Defined Contribution Institutional Investment Association

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BEST PRACTICES WHEN IMPLEMENTING AUTO FEATURES IN DC PLANS

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The Pension Protection Act of 2006 (PPA) introduced multiple safe harbors for implementing automatic enrollment in defined contribution (DC) plans: (1) a safe harbor for preemption of state anti-garnishment laws under ERISA, (2) a safe harbor extending 404(c) protection under ERISA to auto features, and (3) non-discrimination testing safe harbors. While helpful in providing comfort to plan sponsors seeking to implement auto features, the introduction of these safe harbors has also caused considerable confusion in the DC-plan sponsor community. Most plan sponsors may focus primarily on ERISA 404(c) protection and pre-emption of state anti-garnishment laws under ERISA. They wonder if they also need to adhere to the more complex and restrictive requirements of the safe harbors for non-discrimination testing. Many plans that implement automatic enrollment easily pass non-discrimination testing, and therefore may not particularly need the non-discrimination testing safe harbor. This paper seeks to help plan sponsors understand how to implement auto features in DC plans to achieve the best outcomes.

BACKGROUND

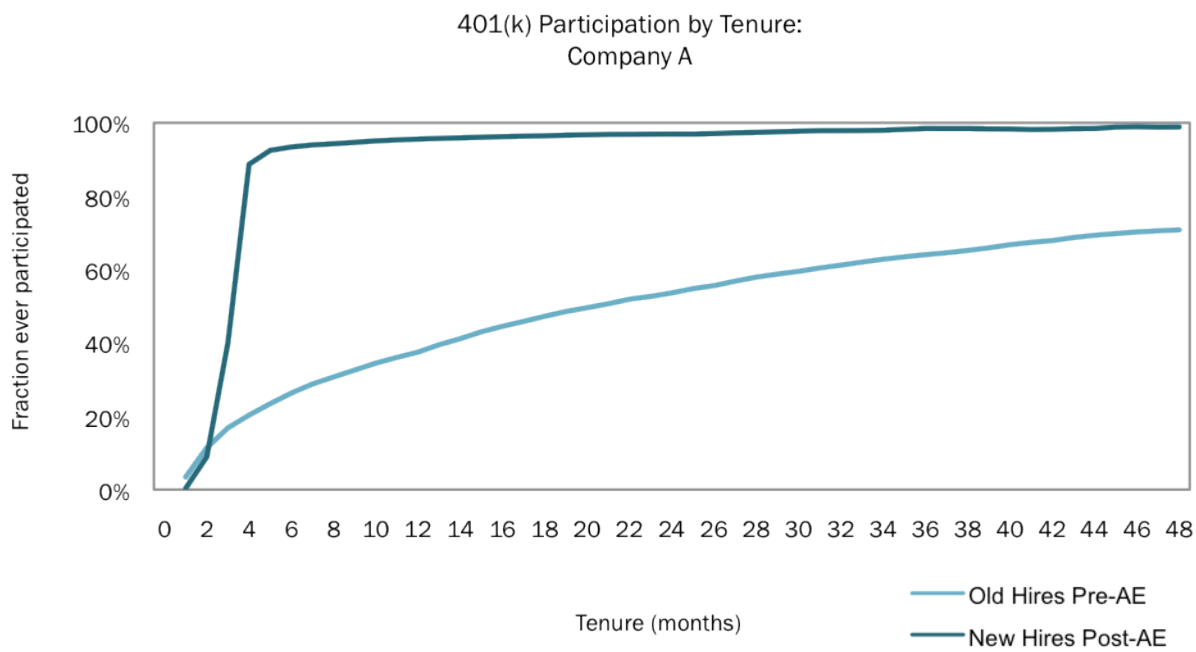
According to a 2012 survey by the Defined Contribution Institutional Investment Association ("DCIIA"), the majority of DC plans (56 percent) offer automatic enrollment.[1] Nearly half of the plans surveyed also offer automatic contribution escalation (46 percent). Auto features are popular because they have proven to positively change participant behavior. According to the DCIIA survey, more than half of plan sponsors describe their employees' attitude toward automatic enrollment as very or somewhat favorable. Furthermore, respondents to the survey noted that, under automatic enrollment, participation rates increased by approximately 20 percent (for an average participation rate of 81 percent). Opt-out rates for participants who were defaulted into the auto enrollment programs were low— less than 10 percent. The median opt-out rate for automatic contribution escalation stood at just 5 percent, with the majority of plan sponsors describing the attitudes of participants as favorable to auto escalation.

