QPA WHITE PAPER SERIES

The Positive Impact of Automatic Features

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The Positive Impact of Automatic Enrollment and Automatic Escalation

I. Introduction

Automatic enrollment and automatic escalation afford an employer the greatest plan design opportunity to improve employees' prospects of a dignified retirement. Automatic plan features offer numerous benefits. Employee savings rates increase, nondiscrimination test results improve, financial wellness improves, and employees become more productive while working and more prepared to cease working at the optimal time. These positive impacts occur amidst a backdrop that surprises many employers: employees favor automatic features and appreciate an employer that utilizes them. Perhaps most importantly, employees' appreciation and acceptance extends to automatic rates much higher than employers would initially assume. This White Paper will help employers to strengthen their commitment through a thoughtful and informed automatic enrollment and escalation structure.

II. Automatic Features: What They Are (And What They Are Not)

Let's start with the meaning of "automatic". Automation makes things easy; it does not make them mandatory. Your car's automatic windows mean you can easily roll down your window; this does not mean that you must drive through the rain and snow with your windows down. Your electric company's automatic bill pay option means you can pay your bill without effort each month. An automatic car wash gives you the easy option of staying dry and checking Facebook while your car is cleaned; it does not eliminate the old-fashioned notion of washing your car in your driveway. When my sons set the DVR to automatically record every NBA game on television, our cable box conveniently records the games without any action on our part; this certainly does not mean we must watch every game. Thank goodness.

Thus, "automatic" enrollment and "automatic" escalation features are aptly named. An employer that implements automatic enrollment for its employees simply makes plan participation easy. It permits the employer to tell a new employee: "We care about your retirement savings, so we have set up our retirement plan to make it easy for you to save." An employee who desires to save more, less, or nothing at all certainly retains that option – initially, after the first paycheck, and indefinitely into the future.

The genius of automatic features is that they use employees' inertia to their benefit. Given a choice between doing nothing and doing something, which takes less work? Doing nothing. It is pretty easy to do nothing. And this is the choice most employees intentionally or unintentionally make. In the context of automatic enrollment and escalation, thank goodness. That choice means employees and employers reap the benefits referenced above and discussed in greater detail below.

When the Pension Protection Act of 2006 (PPA) created new types of automatic contribution arrangements and cleaned up questions relating to existing arrangements, it provided a timely endorsement for the widespread implementation of automatic features. Despite its title and "protective" intent, PPA served to accelerate the decrease in defined benefit pension plans. This further accelerated the reliance on defined contribution plans and exacerbated the problems stemming from workers' retirement futures depending on their choices. The defined benefit plan culture did not require employees to decide whether to participate, how much to save, when to increase their savings rates, how to invest their retirement savings account, and how to make that money last in retirement. The defined contribution culture, though, dangerously places those decisions in employees' hands. And when they can choose between those hands holding a Starbucks latte today or the arm of a comfortable rocking chair in 40 years, the latte is the easier choice. Yet they want their employers to make it easier to choose the rocking chair.

III. Understanding How to Use Automatic Features

Automatic features protect employees from themselves. We hear that defense wins championships, so this is probably a good starting point. But when implemented thoughtfully – and in recognition of the significant amount of data – automatic features lift employees to higher heights. This combination of a strong defense and consistent offense is what allows employers to accomplish their goal of helping employees to truly attain retirement readiness.

a. Automatic Enrollment and Automatic Escalation, When Properly Implemented, Are Highly Likely to Increase Savings Rates.

