Getting Beyond Ordinary: Advances in Automatic Savings Program Design

INTRODUCTION

Defined contribution plans have experienced significant growth in the adoption of automatic savings programs since the 2006 introduction of the Pension Protection Act (PPA). While these programs have generally delivered laudable results, their progress can be hindered by certain plan designs:

1. Plan designs incorporating relatively low default rates often result in overall lower savings rates.
2. Since its inception, automatic enrollment has been applied primarily to newly eligible employees, largely ignoring a substantial number of nonparticipating existing employees.
3. A growing number of plan sponsors have implemented automatic increase programs, but these programs have most often been applied on an opt-in basis rather than an opt-out basis, thereby limiting their impact.

At T. Rowe Price, we view these early automatic programs as an important first step to overcoming employee inertia. The next step is to evolve these programs and combine them in ways that produce greater results per dollar of employer cost.

This paper explores the merits of solutions that involve the following:

- Auto-enrollment for employees at higher initial default rates,
- Auto-enrollment for employees who are not currently enrolled,
- Auto-increases in deferral rates on an opt-out basis, and
- Auto-investing in a qualified default investment alternative (QDIA).
AUTOMATIC SAVINGS PROGRAMS VERSION 1.0

Results from basic programs suggest high potential for improvements

Employers facing participation challenges that often complicated plan administration and curtailed savings for highly compensated employees found auto-enrollment to be an attractive solution. Armed with specific guidance and limited protections offered under the provisions of the PPA covering QDIAs, employer fears about market fluctuations or the effect of investing too conservatively fell to the wayside as did the previous state-level restrictions concerning automatic withholding of payroll.

Today, 56% of plan sponsors participating in a recent survey report offering automatic enrollment programs, with 77% of those sponsors using target-date or life-cycle funds as the default investment vehicle. However, the overwhelming majority of plan sponsors surveyed—70%—only auto-enroll new hires (Deloitte, 2011). And, while participation rates continue to rise in these programs, the majority of plans (61.8%) are utilizing a default rate of 3% (Deloitte, 2011).

This default rate mirrors both safe-harbor guidelines and early government illustrations of the impact of automatic enrollment programs, which frequently used 3% savings in modeling. The 3% rate also reflects the generally acknowledged deferral rate likely to decrease the instance of participants opting out, even though there is no definitive evidence that higher default rates would result in higher opt-outs.

In addition to applying automatic enrollment utilizing the QDIA, many plans are also using automatic increase programs to drive escalation of deferral rates. Of T. Rowe Price Retirement Plan Services (RPS) clients for whom we track deferral rates, 83.7% have adopted some form of automatic increase program. However, 68.5% of those plans utilizing this feature do so on an opt-in basis. This opt-in approach resulted in only 8.3% of participants opting in to the program. However, of those plans offering the program on an opt-out basis, 64.7% of participants remained in the program, further supporting the evidence that automation effectively overcomes participant inertia (T. Rowe Price, 2012).

KEY FACTS CITED IN THIS PAPER

- When asked to rank the top improvements that recordkeepers can help plan sponsors with, “improve participant readiness for retirement” rated #1 (Deloitte, 2011).

- The overwhelming majority of plan sponsors—70%—auto-enroll new hires only (Deloitte, 2011).

- The majority of plans (61.8%) are using a default rate of 3% (Deloitte, 2011). This is one reason today’s average deferral rate (6.2%) is well below what experts generally recommend (15%) (PSCA, 2011).

- Of the participants defaulted into a QDIA, 96.3% remained in the default option (T. Rowe Price, 2012).

- When automatic increase was offered on opt-in basis, only 8.3% of participants chose to opt in, versus 64.7% staying in when offered on an opt-out basis (T. Rowe Price, 2012).
Early adopters of automatic savings programs were pioneers, often seeking ways to help their retirement plans operate more effectively and for employees to become more self-reliant and better prepared for retirement. According to AARP’s June 2010 survey of plan sponsors:

- 74% of respondents reported that the reason for implementing auto-enrollment was to help employees save more,
- 49% did so to make it easier to pass non-discrimination testing, and
- 35% were motivated to demonstrate that they were a socially responsible company.

