Defined Contribution Plan Design in a Post-PPA Environment

by Rita Holder

The Pension Protection Act (PPA) opened the door to new features that enable employers and employees to manage their retirement savings risks. This article gives an overview of the defined contribution plan design changes that PPA has brought, including automatic enrollment, automatic contribution increases and default investments. The author provides plan sponsors with information about potential fiduciary liabilities and suggests best practices for ensuring fiduciary compliance in the current post-PPA environment.

As defined contribution plans continue to grow in popularity, they can pose a variety of risk issues for both employers and employees. DB plans have several advantages: They provide benefits that vest quickly, they can be moved from one job to the next, and they allow techno-savvy employees to manage their investment portfolios from their desktops. It's this very advantage that has the potential to cause problems for employers.

The Pension Protection Act (PPA), enacted into law on August 17, 2006, made significant changes to the rules affecting defined contribution plans such as 401(k) plans. PPA opens the door to new features that enable employers and employees to manage their retirement savings risks, including automatic enrollment, automatic contribution increases and default investments. In addition, PPA addresses, but does not eliminate, some employer fiduciary liabilities for investment losses in their defined contribution plans.

AUTOMATIC ENROLLMENT AT A GLANCE

With automatic enrollment, employees become contributing members of the 401(k) plan unless they affirmatively elect not to participate. Employees who do not make an election have pay deferred at the percentage of pay specified in the automatic enrollment provision.

Automatic enrollment in 401(k) plans has been available for many years. PPA adds a qualified automatic contribution arrangement (QACA) to existing design-based safe harbors to avoid actual deferral percentage testing. Unless a participant elects otherwise, a QACA must provide for automatic deferrals from the participant's compensation at a specified minimum percentage that depends on, and escalates with, years of service.

Under this safe harbor, automatic contributions must be at least:

- 3% of pay during the first year of plan participation
- 4% of pay during the second year

- 5% of pay during the third year
- 6% of pay in the fourth year and thereafter.

Also, nonhighly compensated employees must receive:

- A 3% nonelective contribution from the company, or
- A 100% match on the first 1% of elective employee contributions, plus a 50% match on the next 5% of elective employee contributions.

Employer safe harbor contributions must fully vest within two years, and employees must receive a notice explaining their right to opt out and how contributions under the arrangement will be invested.

IMPACT OF AUTOMATIC ENROLLMENT ON U.S. RETIREMENT SAVINGS

Automatic 401(k) features can have a variety of subtle (and some not-so-subtle) benefits for a defined contribution plan. They

- Enhance employees' perceived value of the 401(k) program
- Help support a culture of shared responsibility for financial security in retirement
- Help ensure the level of financial security necessary to enable employees to retire
- Strengthen a company's value proposition to its employees and help brand the company as an employer of choice
- Enhance employee retention.

From a financial security perspective, the U.S. Department of Labor (DOL) estimates that the adoption of automatic enrollment plans and the encouragement of investments appropriate for long-term retirement savings will result in between $70 billion and $134 billion in additional retirement savings by 2034.

The number of companies offering these features is expected to continue to grow rapidly in coming years. In a recent Towers Perrin survey of 126 financial executives working in midsize and large U.S. companies, 42% said their companies are now more likely than ever to introduce automatic enrollment.

AUTOMATIC CONTRIBUTION INCREASES

However, auto enrollment alone does not necessarily lead to adequate retirement savings for employees because, in many instances, they elect to contribute only a fraction of the pay they are entitled to set aside. This is especially true of employees in the lower salary grades.

Employers can address this to some extent by adding an "automatic escalation" feature. It adjusts an employee's contribution rate (or deferral rate) automatically each year at a specified time, such as the end of the fiscal or calendar year. For example, it can increase an individual's plan contributions by an additional 1% of eligible pay each year until a certain threshold (e.g., 6%) is reached.

Under the assumptions and scenarios modeled in the survey, the automatic escalation feature is likely to increase overall 401(k) accumulations from 11% to 28% for participants in the lowest-income quartile, and 5% to 12% for those in the highest-income quartile. Simply put, it narrows the gap in contribution rates between high-paid and low-paid employees.

AUTO-REBALANCING FEATURE

For 401(k) participants who are passive investors and don't review their investments regularly, the auto-rebalancing feature can be a great help. It regularly rebalances participants' accounts automatically to restore the original level of targeted investment in various asset classes (e.g., large cap stocks, small cap stocks, fixed income investments, cash equivalents).

Over time, even an appropriately diversified portfolio can become unbalanced because of swings in the market. In a recession, for example, large cap stocks may register large declines while bonds increase in value. Without an adjustment, this could leave a portfolio overweighted in bonds and underweighted in stocks.

