JOURNAL
of
PENSION
BENEFITS

ISSUES IN ADMINISTRATION, DESIGN, FUNDING, AND COMPLIANCE
Volume 25 • Number 4 • Summer 2018

PLAN DISTRIBUTIONS

Outsourcing Automatic Rollovers Strengthens Core Recordkeeping Functions

Although they enhance retirement security for many participants, automatic rollovers also present challenges for plan sponsors.

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A rapidly evolving regulatory environment is galvanizing change in the retirement industry, with automatic enrollment acting as a double-edged catalyst. On one side, it may help improve retirement security for millions of Americans who might otherwise never have saved in a workplace retirement plan. On the other, it has exacerbated issues associated with small accounts that are left behind by former employees.

During the past few years, the Department of Labor (DOL), Internal Revenue Service (IRS), and Congress have focused more closely on plan sponsors' and plan service providers' management of small accounts that have been left behind. Greater regulatory scrutiny is changing the way some service providers approach automatic rollover services. Instead of providing the services in-house, they've begun to outsource rollovers to firms that specialize in servicing small balance accounts.

Automatic Enrollment Has Unanticipated Side Effects

Earlier this year, *PlanSponsor* magazine asked plan sponsors, recordkeepers, third-party administrators, investment managers, advisors, and consultants: "Which retirement industry development over the past 25 years do you think has been the most effective for improving retirement outcomes?" The top answer was the adoption of automatic enrollment programs for defined contribution plans. [Rebecca Moore, "Survey Says: Least/Most Effective Retirement Industry Developments in the Last 25 Years," PlanSponsor.com. *https://www.plansponsor.com/survey-says-least-effective-retirement-industry-developments-last-25-years/* (Mar. 2018)]

While large private-sector plan sponsors have been more receptive to the opportunity than smaller plan sponsors, the number of plans adopting automatic enrollment has almost doubled since 2007. In 2016, about 60 percent of plan sponsors had an automatic enrollment provision in their plan documents and developed a process for implementing it. About 70 percent of plans with 5,000 or more participants currently utilize automatic enrollment. [Plan Sponsor Council of America, "PSCA Releases Results of 60th Annual Survey of Profit Sharing and 401(k) Plans," PSCA.org, *https://www.psca.org/PR_2018_60thAS* (Mar. 2018)]

Over time, automatic enrollment has become a best practice for plan sponsors. By automatically enrolling new employees or re-enrolling all employees, plan sponsors overcome employee inertia, raise participation rates, and may improve participants' retirement security. In addition, higher participation rates may help highly compensated employees whose contributions may be limited by low participation rates.

One consequence of the practice has been an increase in the number of workplace retirement accounts left behind by participants who change jobs or retire. A 2015 working paper by RAND reported that 40 percent of employees hired between 2010 and 2013 left their employers before the end of 2013. The average tenure for these employees, who tended to be younger and lower earners, was one year. [Angela A. Hung, Jill E. Luoto, Jeremy Burke, "Defaulting in and Cashing Out? The Impact of Retirement Plan Design on the Savings Accumulation of Separating Employees," p.8 Table 1, RAND.org, *https://www.rand.org/content/dam/rand/pubs/working_papers/WR1100/WR1115/RAND_WR1115.pdf* (Feb. 2018)]

These departing employees are tasked with deciding how to manage the savings in their workplace retirement accounts. According to the U.S. Government Accountability Office, 25 million participants in workplace plans separated from an employer and left at least one account behind between 2005 and 2015. [U.S. Government Accountability Office, "The Nation's Retirement System: A Comprehensive Re-evaluation is Needed to Better Promote Future Retirement Security," p.46, GAO.gov, *https://www.gao.gov/assets/690/687797.pdf* (Feb. 2018)] The combination of high turnover, low earners, and tendency to leave balances means the Plan is left with an increasing number of small balances for terminated employees, and, when accounts are left behind, plan rules determine what happens to the accumulated retirement savings.

Exhibit 1

Plan Characteristics	Voluntary Enrollment	Automatic Enrollment
Mean number of total employees	5,485	2,945
Mean number of new hires 2010–2013	2,245	956
Participation rate among new hires	0.35	0.92
Has automatic increase	N/A	0.78
Mean default contribution rate	N/A	3.56
Has an employer match	0.87	0.91
Plan offers immediate vesting of employer contributions	0.37	0.33
Default fund is Target Date Fund	0.88	0.98
Allows loans	0.96	0.95
Rules on account balances for separated employees		
Distribution rule 1 (defer indefinitely; no cash outs)	4 (3%)	4 (2%)
Distribution rule 2 (cash out <$1000; defer above $1000)	44 (28%)	32 (14%)
Distribution rule 3 (cash out <$1000, Auto-Rollover $1000-$5000, defer above $5000)	107 (69%)	194 (84%)

One Best Practice Leads to Another

Automatic enrollment, in tandem with high turnover and account abandonment, has had some unanticipated side effects. These included higher plan costs, increased administrative complexity, greater disclosure and reporting burdens, and elevated exposure to fiduciary liability. The go-to solution, which is considered a best practice by many in the industry, has been automatic rollovers into safe harbor Individual Retirement Accounts (IRA).

