Arnerich Massena
Securing the Future Together

Retirement Plan Best Practices:

Plan Design

Second of five-part series

Arnerich Massena, Inc.

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Contributors:
Ryan Cunningham, CAIA; Corrie Oliva, CFA; Jillian Perkins;
Terri Schwartz; Chris Van Dyke, CFA, CAIA

This paper is the second in Arnerich Massena's five-part series on retirement plan best practices. The full series, which we will publish throughout 2016 and 2017, will cover retirement plan best practices in the following areas:

- Plan Governance
- Plan Design
- Menu Construction
- Plan Monitoring
- Participant Education

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PLAN DESIGN

As a plan sponsor, you are faced with numerous decisions about how to structure your retirement plan. How do you design a plan that meets your fiduciary obligations and provides your participants with the best possible opportunities for a secure retirement? In this paper, our goal is to help sponsors navigate through plan design decisions to help create a plan that will best serve their organization and their participants. Following are some of the questions we'll address:

- How should you structure eligibility requirements?
- Should you use automatic features?
- How can you make the most of an employer match?
- What rules should you implement about loans and withdrawals?
- Should you offer a Roth option?
- How do you keep fees fair for all participants?
- Should you use a bundled provider or use an open architecture structure?
- What are the advantages to moving to a discretionary 3(38) structure?

How you structure your plan can have tremendous impacts on participant outcomes. We'll examine the factors that you should consider as a fiduciary when making decisions about plan design, look at how other plans handle different options, and identify some best practices. The goal of this paper is to help you make the decisions that will lead your participants to retirement readiness.

PLAN STATISTICS (FROM PSCA'S 59TH ANNUAL SURVEY REFLECTING 2015 PLAN EXPERIENCE)

% of plans that use automatic enrollment	57.5%
Most common default contribution rate	3%
Most common QDIA	target-date funds
% of plans that use automatic deferral increases	13.3%
Most common auto-escalation formula	1% per year up to 10%
% of plans that offer a matching contribution	49.4%
Most common match formula	$0.50 per dollar on the first 6% of salary
% of plans that allow loans	82.8%
% of plans that allow hardship withdrawals	83.8%
% of plans that include a Roth contribution feature	54.8%

PLAN ENROLLMENT & ELIGIBILITY

When participants first enroll in your plan, what will they encounter? Studies show this can have an enormous impact on eventual participant outcomes. Is enrollment automatic, where participants must opt out, or do participants need to take action to opt in? What is the default contribution rate, if there is one,

and the default investment option? All of these factors work together to affect participation, savings rates, and plan costs.

The Profit Sharing/401(k) Council of America's (PSCA) 59th Annual Survey reported that almost 60 percent of retirement plans now use automatic enrollment. And while studies repeatedly show that automatic enrollment definitely increases plan participation, sometimes quite significantly, it can have some unintended effects when it comes to contribution rates. How well it works depends on a number of other factors, so sponsors should not evaluate auto enrollment alone without looking at the bigger picture.

Automatic enrollment can be a great tool for increasing participation, depending on your participants and the structure of your plan. However, studies have shown that in plans with automatic enrollment and a low default contribution rate, participants tend to save less — even those participants who might otherwise have saved more. A default contribution rate of 3%, for example, could result in a majority of participants saving 3%. The default rate can serve as an implicit recommendation, and it plays into participant inertia. However, this effect can be countered in a variety of ways: choosing a higher default rate, including an employer match, and implementing automatic deferral increases.

What is automatic enrollment?

Normal plan enrollment requires participants to opt in by completing a form, whether printed or online, that certifies that they want to participate and notes what contribution rate and investment options they select. With automatic enrollment, unless an employee explicitly opts out of participating in the plan, they are automatically enrolled once they are eligible. If they don't make an active selection of a contribution rate and investment options, they are assigned a default contribution rate and assets are directed to a qualified default investment option.

Automatic enrollment is designed to overcome participant inertia, which otherwise can prevent employees from starting to save for retirement.

Implementing a higher default rate has its own pitfalls, largely the possibility that more participants will opt out when faced with a higher contribution rate. And even with a slightly higher default rate, it can continue to dampen overall participant savings rates. Other options for incentivizing greater participant savings are employing a match or implementing automatic deferral increases.