The motivation and progress in getting more people to save more is extremely encouraging. At the same time, these basic approaches to automatic savings programs raise some serious questions:

- Will participants who fail to engage in active retirement planning and move beyond the initial default rate established by their plan sponsor interpret the default as the “proper” savings rate for their retirement?
- Will opt-in approaches to deferral increases move the needle enough to fuel adequate savings as more people are enrolled at low initial automatic default rates?
- Will the employees who joined the company prior to auto-enrollment and QDIA availability be left on their own while new employees receive automatic help and guidance?
- Does the company’s current adoption of the basic automatic programs align with and accomplish corporate goals and provide an adequate level of retirement income for employees?

These important questions, along with recent research indicating that there is an overwhelming plan sponsor interest in helping improve participant retirement readiness, set the stage for the next evolution of automatic savings programs where more comprehensive application of auto-enroll, auto-increase, and auto-invest strategies are combined to drive better outcomes.

**Evolving Automatic Savings Programs**

*Linking to retirement readiness is essential for continued success*

The next generation of best practice considerations in retirement plan design aims at improving retirement readiness while reducing potential fiduciary risk and reflects a renewed corporate sense of responsibility for successful retirement outcomes.

We characterize automatic savings programs in three categories—basic (as discussed previously), enhanced, and advanced. These programs start with core elements of automation and build upon those basics with features that expand employee coverage and maximize savings and investment impact. The full power of automatic programs rests in the deployment and integration of multiple features that, when combined, achieve plan and participant objectives within the constraints of corporate benefit budgets.

This spectrum of programs provides sponsors with additional options to redesign their plans with a customized combination of features to:

- Better achieve their plan’s objectives,
- Protect against potential fiduciary risks associated with uneven application of benefit programs, and
- Consistently improve retirement readiness for a broad range of employees.

The selection of these features should be guided by an analysis of employee demographics and a fresh evaluation of how the benefit program supports the company, the plan, and the employees’ goals.
## Combine the Features That Best Align with Corporate and Benefit Program Goals*

<table>
<thead>
<tr>
<th>Key Elements in Successful Outcomes</th>
<th>Basic Program</th>
<th>Enhanced Program—Basic Program, Plus:</th>
<th>Advanced Program—Enhanced Program, Plus:</th>
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<tbody>
<tr>
<td>Participation</td>
<td>- Auto-enroll new employees at low default savings levels</td>
<td>- Auto-enroll all eligible employees at higher initial default rates</td>
<td>- Periodically reenroll nonparticipating employees</td>
</tr>
</tbody>
</table>
| Savings Adequacy                 | - Improve savings adequacy with opt-in auto-increase | - Implement annual auto-increases in deferral rates on an opt-out basis  
- Implement “auto-boost” deferral rate increases to bring savings rates up to a minimum default rate or up to the maximum matching contribution level (if offered) | - Periodically reenroll participants who have previously opted out of auto-increase |
| Diversification                  | - Provide diversified investments that align with participant retirement time horizons  
- Auto-default into QDIA | - Reset formerly defaulted investors into new QDIA  
- Reset improperly diversified portfolios to QDIA  
- Reset unengaged participants to QDIA | - Periodically reset improperly diversified portfolios to QDIA |

* Utilize an opt-out approach to fully harness inertia to help achieve retirement readiness.

* Possible automatic program features highlighted on this page are ultimately the decision of the plan administrator and each option should be carefully reviewed by the company's committee and/or ERISA attorney.
**ENHANCED PROGRAMS**

*These steps build on the success of basic automatic programs*

**Enhanced Features to Improve Participation**

Enhanced programs can have a greater impact by applying automatic enrollment features to all eligible employees—not just the newly eligible. More recent adopters of automatic programs seem to be attracted to this approach (AARP, 2010).

**Enhanced Features to Improve Savings Adequacy**

Some experts estimate that a savings rate as high as 15% throughout the working years is required to accumulate sufficient funds to sustain one's lifestyle in retirement. With today's average salary deferral rate at less than half that amount (approximately 6.2%) (PSCA, 2011), plans need to have effective programs for increasing participant deferral rates.

Auto-increase features offered under an opt-out arrangement are designed to address this situation.

Auto-boost is another particularly effective technique for existing participants, which jumpstarts the auto-increase feature by automatically boosting deferral rates for existing participants. Different versions of auto-boost can be used to elevate participant deferral rates to do the following:

- Bring participant savings levels up to the minimum default level where applicable; or
- Maximize the company match, if one exists.

