The case for proactive re-enrollment as industry best practice

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Proactive plan design elements, such as auto-enrollment and auto-escalation, represent industry best practice and have become the norm among plan sponsors. Their presence results in better participant outcomes, particularly when used in an opt-out fashion. The practice of re-enrollment is a simple extension of this general framework, that similarly represents consensus industry best practice.

Introduction

Target Date Funds (TDFs) have been utilized since the Pension Protection Act (PPA) of 2006 in a QDIA setting, as a means of providing retirement savers with a one-stop solution suited to their age and, in some cases, risk tolerance level. According to a recent survey, 91% of plans offer a TDF option.1 This framework with TDFs is meant to provide a comprehensive but generalized asset mix solution appropriate for most retirement investors. The associated asset mix glide path typically decreases in portfolio risk level over a person's lifecycle. The academic foundation of this lifecycle approach is, in large part, Human Capital Theory, that was first posited by Jacob Mincer and Nobel economist Gary Becker, in the late 1950s and early 1960s. Later extensions of this work, oriented toward lifetime savings strategies, posited that as the relative weight of the current financial value of the portfolio increases relative to the present value of future human capital, the ability to weather volatility shocks declines.

Empirical work by behavioral economists had demonstrated that, in practice, savers' investment allocation choices in the absence of QDIA options tended to follow more haphazard construction approaches, such as equally allocating among investment options, otherwise known as the 1/n heuristic.2 The systemic response to problems identified by behavioral economists resulted in a system comprised of stimulants and stabilizers designed to address historical behavioral shortcomings in investor retirement savings behavior, including automatic enrollment, automatic contribution rate escalation and the use of QDIAs.

These systemic solutions proposed by behavioral economists, such as Benartzi and Thaler3 that espoused automatic enrollment, investment defaults and automatic contribution escalation, have certainly helped to improve the situation for those with access to sponsored retirement plans. In fact, these plan design elements have become the standard in retirement plans in the years since the introduction of the PPA of 2006.

Re-enrollment is a simple extension of this general framework. Mesirow Fiduciary Solutions believes that it is a best practice standard that offers numerous benefits to plan sponsors and participants. It results in superior outcomes to standard fallback solutions, such as employee education or online/call-in help centers, where the onus is on the employee to initiate changes in investments.

The drawbacks of traditional approaches

Many elements of retirement plans change through the fiduciary decision-making process and these changes accumulate over time. Investment committees may select to add or delete asset classes, change investment managers, change share class offerings, or change the QDIA glide path in some manner, to name a few. Participant allocations that result in sub-optimal outcomes similarly can manifest over time from the date of initial hire and auto-enrollment. Employer education alone is not an adequate solution to addressing either employer or employee migrations. Employee education is a standard fallback for many plan sponsors to fulfill their proactive fiduciary obligations in many instances. In the defined contribution survey from Callan in 2018, participant communication ranked #3 among plan sponsors a priority for the coming year.4

Employee education or the provision of voluntary help line advice are usually not sufficient to meaningfully result in desired outcomes when measured at either the plan level or the average individual participant. The deficits in employer education programs correlating with subsequent participant action have been well documented.5 “Though many plan sponsors have engaged in robust participant education efforts, inertia has persisted and there is a general lack of confidence that participants are appropriately diversified within their 401(k) portfolios…only about one third of plan sponsors are highly confident that the majority of participants has an appropriate asset allocation. Plan participants themselves are even less confident, with only 25% of them highly confident in their ability to appropriately allocate their savings across available options.”6 In fact, this poor historical experience with results of employer education led to the creation of the more prescriptive solutions that exist today, such as auto-enrollment and auto-escalation regimes.

More interactive options generally achieve somewhat better outcomes. Some form of plan sponsor provided interactive help, such as online/phone help lines, can be beneficial, but usage rates are quite low — around 35% according to some studies.7 The investment portfolios, overall, are better for participants that utilize help, with better outcomes in the form of both more risk-appropriate portfolios and superior risk-adjusted returns.8 The vast majority of participants, however, do not respond with subsequent action to employee education and do not utilize plan sponsor provided help. Those participants that do not utilize help options have wider risk variance in portfolio allocations and more inferior risk-adjusted returns. That is a problem. “In fact, re-enrollment is becoming increasingly more popular because investment education has not worked as well as was initially hoped. And, even with one-on-one meetings, the process has not affected the large number of participants who are commonly impacted by re-enrollment, that is, the employees who have been in the plan for a number of years.”9

The advantages of re-enrollment

Re-enrollment can be defined as: “Redirecting existing account balances and future participant contributions from existing investment allocations to a QDIA, unless participants opt out or make another election before assets are moved. Provided the plan sponsor has satisfied the safe harbor requirements, it will be provided relief under ERISA Section 404(c) for investment outcomes related to the QDIA.”10 Re-enrollment will help in the instances noted previously, such as plan changes of some type or participants that have strayed over time from initial enrollment, by ‘sweeping’ participants into largely appropriate TDF risk-adjusted portfolios, unless they opt out. Re-enrollment can be thought of as periodic clean-ups or sweeps of a plan that proactively attempt to shepherd participants into the most appropriate investment options or else, to be administered whenever there is a substantial change in plan design, QDIA or investment manager changes.