FIDUCIARY RELIEF

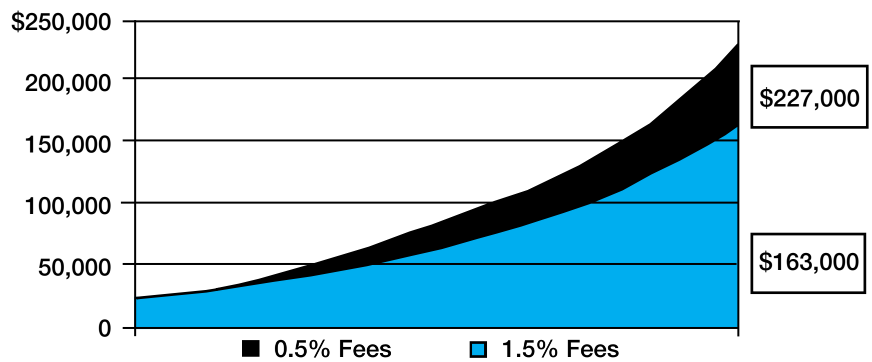
Under ERISA, a plan fiduciary is generally liable for investment decisions concerning plan assets.[1] Under certain circumstances, a fiduciary could be relieved of investment responsibility under an individual account plan if the participant affirmatively exercises investment authority for his or her account. A fiduciary remains responsible for investment decisions, however, if a participant fails to exercise his or her right to invest his or her own assets.

In other words, the mere fact that a participant could exercise control over the investment of his or her account is not enough to shield the plan fiduciary from potential liability. This means a plan fiduciary could be liable when a default investment protocol is used for participant accounts—as would be the case under a plan with an automatic enrollment feature.

PPA changes this outcome by adding new ERISA §404(c)(5). A participant is now deemed to have exercised investment control, and the fiduciary relieved

FIGURE

POTENTIAL IMPACT OF ONE PERCENTAGE POINT DIFFERENCE IN PLAN FEES ON ASSET BALANCE



—No further employee or employer contributions are made to the account balance for 35 years.
—Return on investments average 7%, compounded annually over 35 years (without offset for fees/expenses).
—Scenario 1: Fees/expenses reduce average returns by 0.5% ($227,000 final account balance).
—Scenario 2: Fees/expenses reduce average returns by 1.5% (163,000 final account balance).

Source: U.S. DOL—A Look at 401(k) Plan Fees.

of liability for investment results, if the requirements for a qualified default investment arrangement (QDIA) are satisfied.

This relief from fiduciary liability will apply if a participant, within a reasonable period of time before each plan year, receives a notice explaining that the participant has the right to exercise control over the investment of his or her individual account and how, if the participant fails to do so, the account will be invested. Of course, plan fiduciaries remain liable for prudent selection and monitoring of qualified default investment alternatives.[2]

SCRUTINY OF FEES

DOL encourages employers to help workers manage their savings accounts in a responsible manner. According to DOL, plan fees and expenses are important considerations for all types of retirement plans.

Understanding and evaluating fees and expenses associated with plan investments, investment options and services are an important part of a fiduciary's responsibility. This responsibility is ongoing.[3]

There is mounting scrutiny of defined contribution plan fees by government agencies (e.g., DOL, Securities Exchange Commission) and the public. This growing scrutiny has, for the most part, arisen because a participant's account balance growth can be significantly affected by the fees and expenses allocated to his or her account.

- For example, a participant with 35 years until retirement and a current account balance of $25,000 will accumulate a $227,000 balance at retirement (0.5% fees) versus $163,000 (1.5% fees) if the fees and expenses vary by 1%.
- This 1% difference represents a 28% reduction in the participant's account balance at retirement, as shown in the figure.

Plan fees and expenses include the following categories:

- **Asset-based fees—**computed based on an annual percentage charge on asset balances. These include investment management fees and administrative service fees.
- **Census-based fees—**charged on a per-capita basis (e.g., a per participant recordkeeping fee of $27 a year).
- **Itemized fees—**specified as a fixed charge for a specific service (e.g., distribution or loan fees).

