

# Deferred Compensation Plan BOARD REPORT 13-38

Date: December 6, 2013  
To: Investments Committee  
From: Staff  
Subject: Developing an Automatic Enrollment Option for the City's Deferred Compensation Plan

*Board of Deferred  
Compensation Administration  
Eugene K. Canzano, Chairperson  
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## Recommendation:

That the Board of Deferred Compensation direct its Plan Governance and Administrative Issues Committee to (a) develop recommendations for creating an Auto Enrollment option within the City's Deferred Compensation Plan; and (b) direct staff to draft and issue correspondence to come from the Board Chairperson to the City Administrative Officer and employee labor organizations advising them that it is in the process of developing an auto enrollment option within the City's Plan.

## Discussion:

At the Board's November 19, 2013 special meeting, staff was asked to return with information related to options for developing an automatic enrollment program for the City's Deferred Compensation Plan. In this report staff will address the following:

- Federal Law and Auto Enrollment
- California Law and Auto Enrollment
- Rationale for Establishing an Auto Enrollment Option
- Designing a "Turn-Key" Auto Enrollment Option
- Key Decision Points for Auto Enrollment
- Recommendations for Further Action

### **(A) Federal Law and Auto Enrollment**

In 2006 the Federal Government passed the Pension Protection Act (PPA). The PPA included provisions encouraging employers to facilitate enrollment in 401(k), 403(b) and 457(b) plans. This concept is known as "auto enrollment" and generally involves automatically placing new employees in an employer's optional retirement savings plan at their beginning eligibility date. **Auto enrollment is not "mandatory enrollment" because employees have the ability to opt out of participating at any time.** Rather, the intent of auto enrollment is to facilitate plan participation and the creation of retirement income security by facilitating the initial enrollment process for new employees.

In addition, the PPA encouraged auto enrollment by providing fiduciary safe harbors for employers subject to the Employees Retirement Income Security Act (ERISA). The PPA also established that automatic enrollment programs are not subject to state wage

withholding restrictions, except that this exemption was not extended to state and local government employers. Thus, plans administered by governmental agencies must still address the question of State law wage withholding limitations if they are contemplating establishing auto enrollment programs.

## **(B) California Law and Auto Enrollment**

The relevant State law language related to wage garnishment can be found in Sections 221 and 224 of the California Labor Code. Section 221 states:

*"Section 221. It shall be unlawful for any employer to collect or receive from an employee any part of wages theretofore paid by said employer to said employee."*

Section 224 states that the sanction of Section 221 does not apply in three circumstances:

- (i) *When the employer is required or empowered so to do by state or federal law or*
- (ii) *When a deduction is expressly authorized in writing by the employee to cover insurance premiums, hospital or medical dues, or other deductions not amounting to a rebate or deduction from the standard wage arrived at by collective bargaining or pursuant to wage agreement or statute, or*
- (iii) *When a deduction to cover health and welfare or pension plan contributions is expressly authorized by a collective bargaining or wage agreement.*

The Board Counsel, Assistant City Attorney Curtis S. Kidder, with the assistance of the City's tax counsel, Donald Wellington at Steptoe and Johnson LLP, reviewed Sections 221 and 224 and determined that, although it is not absolutely clear under those statutes, an auto enrollment program could likely be established so long as it is provided for within a collective bargaining agreement. It should be noted that there is no reported court decision that specifically addresses this issue; however, the scope of Section 224 appears broad enough to include wage deductions for agreed-upon contributions to a deferred compensation account.

It should also be noted that the State Supreme Court's recent ruling that the Labor Code's prevailing wage requirements do not apply to charter cities' public works construction projects raises the issue as to whether other sections of the Labor Code, including Sections 221 and 224, are applicable to charter cities. Regardless, it appears that the most appropriate mechanism for the provision of auto enrollment for represented employees would be within collective bargaining agreements for those labor organizations which would like to provide this program to their members. In addition, it appears that it would be appropriate to have a provision in the Los Angeles Administrative Code for allowing auto enrollment payroll deductions for non-represented employees, since these employees are not part of a collective bargaining agreement.