The trend toward proactive elements of plan design has continued to increase over time. For instance, according to JP Morgan Asset Management, auto-enrollment increased from 43% of plans to 55% from 2013 to 2019, while auto-escalation contribution features increased from 21% to 38% over the same time frame.11 A Callan survey states that among non-government plans, the auto-enrollment feature is higher, at 71.4% in their 2019 survey. The disparity between the two survey data sets is largely due to the fact that 61.9% of government plans were not able to offer re-enrollment due to existing laws. Auto-escalation features are employed by roughly 80% of non-governmental plans and 70.8% of those employ the feature in an employee opt-out fashion.

That opt-out feature has increased dramatically from four years earlier, when it stood at 52.8%.12 Presumably, the trend towards opt-out is increasing because it is the most effective in achieving the desired goals and is permissible under current DOL guidelines. In terms of re-enrollment elements, while 94.5% of plans had auto-enrollment for new hires, over a quarter (25.4%) also have auto-enrolled existing employees in either a one time, or periodic, recurring sweeps.13 The usage of re-enrollment is not an oddity, by any means, but still represents a clear minority of plans.

The increase in proactive elements of plan design, such as auto-enrollment and auto-escalation, have substantially improved participant outcomes in terms of participation rates and contribution rates, which is consistent with the fiduciary obligation of plan sponsors. Periodic re-enrollment is a natural extension of this trend and is increasingly being adopted as a regular feature in order to enhance the auto-enrollment and auto-escalation features' effectiveness. A substantial number of plan sponsors engage in some form of plan changes in a given year, whether it be addition of funds, deletion of funds, changes in share class offerings, etc. For instance, 34.8% of plans either added or deleted a fund in 2018.14 Often the best approach to proactively deal with plan changes that accumulate over time is periodic sweeps of participants through a re-enrollment process. The same applies to re-enrolling participants to deal with any plan sponsor perceived problem of participants with inappropriate portfolios based upon an analysis of aggregate plan characteristics. The results of re-enrollment have been good in these instances. "For example, it is not uncommon for re-enrollment to result in 50%, 60%, or more of the participants allowing their money to be transferred to well balanced portfolios, such as TDFs. Nothing, other than automatic enrollment, has produced similar numbers. Even with automatic enrollment, though, the results are less impressive."15

Big plan changes create a particular need for proactive re-enrollment

If there is a change in the QDIA, in particular, then re-enrollment is an appropriate plan sponsor action. This sentiment is conveyed by Russell Investments, "…the new target date funds will be the centerpiece of the plan — essentially, embedded advice representing the investment committee's best thinking of age-appropriate allocation. Yet, unless the sponsor takes action, the legacy employees will remain invested in their existing portfolios, which, if they are like those of most plans, will be severely misallocated."16 Similar sentiments are expressed in various opinions from ERISA-based law firms: "Because of participant inertia, even if new TDFs are offered by a plan, most participants who have already directed their investments are unlikely to act to move their accounts to the new TDFs. For fiduciaries who want to improve the quality of the investing of current participants, re-enrollment, together with the QDIA rules, affords that opportunity."17

Plan sponsors’ most often stated reason for avoiding re-enrollment is the perceived fiduciary risk. The exact same protection, however, is afforded for re-enrollment by the PPA Act of 2006 as is granted to auto-enrollment of new hires or defaults into the QDIA. This is a broadly accepted fact among ERISA consultants and established legal opinion. Moreover, it can be transformative for participants. “No other single action provides as dramatic an opportunity to transform the investment experience of plan participants than a plan re-enrollment.”18 Furthermore, rather than employee backlash or resentment, the results are often simply better participant investment outcomes. In fact, evidence shows that employees generally appreciate that the employer is looking out for their best interests.19

Interestingly, most plan sponsors aren’t aware that re-enrollment is afforded clear fiduciary protection, which may partially explain the low usage rate. According to a survey by JP Morgan Asset Management, 56% of plan sponsors were not aware of this fact,20 even though re-enrollment is actually associated with best industry practice from a legal perspective. “A defined contribution plan “re-enrollment” has become a retirement plan industry best practice. The mechanism illustrates that the most prudent — and therefore safest — fiduciaries are not those who defensively opt for inaction, but instead are those fiduciaries who assess and understand what is in their participants’ best interests and proactively take steps to further those interests.”21 Rather than being pushing the envelope, some legal opinions actually view the re-enrollment process as the most defensive and safest position, particularly in light of plan changes to the QDIA in one form or another. “Fiduciaries improve their levels of protection, particularly when adding new investment elections that meet the DOL’s QDIA … As employers attempt to put their employees on a course for a dignified retirement, an “investment refresh” or “re-enrollment” is a best practice designed to help employers achieve those goals.22

Conclusion

Proactive plan design elements, such as auto-enrollment and auto-escalation, represent industry best practice and have become the norm among plan sponsors. Their presence results in better participant outcomes, particularly when used in an opt-out fashion. The practice of re-enrollment is a simple extension of this general framework, that similarly represents consensus industry best practice. The presence of re-enrollment also clearly results in better participant outcomes. Rather than exposing a plan sponsor to fiduciary risk, it is viewed by many experts as the safest route for plan sponsors.

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