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Commco Comments

Timely Information and Updates for Employers and Retirement Plan Sponsors

Contributions Rise as Employers Leverage Auto-Enroll

More employers are automatically enrolling employees in 401(k) plans, at higher deferral rates than in the past – and it's working.

A decade ago, only 46% of employer-sponsored retirement plans had an auto-enroll feature. As of 2020, that figure had climbed to 60%, and last year it notched up again to 62%, according to the Plan Sponsor Council of America's 64th Annual Survey. Additionally, for the first time, the most common default deferral rate is now 6% of pay (used in 32.9% of plans), double the old standard of 3% (now used in 29% of plans).

Automatic enrollment leverages the "default effect," a concept that explains the tendency for people to accept an option presented as the default when making a strategic decision. A survey conducted by Vanguard (available online here) found that three years after being hired, 92% of employees who had been automatically enrolled in a retirement plan were still contributing, while plans without automatic enrollment had only 29% of employees participating three years after their hire date.

Another way employers are increasingly using the default effect to boost participation is through automatic escalation, a feature that gradually increases automatically-enrolled employees' deferral rates over time, generally by one percent per year up to a pre-determined maximum. Five years ago, 68% of plans with automatic enrollment also had automatic escalation. As of 2021, that figure had increased to nearly 79%.

Most retirement plans, including all plans that allow for automatic enrollment, also specify a default investment for participant contributions. By meeting certain criteria, a default investment can be designated as a Qualified Default Investment Alternative (QDIA), which provides some safe harbor protections for employers.

While participants generally have the right to direct their own investments for a more custom approach, employees who are less engaged with their accounts may be more likely to make changes only in moments of market volatility and heightened emotion. Offering a QDIA such as a managed, age-based portfolio may help investors feel more comfortable with staying the course in those moments, potentially reducing the incidence of emotionally-motivated investing errors that can reduce long-term account performance.

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What is the most common default deferral rate for retirement plans with automatic enrollment?

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A research paper published by the Social Science Research Network in December of 2021 (full text available for download here) found that all of these features have a significant impact on account outcomes. Of all variables considered in the study, automatic enrollment with a higher default rate was found to have the largest impact on overall employee savings rates, as well as the smallest disparities between the savings of lower and higher income employees.

When plan default rates were set low, but a generous match was offered, higher-earning employees tended to electively increase their deferrals to capture the full match. Lower-earning employees did not, resulting in a wider savings gap; however, when the default deferral rates were set higher, lower-earning employees had less tendency to electively decrease their contributions, so overall savings rates were more equal. Employees who accepted the default enrollment contribution rate were also more likely to accept and remain invested in the QDIA.

The research paper concluded that the plan design resulting in the highest employee savings rates, highest acceptance of the default investment, and lowest disparities in savings rate by income was one with automatic enrollment at a higher deferral rate and with a lower or more moderate employer matching contribution.

If you are interested in discussing automatic enrollment or reviewing your plan's design features with your financial advisor, please reach out to us at newsletter@thecommco.com to schedule a conversation.