"Recently, the Center for Retirement Research at Boston College concluded that although auto enrollment policies may boost the retirement savings of workers that would have never contributed at all, they could hinder the savings of those who would have been conscientious contributors due to low employer match rates and low default contribution rates."

~ Stanley, 2013

While most plans only automatically enroll new hires, some employers who implement auto enrollment are choosing to include everyone in a single re-enrollment sweep. In this process, all existing employees are temporarily unenrolled, and then everyone is automatically re-enrolled, either using active enrollment elections or the default elections if nothing is chosen. This action tends to capture many existing employees who weren't previously participating due to inertia. It may boost savings rates of low-saving participants if the default rate is higher. Reenrollment can also make use of inertia to place employee assets into a default investment option, such as a target-date fund, which may be more suitable for them than their current investment election.

What about eligibility? When participants are eligible to join the

> "In one firm with a default contribution rate of 3 percent of salary, more than one quarter of workers contributed exactly that amount to the plan, despite the existence of a dollar-for-dollar employer match on contributions up to 6 percent of salary. Once the firm switched to a 6 percent default, virtually no new hires selected a 3 percent contribution rate."
>
> ~ National Bureau of Economic Research, 2006

retirement plan depends on plan features and fee structure. Consider the costs and benefits to making the plan available sooner rather than later. Sponsoring a retirement plan is a tremendous benefit, and you'll want to make the most of it. Rather than withhold eligibility, consider using a vesting schedule for employer contributions to reduce costs.

If you implement automatic enrollment, you will need a Qualified Default Investment Alternative (QDIA) for those participants who do not make an active investment election. Investment options that are qualified to serve as a default option are diversified options, such as balanced funds, risk-based/lifestyle funds, or target-date funds. Regardless of whether you incorporate automatic enrollment, having a diversified option can benefit your participants. We'll cover this further in the next paper in this series, investment menu construction.

> "...the overall trend is to scale back or reduce any barriers to retirement plan entry for employees... plans offering immediate eligibility have increased from 45 percent of defined contribution plans in 2001 to 76 percent in 2013."
>
> ~ Sammer, 2014

Ultimately, your choices about plan enrollment and eligibility will depend on your organization, your plan, and your participants. Consider your employee population and how to best serve them as you make these plan design decisions.

