# USING AUTO-ENROLL TO IMPROVE PARTICIPANT OUTCOMES

For decades governmental defined contribution plans were viewed as a supplemental savings tool that could be used to pay extraneous expenses in retirement such as vacations, a new car or boat. The defined benefit pension would replace, in some cases up to 90% of a worker's income in retirement. As the governmental defined benefit plan landscape continues to evolve, more and more responsibility to fund this important benefit is shifting to employees. These former supplemental programs can have an impact as to whether an individual faces a drastic reduction in lifestyle in retirement.

## Shift in Defined Benefit Formulas

Half of all of the public defined benefit systems were founded shortly after the Social Security Act of 1935. At the time of its establishment, state and local governmental employees were excluded from the Social Security system. From 1936-1950, states began establishing systems to offer their own employees retirement protection.

When these systems were established the average life span was around 60 years. That number has increased by 30% over the past 60 years to 78 years. Men and women who live to age 65 today have a 31% and 40% chance of living to age 90, respectively.

Longer lifetime payouts, coupled with a volatile stock market that featured two major recessions in 10 years and a fixed income market that has been providing lower yields since 1980 have placed a tremendous amount of stress on the funding levels state and local defined benefit systems.

Many systems have responded by reducing the formula designed to provide the lifetime payout in retirement in order to improve the health of their systems, or considered significant plan design changes. A National Conference of Public Employee Retirement System (NCPERS) conducted survey concluded that in 2014, 23% of all public pension systems reduced or tiered their benefit formula. According to the National Conference of State Legislatures, 43 states legislatures enacted significant changes to their retirement systems between the post-recession years of 2009-2011.

Changes Included:
1. Higher Employee Contributions
2. Longer Vesting/Age Requirements
3. Reduced Formulas for New Employees
4. Reduced COLAs
5. Consideration of a defined contribution hybrid plan to supplement reduced pension benefits

## Healthcare Impact

Public sector retirees with longer life spans and reduced pension payouts face strong headwinds dealing with the rising cost of healthcare. A change in accounting rules known as GASB 45 required public employers to disclose unfunded retiree healthcare liabilities on their balance sheet. As a result of that regulatory change, some states and other public entities chose to discontinue offering retiree medical benefits.

A healthy male and female age 65 will need $144,000 and $156,000 respectively, to fund post-Medicare health care expenses at the 90% confidence level. Without having significant personal savings to cover rising healthcare costs, seniors could find themselves having to choose between their health and their personal finances.

## Job Hopping

Two decades ago, a job search consisted of looking at classified ads and hoping something matched your qualifications on the day you happened to look at the newspaper. Today, jobs tend to search for you. With hundreds of job search websites, many that will send positions to your inbox every morning based on your experience, it has never been easier to move between organizations.

A 25-year-old will have already worked on average 6.3 different jobs today. At that pace they will work 12-15 different jobs before age 45. With 92% of all governmental defined benefit plans requiring a vesting period of five years or longer, having a portable auto-enrolled and employee directed personal savings plan becomes critical to avoid completely starting over in terms of preparing and saving for retirement at every different job. Although technology has made the job search much easier, baby boomers had similar success in job hopping using the traditional classified ads, averaging 11.6 different jobs before age 45.

Employees that spend less than 50% of their career in the public sector can expect to earn on average a 54% income replacement ratio inclusive of both defined benefit pension and social security. Having personal savings is essential to augment lower pension payments to avoid a drastic reduction in retirement lifestyle.

## Public Sector Defined Contribution Plans

Due to their history of being viewed as supplemental, defined contribution plans in the public sector have lagged behind their ERISA counterparts in both innovation and participation. While participation in private sector 401k plans has steadily increased with automation features, supplemental plans in the public sector have remained in the 30-50% participation range for decades.

With increased longevity, lower defined benefit pension formulas, a higher burden for healthcare on the employee and the potential to work for multiple employers during a career; it is time for public sector defined contribution plans to improve their plan design in an effort help public sector employees achieve retirement readiness.

