Success of Auto Enrollment and Auto Increase: Using Behavioral Finance to Improve Retirement Planning

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Mark Robinson
T. Rowe Price Retirement Plan Services
Focus for Discussion

- Four Key Retirement Decisions Employees Face
  1. Whether to participate in a retirement plan
  2. How much to contribute to the plan
  3. How to invest contributions
  4. How to manage money in retirement

- Lessons Learned from Behavioral Finance
  - Auto-Enrollment and Overcoming Participant “Inertia”
  - Auto-Increase and Hyperbolic Discounting
Participation in Retirement Plans

- **Issue: Employees Do Not Participate**
  - 3 out of 10 employees do not participate in their retirement plan
  - Employees miss out on tax benefits & employer match

- **Psychological Barrier: Inertia**
  - Newton’s First Law of Motion: The property of an object to remain still or moving in its established direction unless acted upon by an outside force.
  - Applies well to human behavior, too

Source: Benartzi (2010)
Tools Used to Increase Participation in Retirement Plans

- Education has had little impact on participant inertia
- Automatic enrollment uses inertia to improve participation in retirement plans

### Does Education Spur Action?

<table>
<thead>
<tr>
<th></th>
<th>Before</th>
<th>After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seminar Attendees Planning to Join</td>
<td>100%</td>
<td></td>
</tr>
<tr>
<td>Seminar Attendees Actually Joining</td>
<td>14%</td>
<td>91%</td>
</tr>
<tr>
<td>Non-Attendees Actually Joining</td>
<td>7%</td>
<td>88%</td>
</tr>
</tbody>
</table>

### Automatic Enrollment Overcomes Participant Inertia

- Case A by Choi et al: 53% Before, 88% After
- Case B by Choi et al: 53% Before, 88% After
- 13 Case Studies by Benartzi and Thaler: 83% Before, 95% After

Source: Choi et al, Bernartzi and T. Rowe Price (2006)
T. Rowe Price Automatic Enrollment

- Adoption of auto enrollment continues to grow
- Majority of plans use a 3% default rate

53% of eligible T. Rowe Price clients use Automatic Enrollment
- 56% default @ savings rate of 3%; another 36% > 4%
- 1/3 also apply it to existing nonparticipants
- ~5% annually implement auto-enrollment for opt-outs

**Percentage of Participants Saving At, Above, and Below the Plan Default Rate**

- 0.7% at Default, 39.1% above Default, 60.2% below Default
- 1.7% at Default, 56.8% above Default, 41.5% below Default
- 3% at Default, 75.3% above Default, 22.2% below Default
- 4% at Default, 52.6% above Default, 7.1% below Default
- 5% at Default, 35.7% above Default, 13.4% below Default
- 6% at Default, 79.5% above Default

Source: T. Rowe Price (3/10), DiCenzo and T Rowe Price (2009)
Participants at T. Rowe Price: Auto Enrollment Impact Over Time

- Opt out rates for participants do not change much for different participant populations
- Participants with deferrals above their default rate grow over time (due in part to auto services such as auto increase)

![Bar chart showing Automatic Enrollment Participants’ Salary Deferral % Compared to their Automatic Default Rate](chart.png)

Source: T. Rowe Price (12/09)
Savings Rate and Hyperbolic Discounting

- **Issue: Average Savings Rate is Low**
  - Even when combined with employer match, employees are not saving enough in 401K plans

- **Psychological Barrier: Hyperbolic Discounting**
  - Immediate gratification is hard to resist
  - Self-control restrictions are easier to accept if they take effect in the future
  - Case in point: Bananas or chocolate?

Sources: PSCA 52nd Annual Survey, Read and Van Leeuwen (1998)
T. Rowe Price Automatic Increase

- Use of automatic increase in retirement plans is growing
- More clients are shifting the automatic increase percentage from 1% to 2%

- Adopted but not optimized by clients
  - 82% of eligible clients offer Automatic Increase
    - 77% as an opt-in solution (only 5.8% of participants opt-into service)
    - 23% as a default (opt-out) solution (70% of participants maintain default)
  - Rate of increase is shifting up – 43% of clients at 2% vs. 1%
  - Majority set ceiling for contribution rates above 20%

Percentage of Participants Saving At, Above, and Below the Plan Default Rate

- 53% ≤ 5%
- 33% >5% ≤ 10%
- 11% >10% ≤ 15%
- 3% ≤ 20%

Source: T. Rowe Price 3/10
## Automatic Increase: Key Lessons

<table>
<thead>
<tr>
<th>Opt-out Rate</th>
<th>Just 15% of participants would opt-out, 85% would remain in the program</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Best Time to Implement</strong></td>
<td>“Future date”; January - synchronize with pay raises</td>
</tr>
<tr>
<td><strong>Annual Incremental Amount</strong></td>
<td>Sign-up rates for 1% and 2% are virtually equal</td>
</tr>
<tr>
<td><strong>Sensitivity to “Cap”</strong></td>
<td>Signup rates are the same with a cap of 10% and 20%</td>
</tr>
</tbody>
</table>

Source: Benartzi (2010)
Summary

- Automatic enrollment and automatic increase can help improve retirement outcomes of all employees by helping them overcome behavioral barriers

- Five Key Opportunities To Improve Employee Savings
  - Utilize opt-out vs. opt-in
  - Adopt automatic enrollment for existing employees
  - Use default savings rate higher than 3% in automatic enrollment
  - Raise auto increase from 1% to 2%
  - Combine auto enrollment and auto increase and use inertia to improve participant behaviors

THANK YOU