

Alternatives to the Traditional 401(K) Match

Can Meet Longer-Term Objectives for Attracting and Retaining Talent

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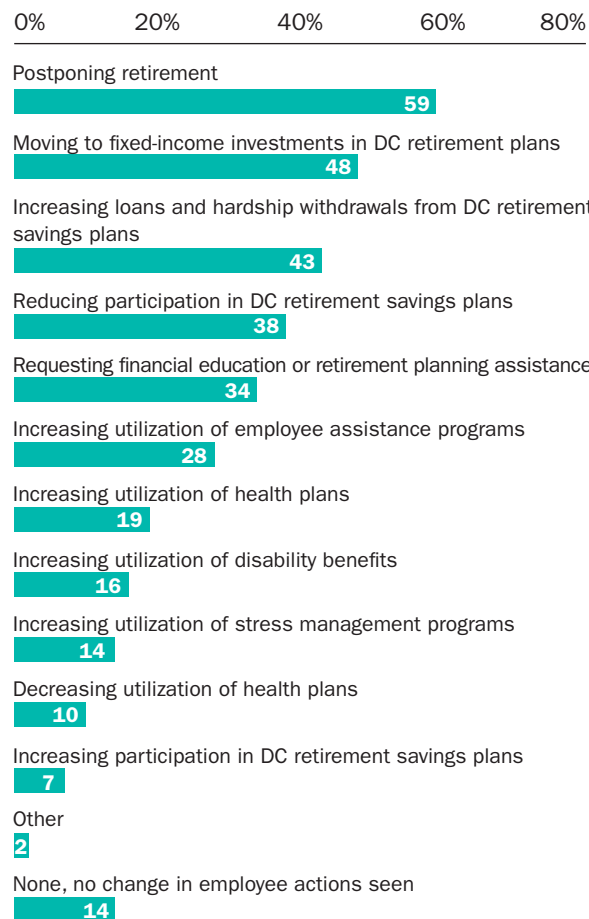
Companies looking ahead to how they will restructure their reward programs in a recovering economy will no doubt be asking some tough questions about their 401(k) plans.

Those organizations that suspended their matching contributions at the height of the financial crisis will face a choice as their business recovers. One option is simply to restore the matches and go back to business as usual. The other option is more challenging but also more intriguing — reengineer their strategies to make their employees’ retirement objectives more achievable, focus more on health care needs, and attract and retain the best people.

Scores of companies have reduced or suspended matching contributions to 401(k) retirement savings accounts since October of last year. Prior to this, 401(k) matching had been a highly reliable feature of many company-sponsored retirement programs. Coming on top of the large decline in the value of retirement accounts, the cutbacks in employer matching contributions represented another blow to a workforce struggling under the impact of salary freezes and other measures taken by employers to rein in costs.

Faced with real economic uncertainty, employees have made significant changes in their retirement preparations. A 2009 Towers Watson survey of approximately 500 U.S. companies found that many employees have postponed their retirement, moved to fixed-income investments, drawn down on their 401(k) accounts and reduced participation in retirement plans. Many are urgently requesting financial education or retirement planning and accessing employee assistance programs (*Exhibit 1*).

Exhibit 01. Actions Employers Believe Employees Are Taking in Response to the Current Economic Climate



“Prior to the economic downturn, 401(k) matching had been a highly reliable feature of many company-sponsored retirement programs.”

The economic slump has also led to rapid changes in employees' priorities. Towers Watson's 2007-2008 Global Workforce Study, an international survey of more than 90,000 workers, revealed employees' highest priority was ensuring work/life balance. This was confirmed in Towers Watson's August 2008 Total Rewards Survey, conducted one month prior to the banking crisis. In contrast, our Total Rewards Pulse Survey, completed in December 2008, showed that employees' priorities have shifted away from broader work satisfaction issues toward the fundamentals of economic security (*Exhibit 2*).

What Now?

Many companies that suspended their 401(k) contributions are considering their recovery options. Once the economic situation has stabilized and the outlook has improved, many will probably reinstate their matching contributions.

But some are taking the opportunity to look at the structure of their benefit programs and ask whether simply restoring matching in its earlier form is the most efficient way to provide for their employees' retirement, and whether by doing so they are meeting longer-term objectives for attracting and retaining talent.

In particular, many employers are considering three opportunities:

- **Linking to profitability.** While many employer 401(k) matches have not historically been explicitly linked to profitability, the suspension of the match revealed

that there is a clear, but implicit, relationship between the two. Companies are now considering whether they should make that link more explicit — with upside and downside potential based on profitability.

