Solutions for When Former Employees Leave Retirement Accounts Behind

Higher turnover in the job-market is resulting in an increased number of small retirement plan balances.

By Terry Dunne

With DC Plan participation at an all-time high,[1] why is the Stress-o-Meter for plan sponsors seemingly in the red zone? One factor driving stress among plan sponsors is the double-edged nature of historically unprecedented high DC plan participation and changing workforce demographics. While the median job tenure for baby boomers is 10.4 years, the median job tenure of younger workers age 25–34 (millennials) is just three years.[2]

This extraordinary generational discrepancy is wreaking havoc on many plan sponsors' ability to effectively and efficiently manage their DC plans, especially in business sectors such as Retail and Hospitality where turnover approaches 75–100 percent. This high turnover is resulting in an increase in the number of small plan balances left behind at employers when employees move on.

Since benefit departments are already stretched thin and their organizations have invested heavily in the success of their DC plans, it is essential to explore opportunities to simplify and streamline.

As, a leading IRA custodian and service provider, Millennium Trust is a stakeholder in helping both employers and employees succeed in consolidating and building retirement plan assets. Below is an overview of some of the challenges, and some of the options available to plan sponsors in addressing those challenges.

The Downside of High Participation

Mobility may work for certain employees, but 401(k) plan participants who switch jobs every couple of years are likely to cause headaches for plan sponsors. There are demonstrable administrative and carrying costs associated with establishing and maintaining 401(k) accounts for employees, and there are additional costs associated with abandoned, low-balance accounts.

Whether on purpose or for lack of interest, many terminated employees leave money behind in a former employer's 401(k) plan. According to the most recent data from the Department of Labor (DOL), there were roughly 92.5 million plan participants in DC plans as of December 2013.[3] And, given estimates that the national employee turnover rate of U.S. companies across sectors was approximately 46 percent from Q2 2014 to Q1 2015,[4] the cost of managing orphaned retirement accounts is significant.

Make no mistake; for many plan sponsors, this is a big problem.

When a Plan Sponsor's Hands Are Tied

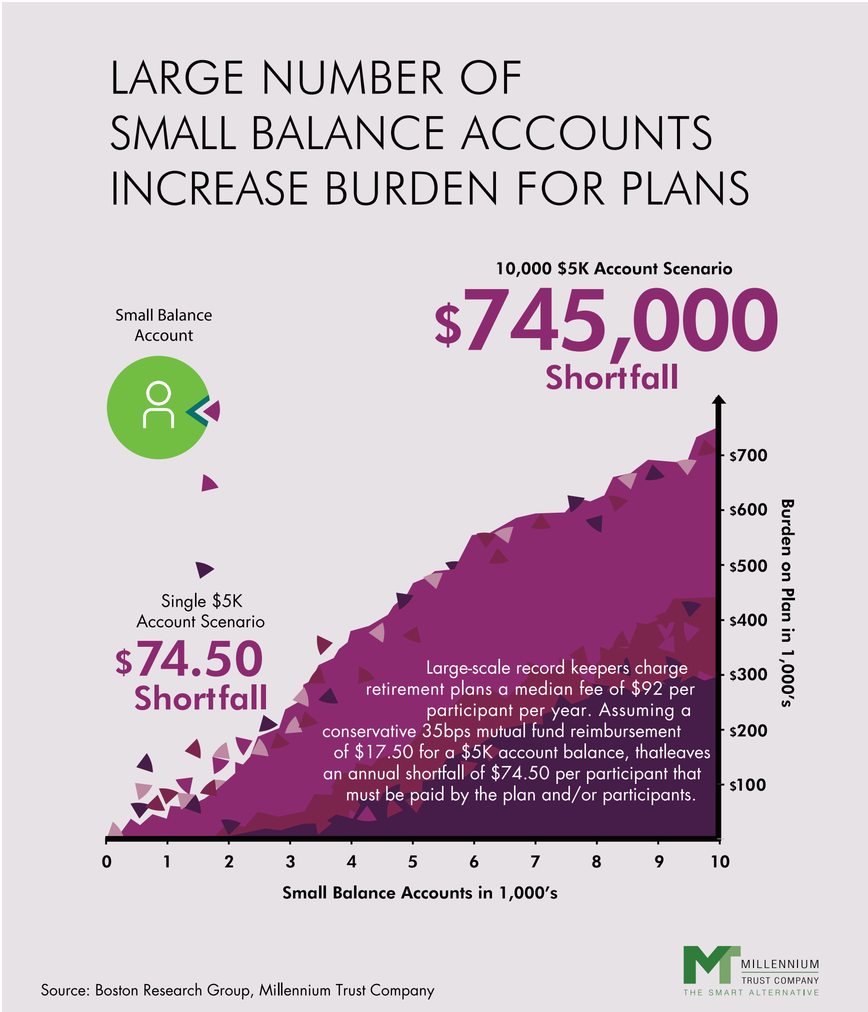
Retirement plans are typically required by law to keep accounts for participants who have left the company unless the account is less than $5,000. The Boston Research Group found that it costs plans a whopping $43.5 billion to maintain these accounts over a 10-year period.[5]