TABLE

AREAS OF FIDUCIARY FOCUS RELATED TO FEES AND INVESTMENTS	CORRESPONDING QUESTIONS PLAN FIDUCIARIES SHOULD BE ASKING THEMSELVES
Allocation and delegation of fiduciary duties	What procedures are in place to determine if the plan is operated in accordance with its terms?
Trust/custodian agreement and responsibilities	Does the plan operate in accordance with the plan and trust documents with regard to the investments and oversight?
Committee meeting frequency and documentation	Is there a prudent fiduciary decision-making process, and is there sufficient documentation to support decisions?
Payment of expenses from plan trust assets	Do the plan fiduciaries have a prudent process to ensure that the expenses paid are appropriate for the plan and not actually expenses of the company?
Communications to participants and beneficiaries	Do the participant education program and disclosures comply with ERISA and PPA?
Compliance with ERISA bonding requirements	Does the plan meet the reporting, bonding and disclosure requirements of ERISA?
Adequacy of fiduciary liability insurance policies	Do the plan fiduciaries have enough insurance coverage to ensure that their personal assets will not be at risk in the event of an ERISA-related lawsuit?
Potential conflicts of interest among consultants, advisors and other vendors	On the basis of the current investment holdings, has the plan entered into any prohibited transactions or used the plan assets to promote the interests of anyone other than the plan participants and beneficiaries?
Adequacy of internal investment resources (staff, systems, etc.)	Is the investment return appropriate for the objectives of the plan?
	Do plan investments appear prudent and are investment losses the result of market forces rather than imprudent fiduciary conduct?

Typically, all three types of fees may be charged in connection with administrative services. This is especially prevalent in a "bundled arrangement." These fees can be charged directly to the participant (e.g., loan setup fee) or indirectly by netting the investment returns after investment fees and expenses have been subtracted. Revenue sharing from fund companies and float earned from distribution checks may offset some fees charged by the administrator.

DOL warns that fiduciaries that do not follow the basic standards of conduct will be personally liable to restore any losses to the plan, or to restore any profits made through improper use of the plan's assets resulting from their actions.[4]

QUALIFIED DEFAULT INVESTMENT ALTERNATIVES (QDIAS)

These are the elements required by DOL for an arrangement to satisfy the standards for a QDIA:[5]

- Participants and beneficiaries must have been given an opportunity to provide investment direction, but have not done so.
- A notice generally must be furnished to participants and beneficiaries in advance of the first investment in the QDIA and annually thereafter. Employees must be notified about the default investment arrangement at least 30 days before the initial investment and annually after that.[6]

Best Practice Pointer: The notice must cover all of the following: (i) explain the circumstances in which assets will be invested in the QDIA (i.e., where a participant fails to provide investment direction); (ii) describe the investment objectives, risk and return characteristics, and applicable fees and expenses of the QDIA; (iii) describe participants' right to direct their own investments; and (iv) describe where participants can obtain more information about the other investment alternatives under the plan.[7]

- Material, such as investment prospectuses, provided to the plan for the QDIA must be furnished to participants and beneficiaries.

Best Practice Pointer: Maintain a stock of any material provided to the plan (e.g., prospectuses) relating to the QDIA and pass it on to the participants. Or better yet, arrange for the investment manager to mail it directly.

- Participants and beneficiaries must have the opportunity to direct investments out of a QDIA as frequently as from other plan investments, but at least quarterly.

Best Practice Pointer: This means that employees must have the right to direct the investment of their account into other investment options under the plan, with the same frequency available generally under the plan but no less frequently than quarterly and without financial penalty.

- The rule limits the fees that can be imposed on participants who opt out of participation in the plan or decide to direct their investments.

Best Practice Pointer: The imposition of restrictions, fees and expenses are prohibited (other than investment management fees, 12b-1 fees and other ongoing fees) with respect to transfers or permissible withdrawals of defaulted investments out of a QDIA elected within 90 days of the first elective contribution or first investment in a QDIA.[8]

- The plan must offer a "broad range of investment alternatives" including these four types of QDIAs:[9]

1. A product with a mix of investments that takes into account the individual's age or retirement date (e.g., a lifecycle or targeted-retirement-date fund)
2. An investment service that allocates contributions among existing plan options to provide an asset mix that takes into account the individual's age or retirement date (e.g., a professionally managed account)
3. A product with a mix of investments that takes into account the characteristics of the group of employees as a whole, rather than each individual (e.g., a balanced fund)
4. A capital preservation product for the first 120 days of participation (an option for plan sponsors wishing to simplify administration if workers opt out of participation before incurring an additional tax).

Best Practice Pointer: Sharp-eyed readers will notice that the plan must offer a broad range of investment alternatives as defined under ERISA 404(c). (Note that the QDIA relief is available without satisfying all the requirements for 404(c) relief.) In addition, the QDIA must be managed by either the plan trustees or the plan sponsors who are named fiduciaries, an investment manager or an investment company registered under the Investment Company Act of 1940.

CONCLUSION

Fiduciary compliance issues can overwhelm even the most diligent plan sponsor, leading to the need for ongoing special cleanup work. The government continues to roll out new rules and regulations that affect pension plans, creating a burden that can strain resources. And with growing regulatory scrutiny and today's emphasis on transparency, managing fiduciary risks is more critical than ever. It can distract organizations from providing service to their employees, managing plan costs and setting benefit direction for the company.

