

DEFERRED COMPENSATION PLAN BOARD REPORT 06-42



Date: December 5, 2006

To: Board of Deferred Compensation Administration

From: Staff

Subject: Automatic Enrollment

Recommendation:

That the Board of Deferred Compensation Administration (a) endorse establishment of an auto enrollment program for the City's Deferred Compensation Plan; (b) request a response from the Office of the City Attorney regarding the question of what barriers exist in State law to the City being able to offer auto enrollment; and (c) once a response is received from the City Attorney, direct staff to return to the Board with recommendations for follow-up action.

General Information:

Recently the Board requested that staff return with a report on issues related to the potential implementation of automatic enrollment in the City's Deferred Compensation Plan. This issue has received renewed attention in light of provisions included within the Pension Protection Act of 2006 encouraging employers to offer such programs.

The City's Deferred Compensation Plan has no auto enrollment program currently. Based on staff's analysis, offering such a program would likely require some combination of (a) a change in State law; (b) endorsement by employee labor organizations, potentially including adoption of auto enrollment provisions within employee memoranda of understanding; (c) endorsement by the Board; and (d) revisions to the Deferred Compensation Plan's "Plan document.

However, before discussing what must be done to implement a program, it may be helpful to begin by generally outlining the broad features of what staff believes would constitute a successful auto enrollment program for the City. In general, staff believes that the keys to success are appropriately defining the core philosophy of the program, making the program user-friendly, and providing excellent communications.

POTENTIAL AUTO ENROLLMENT PROGRAM FEATURES

In staff's view, an auto enrollment program offered by the City must avoid being structured as some type of "mandatory" enrollment. Rather, staff believes it is appropriate to approach auto enrollment as a more sophisticated form of voluntary enrollment, in which both participation in the Plan, as well as the ability to opt out, are substantially facilitated by the City and require little effort on the part of the employee. In short, "user-friendliness" would be the guiding principle of

the program, as opposed to proceeding from a paternalistic assumption that “all employees belong in the Plan.”

It is likely that the majority of City employees who do not enroll in the Deferred Compensation Plan simply do not find the time or receive sufficient exposure to the information to allow them to take the affirmative step of enrolling. These individuals might be thought of as *Access Limited Employees*. These types of employees, in looking back from a future vantage point, would typically express regret that they had not enrolled earlier and, in fact, might well have enrolled earlier had they received greater exposure to the Plan.

For *Access Limited Employees*, multiple exposures to the features and benefits of the Plan are often necessary before they are compelled to take action. In staff’s view, it is no accident that the under-enrolled populations in the City family are in work groups that (a) are scattered and thus have fewer opportunities to be exposed to information about the Plan through venues such as group meetings; (b) are unlikely to have been previously exposed to retirement and financial planning concepts; (c) may have language barriers that add to communication challenges in presenting information about the Plan; and (d) lack peer networks to encourage participation. Auto enrollment is a way that the City as plan sponsor can make it easy to overcome barriers to enrollment, rather than placing the entire burden of overcoming them onto the employee.

However, it is equally true that another group of non-enrolled employees have either made decisions, or would make decisions, not to enroll because they find that their financial resources are better directed elsewhere. These individuals might be thought of as *Resource Committed Employees* because they have committed their financial resources elsewhere (to living expenses, debts, alternative savings, or other financial commitments) and, even when fully aware of the benefits of the Plan, would not choose to participate because doing so would be inconsistent with their present goals and needs.

A balanced auto enrollment program focused on user-friendliness could accommodate both groups of employees by having the following key features:

- Auto enrollment at time of hire – Contributions to the Plan beginning immediately after employment will ensure that *Limited Access Employees* are given the assistance in overcoming obstacles to enrollment before years, or even an entire career, goes by. In addition, particularly for those under-enrolled populations which tend to have lower salaries, the Deferred Compensation Plan nest egg functions not only as a retirement supplement but as a financial resource (via the loan program) for major life purchases, expenses, and debt consolidation.
- Communicate Ability to “Opt Out” Immediately – Immediately following employment and participation in the Plan, each participant should be given not only detailed information about the Plan but a convenient means of “opting out” of participating – including, as one example, a user-friendly form and postage-paid envelope. This will ensure that *Resource Committed Employees* have no substantial impediment to declining enrollment should they so choose. Further, should the auto enrollment program include existing employees as well as new hires, a means should be developed to allow them to affirmatively decline participation before a deduction is taken.
- Contributions Based on Dollars, Not Percent – Staff believes that establishing a minimum auto enrollment in dollars, rather than as a percent of pay, is more user-friendly. The City’s Plan has historically operated on a dollar rather than percentage basis, which is helpful

because employees know precisely how much they're contributing. Doing it on a percentage basis requires that employees "do the math," which is an extra step and can lead to confusion. It would also conflict with how contributions are currently designated within the City's payroll systems.