## Impact of Inertia

When defined benefit plans were created, enrollment and employee contributions were automatic and the benefits were typically determined by a formula using service time and final average salary/wages. Defined contribution retirement plans were subsequently introduced as supplemental retirement plans and it was historically

left to the employees to decide whether to save and how much to save. Inertia and other behavioral factors have resulted in inadequate savings as employees often do not enroll in a defined contribution plan or, once enrolled, do not increase the amount of their contributions over time.

Behavioral research has identified the negative impact that inertia has on defined contribution savings and has demonstrated how inertia can be turned into a positive force through automatic enrollment and automatic escalation. As previously mentioned, when automatic enrollment is introduced in plans, a vast majority of those enrolled remain in the plan. Similarly, when automatic escalation is introduced, a high proportion of participants continue with automatic escalation over time.

The Pension Protection Act (PPA) of 2006 paved the way for the most beneficial design changes to impact defined contribution plans. Instead of continuing to fight against participant inertia, the PPA embraced that inertia to work for participants. Safe Harbors were provided to plan sponsors that designed plans to include auto-enroll, auto-escalation and a diversified qualified default investment alternative. The results have been impressive, with auto-enroll capturing a 90% average stick rate of those continuing to save for retirement. Those in the lowest income group have benefited the most as research has shown auto-enrollment to nearly double (82% increase) replacement incomes among that group.

## Legislative Concerns

Because public sector defined contribution plans are not subject to the Employee Retirement Income Security Act (ERISA), many states' anti-wage garnishment laws are not preempted with the addition of auto-enrollment. Since public sector plans continue to be subject to state law, some states prevent an employer from deducting any amounts out of an employee's paycheck without that employee's consent. To date, 12 states have passed legislation to allow for auto-enrollment into public DC plans, with Wyoming and Washington being the most recent. For some of these states, the legislation only applies to either state employees or participants in the state run plan, leaving it unavailable to municipal employers within the particular state.

Some public plan sponsors are in states that allow creative methods to circumvent state anti-wage garnishment laws. States, such as California, allow unions to negotiate for auto-enrollment for their members through a memorandum of understanding achieved in the collective bargaining process. The City of Los Angeles is the largest employer attempting to utilize this method of auto-enroll. The City is currently conducting a pilot program to allow for auto-enroll to its police union members and hopes to successfully expand the program to other unions in the future.

## Auto-Enroll Process

Auto-enroll procedures (e.g. default rate, waiting period, covered employees, etc.) may vary but one of the most popular is the Eligible Automatic Contribution Arrangement (EACA). If each of the specific Internal Revenue Code rules is met, an EACA can allow an employee to opt out after an automatic contribution has been made and request a refund of contribution within 90 days of the first contribution. Typically, the plan sponsor provides employees with a 30-day notice prior to the first withdrawal. Under an EACA, the plan defaults the automatic contributions into the plan's capital preservation fund option for the first 90 days, and then switches the employee to an age appropriate diversified option or life cycle fund; such as a Target Date Fund.

To further improve an employees' retirement readiness, research has found that including auto-escalation is necessary to fight participant inertia and according to a recent SHRM study, 55% of employees would favor an automatic annual increase. If the plan includes auto-escalation, the increase typically begins on the first payroll date of each new calendar year. Employees may opt out of the auto-escalation at any time by making any type of positive deferral election, but additional research has shown that 68% of employees remain enrolled in the auto-escalation.

Improved participant outcomes by combining auto-enrollment with auto-escalate and increasing the initial default deferral rate, participants can significantly increase their savings over time. Just as participant inertia keeps employees from enrolling in the plan, so, too, can it put them on the path to a more secure retirement when effective auto-features are implemented. Although formula guidelines have been established in the private sector, it is important to consider the defined benefit pension replacement amount and employee contribution rates when constructing public sector auto-enrollment formulas to ensure maximum success.

