**WRITTEN TESTIMONY**

**SUBMITTED BY**

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**FOR**

**THE U.S. SENATE COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS**

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# HEARING ON SIMPLIFYING SECURITY: ENCOURAGING BETTER RETIREMENT DECISIONS

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# SIMPLIFYING SECURITY: ENCOURAGING BETTER RETIREMENT DECISIONS


**Summary**
Since the 2006 passage of the Pension Protection Act (PPA), which provided valuable guidance and safe harbors to plan sponsors seeking to implement automatic enrollment and automatic contribution escalation, prevalence of these features within 401(k) plans has increased dramatically.

Research finds that such features greatly improve the expected level of savings that workers can achieve in retirement. However, research also concludes that many plans implement auto features in a way that is too conservative—reducing the probability that workers will succeed in saving enough to retire comfortably.

A study by EBRI and DCIIA finds that more robust implementation of auto features—such as increasing the automatic contribution escalation rate cap—can dramatically improve savings outcomes for American workers. Yet, policies such as the PPA non-discrimination testing safe harbor, actually discourage plan sponsors from robust implementation, and in fact encourage them to be overly conservative with their automatic contribution escalation rate caps and other auto features.

Policymakers can help by:

- Revisiting the PPA non-discrimination safe harbor to:
    - increase the maximum allowed cap from 10% to a higher level, or eliminate it altogether so that plan sponsors can choose their own cap.
    - start the automatic enrollment deferral at 6% immediately, as opposed to starting it at 3% and having it escalate to 6%.

- Providing guidance explaining that there is no “inferred” safe harbor for non-safe harbor plans and that the deferral amounts for the non-discrimination safe harbor should not be viewed as fiduciary guidance.

Policymakers could also explore ways to incentivize plan sponsors to adopt auto features: One way is to ease the company contribution requirements under the automatic enrollment non-discrimination testing safe harbor.

Finally, policymakers may wish to consider a fiduciary safe harbor that would support plan sponsors in educating participants on how their savings translates into expected income in retirement. This could reduce opt-outs and increase savings rates.

## Introduction

Good morning Mr. Chairman and Members of the Committee. Thank you for the opportunity to testify at this important hearing.

My name is Lori Lucas and I am the Defined Contribution Practice Leader at Callan Associates–one of the largest independently-owned investment consulting firms in the country. Our client services include strategic planning, plan implementation, monitoring and evaluation, and education and research for institutional investors such as sponsors of pension and DC plans. We were founded in 1973 and we have $1 trillion in assets under advisement.

I am also the Executive Chair of the Research and Surveys Committee of the Defined Contribution Institutional Investment Association (DCIIA). Founded in 2010, DCIIA is a non-profit association dedicated to enhancing the retirement security of American workers. DCIIA fosters a dialogue among the leaders of the defined contribution community including investment managers, consultants, law firms, record keepers, insurance companies, plan sponsors and others committed to the best interests of plan participants.

In today's testimony I will address the following topics:

- How automatic features are being implemented in DC plans.
- How current implementation of auto features is impacting American workers' retirement income adequacy.
- How we can raise the bar and dramatically improve outcomes through the use of auto features.

## Prevalence and Implementation of Auto Features in DC Plans

Prior to the Pension Protection Act (PPA) of 2006, which provided valuable safe harbors to plan sponsors seeking to implement automatic enrollment and automatic contribution escalation, just one in five (19%) 401(k) plans automatically enrolled employees. For the majority of those plans, the money market or stable value fund was the default investment fund, and participants were commonly defaulted into the plan at just 2% or 3% of pay. Meanwhile, just 9% of plans offered automatic contribution escalation prior to the 2006 passage of the PPA.[1]

Today, half of DC plans automatically enroll participants. In most cases, new hires are automatically enrolled, although four in 10 large plans have done a one-time automatic enrollment sweep for existing employees. Today, asset allocation-type vehicles are the most common default investment fund by far, largely as a result of the PPA's qualified default investment alternative (QDIA) provisions. However, the common default contribution rate remains modest at 3% to 4% of pay.

[1] Hewitt Associates. 2005 Trends and Experiences in 401(k) Plans Survey.

Also, currently nearly half of DC plans offer automatic contribution escalation. The majority does not link automatic contribution escalation to automatic enrollment, but offers it as an opt-in option. Most plans with automatic contribution escalation as a default increase participant contributions by just 1% of pay annually, and cap annual contributions at low rates, such as 6%–which might be the company's match threshold.[2]

According to the preliminary results of a 2011 DCIIA survey of more than 100 plan sponsors, there are many reasons that plan sponsors do not offer automatic enrollment including: it is seen as unnecessary because plan participation is already sufficiently high, it doesn't fit into the plan's corporate culture because it is too paternalistic, it is inappropriate in the current economic environment, and it is too costly from a company matching perspective. Only a small percentage of plan sponsors who do not offer automatic enrollment are very likely to do so within the next 12 months.