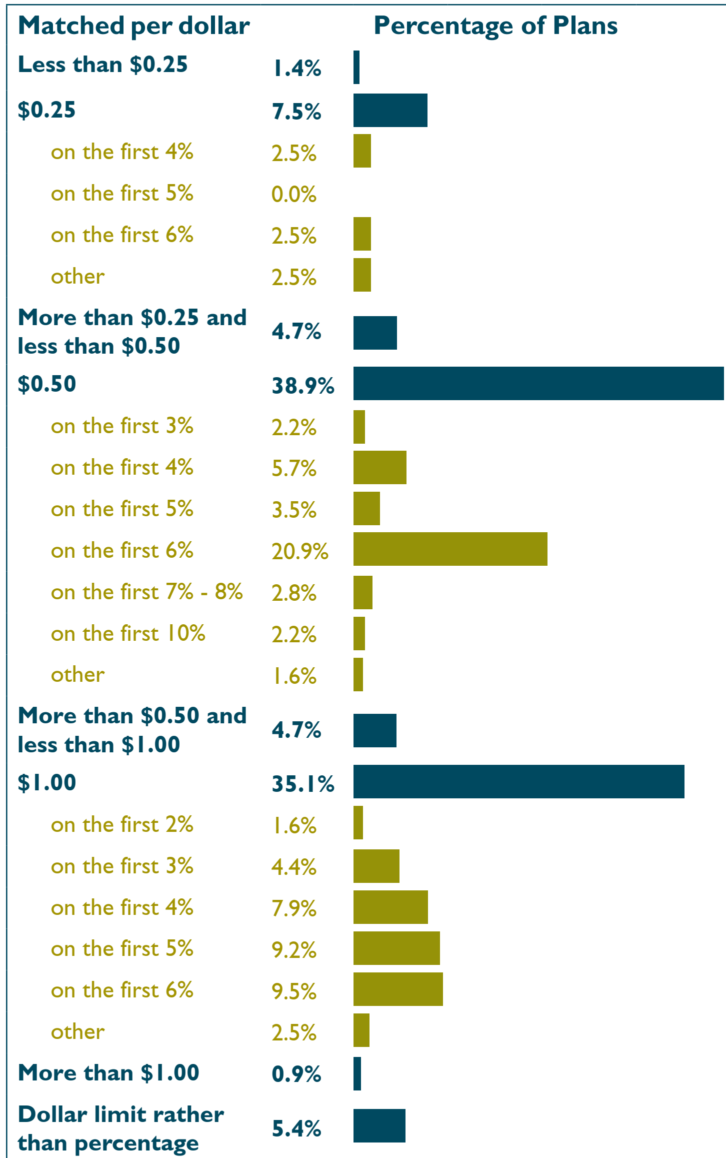
Making the most of your match

Making matching contributions may have less of an impact on the bottom line than you think, as contributions are tax-deductible. The benefits are meaningful; an employer match is a significant benefit that can help attract candidates to your organization and retain existing employees. It can also be an important part of an employee's overall retirement savings strategy, helping them to reach their retirement goals. Instituting a match program may also be important to the plan's nondiscrimination testing, increasing participation enough among non-highly compensated employees to allow highly compensated employees to contribute more to the plan.

According to the "Trends in 401(k) Plans and Retirement Rewards" report, 92 percent of employers make some type of employer contributions, many of them through a matching program. About 72 percent of plans with a match offer a fixed match, with the other 28 percent offering a graded match. (PSCA, 2016) Most plans have immediate full vesting for employer contributions, and vesting schedules for the others varies from two to six years.

There are a wide variety of formulas used for the employer match, and for good reason. How the match is structured can significantly affect whether employees participate in the plan, how much employees save on

Table 1: Matching formulas used in plans



Matched per dollar	Percentage of Plans
Less than $0.25	**1.4%**
$0.25	**7.5%**
on the first 4%	2.5%
on the first 5%	0.0%
on the first 6%	2.5%
other	2.5%
More than $0.25 and less than $0.50	**4.7%**
$0.50	**38.9%**
on the first 3%	2.2%
on the first 4%	5.7%
on the first 5%	3.5%
on the first 6%	20.9%
on the first 7% - 8%	2.8%
on the first 10%	2.2%
other	1.6%
More than $0.50 and less than $1.00	**4.7%**
$1.00	**35.1%**
on the first 2%	1.6%
on the first 3%	4.4%
on the first 4%	7.9%
on the first 5%	9.2%
on the first 6%	9.5%
other	2.5%
More than $1.00	**0.9%**
Dollar limit rather than percentage	**5.4%**

Source: PSCA 59th Annual Survey Reflecting 2015 Plan Experience

their own, how much people are able to accumulate in all, and eventual retirement outcomes.

As with setting an automatic deferral rate, setting the match formula impacts employees' saving behavior. A match will often incentivize a large proportion of employees to save enough to capture the match, but can also serve as a disincentive to increase savings beyond the level of the match. For this reason, many employers choose a match formula to encourage greater savings on the employee's part. For instance, matching $0.50 per dollar up to 6% will incentivize higher employee saving than matching $1.00 per dollar up to 3%, even though the net total of the match is the same.

It is possible to further stretch out the incentive properties of a match by using a variable-rate formula instead of a fixed-rate formula. For example, a plan might offer to match $0.50 per dollar up to 5% of salary, and then $0.25 per dollar up to 8%. This has the added benefit of providing a higher "implicit recommendation" via the match amount. There is a strong message that employees should save at least 8% of their salary themselves. Variable-rate matches are not common in the industry, but we expect to see this strategy become more frequently employed.

Sustainability of a match program is a key consideration. Any future changes to the match will be highly visible and likely to cause a significant reaction, so it's important to carefully model the match relative to your growth and revenue projections and make sure that you select a formula that will be sustainable over the long term. If a match is not feasible, consider making discretionary contributions; this may not incentivize saving the way a match does, but it can help participants get closer to their retirement goals.

