How smart is your retirement plan design?

Adding automatic enrollment and automatic increase can benefit employees and the plan's fiduciaries

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Introduction

Automatic enrollment and automatic increase are plan design features that help employees save for retirement without the need to take any action.

Nearly 20 years ago, Congress paved the way for employers to add automatic enrollment and automatic increase features to their retirement plans by providing safe harbor relief from a variety of concerns that often deterred interested employers from adopting these features. Since that time, Congress, federal regulators and even state legislatures have increasingly embraced automatic enrollment and automatic increase features as best practices in plan design.

What were once novel plan design features are fast becoming standard among retirement plans and, in some cases, are even **required** under federal law. In 2022, Congress enacted a new requirement that most new 401(k) and 403(b) plans must include automatic enrollment and automatic increase features. States are increasingly adding automatic enrollment for state and local government employees. Additionally, since 2017, a growing number of states have required private-sector employers with as few as one employee to automatically enroll their workers in a state-run individual retirement account (IRA) program if the employer doesn't already offer a plan.

The growing prevalence of automatic enrollment and automatic increase features means that workers throughout the United States are increasingly coming to expect that they will have access to workplace savings and be automatically enrolled in a workplace retirement plan, even in industries where plan coverage and plan participation have historically been low. Due to the recent changes in federal retirement law and the evolving state landscape we describe below, this is an ideal time for those employers who had previously been reluctant to implement auto features to adopt automatic enrollment and automatic increase for their plans.

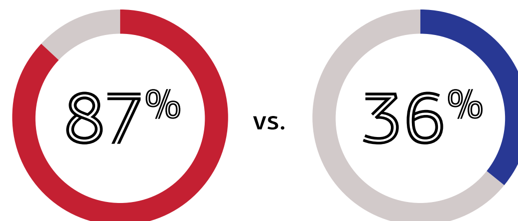
In this white paper, we provide a quick refresher on these automatic features, which have proven to be astoundingly effective in increasing participation and savings. We then provide a summary of how policymakers have increasingly supported and encouraged the adoption of these features — in some cases even **requiring** their use.

We also include a discussion of an aspect of this plan design decision that employers may not have considered: how adding automatic enrollment and automatic increase features may provide benefits to the employer in its role as a fiduciary.

Automatic enrollment and automatic increase features

As an employer, offering a workplace retirement plan is an important tool in supporting your employees as they prepare for retirement. But even when employees have access to a retirement plan through work, it's not uncommon to find that a large portion of the workforce isn't taking advantage of the opportunity to save for retirement through the plan. Although this can be due to a variety of reasons, many workers simply never get around to taking the steps necessary to begin making contributions to the plan, putting off the task for another day. Other workers may feel overwhelmed at the thought of selecting investments or determining how much to contribute from each paycheck. And some simply don't understand the need to save.

As 401(k), 403(b) and other types of defined contribution plans have become a more critical component of employees' paths to a financially secure retirement over the last few decades, employers have increasingly found it important not only to offer a workplace retirement plan to their employees, but to actively encourage employees' participation and increased savings in the plan. Educational materials, investment tools and targeted communications are just some of the approaches that employers may use with employees in this regard. More and more employers, however, are also turning to smart plan design features to accomplish these goals. **Automatic enrollment** and **automatic increase** features are two such plan design tools that have proven to materially increase participation and savings in a plan.



Employee participation rate in plans **WITH** automatic enrollment feature

Employee participation rate in plans **WITHOUT** automatic enrollment feature

Automatic enrollment

When a retirement plan includes an automatic enrollment feature, the employer automatically begins deducting a certain percentage (or amount) from an eligible employee's paycheck and depositing that amount in the employee's plan account where it's invested in a default investment option preselected by the plan sponsor. Employees may opt out of the plan at any time or change their contribution level or investment. In this way, automatic enrollment helps to ensure that no employees who are eligible for their workplace retirement plan fail to begin saving for retirement simply due to inaction on their part.

Automatic increase

Under an automatic increase feature (also known as “automatic escalation”), employees’ contributions to their plan account are automatically increased at periodic intervals to facilitate increased savings over time, without any action required. For example, a plan may provide that an employee’s contribution will be increased by 1% of the employee’s wages each year until the employee reaches a contribution level of 10% of wages. In that case, employees who are contributing 5% of their wages would be increased to 6% the following year, 7% the year after, and so on until they’re contributing 10%. As with automatic enrollment, employees may opt out of these automatic increases or select a different contribution level at any time.