- **Total retirement adequacy.** In many cases, the 401(k) plan has become the primary retirement capital accumulation vehicle, replacing defined benefit pension plans. This has also shifted more employer dollars to employees leaving prior to retirement. Has retirement adequacy been compromised? Would retirement adequacy be enhanced by providing a portion of the employer contribution independent of an employee's own contributions? Should other provisions be modified to prevent leakage of funds that are intended to provide for retirement? Another possibility is reallocation of some money to retiree health care benefits to help employees meet postretirement needs (see "A Win-Win Option," page 3). This option has the added advantage of providing a more tax-effective form of deferred compensation.
- **Total rewards allocation and health/wealth linkages.** Many employers are redefining numerous components of their reward programs in response to the recession. Ideas now on the table include redeploying some funds once used for the 401(k) match to seed individual health savings accounts (HSAs) or health plan incentive payments that support desired behavior changes. In addition, some employers are moving closer to a total pay approach and guiding employees through a selection process that tailors rewards to personal and career-stage priorities.

"Many companies that have suspended their 401(k) contributions are considering their recovery options."

Exhibit 02. The Starting Point Is Understanding What Matters Most to Employees

Rank	2007	August 2008	December 2008
1	Work/life balance	Work/life balance	Secure position
2	Secure position	Secure position	Adequate benefit protection
3	Adequate benefit protection	Good quality coworkers	Work/life balance
4	Doing exciting/challenging work	Adequate benefit protection	Good quality coworkers
5	Maximizing amount of money	Doing exciting/challenging work	Working for a successful organization with a strong future
6	Working for a successful organization with a strong future	Maximizing amount of money	Doing exciting/challenging work
7	Doing work with a lot of variety	Working for a successful organization with a strong future	Maximizing amount of money

Profit Linking

Employees implicitly understand that their destiny is linked to the fortunes of their employer. But when companies make sudden radical changes to benefit programs as a result of shifting economic conditions, especially without a clear, complete and empathetic explanation, employees consider it a breach of leadership support, and it can undermine engagement.

Suspending 401(k) matching contributions in response to the economy revealed the extent to which benefit programs are linked to company profitability — even if the companies themselves had not explicitly said so beforehand. Companies are now in a position, one that has enhanced credibility, to make the connection between profitability and retirement benefits stronger by formally linking 401(k) matching contributions to particular business metrics.

For instance, a plan could be designed specifying that the company match will equal:

- 75% of employees' 401(k) contributions if earnings per share exceed a particular level, say \$x/share
- 50% if earnings fall between \$0.5x and \$x/share
- 25% if earnings fall between \$0 and \$0.5x
- zero if earnings per share turn negative.

Aligning retirement benefits with profitability in this way has real advantages for both employees and employers.

Under a profit-linked contribution system, employees have:

- a clear line of sight between the performance of the business and the variability of their retirement benefits — no more nasty surprises
- a better understanding of how they will achieve minimum benefits, without relying on discretionary contributions from their employer that might not eventuate
- a clearer understanding of the need to take responsibility for their retirement finances
- an appreciation that, when times are good, retirement benefits will be enhanced.

For employers, the gains are also significant:

- Cash flows are aligned with the performance of the business, ensuring they will not be put under pressure by contribution requirements when economic conditions are poor. Companies in cyclical industries would benefit from minimizing their benefit contributions in down times while being able to fund higher benefits when profitable growth is realized.
- Benefit matching can be linked to whatever measure of organizational performance (e.g., earnings per share, sales, net income) is appropriate.

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A Win-Win Option*

An employee earning \$50,000 a year who saves 1% of pay per year and receives a 100% employer match will be able to fund about two years of pre-65 retiree health care premiums for two people (the individual and the spouse) without additional employer support at retirement.

For employees, offering the option of reducing 401(k) matching levels and redirecting payments to other retirement programs:

- addresses the number one concern regarding retirement security — health care costs
- can provide a highly valued service — financial planning — at a relatively low cost. In surveys, employees routinely place a high value on support for financial planning, often rating it ahead of more costly employer efforts
- reduces the possibility of having to work beyond the minimum retirement age just to fund health care costs.

For employers, shifting the focus from retirement income to the overall adequacy of retirement benefits provides:

- tax efficiency
- the option to limit payouts to those who remain with the company until retirement, leveraging early forfeitures to increase retirement payouts
- retirement planning services to employees, a service that is valued highly but is provided cost-effectively by the market.

*Employee choice programs need to comply with applicable IRS rules and restrictions.

- The organization emphasizes and encourages business literacy with a direct tie to employee compensation. At the same time, the shared destiny message is reinforced by linking benefit growth to profitability.
- A solid track record of company payouts will strengthen the attraction and retention of talent.

There are, however, certain disadvantages to linking profits to the employer match. In particular, long-term financial planning is made more complicated for employees who cannot be sure of the level of future company contributions. This unpredictability could run counter to the desire of employees for security and adequate benefit protection and has to be addressed by thoughtful communication, including Web-based support tools.