## Cost and Savings Considerations

There are potential costs and savings to consider prior to beginning an auto-enroll and/or auto escalation design change. If the plan provides matching contributions, it will be necessary to determine the impact the increase in participation may have on the employer's budget. It is equally important to consider the financial and organizational impact of having an employee continue to remain employed well past the plan's normal retirement age.

Recordkeeping costs should also be considered. Many plans are priced by looking at the number of participants in the plan and average participant account balance. Taking into account normal turnover, auto-enroll can have an impact of increasing the number of small balance accounts and negatively affecting the average account balance, particularly if the plan is successful in retaining lower income workers that have never previously been a part of the plan. Over the long term however, one can reasonably expect those who remain employed will have a significant positive impact on the overall growth of the plan size which could lead to reduced plan costs.

Having a process in place to transfer the accounts of terminated participants with small balances to an IRA can help alleviate the negative impact to overall plan pricing.

## Case Studies

## State of Texas

Auto Enrollment — Implemented January 1, 2008

### Legislation

The passage of H.B. 957 in 2007 authorized the automatic enrollment of newly hired state employees into the Texas Saver 401k plan. The automatic enrollment bill, was an attempt to encourage state employees to save more for retirement. Beginning January 1, 2008 new hires and rehires with a break in service were auto enrolled at 1%.

| Results | Pre-Auto Enroll (2007) | 2013 | 2015 |
|---|---|---|---|
| **Participation Rate** | 34% | 48% | 56% |
| **Average Contribution** | $3,408 | $1,512 | $1,428 |
| **Average Balance** | $21,411 | $11,707 | $11,583 |
| **Stick Rate** | | | 89.40% |

Observations & Lessons Learned:

- Increased plan participation for new hires.
- Few make changes after enrollment; 53,682 still at 1% rate.
- With automatic increase of 1% per year, capping at 6%, the employee would have tripled assets.

## State of Wyoming

Began July 1, 2015 for new employees of the executive, legislative and judicial branches of Wyoming State Government. Default contribution rate of the greater of $20 or 3% of pre-tax gross pay.

### State of Wyoming 457 Plan

| Auto Enrollment Summary | 7/1/15 - 12/31/15 |
|---|---|
| Eligible new employees, auto enrolled | 260 |
| Returned mail (excluded) | 3 |
| Gross eligible new employees | 257 |
| Electively enrolled | 27 |
| Terminated (before 30 day waiting period ended) | 14 |
| Pre-July hire | 4 |
| Net eligible new employees | 209 |
| Opt outs | 4 |
| Permissible withdrawal | 1 |
| Auto enrolled employees | 204 |

**Auto enrollment "stick" rate - 97%**

Observations & Lessons Learned:

- Once automatic enrollment was implemented, it was onerous to return the $20 per month employer match to the employer in the event of a permissible withdrawal. The Wyoming Retirement System partnered with a legislative sponsor to adjust the enabling legislation in 2015 to allow the $20 per month employer match to be distributed to the employee in the event of a permissible withdrawal.

## State of Indiana

### Indiana Hoosier S.T.A.R.T. Plan

2007- introduced auto-enroll at 0.5%
2011-added auto-escalation of 0.5% per year
2013- increased auto-enroll rate from 0.5% to 2%

| Results | Pre-Auto Enroll | Post Auto-Enroll |
|---|---|---|
| Participation Rate | 51% | 64% |
| Stick Rate | | 97% |

Observations & Lessons Learned:

- Of those auto-enrolled, 62% make less than $30,000 per year, dispelling the myth that lower income employees can't afford to save.

