



Automatic 401(k) Basics

What You Need to Know

Elements of an Automatic 401(k) Plan

Automatic Enrollment

When it comes to savings behavior, employee inertia is well-documented. Too many employees 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 pre-set deferral rate defined by the plan. Employees are enrolled in the plan unless they decided to opt-out.

This relatively simple solution results in remarkable participation gains and potential for administrative safe harbor relief. A study by Vanguard found that participation rates in plans that adopted automatic enrollment boosted participation rates for all racial and ethnic groups, with many plans experiencing rates of 90 percent or more.³

Tool Tip: Use our Automatic 401(k) Impact Calculator to estimate the impact of automatic enrollment on employee participation and deferral rates. Go to: <http://www.retirementmadesimpler.org/calc>.

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. Three out of five plan sponsors automatically enrolled their employees into defined contribution plans in 2010.⁴

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 future default deferral rates. Sponsors had set the rates low (typically three 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.

³ Vanguard. *Diversity and Defined Contribution Plans: the Role of Automatic Plan Features*. 2011.

⁴ Plan Sponsor Magazine. *Auto Enrollment Boosts Participation, Hurt Contribution Rates*. May 2011.



The Answer?

Design the plan to allow automatically increased deferral rates each year. (For example, an employee's automatic contribution rate could increase by one or two percent each year the employee stays with the company, or each time the employee gets a raise.) Again, employees can opt-out or simply modify the deferral rate, but most don't. If the plan does not provide automatic annual increases for all employees, it could educate and encourage 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 three percent, for example). Some set it to align with employer matching contributions. Research shows that participation rates remain high in plans offering up to six percent initial deferral rates. The positive impact of higher rates on employee contributions is much greater than other factors. It is important to consider additional factors such as automatic annual contribution increases, financial education to reduce historical opt-out elections and maintaining affirmatively elected contribution rates during major life changes. All factors considered with automatic 401(k) plan designs, a plan sponsor can more than double the positive impact than by setting higher deferral rates alone.⁵

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 may select a default investment. This is an important feature with fiduciary protection. Many participants will simply remain in the default investment rather than make their own selection.

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.

Today, many sponsors are concerned about encouraging employees to stay parked in a low-risk default fund for many years. The 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

⁵ Employee Benefit Research Institute *Issue Brief No. 349*. November, 2010.



composed only of fixed-income investments.⁶ This, plus new protections for fiduciaries under the Pension Protection Act of 2006 (PPA), have encouraged many recent automatic enrollment adopters to select equity-based default investments rather than principal preservation funds.⁷

Lessons Learned

- A low-risk default investment fund can be high-risk for retirement income adequacy if employees stay in it for many years.
- Many sponsors now favor diversified equity-based default investments over principal preservation funds; the Department of Labor regulations encourage this.

Pension Law Clears Hurdles to Automatic Defaults

The PPA addressed several concerns that had left many 401(k) plan sponsors on the sidelines. For one, the PPA clarified that automatic enrollment meeting certain requirements is permitted even in states where wage laws generally require an employee's written authorization for payroll deductions. Plans meeting certain conditions set by the PPA may give automatically enrolled employees the option to revoke automatic enrollment within 90 days and get their money back tax penalty-free. Final regulations further clarified the revocation period can be set at less than 90 days, but must be at least 30 days from the date the employee would have otherwise received their money.

The PPA overrides state laws that otherwise might be interpreted to preclude automatic enrollment. It also gives a green light to diversified equity-based default investments.

The PPA cleared away one of the biggest barriers to automatic 401(k) plan adoption. The law directed the DOL to publish regulations on acceptable investment defaults that would help shield sponsors from increased fiduciary liability. Regulations confirm that plan sponsors can safely select default investments that include stocks, under certain conditions.

Sponsors will not increase their risk of fiduciary liability for investment losses as long as they choose a Qualified Default Investment Alternative, or QDIA.⁸ QDIAs include common types of diversified default investments that include stocks; in particular, balanced funds, lifecycle funds or managed accounts.

