

Automatic 403(b) Basics

What You Need to Know

Elements of an Automatic 403(b) Plan

An automatic 403(b) plan automatically enrolls employees at a set contribution rate. It requires no initial action by employees. They are in the plan unless they opt out. In an automatic plan, contributions go into a pre-selected investment fund. Also, employers may set contributions to increase automatically each year.

Automatic arrangements have taken the 401(k) world by storm, and organizations offering 403(b) plans are focusing on them as well. The passage of the Pension Protection Act (PPA) and resulting regulatory guidance has led 40 percent of all 401(k) plan sponsors to institute automatic plan features.¹ While take-up among 403(b) plans has been slower, at 16.5 percent,² there is growing interest in implementing best practices with respect to automatic retirement plan features. Like their 401(k) counterparts, 403(b)s can be automated in a number of ways.

Automatic Enrollment

When it comes to savings behavior, employee inertia is well-documented. Too many employees just don't get around to signing up for the plan. With automatic enrollment, they don't have to. The plan sponsor simply enrolls employees automatically at a set deferral rate. Employees participate in the plan unless they decide to opt-out.

This relatively simple solution can result in remarkable participation gains. A study of 401(k) plans by Vanguard showed a 41 percent increase in participation by new employees in plans that adopted automatic enrollment (86 percent versus 45 percent).³ Other studies show similar findings and suggest that the experiences in the 401(k) world are likely to be replicated with 403(b) plans.

When plan sponsors first tested the waters of automatic enrollment back in the late 1990s, they focused their efforts on new hires. Since then, sponsors have learned the benefits of annual "reenrollment" to increase participation rates across all employees. Surveys and other evidence confirm that opt-out rates are low and employee response is positive.

¹ PSCA, *52nd Annual Survey of Profit Sharing and 401(k) Plans*. September 2009.

² PSCA, *403(b) Plan Survey*. 2008.

³ Vanguard. *Measuring the Effectiveness of Automatic Enrollment*. December 2007.



Lessons Learned

- Employee response to automatic enrollment is extremely positive.
- Applying automatic enrollment to existing employees as well as new hires results in higher participation gains.

Automatic Contribution Increases

Even though early adopters were pleased with participation gains, some of them discovered an unintended consequence. The same inertia that kept employees from enrolling in the plan was keeping them from changing the default deferral rate. Sponsors had set the rates low (typically 3 percent of pay). But, average contribution rates were not as high as they could be because employees who would have signed up on their own at higher rates were staying at the lower default rate.

The answer? Automatically increase the deferral rate each year. (For example, an employee's automatic contribution rate could increase by 1 or 2 percent each year the employee stays with the organization, or each time the employee gets a raise.) Again, employees can opt-out, but most don't. If the plan does not provide automatic annual increases for all employees, it could allow employees to sign up for them.

Also, plan sponsors have increasingly been setting the initial deferral rate at a higher percentage of pay (as opposed to only 3 percent, for example). Some set it to align with employer matching contributions. Surveys suggest that employees tend to find higher deferral rates acceptable.⁴

Lessons Learned

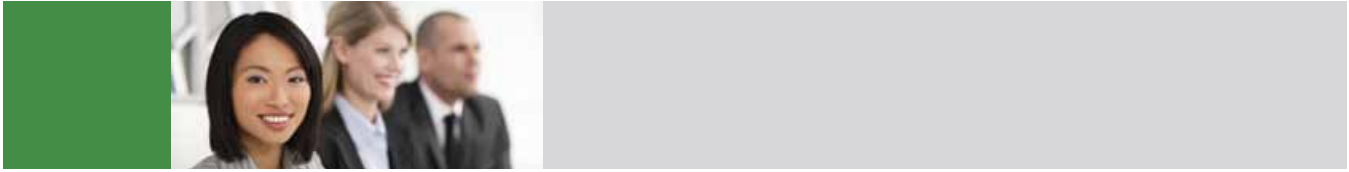
- Don't fear a higher initial deferral rate. Consider setting it at the maximum percentage of employee contributions that you match.
- Set the deferral rate to increase automatically each year.

Automatic Investment

When adopting automatic enrollment, plan sponsors select a default investment. This is an important feature. Many participants will simply remain in the default investment rather than make their own selection.

Early on, many plan sponsors took a cautious approach, opting for principal preservation (money market or stable value funds, for example). They were concerned about fiduciary liability—participant lawsuits over investment losses if, for example, the employer selected a default investment that involved stocks, and if the stock market declined.

⁴ T. Rowe Price. *Best Practices for a Better Retirement Plan: The Case for Automated Services*. 2006.



Today, many sponsors are concerned about employees who stay parked in a low-risk default fund for many years. The U.S. Department of Labor (DOL) expressed a similar theme when it released plan investment regulations. The DOL pointed out that, over long time horizons, diversified portfolios containing equities have historically generated higher returns than those composed only of fixed-income investments.⁵ This, plus new protections for fiduciaries under the PPA have encouraged many recent automatic enrollment adopters to select equity-based default investments rather than principal preservation funds.

Lessons Learned

- A low-return default investment can be high-risk for retirement income adequacy if employees stay in it for many years.
- Many sponsors now favor diversified default investments over principal preservation funds.

