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HOW BIG IS THE PROBLEM: THE HIGH COST OF ACCOUNTS LEFT BEHIND

On the surface, the expense of administering accounts with small balances in a retirement plan may seem relatively immaterial and inexpensive. It's only upon closer inspection, when plan sponsors realize that the number of small accounts in their plan is growing and that many of these accounts are connected with former employees, that the cumulative costs associated with a large number of these types of accounts begins to sink in. Not only do these accounts increase plan administrative expenses, but they may also expose plan sponsors to greater fiduciary responsibility and impair effective plan administration.

Some newly 'budget-minded' individuals have had a similar realization the first time they sat down and worked out a budget. After inputting all of their expenses from previous months, they begin looking for places to save. The first (and most common) place to look is in discretionary items, i.e. things you like but don't need. Standing at the counter three times a day, handing over $4.65 for a Venti, Skinny Vanilla Latte doesn't seem too bad at the time and can appear relatively inexpensive. However, after adding it up, $13.95 a day, $97.65 a week… $5,091.75 a year; many realize that coffee could be a perfect place to begin tightening the budget. Put more succinctly, often small, seemingly insignificant expenses have a way of adding up over time.

In this whitepaper, we will share our experience, as well as the sparse data available, to help quantify the costs of maintaining small balance accounts for former employees. We will also offer some solutions for mitigating these costs as well as minimizing the fiduciary responsibilities created by these accounts.

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SO, HOW BIG IS THE PROBLEM?

According to the Investment Company Institute's 2016 Investment Company Fact Book, "Assets in employer-sponsored defined contribution (DC) plans have grown faster than assets in other types of employer-sponsored retirement plans over the last three decades, increasing from 26 percent of employer plan assets in 1985 to 46 percent at year-end 2015." Combined, DC plans held an estimated $6.7 trillion in assets by the end of 2015 with $4.7 trillion of those assets held in 401(k) type plans.[1]

Plan participation is at an all-time high, according to the Profit Sharing Council of America (PSCA). The PSCA's 58th Annual Profit Sharing and 401(k) Survey found that almost 88% of eligible employees had a balance in their employers' DC plans in 2014. One obvious reason for improved participation is automatic enrollment programs, which we expect to continue to play a significant role in DC plan growth. According to the PSCA, automatic enrollment is employed by 52.4% of DC plans overall.[2]

However, improved plan participation hasn't necessarily translated into greater employee loyalty. Workforce demographics show that the average tenure of employees remains relatively short. The Bureau of Labor Statistics (which publishes a report on wage and salary worker tenure every 2 years) reported that as of January 2014, the median number of years that all wage and salary workers stayed with employers was 4.6 years. The median length of employment for younger workers, age 25 to 34, was even shorter at 3 years.[3]

One consequence of high employee participation and rapid employee turnover is that an abundance of retirement accounts are 'left behind' by employees who have separated from service. One estimate suggests that 9.5 million DC plan participants change jobs each year.[4] Since many leave plan assets with a previous employer for some period of time, some estimates suggest that there may be 38 million accounts of former employees in DC plans alone.[5]

The cost of managing these accounts for former employees can be quite significant. According to a 2013 report by Boston Research Group:

"To understand the cost of stranded accounts from a DC system perspective, simply apply the [median] recordkeeping, custody and administration fee of $92 [per account per year] (source:NEPC) to the 38 million stranded DC accounts [to arrive at an annual cost of about $3.5 billion]... Assuming growth of 5 percent in stranded accounts (about 1/3 the annual turnover rate in the job market) and flat annual recordkeeping costs, this number grows to $43.5 billion over a 10-year period."[6]

Unless a retirement plan is terminating, and except where mandatory payouts are required, it is typically required to keep accounts for participants who have separated from service until the participants reach full

Quantifying The Problem

9.5 million	**Employees change jobs each year**
38 million	**Retirement account connected with former employees left with previous employers**
$92/year	**Average recordkeeping, custody, and administration fee per account**
$3.5 billion	**Estimated annual cost of DC plan accounts belonging to previous employees**
$43.5 billion	**Estimated cost of former employees over a 10-year period**

Source: Benefitspro.com; Boston Research Group retirement age. That means plan sponsors must keep track of former employees, which may create additional cost concerns and fiduciary headaches.

Another related problem is uncashed distribution checks. Retirement plans, collectively, hold billions of dollars of uncashed checks that they've unsuccessfully distributed to former participants. The funds represented by these checks remain as plan assets and rightfully belong to the former participants; therefore, plan sponsors are responsible for returning the assets to the plan, administering the funds and including those values into their 5500 reporting and supporting schedules.

EXACERBATING THE PROBLEM: SMALL ACCOUNTS

Not every retirement plan account has a significant balance. As indicated, every year, retirement plans are left with small accounts that belong to employees who have left the company. Plan administrators do not always realize the cumulative cost of maintaining these small balance accounts because of revenue equalizations from recordkeepers and investment fund managers.