⁶ U.S. Department of Labor. *Default Investment Alternatives Under Participant-Directed Individual Account Plans, Final Rule*, 72 *Federal Register* Reg. 60452, 60470. October 24, 2007.

⁷ Defined Contribution Institutional Investment Association. *Plan Sponsor Survey: Structuring DC Plan Automatic Features to Pump Up Retirement Savings*. March, 2011

⁸ A QDIA is designed to protect the sponsor that uses certain default investments, so that it won't face more risk than if it had a 401(k) plan that let participants choose among investment options without any default investment.



Employee Notification Requirements

The PPA and final regulations require upfront written notification to let employees know they will be automatically enrolled in the plan, at what percentage of pay and to which investment options the contributions will be directed. The notice needs to tell employees that they can override any of these defaults and choose their own contribution amount and investments, do nothing and stay at the defaults or opt-out altogether. Plans can provide the initial notice at least 30 days, but no more than 90 days, before the date employees first become eligible to participate and timing of the notice will be deemed to satisfy requirements as stated in the final regulations. The final regulations provide the timing requirement for notice is satisfied based on all relevant facts, practical circumstances and sufficiently early for an eligible employee to make an affirmative election prior to the default contribution. Sponsors need to repeat the written notice annually within “a reasonable period of time of at least 30 days (no more than 90 days)” before the start of the plan year.

New Nondiscrimination Testing Safe Harbor

The PPA offers, and final regulations confirmed, an automatic enrollment alternative to bypass nondiscrimination tests and the employer may not be required to make additional contributions to satisfy so-called “top-heavy” contribution requirements. Prior to the PPA, a plan sponsor had two ways to avoid testing and top-heavy contribution requirements: the matching safe harbor and the non-elective contribution safe harbor.

Under the pre-PPA *matching safe harbor*, plan sponsors have to match 100 percent of rank-and-file employee contributions on the first three percent of pay, and then 50 percent on the next two percent of pay.⁹ The *non-elective contribution safe harbor* requires plan sponsors to provide at least a three percent employer contribution for all eligible rank-and-file employees¹⁰, regardless of whether the employee contributes.

Vesting of the employer contribution is immediate under both approaches, and both approaches continue to be available after the PPA and publication of the final regulations.

The PPA allows plans to let automatically enrolled employees opt-out within 90 days and get their contributions back without tax penalty.

After the PPA and further clarified by the final regulations, plan sponsors qualify for the new PPA 401(k) safe harbor option (and therefore bypass nondiscrimination testing and top-heavy contribution requirements) if their plans meet the following requirements:

- They use automatic enrollment and the automatic (default) contribution rate starts at no less than three percent of pay at the start of an employee’s participation, rising over the next few

⁹ These are non-highly compensated employees. In very general terms, highly compensated employees are defined by the Internal Revenue Code as those earning \$105,000 or more (the indexed figure for 2008) or owning more than five percent of the company.

¹⁰ The three percent minimum applies when the employee is first automatically enrolled and continues through the first full plan year that begins after initial automatic enrollment. After that initial period (usually a year and a fraction, sometimes two full plan years of participation if the employee started on the first day of the plan year), the required minimum rises to four, five and six percent in each of the next three plan years, with the minimum of six percent continuing into the future.



years to at least four percent five percent and finally six percent. The maximum permitted automatic contribution rate for a plan using the 401(k) safe harbor is 10 percent;

- An employer matches 100 percent of rank-and-file employee contributions on the first one percent of pay, and 50 percent from there up to a maximum of six percent of pay; **or**
- As an alternative, the employer can provide a three percent non-matching contribution to all rank-and-file employees.
- Employer contributions vest in two years or less.
- Employees receive required notices regarding the right to opt-out and to elect a different deferral rate or investment, and an explanation of the default investment.

The PPA established a safe harbor for 401(k) plans using automatic enrollment as an alternative to nondiscrimination testing and potential to satisfy the top-heavy contribution requirements.