Automatic Plan Types

It is possible to set up a basic automatic 403(b) plan to communicate to employees that they will be automatically enrolled in the plan unless they elect otherwise. Also, employees must be notified of the specific percentage of their wages that will be automatically deducted from each paycheck for contribution to the plan. The document must also explain that employees have the right to elect not to have salary deferrals withheld or to elect a different percentage.⁶

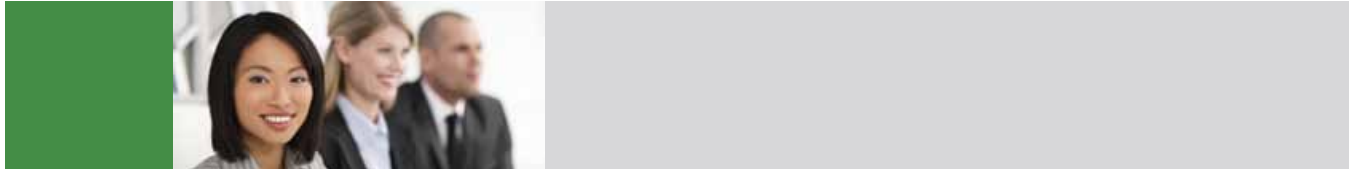
PPA and ensuing regulations created two types of automatic contribution arrangements. The first is an Eligible Automatic Contribution Arrangement, or EACA. An EACA plan is an automatic plan that meets Employee Retirement Income Security Act requirements related to the investment fund a plan sponsor selects for depositing automatic contributions. An EACA may permit employees to withdraw contributions penalty-free within a 90-day window.

The second is a safe harbor plan, called a Qualified Automatic Contribution Arrangement, or QACA. These plans conform to deferral, matching, and vesting rules that relieve employers of nondiscrimination testing. A QACA can also be an EACA, but is not required to be.

With respect to selection of a default investment, PPA and related DOL regulations provide fiduciary relief to plan sponsors that default participants into a qualified investment fund. If a participant does not make an explicit investment decision, plan sponsors can invest assets in a “Qualified Default Investment Alternative,” or QDIA.

⁵ U.S. Department of Labor. *Default Investment Alternatives Under Participant-Directed Individual Account Plans; Final Rule*, 72 Federal Register Reg. 60452, 60470. Oct. 24, 2007.

⁶ U.S. Department of Labor, Employee Benefits Security Administration, *401(k) Plans Supplement, Adopting a Written Plan*, www.dol.gov/ebsa/publications/401kplans-supplement.html#section1



When plan fiduciaries adopt a QDIA as the default, they are generally not liable for investment losses, as long as they meet notification requirements: employers must provide employees notice in advance of the first investment of automatic contributions and yearly, thereafter.

As noted earlier, an automatic plan that meets the rules surrounding QDIAs is an EACA. An optional feature of the EACA allows employers to permit penalty-free contribution withdrawals within a 90-day window.

So what is a QDIA? Final regulations from the DOL identify them as lifecycle funds (often called target retirement date funds), balanced funds or managed accounts. The final regulations also permit initial contributions to go into a capital preservation fund, but all of these contributions must be transferred into another QDIA within 120 days of deposit.

According to a survey of 403(b) plans, 30 percent of plans currently use a money market or similar capital preservation account for all default investments.⁷ So this rule is important to all 403(b) plan fiduciaries, regardless of whether the plans are traditional or automatic.

Lessons Learned

- Take advantage of fiduciary relief by adopting a QDIA as the default investment.
- The majority of Automatic 401(k) Plan sponsors use a target retirement date fund for the QDIA.

QACA Plans Eliminate Testing

As noted earlier, IRS regulations established a plan design option, the QACA, to provide a safe harbor from nondiscrimination testing. Under a QACA, the automatic plan must meet certain employee and matching contribution rules, vesting requirements, and notification rules. Specifically:

- Employee contributions must start at no less than 3 percent in year one, rising to at least 4 percent in year two, 5 percent in year three, and at least 6 percent in year four and beyond. The maximum is 10 percent.
- An employer matches 100 percent of the first 1 percent of pay and 50 percent from there up to a maximum of 6 percent. As an alternative, the employer can provide a 3 percent non-elective contribution.
- The vesting period on employer contributions must be two years or less.
- Employees must receive required notices regarding the right to opt out, to elect a different deferral rate and investment selection and an explanation of the default investment.

⁷ PSCA, *403(b) Plan Survey*. 2009.



To avoid administering the step increases within the QACA rules, employers may choose to set the initial deferral rate at 6 percent.

Adopting a QACA eliminates nondiscrimination testing.

Employee Notification Requirements

Both the IRS and the DOL require employers to notify eligible employees about the plan and its characteristics when automatic enrollment first occurs, and annually thereafter. The two agencies concur that employers can combine the required information into a single notice. (For a detailed overview of notice requirements, see “Automatic 403(b) Notification Rules.”)

The notice needs to inform employees of the circumstances under which automatic enrollment will occur, when and at what percentage of pay. It must state vesting rules, the employer matching formula and identify the default investment fund. If the plan is an EACA, the notice needs to describe the QDIA, including the fund’s investment objectives, risk and return characteristics and fees and expenses. Further, the notice must inform employees of how they can override any of the plan’s defaults. The notice for EACA plans that offer the 90-day opt out window must describe it.

Employers can meet the initial and annual notice requirements with one document.

Is Automation Right for Your Plan?

The PPA and regulations provide important guidance and welcome regulatory relief to plan sponsors that have wanted to automate their plans. However, is an automatic 403(b) plan right for your organization and employees?

Think about your plan goals. Do you want to increase participation, raise contribution rates or get employees to recognize the value of your plan? Do you want to eliminate nondiscrimination testing? Most of all, do you want to help your employees save enough to secure a comfortable retirement? If so, adding automatic features to your 403(b) plan makes sense.

PPA officially cleared the way for automatic plan design. IRS and DOL guidance has clarified the how-to’s. Adoption by 401(k) plan sponsors has highlighted what works and what to look out for. It’s now the 403(b) plan’s turn to evolve into a meaningful retirement benefit for millions of participants.