

BEST PRACTICES IN Compensation & Benefits

January 2005

CASE Study

Automatic Enrollment May Not Be Worth the Cost

When something new and innovative is introduced in employee benefit plans, it is only after careful consideration that Pamela Constantino, co-owner and CEO of consulting firm Polycomp, advises her clients to pass.

A few years ago, the latest trend was automatic 401(k) plan enrollment. It's a trend that continues to gain ground today, according to the Profit Sharing/401(k) Council of America (PSCA). Their 48th Annual Survey of Profit Sharing and 401(k) Plans, conducted in 2004, shows an increase in the number of plans utilizing automatic enrollment, from 8.4 percent in 2003 to 10.5 percent in 2004. And while the survey shows that large plans are more likely to use automatic enrollment than are small plans, it is something that many companies consider as the trend escalates. (Just 0.9 percent of plans with fewer than 50 participants used automatic enrollment in 2004, and 30.9 percent of those with more than 5,000 participants did so.)

It's no secret that when employees save for retirement through a company-sponsored 401(k) plan, everyone wins. The company buys employee goodwill by providing a benefit appreciated by employees at all levels, and they're able to avail themselves of tax advantages. Most importantly for most companies, employees accumulate wealth to provide themselves with a comfortable retirement.

There is one caveat, though: This particular retirement vehicle only works when employees use it.

While the PSCA survey of 1,052 plans covering more than 9 million participants with more than \$500 billion in plan assets shows a reasonably high rate of participation—77.3 percent of eligible employees have plan balances—many companies can only wish for that much participation. Or so they thought until they heard about automatic enrollment.

Many of Polycomp's clients, frustrated by a lack of participation in their plans, liked the idea of automatic enrollment, thinking it could solve their discrimination testing problems and encourage employees to save for themselves. Constantino admits that both are sometimes true, but she and her associates advise caution. "Obviously I think it's better for everyone to save for retirement," she says. But the downside of using automatic enrollment is both too great, and avoidable.

Sacrificing Employee Trust for Higher Participation

Normally, employees who want to enroll in a 401(k) plan ask to do so by completing the

enrollment paperwork. With negative enrollment, as Constantino calls it, there is a 'presumption of participation'—employees are automatically enrolled in the 401(k) plan unless they complete the forms to opt out. Of course, you must provide proper notification and information to the employees so they understand what's happening. So what's the problem? They often do not understand.

Constantino worries about the employer/employee relationship in these circumstances, saying that some employees feel that their trust has been violated. "With negative enrollment, this is something that is going to be done even if the employee doesn't understand. In many states, you can't withhold money from an employee's paycheck without their written consent. ERISA supercedes state law, so it's okay for employers to use negative enrollment. But there's a reason that states require employees to consent to having something withheld from their paycheck."

And while negative enrollment can increase the amounts allowed to be deferred by the plan's highly compensated group, the cost may be too high. Take the (fictional) case of Mid-Size Widgets, a 500-employee manufacturing company that is dissatisfied with its low rate of plan participation. They decide to institute automatic enrollment, deferring 3 percent of pay for each employee who does not opt out of the plan upon becoming eligible. They send out notices, as required by law, set up their payroll run, and wait for the pats on the back from happily saving participants.

"An employee gets his or her paycheck and it's smaller than expected—there's the employee relations issue," says Constantino. "Then the employee says, 'Stop—now I understand what you mean. Now I'm telling you 'no'—I do not want this withheld from my paycheck.' Then the employer has this small account within the plan, maybe \$5 or \$20. They can't distribute it, because there hasn't been a distributable event. So the employer may end up with a lot of these very small accounts that end up costing them more in the long run than they would if they had just discussed it initially with the employee."

Cost in Dollars

"Typically, employers pay for plan administration based on the number of account balances," Constantino continues. "Of course, it depends on the plan's fee structure. But nothing is for free; costs are built in somewhere. The fees for ongoing administration by a third-party administrator can range from \$20 to \$50 a year for each account, and then you have the ultimate distribution fees on top of that. They can range from \$50 to \$150 to process."

For a plan with 50 of these small accounts, then, unnecessary fees may mean \$1,000 to \$2,500 in extra costs annually, and an additional \$2,500 to \$7,500 when distributions are made. That's a significant portion of overall plan costs for a company like Mid-Size Widgets.

There are three keys to increasing plan participation without resorting to automatic enrollment, says Constantino. Her suggestions include:

- **Offer a matching contribution.**

"A lot of employers really have problems with discrimination testing, particularly if they're not making any matching contributions. It's hard to get people to participate when there's no incentive." The PSCA survey shows an average 401(k) match of 2.9 percent of pay. And while a match will cost you, in the long run the cost may be lower, in dollars and in employee morale, than if you had utilized automatic enrollment.

- **Communicate individually with employees who become eligible for the 401(k) plan.** "We have 120 employees here at Polycomp," says Constantino. "To me, that's a very manageable size to communicate with each one individually. We have quite a high participation rate. I understand that in our business we have people who are more sophisticated and understand the advantages of a 401(k) plan. But you need the individual communication all the more so for companies where the employees don't understand. They really need individual education, and that's what we advocate. We meet with people individually and show them what their paycheck would look like if a particular amount is withheld, and what they're saving. They can see the benefits for themselves." If your company is large, you can still communicate individually with newly eligible employees. "Most companies have a human resources department that's meeting with employees about their benefits. It won't be the president of the company talking to each employee, but everyone has a manager."

- **Communicate often.** You've heard it here before, but it bears repeating: When it comes to communicating an idea, once is not enough. "Take every opportunity, particularly if your company doesn't have a high participation rate," says Constantino.