Strengthening Total Retirement

Many employers understand that a simple 401(k) match is not the best instrument for tax-effectively contributing to their employees' retirement or ensuring that the maximal amount of benefit dollars accrue to those employees who remain with the company until retirement.

These issues can be addressed by reallocating benefit payments among 401(k) matching and other reward programs, in particular, arrangements designed to pay retiree medical benefits. A portion of the 401(k) match may also be redirected toward funding financial planning services for employees — enabling employees to be confident that their retirement needs will be adequately funded. Employers can also establish a “core” contribution independent of contributions employees make to the plan, as well as establish more restrictive conditions for the withdrawal of employer contributions to the plan — core, matching or both.

Providing some of an employer's financial support for retirement assures that all covered employees receive some employer funding for retirement. And restricting access to employer funding minimizes the leakage that often occurs during an employee's career. Both of these can further an employer's objective of assisting employee efforts to accumulate sufficient assets to retire comfortably.

Careful allocation of retirement benefits between matching contributions and health accounts can minimize another type of leakage — employer-funded benefit payments to employees who leave before retirement. Employers can structure their health care payments as funded or unfunded arrangements depending on their financial requirements. Specific options include an employee-pay-all VEBA — employee optional accounts that make payments only upon retirement — and employer-funded retiree medical

accounts. If employers choose to use a company-funded medical savings account, they may stipulate that employees who leave the firm prior to retirement will forfeit contributions, significantly reducing the cost to employers.

Whatever the structure, by redirecting benefits to retiree health care funding, employers save on FICA contributions as compared to 401(k) contributions, and the ultimate distribution to the retiree (if used for health care) is free from federal income tax.

Moreover, there is no financial statement accrual for the employer beyond the annual allocations to accounts, as no residual obligation for funding exists.

Total Rewards Context

Employers looking to reallocate their 401(k) matching contributions away from retirement and toward other forms of rewards also have the option of directing money to health initiatives focused on encouraging more cost-conscious behavior by active employees. Areas employers are looking at include:

- *HSA seed money to help launch a high-deductible health plan (HDHP).* HSAs have significant tax advantages, and can support efforts by employees to save for retirement.
- *Incentives that are part of wellness and other consumer-driven health care programs for either active or retiree populations.* These programs can reward a broad variety of health care activities, including completion of health assessments, compliance with clinical guidelines and engagement with health coaches to address specific high-cost risk factors.
- *Larger incentive pay programs, either broad-based or targeted to particular employee groups, and based on rewarding business-focused behaviors or performance outcomes.*

Each of these options has pros and cons. While HSAs are tax advantaged, they do require employees to participate in an HDHP, which they may not like. However, HSAs add another tax-advantaged savings opportunity that employees have to consider in directing their retirement funds. Health incentives focus employees on the health and wealth connection without requiring them to sacrifice income today, while also cutting benefit costs and improving productivity. The incentives, of course, need to comply with the relevant legislative and regulatory requirements. And each adjustment to the benefit program will require revised structuring and administration, along with change management and communication. For example, an employer should determine if 401(k) nondiscrimination testing results may be affected by a reduction in matching contributions.

“By redirecting benefits to retiree health care funding, employers save on FICA contributions as compared to 401(k) contributions, and the ultimate distribution to the retiree is free from federal income tax.”

At the same time, by providing employees with a broader menu of benefit choices, companies can reinforce employee empowerment to address personal health, financial security or performance issues. Research has consistently shown that employees value the ability to pick and choose benefits.

By reassessing the structure, cost and benefits of the company's retirement income program, you may be able to address many issues at once: the "deal" around retirement income responsibilities, the effectiveness of the retirement program, the line of sight between organizational performance and total remuneration, and the links among health, wellness, productivity and wealth, among others.

Employees Value Choice

Recent Towers Watson research examined possible trade-offs across all types of reward programs to achieve desired cost-reduction targets and to understand the impact on employee behavior, especially sustained engagement in their work. The surveyed population was predominantly covered for

retirement by a stand-alone 401(k) plan and did not have access to retiree medical.

The findings indicated that employers had a significantly favorable impact on employee engagement by simply offering access to retiree medical insurance coverage (Exhibit 3). Interestingly, the respondents did not exhibit any desire to return to a traditional retirement income approach combining pension and 401(k) plans. This fact and the preference for a financial education benefit demonstrate willingness by employees to assume responsibility while needing the tools to craft a more financially secure future.

The research also examined a subset of employees covered by traditional pension, 401(k) and subsidized retiree medical coverage (Exhibit 4). Predictably, this group expressed a decline in engagement when confronted with the takeaway of retiree medical coverage. The negative impact on engagement of removing retiree medical exceeded the negative impact on engagement of a 10% pay cut. However, this negative impact was largely mitigated by just offering access to retiree medical.