The most obvious effect of automatic enrollment is to increase plan participation rates. This happens because a large portion – more than 30% of automatically enrolled participants, in one study – indicate that they were unlikely to have enrolled otherwise.[1] One large recordkeeper found that the participation rate for plans with automatic enrollment is almost twice as high as the rate for plans without automatic enrollment.[2] Automatic enrollment has a particularly positive impact on young employees' participation rates. Plans using automatic enrollment demonstrate an increase in participation from 38 to 78% for workers age 21-27 and from 60 to 88% for workers 28-34.[3]

Most employers believe that automatic enrollment also has a positive impact on a plan's average contribution rate.[4] Yet that may not be the case if the default rate is too low. For example, a plan using a 3% default rate may very well have featured higher savings rates in the absence of automatic enrollment.[5] As a result, a plan that uses a low default rate – and particularly one without the accompanying automatic escalation feature[6] – may increase the plan's participation rate but result in a lower overall savings rate.[7] Such an approach provides an employer a false sense of security that its use of automatic enrollment is helpful.

In order to accomplish the intended effects, an employer must focus on the appropriate measurement – savings rates, not merely the participation rate. A 401(k) plan's participation rate is akin to a company's revenue number; it is a good indicator of potential, but not the bottom line goal. A plan's retirement readiness score, however, is akin to a company's profit number; it reflects the achievement of an intended purpose. Fortunately, as indicated below, employees appreciate their employers' use of automatic features to achieve the plan's intended purpose.

b. Employees Appreciate Automatic Features.

Automatic enrollment and escalation not only make it easier to do something employees think is right, but also allow employers to fulfill a responsibility employees attribute to their employers. Employees

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[1] JP Morgan, "Defined Contribution Plan Participant Survey Findings", 2016 (hereinafter, "JP Morgan DC Plan Findings").
[2] T. Rowe Price, "Reference Point, 2016".
[3] Bank of America Merrill Lynch "Plan Wellness Scorecard", June 30, 2016 (hereinafter, "BOA ML Scorecard").
[4] Deloitte Benchmarking 2015 (finding as much for 70% of responding employers).
[5] Aon Hewitt, "Universe Benchmarks: Measuring Employee Savings and Investing Behavior in Defined Contribution Plans", 2014.
[6] JP Morgan DC Plan Findings.
[7] JP Morgan, "Ready! Fire! *Aim?*" 2015.

believe it is important to save for retirement.[8] More than three-fourths of employees believe their employer has at least some responsibility to help them save for retirement.[9] More than 80% agree that employers should fulfill that responsibility, in part, by encouraging employees to contribute to the company retirement plan.[10] More than half of employees look to their employer to provide a viewpoint on how much to contribute to their plan.[11]

Employees of all ages have expressed their support for automatic features. Three-fourths of employees are in favor of or at least neutral toward automatic enrollment.[12] Roughly the same percentage are in favor of or at least neutral toward automatic escalation.[13] More than two-thirds of employees support the combination.[14] Among employees who have been automatically enrolled or automatically escalated, nearly all – 96 and 97%, respectively – are satisfied.[15] As one study notes: "Most participants see the implementation of these features not as an example of an employer overstepping its role to encourage saving or 'deciding' how much employees will save but rather as proactively placing employees on a path to a secure retirement . . . one they can choose to follow or not."[16]

Young employees are even more supportive than the general population. Support for automatic enrollment and automatic escalation jumps to 84% and 86%, respectively, among employees under 30.[17] Almost three-fourths of young employees support the combination.[18]

Automatic features take advantage of employees' inactivity on the front end, then often increase employee activity on the back end. They have proven to increase plan engagement on a variety of levels and at a variety of age groups, which in turn helps to further enhance American workers' financial security.[19] In light of employees' support and the favorable engagement data, employers are discovering that they may establish much more aggressive automatic levels than previously assumed.

c. Contrary to Popular Belief, Higher Automatic Enrollment Percentages Do Not Significantly Increase Opt Out Rates.

Plans with higher default rates also feature higher participation rates. This reflects participants' comfort level with higher default rates. One study found plans with a 3% default rate to demonstrate a 78% participation rate. The participation rate crept higher – to 80% - among plans with a default rate of 4, 5, or 6%. The participation rate then leapt to 84% among plans with a default deferral rate of greater than 6%.[20]

[8] Transamerica 17th Annual Retirement Study, December 2016.
[9] JP Morgan DC Plan Findings.
[10] JP Morgan DC Plan Findings.
[11] JP Morgan DC Plan Findings.
[12] JP Morgan DC Plan Findings.
[13] JP Morgan DC Plan Findings.
[14] JP Morgan DC Plan Findings.
[15] JPMorgan DC Plan Findings.
[16] JP Morgan DC Plan Findings.
[17] JPMorgan DC Plan Findings.
[18] JPMorgan DC Plan Findings.
[19] BOA ML Scorecard.
[20] BOA ML Scorecard.

