OVERCOMING PARTICIPANT INERTIA

Automatic Features That Improve Outcomes While Improving Your Plan’s Bottom Line
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INTRODUCTION

As the burden of responsibility for retirement savings continues to shift from the company to the individual, research conducted by Prudential Retirement® indicates that plan sponsors should be aware of not just the looming retirement income gap that tomorrow’s plan participants face, but also of both the immediate and long-term negative impacts this gap can have on their businesses.

By all accounts, today’s plan participants are falling short of building retirement reserves that will provide income to last a lifetime. The principal culprits—inertia and a propensity to place more value over present rewards than future rewards—are deeply rooted phenomena that serve as the foundation of much of what we know about behavioral finance. The challenge for plan sponsors, therefore, is how to motivate employees to participate in their retirement plan at sufficient contribution levels to improve the likelihood of a successful retirement outcome.

Without meaningful intervention, the potential for substantially delayed retirements is real. For sponsors, delayed retirement can translate into increased healthcare costs, inflated salaries and potential diminished productivity.

One solution can be found in the addition of plan auto-enrollment and auto-escalation features. Not only do the statistics substantiate markedly higher participation levels and increased deferral rates, they conclusively dispel many commonly held myths associated with automated features. Our research shows that automatic features can improve deferral rates without triggering high opt-out rates, and when properly implemented as part of a DC optimization effort, can actually reduce overall plan costs—even when factoring in the cost of matching contributions.

While there are no hard and fast rules as to what construes an optimal default deferral and escalation rate, Prudential Retirement’s accumulated data suggests that a 5–6% default deferral rate with a 2% annual acceleration up to a cap of at least 10–12% significantly improves the likelihood of successful retirement outcomes while maintaining participation levels well above the national average.¹

¹ Prudential Retirement, 2012.
### SECTION 1:

**Participants face a mounting challenge**

Much has been written over the past few years documenting the demise of pension plans across the U.S. employment landscape.

In 2012, the number of firms maintaining a defined benefit plan as a primary retirement vehicle had dropped to just 30%, with defined contribution plans now constituting 70% of those firms’ retirement plans.

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#### Retirement Plan Types at Fortune 100 Companies

<table>
<thead>
<tr>
<th>Year</th>
<th>Defined Benefit Plan</th>
<th>Defined Contribution Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>90%</td>
<td>10%</td>
</tr>
<tr>
<td>2012</td>
<td>30%</td>
<td>70%</td>
</tr>
</tbody>
</table>

As a result, the burden of responsibility for retirement saving has dramatically shifted. The days of paternalistic sponsor-directed savings are a thing of the past, having been supplanted by a new, largely participant-driven model. And while the effect of this systemic change has yet to be fully realized, the preliminary results indicate a significant cause for concern.

According to a 2013 study conducted by the Employee Benefits Research Institute (EBRI), six out of 10 baby boomers (those individuals retiring right now and for the next 18 years) feel unprepared for retirement. In fact, 58% of Americans have made no attempt whatsoever at figuring out how much they’ll need to retire.

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Plan sponsors also face risks
ERISA Section 404(a)(1) requires that plan fiduciaries act prudently and solely in the best interest of the plan’s participants and beneficiaries.

While this is primarily intended to help ensure that sponsors are diligent in monitoring and managing plan fees and providing adequate investment oversight, the scope of fiduciary responsibility is broad. Helping participants move closer to retirement goals benefits both the participant and the plan sponsor.

The potential business impact
Experts estimate that the additional cost to employers is between $10,000 and $50,000 per year, per employee for every year that participants delay their retirement beyond normal retirement age.\(^5\)

Delayed retirements have the potential to increase workforce costs for employers. According to a recent survey, employers expect that half their employees will lack the resources needed to retire at their organization’s traditional retirement age. The surveyed employers are lukewarm about creating opportunities for even half of these employees to work longer, particularly if the employer views older employees as costly.\(^6\)

Delayed retirements may also increase employers’ healthcare costs, because annual healthcare costs for a 65-year-old or older worker are twice those of a worker between the ages of 45 and 54.\(^6\)

However, the relationship between the age of a workforce and its cost is complex, with factors such as productivity also playing a role.

