

the Pension Studio

Automatic Enrollment

The concept of automatic enrollment is becoming more and more appealing to Plan Sponsors. Automatic enrollment is essentially the opposite of conventional enrollment where employees do not make any contributions to their company's 401(k) plan until they submit instructions. Automatic enrollment allows the employer to automatically enroll employees into its 401(k) Plan at specified contributions and investment percentages immediately upon hire or upon meeting eligibility requirements. Typically, the rate of deferral is 3% to 4%.

With all employees contributing (at least upon their initial eligibility), the plan will likely produce more favorable nondiscrimination test results. Meanwhile, employees may come to appreciate that salary deferrals are an easy way to save for retirement, without having a significant effect on take home pay.

Some of the advantages associated with automatic enrollment:

For the Plan: improved nondiscrimination test results – Since participation rates are higher, the ADP test results are typically better thus allowing the HCE employees to defer more money into the plan.

For the Employee: immediate savings on hire or meeting eligibility requirements. Inertia dominates human actions, thus by making enrollment easier many employees will simply join and remain in the plan.

For the Employee: immediate appreciation of the convenience of payroll deductions. The federal government learned this years ago when designing our tax system. If money is taken out before we see it we don't miss it (as much).

Some of the cons:

Potential employee confusion over default percentages and the ability to make changes.

Increased administration expenses with more participants

Uncertainty over appropriateness of default investment options.

More and more plans have automatic enrollment including some very large plans such as JC Penny, Vanguard Group, and Principal Financial Group. In light of the concern over the federally funded retirement program, Social Security combined with the need for increased savings we expect to see more and more companies headed in this direction. Below is an interesting chart illustrating the increased savings rates among typical worker when offered an employer sponsored plan.

The Pension Protection Act of 2006(PPA) has provided clarification for Employers who wish to adopt the automatic enrollment provisions into their plans. The PPA provides basic stipulations for Automatic Enrollment as well as a Safe Harbor provisions. These provisions will generally be for plan years beginning after December 31, 2007.

Automatic Enrollment Safe Harbor Stipulations:

- 1) Each eligible employee should be automatically enrolled as if they elected to make deferrals. However they can not exceed 10% of compensation but must satisfy the following requirements: 3% of compensation the first year; 4% of compensation the second year; 5% the third year and 6% thereafter. Employees will always have the right to opt out or to change the amount of deferral.

- 2) The plan must give a matching contribution on behalf of each non-highly compensated employee of 100% on deferrals up to 1% of compensation, plus 50% on deferrals over 1% but less than 6% of compensation. Or if the employer wishes, this matching contribution can be substituted with a 3% non-elective contribution.
- 3) There will be a vesting requirement that after 2 years the employee becomes 100% vested.
- 4) By adopting the Automatic Enrollment Safe Harbor provisions the plan will be deemed to satisfy the ADP/ACP tests will also meet Top-Heavy requirements, if certain conditions are met.

There are also some general stipulations for Employers who do not wish to adopt the Automatic Enrollment Safe Harbor but want to participate in Automatic Enrollment. They are as follows:

General Automatic Enrollment Stipulations

- 1) An employee notice will be required. This notice should discuss the employee's right to opt out how to change their current deferral amounts. It should also state the default investment should the participant not give investment direction. The department of labor will produce guidelines for these default fund provisions within about six months.
- 2) For up to 90 days, an employee can withdraw the contributions and related earnings due to Automatic Enrollment. These will be penalty free but income tax will be owed on the money.
- 3) Plans that offer Automatic Enrollment are granted an extension of the corrective distribution period. For plans subject to ADP/ACP testing, corrective distributions can be made up to six months after the end of the plan year without any penalties. (Note: current law only allows 2 ½ months for corrective distribution to be penalty free)
- 4) ERISA will pre-exempt state withholding laws provided the annual notice requirement and DOL guidelines are met.

Effectiveness of Employer Plans

Savings rates of people with incomes of \$30k - \$50 covered by an Employer Sponsored Plan as compared to those not covered by an Employer Plan. Source Employee Benefits Research Institute (203).