## **(C) Rationale for Establishing an Auto Enrollment Program**

Based on discussion that occurred at the Board's November 19, 2013 Strategic Planning meeting, there is interest on the part of at least some of the City's labor organization in participating in an auto enrollment program. Auto enrollment has many benefits which have only become more pronounced in the years since the Board originally endorsed the concept. The following is a summary of some of key reasons for establishing an auto enrollment program:

### Increase Participation Rates

There is now ample data indicating that automatic enrollment significantly improves participation rates. Depending upon the case study, participation rates range from 75-95%, even within employee populations where participation rates prior to implementation of auto enrollment averaged 25-45%. Research conducted by behavioral economists Richard Thaler and Shlomo Benartzi indicates that automatic enrollment programs have seen such success because of predictable patterns of human psychology, and that these programs in particular benefit lower-income and other populations who have lower comfort with financial matters. The City has struggled with trying to improve participation rates among lower income employees. The auto enrollment program would allow us to increase participation rates for all employees as well as those groups with traditionally lower participation rates.

### Early Participation – Best Foot Forward

As new retirement tiers (with lower benefits relative to prior tiers) are introduced, the value and importance of participating in the City's Deferred Compensation Plan grows. In addition, the value of participation in the Deferred Compensation Plan at the start of an employee's career with the City has a positive impact on the employees' attainment of retirement savings goals. The objective of all retirement savings plans is to create retirement income security. To the degree that achieving this becomes more challenging within lower-benefit pension tiers, the Deferred Compensation Plan provides opportunities for newer-tier employees to bridge a larger gap between working pay and retirement income security.

Related to this, it's clear that the diversity in the City's workforce in a number of areas is pronounced and likely growing more so. Substantial diversity exists with respect to entry age, length of service, defined benefit plan structure, and post-retirement income needs, to name a few areas. This diversity necessarily implies that a substantial portion of the City's current and future workforce will need a strong balance in their defined contribution plan in order to achieve retirement income security.

### Diversify Retirement Strategy and Increase Financial Options

Contributions to the Deferred Compensation Plan also have value in the area of risk-management, by allowing participants to diversify their retirement assets so that they are not all effectively held with the employer. Section 457 assets are required to be held in trust for the exclusive benefit of Plan participants, and deferred income assets are exclusively the property of each individual account holder.

In addition, as the defined benefit retirement landscape has evolved, so has the defined contribution landscape. Section 457 plans as originally established were fairly restrictive in terms of participant access to funds. But when flexible distribution rules were introduced, retired participants were given a broad range of tools for structuring and modifying the use of their accounts over their retirement years. And for current employees, with the introduction of loan programs, these accounts now function as important resources for any number of important financial objectives during an employee's working career. Borrowed assets can be used to help purchase homes, resolve financial emergencies, and otherwise provide for loans allowing participants to retain interest payments in their accounts rather than pay them to a third party.

#### Streamline and Automate DCP Enrollment Process

The auto enrollment plan feature will allow plan participants to enroll in the plan and begin to utilize online features to modify contribution amounts and investment choices, designate beneficiaries, and begin developing a retirement strategy. Auto enrollment process should also provide for certain efficiencies in the speed and processing of new enrollments.

These factors establish a basis for designing an auto enrollment option in the City's Plan that can be utilized by interested City unions.

#### **(D) Designing a "Turn-Key" Auto Enrollment Option**

Offering an auto enrollment program in the City's Plan requires developing a "turn-key" module that can be utilized by any bargaining unit electing to participate in it. Since all the rules and features of the City's Plan are regulated by its Plan Document, and since the Board has sole authority to create and modify the Plan Document, the Board is responsible for establishing the auto enrollment option and the parameters within which it operates. Individual bargaining units would not be able to modify that program (and by extension the Plan Document) in the collective bargaining process; they may only elect to participate in the auto enrollment program established by the Board within the Plan Document, and determine whether auto enrollment would apply only to new employees who are members of that bargaining unit.