Small accounts exacerbate this problem. Younger employees who change jobs frequently don't stay at a company long enough to build significant assets in their 401(k) plans. And, many aren't fully aware of their rollover options.

Plan administrators may not realize the cumulative cost of maintaining these small balance accounts. Large-scale recordkeepers charge a median fee of $92 per participant per year[6] for recordkeeping, investment, and other administrative costs. Mutual fund reimbursements typically range from 25 to 50 basis points (bps) annually. If we assume a reimbursement of 35 bps on an account with a $5,000 balance, the average annual reimbursement would be $17.50 ($5,000 times 0.0035). That leaves the plan sponsor with a shortfall of $74.50 per account per year[7], which is substantial.

Some plan sponsors pass the expense onto participants, which can erode investment performance, while others generously absorb or share the costs with the participants.

Therefore, plan sponsors may prefer that former employees move their money out of the plan to avoid fiduciary and legal responsibilities, as well as the continuing costs associated with maintaining the account. While having more assets in a 401(k) plan may give a plan sponsor increased bargaining power, there are real costs associated with maintaining the accounts.



An effective way to deal with small balance accounts is to devise a process that will help both parties — one that allows the employer to get these accounts off the books while helping the former employees reunite with their retirement money.

Let's take a look at the various options available to plan participants when they leave their job.

Options for Departing Employees

When employees who are vested in an employer's 401(k) plan leave their job, they have four choices for dealing with their retirement assets:

- Cash out the account and pay required taxes and potential penalties
- Leave the assets in their former employer's 401(k) plan
- Transfer the assets to the new employer's 401(k) plan, if allowed
- Roll over the assets into an IRA

Cashing out an account is rarely the optimal choice for an employee. When an employee takes a check instead of retaining retirement assets in some type of retirement plan, he or she faces a significant shortfall due to taxes and penalties. The individual also loses momentum toward retirement readiness achieved through the creation of, and contribution to, a retirement savings account. While this option helps clear terminated employees from a plan sponsor's books, it is neither good for the individual, the financial services industry, nor our country — which is at risk of a retirement crisis.

Leaving money in the former employer's 401(k) is an option, but it can be a headache for all. Employees who switch jobs frequently can lose track of what money is where. They will continue to share in plan costs (usually not well understood by participants), but cannot make contributions or take loans. And, if the former employee has less than $5,000 in the plan, the previous employer is not required to keep the account in-force.

Transferring assets from the former employer's plan to the new employer's plan is a lesser-known, but viable, option. Employees who want to retain assets in a 401(k) structure can see if their new employer will allow a "roll-in." By transferring assets from one 401(k) plan to another, the participant continues to build tax-deferred savings in support of retirement goals and benefits from consolidating accounts.

While 401(k) plans are not required to accept "roll-ins," most have the capability to do so. Consolidation of retirement accounts makes it easier for participants to track statements and manage their retirement assets. Chances are better their portfolio will be properly allocated if all retirement assets are in one account. Participants will also avoid sharing plan costs for numerous plans.

As mentioned, consolidation of one's retirement assets is usually a good thing. Costs are usually modest — often less than IRAs — for participants given certain classes of shares/investments that are used. Yet in some 401(k) and 403(b) situations, the costs are not as transparent as they may be in IRAs. A big advantage to the former employee is the continued professional investment management that is typically provided in a 401(k) plan.