## State of South Dakota

### South Dakota Supplemental Retirement Plan

2008- State legislature passed auto-enroll legislation

2009- New employees enrolled at $25 per month

**Effect of New Policy on Enrollments and Opt-Outs from the SRP**

Observations & Lessons Learned:

| | New Enrollments | State Employees | Local Employees and Regents (University Employees) | Opt-Outs Received During the Month | Opt-Out % |
|---|---|---|---|---|---|
| Jul-09 | 106 | 89 | 17 | 0 | 0.0% |
| Aug-09 | 190 | 90 | 100 | 8 | 4.3% |
| Sep-09 | 256 | 67 | 189 | 13 | 5.1% |
| Oct-09 | 141 | 49 | 92 | 34 | 24.1% |
| Nov-09 | 126 | 71 | 55 | 22 | 17.5% |
| Dec-09 | 135 | 84 | 51 | 11 | 8.1% |
| Jan-10 | 124 | 77 | 47 | 6 | 4.8% |
| Feb-10 | 94 | 43 | 51 | 8 | 8.5% |
| Totals | 1,172 | 570 | 602 | 102 | 8.7% |

- 91.3% overall auto-enroll stick rate
- Employers in the State that did not adopt auto-enroll conversely saw less than a 1% opt-in enrollment rate with 17 of the 2,360 employees choosing to save.

## Conclusion

Having a competitive retirement program is essential to attracting and retaining employees for not just a corporation or not for profit entity, but for governmental entities as well Governmental entities will therefore need to provide more competitive and well-designed retirement plan and benefit programs. Employees tend to look for guidance from their employer when it comes to employee benefits. Employers can set an important precedent by offering an automatic enrollment arrangement and impressing upon employees how important it is to begin saving for retirement as soon as possible. Many employees will appreciate the effort made to easily get them into the plan, and most will continue to save as evidence by the 90% stick rates of auto-enroll. Auto-escalation also becomes very important because employees may conclude that if 1% was the suggested rate by the employer, then it must be sufficient, as the Texas case study proves with most participants never changing their deferral amount.

Excuses for not beginning a savings program can be made at every phase in life - student debt, getting married, buying a house, having kids, paying for college, etc.; before you know it you are out of time.

With so much burden of responsibility being placed on the individual today, it is imperative to change the system to better serve those that serve the public, by working to make auto-enrollment and auto-escalation programs available to all public sector employees.