Delayed retirements may impact employee morale. For example, younger employees may become discouraged by a lack of advancement opportunities as fewer employees retire. A survey of finance executives found that more than 60% of the executives have become more concerned about employees who are unable to retire, and a resulting shortage of growth opportunities for younger staff.\(^6\)

Delayed retirements may also reduce employers’ ability to hire new employees, reducing the flow of new ideas and talent into their firms.

These workforce management challenges are likely to become more pronounced over the next several years because the number of employees over age 55 is expected to grow by more than 40% by 2020.\(^6\)

There’s also an important but often overlooked residual benefit associated with greater plan participation: it may positively impact the ability of highly compensated employees to contribute more to the plan, providing a valuable added inducement to the organization’s key constituencies while improving non-discrimination testing results.

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Understanding the causes of participant inertia
The study of behavioral finance, based on the Nobel Prize-winning work of Daniel Kahneman and expanded upon by a new generation of psychologists and economists, including Professor Shlomo Benartzi at UCLA, points to two powerful psychological biases that lead plan participants to make poor financial decisions.

The first of these, status quo bias, is more commonly known as inertia. It’s a cognitive bias where people tend to prefer their current state, and therefore have a tendency to delay decisions—even decisions they know are in their best interest. As it relates to retirement plan participation, inertia tells us that left to their own devices, non-participants will tend to value their current state (higher take-home pay and no enrollment hassles) more than they will value participating in the plan and the resulting retirement savings they accumulate.

As a compelling example, Professor Benartzi points to the organ donor programs in Germany and Austria. Whereas only 12% of Germans participate in the country’s organ donor program, the participation rate in neighboring Austria is in excess of 99%. The only appreciable difference is that Germany’s program is an opt-in system while Austria’s is an opt-out program.7

Also working against successful participant outcomes is the psychological principal of present bias. Also referred to as hyperbolic discounting, present bias asserts most individuals place a greater value on a benefit received in the present than the same benefit received at some point in the future. Studies have shown that when offered the choice between $50 now and $100 a year from now, most people will choose the immediate $50.7

With respect to retirement plan participants, these factors can impede their retirement plans and cause them to save far less than is optimal in the present, rationalizing the decision with the thought that they will “catch-up at some point down the road.”

Both of these behavioral finance biases pose a substantial risk to successful participant outcomes, and without active plan sponsor intervention signal the likelihood of a sizable portion of the workforce delaying their retirement.

Research suggests that most plan participants need to increase their savings rates by 5–8% above their current levels.8

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8 Prudential Retirement, 2014.
Auto-enrollment: an effortless path to a more secure retirement

As referenced before, participant inertia can be a daunting, if not crippling impediment to boosting participation rates.

Automatic enrollment helps to break the hold of inertia and launch employees onto the path to a more secure retirement. And the impact of adding this plan feature is extremely persuasive.

Plans at Prudential Retirement that have adopted an automatic enrollment feature have a 90% participation rate, compared to a 62% participation rate for plans without automatic enrollment.\(^9\) Perhaps more importantly, those percentages hold up over time with no meaningful increase in opt-out rates. This is clearly not a case of artificially high initial participation rates that regress back to previous levels.

Research also suggests that the introduction of automatic enrollment (in addition to employer match level) has a tendency to “anchor” participants’ contribution rates and asset allocation to the defaults chosen by the sponsor. Therefore, the overall increase in expected account balances from adopting automatic features will be a function of both the employee’s relative wage level and the employer’s default decisions.\(^10\)

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At Prudential Retirement, plans with auto-enrollment have a 45% higher participation rate than plans without.\(^9\)

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\(^9\) Plans at Prudential Retirement, Prudential Retirement, Q1 2013.


An earlier start yields better participant outcomes

Automatic enrollment also motivates employees to begin saving sooner.

Data shows that sponsors who implement automatic enrollment see a marked reduction in the average age of plan participants (from 48 down to 38). Those eight extra years in the plan can have a dramatic, positive impact on retirement savings outcomes.\(^\text{11}\)

Take two nearly identical plan participants, both earning $50,000/year with a 3% salary deferral and a 50% employer match up to the first 6% of salary. The only difference is that Jim is 47 years old while Lauren is 39. As the following chart depicts, based on the assumptions below, by the time the two reach a retirement age of 65, as a result of the eight additional years of participation Lauren's account would be worth nearly $105,330 more than Jim's.