INSIGHTS FROM AUTO FEATURE RESEARCH

Academic research has long supported the view that, because of employee inertia when it comes to DC plans, automatic enrollment can increase participation among difficult-to-reach employees, such as those with low tenure. A study by Choi et al found that a company that implemented automatic enrollment saw participation among employees with less than six months of tenure soar--from less than 20 percent prior to the implementation of automatic enrollment, to about 90 percent after implementation. [2]

Exhibit I shows the participation rate of employees (by tenure) in Company A before and after automatic enrollment was implemented. Prior to automatic enrollment, participation in the plan was extremely low at tenure levels up to 18 months; it leveled out at 70 percent after 48 months of tenure. Employees hired under automatic enrollment, however, participated at rates nearing 100 percent almost regardless of tenure.

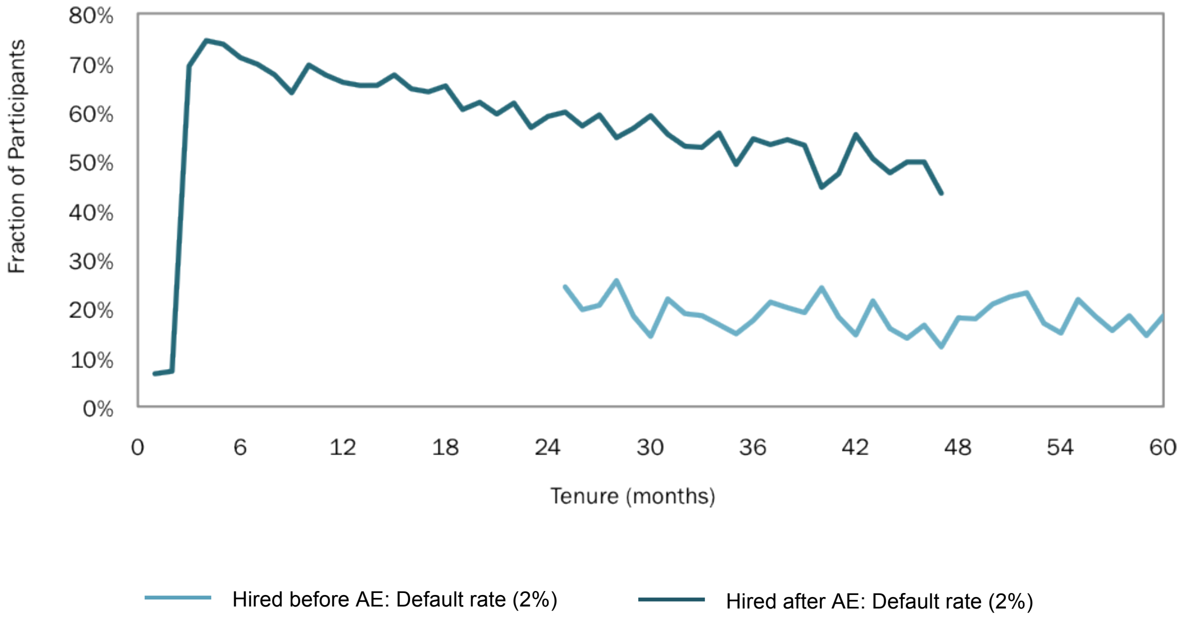
Exhibit I:
Research shows that participation increased dramatically with automatic enrollment.



At the same time, research shows that inertia can cut two ways: While it is good news that employees remain in the plan once auto enrolled, on the other hand, inertia can also cause them to remain at the automatic enrollment defaults, regardless of how closely those default levels match what the employee would have selected if he or she had proactively elected to enroll in the plan. For the same Company A mentioned earlier, for instance, Choi et al found a dramatic increase in the number of participants whose contribution levels equaled the default contribution rate level under the automatic enrollment program, compared with the number of employees that had elected that same deferral level before automatic enrollment was in place.

Exhibit II shows that prior to automatic enrollment, an average of about only 20 percent of participants elected a 2 percent deferral rate. Once 2 percent became the default deferral rate under automatic enrollment, participants with a 2 percent deferral rate soared to more than 70 percent at low tenure levels. And even at tenure levels as high as 48 months, participants were much likelier to have a 2 percent deferral rate than prior to automatic enrollment.