The Time is Right

The PPA gave the plan sponsor community the green light it was waiting for to adopt automatic defaults. The law removes most of the legal and regulatory barriers that have held plan sponsors back from automatic 401(k) plan implementation.

The automatic 401(k) offers welcome relief to sponsors that have tried to convince their employees to participate in the plan and adequately save for retirement. Financial education no longer needs to shoulder the daunting task of changing behavior. It can now do what it is supposed to do—educate employees about smart strategies for achieving retirement security, delivered to them as they are building their nest eggs.

The PPA and final regulations officially cleared the way for automatic plan design. Early adopters have taught us what works and what to look out for. Today's environment sets the stage for employers to confidently adopt automatic design features, knowing they are right by law.

The automatic 401(k) plans, called *Automatic Contribution Arrangements (ACA)*; *Eligible Automatic Contribution Arrangements (EACA)*; or *Qualified Automatic Contribution Arrangements (QACA)*, newer and wiser versions of its earlier self, holds real promise for improving the retirement prospects of today's workers. Combined with continued financial education, the 401(k) is coming into its own as a source of retirement income security for the 21st century.

Which Automatic Contribution Arrangement Design is the Right One?

Think about your plan goals. Do you want to increase participation, raise contribution rates and get employees to better appreciate the value of your plan? Do you want to improve nondiscrimination testing results, or do away with testing altogether? Do you want to satisfy the additional top-heavy contribution requirement without additional expense? Would allowing higher paid employees to



contribute more make your life easier? Most of all, do you want to help your employees save enough to secure a comfortable retirement? If so, adding automatic features to your 401(k) plan makes sense.

The following ACA, EACA, QACA comparison chart provides a snapshot of each type of automatic contribution arrangement. As you determine your plan goals, the chart may be a helpful tool in maximizing the benefits of your new automatic 401(k) plan.

ACA, EACA, QACA Comparison Chart

FEATURE	AUTOMATIC CONTRIBUTION ARRANGEMENT (ACA)	ELIGIBLE AUTOMATIC CONTRIBUTION ARRANGEMENT (EACA)	QUALIFIED AUTOMATIC CONTRIBUTION ARRANGEMENT (QACA)
Participant Notice Timing Requirement	Required	Required	Required
Safe Harbor Compensation	Not Required	Not Required	Required
Automatic Salary Deferral Percentage	Required – Defined in Adoption Agreement	Required – Defined in Adoption Agreement	Required – Defined in Adoption Agreement
Specified Automatic Salary Deferral Contribution Levels	None	None	Minimum of 3%; gradually tiered to 6%, not to exceed 10%
Automatic Annual Deferral Escalation That Satisfies Uniform Percentage Rule / Qualified Percentage	Optional	Optional	Minimum Escalation: Up to 2 years – 3% 3 years – 4% 4 years – 5% 5 years – 6% May begin deferral at 6% to avoid escalation. However, deferral escalation may not ultimately exceed 10% of compensation.
Required Employer Matching OR Non-Elective Contribution for Each Eligible NHCE Regardless of Affirmative or Default Salary Deferral Election	Not Required	Not Required	Required: Match – 100% of 1 st 1% + 50% of deferral over 1% up to 6% OR Non-Elective – 3% of compensation
Required Vesting Schedule for Employer Contributions	Not Required	Not Required	Required: Fully vested after no more than 2 years
90 Day Withdrawal Option - Match Related to EACA Deferrals Opting 90 Day Withdrawal – Forfeited	Not Required	Required – However without the 10% tax penalty for early withdrawals	Not Required – However an EACA provision can be incorporated to allow
Qualified Default Investment Alternative – Fiduciary Protection	Optional – QDIA Highly Recommended	Optional – QDIA Highly Recommended	Optional – QDIA Highly Recommended



Nondiscrimination Tests & Top Heavy Safe Harbor	No	No – However excise tax doesn't apply for corrective distributions within 6 months after Plan Year End	Yes
--	----	--	-----