

Automatic Enrollment Is the Future of 401(k) and 403(b) Plans

One of the most important developments in the history of U.S. retirement plans continues to unfold and will keep getting more interesting in the months ahead. Called “automatic enrollment,” it creates a compelling need among 401(k) plans for services.

It will create two attractive “safe harbors” that can free plans and their fiduciaries from cumbersome discrimination tests, top-heavy rules and investment liabilities. Under federal law enacted in August ‘07, a new structure-of-choice has been defined for “**Qualified Automatic Contribution Arrangements**” (QACAs).

If any retirement plan idea has ever been “all-American apple pie,” it is this one. Congress, the Department of Labor, and almost every leading trade association agree that QACAs are the right medicine for America’s sagging personal savings rate and “retirement readiness” problems.

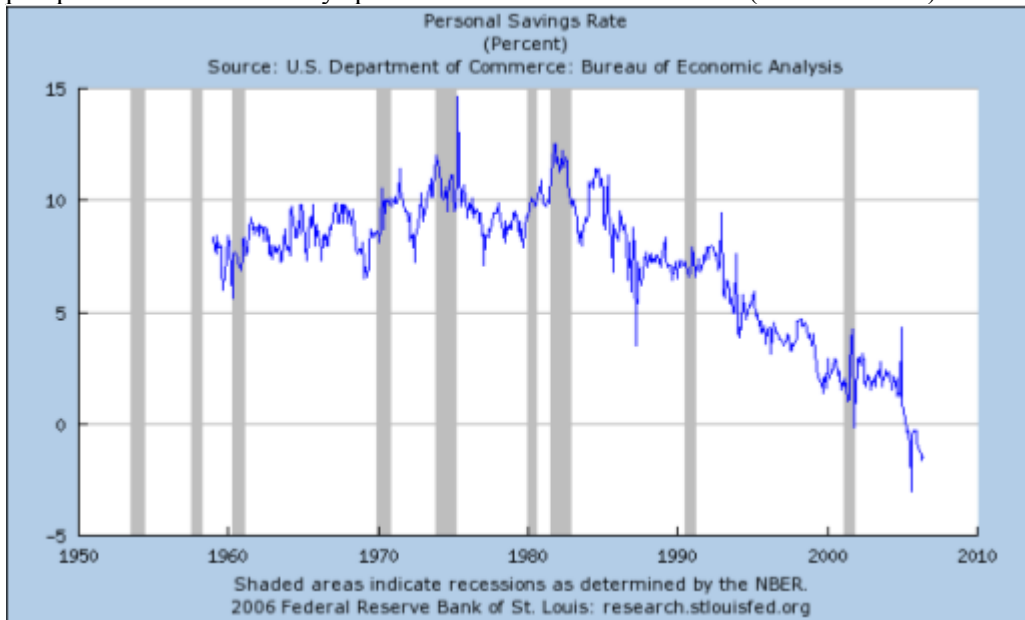
Note: On September 27, 2007 the U.S. Department of Labor issued proposed regulations that would clarify acceptable “default” investment choices under QACAs. The full text of the proposed regulation may be downloaded here:

<http://www.dol.gov/ebsa/regs/fedreg/proposed/2006008282.pdf>

What is Automatic Enrollment?

Automatic enrollment began as a small idea that keeps getting bigger, because it is increasingly seen as the solution to a huge national problem.

For the past decade, the U.S. personal savings rate has been plummeting. From the 1960s through the mid 1990s, Americans saved on average a steady 5% to 10% of their pay, according to the Federal Reserve. But from the mid-1990s through early 2005, the U.S. savings rate descended from about 5% to zero. Since April of 2005, the rate has been negative every single month. This is perhaps the most dismal macro-economic statistic of modern times, because no nation can prosper when it consistently spends all the income that it earns (and then some).



<http://research.stlouisfed.org/fred2/series/PSAVERT/112>

There is only one bright spot in the U.S. savings picture – participant-directed retirement plans. In 2005, the EBRI / Investment Company Institute (ICI) Participant-Directed Retirement Plan Data Collection project estimated that 43 million Americans held \$2.1 trillion in 460,000 employer-sponsored 401(k) plans. The average account balance among those with at least five years of participation increased from \$60,926 to \$91,042 over just two years. Other statistics indicate that the average plan balance has since grown to well above \$100,000.

