Retirement Requirement

Does your company sponsor a 401(k) savings plan or a 401(k) retirement plan?

AS A STARTING POINT, most 401(k) plans are savings plans—OK for retirement, but not great. Some plans have taken steps to become retirement plans, such as automatic enrollment, automatic deferral increases, and investment portfolios designed for retirement investing, like age-based target-date funds or managed accounts. Those are some of the criteria for evaluating whether a 401(k) plan is a retirement plan, but they are not enough to convert a savings plan into a retirement plan.

What's the difference? Here is my list of the key characteristics of a 401(k) retirement plan:

Each participant knows how much retirement income a typical retiree of the employee's income level needs for a reasonable standard of living. Most experts say that people need an income replacement ratio of 75% to 85% of their final pay. Part of that will be from Social Security—on average, about 40%—and, for most people, the balance will come from their 401(k) plans. (That is because most participants have few, if any, other financial assets.) If you don't know what you need, how do you know if you will have enough?

In a retirement plan, participants also know how much retirement income their current 401(k) account will "buy" at retirement. (Alternatively, the estimated retirement income could be based on both the current account balance and projected future deferrals.) Each of your participants is on schedule, behind schedule, or ahead of schedule in their retirement savings. How can they calculate that? Most can't; as a result, participants need help from plan sponsors and providers. In a "real" retirement plan, each participant is told whether he is on course or not and, if not, what changes need to be made. The calculation of the shortfall between current behavior and the needed retirement amount is called "gap analysis" and is available from some providers.

The key is that the participants be given the information—for example, on their quarterly statements. Simply providing Web site calculators hasn't worked.

If participants are behind schedule, a 401(k) retirement plan would tell them how much they must increase their deferrals to get on schedule. Some providers already offer this service and others will develop it—if the demand is there. Without that information, how can participants accumulate the right amounts?

When this information is automatically provided to participants, it must be based on assumptions (which should be stated clearly) and on the needs of the average or typical participant. Of course, no participant is truly typical—or even average. However, without that general guidance, participants will have a hard time making decisions about their individual needs. It is better to have the "solution" for an average participant than no information at all.

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Also, with that information, participants can better understand that the long-term objective is retirement income—and how to get to that income through saving and investing. Without the information, success is largely a function of luck.

Of course, for participants who want to customize their retirement planning—for example, a later retirement age, a higher savings rate, or a different investment strategy—the plan can offer retirement calculators. Many providers already have services to help participants with those calculations.

If your plan offers these services, you are sponsoring a 401(k) retirement plan. If not, talk to your providers and advisers about how to convert your savings plan into a retirement plan.

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