



The Business Case for 401(k) Automatic Enrollment

Two years after the Pension Protection Act of 2006 helped smooth the way for 401(k) automatic enrollment—enrolling employees in a 401(k) plan unless they choose to opt out—plan sponsors are increasingly adopting automatic enrollment and other automatic features. Companies using automatic 401(k)s have seen employee participation rates soar—often to well above 90%—and especially among lower-income and minority workers who are too often left behind.

If you are considering automatically enrolling your employees in your company’s 401(k) plan, you may be asking yourself this question: Is automatic enrollment worth the cost of additional employer matching contributions plus any cost of implementation or ongoing administration? It’s a question every company has to answer for itself, but more and more companies are concluding that adopting automatic enrollment is well worth it. Companies have found there are at least three sound business reasons for using automatic enrollment:

- Improving 401(k) nondiscrimination results
- Recruiting and retaining valued employees
- Mitigating the loss of defined benefit (“DB”) pensions

Company Benefits: Improving Nondiscrimination Results

By raising participation and/or contribution rates among middle- and lower-income workers, automatic enrollment and escalation (automatically increasing the contribution rate over time) tend to produce better performance under the 401(k) nondiscrimination standards. By comparing the average contribution percentage for highly paid and non-highly paid employees, the nondiscrimination standards link executives’ ability to enjoy larger tax-preferred benefits to the employer’s success in encouraging or providing greater benefits for the majority of employees. This seeks to align management’s interest in tax preferred saving with the interests of average employees and of the taxpayers who tax subsidize 401(k)s.

Automatic enrollment and escalation improve nondiscrimination performance by inducing participation by more moderately compensated and lower-paid employees. When these workers don’t participate, they depress the non-highly paid group’s average contribution level.

Inadequate performance on the nondiscrimination (“ADP” or “ACP”) tests requires either remedial action—such as undoing a portion of executives’ tax-favored contributions or incurring the cost of special employer contributions for non-highly paid employees—or preventive restrictions on executives’ contributions. Such measures tend to cause pain and friction within the company. Automatic enrollment and escalation have enabled many HR and benefits professionals to deliver to senior management the good news that such remedial or preventive steps can now be reduced or avoided entirely.

- Occasionally, some employees who are automatically enrolled at the automatic (default) contribution level (for example, 3%) might otherwise have contributed at a higher percentage had they made an affirmative election instead of going along with inertia. The fix for this is to begin automatic enrollment at a higher rate (5 or 6%, for example), steadily escalate the automatic contribution level (typically 1% a year), or both.
- Plans opting to meet the employer contribution and other conditions of a new nondiscrimination safe harbor (under the Pension Protection Act of 2006) can avoid nondiscrimination (and “top heavy”) testing altogether.

Company Benefits: Recruiting and Retaining Valued Employees

Automatic enrollment and automatic contribution increases (“escalation”), with appropriate automatic (default) investments, make 401(k) plans more effective in recruiting and retaining valuable employees. Many companies recognize that employees’ appreciation of employer-provided benefits depends on actual results: the size of the employee’s account balance. Accordingly, many companies no longer simply offer their employees the opportunity to save. Instead, using automatic features, they harness the power of inertia to strongly encourage saving. Sponsors of 401(k)s are increasingly viewing automatic features as “the right thing to do” to help employees save for their long-term future.

Americans are anxious about being financially underprepared for retirement. Automatic enrollment with appropriate default investments can help make the 401(k) more effective at generating larger account balances to replace a meaningful portion of employees’ pre-retirement wages.¹

This is particularly the case since, in general, a disproportionate number of nonparticipating employees tend to be minorities and lower-income employees. There is powerful evidence that automatic enrollment tends to dramatically increase participation by these groups (in some cases raising their participation rates from 1 out of 5 to 4 out of 5).² Many companies believe there is all the more reason to encourage their minority and lower-income employees to save and get the benefit of the employer match.