However, even in 401(k) plans, there is a savings disparity. Nationally, 73% of all workers eligible for these plans participate through elective deferrals or employer contributions (or both), yet among younger and lower-paid workers, participation drops sharply. For example, PlanSponsor.com has reported participation rates of just 37% among the lowest-paid cohort of workers in their 20s, and 47% among the lowest-paid workers in their 30s. Anecdotal evidence suggests that many younger and lower-paid workers feel too overwhelmed by complexities and financial pressures to enroll in plans, even when employers offer attractive matching contributions.

The essential force behind automatic enrollment is inertia. Each participant's active enrollment choice isn't necessary, because all employees automatically begin making deferrals and receiving any matching contributions as soon as they become eligible.

A Decade of Favorable Rulings:

Over the past decade, automatic enrollment has steadily gained support as a solution to the U.S. savings debacle and plan participation disparity. Two Department of Labor Advisory opinions in the mid-90s (94-27A and 96-01) paved the way by allowing ERISA to preempt New York and Puerto Rican wage withholding restrictions. In 1998, an IRS revenue ruling (98-30) defined an acceptable arrangement as one with at least a 3% "default deferral rate." In subsequent revenue rulings, the IRS approved automatic enrollment for current workers (as well as new hires) and also authorized the use of this concept in 403(b) and 457(b) plans.

- In a basic automatic enrollment program, every eligible worker becomes a plan participant and a default deferral rate (typically 3%) is deducted from pay and diverted into the plan. To hold this money, plan trustees must choose a "default investment option," which traditionally has been a stable value or money market fund (we'll consider a balanced fund for greater diversification). Adopting automatic enrollment can have two important advantages for plans: 1) It increases participation rates; and 2) It can improve non-discrimination test results, which in turn allow Highly Compensated Employees (HCEs) to defer more money.

According to a 2006 survey by Hewitt Associates, 25% of large 401(k) plans reported that they already had adopted automatic enrollment, and another 23% said they were considering adoption in 2006. The main drawback to increased acceptance has been the lack of a "safe harbor" from fiduciary responsibility for the default investment choice. In other words, if a plan selects a more aggressive default investment choice than a money market or stable value fund and a participant loses money, plan fiduciaries can be held personally liable. This liability currently exists even in plans that have adopted 404(c) protections for investment choices made by participants.

How to Eliminate "Safe Harbor" Confusion

The Pension Protection Act of 2006 has created an important new safe harbor connected to automatic enrollment, but it is different than the one described above. The existence of two separate "safe harbor" concepts is sure to create confusion in the market.

Safe Harbor #1

As defined in the new law, this is a structure for a QACA, which is effectively a new type of participant-directed retirement plan. When 401(k) or 403(b) plans follow the law's template for automatic enrollment, employer contributions, and participant notification, they can become permanently exempt from non-discrimination tests (ADP/ACP) and top-heavy requirements while also enjoying more favorable vesting requirements than in an existing 401(k) safe harbor.

The table below compares the Pension Protection Act's QACA safe harbor, which will take effect on January 1, 2008, with the 401(k) safe harbor currently in effect (available since 1999).

Feature	QACA	Current 401(k) Safe Harbor
The safe harbor provides relief from...	ADP/ACP and top-heavy rules.	ADP in all cases; ACP and top-heavy requirements vary with employer contribution methods.*
Vesting of employer contributions	May be delayed up to two years (cliff).	Must be immediate and 100%.
Employer non-elective contributions **	3% of compensation for each non-highly compensated employee.	3% of compensation for each non-highly compensated employee.
Employer matching contributions **	100% up to 1% of salary; 50% from 1% to 6%.	100% up to 3% of salary; 50% from 3% to 5%.
Restrictions on matching	Not more than 6%.	Not more than 6%.
Employee notification	Before the employee becomes eligible to participate in the QACA.***	At least 30 days prior to the start of each plan year.
Employees who must be covered	Those hired after adoption of the QACA.	All eligible employees.
Automatic enrollment	Is required at a minimum of 3% in the first year, increasing to 6% through year four.	Is not required.

* A 403(b) plan is subject to ACP testing but not ADP testing or top-heavy rules. Some 403(b) plans currently can qualify for safe harbor protection from ACP testing.

** The employer may choose to make either a non-elective or a matching contribution.

*** *Annual* notification is required of the default investment choice and opportunity to "opt out."

The current 401(k) safe harbor has been a niche solution, at best, because it is complex for plan sponsors to understand and adopt. It requires an election to use the safe harbor each year (prior to December 1 of the previous year), with timely annual notification made in advance to all non-highly compensated participants. In some cases, it has been difficult for plans to implement an affordable matching arrangement that provides relief from ACP/ADP non-discrimination tests and top-heavy rules.