## REFERENCES:

**Current 10-Year Treasury Rate:** 1.76%

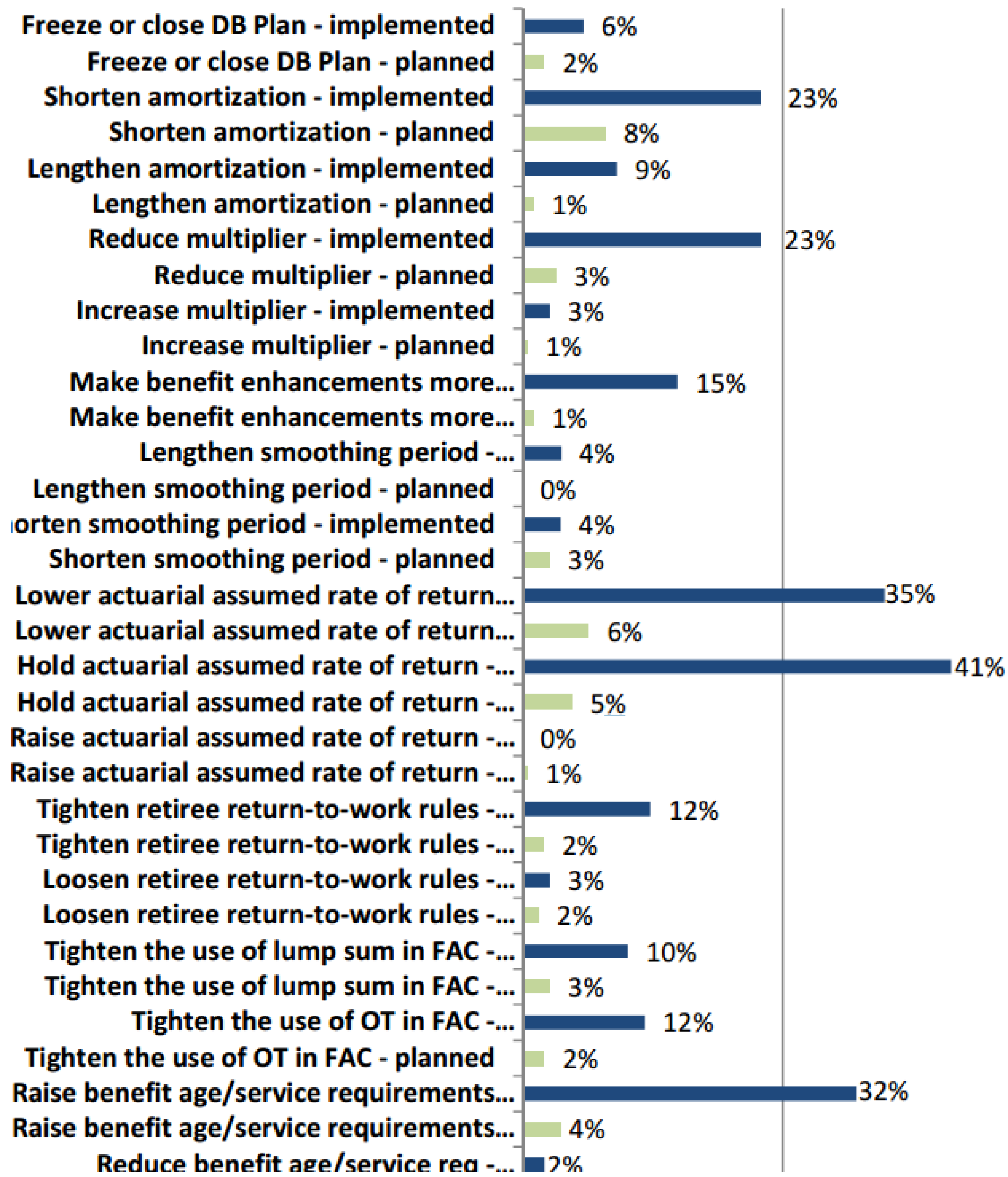
At market close Fri Feb 26, 2016

| | | |
|---|---|---|
| **Mean:** | 4.60% | |
| **Median:** | 3.88% | |
| **Min:** | 1.53% | (Jul 2012) |
| **Max:** | 15.32% | (Sep 1981) |

US 10 Year Treasury Yield.