By adding an automatic enrollment feature to their plan, sponsors can take an important step both in striving to improve participant outcomes, and in fulfilling their duty to serve the best interests of their participants.

Jim (Age 48) vs. Lauren (Age 38)

\[
\begin{align*}
\text{AGE 65} & \\
$74,683 & \quad $180,013
\end{align*}
\]

Compounding examples are hypothetical and not meant to represent the performance of any specific investment. Model assumes a $50,000 salary, 3% deferral rate and a 50% employer match up to the first 6% of salary. Model assumes a 2% annual salary growth and 6% average annual return. Participants can lose money investing in securities.

\(^{11}\) Prudential Retirement, 2014.
### Auto-escalation: helping drive increased deferrals

While increasing plan participation is critical, in and of itself it’s simply not enough.

Numerous recent studies have shown that in order to accumulate enough money to achieve a secure retirement, the average plan participant needs to contribute between 12–15% of their annual salary.

Heavily influenced by their present bias, however, most participants place a significantly higher value on their net pay to the detriment of their retirement savings. The result is an actual average participant contribution rate of between 5–7%.

It’s a glaring gap, and one that plan sponsors can help rectify.

That’s the challenge that auto-escalation features were built to address, and have done so successfully for a myriad of plan sponsors. In a 2013 study of nearly 270,000 participants in 197 plans offering auto-escalation, Prudential Retirement found that plans offering auto-escalation for five or more years had average deferral rates that were 21% higher than plans without auto-escalation. Not surprisingly, those higher deferral rates also translated into higher account values. Plans that had been offering auto-escalation saw average account balances grow by 78% versus 57% for those plans that didn’t.*

Returning to the previous example of Jim and Lauren, compare what happens to Lauren’s account values when auto-escalation is added to auto-enrollment. The chart below uses the exact same assumptions as the previous example, but with the addition of a 1% annual auto-escalation up to a maximum of 10%. That small 1% annual deferral rate increase translates into roughly $270,000 more retirement savings for Lauren.

Because auto-escalation typically employs small incremental increases, the resulting impact on participants’ take-home pay is lessened. To further reduce the effect on take-home pay, many plan sponsors choose to link the timing of annual deferral rate increases to coincide with their annual performance review and salary increase schedules.

<table>
<thead>
<tr>
<th>Jim (Age 48)</th>
<th>Lauren (Age 38)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Without auto-escalation</strong></td>
<td><strong>With auto-escalation</strong></td>
</tr>
<tr>
<td><strong>AGE 65</strong></td>
<td><strong>WITH AUTO-ESCALATION</strong></td>
</tr>
<tr>
<td>WITHOUT AUTO-ESCALATION</td>
<td>$451,009</td>
</tr>
<tr>
<td>WITH AUTO-ESCALATION</td>
<td>$74,683</td>
</tr>
</tbody>
</table>

Compounding examples are hypothetical and not meant to represent the performance of any specific investment. Both models assume a $50,000 salary, 3% deferral rate, a 50% employer match up to the first 6% of salary, 2% annual salary growth and 6% average annual return. Lauren’s model also assumes the addition of 1% auto-escalation increases each year to a max of 10%.

*Participants can lose money by investing in securities.

*Percentages reflect continuously active participants. This growth includes cash flows.
Overcoming the fear of participant alienation

Some plan sponsors may be hesitant to implement automatic enrollment and automatic escalation. These sponsors believe that implementing automatic features could alienate current non-participants as well as drive some existing participants out of the plan.

In reality, however, quite the contrary is true. Numerous studies over recent years have shown time and again that overall participants respond very positively to auto plan features. According to the DCIIA plan sponsor survey, 70% indicate that employees’ attitude toward automatic enrollment was either very or somewhat favorable.12 And a 2012 survey conducted by Cogent Research showed that nearly half (49%) of plan participants report wanting access to auto-escalation features.13

Prudential Retirement’s own data bears out these positive perceptions. One might think that opt-out rates would increase as the default deferral rates increase, however the converse is true.

Across all Prudential Retirement defined contribution plans there is an average opt-out rate of 8.1%. For those plans offering both auto-enrollment and auto-escalation features, however, the average opt-out rate falls to 7.0%.