Those plan sponsors who do not offer contribution escalation either haven't considered it, find it too paternalistic, or find it inappropriate in the current economic and legal/ regulatory environment. Plan sponsors who do not offer contribution escalation say that increased regulatory/legislation changes/or support would encourage them to do so, such as by having the safe harbor rules extended to higher levels of auto escalation. Otherwise, those who don't currently offer automatic contribution escalation are not very likely to do so in the next 12 months. Those who do not offer automatic contribution escalation as a default also cite the fact that their employees would be upset if they increased rates automatically. Others mention that it is too paternalistic or that they haven't really considered it.

Today, I would like to make the case that automatic enrollment and automatic contribution escalation are two DC plan features that can dramatically improve the retirement income adequacy of American workers in DC plans. However, these features must be more widely used by plan sponsors and more robustly implemented in order to have the necessary impact on workers' retirement savings.

**Impact of Auto Features on Retirement Income Adequacy of American Workers**

Research by Jack VanDerhei of the Employee Benefit Research Institute (EBRI) in 2010 simulated the savings differences generated by plans with automatic enrollment versus voluntary enrollment by comparing large 401(k) plans given actual plan design parameters based on participant data from EBRI's 401(k) database. The analysis looked at all workers, not just those eligible for 401(k) plans. According to the analysis, when workers aged 25 to 29 under voluntary enrollment are compared to those under automatic enrollment of the same age cohort, the difference in projected median 401(k) balances is four times higher in the auto-enrolled group. Voluntary enrollment was at 1.5 times final earnings whereas automatic enrollment resulted in 6 times final earnings. This shows the importance of automatic enrollment in improving retirement savings levels of workers over their full career.

[2] Callan Associates. 2011 Trends in DC Plans Survey. Preliminary results of 2011 DCIIA Auto Features Survey.

EBRI and DCIIA then collaborated on a project analyzing how the probability of reaching a “successful” retirement income level changes with different 401(k) plan design variables and assumptions. While the definition of success using this simulation model can be quite complex, the analysis starts out with a very simple definition for this application: namely, a 401(k) accumulation large enough that, when combined with the worker-specific benefits projected under Social Security, will provide a total real replacement rate of 80%.

In other words, for purposes of this analysis, we will define an 80% income replacement rate as “success.” Eighty percent is in the typical range of replacement rates suggested by many financial consultants. Importantly, this new analysis looks at workers eligible for 401(k) plan participation over 30 to 40 years—not all workers regardless of eligibility.

The analysis found that in the base case—that is, the way that automatic enrollment and automatic contribution escalation are implemented across thousands of DC plans—the probability of replacing 80% of income in retirement for workers who spend a full career in the DC system is 45.7% for low-income workers and 27% for high-income workers. In other words, these statistics also show that the current implementation of auto features is not likely to generate sufficient retirement for most workers.

However, when the implementation of auto features was more robust, coupled with improvements in employee behavior (described below), the picture changes. The analysis assumed the following changes to the way auto features are implemented in DC plans:

- Increase in the contribution rate cap (e.g., from 6% to 9%, 12% or 15% of compensation).
- Increase in the annual contribution rate change (2% vs. 1% of compensation).
- Successfully educate employees so that they don’t opt out of the automatic escalation program.
- Encourage employees to remember and implement their previous level of contributions and not merely accept the new low default contribution rate under automatic enrollment when they change employers.

In the best-case scenario—when all of these positive changes were made to auto features and implementation was robust—the probability of success increased dramatically. In fact, for the lowest quartile income level, the probability of replacing at least 80% of pre-retirement income increased 33.5 percentage points from 45.7% to 79.2%. For other quartiles, the probability improvement was similar. In my experience, there are few DC plan feature changes that can result in such dramatic improvements in retirement income adequacy.

The results essentially reflect the fact that when auto features are implemented conservatively—such as with a low initial contribution default, a small annual increase, and a low cap on contributions—participants are not prone to override these defaults, instead remaining with them for many years. This type of participant inertia has been well documented for over a decade by researchers such as Brigitte Madrian and David

Laibson of Harvard University. Even employees who might have participated more robustly under voluntary enrollment (such as with a 7% to 8% initial contribution to the plan) are likely, according to this behavioral research, to remain with the auto features' less robust defaults, resulting in low quality participation. As Choi et al. concluded in their paper "Saving for the Path of Least Resistance," "sophisticated employers should choose their plan defaults carefully, since these defaults will strongly influence the retirement preparation of their employees."[3]

**Raising the Bar on the Usage of Auto Features in DC Plans**
Given these results, why do plan sponsors implement automatic features conservatively when it comes to contribution levels? The reasons include:

1) ***Desire to minimize opt-outs:*** plan sponsors widely believe that more modest contribution rate defaults minimize opt-outs, and encourage employees to remain in the plan under automatic enrollment and in the program under automatic contribution escalation.

