FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
77 K Street, NE Washington, DC 20002

September 10, 2015

MEMORANDUM FOR BOARD MEMBERS KENNEDY, BILYEU, JONES, MCCRAY, AND JASIEN

FROM: GREG LONG
Executive Director

SUBJECT: Auto-escalation

The Thrift Savings Plan (TSP) Enhancement Act of 2009 (P.L. 111-31, Div. B, Title I § 104) (Act) authorized automatic enrollment for the TSP, and this feature was implemented for newly hired and rehired civilian employees in August 2010. It has been five years since implementation, and automatic enrollment has proven to be a beneficial tool in helping participants retire with dignity. Based on the past five years of experience, it appears that automatic enrollment has had the beneficial effect of increasing participation but has had a dampening effect on deferral rates. Deferral rates are a key component of retirement readiness, and a steady decline in these rates warrants concern and action. This memorandum outlines my recommendation to implement auto-escalation as a solution to participant inertia and weakened deferral rates.

BACKGROUND

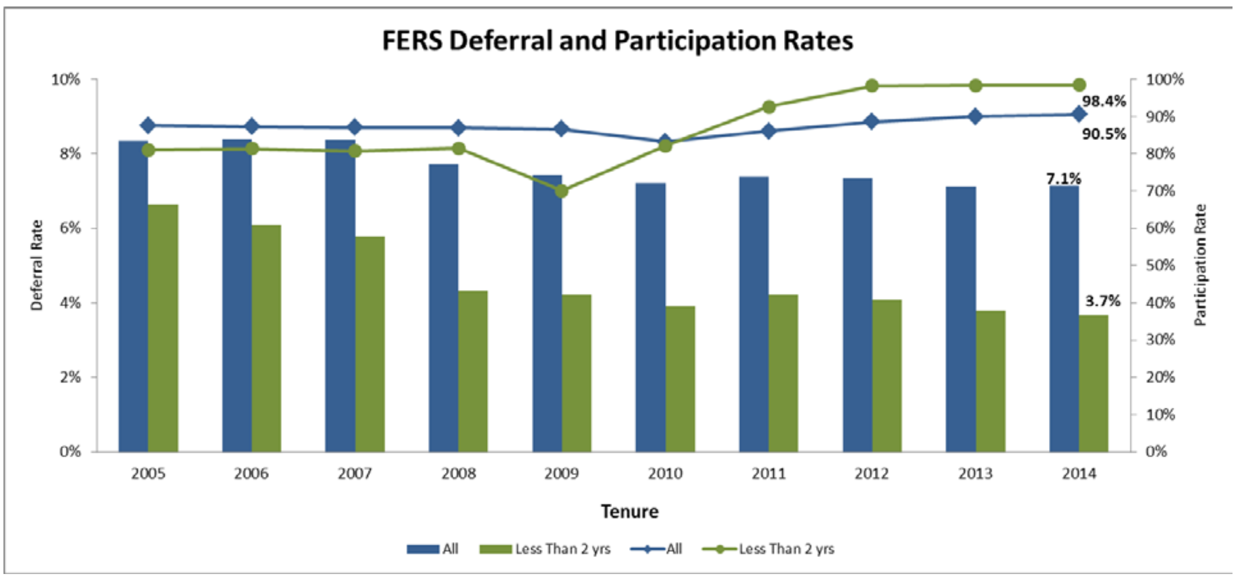
The automatic enrollment legislation authorized the Executive Director to automatically enroll new civilian employees and to establish a default percentage rate of not less than 2% nor more than 5% of basic pay. For a variety of reasons that I still deem prudent, we selected 3% as the default percentage. Individuals have the ability to opt-out of auto-enrollment and have a period of 90 days in which to request a refund of the initial contributions made via auto-enrollment. Approximately 4% of auto-enrolled participants have opted out of making contributions. This opt-out rate compares favorably to the opt-out rates of other plans, which average about 9%.[1] As a result of automatic enrollment and a low opt-out rate, participation for fulltime Federal Employees' Retirement System (FERS) employees has risen from 87.6% in 2005 to 90.5% in 2014. Focusing on the participation behavior of the newly hired, the impact of

[1] Jeffery W. Clark, et. al, *Automatic enrollment: The power of the default,* Vanguard Research, January 2015.

automatic enrollment is staggering. In 2005, 81% of eligible FERS employees who had two years or less of tenure participated in the TSP. By 2014, the participation rate for this tenure cohort soared to 98.4% – the highest rate of participation for any tenure cohort.

When we examine deferral rates, there is not a comparable improvement in participant behavior. In 2005, the average deferral rate for fulltime FERS participants was 8.3%. The rate as of 2014 is 7.1%. When examining the "less than two years" tenure cohort, the average deferral rate has fallen 44% from 6.6% in 2005 to 3.7% in 2014 – a ten-year low. While there may be a number of factors causing the decline in deferral rates, it must be noted that current rates are even lower than they were in 2008 and 2009 at the height of the economic downtown. In comparison, participation rates have improved steadily since the economic downturn.

The chart below illustrates the trends in participation and deferral rates over the past ten years.



