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MANAGING YOUR FIRM'S 401(k) PLAN

A COMPLETE ROAD MAP TO MANAGING TODAY'S RETIREMENT PLANS

Edited by **Matt Smith**

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Preface

401(k) plans hold *trillions* of dollars of retirement wealth in the United States. What started as a way to save a little extra money for retirement has now turned into a critical source of retirement security for millions of people. This is serious business.

Managing a 401(k) plan is not an easy task, yet thousands of corporate officers, finance, and human resource professionals across the country are handed this responsibility. The decisions they make *will* have a meaningful effect on the retirement wealth of their co-workers. *Managing Your Firm's 401(k) Plan* is a resource for anyone who has responsibility for the design or management of the employer's 401(k) plan.

There are many sources for information about design and management of 401(k) plans. Many of these sources are highly technical in nature, while others are oversimplified. What we've tried to accomplish with this book is to present a practical and objective overview of the important issues that you need to know about your 401(k) plan. The content in this book will enable you to be an informed consumer of plan services and an empowered manager of your 401(k) plan.

This book is not just a technical manual, although there is a fair amount of technical detail contained. We do not expect you to come to this book with a great deal of technical knowledge, although if you do, we feel there is a lot here that will interest you as well. A great deal of effort was put into keeping the content in this book interesting and at the same time tethered to the technical aspects of the laws and regulations that govern 401(k) plans.

Also, it will help you think through or reexamine fundamental questions about your plan: What should your role be in helping your employees reach a secure retirement, why should you sponsor a 401(k) plan, how does your plan design affect better participant decisions, what kinds of risks are you assuming by sponsoring a plan, or by not sponsoring a plan?

HOW THE BOOK IS ORGANIZED

The opening chapter of this book provides a context for why the 401(k) plan is becoming more important in the United States. 401(k) plans have been around since the early 1980s. What is different today that is making them so important to our retirement security? As baby boomers reach retirement, they will spend more years in retirement than previous generations and their expenses will likely be higher. As this is happening, employers are shifting more of the responsibility for retirement to their employees by changing from defined benefit (DB) to defined contribution (DC) plans. The shift from DB to DC is putting the 401(k) plan at the center of the retirement spotlight, and as a result, the individual is left to manage many of the risks associated with retirement, including funding, investment, longevity, and spending risk.

In this new DC-dominant era of employer-sponsored retirement plans, the employer's role is being redefined. This is the topic of Chapter 2. Why do employers sponsor 401(k) plans and what roles do they play are questions we address. As the employer's role evolves, so does the standard for 401(k) plan stewardship. Seven areas of plan stewardship are discussed from the perspective of how they are changing.

The main purpose of every 401(k) plan is to help individuals become ready for retirement, but how is retirement readiness measured? A place to start is to understand the concept of income replacement ratio. The amount of income someone needs in retirement as a percentage of his preretirement income is an income replacement ratio. This concept is covered in detail in Chapter 3. Also in Chapter 3, we cover ways to improve retirement readiness by making your 401(k) plan as effective as possible.

In Chapter 4, we talk about the basics of establishing a 401(k) plan: how they work, establishing plan objectives, benchmarking plan design features, and documentation requirements for the plan and trust.

Plan governance and related fiduciary issues are the topics covered in Chapter 5. Here we define who a plan fiduciary is, her basic duties, and the selection and monitoring of outside fiduciaries. Also discussed are establishing roles and responsibilities for managing your 401(k) plan, including the setup and operations of a benefits committee and using plan assets to pay expenses.

Being a plan fiduciary involves risk, so we include a chapter on protecting yourself as a plan fiduciary. Over the past decade, high profile incidents such as the collapse of Enron and scandals in the mutual fund industry have changed the fiduciary landscape for 401(k) plans. These are covered in Chapter 6 along with the consequences of a breach of fiduciary duty, the voluntary fiduciary correction program, ERISA bonding requirements, and fiduciary indemnification strategies.

The core of any 401(k) plan is its investments. Chapter 7 covers investment topics, including creating an investment policy statement and the plan's investment menu, the use of prediversified portfolios such as target date funds, selecting and monitoring investment managers, understanding investment related expenses and complying with Code Section 404(c). Also discussed in Chapter 7 is the use of company stock in 401(k) plans, default investment options, the mapping of assets from one fund to another, advice and education options, brokerage accounts and mutual fund windows, and socially responsible investment options.

When it comes to plan operations, most plan sponsors think of their recordkeeper. While the plan's recordkeeper does a tremendous amount of the day-to-day plan operations, the plan sponsor still has the responsibility for overseeing the work as well as the ultimate responsibility for the recordkeeper's actions. Chapter 8 covers monitoring your service providers, operational and regulatory compliance, and special considerations related to changing plan recordkeepers.