Some companies elect to provide their employer match in the form of company stock. There is a risk to this

"The [match threshold] 'serves as a natural reference point when individuals are deciding how much to save, and may be viewed as advice from the savings program sponsor on how much to save,' according to Brigitte C. Madrian, the Aetna Professor of Public Policy and Corporate Management at the Harvard Kennedy School of Government."

~ Miller, 2012

that employees' portfolios will become overly concentrated in a single stock. As a fiduciary, this can be a significant liability, and employers who consider providing a match in company stock should carefully consider the risks. We'll discuss company stock further in our next paper in this series covering the investment menu construction.

Automatic deferral increases

Like automatic enrollment, a program of automatic deferral increases, also called automatic escalation, is intended to use participant inertia on their behalf. About 24 percent of plans that have automatic enrollment also have a program of automatic deferral increases for all participants, and just over 13 percent of plans that do not use automatic enrollment implement automatic deferrral increases. (PSCA, 2016)

In a program of automatic contribution increases, unless they opt out, participants' contribution amounts are increased at various intervals. Most commonly, automatic escalation programs implement jumps of 1 or 2% of pay annually up to a cap, which may be as much as 12 or 15%. Some automatic escalation programs are tied to employee pay raises, increasing as their salary rises. When they first gained popularity, these programs capped out after just a few years of increases, but more and more, employers are recognizing that higher caps can help people reach higher savings rates. Two years ago, only 9 percent of plans had a cap of more than 10%; now, that number has increased to 14 percent of plans, and 44 percent of plans increase deferrals up to 10% of salary, up from 32 percent of plans in 2013. (PSCA) To reach retirement goals, most people should be saving as much as 12 to 15% of their income for retirement.

Research into automatic deferral increases has shown that for automatically enrolled participants, automatic deferral increases can make a big difference. For example, "automatically enrolled participants who also have deferrals automatically increased have an average contribution rate of 4.4%, compared to 3.5% who don't have deferrals automatically increased." (Moore, 2011) A Schwab study showed that 83 percent of participants remained at the increased contribution rate a year later, demonstrating some sticking power.

However, it may have the opposite effect on self-enrolled participants. "Mercer found the opposite to be true for self-enrolled participants. Those who had deferrals automatically increased had an average contribution rate of 7.4%, while those who did not use automatic escalation had an average deferral rate of 8.5%." (Moore, 2011) The key takeaway here is that the choice of whether or not to use automatic deferral increases should depend largely on your participant population. A highly engaged or more sophisticated group may not be served by automatic escalation, whereas for a population more prone to inertia, it can enhance their retirement savings.

"An analysis from Mercer finds participants who were automatically enrolled in their plan and participate in an automatic contribution increase program have a 25% higher contribution rate than those who do not use automatic deferral increases."

~ Moore, 2011

Loans and withdrawals

401(k) and similar retirement plans all have some regulated restrictions on withdrawal of retirement assets. The plans are designed to help people put money away for later in life. However, there is quite a bit of flexibility in how your plan administers the processing of loans and withdrawals and how available they are to participants. There are somewhat competing objectives when it comes to loans and withdrawals that need to be balanced: on the one hand, you want participants to be able to access their funds in an emergency, and having that access may increase participation, but on the other hand, you want to encourage long-term saving. How do you do find the right balance?

Most employers want to discourage loans as much as possible, while still providing some loan provisions that give participants a way to access assets if needed. More than 80 percent of plans offer loans (with about 40 percent of those permitting multiple loans), and almost 84 percent of plans make provisions for hardship withdrawals. (PSCA, 2016)

If you choose to permit loans, there are a variety of considerations you will have to make along with your recordkeeper/service provider, including how many loans to permit, whether there is a minimum, how to calculate the interest rate, and the fees associated with loans. For hardship withdrawals, you will need to consider which reasons will justify a hardship withdrawal.

Participant education and communication is essential if you allow loans and hardship withdrawals. Helping participants understand the benefits of leaving their money in the plan versus taking a loan or early withdrawal can help to minimize incidences and keep participants on track with their retirement savings.

