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Auto-Enrollment and Auto-Escalation: Right for Your Retirement Plan?

When it comes to saving for retirement, getting started can be the hardest part for many employees. This challenge, however, is being solved for many American workers by the dramatic increase over the past decade in the percentage of 401(k) plans that use automatic enrollment and automatic escalation features to encourage participation.

Nearly 60 percent of plan sponsors automatically enroll workers in their defined contribution plans today, according to the Plan Sponsor Council of America's 60th Annual Survey of Profit Sharing and 401(k) Plans. That's nearly double the amount from a decade ago, and up from 46 percent in 2011. More than 73 percent of plans with automatic enrollment also automatically increase deferral rates, an increase of more than 18 percentage points over the past 10 years. PSCA also reports that 89 percent of eligible workers participate in a company defined contribution plan.

Despite the growing popularity of automatic enrollment and escalation features, determining whether to adopt them is far from being a decision that plan sponsors can put on cruise control. While automatic enrollment and escalation offer many benefits to employees as well as plan sponsors, sponsors need to consider and manage them effectively to ensure a successful program.

Background and Latest Data on Automatic Enrollment

The Pension Protection Act of 2006 (PPA) created a safe harbor for plan sponsors to automatically enroll workers into 401(k) plans. Instead of requiring employees to choose to join a plan, automatic enrollment flips the decision to start saving and requires them to opt-out if they don't want to participate. With automatic enrollment, employers elect a default contribution rate and can use a Qualified Default Investment Alternative (QDIA), such as a target date or lifestyle fund, to relieve employers of any fiduciary liability for this initial investment choice. The PPA also allows plan sponsors to automatically increase employee contributions over time. Once in the plan, participants can reallocate the assets out of the QDIA to whatever investments they see fit within the plan's eligible investment options.

The PPA has paved the way for workers' inertia to work for them, not against them, when saving for retirement. Studies have shown that automatically enrolling workers into defined contribution plans and boosting their contribution rates on an annual basis has helped more people to save for retirement than if left on their own to do the work. In addition, Wells Fargo Institutional Retirement and Trust's 2017 Driving Plan Health study showed that there is little difference in opt-outs when deferral rates are set at 3 percent versus a higher 6 percent contribution rate.

Automatic enrollment is most common in large plans (i.e., plans that have 5,000 or more employees); 70 percent of large plans use automatic enrollment. Industry-wise, 84 percent of insurance and real estate companies use the strategy, followed by non-durable goods manufacturing at 82 percent. Industries with lower usage rates include utility and energy companies (39 percent) and service businesses (46 percent).

So why are nearly 40 percent of plans not following suit and using automatic enrollment? And why are t nearly a quarter of companies currently using auto enrollment not pairing it with annual contribution escalations? For those not using auto enrollment, nearly half of the respondents to the PSCA survey said they were happy with their participation rates while a third said auto features don't line up with corporate thinking.

Understanding the Benefits

As with any element of plan design, there are important items to consider when - using automatic enrollment and escalation. Various types of automatic contribution arrangements can meet safe harbor provisions and exempt plans from certain non-discrimination testing requirements. Even though auto features are increasing in popularity, there is not a one-size-fits all program for every retirement plan. As companies consider whether to adopt these features—or amend their use of them—they need to evaluate the potential benefits and costs from both the employees' perspective and the company's perspective.

Benefits of Automatic Enrollment and Escalation

For Plan Sponsors:

- Defaults employees into an investment vehicle that is pre-approved by the Department of Labor
- May streamline and simplify the new employee on-boarding process
- May lead to lower administrative fees and/or the ability to offer additional tools and services to participants thanks to higher cumulative assets under management
- Puts employees on an automatic savings track, which may help improve employee retention and help them feel more secure about their financial futures
- Adds a benefit that can be used to attract and retain top talent
- Aids in non-discrimination testing
- Certain auto enrollment plans allow highly compensated employees to contribute the maximum amount and relieves the plan sponsor from anti-discrimination testing
- Reduces employer payroll taxes because funds are being contributed pre-tax
- Generates certain tax credits and deductions, such as matching contributions, for employers

For Employees:

- Increases plan participation among all incomes and age groups
- Allows many participants to save for retirement who might not do so if left on their own
- For traditional plans, participants defer paying income tax until they withdraw funds at retirement
- Allows participants to take advantage of company match or "free money"

Necessary Considerations for a Successful Automatic Enrollment and Escalation Program

For Plan Sponsors:

- Requires administrative oversight, particularly in regard to ensuring all eligible participants are properly and timely enrolled and escalation amounts are properly aligned with payroll withholdings
- Requires coordination and controls with record keepers and other third-party service providers
- Requires amending plan documents
- Certain auto enrollment plans need to start at the beginning of the plan year
- May call for more robust communication campaigns with employees to help them understand new plan features
- If mistakes are made, corrective measures can be costly and time consuming
- May cause employer contribution amounts to rise as more employees participate in the plan
- May result in more accounts with lower balances, especially for plans with lower default contribution rates and adds more burden on administrator to clean out balances when participants terminate

For Employees:

- May give employees a false sense of security, especially if the default rate is set too low and no automatic escalation is paired with the enrollment
- May increase the risk that employees end up with suboptimal asset allocations across their entire portfolios if they don't fully understand the holdings in their target date or lifecycle funds

Insight: Consider Leveraging the Power of Automation to Improve Financial Wellness

As Americans' retirement savings rates continue to be lackluster and as companies become increasingly focused on their employees' financial wellness, automatic enrollment and escalation features may be useful tools in managing your workforce and getting employees prepared for their financial futures. In addition to helping put employees on track for a successful retirement, implementing these features can have powerful benefits for employers, as well, by streamlining the enrollment process and serving as a tool to attract and retain talented workers.

Before adopting automatic enrollment or escalation, plan sponsors should work closely with their internal teams, as well as with their third-party service providers, to ensure that the proper controls and procedures will be put in place.