Auto-Enrollment and its Increases: Stay the Course to Success

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Auto-enrollment expanded with the Setting Every Community Up for Retirement Enhancement (SECURE) Act, something that best-in-class 401(k) plan sponsors have been utilizing for years. There are grumblings from certain sectors, questioning whether auto-enrollment is the panacea it is made out to be. This article reinforces the significant reasons for utilizing this strategy.

"Attract and retain your employees with a new and improved 401(k) plan" has been a mantra of retirement plan professionals for years. Whether addressing a match, profit-sharing contributions, or even the basic need for the qualified plan, the thought has remained at the top of HR professionals, usually backed by data from their trade groups.

In these novel coronavirus (COVID-19) days, it is appropriate to reexamine this principle and determine what truths are lurking under this big thought about attraction and retention. Over the years we have heard from clients in the nursing home industry that employees will move jobs among local facilities as each has a push to raise salaries, reflecting that the biggest issue is compensation. Even when defined benefit plans began to die beginning in the late 1980s, thus shifting the burden of retirement funding to employees, there was an underlying belief from the C-suite that it was all about the compensation despite what data purported to show.

Waterford has always taken the position that, like any other component in business planning, execution is key. That is, having a 401(k) plan alone will not attract and retain, but customizing the plan to utilize auto-enrollment (with annual increases up to the legal limit), one-on-one meetings with each participant, and enact an overall retirement strategy that is an integral part of overall business strategy. This has shown to create an environment where employees feel involved and invested.

Let us check with some sources and test these theories. In a recent article in *Inc.,* "Why Do People Leave Their Jobs, Exactly? The Entire Reason Can Be Summed Up in a Few Sentences" by Marcel Schwantes, he reviewed a famous 2013 Gallup poll that looked at exit interviews to answer that important question. Simply put:

> "[In the] State of the American Workplace" study, Gallup CEO Jim Clifton summarized in a succinct sentence the bottom line of why your company's employee turnover may be high: "The single biggest decision you make in your job—bigger than all the rest—is who you name manager. When you name the wrong person manager, nothing fixes that bad

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> decision. Not compensation, *not benefits*—nothing." [emphasis added]

Mr. Schwantes contends that eight years later, businesses are still "getting it wrong." Managers' empathy, shared accountability, and vulnerability are, in his opinion, much more important than benefits. While we are not employment experts, we do know that managers and job responsibilities change, and where a 401(k) plan fits in any employee's priorities depends on many factors, including age and stage of the employees and most certainly the size of the company match. It is about the relationship, and how the plan fits into the relationship is crucial.

What the Society for Human Resources Management (SHRM) finds generally drives trends. In its last *Retirement Benefits Survey* (2019), it concluded that the vast majority of employers believe that retirement benefits are "very" or "extremely" important to their workforce. It noted, however, that there has been little change in retirement benefits programs in the last several years, in part or largely due to unchanged tax advantage for employers. We find this puzzling, because, for example, a match is 100% deductible by a corporation . . . so what type of tax advantage would drive a change? A tax credit beyond the deduction?

Further, SHRM's survey concluded that a "competitive retirement plan motivates both young and established employees," but this conclusion is not supported by data. Could this be yet another chanting of the mantra about retirement plans?

This leads us back to auto-enrollment. We discuss the issue frequently and with good reason: automatic enrollment, while often considered paternalistic, is one thing that even Republicans and Democrats agree upon. For example, today bipartisan proposals anchored by automatic enrollment that would sweep in millions of new participants. Specifically, analysts at the Georgetown University Center for Retirement Initiatives (CRI), in its December 2020 report, calculated that 57 million employees are not able to access work-sponsored tax-advantaged savings plans. It also estimated that by 2040, auto-enrollment programs like those proposed in the leading House and Senate bills could expand coverage to nearly 40 million of the 57 million workers who currently do not have the ability to participate.

And here come the tax breaks that SHRM hoped would spur further adoption of plans. The auto-enrollment provisions before Congress are meant to cause employers to adopt new retirement programs. To qualify for a tax breaks, companies would have to default workers into new plans and automatically increase the deferred contributions each year until reaching 10% of the participant's salary. Of course, those employees who did not want to participate would still have the choice to opt out. Certain companies, at least in the current version of the House Bill, would be exempt (companies with fewer than 10 employees or that are less than three years old).