Plans with higher default rates also feature higher savings rates. The total plan savings rates increase approximately 86 basis points (0.86%) for each one-percent increase in the default level.[21] This occurs through a combination of: (a) the high percentage of employees who accept the default rate; and (b) the potentially surprising discovery that opt-out participants tend to save more in plans with higher default rates.[22] Those higher elected rates among opted-out participants illustrate the "endorsement effect" and the "anchoring effect". [23] The endorsement effect reflects that employees view the default rate as an employer's trustworthy endorsement of an appropriate savings rate. The anchoring effect reflects that employees make decisions in relative terms, and are more likely to arrive at a higher number when comparing possible alternatives with a higher default rate. A Wall Street Journal column nailed it: "In other words, a higher default level was a win-win: It was accepted as often as the lower default levels, and those who didn't accept it tended to save more on average."[24]

Opt out rates are low across the board. That same Wall Street Journal article noted, rather simply and clearly: "Regardless of the default level, adoption was about the same."[25] In fact, acceptance of the default increases slightly as the rate increases from 2% to 6%, including a sizable jump of 10% of participants when comparing plans at 5 or 6%.[26] American Century found that 91% of employers reported opt out or automatic escalation cancelations of 10% or less. More than 2/3 of employers reported opt outs or cancelations of 5% or less.[27]

There is an abundance of data confirming that many employers have moved on from the 3% default rate and are moving toward 6%. More than half of employers using automatic enrollment are now using something higher than 3%.[28] Although 3% remains the most common default rate, 6% has become a close second.[29] Asked whether employers should auto enroll employees at 6% deferral, 68% of participants said yes.[30] Testimony before the U.S. Senate Finance Committee included recommendation of automatic enrollment at 6% of pay and automatic escalation up to 10% of pay in annual 1% increments.[31]

Employers have also begun to acknowledge that employees are supportive of higher limits on an automatic escalation structure. When asked about their interest in 1% annual auto increase up to 10% or more, 69% of participants were very or fairly interested.[32] It stands to reason that employees who have embraced automatic escalation are unlikely to, for example, approve of a one-time increase to 8%, only to run from a one-time increase to 9% the following year.

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[21] Morningstar, "Save More Today: Improving Retirement Savings with Carrots, Sticks, and Nudges", April 5, 2017 (hereinafter, "Morningstar Save More Today").
[22] Morningstar Save More Today.
[23] The Wall Street Journal, "Let's Increase the Default Savings Rates on 401(k)s", April 23, 2017 (hereinafter "WSJ Increase Savings Rates").
[24] WSJ Increase Savings Rates.
[25] WSJ Increase Savings Rates.
[26] Morningstar Save More Today.
[27] American Century, "Who's in the Driver's Seat? Participants Just Want to Ride Along: 2015 National Survey of Defined Contribution Plan Participants" (hereinafter, "American Century Survey of DC Participants").
[28] Plan Sponsor Council of America, "59th Annual Survey of Profit Sharing and 401(k) Plans", December 2016.
[29] T. Rowe Price, "Reference Point 2016".
[30] American Century Survey of DC Plan Participants.
[31]Testimony of John J. Kalamarides of Prudential Retirement to Senate Finance Committee, January 26, 2016.
[32] American Century Survey of DC Plan Participants.

d. Automatic Features Improve Nondiscrimination Testing Results.