Exhibit II:
Company A: 2% default contribution rate under automatic enrollment

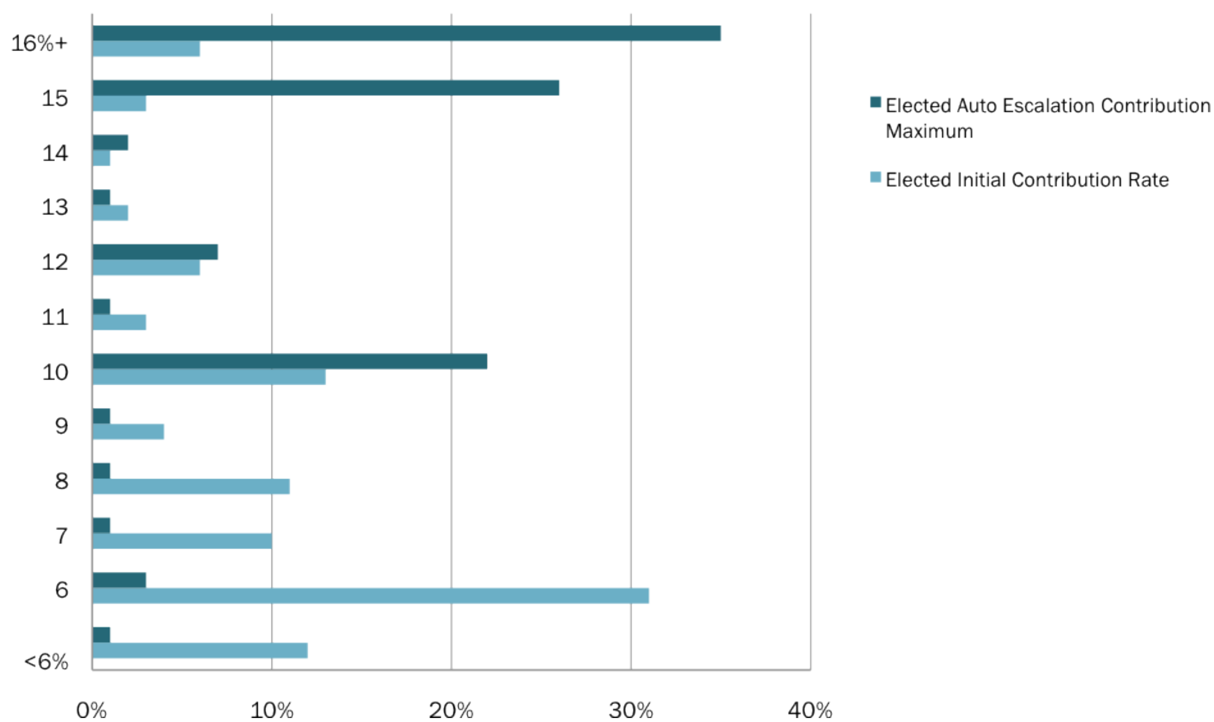


Interestingly, according to the DCIIA survey, 78 percent of plan sponsors reported that the optimal savings rate for participants is 10 percent or more—despite the fact that the typical default contribution rate used for automatic enrollment (as reported in the survey) is just 3 percent of pay.

Plan-sponsor implementation of automatic contribution escalation tends to be conservative as well. According to the DCIIA survey, 88 percent of plans that default participants into automatic contribution escalation increase participant contributions by just 1 percent per year. (Eleven percent of the plans increase contributions by 2 percent annually). Also, the most common cap on annual rate increases is 6 percent, followed by 10 percent.

Research by Aon Hewitt, however, shows in Exhibit III that in a plan where participants elected their own auto escalation contribution rate maximum, 35 percent elected a target rate of 16 percent or more; very few elected a cap as low as 6 percent.

Exhibit III:
Defaulted versus Elected Contribution Rates for Company C



Research by DCIIA and the Employee Benefit Research Institute (EBRI) shows that plan sponsors who use low default contribution rates under automatic enrollment could be setting up participants for failure. The research, titled, *Raising the Bar: Pumping Up Retirement Savings,* compared the potential retirement-income replacement potential of conservatively implemented auto features with those of robustly implemented ones.

"Conservative" was defined to include all of the following: participants failing to remember their former deferral levels (and remaining with a low initial default deferral level); some participants opting out of automatic contribution escalation; plan sponsors capping automatic contribution escalation at a maximum 6 percent salary-deferral level; and plans escalating automatic contributions by only 1 percent annually.