○ The primary market for the new QACA safe harbor includes manufacturing, retail, food-service, and temporary employment services with large numbers of younger and lower-paid workers and fairly high job turnover. In such companies, HCEs often are precluded from meaningful plan participation by non-discrimination tests and top-heavy rules. Also, the immediate 100% vesting requirement of the existing safe harbor has made matching expensive for such companies, while creating no incentive for worker retention.

- The new QACA structure is far more favorable for such companies. For example, the maximum QACA annual matching contribution - assuming that every worker participates and defers 6% of salary - is 3.5% of salary. But workers are not required to be enrolled in the QACA until completing one year of service, and up to two additional years may be required for employer contributions to be vested.
- If only a fraction of the work force stays employed for three full years (and forfeitures are subsequently used to make matching contributions), the matching cost could easily be below 1% of compensation for rank-and-file workers. Yet the employer would be allowed to contribute 3.5% of pay for all HCEs while enjoying freedom from non-discrimination tests and top-heavy rules. Also, all HCEs could defer up to the maximum allowed. If the company elects to include in the QACA only those employees hired after its adoption, the matching cost could be lower yet.

The Pension Protection Act of 2006 has defined how automatic enrollment plans will be structured in the future. Ever since Revenue Ruling 98-30 specified a minimum 3% default deferral rate, the number has stuck as a standard. Some employees who were automatically enrolled at 3% years ago are still deferring at that rate today. However, Congress and the Department of Labor now recognize that a flat 3% deferral is not enough to provide future retirement security, and they have responded by including a concept called “auto deferral step-up” in the new law. To qualify as a QACA, the plan must begin with a deferral rate of 3% in the first year (but not more than 10%) and then defer at least 4% in the second year, 5% in the third year, and 6% in the fourth year and after. (At any time, a participant may opt out of the QACA by choosing a lower deferral rate). It is a good bet that the majority of 401(k) plans in the U.S. will soon adopt an “auto deferral step-up” QACA structure. Recordkeepers and turnkey plan providers will encourage this design to simplify systems and choices.

The 2006 legislation has further encouraged adoption of the QACA template by confirming that ERISA preempts all state laws in this area and by allowing corrective distributions of both employee deferrals and employer excess contributions, when required for safe harbor compliance purposes. The ERISA preemption is effective immediately and apparently opens the door to QACAs in states such as California, where wage withholding law restrictions have been greatest.

Safe Harbor #2

The developments described above leave one remaining impediment in the way of massive adoption of QACAs - a regulatory safe harbor that protects plan fiduciaries when they select an appropriate default investment choice. The new law mandates that the Department of Labor must establish final regulations that include default investment choices under Section 404[c] fiduciary protections not later than six months after enactment, provided that affected participants are given adequate notice. Preliminary regulations were published in late September.

In essence, the proposed regulations recognize two key points that are becoming widely accepted by policymakers: 1) Inertia is a powerful force, and many participants tend to stay in their original plan investment choice for years; and 2) Money market and stable value funds are not the most suitable default choices for accumulating enough assets to meet retirement goals.

In written comments to the Department of Labor made a year ago, the Investment Company Institute (ICI) argued for a regulation that will include as default investments options that: 1) are intended to provide broad diversification across a range of asset classes (i.e., balanced and asset allocation funds); and 2) target date or lifestyle funds.

○ The proposed DOL regulations issued last September would require that participants receive notice "within a reasonable period of time of at least 30 days in advance" of the first automatic deferral investment and annually thereafter. Also, the participant must be allowed to transfer money out of the default investment choice into another choice without financial penalty. The default investment chosen must be managed by an investment manager or investment company. It must be diversified so as to minimize the potential for large losses. And it must be one of three types of products: 1) target date ("life cycle"); 2) balanced funds; or 3) managed accounts.

While notice of the QACA automatic deferral percentage must be made just once (at first eligibility), the notice of a default investment choice must be made annually, before the start of each plan year, in a format specified under tax code section 401(k)(12)(D). All affected employees must have adequate time and information to "opt out" of this choice annually, if they wish.

Even in a QACA, it will be a good idea to invite all new hires to an enrollment meeting, at which retirement savings can be emphasized and all options explained. If participants then choose to do nothing, they will at least have had exposure to professional financial guidance. And by default, they will begin making steady progress toward retirement goals.