Higher participation and deferral rates assist employers that struggle with – and fail – nondiscrimination tests. To that end, automatic enrollment may allow a plan to satisfy nondiscrimination tests without the need for a safe harbor structure. Deloitte found that more than half of automatic enrollment employers describe automatic enrollment as positively impacting nondiscrimination results, while only 2% identified a negative impact. [33] A higher default rate coupled with automatic escalation is likely to have the greatest impact. Yet even low default rates are likely to have a positive impact, particularly for plans with low participation rates.

In order to best accomplish this testing improvement, a plan sponsor should apply the automatic features to all employees – not merely future hires. Consultants may refer to that approach as "backsweeping" or "re-enrolling". Whatever the terminology, there are two strong reasons for applying any automatic features to all employees. First, an employer will see immediate dividends through the backsweep process, while applying the features to only future hires will greatly delay and mute the features' positive impact. Second, employee messaging is consistent when applying the same plan terms to all employees. How does an employer explain that it has embraced the virtues of automatic features for people who have not yet contributed to the organization, yet shies away from those virtues for employees who have?

e. Greater Retirement Readiness Provides Immediate and Long-Term Financial Benefits for a Company

Automatic features are likely to benefit an employer on a scale much larger than mere improvement in nondiscrimination testing results. This paper's scope does not allow for a detailed exploration of the degree to which greater employee retirement readiness provides the employer with immediate and long-term financial benefits. But in general terms, employers that help to address a key aspect of employees' financial stress – their retirement – are likely to see a reduction in the number of financially stressed employees, which may lead to improved productivity and lower healthcare costs.[34] Moreover, an employer that demonstrates and expresses commitment to a strong retirement plan may reap advantages when competing for and retaining talent. Four out of five employees said that benefits are the deciding factor for them when deciding whether to take a new job or stay with their current employer.[35]

IV. Closing Thoughts

The stakes are simply too high; the retirement plan status quo is destined to result in failure. A national retirement crisis is on the horizon, and the ability (or inability) to weather the crisis depends on the action (or inaction) of three distinct groups: employees, Congress, and employers. Among those three, which is best situated to take the future-saving steps the country needs?

Employees, despite the best of intentions, have clearly demonstrated the inability to take those steps. As discussed above, the participant-directed plan culture simply depends too much on employees' decisions. The most common of those decisions is to do nothing instead of something, which presents

[33] Deloitte "Annual Defined Contribution Benchmarking Survey", 2015.
[34] DCIIA, "Automatic Plan Features in Defined Contribution Plans: What's in it for Plan Sponsors?" July 2016 (hereinafter "DCIIA Automatic Plan Features").
[35] DCIIA Automatic Plan Features.

further cause for concern. An optimist, however, would take solace in knowing that employees want to save, believe they need to save, and appreciate an employer that makes saving easier.

Congress may, on paper, be best-situated to have the greatest impact. Yet, in reality, political gridlock and other priorities provide little certainty that Congress will take the bolder steps needed in the face of an enormous retirement savings crisis.[36] One expert, Alicia H. Munnell, the director of the Center for Retirement Research at Boston College described the necessary level of boldness:

> The most important policy change would be requiring all 401(k)s to be fully automatic, while continuing to allow workers to opt out if they choose. Plans should automatically enroll all of their workers – not just new hires – and the default employee contribution rate should be set at a meaningful level and then increased until the combined employee contribution and employer match reach 12% of wages.[37]

Despite that laudable aspiration, Congress currently rests far from a position that would lead to such a system.

This leaves employers as the most likely candidate to reverse the course toward crisis. Automatic features provide the sharpest plan design tool for clearing the path along that course. They result in higher participation rates. When used thoughtfully and purposefully, they result in higher savings rates, higher retirement readiness levels, higher contribution levels for highly compensated employees, and appreciate and engage employees. And they're so simple. They make it easier for employees to do what they want and need to do. If done right, in fact, employees need not choose between the latte now and the comfortable chair in retirement; financially well employees may have both. Employers must step up to the plate to play their role in making that possibility a reality.

[36] Testimony of Alicia H. Munnell of Center for Retirement Research at Boston College to Senate Finance Committee, January 28, 2016.
[37] *Id.*