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IN THIS ISSUE...

NEWS AND INFORMATION

Sibson's Compensation Planning Analysis for 2015: Salary Increase Budgets Are Flat

Nostaja Named National Human Capital Practice Leader

Segal Names National Medical Director

Segal Adds East Region Compliance Leader

Upcoming Presentations

Articles by Sibson Experts

Sibson in the News

Other Publications of Interest

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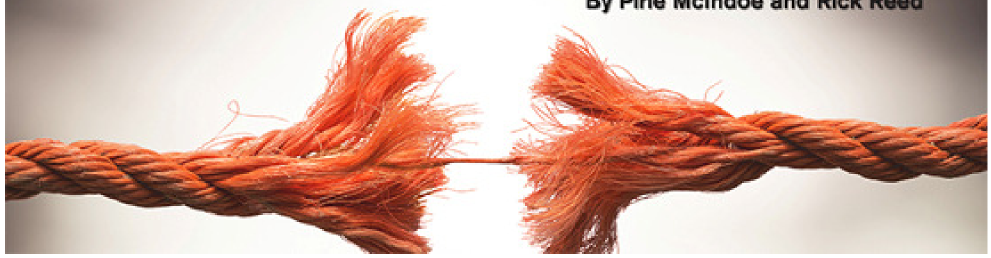
Mitigating Risk in DC Retirement Plans: The Time to Act Is Now

By Pirie McIndoe and Rick Reed



One of the reasons many organizations have adopted defined contribution (DC) plans in recent years is the widespread belief that because the investment risk is shifted to the plan's participants, the employers are largely off the hook. Nothing could be further from the truth. Plan sponsors are still subject to many other risks, including vendor-management risk, financial risk, administration and compliance risk, plan design risk and reputational risk. Moreover, several of these five risks are interrelated, and a failure in one area can lead to trouble in others.

This article examines these risks and how they can negatively affect an organization's DC plan and the retirement readiness of its employees. It further explores the steps organizations can take to remedy or mitigate these risks.

Have You Reviewed the Services Provided by Your Vendors Recently?

DC plans use many vendors, including recordkeepers, investment managers, banks and legal counsel. Each of these vendors provides an important service for the proper administration of a DC plan. Plan sponsors need to thoroughly vet new vendors and develop a process to monitor all vendors on an ongoing basis.

One important process is to conduct a rigorous administrative audit of the recordkeeper every three years. This should include a careful review of the vendors' annual SSAE 16[1] reports, trustee and custodial reports, ratings agency reports and actual plan administration compared to the requirements contained in the plan document.

For example, a large professional services firm recently hired a new CFO. Shortly after starting in her new position, she reviewed a hardship distribution report provided by the DC plan recordkeeper. The report showed that several employees who had taken hardship distributions had not suspended their voluntary contributions for six months following the distribution. Since it was not in compliance with current regulations, the plan had to file under the Internal Revenue Service (IRS) self-correction procedure. The company had assumed that the recordkeeper was monitoring this as part of their administrative process. As a best practice, the CFO now reviews all procedures on an annual basis.

Are You Aware of Financial Risks Under Your DC Plan?

Improper administration of a DC plan can drive up costs. Higher costs from inadequate retirement readiness and/or IRS or Department of Labor (DOL) penalties represent preventable financial burdens. Moreover, as recent litigation has demonstrated, retirement plan fees that are too high, are collected inequitably or are not transparent enough can result in significant legal fees and settlement costs.

When a large southeastern hospital ran a benchmarking study to evaluate the reasonableness of the current cost structure of its retirement plan, the retirement committee learned that lower-cost share classes were available for some of its investment options and mapped participant balances accordingly. This resulted in significantly lower plan fees without adversely affecting participant choice. Organizations should perform this due diligence annually to ensure fees remain reasonable for all plans.

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To reduce the risk of having to pay to correct a plan deficiency, plan sponsors should take the following four steps:

1. Set up a custom charter[2] to guide the retirement committee in the administration and oversight of the plan and ensure ongoing compliance and improved fiduciary governance,
2. Review all fees and benchmark them on an ongoing basis to ensure the plan and its participants are paying reasonable fees for the services provided,
3. Recognize that plan fees should be allocated equitably among the participants, and
4. Document policies and procedures to ensure accurate ongoing administration of the plan.

What Pitfalls Exist in the Administration and Compliance of Your DC Plan?

Plan sponsors work to ensure that their plans comply with all applicable regulations but, unfortunately, problems still arise. Plan administration and compliance is complex and even small things can turn into large issues that are expensive to correct. Even though plans must undergo annual audits, government agencies still find a surprising number of errors.