Interestingly, there are differences of opinion as to whether automatic enrollment among those who are supposed to be in the know. For example, Harry Dalessio, institutional retirement plan services director at Prudential Retirement, said in published reports that existing auto-enrollment programs have already changed the retirement landscape by sweeping more first-time savers into the system but believes it is time to move on from that thinking. "Now we can really focus on a broader financial wellness approach," he said, noting the difference of having to go "far beyond basic participation." Prudential is planning on adding emergency savings accounts that are accessible funds from post-tax contributions. Angling these new funds with the idea of promoting employer matching, the company is going to encourage savings for pre-retirement emergency issues. The funds will be held in accounts designed for liquidity.

Waterford, while understanding the potential need for such funds, is wary of both the potential confusion and draw away from retirement savings such a fund might entail. While on its face it seems to benefit employees, it could easily divert funds from retirement and at the same time does not have the potential for any potential earnings in today's low interest environment. In essence, it is sitting cash which may be important but does not need the expense of a third-party investment group.

Why do we continue to push auto-enrollment and the corresponding education that comes with it? Our data from pre-auto-enrollment indicated that college-educated workers with typical earnings did not start saving for retirement until their late 30s or early 40s, data reinforced recently in a *BNA Daily Benefits Reporter* article entitled, "401(k) Auto-enrollment—Does One Size Really Fit All?" The article echoes another myth that we have attempted to bust over the years: levels of employer matching are not enough to change this behavior. In fact, it takes match rates above *1,000%* to induce rational workers in the authors' model to start saving in their 20s!

The hours we have spent attempting to convince plan sponsors that raising the match by, for example, 1% does not come close to utilizing automatic enrollment with incremental increases under today's safe harbors! Yet we find the pull is still there . . . the desire to not be "parental" when it comes to employees' benefits versus the long-term benefit to the employees. All that we are looking to do is to bring inertia on the side of the employee.

The tremendous swing away from defined benefit plans began in the late 1980s was driven by economics as many plans were drained with early retirement incentives to cut headcount, but the common parlance was that plan sponsors said that the days of being paternalistic needed to end, with at least joint responsibilities where employees needed to save more for retirement the better choice for all. Employees saw only the negatives, however, as rich retirement annuities were replaced with accrued benefits left from frozen defined benefit plans along with those who had not sufficient time to catch up from a later-in-career elimination of a full pension.

At the same time, that shift was instructive to a generation of workers. Younger workers who today are winding down their careers realized that institutions like Waterford banging the drum for early-in-career savings to allow time for compound earnings genuinely worked. The Department of Labor (DOL) chipped in when it published a report stating that even higher fees could eat away over the long-term, showing employers that low-cost funds were a tremendous benefit to employees.

Accordingly, like it or not, employer-based retirement necessarily causes some type of paternalism. When employers did not move towards auto-enrollment of their own accord, Congress stepped in to provide the so-called "nudge" towards earlier employee deferrals. The burden of removing inertia switched from the employee having to start to save to the employee having to *stop* saving by opting out of the automatic. It was a strategic move that we parents should somehow adopt with our teenagers . . . and it worked.

To be fair, we must recognize that there may be some unintended consequences of auto-enrollment. The authors of that recent BNA article compared a "rational" economic actor's retirement saving choices with the choices that automatic enrollment incentivizes. Using a standard economic model in which the goal is to keep consumption spending relatively steady by avoiding large changes in standard of living, it attempted to mirror the usual employee's wage increases despite fluctuations or trends in their earnings. The study's key result was that for workers who expect higher labor earnings in the future (that is, college graduates), saving for retirement during their 20s does not make sense. Simply put, their conclusion was that in order to keep consumption spending as steady as possible, it makes more sense to save nothing for retirement before age 30, then ramp up saving later when earnings are higher.

Specifically (and might we add dangerously), the authors concluded that a college-educated worker with a typical earnings pattern should not start saving for retirement until their late 30s or early 40s. They noted, and we agree with this part of the study, that "standard levels" of employer matching (that is, 50% of the first 6% of salary) are not enough to change this behavior. Today's persistent low interest rates, they argue, only strengthen these results.

We disagree fully, and believe this model creates an extremely slippery slope and ignores some basic truths. First, it is clear that savings delayed are savings never accomplished. The power of a decade of deferrals, even at smaller amounts, results in significant gains over a 30-year career.

