



The Automatic 401(k) 401(k) Plans Come of Age

Why do you sponsor a 401(k) plan? Maybe it's part of your strategy to attract talent, or to encourage key employees to stay. If you are like most plan sponsors, you run the plan to help your employees save and invest for a financially secure retirement.

Yet sometimes it seems like your employees don't get it. You see it in lagging participation levels, inadequate deferral rates, and poor investment decisions.

You've tried to get your employees to take action. But when your efforts don't get results, the retirement readiness of your employees suffers. Plus, the plan can fail nondiscrimination testing, leaving you to deal with the headache of restricting or returning excess contributions to higher paid employees.

It doesn't have to be this way. A highly effective solution—the “Automatic 401(k)” —is sweeping the defined contribution landscape. For employees offered such a plan, participation is automatic. Your employees are enrolled at a pre-set contribution rate into an investment fund you select. Employees are in the plan unless they opt-out. Automatic enrollment relieves you of the effort it takes to fight employee inertia. Now, inertia works in your employees' favor.

Between 2004 and 2005, the percentage of 401(k) plans with automatic enrollment jumped from 10.5 percent to 17 percent.¹ Benefits experts predict automatic plan design will soon be the norm.²

The reason for the success of automatic 401(k) plans? They remove impediments that too often stand in the way of employee participation—from the “analysis paralysis” over investment decisions, to simply getting sidetracked and not taking action to sign up and start saving.

The time may be right to join the march toward a simpler and better 401(k). You have the experiences of early automatic 401(k) adopters as well as the Pension Protection Act of 2006 (PPA) to guide you. The following information will help prepare you to upgrade your plan to meet your needs and put your employees on a steady course to retirement security.

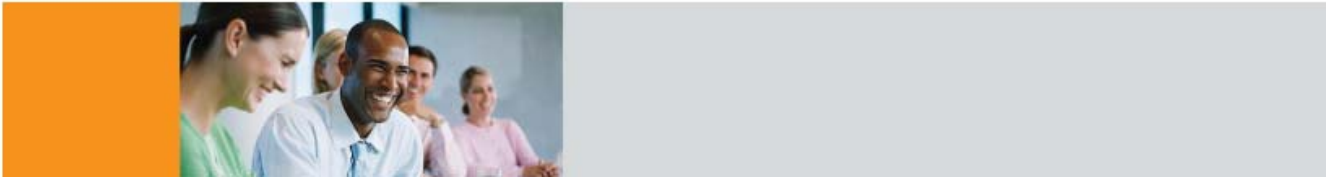
Elements of an Automatic 401(k) Plan

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 are in the plan unless they get decide to opt-out.

¹ Profit Sharing /401(k) Council of America. *49th Annual Survey of Profit Sharing and 401(k) Plans*. 2006.

² *Automatic Plan Designs: Taking it up a Notch*. Plan Sponsor Magazine, April 2007.



This relatively simple solution results in remarkable participation gains. A study by Vanguard showed a 17-percentage point increase in participation in plans that adopted automatic enrollment.³ Other studies show similar findings.

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 “re-enrollment” to increase participation rates across all employees. Surveys and other evidence confirm that opt-out rates are low and employee response is positive.

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

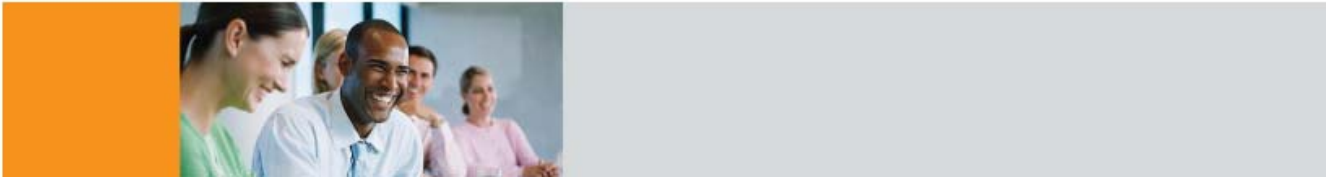
Even though early adopters were pleased with participation gains, some of them discovered an unintended consequence. The same inertia that kept employees from enrolling in the plan was keeping them from changing the default deferral rate. Sponsors had set the rates low (typically three percent). But 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 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, 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 three percent, for example). Some set it to align with employer matching contributions. A recent survey suggests that employees tend to find higher deferral rates acceptable. The survey concluded that most participants would accept an initial deferral rate as high as six percent.⁴

³ Vanguard. *Automatic Enrollment: Client Experience*. July 2001.