The intent of the auto enrollment option is solely to facilitate participation in the Plan, and does not represent the conferring of a benefit. This is because participation is always optional to each employee. In light of the size and complexity of the City's workforce and payroll systems (DWP and City), and the fact that procedural errors and variations are likely, it will be important to make clear in all relevant authoritative and communication materials that the program is not guaranteed or obligated to enroll every subject employee in every instance.

#### **(E) Key Decision Points for Creating an Auto Enrollment Option**

In December 2006 the Board of Deferred Compensation Administration endorsed the creation, in concept, of an automatic enrollment program for the City's Plan. The Board did not at that time address the various decision points needing to be resolved before the appropriate Plan Document language can be drafted and ultimately adopted.

Major decision points include the following:

- (1) Timing of Initial Participation – Generally an automatic enrollment program can begin as soon as an employee is eligible to contribute to the defined contribution plan. In the City’s case, employees are eligible immediately upon time of hire, but the timing of the first contribution could be impacted by the flexibility of the City’s two payroll systems (City Controller and DWP payroll) in administering the desired rules.
- (2) Opt Out Provision – PPA permits an employee to opt out of the program within 90 days of the first contribution, and to withdraw funds in full without penalty; a number of mechanical details (e.g. how an employee authorizes opting out, and tax reporting of the initial contribution and subsequent distribution) would need to be resolved.
- (3) Default Investment – PPA regulations developed by the Department of Labor offer fiduciary safe harbors for ERISA plans (meaning plans are not liable for investment losses) for default investment selections in what are called Qualified Default Investment Alternative (QDIA) options. The City’s Plan is not governed by ERISA, although the regulations can be considered a guideline. The regulations define QDIAs as including Target Date Funds, Balanced Funds, and Managed Accounts. The City’s Target Risk funds would presumably be included within the definition of “Balanced Funds.” The Stable Value Fund or FDIC-Insured Bank Deposit Savings Account would also presumably be candidates because they offer virtually no risk of investment loss. Important factors to consider for establishing the QDIA include the potential for participant investment losses for those who utilize an opt-out provision within 90 days, vs. longer-term accumulation potential for participants defaulted into a broadly diversified investment fund.
- (4) Default Contribution Amount – Default contributions can be established as a dollar amount or percent of pay. Historically the Deferred Compensation Plan has translated contributions to participants as dollars rather than as a percent of pay. Shifting to a percent of pay model would create additional communications complexity but would more precisely correlate contributions to gross salary and probably result in higher contributions over time. Maintaining the dollar model provides for communications simplicity but is less correlated to income levels and would likely result in relatively lower contributions over time. Shifting to a percent of pay model would also add more complexity to payroll processing. These issues have not yet been explored with either the City Controller or DWP Payroll.
- (5) Default Auto Escalation – Employers can also include a default auto escalation feature which would automatically increase the contribution amount at certain pre-designated intervals. Auto escalation can greatly improve an employee’s accumulation potential. The auto escalation feature would presumably be controlled at the Plan Administrator level (Great-West) rather than payroll system level, because participants modify contribution amounts through the Plan Administrator and then those updates are fed to the City’s payroll system on a bi-weekly basis. However, it has an impact on the payroll systems because the data upload is currently strictly by dollar amount – moving to a percent of pay model would likely require a more complex interface between the Plan Administrator and the City.

- (6) Communication Strategy – How the program is communicated to new participants will be important, including not only information about how to opt out and change contribution amounts or investment allocations, but how to familiarize these individuals with the features and benefits of the Plan and maintain engagement with their accounts over time.

**(F) Recommendations for Further Action**

To move forward, staff recommends that the Board refer to its Plan Governance and Administrative Issues Committee the development of recommendations for creating an Auto Enrollment option within the City’s Deferred Compensation Plan. These recommendations would address the key decision points identified in this report as well as any other issues that may come forward as a result of discussions with the Plan Administrator, City payroll systems, and Board counsel.

In addition, staff recommends that the Board direct staff to draft correspondence to the City Administrative Officer and employee labor organizations advising them that the Board is in the process of developing an auto enrollment option within the City’s Plan.

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