

Retirement Plan News Update

Brought to you by the Barnes Dennig Employee Benefit Plan Audit Team

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PLAN PARTICIPATION: Is Automatic Enrollment The Answer?

The numbers are hard to ignore: The national average for participation in automatically enrolled 401(k) plans is between 85 and 95 percent—considerably higher than the two-thirds level of participation for non-automatically enrolled plans.

And the Pension Protection Act of 2006 (PPA) has made it even easier for plan sponsors to automatically enroll employees. Now, companies can choose to gently nudge their workers toward saving by automatically signing them up for the firm's retirement plan. Once eligibility requirements are met, contributions are automatically deducted from their paychecks unless employees proactively opt-out of the plan. Prior to passage of the Act, some states prohibited such deductions without an employee's affirmative election to participate.

The Pros

Many say auto-enrollment is a long-overdue concept, noting that it is far too easy to put off signing up for an employer's 401(k) plan. Of particular concern are new hires, especially younger workers, who are often more focused on getting a paycheck than planning for retirement. Indeed, less than half of eligible workers in their 20s participate, according to industry statistics.

- It's good for employees. Yes, plan sponsors are "pushing" employees by automatically enrolling them — but certainly pushing them in the right direction from an ideological standpoint. In addition, research clearly shows that participants who are auto-enrolled tend to stay enrolled.
- It offers protection for plan sponsors. With automatic enrollment, the resulting dramatic increase in participation, in and of itself, significantly reduces the potential risk of the employer and the fiduciaries because it eliminates potential claims from people who did not get into the plan. Further, any employee who does

not participate has to affirmatively file an election to get out of the plan. So, on top of high levels of participation, there is written evidence from every employee who opted out that the employee did not want to be in the plan.

- It helps with discrimination testing. Automatic enrollment also brings employees who might otherwise not participate (i.e., lower-paid workers who lack the savvy or motivation) into the fold. This helps with discrimination testing, which can be skewed toward more highly motivated, higher-income employees. In many cases, owners, managers and other highly compensated employees are impacted when lower-compensated employees don't participate and the plan fails either the actual deferral percentage (ADP) test or the actual contribution percentage (ACP) test. Then, a portion of the elective contributions of highly compensated employees may need to be either re-funded or re-characterized as after-tax contributions.

The Cons

However, this concept is not without its drawbacks. Auto-enrollment does raise important questions about the appropriateness and liability.

- The potential for uncommitted participants increases. By casting such a large net, automatic enrollment can result in plan participants who really aren't committed for the long haul. Sponsors tell of auto-enrolled employees who see that first deduction in their paycheck and immediately opt out, leaving very small balances that must still be administered (some plans allow those small amounts to be distributed).
- The liability for matching contributions increases. The flipside is that there are some employers who don't want to auto-enroll employees because it automatically increases the matching contributions for which they are liable.

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Factors To Consider

From a documentation standpoint, adding an automatic enrollment feature is fairly straightforward, requiring a simple amendment to your documents. But there are additional factors to consider.

Make sure it's appropriate. Auto enrollment tends to be more impactful and effective for manufacturing companies. In professional firms and white-collar companies, employees typically understand the value of the plan and already want to participate. But, auto-enrollment may not be appropriate for companies with a high percentage of "questionable workers," such as transient, seasonal or undocumented workers.

Establish eligibility. A one-year waiting period is the norm, although some companies have made employees eligible for participation in as little as three months.

Communicate and educate. Under an automatic enrollment option, plan sponsors must make every effort to communicate with and educate employees about their options. Payroll stuffers, 90-day notices, posters, employee meetings and the company intranet site should all be utilized.

A Word About Default Investments

Understandably, some companies have shied away from auto enrollment, fearing lawsuits by participants if the investments chosen for the auto-enrollees should result in lost retirement savings.

Here, the Pension Protection Act creates safe harbor rules for selecting default investments. But, to get this protection, plans must follow specific Department of Labor guidelines—in particular, which investment options the DOL has sanctioned as qualified default investment alternatives (QDIA).

Under the guidelines, a QDIA must be one of three types to offer a rate of return that, over time, will generate adequate retirement savings. The investment objectives must consider the participant's age but not factors such as risk tolerances and other investment assets. The types of investment products include:

- A life-cycle or targeted retirement date fund or account.

- A balanced fund.
- An investment management service, which allocates assets to achieve varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures.

The Act also allows companies to shift liability to "fiduciary advisors." Under this scenario, every participant would either be enrolled in the managed 401(k) service (liability shifted to the managed 401(k) provider) or they would have signed a document stating they have willingly taken on the risk of managing the account on their own.

Parting Thoughts

Automatic enrollment has been shown to be remarkably effective in raising participation rates among eligible workers. The effects appear to be particularly promising for middle- and lower-income households, who have the greatest need to increase their savings.

A growing body of evidence suggests that the judicious use of default arrangements holds substantial promise for expanding retirement savings. Employees who fail to sign up for the plan—whether because of simple inertia or procrastination, or perhaps because they are not sufficiently well organized or are daunted by the choices confronting them—would become participants automatically.

If you would like to talk further about automatic enrollment to see if this would make sense for your plan, please call your Director or Manager contact at Barnes Dennig at (513) 241-8313 and we would be happy to help you.

