An Automatic Affair

Promoting Retirement Plan Participation

BY IAN TOCHER

According to Allstate's 2005 Retirement Reality Check survey, Americans identified financing retirement as their number one concern, outranking terrorism, family matters, current finances, getting into an accident, their own health, death and career issues as sources of worry. Across the board, regardless of age, gender or region, respondents said not having enough money remained their greatest concern about retirement.

With the recent failures and cutbacks of defined benefit (DB) plans at several large, high-profile employers, the uncertainty is understandable. However, the unfortunate truth is that not enough employees participate in 401(k)s and other defined contribution (DC) plans, and those who do are often not contributing enough to adequately meet their retirement needs.

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"For U.S. workers, 401(k) plans play an increasingly important role in retirement income security, but many employees continue to underutilize them—whether it's because they don't feel comfortable investing in the plan, or they simply lack the motivation to save," said Lori Lucas, director of participant research at Hewitt Associates. "A number of employers are taking more aggressive steps to address this issue by automating features of the 401(k) plan—essentially taking the 'legwork' out of retirement saving and investing by enabling employees to maximize the value of their 401(k) plans without having to spend a lot of time thinking about or proactively managing them."

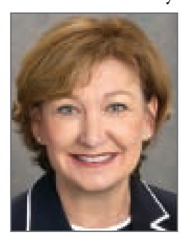
Beyond wanting employees to benefit in the long run from a long, productive work life, employers need to promote retirement saving because plan satisfaction helps to attract and retain quality employees and can positively influence total returns to shareholders (TRS).

A 2003 Watson Wyatt survey concluded that DB plans ". . . appear to exert a stronger influence on employees' decisions to remain with their employer . . . " though respondents expressed greater satisfaction with DC plans, perhaps because DC plan benefits are communicated more clearly, accrue earlier, and since the employee typically has a more active role in plan management, their accruals seem more tangible than those in DB plans. Additionally, the survey said the average five-year TRS was more than 10 percentage points higher at companies where employees were "highly satisfied" with their retirement plans—regardless of plan type—than at companies with employees unsatisfied with their retirement prospects or where no retirement plan was in place.

AUTOMATIC ENROLLMENT

To encourage participation in 401(k) plans, employers are increasingly turning to automatic enrollment, often accompanied by automatic deferment step-ups and automatic rebalancing. Upon instituting automatic enrollment, the employer places all new employees in its sponsored 401(k) plan and adds current employees who were not previously enrolled. Current 401(k) holders may not be affected unless they were committing less than the new automatic enrollment deduction minimum.

"Some people refer to it as negative enrollment because in order not to participate you have to have a negative election," said Pam Constantino, president and COO of Polycomp, a California-based benefit plan administration and consulting company. "Employees are automatically enrolled in the plan, so they have a contribution that's automatically deducted from their salary unless they sign a form that specifies a different amount or elects against participation in the program."



Constantino

Al Otto, vice president at White Horse Advisors in Atlanta, said traditional 401(k) plans tend to have about 70 to 75 percent of a company's employee population participating at some level, with another 20 percent "…kind of stuck in their own inertia… " and the last 5 to 10 percent opting out entirely.

"But I've seen studies that place the participation rate in automatic plans at 90 percent plus, and that's a real positive," said Otto. "The plans that also have the automatic step ups have, after a period of five or six years, an average deferral rate in the teens, rather than around 6 or 7 percent and that's a huge improvement, too."

Otto

Regardless—and despite having called automatic enrollment "an excellent idea"—401(k)Exchange president and CEO Fred Barstein said automatic enrollment still has issues to be worked out for employers.

"The thing I think everybody is waiting for is a safe harbor from Congress," he said. "In other words, if you have automatic enrollment, what kinds of funds or investment categories do you put that participant in, and if you do and they don't like it have you exposed yourself as a plan sponsor to liability?"

With money-market funds no longer offering the returns of just a few years ago and the inherent expenses of 401(k)s, Barstein said that automatically placing employees into money markets is just not safe right now and they may actually lose money. "So what people are seriously looking at is putting it into a balanced, conservative lifestyle fund, and we're waiting for Congress and the Department of Labor to give us guidance on that."

Employee education also should be part of a company's automatic 401(k) enrollment initiative, especially if it's replacing a DB plan where the employer made all the investment choices—and assumed the liability, too.

