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Changes are Needed in 401(k) Laws - More Incentives Should be Given for Automatic Enrollment

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By Todd Cleary, for SBT

The ongoing debate about Social Security reform has drawn attention to Americans' woeful savings rate. One recent study found that the average American saves only $1 of each $100 he or she earns. Worse yet, the Bureau of Economic Analysis reports that the national savings rate is now negative: The average American spends more than he or she earns. Given these figures, it is no surprise that many Americans might not be able to afford retirement. Compounding this crisis, fewer employers sponsor employer-paid pension plans that provide a steady stream of retirement income. Instead, more and more employers offer only 401(k) plans, funded mostly by employees' own contributions, which will be the primary (or only) source of retirement income for many workers.

The problem with this approach is that many of these employees do not maximize their 401(k) savings. Statistics indicate that only 75 percent of eligible employees actually contribute to their 401(k) plans (for new hires, the percentage is much lower), and the employees who do contribute do not save as much as they should.To help employees increase their 401(k) savings rates, some employers have added employer matching contributions, more investment options, participant loan programs and other attractive features to their 401(k) plans. However, even these enhancements have not significantly raised employees' savings rates.

Another 401(k) plan feature, automatic enrollment, has received significant media attention in recent months and has been blessed by the Internal Revenue Service. Automatic enrollment reverses the usual way in which an employee enrolls in a 401 (k) plan. Normally, an employee must affirmatively elect to save a specified percentage of his or her compensation on a pre-tax basis. Under the automatic enrollment feature, if an employee does not return an election form, the employee's compensation is automatically reduced by a predetermined percentage, and the applicable amount is contributed to the 401(k) plan. There is no minimum or maximum automatic savings rate, which an employer may set, but the most common rates range from 2 to 6 percent.

An employer cannot apply the automatic enrollment feature to an employee until it provides notice to the employee that explains the automatic enrollment process and the procedure for changing the employee's savings rate. The employer also must provide a similar notice to each eligible employee before the beginning of each subsequent plan year. Employees must be able to change their savings rates or stop their savings altogether.

Considerations for employers
The automatic enrollment feature can benefit 401(k) plan sponsors. For example, studies have shown that automatic enrollment increases participation rates. One study found that after three years of automatic enrollment, participation among employees to whom automatic enrollment applied was 30 percent higher than among employees hired before automatic enrollment was implemented. In addition, automatic enrollment generally increases the savings rates of lower-paid employees more than those of higher-paid employees. To the extent that is true, automatic enrollment can be attractive to a 401(k) plan sponsor because it increases the likelihood that the plan will pass certain tests required under the Internal Revenue Code that compare the savings rates of "non-highly compensated" employees to those of "highly compensated" employees.

Despite these advantages, most employers have not added an automatic enrollment feature to their 401(k) plans. No doubt, the drawbacks to the automatic enrollment feature have limited its use. Generally, an employer that allows an employee to exercise control over his or her 401(k) plan investments is not liable for any loss that results from the employee's investment choices. However, that protection from liability is not available with respect to automatically enrolled employees because those employees do not "control" their investments. The plan designates a default investment for their accounts.

There are other disadvantages to automatic enrollment. For example, an employee may feel that automatic enrollment is overly paternalistic. Also, an automatic enrollment feature may make a 401(k) plan more expensive because it may require additional employer matching contributions. Finally, many states (although not Wisconsin) prohibit employers from requiring payroll deductions without their employees' consent.

Proposed legislation
Several proposals currently before Congress would increase the benefits and reduce the risks associated with automatic enrollment. One bill would impose less stringent nondiscrimination tests on 401(k) plans with automatic enrollment. Another bill generally would extend the liability exemption to default investments for automatically enrolled employees. Other proposed legislation would confirm that automatic enrollment may not be restricted by state laws that prohibit payroll deductions without employee consent.

Outlook
Although evidence suggests that automatic enrollment increases employees' participation rates, it is too early to determine

whether it will mitigate the pending retirement crisis. Current retirement plan law does not provide enough rewards and poses too many risks to make automatic enrollment worthwhile for most plan sponsors. Until further legislation is enacted, an employer should not implement automatic enrollment without carefully considering the effect this feature will have on plan costs and employee morale.

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