"Employers have a significantly favorable impact on employee engagement by simply offering access to retiree medical insurance coverage."

Exhibit 03. Retiree Medical Plan "Takeaways" Matter — But Employees See Access as a Benefit
(% change in engagement)

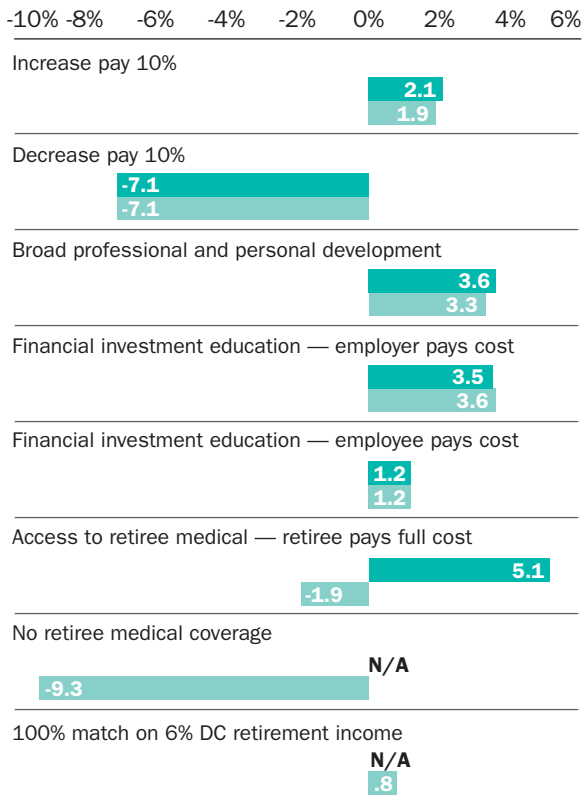
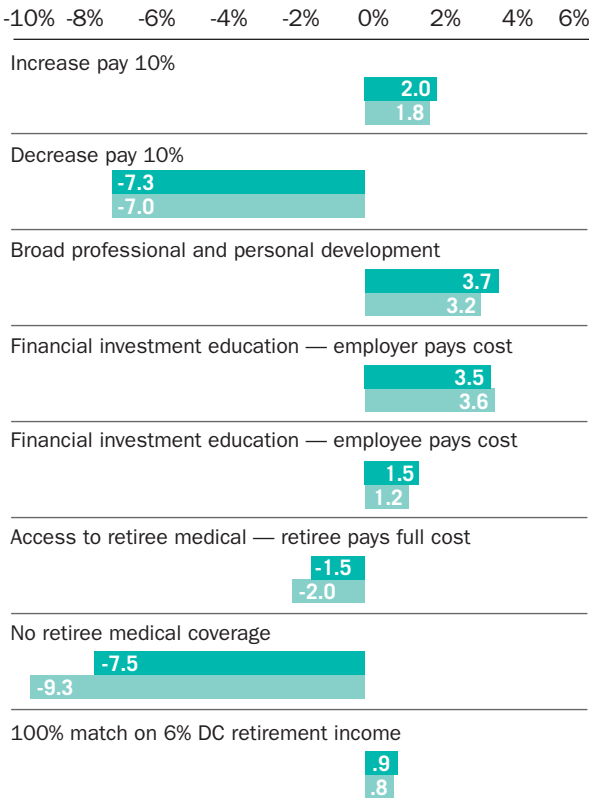


Exhibit 04. Age and Benefit Security Concerns Are Strongly Correlated

(% change in engagement for employees currently covered by defined benefit and retiree medical programs)



■ All survey participants ■ Participants with defined benefit and retiree medical

■ Employees under age 45 ■ Employees age 45 and over

These findings suggest that there are steps companies can take to remix their benefit and reward offering, and achieve superior employee impact at little or no additional cost.

Uncertainty of Health Care Reform

Health care reform does present challenges in finalizing reward program changes. Detailed implications of changes in the U.S. health care system will not be known until the legislation is finalized and signed by the President, but indications are that the reforms will have the effect of accelerating employer emphasis on direct contribution-based approaches to retiree medical coverage.

In all likelihood, health care reform will take some of the cost pressure off retirees, but most active employees will still have to save for health expenses in retirement. Other reform outcomes — such as a Health Insurance Exchange — may offer retirees access to pre-65 coverage, causing employers with programs to reconsider the future of existing programs and how to differentiate their reward package.

In the final analysis, employers will want to optimize the tax and health system changes while offering programs that align with business and human capital goals. Employees recognize that they have personal responsibility and choices to make. The win-win for employers and employees will be to offer programs alongside effective tools and education that make the link back to the business clear and empower employees to manage their personal security.

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