For several reasons—including heightened concern about employees' retirement readiness and participation by minority and lower income workers—automatic enrollment in 401(k) and similar plans is picking up speed.

The Case for Automatic Enrollment—Stronger Than Ever in 2011

by | **David C. John**

Automatic enrollment, where employees participate in a 401(k) or similar retirement plan unless they opt out, continues to be a top benefits trend. Almost 40% of all companies that offer a 401(k)-type plan have adopted automatic enrollment—a dramatic increase from 2006, when only 24% of companies had done so according to the latest survey by the Profit Sharing/401(k) Council of America (PSCA).[1]

Among plans with more than 5,000 employees, over half (53.7%) have an automatic enrollment feature. Furthermore, a recent AARP survey on employer attitudes about automatic 401(k) plans found more than a third of employers that offer automatic enrollment enroll all employees, an emerging best practice.[2]

Recent economic indicators show an economy in recovery mode, prompting companies to reestablish 401(k) matches and consider hiring new employees. With

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retirement security more fragile than ever, it is an opportune time to consider automatically enrolling new and existing employees in an organization's retirement savings plan.

The decisive argument for automatic enrollment is that it results in higher participation rates, as well as creating the potential for bigger retirement nest eggs for employees. Research shows that automatic enrollment can raise participation rates to 85% or more, making it one of the simplest things employers can do to help employees save for retirement.[3]

An analysis of 401(k) plans by Charles Schwab found companies that automatically enroll employees had a 15% higher participation rate in 2009 than those that did not offer it (88% versus 73%).[4] Not only that, but automatic enrollment helped keep people participating in the midst of turbulent economic conditions. Plans conducting automatic enrollment experienced a 13% increase in participation from 2005 to 2009, compared to a 1% decrease among plans without it.

A growing number of companies are combining automatic enrollment with automatic deferral rate increases. Almost 40% of automatic enrollment plans also automatically increase the default deferral percentage over time, according to PSCA. A recent study by Callan Associates found similar results.[5] Automatic deferral escalation jumped from 33.8% in 2009 to 46.2% in 2010. This annual "booster shot" helps build savings—and according to a recent analysis by Charles Schwab, 83% of participants enrolled in an automatic savings program remained at the increased contribution rate a year after enrollment.[6]

Employee Reaction to Auto

How do employees feel about being automatically enrolled? Surveys show that nearly all companies using automatic enrollment are satisfied with it—and so are as many as 98% of their employees.

Company fears that employees will react negatively to automatic enrollment and other autofeatures are not only unfounded—they appear to be just plain wrong. Prudential's 2010 report, "The New Economic Reality and the Workplace Retirement Plan," paints a picture of a workforce craving a simpler and more automatic way to save.[7] When asked if investors felt a fully automatic workplace retirement savings plan could have helped them better weather the 2008-2009 financial crisis, roughly 70% of respondents indicated they would be pleased if their employers had automatically enrolled them in one. And 60% would be pleased if their employers provided a fully automated retirement savings plan. In fact, more than half (54%) of respondents believe that they would have better survived the financial crisis if their employers offered savings plans designed with the entire suite of automatic features.

Being on "autopilot" is actually viewed as a new and improved way to save for retirement. A vast majority of respondents to the Prudential study (85%) felt that a fully automated workplace retirement plan represents a new and different approach to save for retirement. And 65% felt an automatic approach was "an improved and modernized" workplace retirement savings plan.

Passing the Test

Automatic enrollment is especially effective in bolstering participation of minority and moderate-income employees, who tend to be less likely to participate in a company retire-

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ment plan. Participation of moderate- and lower income workers is crucial to improving a company's performance under 401(k) nondiscrimination tests, therefore allowing senior executives to save more for retirement.

Nondiscrimination tests aim to ensure that tax-preferred retirement savings plans benefit employees of all income levels, not just highly compensated executives. If a company does not perform satisfactorily on the tests, it is required to reduce the amount of executives' tax-favored contributions or make special employer contributions for non-highly paid employees. In the AARP study, almost half said it's easier to pass nondiscrimination testing with these features, keeping intact the ability of senior executives to save the maximum amount for retirement.

Indeed, a key way to improve a company's performance on nondiscrimination tests is to either begin automatic enrollment at a higher rate (5% or 6%, for example), steadily escalate the automatic contribution level (typically 1% a year), or both. The Pension Protection Act of 2006 (PPA) included a nondiscrimination safe harbor for companies that meet its employer contribution and other conditions. Companies that qualify can avoid nondiscrimination (and "top-heavy") testing altogether.