Roth contributions

Traditional 401(k) plans help participants save more by accepting pre-tax contributions that reduce their current taxable income. Participants will have to pay regular income tax when they withdraw their assets in retirement, but for many people, the expectation is that they will be in a lower tax bracket in retirement, reducing the tax bite. A Roth option offers a different type of tax advantage; Roth contributions are made after-tax, but qualified withdrawals from a Roth account are tax-free, which also means all account earnings are completely free of taxes. This can be a tremendous benefit if a participant is able to save enough and/or expects taxes to be higher in retirement.

Roth contributions are allowed by about 60% of plans. (PSCA, 2016) In those plans, about 20 percent of all participant contributions are Roth contributions. Whether or not to offer a Roth option depends on your participant population. Are they likely to take advantage of Roth contributions? Is the level of financial sophistication great enough that your participants can understand the benefits of Roth contributions? A participant survey may help to gauge interest and understanding. Lastly, there may be additional accounting and expenses associated with including a Roth feature.

If you are considering making Roth contributions available, you will need to decide whether you will allow in-plan Roth conversions, in which participants may convert some or all of their traditional pre-tax assets into a Roth account. Participant education is extremely important; consider how you will communicate to your participants, and how you can help them decide what type of contributions may serve them best.

Fee equality

As fiduciaries, plan sponsors have an essential duty to ensure that fees are fair and reasonable. While most plan sponsors evaluate their plans' investment and service provider fees to make sure they are appropriate, few closely examine the disparity across participants. Some traditional fee structures impose fees unfairly to different participant groups. Because this can have a significant impact on participant outcomes, and can be a source of fiduciary liability, sponsors should look closely to make sure that fees are level and fair among their participants.

How can fees be unfair? Because this can be quite hidden, it takes a bit of digging to uncover. Revenue sharing, a common arrangement, can impose fees differently depending on how participants are invested. For example, consider a plan in which target-date funds are part of the investment line-up, and the expense ratio fees of the target-date funds are shared back to the provider to pay for the plan's administrative costs. Essentially, then, those participants in the target-date funds are paying the full administrative costs of the plan, whereas those participants invested in other options may not be participating in the administrative expenses at all.

We consider fee equalization to be a fiduciary best practice. If you find inequality in your plan's fee structure, there are several options for leveling fees. One way is to eliminate revenue sharing agreements and apply level charges to participant accounts to cover plan-related expenses. Alternatively, some recordkeeping platforms are able to track revenue sharing fees and equalize by crediting and charging accounts proportionately. It may be possible, also, to simply rebate revenue sharing fees, which can then be charged as a separate line item.

A related issue is how to structure plan administrative fees in a fair way, which is a complex question. Some plans charge a per-head fee across all participants, but that can cause quite a disparity. For instance, if all participants pay a $100 annual administrative fee, Participant A with $2,000 is paying 5%, whereas Participant B with $800,000 is only

Table 2: Comparing Fee Structures

Account balance	Flat $100 per-head fee	10 bps fee	$50 per-head fee plus 10 bps on assets up to $75,000
$2,000	$100	$2	$52
$20,000	$100	$20	$70
$200,000	$100	$200	$125
$800,000	$100	$800	$125

paying 0.01%. An alternative is an asset-based fee, but that can become quite burdensome at higher asset levels. One solution is to combine a flat fee up to a certain account size with the addition of an asset-based fee for larger accounts, often with a cap. See Table 2 on the previous page for a comparison of different fee structures.

Bundled vs. unbundled, proprietary vs. open architecture

This choice continues to be one of the most important decisions for a plan sponsor. In a bundled approach, one service provider is used to provide all investment, recordkeeping, administration, and education services, offering a one-stop shopping package which often includes investment consulting services. Bundled plans frequently use the provider's proprietary funds in the investment menu. An unbundled approach frees the plan sponsor to seek out third-party services such as outside investment consulting. Unbundled plans may use proprietary funds or be structured as open architecture, in which the plan can choose from across the universe of available funds for the menu.

What are the advantages to a bundled approach? For smaller or newer plans, the bundled option may make things simpler for the plan sponsor. If the bundled plan uses proprietary funds, providers may offer attractive administrative fees for the advantage of managing all of the plan's assets in its mutual funds. But plan sponsors should be wary: what looks like low-cost or free administrative services may actually be made up in higher investment management fees. This type of arrangement could result in a conflict of interest, being a situation in which the provider is acting as the investment consultant but has a vested interest in recommending their proprietary funds. It's important to ascertain whether the provider is willing to accept fiduciary responsibility as a fiduciary for both the plan sponsor and participants.