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



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.

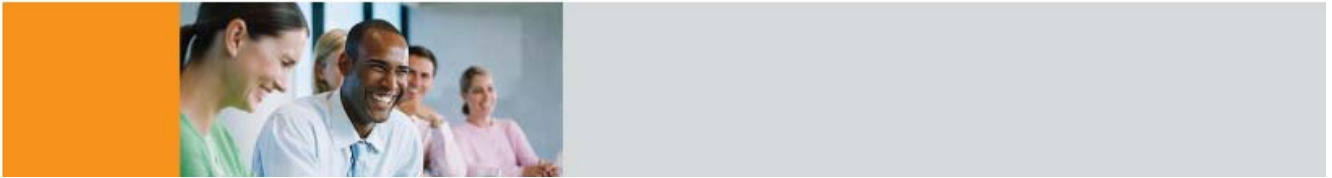
Today, many sponsors are increasingly concerned about encouraging employees to stay parked in a low-risk default fund for many years. The Department of Labor expressed a similar theme in the preamble to its plan investment regulations, noting that over long time horizons, diversified portfolios that include equities have historically generated higher returns than portfolios consisting only of fixed-income investments.⁵ This, plus new protections for fiduciaries under the Pension Protection Act of 2006 (PPA) have helped turn the tide. Recent adopters of automatic enrollment have tended to select equity-based default investments rather than principal preservation funds and the Department of Labor regulations encourage this.⁶

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.

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

⁶ Deloitte Consulting LLP. *Annual 401(k) Benchmarking Survey, 2005/2006 Edition*.



Pension Law Clears Hurdles to Automatic Defaults

The PPA addressed several concerns that had left many plan sponsors on the sidelines. For one, 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. It also allowed plans to give automatically enrolled employees the option to revoke automatic enrollment within 90 days and get their money back tax penalty-free.

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

PPA cleared away one of the biggest barriers to automatic 401(k) plan adoption. The law directed the Department of Labor to publish regulations on acceptable investment defaults that would help shield sponsors from increased fiduciary liability. The Department's final regulations confirm that plan sponsors using certain common types of diversified

default investments that include stocks can do so without increasing the risk of fiduciary liability for investment losses (compared to a 401(k) without default investments), as long as the sponsors meet certain conditions. The investment defaults that get this protection, dubbed Qualified Default Investment Alternatives (QDIA), include, in particular, balanced funds, lifecycle funds, or managed accounts. (See *Don't Lose Sleep over Automatic Investments* for a more specific discussion of default investment funds.)

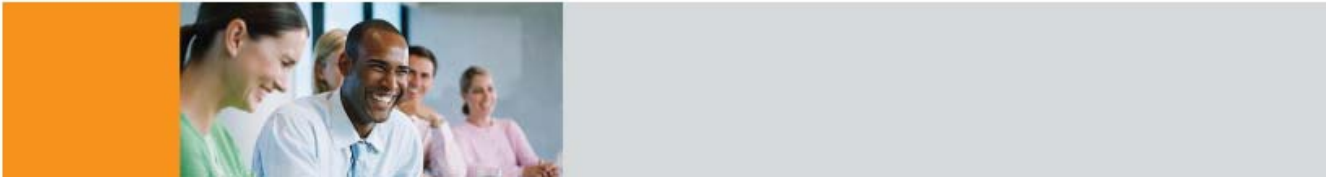
Employee Notification Requirements

PPA requires 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. Employees must be informed 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 that meet certain conditions can give participants 90 days to opt-out and get their money back without the 10 percent tax penalty that usually applies to early 401(k) withdrawals. Plan sponsors need to give written notice not only when automatic enrollment first occurs, or in some cases, 30 days in advance, but also annually thereafter.

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

New Nondiscrimination Testing Safe Harbor

PPA offers a new automatic enrollment alternative to bypass nondiscrimination tests. Prior to PPA, a plan sponsor had two ways to avoid testing: the matching safe harbor and the non-elective contribution safe harbor.