In general, plan sponsors have four options when it comes to managing small accounts that have been left behind by former employees. They may choose to:

1. Leave the assets in the plan.
2. Cash out accounts with balances below $1,000 and allow larger accounts to remain in the plan.
3. Cash out accounts with balances below $1,000 and automatically roll over accounts of $1,000 to $5,000 into safe harbor IRAs.
4. Automatically roll over all accounts of not more than $5,000 into safe harbor IRAs.

The majority of plan sponsors in both voluntary enrollment and automatic enrollment plans have chosen to cash out small accounts with balances of less than $1,000, automatically roll over accounts of $1,000 to $5,000, and allow larger accounts to remain in the plan. (*See* Exhibit 1.) [Angela A. Hung, Jill E. Luoto, Jeremy Burke, "Defaulting in and Cashing Out? The Impact of Retirement Plan Design on the Savings Accumulation of Separating Employees," p.10 Table 2, RAND.org, *https://www.rand.org/content/dam/rand/pubs/working_papers/WR1100/WR1115/RAND_WR1115.pdf* (Feb. 2018)]

By rolling eligible small balance accounts into safe harbor IRAs, plan sponsors have been able to preserve the tax-deferred status of former employees' retirement savings while lowering plan costs, reducing administrative burdens, and potentially minimizing fiduciary liabilities.

Unfortunately, cashouts have proven to be a less effective solution. Historically, the amounts associated with uncashed checks in workplace retirement plans were low enough that auditors did not consider them to be material. That is no longer the case. The DOL estimates that millions of retirement dollars go unclaimed each year because plan participants or their beneficiaries fail to cash distribution checks. These funds remain plan assets, and plan sponsors retain fiduciary responsibility for them. As a result, some consultants encourage plan sponsors to roll over all small account balances into IRAs.

A variety of solutions have been developed to meet growing demand for automatic rollovers. Many large plan service providers prevailed upon their retail IRA divisions to make automatic rollovers available to plan sponsors, even though servicing small balance IRAs was not a core function of these divisions. Regardless, it was an expedient solution that delivered the needed service and helped retain assets.

In addition, a number of boutique firms have emerged offering automatic rollover solutions specifically designed to service small balance IRA accounts. Often, these firms offer search processes designed to reunite missing and unresponsive participants with their retirement savings.

A Changing Regulatory Focus Encourages New Business Structures

Just as litigation and fee compression have caused some plan service providers to outsource non-core recordkeeping functions to "pure" recordkeepers that deliver basic services and charge explicit per-participant fees, greater regulatory scrutiny may be behind the trend of plan service providers outsourcing automatic rollovers to firms that specialize in small balance accounts and have well-defined processes for locating missing participants.

The steps that plan sponsors take to locate missing and unresponsive plan participants are being examined by regulators far more closely than they once were. The DOL's growing interest in these processes has been apparent in proposed Form 5500 revisions and changing audit positions.

Additional pressure is coming from the IRS, which is concerned that plan sponsors may not be making required minimum distributions when former employees who have left accounts behind reach age 70½. Making distributions can be quite difficult when plans cannot locate former employees.

This added scrutiny, paired with the aforementioned fee compression, has forced plan service providers to reassess missing participant strategies and, in turn, their business models. When plan service providers are asked why they decided to outsource automatic rollovers, they respond that a top priority was giving plan participants safe harbor IRAs that had reasonable fees and offered default investments with relatively high rates of return.

In addition, outsourcing strengthens business functions by allowing recordkeepers to focus on core services. Small balance IRAs were not a core competency for many plan providers, and in many cases those providers were losing money servicing these accounts. As a result, firms faced challenges when it came to developing these relationships.

Another driver behind outsourcing automatic rollovers was risk management. After evaluating the requisite outreach and search processes employed by IRA providers, some firms decided it was best to simply outsource to firms with well-established processes and high success rates.

Although auto enrollment has proven successful in helping more Americans save for retirement, it also has focused significant attention on issues associated with missing and unresponsive participants and has led to greater scrutiny of plan and provider practices. A more robust regulatory environment, in tandem with fee compression, appears to have some plan service providers restructuring their business models. One distinct trend has been the outsourcing of services, like automatic rollovers and participant search, that were once kept in-house. ■