401(k) Risk Management

By Fred Reish

I recently spoke at a retirement plan conference for large companies. My topic was risk management for 401(k) plans.

While preparing for the speech, I decided to take a different approach than most speakers on the subject. Instead of talking about recent law changes and court decisions, I decided to talk about how to design a plan, from the ground up, to minimize risk.

The first step is to focus on the benefits being provided to participants. If participants are receiving adequate benefits from a 401(k) plan, there is less chance of litigation. In a way, though, that answer begs the question. Adequate benefits are the output of a well-run plan and the real question is, how should a plan be designed and operated to provide that output?

The three key elements, or pillars, of a well operated plan are: high levels of participation; significant deferral rates; and quality investing by participants. If a plan succeeds in those three areas, it should produce substantial retirement benefits for participants.

A plan sponsor who wants to minimize risk and maximize benefits at the same time should:

1. Automatically enroll.
2. Automatically increase deferrals.
3. Automatically default into qualified default investment alternatives, or QDIAs.

Let me explain.

Automatic Enrollment

The national average for participation in automatically enrolled plans is about 90%. That is considerably higher than the two-thirds level of participation for non-automatically enrolled plans. (By the way, I define participation to mean eligible employees who are deferring into the plan.)

The dramatic increase in participation resulting from automatic enrollment, in and of itself, significantly reduces the potential risk of the employer and the fiduciaries, because it eliminates potential claims from people who did not get into the plan. Further, with automatic enrollment, any employee who does not participate has to affirmatively file an election to get out of the plan. So, on top of high levels of participation, there is written evidence from every employee who opted out that the employee did not want to be in the plan.

Because of those two factors—high participation in the plan and affirmative elections to be out of the plan—it seems virtually inconceivable that a plan sponsor could be sued over participation-related issues.

Automatic Deferral Increases

With automatic deferral increases, plan sponsors start employees at a deferral rate (usually 3% or 4%, but sometimes as high as 6%), and then increase the deferral rates 1% or 2% per year—up to a maximum that is often in the 10% to 15% range. Of course, employees can elect out of the automatic increases, but if they do not file an election, their deferrals will be automatically increased.

As a general rule of thumb, the goal for the combination of employee deferrals and employer contributions should be at least 12% to 15% per year. At that level, most employees will retire with meaningful benefits, and many employees will retire with adequate benefits (when defined

as having income continuation of 75% to 80% of final pay, including social security). So, for example, if the employer contributes 3% of pay (either as a match or profit sharing contribution) and the employee defers 12%, the employee's account will be "funded" at the rate of 15% per year.

As with automatic enrollment, there are two risk management advantages in automatic deferral increases. The first is that many, and perhaps most, employees will end up with substantial retirement benefits. The second is that, by and large, those employees who opt out will have filed affirmative elections to stop the deferral increase program from working in their favor. With those two "defenses," the odds are remote of an employer being sued or being liable for any potential fiduciary violation associated with the adequacy of deferrals.

Safe Harbor Investments

The new QDIA rules provide a fiduciary "safe harbor" for plan sponsors and their responsible officers and committees. The protection is so great that it is fair to say that there is no better protection in ERISA than for a participant who defaults into a QDIA. (The default investments that are "qualified," or "QDIAs," include target maturity or age-based funds, risk-based lifestyle or balanced funds, and managed accounts.)

In fact, the protection is so great that plan sponsors are better off if a participant defaults into a QDIA ... than if the participant affirmatively elects to invest in the QDIA.

From a risk management perspective, plan sponsors would prefer that the largest possible number of participants default into QDIAs. And, that is exactly what automatic enrollment does. Based on reports from advisers and consultants around the country, 75% to 95% of the automatically enrolled participants are defaulting into QDIAs. Stated slightly differently, 75% to 95% of the participants are invested in a way that the fiduciaries have no worries about potential liability for participant investing. And, if a defaulted participant decides to invest in a different way, he must file an affirmative election to invest differently.

Once again, there are the two advantages for risk management: a safe harbor investment and an affirmative election to invest differently.

Conclusion

I realize that plan sponsors and fiduciaries consider issues other than risk management. However, this article is intended to focus on just that issue. As a lawyer, I am confident in saying that, from a risk management perspective, the best possible plan is one which automatically enrolls, has automatic deferral increases, and defaults participants into QDIAs.

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