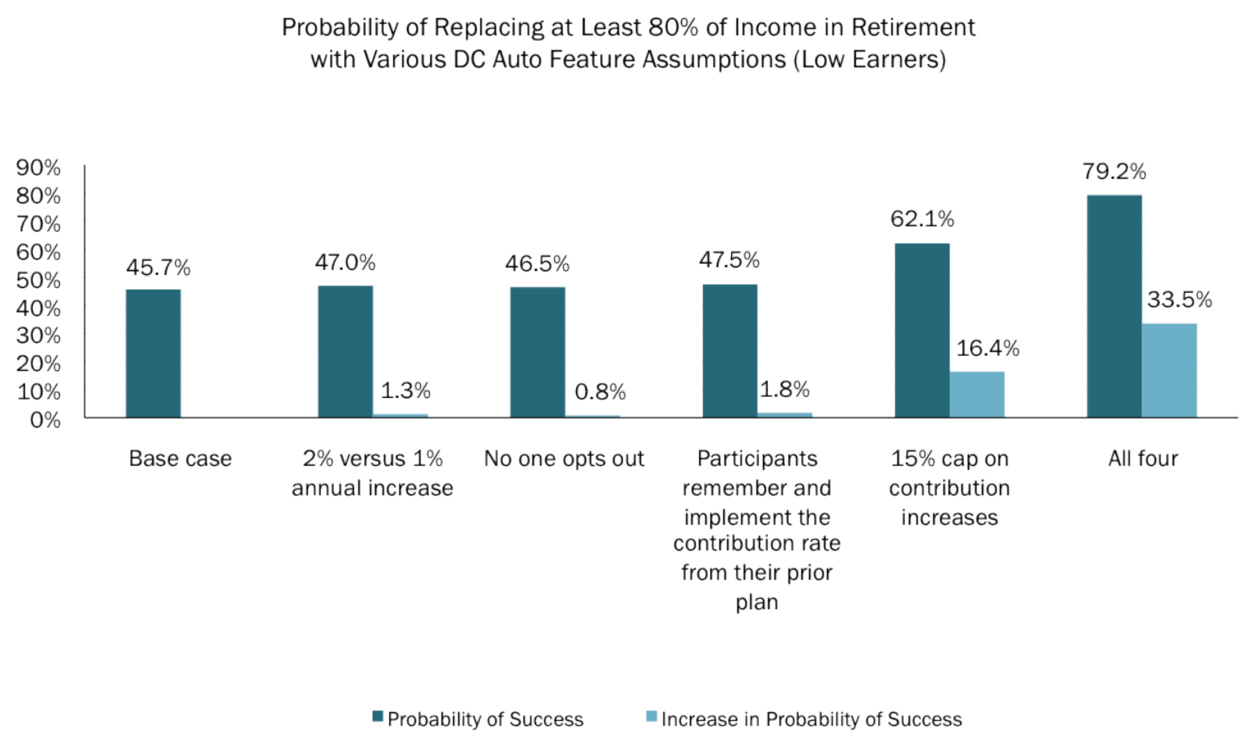
In the "Robust" scenario, it was assumed that: participants do remember and implement their former deferral level at a job change instead of merely accepting the automatic enrollment default; they do not opt-out of contribution escalation; plans escalate deferrals by 2 percent annually; and plans have deferrals automatically capped at 15 percent of pay.

Using Monte Carlo simulation to project retirement-income replacement, the EBRI/DCIIA analysis found that in the Conservative scenario, only 45.7 percent of the lowest income quartile of employees with 31-40 years of 401(k) eligibility were expected to attain enough to provide an 80 percent real replacement rate, even when combined with Social Security. For the highest income quartile, only 27.0 percent were expected to achieve an 80 percent real replacement rate.

In the Robust scenario, the analysis found that for the lowest income quartile, 79.2 percent of employees with 31-40 years of 401(k) eligibility were expected to attain an 80 percent combined real replacement rate. For the highest income quartile, 64 percent were expected to achieve that replacement rate goal. In other words, there was a massive 33.5 to 37 percentage point increase in the probability of success gained from modifying the plan design features of automatic contribution escalation and employee behavior, depending on income quartile. As reflected in Exhibit IV, this analysis shows the profound impact that the selection of automatic feature defaults can have on participant outcomes, and why robust defaults are essential to good retirement-planning policy by DC plan sponsors.