Typically, the former employee provides the proper paperwork from the new plan so the initiating employer can make the proper roll-in to the current employer plan. Currently this process is paper-driven but will likely become easier with use of more technology in the future.

Rolling over the 401(k) funds into an IRA may be a good solution for employees who leave a company's retirement plan.

IRAs offer nearly unlimited investment choices to account holders when compared with a typical 401(k) fund's limited investment selections. Fees can be lower or higher, depending on the investments. And importantly, IRAs are portable. It doesn't matter if an employee switches jobs or employers; the IRA remains intact as an independent retirement account. IRAs have flexibility and give participants more control than 401(k) plans.

For the employer, rolling over participants' balances to an IRA is a fairly common process. Plan sponsors typically send a check to the former employee with instructions to roll the funds over within 60 days, which is simple, or employers request the proper paperwork from the IRA provider to send the funds directly. Most plan sponsors utilize TPAs and recordkeepers to process the rollovers.

Options for Employers

Maintaining communications with a participant who is no longer at the company can be problematic. The former employee might have moved or changed contact information. Getting these accounts off the books should be a priority for companies with changing workforces. Plan sponsors may want to consider the advantages of automatic rollovers for employees with accounts of $5,000 or less that leave both the company and their 401(k) plans behind.

Eliminating Small Accounts Can Make a Big Difference to a Plan and Its Participants

One of the most overlooked strategies available to plan sponsors is the ability to eliminate small accounts from their books, even without receiving further instructions to do so from the participant. As shown above, small accounts (more than large accounts) pose a significant cost to a plan's resources. Moving small accounts out of a plan can significantly increase the plan's economic efficiencies.

The Economic Growth and Tax Relief Reconciliation Act of 2001 amended the Internal Revenue Code to allow plans to establish IRAs for former plan employees with balances under a certain threshold. This allows plan sponsors to effectively distribute participant account funds to the participants or to a qualified IRA provider as an automatic rollover.

In 2004, the DOL officially provided plan sponsors with a safe harbor for automatically rolling over distributions to IRAs. There are a few rules and criteria the plan sponsor must meet. As long as the plan sponsor complies with the rules, the plan sponsor will have satisfied its fiduciary duties under ERISA.

Small account balances that linger in a retirement plan are likely due to missing or non-responsive participants. With the blessing of the IRS, plan sponsors have the authority to off-load small, unclaimed accounts from their books.

How Plans Can Implement Automatic Rollovers

Plans can benefit when departing employees move their assets out of the company's 401(k) plan whether the employee cashes out the account or rolls it into a new 401(k) plan or an IRA. What causes problems for plan sponsors is when departing employees do nothing with their 401(k) assets.

Plan sponsors can facilitate rollovers by working with qualified IRA providers. The better IRA providers search for missing participants. If the participants are located, the participants will then have the options discussed above, including rolling the funds into their current 401(k) plan. It's a win-win for all when the participant is found and given a choice.

A handful of IRA providers are able to offer all these services in connection with automatic rollovers and upon the participant's direction can roll over funds to the participant's new employer's plan. Providing these services effectively requires the right technology and infrastructure. Faced with an increasingly mobile workforce, plan sponsors can protect the interests of their plans and former employees by engaging with an IRA provider who can work with individuals to implement the best type of retirement option for them.

In a future article, we will attempt to explain general pricing structures and considerations for securing these different services. Ultimately, all plan service providers are in this together. We know that creating the right solution for the plan sponsor and the participant is what is most important.

Terry Dunne is Managing Director of Automatic Rollovers at Millennium Trust Company, an industry-leading independent custodian serving financial advisors, institutions, and individual investors.

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[1] PSCA. "Plan Sponsor Council of America: Serving retirement plan sponsors for over 60 years." N.p., 17 Oct. 2013. <http://www.psca.org/401-k-plans-are-working>

[2] www.bls.gov/news.release/tenure.toc.htm, August 2014

[3] https://www.dol.gov/ebsa/pdf/historicaltables.pdf , p 5, Accessed June 14, 2016

[4] https://www.talx.com/benchmarks/turnover/, Accessed June 14, 2016

[5] "Eliminating Friction and Leaks in America's Defined Contribution System", Warren J. Cormier, April 2013, p. 18

[6] Ibid

[7] Millennium Trust Company, "How Big is the Problem: The High Cost of Accounts Left Behind", June 2016, p. 3