For example, if a plan adopts automatic enrollment for new hires at a default rate of 6% and implements an employer match of 100% on the first 6% of employee contributions, new hires automatically are maximizing the match at the point of enrollment. However, there may be existing participants who are still saving below that rate. Auto-boosting these participants to 6% immediately maximizes their receipt of the employer match. Thereafter, an annual automatic increase program for all participants offered on an opt-out basis continues to raise the employee savings rate to the maximum allowed by the plan over time.

Combining automatic boost with automatic annual savings rate increases can help participants achieve the savings rates necessary for accumulating meaningful retirement balances.

Kick off an automatic increase program by implementing a one-time automatic “boost.”

**15%**

**≤ 6%**

**AUTO-ENROLL** + **AUTO-BOOST** + **AUTO-INCREASE**

InVEST WITH CONfIDENCE™
Enhanced Practices for Addressing Diversification

Creating good savings behavior utilizing automatic participation, auto-increase, and auto-boost features can provide more adequate cash inflows. Pairing good savings behavior with a well-diversified investment plan can help grow those cash inflows into the higher account balances needed to adequately fund retirement income needs.

A well-chosen QDIA solution is often the easiest way for participants to keep their investment portfolio on track, and many plan sponsors have taken advantage of the fiduciary protections associated with QDIAs. However, according to a recent survey, nearly 56% of sponsors are not familiar with the potential of utilizing QDIAs through automatic reset programs as a way of correcting improperly diversified participant investments (Deloitte, 2011).

Enhanced programs automatically reset participant investments into a QDIA with an appropriately communicated opt-out offer on a one-time basis. This automatic investment reset approach can be applied in multiple ways, as outlined below.

The primary objective of these diversification features is to help ensure that participants who appear to need the most help are given opportunities to affirm their decisions or automatically take advantage of a prudent alternative option.

In addition to providing help to those participants who appear to be most in need of it, a secondary objective is to ensure that there is an even application of guidance—regardless of when a participant joined the plan—to potentially reduce plan risk and more fully afford sponsors the fiduciary protection prescribed for QDIAs.

### Targeted Populations for Automatic Reset

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<th>Examples</th>
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<td>Selectively, to participants invested in a default option available prior to the introduction of a QDIA</td>
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<tr>
<td>- If the plan had a stable value investment as the default option prior to the introduction of the QDIA, automatically reset those participants who were defaulted into the stable value investment to the new QDIA</td>
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<td>Selectively, to participants with portfolios that are not diversified</td>
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<tr>
<td>- Participants who have high concentrations in one investment position</td>
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<td>- Participants who have multiple target-date investment holdings</td>
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<td>- Participants who do not have representation across the three primary asset classes</td>
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ADVANCED PROGRAMS

Keeping employees engaged with appropriate savings and investing is the mark of a successful plan

Advanced programs take automation beyond the one-time impact activities of the enhanced features. They implement automatic features on a periodic, ongoing basis as a commitment to investment and savings due diligence. The advanced program addresses those participants who may have previously opted out of a feature but failed to reengage in the plan as the circumstances that prompted their opt-out changed.

Advanced Features for Participation and Savings Adequacy

While the percentage of participants who opt out of automatic enrollment is small (less than 5% according to our RPS clients) (T. Rowe Price, 2012), these participants could respond differently at different points in time with different personal situations. Periodic reenrollment of nonparticipating eligible employees can offer these employees a chance to rethink that decision at regular intervals during their working life. Periodic reenrollment offered via an opt-out approach can help overcome inertia in voluntarily revisiting previous actions.

Similarly, participants who have previously opted out of an annual automatic increase feature may be able to save more as their situations change. A periodic reenrollment of participants not taking advantage of an annual automatic increase feature can assist them in revisiting their decision and may in fact cause them to both accept the automated annual program and raise their current rates due to a change in the circumstances that caused the original opt-out. And research shows that the number of full-career contributors who can retire with sufficient retirement assets increases from 29% to 46% if they increase retirement contributions by as little as 1% each year for five years (Aon/Hewitt, 2012).

More Active Investment Monitoring

Advanced plan sponsor programs also vigilantly monitor for potentially inappropriate investment patterns—and build on the one-time activities of enhanced programs—by periodically resetting participant portfolios and elections into the plan’s QDIA.

Providing appropriate investments to help participants achieve retirement goals was rated by 92% of plan sponsors to be quite or very important (Deloitte, 2011). This attitude has resulted in strong plan investment choices and strong investment monitoring of the menu options. However, too often, plan participants are left on their own to use the plan’s investment menu, in spite of observable patterns of limited diversification. And, according to a recent Aon/Hewitt research report, a 1% difference in average returns over a career and retirement period can result in a two-times-pay difference in retirement resources (Aon/Hewitt, 2012).