The astounding effect on participation rates

Multiple studies have demonstrated just how powerful automatic enrollment is in increasing participation rates. For example, Bank of America Workplace Benefits™ research found that, in 2022, only 36% of employees participated in their workplace retirement plan when the plan lacked an automatic enrollment feature. Plans that include automatic enrollment had an employee participation rate of an astounding 87%.[1]

Even more astounding, only 2.2% of participants opted out of participation after being automatically enrolled — evidence that, when saving for retirement is made easy, the vast majority of employees will do so.

This research is consistent with what many other researchers have found.[2]

The evolution of automatic enrollment under federal law

Congress added section 401(k) to the Internal Revenue Code in 1978, and the design took off in 1981 when the Internal Revenue Service (IRS) issued proposed regulations that explained how these plans would work.[3] As 401(k) plans became more prevalent throughout the 1980s and 1990s and, for many workers, supplanted traditional defined benefit plans as the employers' primary retirement plan, employers began experimenting with different plan designs. Most early 401(k) plans required employees to take action to enroll in the plan, although a small number of employers took a page from defined benefit plans by automatically enrolling their employees in the 401(k) plan.

Guidance issued by the IRS in the late 1990s and early 2000s clarified that automatic enrollment and automatic increase features were generally permissible under federal tax law,[4] but many employers remained hesitant to add these features due to other federal and state law concerns. According to one estimate, only 11% of 401(k) plans included automatic enrollment in 2004.[5]

By 2006, however, the future of automatic enrollment and automatic increase looked much brighter as Congress took definitive steps in the Pension Protection Act of 2006 (PPA) to address the legal barriers deterring plan sponsors' widespread adoption of these features. Most recently, with the enactment of the SECURE Act of 2019 and the SECURE 2.0 Act of 2022 (SECURE 2.0), Congress has solidified its view of automatic enrollment and automatic increase as not merely permissible features, but as best practices in retirement plan design.

Next we describe how the PPA paved the way for greater adoption of automatic enrollment and automatic increase features in retirement plans. We also look at the more recent steps that Congress took in the SECURE Act of 2019 and SECURE 2.0 to make the usage of these features much more widespread and to further reduce some of the remaining financial and administrative burdens on employers.

Pension Protection Act of 2006

At the time of its enactment in 2006, the PPA was the most comprehensive retirement package to be signed into law since the passage of the Employee Retirement Income Security Act (ERISA) in 1974. Although many of the PPA's reforms were targeted at traditional defined benefit plans, the law also had a significant impact on defined contribution plans in order to encourage the wider adoption of automatic enrollment features. The PPA included the following changes, which continue to be helpful and important to plan sponsors to this day.

- **QDIA relief.** ERISA requires plan fiduciaries to administer plans prudently and solely in the interest of plan participants and beneficiaries. Prior to the PPA, plans utilizing automatic enrollment often selected a very conservative investment option, such as a stable value fund, as the default investment option for employees whom the plan automatically enrolled due to fiduciary liability concerns under ERISA. Congress thus sought to encourage employers to select a default investment that would be more likely to appreciate at a rate that would help employees achieve long-term retirement security. To accomplish this, the PPA amended ERISA to provide that fiduciaries would be protected from liability if the plan's default investment complies with the U.S. Department of Labor's qualified default investment alternative (QDIA) regulations and a notice requirement is met. QDIAs may include, for example, a professionally managed account, a target date fund and a balanced fund.

Since the Pension Protection Act was enacted in 2006, Congress has transitioned from its focus on reducing barriers to automatic enrollment in retirement plans to treating automatic enrollment as a best practice.

- **New safe harbor.** The PPA created a new safe harbor under which plans that adopted automatic enrollment would be deemed as satisfying the average deferral percentage (ADP) test and average contribution percentage (ACP) test if certain requirements are met (in addition to employer contributions required under the normal safe harbor). When the PPA was enacted, one of the requirements of this new safe harbor was that employees automatically enrolled in the plan must be enrolled at a contribution rate of at least 3% in the first year of participation, at least 4% in the second year, at least 5% in the third year, and at least 6% in the fourth and any subsequent year, up to a maximum default contribution rate of 10%. As described below, Congress later amended this requirement in the SECURE Act of 2019 by raising the 10% limit to 15% for years after the first plan year in which the employee is automatically enrolled.
- **State wage garnishment laws.** The PPA amended ERISA to provide that ERISA supersedes any state law that would directly or indirectly prohibit or restrict the inclusion in any plan of an automatic contribution arrangement. This change was aimed at addressing concerns over state laws that require employers to obtain an employee's permission before making any payroll deductions not required by law.

