Auto Enrollment in 401(k) and 403(b) Plans:

Can one solution fit every plan's needs?

Modeling Excellence In Benefits Solutions

The Paragon Alliance Group LLC

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Executive summary:

Automatic enrollment and automatic deferral escalation continue to get a lot of attention in the press. The main reason to consider automatic enrollment is to help more employees accumulate more retirement savings by removing the inertia that employees succumb to, rather than taking positive action and making informed choices.

On the other hand, it can become expensive and problematic for some plan sponsors. Why? Execution of specific tasks and reporting are required to have the auto feature(s) work properly. An Employer could face the consequence of unexpected expenses if corrections are required and cost projections are not run. With automatic enrollment implementation, coordination between all service providers is critical.

This white paper is intended to provide insight into the pros and cons of auto-enrollment, and why it may or may not be suitable for all plan sponsors. In the complex world of retirement planning and regulations there is no one "silver bullet solution". This is why obtaining experienced and detailed consulting is imperative. The consultative process will help you understand the options and implications to enable your firm to establish goals and create the plan your firm needs.

Introduction:

The "traditional" 401(k) or 403(b) plan is set up to have employees **choose to enroll**. This includes completing enrollment paperwork to join the plan. Eligible employees select the percentage or amount deducted from their pay on a pre-tax or Roth (if plan allows) basis, the investments best suited for them, and their beneficiary designation. Some plans also include an annual "automatic escalation" provision where the plan will automatically increase deferral default rates by a certain percentage (typically 1%), unless an employee opts out.

- Did you know that most people spend more time planning a 2 week vacation than planning their retirement? (*Source: Your Retirement Quest, 10 Secrets for Creating and Living a Fulfilling Retirement, Alan Spector and Keith Lawrence)*
- One of the primary reasons that employees need to be encouraged to save more is due to "myopia", which is a detrimental focus on the short term.

When an employee becomes eligible for a plan with "automatic enrollment" provisions, the employee will be **automatically signed up** to contribute from their pay at the deferral rate (typically 3% to 6% of pay, some as high as 10%) elected in the plan, unless they opt out or enroll on their own. If automatically enrolled, the contributions will be invested in the default investment option approved by the Plan Trustees, which is typically a Target Date (Age Based) investment or Balanced Portfolio of investments (like many pension funds) that qualifies as a Qualified Default Investment Alternative (QDIA). Target Date funds are designed to invest a participant in a well-diversified portfolio that becomes more conservative over time, up to and sometimes after a participant's intended retirement age. QDIAs are designed to not impose financial penalties or restrictions to transfer out of the QDIA.

Automatic enrollment popularity in 401(k) and 403(b) plans grew after the passage of the Pension Protection Act of 2006 (PPA). This was critical legislation and several provisions of PPA were designed to enhance automatic enrollment participation. Guidance and protection were offered to plan fiduciaries to enable them to select default investment options for employees who do not select their own investment options. Where applicable, PPA overrode state law that required employee affirmative election prior to withholding deductions from payroll. Of course, certain rules have to be followed in order to comply.

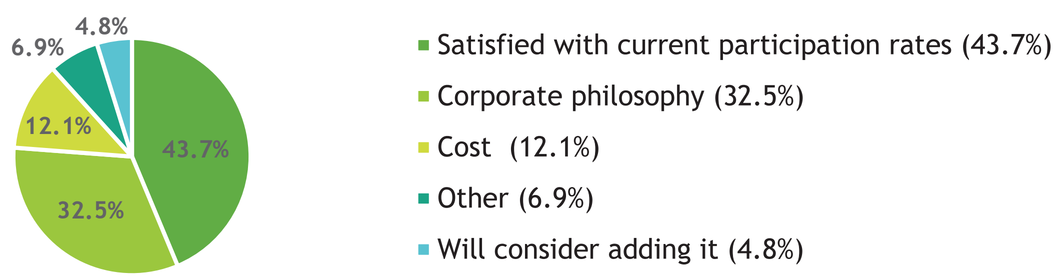
The effectiveness of retirement plan design with 401(k), 403(b), and Roth deferral options is primarily measured by plan sponsor and participant satisfaction with the plan. How do you measure satisfaction? Is it based on any of the following:

- The ability of your employees to retire financially secure?
- Employee understanding and appreciation of your plan?
- Your plan's overall participation percentage?
- The average deferral rate of your employees?
- Knowing that your plan providers are really looking out for you and helping protect you as fiduciaries, while educating your employees?
- The ability for key employees to defer as much as possible?
- Spending little or no time on your plan?
- Obtaining the lowest fees? If so, will it be possible to obtain the highest level of satisfaction?
- A combination of the above or none of the above?