Computing the Cost

It is hard to justify any additional costs in difficult business conditions, but adding automatic features to a company's retirement savings plan may be an exception. For one thing, the actual cost may be much lower than expected. And because employees like both automatic enrollment and automatic escalation, the returns in the form of keeping valued employees may be high. Also, an employer match is more flexible and can be increased, decreased or even temporarily suspended depending on business conditions.

The cost of implementing automatic 401(k) plans is usually modest, in part due to the average determined contribution rate most employers opt for. According to PSCA survey data, almost 60% of plans automatically enroll new participants at an automatic contribution rate of 3% of pay, less than the full potentially matchable contribution. Also, the majority of current employees that begin contributing after they are automatically enrolled tend to be lower earning employees. This means that the additional cost of an employer match per employee should be lower than it is for those who were already participating in the 401(k) plan.

To further offset the costs of additional participants, companies can implement their automatic enrollment plans only for new employees, therefore gradually increasing the participant rate as new employees filter into the company. Firms are in full compliance with antidiscrimination tests (which determines when higher paid employees can make full use of their tax-favored savings limits) only when both new hires and existing employees are automatically enrolled, but phasing in the process is a way to stretch out costs.

Case Study

Companies of all shapes and sizes

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takeaways >>

- Automatic enrollment results in higher participation rates—especially of minority and moderate-income employees—and the potential for bigger retirement nest eggs.
- A key to improving performance on nondiscrimination tests is to either begin automatic enrollment at a higher rate (e.g., 5% or 6%), steadily escalate the automatic contribution level (typically 1% a year), or both.
- Automatic enrollment and other automatic features must comply with government regulations—such as the PPA requirement that plans give employees the option to revoke enrollment within 90 days and get their money back with no tax penalty.

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by Steven J. Franz, Lisa R. Richardson, Joan C. McDonagh and Marilyn R. Collister. Aspen Publishers. 2011.

For more details, visit *www.ifebp.org/books.asp?8862.*

have experienced success in boosting 401(k) plan participation and passing nondiscrimination tests by adopting automatic enrollment. The Mandarin Oriental Hotel Group, an operator of luxury hotels around the world, had just a 40% enrollment rate in its 401(k) plan in 2006. To boost enrollment rates and ensure all locations passed annual discrimination testing, the company adopted automatic enrollment of all employees, not just new hires, at a 3% salary deferral rate. In only two months, enrollment increased from 40% to 86%, and Mandarin Oriental passed nondiscrimination tests at all locations. The group believes both results helped it to retain valuable employees.

Playing by the Rules

As with any important employee benefit, it is vital that automatic enrollment and other automatic features be implemented in accordance with all appropriate government regulations. For instance, PPA requires plans give automatically enrolled employees the option to revoke the enrollment within 90 days and get their money back with no tax penalty. While PPA helps protect sponsors from increased fiduciary liability, this relief comes when plan sponsors use specific diversified default investments dubbed *qualified default investment alternatives (QDIAs),* which include *balanced funds* (a type of mutual fund with a relatively fixed allocation of stocks, bonds and sometimes a money market component), lifecycle or target-date funds, and managed accounts.

Companies seeking to implement automatic features should consult a plan vendor that supports them. For small and midsize employers, it may be important to find a provider that will offer a turnkey approach. Choosing a service provider for a plan is a fiduciary action, so employers need to undertake any provider-related decision with great care.

The U.S. Department of Labor (DOL) offers numerous resources to help companies automate their retirement plans in compliance with government regulations. Helpful publications include *Automatic Enrollment Plans for Small Business,*[8] a joint project of DOL's Employee Benefits Security Administration (EBSA) and the Internal Revenue Service, and EBSA's *Meeting Your Fiduciary Responsibilities.*[9] Retirement Made Simpler™, a coalition that includes AARP, the Financial Industry Regulatory Authority (FINRA) and the Retirement Security Project, provides a comprehensive set of resources at www.retirementmadesimpler.org, including the latest automatic-related news and research, and both an *Automatic 401(k) Toolkit* and *Automatic 403(b) Toolkit.*

Automatic plan elements hold real promise for improving the retirement prospects of the modern employee. Automatic enrollment of new and existing employees—combined with best practices such as automatic escalation—are design features that can be a powerful source of retirement income security for the 21st century.

Endnotes

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