Permissive withdrawals. The PPA added a provision to federal tax law that provides an optional plan design feature that would allow new employees who had been automatically enrolled in the plan — but decided to opt out after seeing the deduction from their paycheck — to take a withdrawal of the small amount that was automatically contributed. There was a fear during the development of the PPA that there would be employees who would opt out and want their money back, along with concerns about this creating very small accounts. While this design option can provide an important safety valve for employers and employees, employers that have implemented automatic enrollment since the PPA was enacted have found that very few employees do, in fact, opt out after they're automatically enrolled in the plan.

SECURE Act of 2019

Plan adoption of automatic enrollment features experienced a significant boost in the years following the PPA. Several estimates indicate that the use of such features doubled or even tripled as compared to adoption rates prior to the PPA. But even with that boost, many plans, especially those of smaller employers, continued to require eligible employees to proactively opt in to plan participation. As a result, Congress sought to increase and further encourage the usage of automatic enrollment and automatic increase even more when, in December 2019, it enacted the first significant retirement bill since the PPA. That legislation, known as the SECURE Act of 2019, included the following provisions:

- **Increase in safe harbor cap.** The SECURE Act of 2019 raised the previous safe harbor 10% limit on the automatic deferral contribution percentage to 15% for years after the first plan year in which employees are automatically enrolled. In the first plan year, the default contribution rate still may not exceed 10%.

- **New tax credit for small employer plans adopting automatic enrollment.** Effective in 2020, the SECURE Act of 2019 created a new tax credit under which employers with generally up to 100 employees are eligible for a credit of $500 per year for up to three years, beginning with the first taxable year for which the employer includes automatic enrollment in a qualified employer plan. This credit is available even if the feature was added after the plan was adopted, and it's available in addition to the small employer pension plan startup credit. **Note:** *While these tax credits are only available to smaller employers, we point out this provision as it's yet another instance where Congress is providing incentives to encourage automatic enrollment plan design.*

Is automatic enrollment older than the 401(k) plan itself?

Even before there was a section 401(k of the Internal Revenue Code, some employers — particularly banks — were offering profit-sharing plans under which employees could receive a bonus contribution made to a trust at the end of the fiscal year, based on profits. Some of these employers came up with the idea of offering an "opt out," where employees could affirmatively decide to receive cash instead. This is a kind of automatic enrollment because employees had to affirmatively opt out or their compensation (in this case a year-end bonus) would be contributed to the plan.

In the 1950s and 1960s, the IRS issued a series of rulings allowing these plan designs, which had become known as a "cash or deferred arrangement," or CODA. But in 1972, the IRS changed its mind and proposed to outlaw CODAs. Employers complained to Congress, and when ERISA was passed in 1974, it contained a provision that told the IRS it could not disqualify any CODA adopted before the enactment of ERISA. Four years later, Congress created subsection (k) of Code section 401, and the modern 401(k) was born.

Section 401(k) plans created in the 1980s and 1990s generally focused on CODA contributions from wages and salary, so they didn't include automatic enrollment features. But some of the earliest CODAs were, interestingly, likely early adopters of an "opt out" rather than an "opt in" design.

SECURE 2.0 Act of 2022

After the relatively modest changes affecting automatic enrollment and automatic increase features were enacted in the SECURE Act of 2019, Congress followed up by taking significant steps to increase their usage when it enacted SECURE 2.0 in 2022. For the first time, Congress is now **requiring** certain newly established plans to include automatic enrollment and automatic increase in their plan design, thus firmly establishing these features as a best practice and demonstrating clear congressional support for their adoption by plan sponsors.

