Reversing *INERTIA*

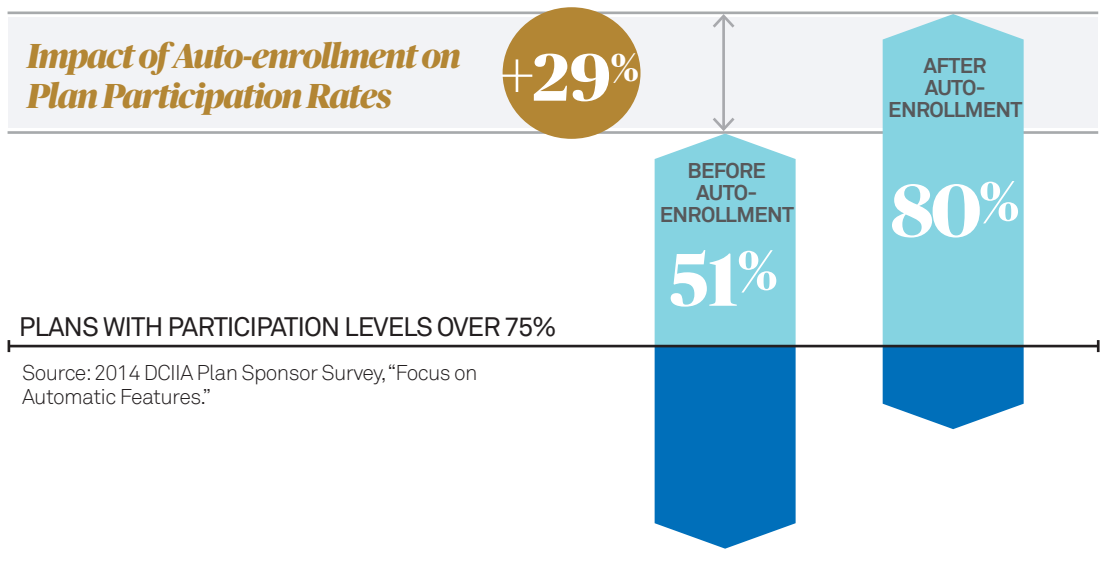
How re-enrollment boosts positive investment behaviors and participant outcomes — automatically.

The advent of automatic features in DC plans has had a positive impact driving retirement readiness by boosting participation and savings rates, especially among workers newer to the job. 73% of large and mega plans use auto-features, such as auto-enrollment and/or auto-escalation, to encourage greater savings in the DC plan.[1]

Through automatically enrolling new hires to the plan, and directing them to the qualified default investment alternative (QDIA) option, preferably with at least a 6% deferral rate to start, employees are not only able to save for retirement but can also do so within an appropriately allocated investment vehicle that matches their specific retirement needs or time horizon.

While most auto-default to the QDIA — whether an off-the-shelf or custom target date fund (TDF), balanced fund or managed account — employees who prefer to allocate and manage their own investments are able to choose from a selection of investment offerings from the plan's core menu, or opt out of the plan altogether. For plans that implement auto-features, less than one-third of participants opt out, making it a powerful lever for the plan sponsor to effect change in the plan — and for participant outcomes.[2]

According to the 2014 DCIIA Plan Sponsor Survey[3] of 471 plan sponsors across various DC plan types, industries and plan sizes (ranging from mega to small plans) auto-enrollment's impact on participation is significant (see chart below).