"Employers are very, very happy and have moved to basically push that liability off to the participants," Barstein said from his headquarters in West Palm Beach, Fla. "But what we've come to realize is that we really haven't equipped these participants to make really good decisions. So the focus has been, recently, in the last five years, on helping them to make the right investment choices: asset allocation, rebalancing and all of that.

"The other piece of that is that you can do the absolute best job at asset allocation and fund choices, but if you don't put enough money away, if you don't defer enough, if you start too late, or you don't even start in the plan, you're in big trouble."

AUTOMATIC REBALANCING

Plan participants may be safeguarded by investing them in lifestyle funds or target date funds, where the participant doesn't have to make investment choices, and automatic step ups, meaning a higher percentage of employees' salaries are automatically deferred each year into their 401(k) accounts, also contribute to the growth of retirement nest eggs.

Related to this is automatic rebalancing, which essentially manages risk, a potentially time-consuming and stressful activity that can distract an employee from job-related tasks, Constantino said.

"If you're comfortable with 25 percent in money-market accounts, 25 percent in growth mutual funds, 25 percent in a balanced fund and 25 percent in high-risk, high-tech stocks, you need to constantly make

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sure that each one has that amount of investment," she said. "Let's say those high-risk stocks do very well. What would happen is the fund would automatically balance by selling off some of those high-tech stocks, so that you'd still have the same percentage of high-risk stocks in the fund."

Beyond improving retirement prospects, automatic 401(k) enrollment also can help a company's highly compensated employees (currently defined as those earning more than $95,000 annually or owners of at least 5 percent of the corporation) to max out their own retirement plan contributions.

"A 401(k) plan, unless it's a safe-harbor plan, needs to satisfy discrimination tests," Constantino said. "What that means is that employees are divided into two groups: highly compensated and non-highly compensated; and the amount the highly compensated employees defer is based upon the average of what the non-highly compensated employees are deferring. So, if the non-highly compensated employees are not participating, that limits the amount that highly compensated employees can contribute. It's an IRS requirement."

The reasoning behind the law is that by encouraging participation among rank-and-file workers, retirement plans don't become benefits only for the highest-paid employees in a company. It gives top earners a vested interest in the retirement plans of average employees.

ROTH 401(K)

The tax bill passed by Congress in May 2001 authorized the enactment of the Roth 401(k) which goes into effect Jan. 1, 2006 and will remain available through Dec. 31, 2010, unless extended by legislative action. Traditional 401(k) participants contribute before-tax dollars and pay tax on withdrawal, whereas after-tax dollars are contributed to a Roth 401(k) and under current rules will be tax free upon withdrawal.

There is no simple answer for individuals regarding which plan would serve them best. "It's very much a function of your tax bracket when you put the money in, and when you take the money out," said Otto.

Likewise, employers have several factors to consider before even offering the new retirement plan option, not the least of which are administrative requirements.

"The payroll companies have to be ready to handle these Roth 401(k) deferrals, and the investment companies need to be ready to keep them in separate accounts because they have to be allocated separately," said Constantino.

"Then there's the issue that one of the requirements for the Roth 401(k), similar to the IRA, is the participant has to remain in the plan for at least five years. And when that period begins is still questionable. For example, if someone contributes to a Roth 401(k) and then terminates employment and rolls it to a Roth IRA, what is the original date we keep track of for that five-year clock?"

In a recent message to clients, The Pension Group recommended that most 401(k) plans should not offer Roth contributions because " . . . they will create significant difficulties and additional expense for plan sponsors, they do not increase overall plan contribution limits, and they are not a good financial bet for most employees." Further, the Irvine, Calif-based pension advisor group suggested it's far from a safe bet that Congress will perpetually honor the decision not to tax Roth 401(k) funds at withdrawal, citing 1983 and 1993 legislation to tax previously untaxed Social Security benefits.

"It is entirely possible, when confronted with mounting deficits in 20 years, Congress will see a study reporting billions of untaxed dollars in Roth accounts and will decide to tax these accounts. It may be a phased-in tax, much like that on Social Security benefits, but there is nothing to stop them from doing so," The Pension Group warned. "Should Congress tax even half of Roth earnings, then

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401(K) FLAWS

In Al Otto's article, "Will Default Turn Into Your Fault" (January 2006 *Benefits & Compensation Solutions*™), it points to one of the many flaws within 401(k) plans: an underlying assumption that folks know the difference between the various fund choices. This is major flaw number one. As Mr. Otto points out, for those who fail to make an investment choice, their money and any employer matching funds fall into the "default" investment.