An EBRI research note titled, "Increasing Default Deferral Rates in Automatic Enrollment 401(k) Plans: The Impact on Retirement Savings Success in Plans With Automatic Escalation," shows how much better participant outcomes can be if plan sponsors simply use a default contribution rate under automatic enrollment of 6 percent, instead of current, typically lower, default contribution rates. EBRI found that simply by moving all plans to a 6 percent default contribution rate, the probability that low-wage employees would replace most of their income in retirement increased from 62.1 percent to 71.8 percent. Among high-wage employees, the probability increased from 41.1 percent to 51.9 percent. EBRI concluded: "In other words, more than a quarter (25.6 percent) of those in the lowest-income quartile who had previously NOT been successful (under the actual default contribution rates) would then be successful as a result of the change in deferral percentage."[3]

Exhibit IV:
Impact of various auto feature defaults on projected participant replacement levels



CASE STUDIES: GETTING TO BETTER IMPLEMENTATION OF AUTO FEATURES

Given all of this research pointing to the importance of robust defaults under auto feature programs, why do plan sponsors implement automatic enrollment with such low default deferrals?

1) **Desire to minimize opt-outs.** Despite the research, some plan sponsors remain convinced that only very low default contribution rates will be palatable to participants.
2) **Cost.** Because auto features so successfully increase DC plan participation, some plan sponsors worry that robust implementation may result in much higher matching costs for the company.
3) **Safe harbor effect.** Plan sponsors may be unsure if the restrictive implementation requirements of the automatic enrollment non-discrimination testing safe harbor apply to them.

DCIIA interviewed plan sponsors that have implemented auto features in more robust ways to understand how they were able to overcome such obstacles. Following are their case studies:

BALFOUR BEATTY CONSTRUCTION: GETTING PEOPLE TO THE RIGHT PLACE

Balfour Beatty Construction ("BBC") is a world-class infrastructure services business operating across the infrastructure lifecycle, with leading positions in major markets. Its DC plan has approximately $250 million in assets, with approximately 2,000 eligible employees. The plan historically offered a profit sharing contribution only, with no matching contribution. However, the plan recently experienced a change in its company contribution to offer both profit sharing and a match. Because employees now must actively participate in the plan to receive the full company contribution, the plan sponsor determined that it was important to implement automatic enrollment and automatic contribution escalation.

According to Mark Crouser, Vice President-Finance at BBC, having partnered with the plan's investment consultant, fundamentally, the BBC investment committee believed that adopting automatic enrollment was simply the right thing to do to drive better participant behavior. However, there was also a need to get comfortable that automatic enrollment would be palatable to employees, and that opt-outs from automatic enrollment would be low.

Initially, the BBC plan adopted automatic enrollment for existing hires with a 2 percent default rate (on January 1, 2012). The experience was positive: employees seemed satisfied with automatic enrollment, and opt-out rates were low. Even better, a number of participants increased their contribution level to 5 percent, which is the level required to receive the full company match. BBC's investment committee saw all of this as a validation of the program. As a result, the investment committee determined to increase the default contribution rate under automatic enrollment to 5 percent (as of January 1, 2013).

At the same time that automatic enrollment was introduced, the plan also adopted automatic contribution escalation. This feature was made opt-in, as opposed to a default—largely due to the weakness of the economy, and slow salary growth. According to Crouser, the investment committee hopes to make automatic contribution escalation a default—perhaps as early as this year. "Once automatic contribution escalation is the default, it will be implemented with a robust 15 percent cap," says Crouser. "The investment committee would like to set the annual increase default at 2 percent; the concern is that a 1 percent annual increase won't get employees to the level they need to be fast enough. However, we are still deciding on this." Eventually, the investment committee would also like to sweep in existing hires under automatic enrollment as well.

Crouser's advice to other plan sponsors who are considering automatic enrollment or automatic contribution escalation: "Educate yourself on how the plan is performing, and work with leadership to make sure that they understand how employees are doing from a retirement readiness perspective." Crouser also notes that if BBC had to do it over again, they would have kicked off the automatic enrollment program with a default deferral level of 5 percent on day one so that people could get the full match.

The bottom line, according to Crouser: As a plan sponsor, BBC had a sense of responsibility for workers' retirement outcomes. Further, BBC understands the importance of not forcing people to actively manage their 401(k) accounts if they don't want to.

