

Adding 401(k) to Traditional Defined Benefit Plans



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If a company already sponsors a traditional defined benefit pension plan, why add a 401(k) plan? We run into this question with a number of firms that have successfully managed and funded traditional pension plans without ever adding a 401(k) plan. Obviously, if the employer intends to put all *company* dollars in the pension plan and doesn't feel employees would use the 401(k) plan without a match, then the administrative costs should be weighed against the benefits of offering a second plan. However, here are some of the reasons to consider adding a 401(k) plan:



Replacement Ratios: By looking at Social Security tables and the pension plan's formula, we can project an employee's replacement ratio – what he is expected to receive in retirement as a percent of final average pay. We find more and more people are discovering that even with a healthy employer-sponsored pension and Social Security benefits, they still need to save something on their own.

Easy Saving: The simplest form of saving is payroll withholding. Once employees start, many don't notice the reduction in take-home pay and future increases can be encouraged in conjunction with raises or bonuses.

Paternalistic Employers: If the employer is paternalistic and feels most employees would not save for retirement without an incentive, then consider doing auto enrollment – telling employees that unless they elect otherwise, there will be 3% withholding, with an annual

increase of 1% until deferrals reach a level of 6% to 10% of pay. Surveys show that many employees don't oppose these "negative elections".

Competition: Having a 401(k) plan is helpful in attracting and keeping good employees who see a value in saving through payroll withholding, especially those who were already doing so with a previous employer.

Simplifying Investments: If the company is worried about letting employees make investment decisions, plans can be set up with default investments or the company can hire an investment advisor who can make all investment decisions. Company liability can also be reduced by following rules established by the Department of Labor.

Economies of Scale: Even if employees try to save on their own, oftentimes they get more economies of scale by participating in a single 401(k) plan instead of many small IRAs.

First Step Toward Conversion: If the company thinks it may ever consider *replacing* its pension plan with company contributions to a 401(k) plan, then having already put a 401(k) plan in place will make it easier to later transfer company funding from one plan to the other.