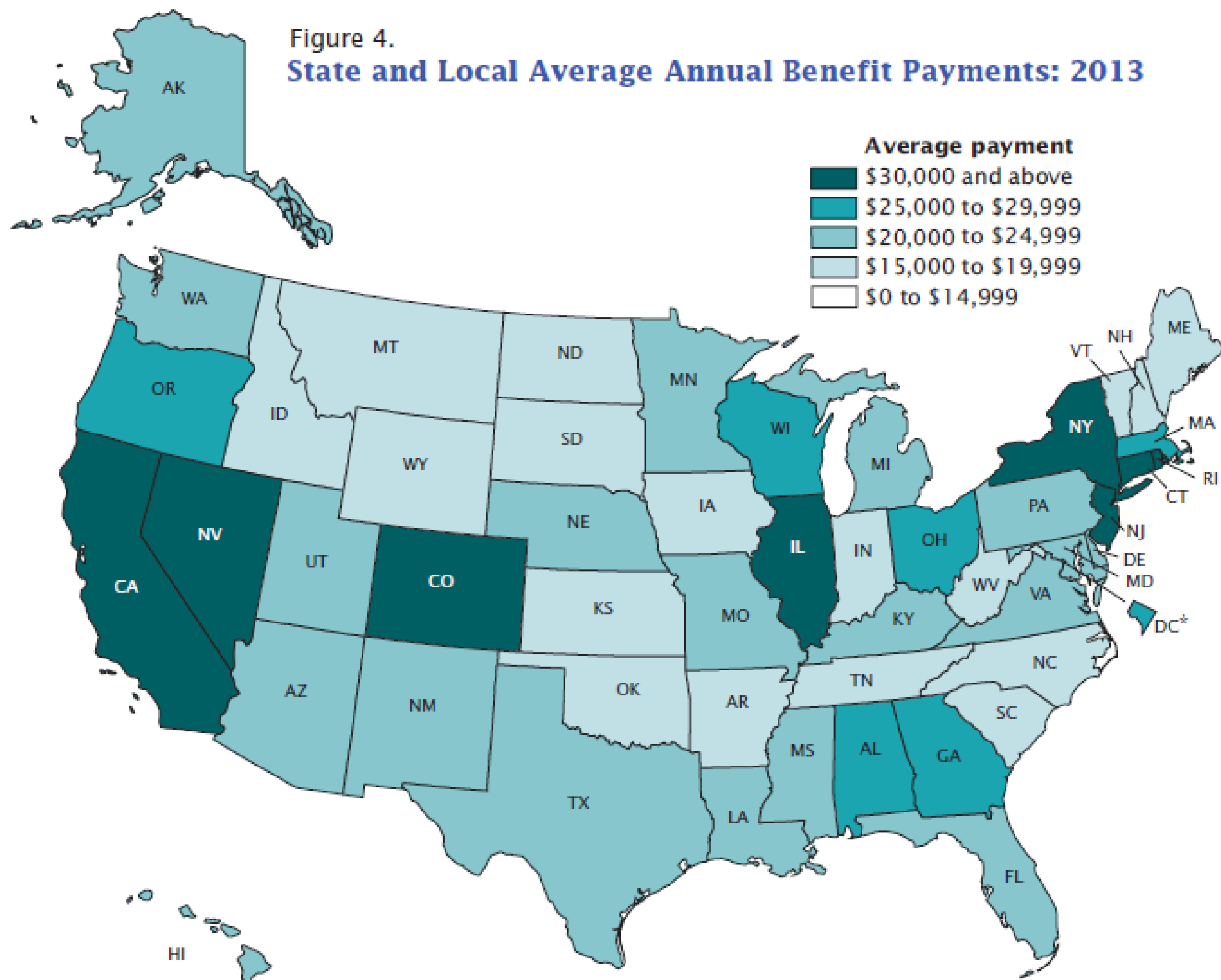
Source http://www.multpl.com/10-year-treasury-rate 10-year historical yield

## NCPERS




Source: http://www.ncpers.org/files/2014%20NCPERS%20Public%20Retirement%20Systems%20Study%20Report.pdf (2015 Report)

The average annual benefit payment for state- and locally-administered pensions (total benefit payments divided by the number of beneficiaries) for the United States was $26,128 in 2013. The state with the highest average annual benefit payment from state- and locally-administered pensions in 2013 was Connecticut (averaging $35,486 annually). Connecticut was one of eight states with average annual benefit payments above $30,000. The other seven states were California, Colorado, Rhode Island, Illinois, Nevada, New York, and New Jersey. At the other end of the spectrum, the state with the lowest average annual benefit payment from state- and locally-administered pensions in 2013 was North Dakota (averaging $14,900 annually). North Dakota was one of 16 states with average annual benefit payments below $20,000. See Figure 4 for state



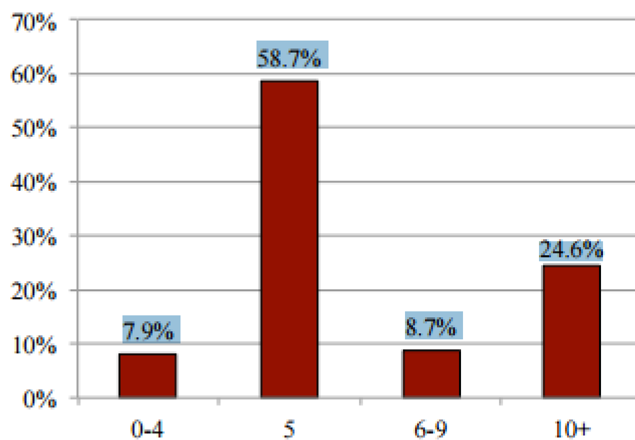

Source: U.S. Census Bureau, 2013 Annual Survey of Public Pensions: State- and Locally-Administered Defined Benefit Data and historical survey data.

