pay (including employer contributions) to have any hope of a comfortable retirement.

Certainly, automatic enrollment programs have been successful at increasing retirement plan participation. Unfortunately, most participants in automatic enrollment programs enroll at default savings rates that are far lower than the suggested 15% to 20% necessary for a sound retirement. And only a small percentage of automatically enrolled participants ever subsequently increase their savings rates.

AUTOMATIC INCREASE DEFINED

Automatic increase program participants agree to automatic periodic increases to their contribution rates. These increases occur on a predetermined date, often coinciding with anticipated pay raises. To alleviate any fears of the participant, automatic increase programs allow participants the ability to stop the increases and to change their contribution rates at any time.

Automatic increase programs use principles from psychology and behavioral economics to help people save more. Three key aspects of the automatic increase program take advantage of accepted human behaviors:

1. The offer is made a considerable time before scheduled increases begin. Because of hyperbolic discounting—the tendency to agree to something that takes place sometime in the future—more individuals agree to join the program.

2. By linking the timing of the increase to a pay raise, we mitigate the perceived loss of a cut in take-home pay. In other words, more people agree to sign up because they won't experience a decrease in current spendable income.

3. With an automatic increase program, the status quo is a continued increase. Once signed up, the participants’ contribution rates will keep increasing to a specified cap rate unless they take action. We all know how difficult it is to move participants to take action. The design of an automatic increase program puts inertia to work in favor of increasing savings amounts.
In addition to increasing savings rates in general, automatic increase programs can be effective at overcoming this shortcoming in automatic enrollment plans. Figure 1 shows the powerful impact of automatic savings increase programs.

**WHAT PLAN SPONSORS NEED TO KNOW**

Many early adopters of automatic increase programs require that participants sign up for the program if they are interested. While this approach can still be very beneficial for participants, it is generally much less promising since it fails to counteract inertia. In addition, many early adopters devised their programs to maximize participant choice. As a result, they have placed less emphasis on the program default choices such as the amount and timing of the automatic increase and the rate at which the automatic increases will stop, often referred to as the cap rate.

However, we know from other behavioral research that increased choice can lead to increased procrastination. It could be that if participants are *required* to choose the increase amount, timing, and cap, they may be less likely to ever sign up and benefit from the automatic increase program.

To better understand the impact that default choices may have on how participants feel about an automatic increase program, T. Rowe Price undertook in-depth research with a large retirement plan client. The research was conducted by Behavioral Research Associates on behalf of T. Rowe Price.

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**Figure 1: The Impact of Automatic Savings Increase Programs**

This chart is for illustrative purposes and does not represent a particular investment in your plan. Assumptions: Salary of $50,000 annually adjusted to anticipate a 3% inflation rate. Annual rate of return is 7%. Replacement income represents the percentage of salary that will be replaced if a participant withdraws 4% of his or her retirement balance at age 65.
In the research, 13 conditions were tested to identify the impact of savings-rate increase amounts, timing, and caps on participants’ intentions to sign up for the program. In each of the conditions, we presented defaults but highlighted the participants’ ability to choose whatever increase amounts, effective dates, and cap rates they preferred. Nevertheless, in some cases, we saw that the default choices selected for the automatic increase program did make a difference in the likelihood that participants would sign up for the program. We also communicated that participants could get out of the program whenever they wanted to.

**WHAT WE LEARNED: AUTOMATIC INCREASE AMOUNT**

Research results showed that participants were equally as likely to sign up for the program whether an annual savings rate increase was 1% or 2%. With a 1% increase, 31% planned to sign up, and with a 2% increase, 30% planned to sign up for the program.

**WHAT WE LEARNED: AUTOMATIC INCREASE LIMIT**

The research focused on testing three levels at which the automatic increases would stop: 10%, 20%, and 75%. Even though it was clear participants could easily select their own cap rates, we found it interesting that the default cap rate did impact the program’s appeal to participants, as shown in Figure 2.

**WHAT WE LEARNED: TIMING**

We hypothesized that the further in the future the savings rate increase would occur, the more likely participants would be to sign up for the program.

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**Figure 2: The Effect of Rate Caps**

<table>
<thead>
<tr>
<th>Rate Cap</th>
<th>Intended Sign-Up Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>37%</td>
</tr>
<tr>
<td>20%</td>
<td>40%</td>
</tr>
<tr>
<td>75%</td>
<td>24%</td>
</tr>
</tbody>
</table>

**Figure 3: How Far Into the Future Should Automatic Increases Begin?**

<table>
<thead>
<tr>
<th>Months Delay Between Offer and Effective Dates</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>28%</td>
</tr>
<tr>
<td>1</td>
<td>33%</td>
</tr>
<tr>
<td>2</td>
<td>33%</td>
</tr>
<tr>
<td>3</td>
<td>30%</td>
</tr>
<tr>
<td>4</td>
<td>30%</td>
</tr>
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<td>5</td>
<td>27%</td>
</tr>
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<td>6</td>
<td>41%</td>
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<td>0%</td>
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<td>0%</td>
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<td>0%</td>
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<td>0%</td>
</tr>
<tr>
<td>11</td>
<td>0%</td>
</tr>
<tr>
<td>12</td>
<td>0%</td>
</tr>
</tbody>
</table>
Most of us are more likely to accept restrictions if they take place in the future—but not today! To some extent, that’s what we found, but there was also a surprise in the results, which are shown in Figure 3.

Note that while a default effective date of one year was found to be most appealing, there’s very little difference in appeal if the effective date of the automatic increase is in one month or three (or four, five, or six).

In addition, some of the most successful automatic increase programs have synchronized the savings rate increases with pay-raise dates so that any reduction in take-home pay is minimized.

**OTHER FINDINGS**

Our research also revealed interesting insight into the demographics of the automatic increase participant:

- The intended sign-up rate was higher for women (39%) than for men (28%).
- People younger than 40 had higher intended sign-up rates than people older than 40 (40% compared to 29%).
- People who have account balances of less than $100,000 are more likely to sign up than those with account balances more than $100,000 (37% compared to 25%).
- The lower the annual income, the higher the intended sign-up rate.
- The lower the current savings rate, the higher the intended sign-up rate.

Could it be that automatic increase programs are most appealing to the employees who need them the most?

**CONCLUSIONS: TAKE ACTION NOW**

Automatic increase programs offer a powerful way to increase participants’ savings rates.

While the research results shown reflect one plan’s findings, you can use this information as a starting point for designing your own program. The following is general guidance you may find most useful:

- Consider an automatic annual increase of 2%. The research showed virtually no difference in the program’s appeal whether a 1% or 2% annual increase served as the program’s default choice.
- Plan a cap rate that will help participants achieve total contribution rates of 15% to 20%, and avoid an excessively high rate cap for a higher adoption rate. In this research, we found that using a cap rate equal to the plan’s maximum allowable contribution rate of 75% was demotivating. On the other hand, capping the rate increases at the maximum matched rate, say 6% for many plans, will not result in sufficient savings rates for most employees.

For more information, talk to your T. Rowe Price representative or call 1-800-638-4546.

Research Methodology

This research was conducted by Behavior Research Associates on behalf of T. Rowe Price. 1,361 plan participants responded to an online survey in September 2005. Each of 13 respondent groups was representative of the active plan population overall. Only those results that were found to be statistically significant are included herein. This series provides information concerning retirement plan participants and research only and does not address any legal issues associated with such. Before implementing any plan of action, please discuss with your legal counsel.