My firm belief is that the plan has to work for the Plan Sponsor and their employees and should not create hardship for either party. As a result, it certainly makes a great deal of sense for service providers to understand the needs and goals of parties in which the plan is intended to benefit.

Automatic enrollment has been around for many years. It continues to gain popularity and legislative support, because it is increasingly seen as a solution to a national retirement savings problem and is designed to overcome employee inertia. Many employees find it hard to make financial decisions and tend to underestimate how much and how long they need to save. Currently about half of firms do not offer auto enroll as an option.

- Reasons why companies do not use auto enroll:



(Source: PSCA 57th Annual Survey, all plans, reflecting 2013 experience)

Problem Definition:

Plan Trustees have the ultimate fiduciary responsibility for overseeing the operation of the plan. Some plans are designed by service providers where the appropriate time, education, and expertise is not afforded to the plan sponsor and/or Plan Trustees. This can become problematic, as one of the primary Fiduciary responsibilities is to act in the best interest of employees. This includes understanding the value received for the fees that are paid from plan assets. It is critical that fiduciaries understand all plan fees, who receives the fees and the services they perform for those fees. All too often, this is misconstrued and the goal becomes to lower fees. Typical of any mature professional service, lower fees tends to mean less services which can lead to unintended consequences and create additional fiduciary liability. As emphasis for service providers to become less expensive continues to grow, it is difficult to provide personalized expertise for the small to mid-size plan market. The impact is that plan sponsors must take the time to understand their plan and their responsibilities. As Employers continue to comply with more and more regulations that take up their valuable time, this can be difficult. By offering automatic enrollment and/or automatic escalation, it typically generates higher plan cash flow and higher participation, which potentially benefits all parties involved. On the other hand, careful consideration to always act in the participant's best interest and operating your plan according to the terms of your plan documents is critical.

Are you prepared as an organization to provide your employees with a benefit that states they will have a certain percentage, as little as 1% and high as 10%, taken from their pay if they do NOT opt out of the benefit? Saving for retirement is a necessary thing to do at some point in everyone's life, so thoughtful conversations with experienced industry experts will provide ideas on the best way for you to engage your workforce, whether you select automatic enrollment or not.

Automatic enrollment options to consider:

3 types of Automatic enrollment. Your plan document needs to allow for the provision and there are guidelines on when the feature can be implemented. Each type requires an initial auto enrollment notice, as well as an annual notice for employees who are automatically enrolled. Contributions are typically invested in a QDIA which provides additional fiduciary protection.

1. **ACA (Automatic Contribution Arrangement).** Also referred to as Traditional
   - Most flexible design
   - No minimum default deferral rate and can be pre-tax or Roth
   - No required escalation
   - No required employer contribution
   - Can apply to newly eligible employees only
   - Can be added at any time
2. **EACA (Eligible Automatic Contribution Arrangement)**
   - Flexible plan design, but potentially more administrative oversight
   - No minimum default deferral rate and can be pre-tax or Roth
   - No required escalation
   - No required employer contribution
   - Must be in place as of the first day of the Plan year
   - Impact on ADP testing. The IRS requires plan sponsors to perform various tests each year to ensure that 401(k) plans are not discriminating in favor of business owners or other high paid employees. Two of the required tests are the Actual Deferral Percentage and Actual Contribution Percentage (ADP/ACP) tests. These tests are most often administered by an independent party due to the complicated nature of the testing.
     - **In order to qualify for the 401(k) plan ADP testing extension, EACA must cover all employees.**

  - An EACA permits the 401(k) plan ADP testing correction deadline to be extended from 2.5 months to 6 months. If your plan fails ADP testing, additional time to process refunds that affects highly compensated employees, if applicable, is granted to avoid 10% excise tax.

- Employees have up to 90 days to request the return of deferrals and applicable gains/losses after being auto enrolled. Employer contributions would be forfeited and processing fees could apply.

NOTE: 401(k) plans not utilizing safe harbor funding are subject to both ADP and ACP testing. 403(b) plans are subject to ACP testing; however, they are not subject to ADP testing.