2) ***Cost***: more aggressive defaults (e.g., escalating deferrals at a 2% rather than a 1% rate; or defaulting at a higher initial contribution rate under automatic enrollment) may result in increased matching costs. This can be difficult for plan sponsors to support, especially in harsh economic times.

3) ***Safe harbor effect:*** even plan sponsors who are not seeking a non-discrimination testing safe harbor under the PPA may infer that it is more prudent from a fiduciary perspective to adopt the QDIA safe harbor for required defaults. Currently, these defaults are conservative when it comes to deferral rates.

The last consideration is one of particular note for policymakers. Plan sponsors are as subject to behavioral biases as any other individual. It is my experience and that of other DCIIA members that the signals being sent by the defaults, which are used in the automatic enrollment non-discrimination testing safe harbor, are influencing plan sponsor decisions when it comes to the implementation of auto features even for non-safe harbor plans. The safe harbor requires that automatic enrollment start at at least 3% and increase to at least 6% over four years. The maximum allowed cap under the safe harbor is 10%. It is important to note that the EBRI/DCIIA study found that the single most important factor in improving retirement income adequacy through more robust auto features was raising the automatic contribution escalation cap. At a minimum, guidance should be given to explain that there is no "inferred" safe harbor for non-safe harbor plans and that the deferral amounts for the non-discrimination safe harbor should not be viewed as fiduciary guidance.

[3] Saving For Retirement on the Path of Least Resistance by James J. Choi Harvard University; David Laibson Harvard University and NBER; Brigitte C. Madrian University of Chicago and NBER; Andrew Metrick University of Pennsylvania and NBER; Originally prepared for Tax Policy and the Economy 2001 under the title "Defined Contribution Pensions: Plan Rules, Participant Choices, and the Path of Least Resistance" Revised in 2004 to include additional data and analysis.

Ideally, the safe harbor cap should be revisited, increasing the maximum allowed cap from 10% to a higher level, or eliminating it altogether so that plan sponsors can choose their own cap. Additional, the automatic enrollment deferral should start at 6% immediately, as opposed to starting it at 3% and having it escalate to 6%.

As mentioned, a key reason that some plan sponsors do not implement automatic enrollment at a higher rate (or at all), and do not incorporate automatic contribution escalation aggressively (or at all) is the cost associated with matching contributions. Therefore, policymakers may also wish to explore ways to incentivize more robust implementation of these features. One way is to ease the company contribution requirements under the automatic enrollment non-discrimination testing safe harbor.

Finally, it is important to educate plan sponsors about likely opt-out rates under various default deferral scenarios. Namely, there is no empirical evidence that the average plan experiences a higher opt-out rate when the default deferral level is 6% than when it is 3%. Because automatic contribution escalation is still relatively new and not yet widely adopted, we don't have enough empirical evidence that would confirm or refute the notion that opt-outs are likely to increase with more robust caps and higher rates. However, most initial indications are that these design features have little to no impact on opt-out rates. Further, research shows that when participants do proactively choose their own automatic contribution escalation maximum cap, it most commonly is 15% or higher.[4]

Opt outs can also be mitigated by educating employees on the value of high retirement savings rates. One way to do this is to show workers what their savings may translate to in monthly retirement income. Many record keepers already provide monthly retirement income projections on DC participant web sites and on statements. Some also even provide "gap" analysis—that is, the amount of additional savings plan participants need to achieve in order to replace sufficient income in retirement. Policy makers can encourage the use of such projections by providing a fiduciary safe harbor for plan sponsors.

**Conclusion**

In the past, DC participants—and plan sponsors—may have relied on the stock market to fill in the gap of workers' low savings and help them generate a sufficient 401(k) retirement nest egg. However, the last few years have shown that the market cannot be expected to "bail out" workers who do not save enough. Indeed, a recent Callan Associates study showed that the annualized total returns experienced by DC plan participants since early 2006 has been 0.11%: virtually all of the growth in participant balances over that time came from plan sponsor and participant contributions.[5] It follows then, that to ensure retirement income security for workers, plan sponsors must commit either to contributing more or to finding ways of increasing participant savings.

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[4] Hewitt Associates. "Improving Defined Contribution Plan Utilization through Retirement IMPACT." September 2005.
[5] Callan Associates. Callan DC Index™. June 2010

The EBRI/DCIIA study demonstrates that automatic enrollment and automatic contribution escalation provide a good starting point to improve worker behavior with regards to savings. However, insufficient attention has been given to ensuring that plan defaults lead to robust outcomes from a retirement income adequacy standpoint. The good news is that much can be done from a plan sponsor, policymaker and provider perspective to facilitate positive outcomes within the context of the existing framework of automatic enrollment and automatic contribution escalation. Thoughtful plan design and communication can materially alter the long-term savings levels of millions of Americans. In contrast, the alternative—plan design and communication that do not consider long-term income replacement ramifications—may have painful long-term social and economic consequences when it comes to American's retirement security.

Appendix