As previously stated, large-scale recordkeepers charge a median fee of $92 per participant per year for recordkeeping, investment and other administrative costs. This cost may be covered in a variety of ways:

- The plan sponsor may pay the cost
- The plan (all participants) may pay the cost
- Mutual fund reimbursements may offset costs
- A combination of the above may pay the cost

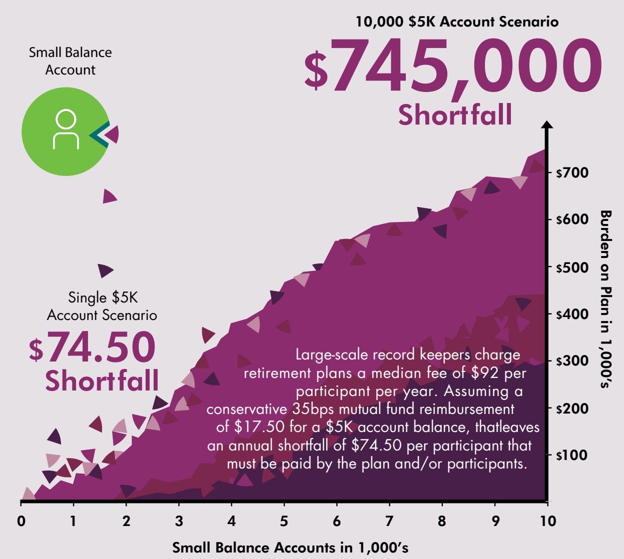
Mutual fund reimbursements typically range from 25 to 50 basis points (bps) annually (basis point is equal to 1/100th of one percent). In this example, we assume a reimbursement payment of 35 bps. If an account has a balance of $5,000, the average annual reimbursement would be $17.50 ($5,000 times .0035). After reimbursement, a shortfall of $74.50 (or $92 less $17.50) in recordkeeping costs remains to be paid

> Generally, the higher the number of small accounts, the larger the shortfall passed on to other participants.

to the recordkeeper/custodian from the plan sponsor and/or plan participants. If the account size is smaller, the amount received from the mutual fund will be less, increasing the shortfall. Likewise, if the mutual fund reimbursement rate is lower, the shortfall will be greater. Regardless, the plan sponsor and/or the participants in the plan pay the remainder.

Generally, the higher the number of small accounts, the larger the shortfall passed on to other participants. How does it show up? The additional costs erode investment performance each year and over the long-term have the potential to expose plans to future litigation.

LARGE NUMBER OF SMALL BALANCE ACCOUNTS INCREASE BURDEN FOR PLANS



Source: Boston Research Group, Millennium Trust Company

We have explained much of the 'what is the problem?' and 'why it is happening?,' but there is still another 'why it is happening?' that we should mention. It is important for plan sponsors to understand how plan service providers are paid. It is a very competitive marketplace and plan service providers have different requirements as to how they describe their fees. But in most cases, fees are calculated and described as a percentage of assets or on a per account basis.

AUTOMATIC ROLLOVERS: A SOLUTION THAT HELPS MINIMIZE PLAN COSTS AND FIDUCIARY RISKS

Fortunately, there is a relatively easy solution. When small balances are removed from retirement plans, plans have fewer participants, relatively larger account balances, lower fixed costs and a higher average account value when revenue reimbursements are calculated.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) amended the Internal Revenue Code to allow plans to establish IRAs for former plan employees with balances that are within a specific range. This allows plan sponsors to effectively distribute participant account funds to the participants or to a qualified IRA provider as an automatic rollover, thereby saving money, time, and valuable personnel resources, while preserving the benefits of tax-deferral for former plan participants.

There are a handful of providers that have an IRA solution dedicated to supporting automatic rollovers. Each IRA provider has developed the requisite technology and infrastructure to help plan sponsors use automatic rollover programs as a solution to a myriad of plan issues related to missing and non-responsive participants. These providers specialize in processing bulk transactions (opening and funding a large number of accounts simultaneously), serving as a custodian for the substantial number of small balance accounts and searching for missing former employees.

Safe Harbor Requirements

In September 2004, the DOL published final regulations providing plan sponsors with a safe harbor for rolling over distributions to IRAs. If done in accordance with these rules, the plan sponsor will be deemed to have satisfied its fiduciary duties under ERISA. In order to meet the safe harbor regulations for ongoing retirement plans, the present value of the participant's vested account balance may not be more than $5,000 or, if the plan so provides, $5,000 plus amounts and earnings rolled over from other plans. The account balance is not limited for terminating DC retirement plans. Other safe harbor requirements include:

- The plan sponsor must enter into a written agreement with an IRA provider addressing the initial investment, services and related fees and expenses
- The initial investment product must be offered by a state or federally regulated financial institution, such as a bank, trust company, credit union, insurance company or '40 Act Investment Company
- The initial investment product must be designed to minimize risk, preserve principal, provide a reasonable rate of return and maintain liquidity
- The fees and expenses cannot exceed those charged by the selected IRA provider for its other comparable IRAs
- The participant must have the right to enforce the terms of the IRA agreement
- The plan sponsor must provide information about the automatic rollover provider and the investment products offered to all participants in either a Summary Plan Description (SPD) or Summary of Material Modification (SMM)

If safe harbor requirements are met, the individual is no longer a participant in the plan after the rollover.

Further, plan sponsors are not required to monitor the IRA provider and have no responsibility for the IRA provider's compliance with the terms of the IRA agreement after the funds are rolled over.

SUMMARY

Maintaining retirement plan balances for employees that separate from service is a more costly problem than many plan sponsors realize. Small accounts increase plan administrative expense, expose plan sponsors to greater fiduciary responsibility, and impair effective plan administration. Accounts with small balances can be particularly insidious because the culmination of the expenses associated with their management may create a drain on plan resources which can impact participants with larger balances.

Fortunately, there are straightforward solutions that can be adopted by plan sponsors. By adding automatic rollover provisions to their plans, plan sponsors create a means of removing smaller accounts. This will reduce plan costs, limit fiduciary liability, and reduce the complexities of plan management.

Fiduciary Responsibilities[7]

Fiduciary responsibilities include providing substantial administrative attention to active employees, former employees, and missing and non-responsive participants. These responsibilities include:

- Maintaining communication with all participants
- Searching and locating missing and non-responsive participants
- Maintaining and tracking plan assets related to uncashed distribution funds
- Ongoing administration and reporting of all plan participants
- Sending notices and updated information to all participants, including educational materials describing their options

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