As deferral rates continue to dip, we must also highlight that many participants are leaving free money on the table when their deferral rate drops below 5%. The TSP matching formula is dollar-for-dollar on the first 3% of pay and 50 cents on the dollar for the next 2%. In 2014, nearly 26% of participants did not contribute enough to receive the full match. As a result, these participants on average did not receive $727 in matching contributions. Assuming that participants missed out annually on the same amount of matching contributions over a 30-year career, they would potentially have $59,000 less in employer-contributed retirement savings.[2]

[2] Assumes 6% rate of return.

Industry research has revealed that many automatically enrolled participants do not opt to change their deferral rates. There are hypotheses that this may be due to participant inertia or to an implied endorsement that the default deferral rate is the "right" deferral rate. Nevertheless, the default deferral rate of 3% still remains the most common default for automatic enrollment, and plan sponsors have begun to recognize the insufficiency of this rate to produce adequate savings. Some of these sponsors have addressed this problem by increasing the amount of the default while others have adopted auto-escalation to improve savings adequacy. Currently, 48% of plans have auto-escalation.[3] A recent study "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."[4]

AUTO-ESCALATION IN THE TSP

In 2012, a bill was introduced to add auto-escalation to the TSP. The draft legislation would have caused new Federal employees who are auto-enrolled to further have their 3% auto-enroll deferral rate automatically increased by 1% each year. The draft legislation further envisioned that auto-escalation would be effective for a period determined by the TSP, but not less than three years. At the time of this proposed legislation, we did not have sufficient data on the impact of automatic enrollment on the TSP. However, with the observations of additional years and as noted above, automatic enrollment has proven to be a strong corollary to declining deferral rates. The data now persuades us to pursue a solution similar to the earlier proposed legislation.

With our proposal, we would retain the 3% default auto-enrollment level and initiate a 1% automatic annual increase. However, we would limit the auto-escalation period to two years, thereby capping the "automatic" deferral rate at 5%. This cap aligns with the amount that a participant must contribute to receive the full match. Furthermore, we note that the matching contribution arrangement in the Federal Employees' Retirement System Act of 1986 (FERSA) was designed to strongly encourage a deferral rate of 5% because contributions at this level

[3] Lori Lucas, et. al., *DCIIA Plan Sponsor Survey 2014: Focus on Automatic Features* Defined Contribution Institutional Investment Association, June 2015

[4] *Overcoming Participant Inertia: Automatic Features That Improve Outcomes While Improving Your Plan's Bottom Line,* Prudential Retirement, 2015

would result in total FERS benefits which approximate or exceed Civil Service Retirement System (CSRS) benefit levels across Federal pay bands.[5]

A 3% auto-enroll deferral rate and a 1% two-year auto-escalation structure would bring auto-enrolled participants to a deferral level of 5% by the third year of employment. With the inclusion of agency matching contributions and the automatic agency 1% contribution, the participant would "automatically" reach a total annual contribution level of 10%, as compared to 7% in the current structure. However, as with automatic enrollment, participants would be able to opt-out of auto-escalation.

PROS and CONS

Auto-escalation takes advantage of participant inertia and moves more people to a 5% deferral rate, thus to the full matching contribution rate and the replacement rate that was envisioned when FERSA was enacted. Furthermore, to the extent that the combined auto-enrollment and auto-escalation rates are seen as having the "good housekeeping seal," we change the implied endorsed rate from 3% to 5%. Lastly, we drive more participants towards a better outcome at retirement. In fact, a Putnam Institute research paper, "*Defined Contribution Plans: Missing the Forest for the Trees*?" placed deferral rates along with plan design at the top of a number of variables, e.g., asset allocation, individual fund performance, to determine plan effectiveness and to boost retirement preparedness.

While we tout the advantages of auto-escalation, we also recognize the potential issues that accompany this feature. The first of these issues is implementation, the burden of which falls on employing agencies. In addition to bearing the cost of increased matching contributions, agencies will have to modify their payroll systems to accommodate the annual increases. Secondly, we recognize that with the advent of higher pension costs, that some participants may not be able to afford the higher deferral rate. Lastly, there is a potential risk that when participants decide that they cannot afford the higher deferral rate, they will decide to opt-out of contributing completely, thus undermining the gains that we have achieved through automatic enrollment.

RECOMMENDATION

[5] Civil Service Retirement Team of the Education and Public Welfare Division, Congressional Research Service, The Library of Congress. *A Retirement Plan for Federal Workers Covered by Social Security: An Analysis of the Federal Employees Retirement System (P.L. 99-335)*, July 21, 1986, p.40.

We have made significant progress in getting participants to contribute to the third leg of their retirement stool, the TSP. However, we have additional work to ensure that participant contributions are at the level that were intended to adequately distribute the weight of retirement on that three-legged stool. While there are some risks associated with auto-escalation, I believe the benefits far outweigh the risks, as it takes an important step towards improving participant retirement outcomes. Thus, it is my recommendation that an auto-escalation feature should be added to the TSP. I note that this change will require legislation, discussion with ETAC, and extensive coordination with employing agencies and or payroll operations. Accordingly, its implementation is contingent upon successful passage of legislation and would then be prioritized along with other planned Agency activities.