

The Effects of Automatic Enrollment

A Comprehensive View of the Popular Feature

“When a retirement plan sponsor tells me they want to implement automatic enrollment, I always ask them why,” explains Scott M. Dufek of Dufek & Co. Certified Public Accountants.¹ A question to which he typically receives blank stares. Since the passing of the Pension Protection Act of 2006 which encouraged automatic enrollment implementation, the industry has been buzzing about this plan feature, many seeing it as a “saving grace” for 401(k) workers who would not have voluntarily saved for their golden years. Automatic enrollment is an optional plan feature in which participants are enrolled into their employer’s plan as soon as they are eligible, with the option to opt out. Various studies have shown that automatic enrollment increases plan participation dramatically with very few participants choosing to opt out, but its effect on the plan overall is often overlooked.

Goals of Automatic Enrollment

Disregarding all of the hype surrounding auto-enrollment, why do plan sponsors want this feature in their plan? What is the primary goal driving its implementation? The desire to implement automatic enrollment should be based on the specific needs of the Plan. Some plan sponsors may add this feature to spark plan participation and enhance retirement readiness for their employees. If the Plan is failing non-discrimination testing, automatic enrollment may be added in an attempt to increase the deferral rates of non-highly compensated employees. The reasons and goals surrounding automatic enrollment make sense, but the effects on other areas of the plan may prove to be more detrimental than beneficial.

Considerations

Increased Costs

The costs associated with increased plan participation may deter plan sponsors from implementing automatic enrollment features. Increased participation equates to more money going to matching contributions. Unless increased costs are not an issue, plan sponsors may consider a few options to combat the increase. Costs may be leveled by reducing the company match, setting a default contribution rate that is below the matching rate, or reducing compensation and benefits outside of the plan. Detailed in an October 2013 brief, research from the Center for Retirement Research² shows that automatic enrollment does not have an impact on compensation outside of the plan, but is associated with lower match and default rates when compared to plans without an automatic enrollment feature. Figure 1 illustrates an average maximum match rate of 3.2% for workers with automatic enrollment compared to an average of 3.5% for workers without auto-enrollment features. Arguably more astounding is the difference found between the average match and default deferral rates in

¹ Moore, Rebecca. Getting Auto-Enrollment Implementation Right. PlanAdviser. 19 February 2015.

² Butrica & Karamcheva. How does 401(k) Auto-Enrollment Relate to the Employer Match and Total Compensation?. Center for Retirement Research at Boston College. October 2013.

plans with auto-enrollment, depicted in Figure 2. Research shows the average default employee contribution rate is only 3.4% while the average match ceiling is 5.1%.²

Figure 1:

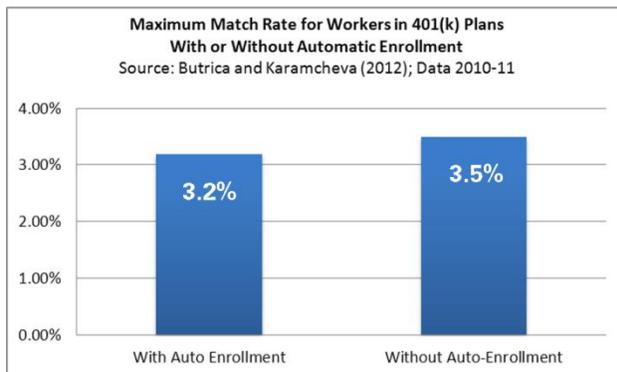
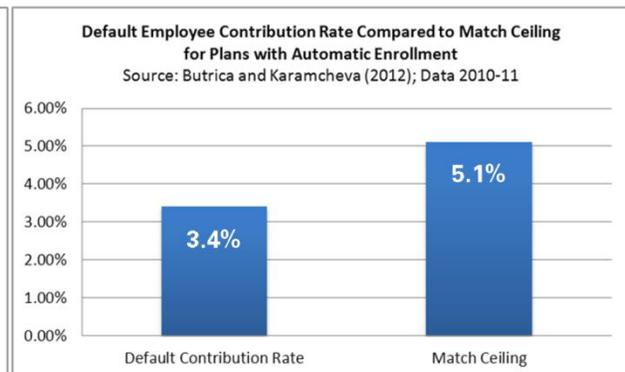


Figure 2:



Implications for Participants

While lowering the match rate and default contribution rate will likely lower plan costs, the implications for participants can be detrimental. For participants that would not have participated on their own, auto-enrollment is a positive tool that helps them to easily save for retirement. However, participants who would have enrolled in the plan regardless may save less than they would have voluntarily. While participants are able to make changes to their accounts, they are less likely to do so since everything has been done automatically for them. Unless the plan also contains an automatic escalation feature, increasing the deferral rate each year, the participant's deferral may remain stagnant at the initial contribution rate.

When participants are enrolled in a plan, they are invested in a Qualified Default Investment Alternative or QDIA. Often, these default investment options are target date funds which set a participant's asset allocation based on age but do not take into account personal risk tolerance, additional savings vehicles, and other factors. While target date funds are a good choice for a QDIA, more customized asset allocation strategies can be achieved through quality participant education.

Since participation is automatic, participants may not feel the need to learn the basics of investing, to build a savings strategy, or to assess the performance of their account. For this reason, they are likely to stay at the default contribution rate in the default investment. Quality participant education can deter this complacency and empower participants to be confident, knowledgeable investors.

Compliance and Administrative Issues

Failure to precisely implement automatic plan features and comply with the respective provisions can be costly. If a Plan contains auto-enrollment provisions, all eligible employees must be properly notified before deferrals are made. Deferrals must be withheld in a timely manner as governed by the plan provisions. Another pitfall is failing to timely increase participant deferrals in the presence of auto-escalation. Incorrect payroll data or

administrative errors, such as inputting the incorrect date of hire or improperly determining eligibility, can lead to very costly fees for correction.

Adding specific policies and procedures can make implementing the automatic enrollment features of the Plan easier. Reducing the number of entry dates or limiting the frequency of automatic escalation can help mitigate some administrative burdens. Increasing plan participation and the average savings rate is an admirable goal. Automatic enrollment is not the only way to accomplish this goal.

Conclusion

Implementing automatic enrollment can increase plan participation and aid in increasing retirement readiness for employees. However, its effect on all areas of the Plan must be assessed before it is implemented. When evaluating how automatic features will impact the Plan, use a holistic approach. If the goal of automatic enrollment is to increase participation and savings, ensure that the benefits of automatic enrollment are not being diminished by a decreased match or lower average deferral rate. When considering auto-enrollment, take into account how it will impact the goals you are trying to achieve and how it will affect the rest of the plan. Improving participant education can increase participation and empower participants to be independent, educated investors while avoiding compliance and administrative issues.