An unbundled approach allows the plan sponsor to select providers to fit their specific needs for administration, investment, recordkeeping, and education — a "best of the best" approach. The advantage to this is that the plan can seek out the providers who offer the best fit for the plan. An unbundled plan may also use proprietary funds from the provider or select from a broader universe in an open architecture structure. Having multiple service providers may be an additional expense, but sponsors are also able to negotiate the best price with each individual provider, which can help keep costs down. An unbundled approach is often better for plans that have unique needs and a desire for highly customized elements.

It is possible to build a plan that combines features of both the bundled and unbundled or open architecture approach. Some providers will offer what is essentially bundled services, but with alliances outside of the bundled provider for additional non-proprietary investment options. In this way, the plan sponsor may have greater flexibility to select outside funds that are not offered in the bundled provider's mutual fund family.

Table 3: Bundled versus unbundled Plans

	Bundled plan		**Unbundled plan**	
	Proprietary	Open architecture	Proprietary	Open architecture
Single point of contact	✔	✔		
One-stop shopping	✔	✔		
Broad selection of investment options		✔		✔
Option for custom plan design features			✔	✔
Potential conflicts of interest	✔	✔	✔	

Discretionary 3(38)

As fiduciaries, plan sponsors have a responsibility to make prudent decisions in the best interest of the participants. The management of a retirement plan's investment options requires highly specialized skills and sophisticated knowledge, as well as time, which can be a burden for some plan sponsors. Many retirement plan sponsors select an investment consultant to assist in this process, and some sponsors elect to take it a step further by turning over some degree of control to a consultant in a 3(38) discretionary arrangement. Section 3(38) of the Investment Advisers Act allows a plan sponsor to delegate some of their fiduciary responsbility to a qualified 3(38) fiduciary.

A 3(38) fiduciary must be a bank, an insurance company, or an RIA who explicitly accepts the fiduciary delegation in writing, and is then deemed an investment manager. With this approach, the 3(38) investment manager bears the responsibility for selecting and monitoring the plan's investment options, relieving the plan sponsor of this fiduciary duty and reducing their liability. Of course, the plan sponsor continues to be responsible for choosing and monitoring the consultant, but they are relieved of the burden of managing the plan's investment options.

The advantages of a 3(38) arrangement can be very attractive to some plan sponsors. The tasks of selecting and monitoring investment options are off their plate, so to speak, allowing them to focus on their business. The fiduciary responsibility and liability of investment selection can weigh heavily, and having this avenue of relief is valuable. A discretionary arrangement allows the consultant greater latitude to make adjustments without seeking approval and can thus reduce the time it takes to make changes in the plan, which can be an advantage for participants. The cost may be higher than with a traditional consulting arrangement, and the sponsor does not have the same level of day-to-day control over the plan's investment options, though the sponsor continues to retain ultimate control over decisions.

Conclusion

Designing a defined contribution retirement plan is a complex process with numerous decision points. As a fiduciary, your decisions should be based on the best interests of your plan participants, which means that no two plans will be alike. Your participant population will drive your decision-making, as you consider what will best help them save for a secure retirement. Successful plan design is measured ultimately by participant outcomes.

It can be helpful to know what your peers are doing and how the market is evolving as you build your plan. It is our hope that the information in this paper can serve as a resource to support your choices. Keep in mind that you are not alone; the plan design process should be a partnership between the plan sponsor and their service providers.

Please don't hesitate to contact your Arnerich Massena consultant to discuss plan design questions or to collaborate to find plan design solutions. Arnerich Massena provides a comprehensive consulting solution for retirement plan sponsors including:

- Plan administrative consulting and governance advice
- Investment Policy Statement development
- Plan analysis and design
- Investment menu construction and investment manager selection
- Investment performance monitoring and comprehensive performance reporting
- Target-date fund and risk-based portfolio evaluation
- Vendor negotiation, selection, and monitoring
- Participant education
- Fiduciary education

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Endnotes

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