

Benefit Insights



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PENSION CONSULTANTS

A non-technical review of qualified retirement plan legislative and administrative issues

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Increasing 401(k) Plan Participation

Cash or deferred retirement plans, more commonly referred to as 401(k) plans, have become the backbone of the private pension system in America. They long ago replaced employer-sponsored pension plans as the most common vehicle for retirement savings.

These plans, which are primarily funded by employee contributions, typically give employees more control, allowing them to direct their own investments and providing more access to their money in times of financial need. But workers can also choose whether or not they want to participate at all. According to the Department of Labor, approximately one-third of eligible employees do not participate in their company's 401(k) plan.

There are numerous reasons why expanding participation is desirable. Let's look at some of those reasons and discuss ways of increasing 401(k) participation and retirement savings.

Advantages of Increased Participation

Many workers have seen a significant decline in the value of their 401(k) accounts in recent years

not only from investment losses but also from hardship distributions they took in order to pay their mortgage, medical bills or college tuition. That's why now, more than ever, it's essential that employees rebuild these accounts so they'll have enough to live on when they retire and have funds available in case of emergency. For many, a 401(k) account will be the only source of income they have to supplement social security benefits.

An elderly population without sufficient sources of income would create an economic burden on society, increasing the need for taxpayer-funded financial assistance. Retirement savings, therefore, is beneficial to society as a whole, and to the strength and soundness of our economy.

Here are some other benefits associated with enhanced 401(k) participation:

- Studies have shown that retirement plan participation and satisfaction helps to retain valued employees and keep them happy. That translates into reduced costs to employers for employee replacement and helps keep the business running smoothly. Plan features can have an impact on overall satisfaction with the plan, as discussed below.

- 401(k) plans must pass an annual nondiscrimination test, unless the employer provides minimum contributions as in a safe harbor 401(k) plan. The test ensures that highly compensated employees (HCEs) are not participating in the plan to a far greater extent than non-HCEs. HCEs are employees who own more than 5% of the company or who earned over \$110,000 in the prior plan year (increasing to \$115,000 as of 2012). In most cases, the more the non-HCEs contribute to the plan the more the HCEs are allowed to contribute under the test. Consequently, encouraging participation by lower-paid employees may directly benefit the HCEs each year.
- Certain fees associated with operating a plan may be reduced as a result of increased participation. Higher asset levels could make a plan eligible for lower investment fees. And, additional participants may help spread out administrative costs where they are paid from plan assets.

In many ways, increasing the level of employee participation is a win-win situation for everyone.

Methods for Increasing Participation

A number of factors can influence an employee's decision of how much, if anything, to contribute to the plan. Each employer should determine which of the following factors are most relevant for its particular situation.

Relaxed Eligibility Requirements

A 401(k) plan can require up to one year of service and attainment of age 21 before entering the plan. Participation can be further delayed by periodic entry dates (quarterly, semi-annually, etc.). These restrictions tend to discourage participation since a new employee is more likely to be enthusiastic about the plan when first hired than after a year or more of not being involved. It's also easier to explain the plan to new employees when

you first have their attention. The longer the wait to enter the plan the more time there is for interest to be lost.

Relaxed eligibility provisions should have no negative impact on 401(k) contribution nondiscrimination testing since early entrants can be eliminated from the test. The age and/or service requirements can be reduced or eliminated altogether and entry dates can be more frequent, such as monthly or immediate.

Automatic Enrollment

Studies have shown that participation rates can increase by as much as 34% by adding automatic enrollment provisions to a 401(k) plan. Under these provisions employees are automatically enrolled in the plan when they become eligible unless they elect not to participate. The plan establishes a default contribution rate, which can remain constant or increase in future years. An increasing contribution rate is another way to maximize retirement savings. Workers who are automatically enrolled have 90 days to cancel the arrangement and have their contributions refunded without penalty.

A Qualified Automatic Contribution Arrangement is an automatic enrollment provision with certain employee and employer contribution requirements, which exempts the plan from the annual nondiscrimination testing (similar to a safe harbor 401(k) plan). The employee deferral rate must be at least 3% of compensation to start, and increase to at least 6% by the fifth year of participation, not to exceed 10% of compensation. Employees always have the ability to change the rate by making an affirmative election.