Reset programs encourage employees to rethink earlier decisions to opt out.

Reset programs encourage employees to rethink earlier decisions to opt out.
Measuring and Improving Retirement Preparedness

There is a growing and discernible corporate concern for facilitating individual retirement readiness. According to the 2011 401(k) Benchmarking Study, 64% of plan sponsors responded affirmatively to the survey selection “We feel that our responsibility includes taking an interest in whether our employees are tracking towards a comfortable retirement” (Deloitte, 2011).

Objectively measuring the effectiveness of the company’s plan and reacting appropriately is essential to the success of the participant and the retirement program. When matched with a clear view of corporate goals and benefit program objectives, a retirement preparedness analysis can help determine:

- Initial default savings rates
- Targeted savings escalation rates
- The consequence and impact of auto-boost features
- The impact of investment default resets
- Which employee populations to target—including the impact of excluding existing employees
- The overall impact—in terms of costs and projected retirement readiness—of benefit program practices

Recognizing that each company has different needs and employee demographics, a combination of automatic features can be structured to create a customized solution for each plan.

This “advanced” approach to the design and deployment of automatic programs provides sponsors with an expansive range of options that can be aligned with corporate goals to achieve desired retirement outcomes within a targeted program budget.

IMPORTANT CONSIDERATIONS

Successful improvements begin with a careful review of fiduciary concerns, employee response, and cost considerations

Though automatic savings programs can be highly effective in producing better retirement outcomes, some plan sponsors may have lingering concerns that preclude them from aggressively adopting such programs, citing fiduciary concerns, employee objections, and cost as primary factors for not yet implementing the programs (AARP, 2010).

Fiduciary Considerations

At times, concerns over the fiduciary implications of choosing automatic programs and the inertia associated with maintaining the status quo seem to carry equal weight. On one hand there are the protections of the PPA that provide specific relief for automatic savings programs. On the other hand there is the very foundation of choice central to the construct of today’s participant-directed 401(k) programs in which the responsibility rests wholly on the employee, with the plan sponsor responsible for fiduciary due diligence and communication activities. In today’s regulatory environment, it may appear that either the adoption of automatic program features or maintaining the original design of a participant-directed 401(k) program can be the “right” way given the fiduciary protections of each.

ANALYSIS TOOL HELPS GUIDE DECISIONS

T. Rowe Price offers the Plan Meter® service to assist plan sponsors in choosing the optimal combination of features and helping them understand the impact automatic program features may have on retirement adequacy. Plan Meter is a retirement preparedness analysis tool designed to quantify the ability of plan participants to replace their current income in retirement and compares existing plan design and participant behaviors with projected outcomes from adopting discrete automatic program features.
However, the very interpretation of what it means to be a fiduciary responsible for “acting solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them” (U.S. Department of Labor) is yet to be fully determined.

Today, most plan sponsor fiduciary activities are deemed to involve performing investment fund selection and monitoring, as well as service provider and fee due diligence, while few activities—beyond documentation of decisions—focus on the broader concepts of acting prudently in the participants’ best interests. Accordingly:

- Will the future measure of prudent behavior extend to active analysis concerning the impact of benefit programs relative to retirement adequacy?
- Will the future bring rise to litigation around whether the right tools—such as auto-enrollment, auto-increase, and auto-diversification—were deployed by plan fiduciaries in support of acting in the best interest of plan participants?
- Will employers who have deployed auto-enroll to new employees only face legitimate concerns about whether benefits were fairly provided to existing employees excluded from the program features?

An unambiguous definition of what it means to be responsible for acting in the participants’ best interest may or may not emerge in the near future. However, multiple research studies make it clear that most people want and need help with their retirement savings and investing—and that far too many are woefully unprepared. Automatic savings programs have proven to move the needle in the right direction and may help regarding financial safety standards for improving American retirement preparedness.

**Employee Response Considerations**

Some reservations about automatic programs revolve around perceptions that employees would object to automatic actions. In fact, 30% of plan sponsors who did not implement automatic programs said they did not do so because they thought that “employees would not like it” (AARP, 2010). Our RPS clients have in fact demonstrated that participants embrace automatic program features:

- Of those automatically enrolled, fewer than 5% have opted out;
- Of those enrolled in an annual automatic increase program, 64.7% remained in the program;
- Of those enrolled in an auto-boost increase, 4.6% opted out; and
- Of those defaulted into the QDIA, 96.3% remained in the default option (T. Rowe Price, 2012).