Moreover, plan sponsors do not always follow all the provisions of their plan document and investment policy statement (IPS). Many plans become noncompliant when they make impermissible loans or hardship distributions, exclude eligible employees, fail to replace investment options in accordance with the IPS or use the incorrect definition of compensation.

A close look at the plan’s administration and compliance processes will uncover issues that need to be addressed, resulting in the development of a comprehensive set of administrative and fiduciary procedures. Keeping committee meeting minutes to document the decision-making process and having a custom charter are both best practices to follow.

A large technology firm’s vice president for human resources was surprised to discover the company’s plan had several violations for delayed loan repayments and allowing multiple loans even though the plan had been amended to allow only one outstanding loan at a time. The correction process took more than half a year to complete and cost more than $60,000 including legal fees. Unfortunately, these errors were not discovered during the plan’s routine annual audit.

Process is paramount in plan administration. Initiating the start of payments on time in accordance with the recordkeeper’s loan amortization schedule would have avoided the delayed loan repayments. The recordkeeper had allowed multiple loans because they had never received a copy of the signed amendment from the plan sponsor that limited loans — a simple, but costly mistake.

Is Your Plan Designed for Success?

Although plan-design risk is often viewed as, say, failing a nondiscrimination test, a major risk is not determining what makes a DC plan successful. Unfortunately, most organizations have not established specific metrics to monitor the performance of their plan design, even though many organizations spend up to 8 percent of compensation on their retirement plans.

If an organization’s DC plan fails to perform according to its design, employees may not have sufficient retirement assets and, as a result, may delay retirement. In addition to having a direct negative impact on employees, this can hurt the organization when indirect ancillary costs — such as retention, recruitment and health care — rise. It also makes it difficult for the organization to hire and develop talent.

A large privately held company in the Northeast recently paid substantial retirement incentives to encourage three managers and directors — who had continued to work well beyond normal retirement age — to retire. Two had gotten a late start in saving for retirement. Another had all his money in the plan’s money market account, where he earned less than 2 percent for much of the past 10 years. As a result, each participant’s retirement income had been slashed by more than 20 percent, which made it difficult, if not impossible, for them to retire.

What could the company have done to avoid this problem? Reviewing the retirement readiness of these employees earlier in their careers, when there was still enough time to make changes, could have led to a more positive outcome. Other steps, including implementing auto-enrollment and auto-escalation features, would have also had a positive impact on employees’ retirement readiness.

Organizations should review their DC plans thoroughly each year to ensure they are helping the employees and the employer reach their goals. Very few organizations use defined measures to determine if their plans are effective. Moreover, many commonly used measurements such as overall plan participation, contribution rates and investment diversification are not sufficient to evaluate a plan.

Organizations need to closely examine their plans’ individual participant data to identify any employees that are under-contributing or are poorly diversified. The organization can then work with its recordkeeper or consultant to provide these employees with targeted communications on how to improve their retirement outcome.

How Valuable Is Your Organization’s Reputation?

The short answer to the above question is “very valuable.” All the risks discussed here can lead to reputational risk, which results from negative publicity when a plan is cited by the IRS or DOL or is sued by its participants for breach of fiduciary duties. Reputational risk may be caused internally (an error or lack of oversight of the plan) or externally (a vendor problem) and the resulting spotlight may linger for a long time. Polishing a reputation after a problem has occurred takes time, effort and resources that are better deployed elsewhere.

For instance, a regional manufacturing company recently discovered it had not included overtime pay when calculating the employer contributions for a group of participants. When implementing an upgrade to their payroll system, an analyst incorrectly coded the definition of compensation as base pay only. Even though the mistake was easily avoidable, several payrolls were run before the error was caught and corrected. Of course, the plan sponsor had to make the affected participants whole and prove to the employees that the recalculated contributions were correct. The company not only had to bear the added costs of this process, it had lost the trust of its employees.

Conclusion

A retirement committee charter and an IPS can help guide the retirement and/or investment committee in fulfilling its responsibilities. Documentation of policies and procedures can help maintain procedural continuity and reduce the risk of error due to staff turnover. These steps will improve compliance and fiduciary governance and reduce the risk of penalties, fines and other expenses.

Overall however, the best way to avoid the risks described in this article is due diligence. It is important to periodically review the organization’s DC plan to verify that it is monitoring its vendors closely, avoiding unnecessary expenses, achieving its goals, following specific processes in the administration of the plan and operating in compliance with all relevant regulations.

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[1] SSAE 16 (the Statement on Standards for Attestation Engagements no. 16), Reporting on Controls at a Service Organization, is the "attest" standard issued by the Auditing Standards Board of the American Institute of Certified Public Accountants.
Back to article.

[2] See “Why Every Retirement Committee Needs a Custom Charter” in the March 2014 issue of *Perspectives*.
Back to article.