http://www2.census.gov/govs/retire/g13-aspp-sl.pdf

## Empower Institute- Health Care Costs

is one of the most significant and worrisome categories of expenses in retirement. These expenses are primarily in the form of premiums for Medicare parts B and D and supplemental insurance, as well as out-of-pocket expenses for copays and cost sharing related to medical treatments and medications. We show that for a healthy 65-year-old male retiree, cumulative savings of approximately $144,000 would be required to fund these expenses for the projected retirement period at a 90% confidence level. For a female, the amount would be $156,000. However, for different health and disease states, the interactions of projected health costs and associated mortality projections often have interesting and counterintuitive effects on retirement planning. For example, the higher retiree healthcare costs of conditions such as diabetes and tobacco use are offset by reduced life expectancies. The net effect is that, in certain health states, less savings are required for healthcare.

- Baby Boomers avg. 11.6 jobs ages 18-45
- 25 yr olds today have already worked 6.3 jobs
- Millennials are pace to have 12-15 jobs before age 45.
- Source: http://www.bls.gov/nls/nlsfaqs.htm
- Source: http://money.cnn.com/2013/04/09/news/economy/millennial-job-hopping



## The Pension Protection Act and 401(k)s

*by Jack VanDerhei, Temple University and EBRI Fellow*

### What Auto-Enrollment Means for Workers

Modeling research by the Employee Benefit Research Institute prior to the passage of PPA indicated that the automatic enrollment feature was likely to be particularly helpful to low-income 401(k) participants (higher-income participants would also benefit, although not as dramatically). Specifically, under a 3 percent) default contribution rate and a life-cycle default investment, median income replacement rates at retirement for the lowest-income group would increase 19 percent points, to 42 percent if automatic enrolment were universally adopted by all 401(k) sponsors.

Table 4. Median Replacement Rates[a] for Households, Including Financial Assets, by Employment History

| Retirement income source | Private sector | | | State-local sector | | | |
|---|---|---|---|---|---|---|---|
| | All | Without pensions | With pensions | All | Percent of career spent in state-local sector: 1-15% | 15-50% | >50 % |
| Social Security | 30.3 | 34.0 | 29.1 | 27.1 | 27.8 | 27.3 | 25.8 |
| Social Security + pensions[b] | 44.8 | 34.0 | 50.0 | 53.1 | 43.4 | 54.2 | 67.5 |
| Social Security + pensions[b] + Financial assets[c] | 51.0 | 40.5 | 55.6 | 60.2 | 50.9 | 61.3 | 72.7 |

[a] The denominator is the individuals' top five years of earnings in the last ten years indexed for inflation plus income from financial assets.

[b] For those with pension coverage, IRA assets are included in defined contribution wealth; for those without pension coverage, IRA assets are classified as part of financial assets.

[c] The real return on financial assets is assumed to be 2.3 percent.

*Source*: Authors' estimates from 1992-2008 HRS.

Source: http://online.wsj.com/ad/employeebenefits-pension_protection_act.html

**Neither NAGDCA, nor its employees or agents, nor members of its Executive Board, provide tax, financial, accounting or legal advice. This memorandum should not be construed as tax, financial, accounting or legal advice; it is provided solely for informational purposes. NAGDCA members, both government and industry, are urged to consult with their own attorneys and/or taxadvisors about the issues addressed herein.**

**Copyright June 2016 NAGDCA**