In addition, the growing prevalence of defined contribution plan lawsuits is an unsettling development for any employer, especially one that maintains employer stock in its plan. Many plan sponsors wonder if they have a lawsuit waiting to happen.

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Rita Holder is a principal in the retirement practice with global professional firm Towers Perrin. An Employee Retirement Income Security Act (ERISA) attorney, Holder has more than 20 years of experience in solving the compliance, recordkeeping and outsourcing challenges of pension, 401(k) and health plans. Prior to joining Towers Perrin, she was a regional compliance manager at a major consulting firm and a tax partner at an accounting firm. Holder has a bachelor's degree in environmental science from the University of California, Berkeley. She holds a J.D. and LL.M. in taxation from Golden Gate University School of Law, as well as a Series 2 license from the National Association of Securities Dealers (NASD).

The Pension Protection Act includes a series of fiduciary and tax incentives to encourage broader adoption of automatic savings and investment features.

PPA also removed one of the final impediments to employers adopting automatic enrollment: fear about legal liability for market fluctuations. This worry prevented many employers from adopting automatic enrollment or led them to invest workers' contributions in low-risk, low-return "default" investments.

DOL warns that fiduciaries that do not follow the basic standards of conduct will be personally liable to restore any losses to the plan, or to restore any profits made through improper use of the plan's assets resulting from their actions. ◀

PPA established that there is no fiduciary liability for default investments selected for participants who fail to make elections, provided there is compliance with new DOL regulations. Under these regulations, a participant is deemed to have exercised investment control, and the fiduciary relieved of liability for investment results, if the requirements for a QDIA are satisfied.

With a QDIA feature in place, employees' contributions can be automatically invested in so-called lifestyle and/or lifecycle accounts—premixed investment funds designed to fit a range of risk tolerances or for employees in different stages of their lives. These funds are often described as "conservative," "moderate" or "aggressive" to help employees understand the risk level.

Automatic investing in a QDIA makes investing easy for employees by helping them invest their 401(k) balances appropriately. A lifecycle fund, for example, would typically offer a higher allocation to equities for a young worker and shift the mix more toward fixed income and cash equivalents designed for preservation of capital as the employee approaches retirement age. ◀

Endnotes

1. ERISA stands for the Employee Retirement Income Security Act.
2. The final regulations reiterate that the use of a QDIA is not the only means by which a plan fiduciary can satisfy his or her responsibilities with respect to default investment alternatives. Other investment options might be prudent but would not be safe harbors entitled to 404(c) relief. For example, the U.S. Department of Labor (DOL) recognized that there may be compelling reasons to use a stable value product as a default investment if such vehicle best suits a plan's participant population (e.g., where participants are closer to retirement, and for participants that tend to be more risk-averse), even though such product may not qualify as a QDIA.
3. U.S. Department of Labor, *Understanding Retirement Plan Fees and Expenses,* (May 2004), www.dol.gov/ebsa/publications/undrstndgrtrmnt.html.
4. U.S. Department of Labor, *Meeting Your Fiduciary Responsibilities,* (August 2007), www.dol.gov/ebsa/publications/fiduciaryresponsibility.html.
5. The final regulations clarify that although these rules facilitate automatic enrollment programs, the relief provided extends to any transaction where participant direction would otherwise be required (e.g., plan merger or asset transfer, elimination of an investment alternative, change in service providers, rollovers into the plan).
6. The final regulations provide that the initial 30-day advance notice requirement is measured from the plan eligibility date or first investment in the QDIA. Importantly, the preamble provides that the 30-day advance annual notice must be provided as a separate document and not included in a summary plan description or summary of material modifications. Plans may rely on either the DOL's or Internal Revenue Service's rules regarding the use of electronic media to disseminate QDIA notices until future guidance is issued.
7. The final regulations broaden the QDIA notice content requirements. For example, the QDIA notice must now also explain, in the case of automatic enrollment plans, the circumstances under which elective contributions will be made on behalf of a participant, the percentage of such contributions, and the right to elect not to have such contributions made on the participant's behalf (or to elect to have such contributions made at a different percent).
8. Thereafter, restrictions, fees and expenses may be imposed but only to the extent that they are applicable to plan participants who affirmatively elect to invest in the QDIA.
9. The final regulations include two exceptions to accommodate limited investments in capital preservation products as QDIAs. First, a capital preservation vehicle, including a stable value fund, can be a QDIA but only for 120 days after the participant's first elective contribution is invested in the QDIA. Second, the final regulations also "grandfather" amounts defaulted into a stable value fund prior to December 24, 2007. The final regulations also clarify that a QDIA can include products and portfolios offered through variable annuity contracts, common and collective trust funds or other pooled investment funds. The availability of annuity purchase rights, death benefit guarantees, investment guarantees or other features common to variable annuity contracts will not affect the status of such fund, product or portfolio as a QDIA.