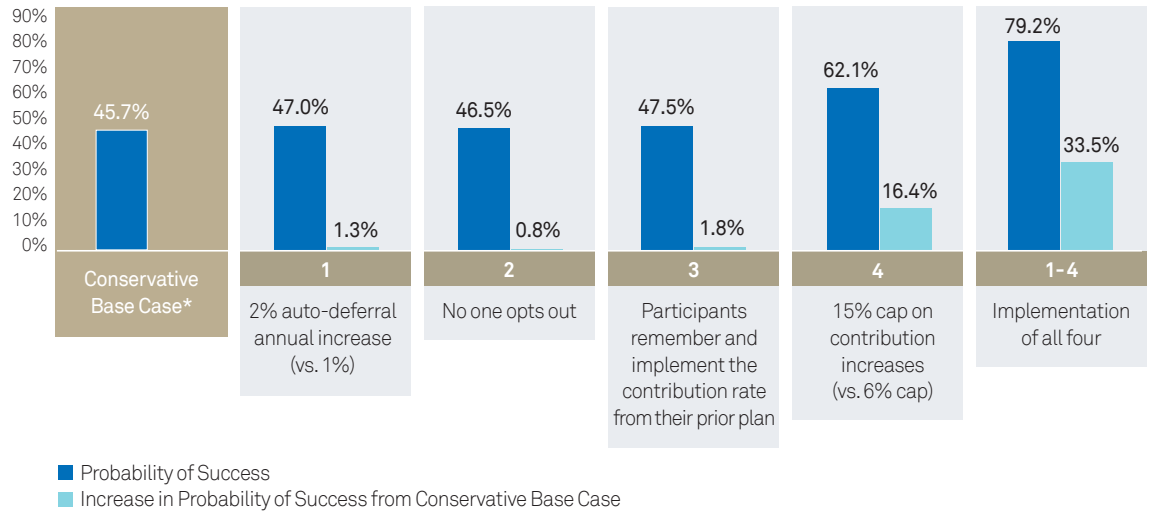


Source: 2014 DCIIA Plan Sponsor Survey, "Focus on Automatic Features."

[1,2]The Cerulli Report, Retirement Markets 2014, "Sizing Opportunities in Private and Public Retirement Plans."
[3]2014 DCIIA Plan Sponsor Survey, "Focus on Automatic Plan Features."

Impact of various auto-feature defaults on projected participant income replacement levels[4]

Probability of replacing at least 80% of income in retirement with various DC Auto-Feature Assumptions (Low Earners)



*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% salary deferral level; and plans escalating automatic contributions by only 1% annually.

Separately, in the same study, plans that offer both auto-enrollment and auto-escalation have over twice as many participants with retirement savings rates over 15% as plans that do not offer both (14% vs. 6%, respectively).[5]

The combination of auto-features and other savings incentives (e.g., a matching contribution) chosen by the plan sponsor creates a "choice architecture" for employees' retirement savings decisions, with increasing behavioral economics literature documenting that these plan design choices can have large effects on savings behavior[6] (see chart above). This in turn leads to an increase in a participant's probability of success in reaching their optimal income replacement levels in retirement.

While this is promising, it's becoming clear that two employee segments have been left out of the impact of auto-features, affecting their chance for retirement savings success:

- Active plan participants hired before auto-enrollment and increased auto-deferral rates, resulting in a potentially misallocated investment strategy that may not meet their future needs, a low plan account balance and/or no ongoing contributions.
- Non-participating eligible employees hired prior to auto-enrollment, who chose not to participate in the plan, and are missing out on an impactful retirement savings tool (and potential match) altogether.

A positive nudge from plan sponsors via a plan re-enrollment could make all the difference.

According to Fred Reish, leading ERISA attorney with Drinker Biddle and Reath's Employee Benefits and Executive Compensation Practice Group, "There is evidence that once participants have made their initial elections, they make few, if any changes — the so-called inertia effect. As a result, a re-enrollment process causes participants to revisit their investment preferences and their objectives and to decide whether to accept the default into QDIAs."[7]

For more Reish insights, see "The Duty to Know. The Duty to Act. Understanding the Evolution of ERISA's Fiduciary Standard and its Impact on 401(k) Committees" *article on page 12.*

Re-enrollment is not only a benefit for employees; when done correctly, plan sponsors can strengthen their fiduciary standing by gaining sought-after safe harbor protections through the Pension Protection Act of 2006 (PPA).

