

Legislation Providing Automatic Enrollment Incentives Would Increase Employee Participation in 401(k) Plans

Provisions Expected to Be Considered as Part of This Summer's Retirement Security Debate

As part of the broad retirement security debate anticipated this summer, Congress is expected to review whether to revamp the rules surrounding 401(k) plans to encourage employers to make employee participation automatic unless the employee opts out. Currently, most employees are required to opt-in to participation in their 401(k) plans, but many employees never do so or wait for years before participating. Once they start, many do not increase their contributions, limiting the amount saved for retirement. So-called automatic enrollment provisions reverse these assumptions so that employees are presumed to participate unless they affirmatively opt out. Automatic enrollment has been shown to increase average national participation rates from 75 percent to between 85 and 95 percent. Among newer female employees, such programs increase participation rates from 35 percent to 86 percent and among newer employees with annual earnings less than \$20,000, from 13 percent to 80 percent. Several bills have been introduced to encourage employers to adopt these provisions and a version is likely to be included in any comprehensive retirement security legislation considered by the House of Representatives.

Defined Contribution Plans Are the Predominant Form of Employment-Based Retirement Plan.

Automatic enrollment has become a topic of substantial interest because of the dramatic shift in the role of defined contribution plans over the last 25 years. Originally, defined contribution plans were seen as add-on plans to existing defined benefit pension plans. Today, defined contribution plans are the primary source of employment-based retirement income for many employees. Data on retirement plan coverage bear this out. In 1981, almost 60 percent of employees with pension coverage had only a defined benefit plan versus just under 20 percent that had only a defined contribution plan. By 2001, only 10 percent had only a defined benefit plan versus nearly 60 percent participating in a defined contribution plan.

Current Opt-in Requirement of Defined Contribution Plans Limits Employee Participation

Unlike defined benefit plans, in which employees are automatically enrolled, employers make the contributions and investment decisions and bear the financial risk, defined contribution plans require the employees to perform these tasks. Employees must affirmatively elect to participate in the 401(k) plan (opt-in), and then must choose the appropriate investments to grow their assets from among the employer-provided options. However, some employees never sign up for their employer's 401(k) plan for a variety of reasons, including procrastination, lack of knowledge about the plans, or anxiety over how to invest the funds. Whatever the reason, current savings rates through 401(k) plans are likely not sufficient to sustain many employees in retirement. According to the Retirement Security Project, in 2001, less than half of the households headed by adults ages 55-59 had \$10,000 or less in an employer-based 401(k) plan or tax-preferred savings account. Thus, while the opt-in arrangement may have made sense when defined contribution plans were seen as secondary retirement funds, now that they are the primary accounts, it may make sense to restructure them to encourage employee participation.

Automatic enrollment is a leading way to do this. Moreover, increasing participation through automatic enrollment can reduce employer 401(k) administration costs by increasing economies of scale.

The IRS Has Permitted Automatic Enrollment for Several Years But Only a Minority of Programs Have Adopted It. Automatic enrollment has come into question under some state laws designed to protect employee rights. It is most likely that those laws are preempted by ERISA, but the issue has never been definitively addressed by DOL or the courts. Meanwhile, since 1998, the IRS has permitted employers to adopt automatic enrollment provisions that assume that eligible employees are participants in 401(k) plans unless they opt out, thus creating a bias in favor of saving. However, a recent survey found that only eight percent of all 401(k) plans have adopted it, and of 401(k) plans with more than 5,000 participants, only 24 percent have adopted such provisions.

Automatic Enrollment Could Provide Additional Means of Meeting ERISA's NonDiscrimination Requirements Currently, employers must demonstrate that under their 401(k) plans, highly paid employees are not receiving more generous benefits than non-highly paid employees. This can be done by showing that the ratio of highly paid to nonhighly paid employees is below a certain level or by providing a certain level of matching contribution for nonhighly paid employees that participate in the program. Most employers currently opt for the latter because it does not require a minimum level of participation. Either way, employers must perform complex and expensive "nondiscrimination testing" to ensure that they have met the ERISA requirements. An additional safe harbor tied to automatic enrollment plans would provide employers another way of meeting their legal obligations while encouraging greater employee 401(k) participation.

Legislation Provides Incentives for Employers to Adopt Automatic Enrollment Provisions To accelerate the adoption of automatic enrollment provisions, several bills have been introduced to provide employers adopting automatic enrollment and other provisions an additional safe harbor under the nondiscrimination rules if they can demonstrate that a certain percentage of employees, ranging from 70 percent to 85 percent, are participating in the plan, depending on the bill. In addition, the bills explicitly preempt state regulations that may restrict automatic enrollment, and also reduce the employer's fiduciary liability for maintaining default investments in 401(k) accounts. Under these bills, H.R. 1961, introduced by Rep. Benjamin Cardin (D-MD) would automatically enroll new participants in the 401(k) plan after the date the plan is adopted, but allow existing employees to make default contributions. S. 875 by Sens. Jeff Bingaman (D-NM) and Olympia Snowe (D-ME), would apply the provisions to new and existing employees, but would give existing employees a one-year delay before they take effect. H.R. 1508 by Rep. Rahm Emanuel (D-IL) would apply to all employees in the plan and would require automatic enrollment to obtain any relief under the nondiscrimination rule safe harbor. In addition, some of the bills include other provisions bolstering employee savings in 401(k) plans by providing accelerated vesting, automatic rollover, and/or automatic escalation of employee contributions.