Automatic Enrollment and Default Funds for Defined Contribution Plans

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Enticing new employees to enroll in the 401(k) plan and diversify their investments from the money market fund or stable value fund has always been a challenge for plan sponsors. Finally employers now have regulatory help in their endeavor to increase enrollment and participant levels.

Pension Protection Act 2006

The recent Pension Protection Act 2006 (PPA) makes it easier for employers to enroll participants in the 401(k) plan and have them invest in a default fund that is conservative yet enables growth of capital.

Effective this year, the PPA allows for automatic enrollment at an automatic deferral rate of 3% to 10% of salary. The employer match must be either 3% overall or 100% on the first 1% contributed by the employee and 50% on the amount contributed between 2% to 6%.

Employees must vest within two years and they must be able to opt out of the plan within the first 90 days. The PPA provides a safe harbor (ERISA) for employers that meet these conditions. Finally, the PPA clarifies that its rules prevail over any state or local regulatory restrictions.

"We implemented automatic enrollment and selected a balanced fund for the default fund last year and dramatically improved our plan participation."

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Director, Global Benefits
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Previously, companies that auto enrolled put participants into principal-protected stable-value funds or money funds. The aim was to let participants decide on an investment approach while their money was protected against short-term losses. Unfortunately, many participants never changed their allocation and became vulnerable to long-term shortfalls in principal growth.

The automatic provisions of the PPA seem to be able to accomplish what decades of education could not--enrollment and deferral at reasonable rates. Education will be critical in encouraging employees to go beyond the minimal participation levels set by the PPA.

Even automatically enrolled participants need to set goals and allocations as their circumstances change in order to meet their eventual retirement income needs. Unlike traditional pension plans (defined benefit plans) in which participants have virtually no input, defined contribution plan participants have greater flexibility and latitude in making specific investment decisions.

There appears to be very little downside to automatic enrollment. However, for plans that have very high participation rates and higher-than-average deferral rates, an automatic default option may not be necessary and those participants may actually decrease their deferral to match the automatic deferral rates proposed by PPA.

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Under the new Department of Labor (DOL) proposed automatic enrollment regulations, defined contribution plan sponsors want more default investment options to be given safe-harbor protection under ERISA Section 404 (c).

The PPA is expected to spur greater use of automatic enrollments because it offers employers protection from fiduciary lawsuits if a plan's default option loses money. But the DOL's proposal announced September 26, 2006, would only provide safe harbor from plans' fiduciary liability under ERISA for three default options (Qualified Default Investment Alternatives or QDIAs):

Balanced funds, which have the same asset allocation for all plan participants, regardless of age. The allocation might be 60% stocks and 40% bonds, for example.

Life cycle funds, which are based on the targeted retirement date of the participant. Generally the percentage of equities is high when participants are younger and is reduced as the participant ages.

Life cycle funds give participants immediate diversification and professional asset allocation of their retirement assets.

Managed accounts, which an investment manager creates for a participant with an asset allocation based on the individual's risk tolerance, outside investments and other sources of retirement income. The manager chooses the investments for the account from among the plan options and rebalances periodically.

Stable funds and money market funds have been omitted from the default fund options which the Washington-based ERISA Industry Committee said should be included as an appropriate default option for companies with older employees, high employee turnover rates or plans that are skewed toward equities.

Many industry experts believe that the safe harbor auto bundle consisting of auto enrollment, auto increase, and a lifecycle fund as a default belongs in every plan.

Also proposed is a requirement that the QDIAs be handled by an investment manager that meets specific ERISA fiduciary requirements or an investment company registered with the SEC. This would require plans to hire an intermediary and could add to plan costs. Also discussed is whether a plan would have multiple default funds.

Other issues being raised by industry experts are that the final rules proposed by the DOL do not eliminate redemption fees charged to participants to move or sell mutual fund shares and they require 90 days notice to an employee that a portion of their pay be put into the default option if they do not select another investment option or specifically opt out of the plan.

The PPA directed the DOL to establish and publish final rules by February 17, 2007. The DOL said its new regulation would go into effect 60 days after a final regulation is published and it is expected to spur greater use of auto enrollment.

Regardless of which kind of default option is chosen, employers still need to do their due diligence in the evaluation, analysis and selection of the fund, as well as the ongoing monitoring of the fund performance. Employers also need to continue to educate their participants on the proper way to use the plan's default option and stress the need for diversification among all asset classes. Too conservative an allocation among funds can be as detrimental to the purchasing power of retirement assets.