While re-enrollment has had a slow start, the adoption rate is increasing as more plan sponsors gain an understanding of the benefits. Among approximately 900 clients for which T. Rowe Price offers a re-enrollment service, the adoption rate reached 11% by mid-2014, versus 10%, 9% and 8% by year-ends 2013, 2012 and 2011, respectively.[8]

According to the 2014 DCIIA Plan Sponsor survey, 15% overall have utilized re-enrollment (19% of plans over $200 million in assets), while larger plans were more likely to have engaged in re-enrollment versus smaller plans (17% of plans over $1 billion versus 11% of plans under $5 million).[9] A Callan 2014 Plan Sponsor survey

BENEFITS OF RE-ENROLLMENT

FOR EMPLOYEES

- **Employee (non-participant) and participant inertia can be used to the plan's advantage by defaulting employees into the plan, and defaulting (and/or re-enrolling) all participants into the QDIA.**
- **Potentially properly allocate retirement assets, with increased deferral rates as needed.**

FOR PLAN SPONSORS

- **Potentially gain fiduciary safe harbor protection.**
- **Help provide a positive impact on employee retirement outcomes.**

[4]DCIIA Best Practices When Implementing Auto-Features in DC Plans, June 2013. [5,9]2014 DCIIA Plan Sponsor Survey, "Focus on Automatic Plan Features." [6]Jeffrey R. Brown, *et al.*, Individual Account Investment Options and Portfolio Choice: Behavioral Lessons from 401(k) Plans (Nat'l Bureau of Econ. Research, Working Paper No. 13169, 2007) per NYU School of Law, "A Behavioral Contract Theory Perspective on Retirement Savings," Ryan Bubb, Patrick Corrigan and Patrick L. Warren, July 2015. [7]Fred Reish/Benefits Pro, "Re-enrollment effective in boosting 401(k) participation," 2012. [8]*Pension & Investments*, "Auto Re-enrollment Adoption Gains Slowly," January 2015.

cited the biggest reasons for re-enrollment as changes in the fund lineup and a concern about participants' poor investment selections.[10]

Beyond the clear benefits, understanding the basics of re-enrollment can shed light on:

- The process and requirements to potentially gain fiduciary safe harbor protection
- The mechanics and timing of proper implementation

Re-enrollment Basics

Depending on the employee segment the plan is looking to help, re-enrollment begins when employees are notified at least 30 days in advance that on a certain date:

- **Active participants'** existing assets and future contributions will be invested in the QDIA based on specific criteria (for TDFs, their date of birth), and in some cases, their auto-deferral and auto-escalation percentages will be increased in line with the current new hire auto-enrollment default (if different from selected), unless they make a new investment election or opt out within the specified time frame.
- **Eligible non-participating employees** will automatically be enrolled in the plan, with future contributions invested in the QDIA at default auto-deferral and auto-escalation percentages, as per participants above, unless they opt out of the plan or select other investments within the specified time frame.

Additional communications efforts around the benefits of the plan, the default QDIA investment, and the saving and educational tools available to employees are beneficial, but not required.

While some plan sponsors may feel paternalistic, studies show that DC participants want their employers to help them save more. As an example, 53% of plan participants in a Cogent Research survey report wanting access to contribution auto-increase and 83% wanted more contact from their plan providers.[11] Re-enrollment is an extension of the auto-enrollment plan in place for new hires; it gives the plan the ability to expand the existing choice-architecture benefit to all employees, while allowing them to opt out or invest on their own.

Consider this: Re-enrollment on its own is not enough — it should be accompanied by a meaningful deferral rate starting with at least 6% that auto-increases at 1% to 2% annually up to at least 10%. By most industry measures, a 3% salary deferral falls short of delivering retirement readiness.[12]

Gaining Fiduciary Safe Harbor Protection

When plan sponsors utilize re-enrollment correctly, they can take advantage of ERISA safe harbor for default investments under the QDIA rules by following key requirements:

1) **Initial Opt-Out Notice:** At least 30 days prior to the beginning of the re-enrollment window, participants must be given the opportunity to make a new investment election before they are defaulted into the plan's QDIA. The 30-day advance notice satisfies the legal requirement. While not legally required, best practices allow for reminder notifications at least two weeks before the window ends to ensure that a well-intentioned but incorrect default does not occur.

2) **Annual Notices:** Per ERISA 404(c), annual notices must be provided to participants to remind them that they were defaulted into the QDIA and that they have the right to direct the investments in their accounts.

For best practices and protection, plan sponsors/fiduciaries should document the notice process carefully, and review (and revise if needed) plan documents and communications to make clear there is authorization for re-enrollment.