For example, the average college graduate in 2019 made $50,000 per year in salary, or $4,166 per month. Assume for the purpose of this exercise that the employer matches the typical 50% on the first 6% of deferral, and the employee elects to defer exactly 6% to take advantage of the match. In the first year, the deferral is $3,000 ($250 per month), and the year-end match is $1,500 . . . a 50% return just on the deferral! Assume a 20% tax savings, thus another $600 in the first year, and 7% earnings. In the first year, the employee's $3,000 is worth approximately $4,500 plus earnings of, say $300. In 10 years, the compounding of an initial $250 per month deferral at 7% earnings results in over $65,000 (without considering the tax savings). Twenty years later, that amount has more than quadrupled to over $260,000! It is not fair to add back in the tax savings, but it is more than equitable to note that the true cost of the deferral each year should be net of tax savings, thus the deferral is actually a net $2,400.

These are basic and rough calculations that are used quite often. At the same time, however, the authors of the above study left out a very important fact that all good future in-laws point out to young couples: as the family grows, it spends what it makes. This has remained true from the days of a single-earning household to both spouses working and paying child care. In 2020 each American household carried approximately $100,000 in debt. For a study to assume that employees will suddenly begin to save more and catch-up what has been missed in their early years is, we believe, strictly fantasy. Sometimes dubbed "the acquisition years," babies, houses, cars, and the like that turn into college tuition bills do not make saving easier, it makes it more difficult. That quarter of a million dollars that can be made by savings beginning fresh out of college, and dare we say for a $50,000 per year 22-year-old may not be missed, simply cannot be recovered.

In fairness, the study's authors concede that their model does not rule out saving for other goals, such as buying a home, taking a vacation, or insuring against future fluctuations in labor earnings . . . all things that are not just possible, but very probable.

Finally, their argument that auto-enrollment potentially pushes young workers into high-interest credit card debt prioritizes the opposite of what one hopes is being learned by auto-enrollment and the accompanying education. The goal is overall fiscal responsibility, not robbing Peter to pay Paul. There is always a downside risk in any paternalistic behavior, but auto-enrollment should not be looked at in a vacuum. Instead, it is one of the few remaining areas where, due to a long-established system, an employer can provide a no-cost benefit, complete with education, to solve America's now long-term crisis of lack of retirement savings. Until an alternative comes along, we believe that to suggest that auto-enrollment—where, do not forget an employee can opt-out of in part or completely—is a negative that should not be offered is irresponsible. By the way, the prestigious Profit Sharing Council of America's *62nd Annual Survey of Profit Sharing and 401(k) Plans* (December 2019) found that 88% of employers report 10% or less of their participants opted out of the plan that were automatically enrolled.

Finally, a word about automatic annual deferral increases as part of auto-enrollment. First and again, an employee may opt out. Second, keep in mind that the SECURE Act, signed into law at the end of 2019, now allow employers offering a safe harbor 401(k) plan with an automatic increase (or auto-escalation) feature that can raise plan participants' contributions until they amount to 15% of pay, up from the prior 10% for safe harbor plans.

According to Fidelity, 34% of employers were auto-enrolling at a 5% or higher default deferral at the end of 2019, versus 19% at the end of 2014. In addition, those defaulting at a 6% rate have doubled in five years to 19.3% from 10.6%. And this is before the SECURE Act changes became effective.

The bottom line at Waterford is that we independently determine what we believe are best practices for our clients. We have an increasing concern that there will be a backlash because the SECURE Act may shock some employers into rethinking auto-enrollment and the accompanying increases. In this age of clickbait and the general desire to attract online attention, the contrary view may gain momentum which in this case could result in the undoing of large gains made in assisting employees save for retirement. This could especially be true when employees in their early 30s experience their first significant and sustained downturn in the markets since they began saving!

An unprecedented bull market decade can create unrealistic long-term expectations, and reasonable employers should always allow their investment advisors to educate employees on markets' certain turbulence. Unprecedented low interest rates will not (despite this having been said for over a decade now) continue forever! Bull markets always come to an end . . . and with it, the continued need for savings.

We encourage plan sponsors to stay the course, and by doing so remain confident in the success of a long-term strategy that keeps participants taking advantage of the tax deferrals, matches, and finally the successful retirement employees will enjoy by sticking to the plan . . . and the plan always starts with auto-enrollment and increases.