Communications play a vital role in transitioning to or evolving automatic savings programs. The perception of someone doing something to you, as opposed to for you, may always be present. However, the way in which the program is communicated and the ease with which one is given the option to say, “no, thank you,” are key determinants in positively addressing potential objections.

Ultimately, the resistance of the few who do opt out must be weighed against the benefits to the majority who begin saving, increase their savings, invest appropriately, and stay enrolled in the plan.

Multiple research studies make it clear that most people want and need help with their retirement savings and investing.
Cost Considerations

Managing the employer’s cost of providing the plan is an important dimension to plan design. For most current designs, the more effective the programs are at getting better participation and higher savings rates, the higher the employer’s cost. Fortunately, there are multiple design approaches that can be used to provide comprehensive automatic features and still contain and manage the employer’s cost within acceptable levels.

For any given level of retirement program success, key determinants of the employer’s cost are:

- The magnitude and structure of the employer contributions
- Eligibility schedules
- Vesting schedules

With judicious design and configuration of these parameters, it is not difficult to construct highly effective programs that are tailored to contain employer costs within desired budget levels. However, it is important that such a plan redesign be guided by a thoughtful evaluation of the company’s strategic objectives related to the demographics, skills, and growth of its employee base. In addition, the deployment of such programs, whether implemented all at once or phased in over time, should be preceded by a carefully designed employee communications program.

Social Considerations

According to the Employee Benefit Research Institute (EBRI), 44% of workers born prior to 1975 are projected to lack adequate retirement income for basic expenses plus uninsured health care costs (EBRI, 2012). Fortunately, the current projections are five to eight percentage points better than the 2003 study, and automatic program adoption has been cited as the primary driver of this improvement.

At the current savings rate, nearly half of retiring workers will face inadequate finances to support themselves and their families in their post-working years. The majority of these under-prepared retirees are likely to be the groups that have historically under-saved: minorities, women, and low- to mid-level income earners. According to EBRI congressional testimony (EBRI, April 17, 2012), with the adoption of automatic enrollment in the past few years, the participation rates for lower-income employees enrolled in these types of 401(k) plans have often increased to values in excess of 80%.

Incorporating improved participation, realized savings rates, and QDIA investment results experienced in fully automatic-featured plans as evidenced in the recent EBRI Retirement Security Projection Model, there is growing evidence that automatic programs will play an important role in improving the future retirement outcomes of Americans (EBRI, 2012).

Workplace Considerations

An additional consequence that may result from mass retirement inadequacy is the likelihood that more aging Americans will stay in the workplace longer—if not for the salary, then for the health care benefits. Some retirement-age boomers have already opted to work longer to keep mentally and physically active, as well as to supplement their costs of living.

If working into our 70s becomes the norm, there will likely be an impact on overall worker productivity, new talent acquisition opportunities, health care costs, and even morale due to the multigenerational differences and biases that may be more prevalent in the workplace.
CONCLUSION AND NEXT STEPS

Today’s plan sponsor is faced with expanding challenges in offering effective employee benefit retirement plans in an environment of constrained budgets. Through advanced use of comprehensive automatic programs and thoughtful plan design, employers can achieve substantial improvement in plan success measures within the company cost constraints.

Whether a firm is considering an automatic program for the first time or basic automatic features have already been implemented, here are some practical steps that can be taken today to improve the effectiveness of the plan and align corporate decision-making with the overall objectives and philosophy of the benefits program:

STEP 1 Conduct a plan analysis

STEP 2 Set long-term plan objectives and near-term goals

STEP 3 Choose and implement the right combination of automatic program features that best align with the firm’s goals

STEP 4 Model, analyze, and refine the features to maximize retirement readiness within employer cost constraints

T. Rowe Price can assist you with the following:

- Thorough understanding of your employee demographics,
- Range of program features to align with your goals, and
- Detailed modeling of both costs and retirement preparedness projections based on various proposed changes.

Contact your T. Rowe Price representative to discuss these approaches and get started on the solution that’s right for you.

WORKS CITED


EBRI. (April 17, 2012). Employee Benefit Research Institute Testimony to Congressional Committee.


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