The ultimate goal of any 401(k) plan is to distribute benefits to retirees. Chapter 9 covers distribution-related issues including vesting rules, distributable events, and forms of distributions. Also covered are optional plan design features specifically addressing both terminated employees and employees who may need to take a distribution while still employed. Finally, we discuss taxation considerations and special distribution situations such as qualified domestic relations orders.

Chapter 10 discusses how business transactions affect 401(k) plans. For the purposes of this book we define a *business transaction* as a structural change to the plan sponsor's business, such as a merger, acquisition, spin-off, or major downsizing. It is not often that the 401(k) plan is at the top of CEOs' minds when companies are planning a business transaction. However, as you'll see in Chapter 10, a business transaction can trigger a tremendous amount of work related to the plan. In addition to the effect of business transactions, we also cover the topic of plan terminations, providing a detailed checklist of related activities.

Effectively communicating your 401(k) plan to your employees is critical to your plan's success. Chapter 11 provides you information on how to develop and measure your communications strategy, branding your communications program, and managing your communications vendors.

It is fitting that our last chapter is about helping participants manage their retirement income because this is the final role a 401(k) plan plays in providing retirement security for the individual. Today, most DC plans only distribute cash payments to retirees, either as lump sums or as installments. Retirees must then deal with the risks associated with managing their retirement income on their own. What help if any should plan sponsors provide retirees in the income phase of retirement? Chapter 12 provides the plan sponsor with information and context for answering this question. Topics covered include whether income products should be offered inside a plan or out, the risks related to managing retirement income, an analysis of eight retirement income product types and how they managed these risks, and additional product features that might be included as part of a retirement income solution.

We hope you find the information in this book useful. If it helps you to understand the design and purpose of your plan more clearly, helps you establish better governance practices, or even prevents you from making a simple compliance error, then it will have been worth our time writing and your time reading this book.

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Matt Smith

Contents

CHAPTER 1

The Importance of the 401(k) Plan

Retirement in the United States is getting more attention every year. The reasons include the baby boom generation reaching retirement age, people spending more years in retirement, rising retirement expenses, and the shift from employer-sponsored defined benefit (DB) plans to defined contribution (DC) plans.

In addition, the traditional sources of retirement security, *government*, *employer*, and *individual* are all straining under the weight of competing economic priorities, causing us to reexamine how these sources interact to provide a secure retirement. Emerging at the center of the new retirement architecture in the United States is the 401(k) plan.

BABY BOOMERS HAVE REACHED RETIREMENT AGE

The baby boom generation, defined by the U.S. Census Bureau as everyone born in the years 1946 through 1964, is having a profound effect on the retirement landscape in the United States. The baby boom generation has left its imprint on each life stage it has passed through. Now it is retirement's turn. In 2008, there were approximately 44 million Americans in the 10-year age cohort from age 45 to 54.[1] For comparison, the 10-year age cohort from age 25 to 34 numbered approximately 40 million. That comparison might not seem dramatic, but keep in mind that the younger age cohort will continue to shrink in size over the next 20 years because of normal mortality. For additional comparison, the current 10-year age cohort from age 65 to 74 number approximately 19.5 million.

The baby boom effect on retirement is multifaceted. Boomers are transitioning from net savers to net spenders as they pull dollars out of their retirement accounts rather than putting new contributions in; they are looking for help for the first time with ways to ensure they don't outlive their accumulated wealth; there will be an increase in demand for health care products and services; and a higher proportion of the population in retirement will cause the Social Security retirement dependency ratio to increase dramatically.

PEOPLE ARE SPENDING MORE YEARS IN RETIREMENT

People are spending more years in retirement because they are retiring earlier than planned and living longer than in the past. While the normal retirement age most people think of is 65, research shows that many are retiring earlier. According to the Employee Benefit Research Institute's (EBRI) 2010 Retirement Confidence Survey (RCS), 28 percent of the individuals surveyed who were still working (workers) indicated that they planned on retiring before age 65. However, of the individuals surveyed who were already retired, 61 percent said they actually retired before age 65. An excerpt from the survey report sheds some light as to why people are retiring earlier than planned.

> *The RCS has consistently found that a large percentage of retirees leave the work force earlier than planned (41 percent in 2010). Many retirees who retired earlier than planned cite negative reasons for leaving the work force before they expected, including health problems or disability (54 percent); changes at their company, such as downsizing or closure (26 percent); and having to care for a spouse or another family member (19 percent). Others say changes in the skills required for their job (16 percent) or other work related reasons (11 percent) played a role. Some retirees mention a mix of positive and negative reasons for retiring early, but just 5 percent offer only positive reasons.*

In addition to retiring earlier than planned, increased life expectancy is causing the number of years people spend in retirement to be longer than in the past. Around the year 1900, average life expectancy at birth in the United States was just over 49 years. It has been increasing ever since. Measured every 10 years (based on the 10-year censuses that we have), it finally passed age 70 in 1970, hitting 70.8 years. By the time of the 2000 census, it had reached 76.9 years.