Moreover, through automatic enrollment, the company can effectively deliver more federal tax benefits to moderate- and lower-income workers. In addition to the normal 401(k) tax benefits, contributors to a 401(k) whose family income is below a certain level (\$53,000 for a married couple; half that for a single person) are entitled to a 50%, 20% or 10% tax credit. The tax credit requires no employer involvement whatsoever, but many employers have chosen to use or adapt an IRS model notice to tell employees about the saver's credit opportunity.³

Company Benefits: Mitigating the Loss of Defined Benefit (“DB”) Pensions

When plan sponsors have frozen or cut back their DB plans, some have upgraded their 401(k)s through automatic features, seeking to mitigate the employees' loss of future DB benefits. By sparing employees the need to take the initiative to enroll and by simplifying their decision-making process (especially through appropriate default investments), automatic 401(k) features can replicate or approximate valuable DB attributes, such as automatic coverage and professional investment management.

Company Benefits vs. Increased Matching Costs

Suppose your company has no 401(k) nondiscrimination issues, is comfortable with current employee recruitment and retention levels, and is not trying to make up for a DB freeze or curtailment? Is it still worth incurring the increased matching cost?

Most employers are concluding that it is.

Employer matching contributions are tax deductible, and the rise in the employer's cost of matching contributions under automatic enrollment will ordinarily be modest—and less than proportional to the increase in participation.

To see why, assume, for example, a fairly typical 401(k): 75% of the eligible employees participate, the average employee contribution is between 6 ½ and 7% of pay, and the employer's match is 50 cents on the dollar up to 6% of pay. If automatic enrollment increased participation to 90% of eligible employees, which is typical, the increase would be 20% over existing participation. But the additional employer match might represent only a 10% or smaller increase over the current match.

- Lower Matched Contributions. This is because the new automatically enrolled participants would generally be contributing at the default or automatic contribution level. If that level started at 3% of pay (instead of the full potentially matchable 6% contribution), the matching contribution might initially rise by only 10% rather than 20%.
- Lower Pay. Even if the automatic contribution level started as high as 6%, employees who participate for the first time through automatic enrollment tend to

be lower paid than those who sign up on their own. Accordingly, the dollar amount of the employer match should be smaller for each percentage of pay contribution by auto enrolled employees than for previous participants.

- **Gradual Phase-In:** If even this moderate increase in matching cost presents an issue for the plan sponsor, the increase can be phased in very gradually. Many 401(k)s begin automatic enrollment by applying it first to new hires, and only after a year or two, extend it to other nonparticipating employees.

Most importantly perhaps, the increased matching contribution (unlike a DB plan contribution obligation) is relatively predictable and easy to take into account in planning and budgeting.

Conclusion

Companies sponsoring 401(k) plans are increasingly adopting automatic enrollment and other automatic features. Surveys show that nearly all companies using automatic enrollment are satisfied with it—and so are as many as 98% of their employees.⁴ In fact, it looks like automatic enrollment will soon become the norm in the 401(k) universe.

Retirement Made Simpler is a coalition formed by AARP, the Financial Industry Regulatory Authority (FINRA), and the Retirement Security Project (RSP). The campaign was created specifically to inspire and support employers who want to help their employees save more for retirement. By providing companies with the tools and information they need to automate their 401(k) plans, more Americans will achieve a safe and secure retirement. For more information, visit www.RetirementMadeSimpler.org.

¹ Sarah Holden and Jack VanDerhei, “The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement,” Employee Benefit Research Institute (2005).

² See Orszag, Peter and Rodriguez, Eric. “Retirement Security for Latinos: Bolstering Coverage, Savings and Adequacy.” RSP Policy Brief No. 2005-7 (July). Retirement Security Project and National Council of La Raza, Washington DC. See also “The Ariel-Schwab Black Paper,” published by Ariel Mutual Funds and Charles Schwab. October 2007.

³ See Gale, William; Iwry, J. Mark; and Orszag Peter. “The Saver’s Credit: Expanding Retirement Savings for Middle- and Lower-Income Americans.” RSP Policy Brief No. 2005-2 (March). Retirement Security Project, Washington DC. See also IRS Announcement 2001-106 (October), available at <http://www.irs.gov/pub/irs-irbs/irb01-44.pdf>.

⁴ See, for example, November 7, 2007 study by Harris Interactive® on behalf of Retirement Made Simpler (RMS), available at <http://www.retirementmadesimpler.org/Library/FINAL%20RMS%20Topline%20Report%2011-5-07.pdf> See also Towers Perrin, “Enhancing 401(k) Value and Participation: Taking the Automatic Approach” (a report for AARP) (June 2007).