3. **QACA (Qualified Automatic Contribution Arrangement)**

- Least flexible plan design
- Default % must start at no less than 3% and increase 1% per year up to 6% of pay and can be pre-tax or Roth
- Can start at 6% to avoid auto escalation; however, automatic deferrals can never be higher than 10%
- Must provide Employer Matching contribution of at least 100% of the first 1% deferred and then 50% of the next 5%. This formula provides a match of 3.5% on 6% or greater deferral rate. The other option is to provide an Employer contribution to all eligible employees of 3% of pay, regardless of the deferral rate.
- Must apply uniformly to all eligible employees. There is an exception to exclude employees with an affirmative election in place.
- Must be implemented prior to the beginning of the plan year and generally must be in effect for an entire plan year.
- If conditions are met, automatically satisfies ADP/ACP and top heavy testing
- The Employer contribution is 100% vested after 2 years of service and is not eligible for hardship withdrawals.
- Employees have 90 days to request the return of deferrals and applicable gains/losses after being auto enrolled. Employer contributions would be forfeited and possible processing fees could apply.

Proper Oversight and Execution critical to avoid plan corrections:

Regulations issued in April, 2015 greatly reduced the financial implications of correcting failures to automatically enrolled employees after becoming eligible. The guidance also added new calculations for other elective deferral corrections as well.

Mark Irwy, Senior Advisor to Secretary of Treasury and Deputy Ass't Secretary (Tax Policy) for Retirement and Health Policy is hopeful that this new correction method will help in promoting automatic enrollment and alleviate some of the stumbling blocks in adopting the provisions. "The issue came up with surprising frequency and fervor," Irwy said.

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— Mark Irwy, Senior Advisor to Secretary of Treasury

Below is our understanding of IRS approved correction methods for failing to auto enroll an eligible participant timely or in accordance with the provisions of the Plan:

1. If deferrals are started within 9 ½ months after the end of the Plan year of the missed deferral, a deferral correction is not required if:
   - Notice to affected employee is provided within 45 days after the date the correct deferral deduction begins.
   - Employer Match is calculated on the full deferral amount that was missed (either the auto deferral default % or the amount affirmatively elected by the participant, if higher) and is adjusted for earnings.
     - Please note – in the case of a newly eligible participant that was never provided with enrollment materials, industry experts have indicated that best practice when calculating the Match would be to use the higher of the Average Deferral Percentage of the affected participant's group or the automatic enrollment default percentage. The rationale is that it is not known if the individual would be automatically enrolled or would have made an affirmative election.

2. If deferrals are not started within 9 ½ months after the end of the Plan year of the missed deferral, but are fixed before the last day of second plan year following the Plan Year in which deferrals should have started, then correction is:
   - QNEC of 25% of the auto enroll default deferral percentage, or alternate amount if a different percentage was elected by a participant, adjusted for earnings.
   - The Employer Match is calculated before the 25% adjustment, i.e., based on the full deferral amount or the amount affirmatively elected by the participant, if higher. The Match is also adjusted for earnings.
   - Notice to affected employee as described above

3. Any errors identified after that time frame must be fixed in accordance with the existing guidelines in EPCRS as follows:
   - QNEC in the amount of 50% of the auto enroll default deferral percentage or the amount affirmatively elected by the participant if higher, adjusted for earnings. Example: Default auto enroll is 3%, QNEC is 1.5%
   - Full Employer Match as described above and adjusted for earnings
   - Notice to affected employee as described above

Note – if an affected participant notifies the Plan Sponsor of the failure before the Plan Sponsor discovers the error, correct deferrals must begin no later than the first payroll after the last day of the month following the month in which the Plan Sponsor is notified.

Business benefits:

Having a financially independent workforce is similar to having a healthy workforce. Generally speaking, medically healthy and financially healthy employees are generally more productive and less distracted with other issues that require their attention. As your workforce ages, medical costs tend to increase and it is important that employees are able to afford the increases.

The primary advantage of automatic enrollment is that the employee does not have to take action. It can be difficult and expensive for certain employers to proactively engage their workforce due to demographics, job functions and work locations.

Saving a modest amount at a young age, increasing the amount over time with pay raises and increased rates enables participants to take advantage of two very powerful wealth accumulation tools. They are dollar cost averaging (buying on the ups and downs of the market), and the account balance compounding effect where money already in the plan will double in 12 years assuming a growth rate of 6% per year.

Additionally, the plan may benefit from obtaining better discrimination testing results, which could help with retention and furthering of financial independence of highly compensated and key employees.

Summary:

All too often, a feature is added to a plan based on someone's suggestion without a "needs" assessment. With proper design, whether automatic enrollment or not, your plan can greatly help your employees pay attention to and take action on saving for the future; after all, that is the primary purpose of a retirement plan.