- **New 401(k) and 403(b) plans required to include automatic enrollment.** Beginning in 2025, SECURE 2.0 requires 401(k) and 403(b) plans established after the enactment of SECURE 2.0 to automatically enroll participants at a minimum initial rate of 3% of compensation (maximum 10%). Further, the law requires that rate must be increased by 1% each year until it reaches at least 10%. The cap on permissible automatic increases is 15% in most cases. Plans subject to the requirement must also include the permissive withdrawal feature mentioned above. Exceptions to this new requirement are available to plans that were established before SECURE 2.0's date of enactment (December 29, 2022), new businesses in existence for fewer than three years, and small businesses that normally employ 10 or fewer employees. SIMPLE 401(k) plans, governmental plans and church plans are also exempt from the new requirement.
- **"Starter" 401(k) plans.** Beginning in 2024, SECURE 2.0 makes a new type of 401(k) plan available for employers that don't already maintain a retirement plan. A "Starter" 401(k) plan has the benefit of being treated as automatically satisfying nondiscrimination testing, but employer contributions are prohibited and annual elective employee contributions are limited to $6,000 (indexed), plus the IRA catch-up contribution limit. Starter 401(k) plans are also **required to include automatic enrollment at a rate of at least 3%** (maximum 15%). Starter 401(k) plans are also subject to the same automatic enrollment and automatic increase requirements described above for new 401(k) plans unless at least one of the available exceptions to that requirement applies.

What changes are next?

Federal retirement law will continue to evolve following the enactment of SECURE 2.0 in 2022.

For more than 10 years, Congress has considered multiple proposals to require employers to offer a payroll deduction retirement savings opportunity for workers. Several of these proposals would have created an auto-IRA program similar to those enacted by several states (described below). Others, including the Automatic Retirement Plan Act introduced by Representative Richard Neal (D-MA), would generally require employers to maintain an "automatic contribution plan."

Congress has so far preserved the historically voluntary nature of private-sector retirement plans in the United States, but economic and societal shifts could spell more changes for employers.

- **Reducing administrative burdens for plan sponsors.** Prior to SECURE 2.0, Congress primarily focused on reducing legal barriers and increasing incentives to promote the greater use of automatic enrollment and automatic increase features. By enacting SECURE 2.0, Congress also sought to address one of the remaining reasons that small plans in particular have remained reluctant to add these features: the administrative burdens of dealing with numerous small accounts, particularly for employers that experience higher turnover rates in their workforce. These SECURE 2.0 provisions in particular seek to reduce the burdens attributable to small accounts:
  - **Increased cash-out limit.** Plan sponsors may include a provision in their plan that allows it to pay out vested account balances to participants with smaller account balances who terminate employment. If certain requirements are met, such as providing notice to the participant, SECURE 2.0 raises this statutory "cash-out" limit from $5,000 to $7,000 for distributions made in 2024 or later. This increased limit will help offset the added cost or administrative burdens a plan may experience if adding an automatic enrollment feature results in a greater number of small-balance accounts in the plan that are attributable to terminated participants.
  - **"Lost and Found" registry.** SECURE 2.0 requires the U.S. Department of Labor to establish an online searchable database that will allow individuals to search for information regarding the contact information for the plan administrator of any plan in which they are a participant. Plans subject to ERISA's vesting standards will be subject to the "Lost and Found" registry. This new initiative, which is currently under development, is expected to help workers locate any "lost" retirement benefits and reduce the cost to plans of searching for missing participants.

State auto-IRA programs push automatic enrollment further

While federal law will now require new 401(k) and 403(b) plans to include automatic enrollment and automatic increase features unless an exception applies, the fundamental decision of whether to offer a workplace savings plan in the first place remains preserved for employers under federal law at this time. A growing number of states, however, have become concerned that federal law isn't evolving fast enough to ensure that every worker has access to a payroll deduction workplace retirement savings option.

In response to that concern, beginning in the 2010s, a number of states began enacting auto-IRA programs that require private-sector employers in the state to automatically enroll their employees in a state-run IRA program unless the employer already offers a 401(k) plan or similar savings opportunity to its employees. Just like with a 401(k) that has automatic enrollment, employees may opt out of the state-run IRA program. The first such state program launched in Oregon in 2017. By July 2024, ten states had implemented an auto-IRA program, and seven additional states were in the process of developing a program. Several other states have considered legislation to create an auto-IRA program, and we expect more state programs to be signed into law in the coming years.

The employer mandate associated with the state auto-IRA programs generally applies to employers of all sizes, with some states offering exceptions for only the very smallest of employers. Because small and mid-sized employers are less likely to offer a retirement plan to their workers, a relatively high percentage of such employers are increasingly finding themselves required by one or more state laws to facilitate the state's auto-IRA program on behalf of their employees. The continued expansion of state auto-IRA programs is increasingly normalizing the use of automatic enrollment in a retirement savings program, especially by small employers and by employers in industries that have historically been less likely to offer a retirement plan. As such, automatic savings programs are becoming normalized and often expected by employees.