Fiduciary Safe Harbors for Participant Investing

Special fiduciary liability protection is available to the plan sponsor if automatic contributions are invested in a default option that satisfies the conditions of a QDIA. Under the QDIA rules, participants (and not the plan sponsor) are held responsible for their passive decision to invest in the QDIA, so long as the:

- Plan sponsor includes information about the QDIA in an annual notice
- Plan meets a number of the investment menu and disclosure requirements of ERISA Section 404(c)

Plan sponsors should work with their retirement plan advisor/consultant to ensure proper re-enrollment steps are taken and fiduciary requirements are met.

The Mechanics of Implementation

Working with a retirement plan advisor/consultant and recordkeeper, plan sponsors can map out a proper re-enrollment plan and process that meets the plan's overall objectives and fiduciary requirements, and ensures a positive employee experience. To start, follow these five steps:

Step 1 Review Current Plan Metrics vs. Goals

Plan sponsors should review current plan metrics (such as participation rates, deferral rates and percentage of assets in professionally managed solutions/QDIA) to see how they are performing against plan objectives. If there is a gap, determine if utilizing a re-enrollment strategy can help improve asset allocations, boost participation and/or increase deferral rates as desired.

Now could be a good time to also review the plan's auto-deferral and/or auto-escalation percentages. While automatic enrollment is a step in the right direction, the default contribution rate is less than 5% for nearly 53% of plan sponsors over $100 million, which is unrealistically low and insufficient for the majority of participants to reach their targeted outcomes.[14] Sponsors may want to consider adding annual auto-escalation of participant contributions at the time of implementing the re-enrollment (see table on opposite page).

While there are costs involved with re-enrollment, they are an enhancement of the company's total benefits package. For those concerned about costs, there are methods to offset these costs by making adjustments to the plan's design, such as revising the matching structure, extending vesting periods, or for plans with high employee turnover, implementing a waiting period for plan inclusion.

Step 2 Review Current Asset Allocations

Plan sponsors can work with recordkeepers to pull data for their plan assets and allocations by participant. From there, plan sponsors can work with retirement plan advisors to assess if assets are allocated properly — or more likely for self-directed participants, improperly — for their time horizon. Are too many pre-retirees in all-equity portfolios or 20-somethings in just bonds and cash? Is a relatively risky investment option overweighted for the participant demographics? A re-enrollment campaign can help to bring poorly constructed portfolios in line toward a more diversified and effective investment strategy through the QDIA default. The following examples show dramatic changes — for the better — in the average employee's portfolio diversification after re-enrollment.

BIDWELL V. UNIVERSITY MEDICAL CENTER

For plan sponsors concerned about perceived liability, the safe harbor provision has been put to the test in court via *Bidwell v. University Medical Center*. In June 2012, the 6th circuit ruled that the plaintiffs, having received proper notice under QDIA requirements, failed to exercise investment direction and were properly moved into the plan's default option.[13]

[10]Defined Contribution Trends, Callan Investments Institute, 2015.
[11]Benefits Pro, "DC Participants Want Employers to Help Them Save More," December 2012.
[12]"A 3% deferral rate is not enough" Investment News, 2012.
[13]Fred Reish: Drinker, Biddle and Reath.
[14]The Cerulli Report, Retirement Markets 2014, "Sizing Opportunities in Private and Public Retirement Plans."

Default Contribution Rates: Auto-deferral percentage rates are still too low[15]

Default Contribution Rate	$100 million to $250 million	$250 million to $500 million	$500 million to $1 billion	$1 billion to $5 billion	>$5 billion	All Plan Sponsors in Survey
1%-2.9%	13.5%	9.9%	10.9%	19.6%	7.1%	12.7%
3%-4.9%	43.8%	38.3%	41.3%	34.8%	42.9%	40.2%
5%-6.9%	21.3%	40.7%	34.8%	32.6%	21.4%	31.2%
7% or greater	21.3%	11.1%	13.0%	13.0%	28.6%	15.9%

Example 1: According to Cerulli's 2014 Retirement Markets Study of large and mega DC plan sponsors:

- One plan sponsor conducted a study with their recordkeeper, and found that the equity allocation across participants was random at best, with 25-year-olds that had 0% equity exposure and 63-year-olds with 100% of their assets in equities.
- A plan re-enrollment was used as a way to fix what this plan sponsor saw as an important problem by redirecting assets into the plan's QDIA.
- After re-enrollment, assets in the plan's QDIA, a target-date strategy, increased from 17% to 67% of plan assets.