And perhaps most surprising, as the following table demonstrates, the higher a plan’s default contribution rate, the higher its sustained participation rates tend to be. At some point, though, the law of diminishing returns must inevitably take effect. The pivotal question is where precisely is that inflection point?

The higher the default contribution rate, the higher the participation:14

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**Plans with a 5–6% default deferral rate have a 90% participation rate (13% higher than the national average).**15

<table>
<thead>
<tr>
<th>Plans defaulting at 1%</th>
<th>Had a participation rate of:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>85%</td>
</tr>
<tr>
<td>Plans defaulting at 3%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>91%</td>
</tr>
<tr>
<td>Plans defaulting at 6%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>97%</td>
</tr>
</tbody>
</table>

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14 Prudential Retirement, 2013.
Finding an optimal default deferral and annual acceleration rate

According to the Plan Sponsor Council of America, the average participant contribution to a 401(k)-type plan currently stands at 6.7%.

The challenge for plan sponsors when implementing auto features is to identify the “optimal” default deferral rate and escalation percentage that will increase deferrals without adversely impacting plan participation.

Unfortunately, there is no universal “one-size-fits-all” target. Plan sponsors need to factor a number of variables into their decision-making process, including current plan design, historical plan participation and deferral rates, and their existing company match formula.

When armed with the necessary data, determining an optimal auto-enrollment default deferral rate usually comes down to a basic balancing act between the positives (higher participation rates and higher deferral rates) and the negative (higher participant opt-out rates).

<table>
<thead>
<tr>
<th>Default Deferral</th>
<th>Participation Rate</th>
<th>Average Deferral</th>
<th>Opt-Out Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1–2%</td>
<td>87%</td>
<td>3.7%</td>
<td>3.6%</td>
</tr>
<tr>
<td>1–2%</td>
<td>87%</td>
<td>4.8%</td>
<td>7.2%</td>
</tr>
<tr>
<td>5–6+%</td>
<td>90%</td>
<td>5.9%</td>
<td>7.1%</td>
</tr>
</tbody>
</table>

As the above table depicts, higher default deferral rates clearly have a markedly positive impact on both overall plan participation and average participant deferral rates. Even despite a notable jump in opt-outs for plans with a 5–6% default deferral rate, overall plan participation still remains well above the national average.

And while most plans with auto-escalation utilize a 1% annual increment, data shows that plans that switch to a 2% increment have a significantly higher average employee deferral rate (8.2% to 7.3%).

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To assess the impact that these default deferral and escalation percentage changes would have on participant outcomes, the following chart portrays the same two previously discussed participants (Jim and Lauren) and the same core assumptions. The only difference is an increase in the initial default deferral rate (from 3% to 6%) and a change to the annual escalation percentage and maximum (from 1% and 10%, to 2% and 14%).

The impact of a small 3% default deferral rate increase combined with a 1% increase in the annual escalation rate on Lauren's outcomes are startling, netting her $633,594 in retirement savings ($467,419 more than the original example). Jim's plan did not implement automatic features so his account balance remains the same at $74,683.

Jim (Age 48) vs. Lauren (Age 38)

**AGE 65**

<table>
<thead>
<tr>
<th>Jim</th>
<th>Lauren</th>
</tr>
</thead>
<tbody>
<tr>
<td>$74,683</td>
<td>$633,594</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>without automatic features</th>
<th>with optimal automatic features</th>
</tr>
</thead>
<tbody>
<tr>
<td>$459 in monthly retirement income*</td>
<td>$3,896 in monthly retirement income*</td>
</tr>
</tbody>
</table>

*Figures based on a 20-year retirement. Compounding examples are hypothetical and not meant to represent the performance of any specific investment. Both models assume a $50,000 salary, and 50% employer match on first 6% of deferrals. Both models assume a 2% annual salary growth and 6% average annual return. Jim assumes a 3% deferral rate. Lauren assumes a 6% deferral rate and 2% auto escalation. Participants can lose money investing in securities.

Plans that switch to a 2% automatic annual acceleration enjoy a higher average employee deferral rate (8.2% to 7.3%).

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*Prudential Retirement, 2014.*
Properly implemented, autos do not necessitate higher costs

Many plan sponsors are initially reluctant to implement auto-enrollment and auto-escalation features out of concern that they may subject themselves to a dramatic increase in company match costs.