Interestingly, states are also starting to implement automatic enrollment for their own state and local government employees. State and local government employees have typically had access to traditional defined benefit plans, making the need to have automatic enrollment in a supplemental defined contribution plan unnecessary.[6] Nonetheless, a number of states have changed their laws in recent years following the trend and implementing automatic enrollment in their supplemental defined contribution plans.[7]

The automatic enrollment decision

For the next generation of new 401(k) plan sponsors, there will be no decision to make — Congress is requiring that most new plans have both automatic enrollment and automatic increase features. But what if you're an employer with a plan adopted before the enactment of SECURE 2.0 and thus aren't required (at least not yet) to have automatic enrollment? What should you be thinking about?

For those employers who aren't subject to the mandate in SECURE 2.0, the decision to add or not add automatic enrollment is what's known as a "settlor" decision, that is, a plan design decision made in the employer's non-fiduciary capacity. Thus, the employer can take into account a variety of considerations, including the extent to which having a workforce better prepared for retirement provides benefits to the employer in terms of productivity and workforce management.

Most employers, plan consultants and advisers generally view the primary reason to adopt automatic enrollment and automatic increase as being the tremendous gains that the employer sees in terms of employees' plan participation and savings. This helps engage more employees in the employer's benefits and allows them to take advantage of matching contributions.

There's a reason why automatic enrollment is often listed as among the top "best practices" from a plan design standpoint. The fact is, automatic enrollment and automatic increase result in employees having more savings — sometimes a lot more. Employees with more financial security and better financial wellness are more productive employees. And in the authors' experience, most benefits managers want their employees to use the benefits offered and get the most out of them.

Fiduciary advantages

Another advantage, however, that's coming more into focus is that having automatic enrollment and automatic increase as part of your plan design might be helpful to the employer (or the plan committee) in its role as a fiduciary to the plan. As a fiduciary, the employer must act prudently, act solely in the interests of plan participants and beneficiaries, and ensure that the fees of the plan are reasonable. The fiduciary must also act with the level of care, skill and diligence that a prudent person "acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims." In non-legalese, this means that fiduciaries must ask themselves: What would a careful and prudent expert do if faced with this same situation?

A plan that includes automatic enrollment may offer the following advantages from a fiduciary standpoint:

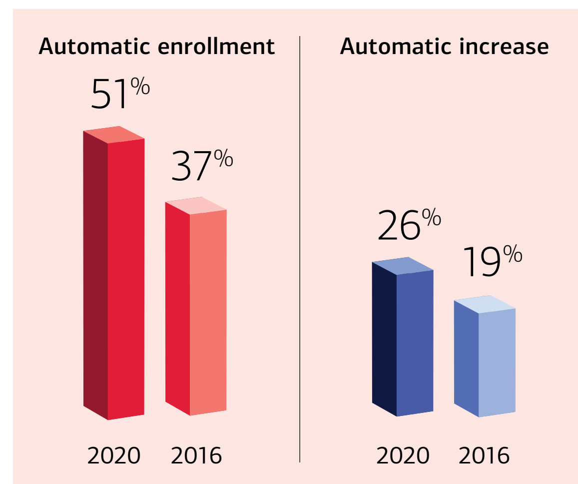
- **More plan assets generally result in lower fees.** A fiduciary's key job is to ensure that the fees of the plan are reasonable. In general, large plans tend to pay lower fees for investments and administrative services. By bringing in more assets, the fiduciary has more leverage to negotiate fees and get access to institutional-priced investments.
- **Reducing the need for education for nonparticipating employees.** Fiduciaries often spend significant resources educating — even cajoling — employees about the need to participate in the plan, and these efforts are often paid for with plan assets. Utilizing automatic enrollment may provide some value in reducing the need for education to ensure that employees don't lose valuable plan benefits.
- **Ensuring that employees are in an appropriate asset allocation.** ERISA section 404(c) is intended to protect a fiduciary from a claim that a participant made an inappropriate investment decision.[8] But in recent years, the usefulness of section 404(c) as a protection for fiduciaries from lawsuits has been called into question.[9] Even if section 404(c) is helpful, the default investment associated with automatic enrollment will place participants in an investment that provides a mix of asset classes. When employees are automatically enrolled, they'll typically be placed in the plan's QDIA. Whether this is a target date fund, balanced fund or managed account, employees will be in an investment that provides asset allocation among a range of asset classes.
- **Avoiding nondiscrimination testing problems.** The nondiscrimination tests, including the ADP and ACP tests, compare the contributions made by highly compensated employees and non-highly compensated employees. When an employer doesn't have automatic enrollment and automatic increase, lower-paid employees are much more likely not to participate, or to participate at lower contribution rates, which can cause testing problems. While failing the tests is not a fiduciary breach by itself, the fiduciary is responsible for figuring out how to correct for the failure, which can mean refunding contributions to highly compensated employees, recharacterizing contributions as catch-up contributions, or calculating "qualified nonelective contributions," which the employer can make to pass the test. All of these are easy to do incorrectly, and the fiduciary must clean up the mess. In short, it's much easier to just pass the tests in the first place, either by adopting a safe harbor design or getting lower-paid employees contributing to the plan and increasing the contributions over time.