Example 2: The State of Illinois' deferred compensation plan recently implemented a re-enrollment campaign:

- Prior to re-enrollment, as much as 29% of assets were in the small-cap value investment option.
- After re-enrollment, the share of plan assets in small-cap value declined to 5.2%, while the percentage in the target-date funds changed from 11.9% to 60%.
- The State of Illinois viewed this as a favorable outcome built out of a strategy designed to move the plan's allocations back to a more diversified mix of investments.[16]

In addition to helping direct participants into more diversified retirement portfolios, re-enrollment can be used to reduce employees' reliance on company stock.

Step 3 Determine the Scope of the Plan Re-enrollment

Based on the plan's metrics, asset allocation status and objectives, plan sponsors should determine the scope of re-enrollment that fits their needs:

- An **in-plan re-enrollment** focused on those already in the plan, yet not in the QDIA and/or at a higher auto-deferral rate, or
- An **all-employee re-enrollment** designed to increase participation overall as well as help existing and new participants with proper asset allocation and/or higher deferral rates.

For existing participants, re-enrollment is more of a "re-election" vs. "re-enrollment" as it simply asks participants to restate or confirm their investment selections for existing investments and future contributions, or be mapped to the QDIA, at the higher deferral rate (if included).

Last, for the best outcomes, the default rate should be at least set to 6% to get employees saving at the minimum amount necessary to accumulate meaningful retirement savings. Also, 6% coincides with the rate necessary for participants to maximize a typical safe harbor employer match. If this is a change for the plan, add the option to select a lesser or greater deferral rate to the opt-out/self-directed investments selection.

Step 4 Determine Timing and Frequency

The timing and frequency of a re-enrollment strategy should align with the plan's objectives and any other efforts designed to evolve the plan. Re-enrollment can occur either:

- In conjunction with another plan change — such as a change in the investment lineup or design and/or the shift to a new plan provider — where communications efforts are already planned.
- On a one-time basis on its own, annually.

Step 5 Build a Communications Plan for the Best Employee Experience

Plan sponsors can leverage the re-enrollment opportunity to develop a communications plan that not only provides the required 30-day notice — including key dates — but also offers a positive experience for employees.

60 DAYS PRIOR

Announce the re-enrollment campaign (via e-mail, mailer, intranet posts, DC plan website, posters, etc.). At the same time, consider promoting the plan's advantages segmented by target:

- Highlight the benefits of investing in the default QDIA over time
- Showcase the wide range of retirement savings, education and planning tools (and match, if offered) designed to help them reach retirement goals

30 DAYS PRIOR

Prior to the beginning of the re-enrollment window, the required 30-day notice highlights the key dates and the opt-out process.

Recordkeepers can help plan sponsors by setting up a special website for those who choose to:

- Opt out of the plan and/or default
- Keep their existing elections
- Select different investments vs. the default

7-14 DAYS PRIOR

Remind employees at least two weeks out, in conjunction with education meetings.

- Create a positive experience for employees from start to finish.

Annual Notices

As part of maintaining fiduciary safe harbor protection, send annual notices as required.

Summary

Re-enrollment can have a significant impact on the success of the plan's objectives and in helping employees reach their targeted retirement outcomes. Providing employees with auto-features through re-enrollment that are designed to combat inertia (to start or increase savings) and to properly allocate their retirement assets is critical.

For plan sponsors, gaining safe harbor protection through proper re-enrollment implementation (providing a 30-day notice and subsequent annual notices) can help strengthen a plan's fiduciary status.

[15]The Cerulli Report, Retirement Markets 2014, "Sizing Opportunities in Private and Public Retirement Plans."
[16]*MarketWatch*, "401(k) plans re-enrolling participants to boost diversification" June 4, 2015.