DELUXE CORPORATION: USING RETIREMENT INCOME REPLACEMENT MEASURES AS A GUIDE

Founded in 1915 with the idea of offering the first personalized flat-pocket checkbook and holder, Deluxe Corporation ("Deluxe") today is a growth engine for small businesses and financial institutions as well as one of the top check producers in North America. Deluxe 401(k) plan is also state-of-the art: taking a page from the way defined benefit plans are managed, Deluxe's $1.2 billion defined contribution plan offers custom target date funds, and institutionally-oriented multi-manager single asset-class funds.

The 401(k) plan is managed with a view to achieving certain retirement income replacement goals: Monte Carlo analysis drove the development of the plan's custom target date funds, and in 2007 that same analysis provided a blueprint for offering automatic enrollment and automatic contribution escalation within the plan. With a goal of helping employees reach a 70 percent retirement income replacement rate funded by assets in the participant's DC accounts in the plan and another 20 percent coming from assumed Social Security benefits, Deluxe found that employees needed to be automatically enrolled in the 401(k) plan at a 5 percent initial deferral rate—which was enough to achieve the full employer matching contribution; auto escalation would then ratchet up contributions 1 percent annually to a maximum of 7 percent of pay.

In the 2007 exercise, all existing employees, as well as new hires, were swept into the plan under the auto features program. This resulted in the participation rate improving from 62 percent to 88 percent. Dan Holupchinski, Manager, Retirement Plans at Deluxe, noted that previous intensive communication efforts to enhance participation rates had yielded unsatisfactory results, but the auto features program was very effective at impacting participant behavior.

Every quarter Deluxe analyzes its plan metrics. In late 2010 it found that most people continued to leave contribution levels at the 7 percent auto escalation resting level, a level that was no longer projected to be sufficient to meet the goal of 90 percent of income in retirement. "The company had frozen its money purchase pension plan contribution and the capital markets outlook had been reduced. This caused our projections to now show a gap to the 90 percent goal, so our initial auto features program was no longer projected to be adequate," says Holupchinski.

To improve the odds that employees would reach their retirement goals, the 401(k) plan's match was increased to 3.5 percent of pay on contributions up to 6 percent. The auto enrollment program, meanwhile, was adjusted so that employees were defaulted at 4 percent of pay in order to reduce opt-out rates. (It had previously been 5 percent.) At the same time, automatic contribution escalation increased fairly aggressively—2 percent of pay per year up to a very robust 15 percent maximum deferral rate. The first auto escalation would occur just prior to when the employee became match-eligible, so employees received the full match at the earliest opportunity. The updated auto features program was applied to existing employees as well as new hires. Everyone contributing 0-3 percent of pay was bumped to the 4 percent auto enrollment deferral rate and those contributing 4 percent or more (up to 15 percent) were slated for a 2 percent auto increase on March 1, 2012.

Holupchinski says the changes have been successful: Ninety-five percent of employees were affected by the program, as only 5 percent of employees contributed 15 percent or more when the enhanced auto features went into place. Opt-out rates from the re-enrollment were a modest 8 percent, with overall participation rising to 92 percent. Interestingly, 67 percent of employees were in the auto increase feature after the March 1, 2012 exercise, and a year later, for the March 1, 2013 auto increase, 67 percent have remained in the feature, thus causing the average deferral rate to increase to 9 percent.

Holupchinski says his key take-way regarding auto features over the past six years has been that, because of inertia, automatic enrollment alone will not facilitate retirement saving success—automatic enrollment has to be accompanied by a robust auto escalation feature. His advice to other plan sponsors considering a similar approach: Communication is key. This includes communication with human resources and with senior managers so that they become advocates of the program. He says it is also important to communicate proactively with employees to ensure buy in. While that may sound like a lot of work, says Holupchinski, the bottom line is that he is "overall very satisfied as to where we are at. People are saving better and getting to a better income replacement rate."

TRAVELERS: MAKING NON-PARTICIPATION A CONSCIOUS EMPLOYEE DECISION

The Travelers Companies, Inc. ("Travelers") is a leading provider of property and casualty insurance for auto, home and business. The company's diverse business lines offer customers a wide range of coverage predominantly through independent agents and brokers. A component of the Dow Jones Industrial Average, Travelers has more than 30,000 employees and operations in the United States and selected international markets. The Travelers 401(k) Savings Plan has over $4 billion in assets and more than 36,000 participants.