- **Automatic increase helps reduce the number of small accounts.** Very small accounts in plans can cause a fiduciary headache. For example, because each account has certain costs that the plan must bear regardless of the size of the account, the plan's fee as a percentage of assets can be higher if there are many very small accounts. In addition, participants with very small accounts are more likely to lose track of their account, or fail to cash a distribution check, when they terminate employment. By adding automatic increase, the plan can help ensure that employees increase their contribution rate, which helps reduce the number of small accounts.

As noted earlier, the decision to add automatic enrollment and automatic increase is a "settlor" decision. Thus, to be clear, it's not a fiduciary breach for a plan not to have automatic enrollment. There are legitimate business reasons why some employers have never adopted it. Some employers, for example, are reticent to adopt automatic enrollment because it might increase their costs, as more employees become eligible for the plan's matching contribution. The point of this section is to highlight how adding automatic enrollment may provide benefits to the employer in its capacity as a fiduciary.

The future of automatic enrollment

According to one survey of human resources professionals, 51% of plans included automatic enrollment in 2020 (up from 37% in 2016), and 26% of plans included automatic increase in 2020 (up from 19% in 2016).[10] The U.S. Bureau of Labor Statistics similarly estimated that, in 2022, more than one-third of workers in establishments with one to 99 workers, and nearly 50% of workers in establishments with 100 or more workers, had automatic enrollment in their savings and thrift plans.



As the SECURE 2.0 provisions that encourage — and in some cases require — automatic enrollment and automatic increase features begin to take effect, the percentage of plans including these features are eventually expected to become nearly universal among employers of all sizes. Workers are increasingly becoming accustomed to having a portion of their pay automatically directed into a retirement savings vehicle, and many will even come to expect it. This paradigm shift in the defined contribution space presents the perfect opportunity for employers that have not yet added automatic enrollment and automatic increase features to their plan design to reevaluate whether now is the time to do so.

[1] *The resurging workforce: Optimism and expectations for the future*, 2024 Workplace Benefits Report, Bank of America Corporation, April 2024.

[2] James J. Choi, David Laibson and Brigitte C. Madrian, *Plan Design and 401(k) Savings Outcomes*, Working Paper 10486, National Bureau of Economic Research, May 2004; and Brigitte C. Madrian and Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior,* Working Paper 7682, National Bureau of Economic Research, May 2000.

[3] For more information on the history of 401(k) plans, see Sarah Holden, Peter Brady and Michael Hadley, *401(k) Plans: A 25-Year Retrospective*, Investment Company Institute, November 2006.

[4] See Rev. Rul. 98-30 and Rev. Rul. 2000-8, Internal Revenue Service.

[5] *Automatic Enrollment in 401(k) Plans*, Congressional Research Service, January 16, 2007, citing data from the Profit Sharing/401(k) Council of America.

[6] State and local governments generally cannot adopt a 401(k) plan, but they can offer a 457(b) plan as a supplement to the defined benefit plan, which is very similar to a 401(k) plan.

[7] See "Automatic Enrollment," the National Association of Government Defined Contribution Administrators webpage on automatic enrollment in government defined contribution plans.

[8] ERISA section 404(c) provides that the plan fiduciary is not liable for "any loss, or by reason of any breach, which results from [a] participant's or beneficiary's exercise of control" of their account.

[9] See *Hughes v. Northwestern University*, 142 S. Ct. 737, 2022 (fiduciary is not protected solely because it offered participants a diverse array of options).

[10] *Employee Benefits 2020 Report: Overall*, Society for Human Resource Management (SHRM).

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