- Establish Minimal Initial Contribution – The minimum auto enrollment amount should be, in staff's view, exceedingly modest (e.g. \$25 per payday). Beyond that initial level, however, Great-West indicates it will soon have an "auto-increase" feature built into its record keeping system. Staff believes it would be ideal to communicate the "auto-increase" program to new participants post-enrollment, providing them with a user-friendly means of signing up to have their deferrals increase by designated amounts on a regular basis (e.g. increase the contribution amount by \$25 annually).
- 90-Day Cash Default – Placing each participant's initial contributions into a cash account ensures that participants who opt out of the Plan will not suffer an investment loss. Following that 90-day period, staff recommends that the funds be moved to one of the Plan's Asset Allocation Funds (e.g. the Moderate Profile Fund) which will provide the vast majority of participants expected to remain enrolled with a well-diversified long-term investment.
- Fast Refund of Auto Contributions – The Plan should promptly issue full refunds to individuals who choose to opt out, so that they do not face a lengthy separation from those funds.

ISSUES AFFECTING IMPLEMENTATION

Board Endorsement – As a threshold action, the Board would need to take a position in support of auto enrollment. As the governing authority for the Plan, the Board is the City's subject matter expert and would likely need to identify the matter as a priority in order to begin building momentum towards establishing a program.

State Law - The Pension Protection Act provides certain guidelines and safe harbors for structuring an auto enrollment program. The Act further preempts any state laws prohibiting implementation of an automatic enrollment arrangement, but this preemption only applies to plans governed by ERISA, not to governmental plans such as the City's Deferred Compensation Plan.

Staff is aware informally that the State of California has payroll laws in effect requiring an employee signature prior to a deduction being taken from that employee's paycheck. As a result, it appears that State law represents a significant barrier to the City offering an auto enrollment program, at least one that would include current employees (for new employees, it may be possible to obtain written authorization by including information about auto enrollment on the employment application). However, the City Attorney's Office has not issued a finding with respect to this matter, and staff believes it would be prudent to issue a formal request from the Board to the City Attorney requesting a response to the question of what specific barriers exist in State law to the City being able to offer an auto enrollment program.

Labor Endorsement – Staff believes it is essential to seek and obtain labor's endorsement of an auto enrollment program as a prerequisite to establishing a program. It is unclear at this point whether codification of such an endorsement would or should take the form of explicit language within MOUs or a change to the Administrative Code provisions governing the Plan.

Irrespective of this, however, the first steps would presumably involve outreach to employee labor organizations providing information about auto enrollment and inviting their feedback.

Plan Document Changes – Once State law and employee relations issues have been resolved, the Board would need to revise its Plan document to include auto enrollment provisions. However, this step would be relatively easy because the Board directly controls the language in the Plan Document.

RATIONALE FOR ENDORSING AUTO ENROLLMENT

Staff is prepared to recommend in favor of the Board endorsing auto enrollment for the following reasons:

- (1) Meeting Needs of Diverse Workforce - If properly constructed, an auto enrollment program can meet the needs of *both Limited Access Employees* as well as *Resource Limited Employees* – in effect, facilitating enrollment for those who have been disadvantaged from enrolling without operating as a mandatory program for those who do not wish to participate.
- (2) Meeting Needs of Aging/Transitory Workforce – The age of the City’s average new-hires has been climbing (currently 45), meaning many of these individuals are likely to retire with substantially less than 65% of pay; further, a majority of City employees (55%) separate service without being vested, meaning they will collect no meaningful retirement benefit from the City. These statistics suggest that the City’s defined benefit plans cannot function as the only, or even primary, source of retirement security for these employees. Auto enrollment will generate a secondary source of asset accumulation for an aging and transitory workforce that is clearly going to need it.
- (3) Leader in Governmental Plans - Given the strong encouragement of auto enrollment programs by the federal government, staff believes it is likely that these programs will become the rule, rather than the exception, for governmental plans going forward – acting now allows the City of Los Angeles to be a leader among its peers.

Given these reasons, staff recommends that the Board endorse auto enrollment and direct staff to prepare a communication to the City Attorney seeking a finding with respect to barriers to auto enrollment which may exist in State law. Once this information is received, staff should be directed to return with additional recommendations for follow-up action.

Submitted by: _____
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