The question in my mind is, among others, is how much time and money can prudent plan fiduciaries spend on the basic selection, monitoring and analysis of plan investments in the first place?

While some plan participants have educated themselves in the investment selection process, most do not. Why not simply turn the entire process over to a professional money manager? Employees no longer need to figure out which fund to participate or be concerned about their risk, the average rate of return or whether they should be in a stock fund or a bond fund. All the decisions are made for them, the rules become much simpler, and the overall plan operating expenses go down dramatically.

In the typical 401(k) plan you're buying into some sort of an investment, but you have no idea what that investment costs. That cost, whatever it is, reduces your overall investment performance and it gets paid whether your investment choice made a profit for you or sustained a loss. This is an insane process to expect folks to buy a product without any knowledge about the costs associated with it and these are questions few folks ask. 401(k) plan sponsors spend millions every year trying to figure out how to beat the odds, reduce the risks, and reduce their shared amount of responsibility under the guise of some limited amount of protection under ERISA 404(c) when there are few, if any, actual court cases providing much guidance in the first place. After spending all this time and money to provide some limited amount of relief under the law no one actually knows what this means yet. This is like buying property on the moon and then buying insurance for it: I'm sure some one is willing to sell you both.

Thank you,

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any small advantage the Roth account had over a 401(k) will be gone. With traditional 401(k) contributions, employees get the tax benefits now."

Likening it to a new car's debut, Otto suggested taking a "wait-and-see" position on the Roth 401(k) until it proves not to be a lemon. "The way it is going to affect a company's payroll system is going to differ by company, by payroll provider and by 401(k) provider. There's just no way right now to know if it's going to be administratively possible," he said.

CHANGING PROVIDERS

No matter the type of retirement plan a company has in place, it has become imperative in recent years to practice due diligence, especially as it regards fee disclosure. Major funds scandals have dictated the need for independent reviews of retirement plan accounting, if not annually, at least every three to five years. Additionally, Barstein said, the due diligence process can, if necessary, help an employer find a new plan provider.

"That due diligence process is almost like an RFP, and once you've done that and found your three final companies, you need to start meeting with them," he said. Barstein recommended against making a site visit to the provider's offices, suggesting instead that employers should ask for a visit from the people who will be handling their account directly.

"You don't just want the sales people to come out, you want to see the people who are going to be your relationship manager or somebody who might be involved in employee communications," he said. "Meet the people who you are going to work with because by the time you get to this process of getting three companies that have what you believe are good service, qualities, comparable prices and good funds, what it's going to come down to is the people. If you do the process correctly, you can't make a mistake by choosing any of your three finalists, so that process of meeting helps you find out who you are most comfortable with, who you feel is going to partner best with you and your participants, and gives you a real sense of the people you'll be working with."


Barstein

Despite figures reaching into the millions or even billions of dollars, like so many aspects of the benefits industry retirement planning all comes down to a human level, Barstein said.

"What we say is that getting invited to the RFP is based on reputation, getting to the finalists is based on the quality of the funds and the service and the cost, and then winning is based on relationships, who you best connect with."

TAKING HOLD

A Hewitt survey of more than 450 large companies released in June 2005 found that 64 percent had 401(k) plans as their primary retirement savings vehicle in 2005, up from 55 percent two years earlier and 35 percent in 1995. Additionally, 19 percent said they were automatically enrolling employees in their 401(k) plans, compared with 14 percent in 2003; 26 percent provided automatic rebalancing, while 20 percent said they offered or planned to offer automatic step ups.

"I think there's a strong movement in Congress, and properly so, to make the defined contribution plan a plan that's actually going to work, to help people achieve a secure retirement," said Otto. "The proposals and the solutions are kind of one and the same, and that is automatic plans, where you have automatic enrollment, automatic step ups and automatic rebalancing. When you think about that, it's similar to a DB plan and means that over time people are going to put more and more money into their plans and will be more likely to achieve their replacement income needs than they are under the current scenario."

Clearly, plan sponsors are taking notice of the value of automatic enrollment. Hopefully, with legislative support, America's workforce will again be able to look forward with confidence and security toward retirement, but with much more personal control over their fiscal destiny. B&C S