The 401(k) plan's auto features odyssey began in 2005 when Travelers merged its plan with recently acquired The St. Paul Companies, Inc.'s plan. Aggregate participation at the time was 75 percent, and to get that number higher, Travelers implemented automatic enrollment for new hires with a default contribution rate of 3 percent of pay. Over time, Travelers went back and auto enrolled most existing employees into the plan at the 3 percent rate as well. "We chose a default of 3 percent because we were worried about opt-outs," says Christine Bayer, Director, Corporate Benefits. But while participation increased to 93 percent, Bayer says, there was a growing concern about the number of employees who stayed at the 3 percent deferral rate. "Our match was dollar-for-dollar up to 5 percent of pay, up to a dollar maximum, and we really wanted our employees to receive the full match."

Bayer's team went back to Travelers senior management in 2007 to explore increasing the default deferral rate to 5 percent. "Senior management is very supportive of the 401(k) plan, and they recognized that we designed the match the way we did for a reason," Bayer says. Travelers' retirement plans were designed to provide for a replacement ratio of roughly 80 percent, as recommended by many financial planners. A portion of this comes from the company's cash balance pension plan and income from Social Security, but about 50 percent of replacement income is designed to come from the 401(k) plan. "To get to the desired income replacement level, employees need to save at least 5 percent of pay in the plan for their full career," Bayer noted.

Senior management ultimately approved of the default deferral rate increase, which was implemented in late 2007 for new hires in 2008. Opt-outs have been modest—7 percent. Travelers is now exploring changing its automatic contribution escalation offering from opt-in to opt-out. After offering the auto escalation on an opt-in basis for 8 years, Travelers only has 7 percent of employees in the program. In addition, there is still a group of employees who were auto enrolled at 3 percent who have never increased their savings rate. The ultimate goal would be to help employees prepare for retirement so that they have enough money saved when they are ready for the next phase of their life.

For now, Bayer says, the key thing is that the only eligible Travelers employees who are not in the 401(k) plan are those who have consciously chosen to opt-out. That means that every single non-participant at Travelers has made a conscious decision if they are not in the 401(k) plan.

CONCLUSION:

Research clearly shows that plan sponsors can play a pivotal role in helping employees save for a secure retirement. They can:

1) Auto enroll new and existing employees, and include auto escalation as a DC plan default option.
2) Auto enroll and auto escalate employees at robust default levels that are consistent with the goals of the plan.
3) Tailor the matching contribution approach to the goal of helping participants achieve high savings, by increasing the match threshold.
4) Not conform to overly conservative defaults, unless the defaults match the plan's goals.

A sample best practice is to:

1) Auto enroll all current and future employees into the plan.
2) Set the initial deferral percentage at no less than 6 percent.
3) Employ an automatic increase of a 1 or 2 percent deferral rate, to a maximum of no less than 15 percent.

FOOTNOTES:

[1] *"Action Needed to Drive Better Participant Outcomes", DCIIA Plan Sponsor Survey (2012)*

[2] *"For Better or For Worse: Default Effects and 401(k) Savings Behavior", Choi et al. University of Pennsylvania and NBER. Date: November 9, 2001*

[3] *The note, titled "Increasing Default Deferral Rates in Automatic Enrollment 401(k) Plans: The Impact on Retirement Savings Success in Plans With Automatic Escalation", analyzed the likely impact on DC participants' ability to accumulate sufficient assets over their career to provide a total real replacement rate of 80 percent (combined with inflation), or most of their pre-retirement income. The analysis compared two automatic enrollment scenarios: In the first scenario, actual plan-specific default contribution rates were used, so that each time an employee changed jobs, he or she would "start over" at the new DC plan's default contribution rate under automatic enrollment. In the second scenario, plans automatically enrolled participants at a 6 percent default contribution rate. In both scenarios, automatic enrollment was coupled with an automatic annual deferral escalation of 1 percent of compensation, an opt-out rate from auto escalation equal to the self-reported rates from EBRI's 2007 Retirement Confidence Survey, and a 15 percent cap on employee contributions under auto escalation.*

ABOUT DCIIA

The Defined Contribution Institutional Investment Association (DCIIA) is a nonprofit association dedicated to enhancing the retirement security of American workers. Toward this end, DCIIA fosters a dialogue among the leaders of the defined contribution community who are passionate about improving defined contribution plan design. DCIIA members include investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants. For more information go to: http://www.dciia.org.