Under the existing matching safe harbor, plan sponsors have to match 100 percent of rank-and-file employee contributions on the first three percent, and then 50 percent on the next two percent.⁷ The current non-elective contribution safe harbor requires plan sponsors to provide at least a three percent employer contribution for all eligible rank-and-file employees, regardless of whether the employee contributes. The employee is immediately vested in the employer contribution under both approaches.

Plan sponsors qualify for the new PPA 401(k) safe harbor option if their plans meet the following requirements:

- They use automatic enrollment and the automatic (default) contribution rate starts at no less than three percent in year one of an employee's participation, rising to at least four percent in year two, five percent in year three, and six percent in year four and beyond. The maximum 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.
 - As an alternative, the employer can provide a three percent non-matching contribution to all rank-and-file employees.
- The vesting period on employer contributions is 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.

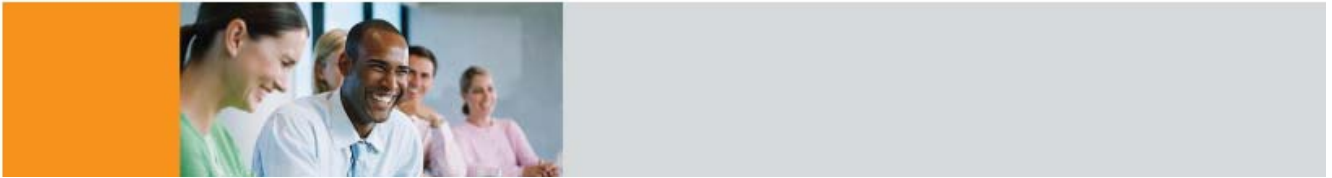
PPA established a safe harbor for 401(k) plans using automatic enrollment as a new alternative to nondiscrimination testing.

The Time is Right

PPA gave the plan sponsor community the green light it was waiting for to adopt automatic defaults. The law removes most 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

⁷ These are non-highly compensated employees. In very general terms, highly compensated employees are defined generally by the Internal Revenue Code as those earning \$100,000 or more or owning more than five percent of the company.



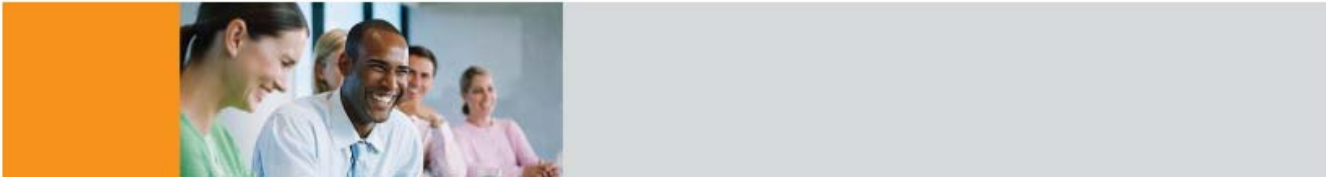
employees about smart strategies for achieving retirement security, delivered to them as they are building their nest eggs.

Think about your plan goals. Do you want to increase participation, raise contribution rates, or get employees to better appreciate the value of your plan? Do you want to improve nondiscrimination testing results, or do away with testing altogether? 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 PPA 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 you to confidently adopt automatic design features, knowing they are right by law and by experience, and knowing that it's a positive thing to do for your people.

The automatic 401(k), an older and wiser version 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.

This document does not provide legal, tax, or investment advice. You are encouraged to obtain such advice from legal counsel and from competent, professional tax and investment advisers.



Resources

Retirement Made Simpler

www.RetirementMadeSimpler.org

Default Investment Alternatives under Participant Directed Individual Account Plans; Final Rule.
Federal Register. 29 CFR, Part 2550. October 24, 2007.

<http://www.dol.gov/ebsa/regs/fedreg/final/07-5147.pdf>

Deloitte Consulting LLP. Annual 401(k) Benchmarking Survey, 2005-2006 edition.

http://deloitte.net/dtt/cda/doc/content/us_consulting_hc_401ksurveyresults_020806.pdf#search=%22automatic%20enrollment%20deloitte%22

Pension Protection Act

Section 902.

<http://www.dol.gov/ebsa/pdf/ppa2006.pdf>