For retirement planning purposes, we are also interested in the average number of years a person is likely to live once they've reached retirement age. In 1900, a survivor to age 65 could expect to live an additional 11.9 years (on average). In 1970, the average remaining life expectancy at 65 had increased to 15 years. In 2000, this figure was 17.9.[2]

It is a fact that people are spending more years in retirement. The effect this has on retirement planning is clear. Either spending rates must come down to allow retirement assets to last longer or additional wealth must be accumulated to fund the same standard of living for these additional years.

EXPENSES IN RETIREMENT ARE INCREASING

If a person wishes to maintain their pre-retirement standard of living in retirement, it will usually require less annual income in retirement than in pre-retirement. The reason is that there are some expenses that go down in retirement such as transportation, taxes, clothing, and savings for retirement. Aon Consulting, in conjunction with Georgia State University, has conducted a Replacement Ratio Study every few years since 1980. This study examines the federal government's Consumer Expenditure Survey (CES) data to determine how people at various income levels spend their income. By examining these data, the study determines what percentage of a person's pre-retirement income they need to replicate their pre-retirement standard of living once they stop working and retire. The 2008 edition of this study concludes that a person making an annual salary of $30,000 per year would need 90 percent of his pre-retirement income to maintain the same standard of living. This percentage is termed an *income replacement ratio*. Someone making $90,000 per year would require an income replacement ratio of 78 percent.

These income replacement ratios are based on a snapshot in time. As such, they do not project changes in spending patterns or variances in expense increases among different expense categories. One area of expense that is likely to increase in the future for retirees is health care. We know anecdotally that health care costs have been increasing at rates of two and three times the rate of inflation in recent years, and retirees spend a higher percentage of their income on health care than pre-retirees. So, what might these income replacement ratios be if we factored in higher health care costs in the future? When the income replacement ratios are recalculated assuming health care costs will increase in retirement by an additional $400 per month (which represents the combined costs of Medicare Parts B and D premiums, and an amount for supplemental coverage) the $30,000 per year individual's ratio increases from 90 percent to 102 percent. The $90,000 per year individual's ratio increases from 78 percent to 82 percent.

THE SHIFT FROM DB TO DC

Over the past several decades, there has been a steady trend of shifting the risks and responsibilities associated with retirement from institutions to individuals. One of the most obvious manifestations of this trend is the shift from DB plans to DC plans as the primary employer-sponsored retirement program. Nineteen ninety-six was the last year in which there were more assets in private DB plans than in private DC plans, when each held approximately $1.6 trillion. Private DC plans include profit sharing, money purchase, and 401(k) plans. Governmental or not-for-profit DC plans are not included in this statistic and usually take the form of 457 or 403(b) plans. By the year 2011, it is estimated that private DC plans will hold $4.2 trillion, while private DB plans will hold $2.5 trillion.[3]

Another comparison, this time conducted by researchers at the National Bureau of Economic Review (NBER) estimates that the assets currently in DB plans versus 401(k) plans are roughly equal (at the time this chapter was written in 2010). By the year 2040, however, it is estimated that there will be four times the assets in 401(k) plans as in DB plans.[4] For workers entering the workforce today, it is highly likely that their primary source of employer-sponsored retirement will be in the form of a defined contribution account rather than a defined benefit. We discuss later in this chapter some of the risks that are transferred to the individual as employers move from DB to DC retirement programs.

SHARING RESPONSIBILITY

There is a popular analogy comparing retirement security in the United States to that of a three-legged stool. The legs in this analogy are represented by government (Social Security), employer (employer-provided retirement benefits), and individual (personal savings). Because of the converging factors discussed at the beginning of this chapter, the three-legged stool is beginning to list to one side. Social Security is facing solvency concerns in the coming decades if changes are not made. As was stated earlier, employers are moving toward DC plans. This move shifts most of the risks associated with retirement to the individual. And finally, personal wealth accumulation is being strained because of lower personal savings rates, lower housing values (a large source of personal wealth for many Americans), and lower investment portfolio values due to the global economic downturn.

The Government as a Source of Retirement Security

Social Security is the federal government's contribution to Americans' retirement security. (We say it's the federal government's contribution even though the source of Social Security's funding is payroll taxes.) Individuals reaching retirement age just as the Great Depression was unfolding found themselves literally in the streets with no resources to maintain a decent standard of