It’s a logical assumption, but one that overlooks the long-term costs associated with delayed retirements and the benefits derived from retaining and cultivating the next generation of leaders for the firm. Any plan decision, whether concerning fees, investment selection or plan features such as auto-enrollment and auto-escalation should be based solely on what’s in the best interest of participants.

Thoughtfully implemented, automated plan features do not have to equate to higher matching costs. DC Optimization is a fully custom plan design process, and allows for plan sponsors to re-allocate their contributions in many different fashions, whether based on service, job classification, points, or in other manners. Through the process of DC Optimization, a typical uniform match structure (where all employees receive the same matching formula) can be modified to a formula specifically structured to remain cost-neutral to the plan sponsor while still allowing for the inclusion or expansion of auto-enrollment and auto-escalation. One possible way to do this is to design a structure with various “tiers” of match for employees, where more match dollars are allocated to older, longer-tenured employees and fewer to younger employees with less service time, as in the simplified example below.

<table>
<thead>
<tr>
<th>Original 401(k) Plan Match</th>
<th>New 401(k) Plan Using DC Optimization</th>
</tr>
</thead>
<tbody>
<tr>
<td>50% of first 6% employee deferral</td>
<td>Age + Service (Points) Match</td>
</tr>
<tr>
<td>Less than 40</td>
<td>20% of first 6% employee deferrals</td>
</tr>
<tr>
<td>40 to 60</td>
<td>40% of first 6% employee deferrals</td>
</tr>
<tr>
<td>60 to 80</td>
<td>80% of first 6% employee deferrals</td>
</tr>
<tr>
<td>More than 80</td>
<td>160% of first 6% employee deferrals</td>
</tr>
</tbody>
</table>

In the above DC Optimization example, the overall match costs to the plan sponsor are the same, but the reengineered matching formula applies those matching dollars in a more thoughtful manner. DC Optimization provides the means to attract and retain key employees without increasing the cost of the current match, and in some cases actually reducing it.

Developing an optimal retirement program, however, requires a deep understanding of the plan sponsor’s business needs and workforce composition. As part of any DC Optimization project it’s vital to partner with experienced retirement plan consultants and investment advisors to ensure that any proposed tiered formula design is implemented properly and takes into account expected employee behavior.
SUMMARY AND CONCLUSION

In order to achieve a successful retirement outcome, the average plan participant needs to increase his or her savings rates by 5–8% above their current levels.

With such a compelling data case, the question that begs answering is why, according to the Plan Sponsor Council of America’s 57th annual survey (2014), do only 50% of plans offer an automatic enrollment feature, and fewer still offer both auto-enrollment and auto-escalation? Plan sponsors have an ethical duty to help their employees close this gap. Through the implementation of auto-enrollment and auto-escalation features, in conjunction with a plan optimization effort, employers can effectively achieve this goal without fear of alienating participants or subjecting their plan to increased matching costs.

In analyzing data from hundreds of plans comprising tens of thousands of participants, Prudential Retirement has come to the conclusion that auto-enrollment with a default deferral rate of 5–6% and an annual auto-escalation of 2% result in significantly higher average employee deferral rates and account balances while still maintaining above-average participation levels. And through plan optimization, the implementation of automated features may be done in a manner to avoid or minimize increased plan costs.

By breaking the stasis of inertia, automated features offer a means of reinvigorating a stagnant plan and bringing participants closer to their ultimate goal of building a retirement portfolio that will last throughout their lives.

Veronica Charcalla  
Vice President of Total Retirement Solutions  
Prudential Retirement  

Gary Crawford  
Manager of Market and Strategic Intelligence  
Prudential Retirement

To learn more about our research and solutions visit bringyourchallenges.com
DC Optimization strategies may rely on the following Internal Revenue Code (the “Code”) and Treasury Regulation provisions, or a combination of the following Code and Treasury Regulation provisions: (1) non-elective contributions in accordance with Treasury Regulation section 1.401(a)(4)-1; (2) matching contributions in accordance with Code section 401(m); (3) design-based safe harbor in accordance with Treasury Regulation section 1.401(a)(4)-2(b)(2); (4) uniform points non-design based safe harbor in accordance with Treasury Regulation section 1.401(a)(4)-2(b)(3); (5) general nondiscrimination testing in accordance with Treasury Regulation section 1.401(a)(4)-2(c).

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