If you feel that automatic enrollment is a possible solution for your plan, reviewing these questions with your existing providers or with a firm like ours would be a beneficial exercise.

Employee demographics and enrollment support:

- ☐ Is your workforce geographically spread out in different locations?
- ☐ Is your advisor or service provider willing to assist you in proactively enrolling employees?
- ☐ If so, will your company allow the enrollment and corresponding education to take place on company time?
- ☐ Will your employees take the time to answer questions about their individual risk tolerance in order for service providers to provide guidance to the appropriate investment?
- ☐ What do the terms "Automatic" or "Default" mean to the employees you are communicating to? Would they interpret them to be "Loss of control and choice" or "My Employer is providing simplified guidance for me"?
- ☐ If employees are accumulating debt, is retirement savings critical to these employees at this point in their life? How would you know?
- ☐ Are goal setting tools available by the provider? Many providers will report the goals on participant statements and some encourage action. How will you help employees utilize the tools available to them?

Impact on discrimination testing:

- ☐ Will it not matter, help or hurt discrimination testing?
- ☐ Will it have a positive impact on what the highly compensated employees (generally 5% owner and owner family members as well as employees earning over $120,000 in 2015) can defer? Example: If auto deferral % selected is lower than the average deferral % of the non-highly compensated employees that you have now, it could have a negative impact, especially without an automatic deferral escalation feature.

Plan costs:

- ☐ How will the auto enroll feature affect your plan expenses/provider fees?
- ☐ If your plan offers a match, has an analysis been done to project the cost increase of adding the feature?
- ☐ Would the projection prompt a decrease in the current match formula or more company costs?
- ☐ Will the potential of an increased number of employees with balances that are no longer with your company force you to have an annual plan audit causing additional expense?

Plan design decisions:

- ☐ What would your default contribution rate be and how would this impact your employees?
- ☐ Should you elect auto enrollment deferrals as pre-tax or Roth?
- ☐ Should you implement annual contribution escalation in conjunction with automatic enrollment?
- ☐ Should you select target-risk, target-maturity or balanced funds as the default investment (QDIA)? Do you want to auto enroll newly eligible only or all employees (regardless of whether they already declined or wanted to save at less than the auto deferral rate)?
- ☐ Will you be able to track the employees who are automatically enrolled, opted out or opted in? If your record keeper tracks this info, what happens if you decide to change record keepers?
- ☐ Will you offer a 90 day window in which employees can withdrawal their deferrals plus or minus the investment gain or loss?
- ☐ Should you simplify the investment selection and maintenance process by offering target date funds, automatic rebalancing, investment education and resources that can help workers maximize their retirement savings without requiring a lot of effort on their part?
- ☐ How will your Employer contribution vesting schedules be affected?
- ☐ Will the plan offer in-service withdrawals?
- ☐ Will the plan offer loans?

Practical considerations:

- ☐ Who within your firm will ensure that the auto-enrollment provision is administered properly?
- ☐ Do you have a trusted and knowledgeable consultant/service provider that will help you coordinate and oversee the various service providers' roles and responsibilities?
- ☐ Are your service providers, primarily payroll and record keeper, willing to assist and at what level?
- ☐ How will you collect and maintain beneficiary information?
- ☐ Is high participation rate a primary measure of success for your 401(k) or 403(b) plan?
- ☐ Is it important that your 401(k) or 403(b) plan facilitates a sufficient retirement income for your employees?
- ☐ Do your employees have the time or patience to actively manage their 401(k) or 403(b) plan?
- ☐ If automatically enrolled, do employees understand the tax impact, investments offered and plan features if they are not provided employee education?

Free Consultation:

As you can see, the decision to utilize the automatic enroll feature should not be taken lightly. To help you assess your options, The Paragon Alliance Group can provide an initial assessment at no charge to you or your firm. As Paragon's owner, Trustee of our Plan, a Plan participant myself, as well as consultant to our client base and various industry advisory councils, I believe we are positioned to offer a unique, unbiased perspective. Our perspective is based on many years of collective experience in plan design consultation and assistance in ongoing operations of our clients' qualified plans. Our staff takes a very active consultative role in doing everything we can to have plans work the way our clients would like them to work.

Rob Wisner, President
The Paragon Alliance Group, LLC
300 Harleysville Pike
Souderton, PA 18964
Phone#: 215.799.1200
Fax#: 215.723.1265
E-mail: rob@tpagroup.com
www.tpagroup.com

"Take time for all things: great haste makes great waste."

— Benjamin Franklin