The employer must make either a 3% nonelective contribution for each eligible employee or a matching contribution equal to 100% of the first 1% of compensation deferred plus 50% of the

next 5% deferred for a maximum matching contribution of 3.5% of compensation. This required employer contribution must be fully vested after no more than two years of service.

Automatically enrolled employees who do not complete an investment election form will have their money put into a default investment. Plan fiduciaries can limit their liability if the default investment meets certain rules which would classify it as a Qualified Default Investment Alternative. The rules are designed to provide long-term growth while minimizing the risk of large losses.

Annual notices are required for Qualified Automatic Contribution Arrangements and Qualified Default Investment Alternatives providing information about the arrangement and the default investment, and explaining an employee's right to make changes through an affirmation election or elect not to participate at all.

An Eligible Automatic Contribution Arrangement is another form of automatic enrollment which does not require employer contributions but does require an annual notice. Although it does not exempt the plan from nondiscrimination testing, it extends the correction period for a failed test from 2½ months to 6 months after the end of the plan year.

Matching Contributions

Many participants base their salary deferral decision on the extent to which their contributions will be matched by the employer. The absence of a match will discourage participation. The formula can be limited to a maximum deferral percentage, and a common formula is 50% of deferrals up to 6% of compensation. Matching 100% up to 3% of compensation results in the same maximum outlay to the employer but will be less effective at increasing employee deferral rates because fewer employees will defer above the 3% matched rate.

Each employer must consider what match formula will best serve the needs of the company.

Regular Employee Communications

Providing employees with information about the plan should not be a one-time event done only when they are hired. Follow-up communications can have a big impact on plan enrollment rates as they help remind employees of the importance of retirement savings as well as the specific features of the plan. This can be accomplished through periodic enrollment meetings, frequent distribution of enrollment forms and materials (including projected benefit illustrations) and newsletters about the plan. It's a good idea to utilize electronic media as well as paper documents, and materials should be designed to be easily understood.

Enhanced Withdrawal Opportunities

Employees will be more comfortable contributing to a plan that gives them access to their money in times of financial need. Hardship distributions and loan provisions can provide this comfort. Hardship distribution rules for deferral accounts have been expanded in recent years and plan sponsors should determine if their plans have been updated to include them. In-service withdrawals of other accounts (e.g., match, profit sharing) could also be considered.

Frequent Election Periods

Each plan establishes the intervals at which participants can make changes to their deferral elections. Allowing them to discontinue or reduce their election frequently will make them less afraid to commit to a higher amount. Some plans offer changes on a monthly basis while others allow them with each paycheck, and most plans allow complete discontinuance at any time. Employers should make sure that the availability to change elections is not too frequent as to create an administrative burden for the company.

Adequate Investment Options

Having a broad range of investment funds from which to choose and the opportunity to make frequent exchanges helps to create enthusiasm for the plan. Funds should be monitored to make sure they remain competitive and relevant to current investment strategies.

Conclusion

Increasing employee participation in 401(k) plans should be an ongoing project for all plan sponsors. There are many benefits of doing so for the company and society. Employees are usually more content and committed to their jobs when they participate and are satisfied with the plan. Plan sponsors can do a number of things to encourage participation, from increasing the company match to having more flexible plan features. Employers should review their 401(k) plan provisions and policies to ensure they encourage maximum utilization of the plan by employees.

IRS and Social Security Annual Limits

Each year the U.S. government adjusts the limits for qualified plans and social security to reflect cost of living adjustments and changes in the law. Many of these limits are based on the "plan year." The elective deferral and catch-up limits are always based on the calendar year. Here are the 2012 limits as well as prior year limits for comparative purposes:

Limit	2012	2009-2011
Maximum compensation limit	\$250,000	\$245,000
Defined contribution plan maximum contribution	\$50,000	\$49,000
Defined benefit plan maximum benefit	\$200,000	\$195,000
401(k), 403(b) and 457 plan maximum elective deferrals	\$17,000	\$16,500
Catch-up contributions	\$5,500	\$5,500
SIMPLE plan maximum elective deferrals	\$11,500	\$11,500
Catch-up contributions	\$2,500	\$2,500
IRA maximum contributions	\$5,000	\$5,000
Catch-up contributions	\$1,000	\$1,000
Highly compensated employee threshold	\$115,000	\$110,000
Key employee (officer) threshold	\$165,000	\$160,000
Social security taxable wage base	\$110,100	\$106,800

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