

The Future of Retirement Plans and Fiduciary Issues

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This is the third in a series of three articles on fiduciary concerns.

In our last two articles, we discussed the growing concerns of plan sponsors and plan fiduciaries in the light of increased class action lawsuits by employees. Recent lawsuits have been focused on company stock in 401(k) plans, but it is widely expected that litigation will branch out to the areas of mutual fund choices offered to participants, as well as costs charged to plans. While the Department of Labor (DOL) offers guidance in many areas of fiduciary compliance, they provide little support in the area of investment issues; leaving plan sponsors to their own (and, sadly, the courts) interpretation of what is right. Of course, the most recent case of the United Airlines pension plans and the potential costs to taxpayers has everyone alarmed. It is no wonder that many plan sponsors are asking the questions “is it worth it?” In this installment, we will discuss plan trends that are developing and will make a few predictions as well.

What’s Happening?

Notwithstanding the fiduciary issues facing plan sponsors, they continue to support the idea of work-based retirement plans and are trying innovative things to increase participation. Indeed, they clearly think it is “worth it”, as a morale booster and critical employee retention tool. Some very creative plan sponsors and providers have developed the following concepts for 401(k) plans, all of which are attracting increased interest.

Automatic enrollment – with this feature, new employees are automatically enrolled in the 401(k) (typically at 3 percent of pay), and must affirmatively opt out to avoid participation. There are two key concerns with this feature. First, high turnover creates a multitude of small accounts, some with less than \$100. Alternatively, an employee continues working, but opts out after a few weeks, with the same outcome. Secondly, there is a great deal of sponsor confusion over what represents a prudent choice for default investment options if the employee doesn’t make an election.

Easy enrollment - less aggressive than automatic enrollment, this allows employees to get in the plan by marking just a few boxes on a postcard. This apparently works wonders for new employees overwhelmed at the prospect of filling out forms.

Immediate enrollment – in order to encourage participation, those employers who haven’t moved to automatic enrollment have increasingly dropped the tenure requirement and allowed new hires to join the plan immediately. This is in contrast to many plans that had six to twelve month waiting periods. Of course, many plans still require those waiting periods to receive a matching contribution.

Step-up contributions – with this feature, employees can ease into a growing and predetermined deferral percentage over time, perhaps starting at 3 percent of pay, increasing it by 1 percent a year. Particularly effective if tied to pay increases.

Automatic rebalancing - with this feature, a participant sets up fixed percentages for each fund chosen and, at least once a year, the fund automatically rebalances the position to the predetermined percentage. This eliminates one of the most difficult problems for many participants, most of whom would like to “set it and forget it.”

Lifestyle funds - Similar to automatic rebalancing, these funds are offered by several fund families, with the mix of investments becoming increasingly conservative as the employee ages. Unfortunately, “*increasingly conservative*” is a term of art and different fund families have unique interpretations of its meaning. Thus, the sponsor may wish to have more than one choice if offering such funds.

Immediate match – as a sign of further encouragement and commitment, many sponsors are now making their matching contributions at the same time the employee deferral is remitted. This is a big difference from the past, where an employee not only needed to meet a minimum period of employment, but also had to be employed at the end of the fiscal year of the plan.

Use of open platforms – due to a perception of simplicity, many sponsors developed their list of mutual fund choices from a single family of mutual funds. That is increasingly giving way to so-called “open platforms,” where the sponsor and, perhaps, the participants, can make choices over a wide range of fund families.

Prognostications

We also have some thoughts about other trends in the retirement area, not to mention a few ideas that are sure to raise a few eyebrows.

Continued Decline of Defined-Benefit Plans – some would say this is a no-brainer, since DB plans have been on the decline for years. However, that trend was driven by business decisions by plan sponsors to start managing retirement costs in a different way – thus the increased use of 401(k) plans and the like. Of course, any reduction of Social Security benefits will increase employers’ costs for plans integrated with Social Security – that is, the plans are designed so that projected Social Security benefits reduce employer costs. Just a small decline in projected Social Security benefits could drive well-funded plans into the red overnight.

Enter United Airlines. Now, we have a multi-billion dollar pension plan default, which is likely to land in the lap of taxpayers. It will also increase Pension Benefit Guarantee Corporation (PBGC) insurance premiums of other DB plans, especially since the PBGC has its own multi-billion dollar deficit. Other airlines, as well other troubled companies in general, may see bankruptcy as an exit strategy for dismantling their own severely under funded plans. Taxpayers, especially the young, are already irritated by the fact that they are supporting Social Security with tax dollars they may never recover. They will not stand still for a massive taxpayer bailout of pension plans, since they probably don’t have them at their own companies.

Where are All the Trustees? – when trustees find out they have unlimited personal liability for their actions as a plan fiduciary, they are likely to resign in droves. At the very least, they will demand formal training, insurance, indemnification, additional resources and compensation. This will increase the cost of sponsoring a plan, but companies will see it as a necessity. Just like Sarbanes-Oxley compliance.

Small Plans Will Disappear – while small companies tend to be paternalistic towards their employees, they cannot afford the costs of compliance and the fiduciary risks associated with ERISA plans. They will either revert to helping employees set up Individual Retirement Accounts where the employer has no investment responsibility, or they will abandon plans altogether. Continuous changes in the Internal Revenue Code have made it increasingly costly to have plans that primarily benefit business owners, and unlimited fiduciary liability may be the last straw.

Education for Real - Plan sponsors are likely to start offering one to one, in-person financial planning advice for participants. Most importantly, this assistance will come from independent financial planners who are not otherwise providers of services to the plan. Only a few hours per year for every employee would be necessary to substantially increase participation and the discipline necessary to get better long-term investment results. Some companies may pay the cost – others may reduce the 401(k) match. Even with the latter, most employees would be far better off with some objective and independent guidance on a regular basis than they would with another \$500-\$1,000 per year in their 401(k) match. Of course, the DOL will have to cooperate and give a blanket exemption from ERISA fiduciary liability for the providers of these services.

Employer Stock Exemption – Plan sponsors want to continue using their stock as a 401(k) match and employees continue to desire it in their portfolios. However, the current litigation against plan fiduciaries, all enabled by ERISA, is forcing a complete reassessment of that practice. Congress is likely to be lobbied for an ERISA exemption (but not an SEC exemption) for company stock in a 401(k) plan, perhaps with the following conditions: An employee can diversify out of the position, either immediately or after a brief period. Next, there is a cap on the percentage of company stock that can be held in a participant's account. Employee education, particularly about the necessity of diversification, will need to be direct and recurring. Finally, all fiduciaries to the plan, including outside service providers, will need to fully disclose their positions and activity in the stock.

Independent Oversight Will Be The Norm - Employees will start demanding that they know who the trustees are and why they are qualified to be trustees. The DOL currently requires financial audits for plans with more than 100 participants. They are likely to require some form of audit of prudent investment practices, with a report available to participants. The DOL will finally realize that, while theft of plans assets may be a concern, there is far more being taken from participant's retirement savings every day in the form of excess fees and inept investment practices.

Conclusion

The debate over Social Security and public awareness about issues in all forms of retirement plans will keep a spotlight on the private retirement system. Employees and plan sponsors alike want a fair and level playing field. Congress will need to reevaluate ERISA and the function of the DOL with regard to investment issues if Americans are going to get comfortable with looking out for their own futures.

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