

CFO

BY LYNN BRENNER

401(k)risis

THE STOCK-MARKET MELTDOWN HAS DEALT A CRUSHING BLOW TO RETIREMENT PLANS. BRACE FOR REPERCUSSIONS.

SOON AFTER SECTION 401(k) OF THE Internal Revenue Code took effect in 1980, it morphed from an obscure investment option into the goose that laid the golden nest egg.

Has that goose been cooked?

The value of the equities held in defined-contribution plans has declined by \$2.8 trillion since the market peaked in 2007. The Hewitt 401(k) Index finds employees moving substantial sums into fixed-income investments. And multiple surveys have found that a majority of employees, from the C-suite to the front lines, are now delaying or reconsidering their retirement plans as a result of the sharp decrease in their personal wealth.

This has already had some short-term effects, notably employees fleeing to safer investments or abandoning 401(k) plans altogether. What it will take to restore their comfort level in equities, and what impact their understandable skittishness will have on their overall retirement strategies, remains to be seen.

But far more profound may be the impacts still to come: lawsuits, new regulations, and the specter of an aging workforce that, like a bad party guest, shows no inclination to leave.

It wasn't supposed to be this way. Almost from the start, 401(k) plans enjoyed a huge marketing push from companies and investment firms, and an enthusiastic

embrace by workers. Positioned initially as the proverbial "third leg" of the retirement-income stool (along with pensions and Social Security), 401(k)s quickly became the dominant leg (see chart, "A Wobbly Stool"), and companies worked hard to encourage participants to invest for growth rather than safety.

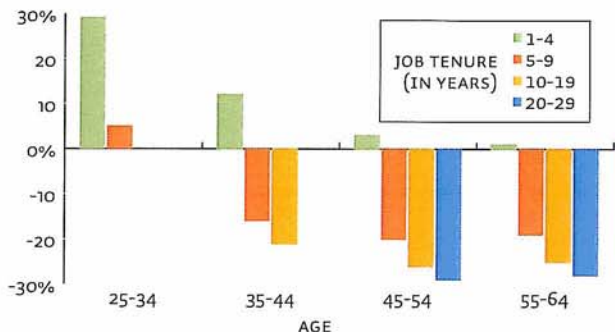
They may rue the day. Many experts in the field say it's nearly certain that the massive investment losses will fuel ERISA-related class-action lawsuits against employers. "If an allegation of a breach of fiduciary duty can be made, it will be made," warns class-action defense attorney Gerald L. Maatman Jr., a partner in Seyfarth, Shaw, a national management-side law firm. Across the board, **anxious sponsors are reviewing and retooling their 401(k) programs to minimize their exposure to litigation**, even as they try to encourage employees to keep saving.

Fear and Anger

COMPANIES FIND THEMSELVES IN A VERY DIFFICULT position. At Call4Health, a medical answering-service company with 60 employees, CFO Nicholas Koutrakos says the company fought a valiant but losing effort to save its plan. "We maintained our match, and we did everything we could to encourage people to stay in the plan," he says. "But our employees are scared. The last thing they want is to put more money into a market that's already down so much." As the economy unraveled, participation

THAT SINKING FEELING

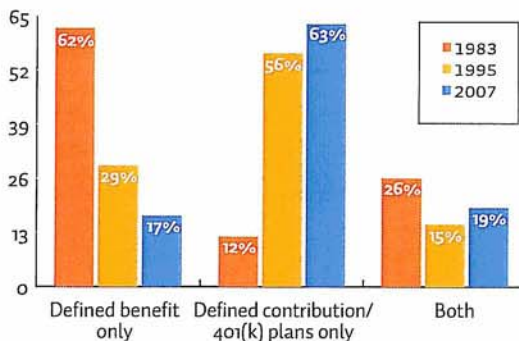
Changes in average 401(k) balance, by age and job tenure



Source: EBRI

A WOBBLY STOOL

Pension plans have largely been replaced by 401(k) plans.



Source: Boston College Center For Retirement Research

dropped from 70 percent to just 30 percent, contribution levels fell drastically, and the plan became too cost-heavy to support. Call4Health terminated the 401(k) plan and now accommodates employees who want to save for retirement by providing direct deposit into individual retirement accounts (IRAs).

"People are afraid," says Karen Martin, who administers Southern Communications Corp.'s SIMPLE Plan. "They aren't looking for a return on their money now; they just don't want to lose any more. Selling seems to make no sense, but neither does riding it out."

Of course, even as companies struggle to address employees' fears and anger, and to maintain a baseline interest in what remains a critical component of a retirement strategy, many are also further dimming the appeal of the plans by reducing or eliminating the company-match component. Kodak, Sears, FedEx, UPS, and many other large companies (12 percent, according to a February survey by Watson Wyatt) have taken that step, and another 12 percent expect to do so in the next year.

Properly managing a 401(k) plan these days entails far more than threading the needle between cost-reduction and participant encouragement, however. First and foremost, companies should take steps to reduce legal exposure. They should also keep a close eye on proposed changes to how the plans operate. And they will, at some point, need to think about the potential impact that all those cracked nest eggs may have on the demographic composition of their workforce.

The 10 biggest settlements for ERISA-related class

actions in the United States topped \$17.7 billion last year, a 10-fold increase over the \$1.8 billion paid out in 2007. Four of the biggest settlements involved allegations of breach of fiduciary duty, says attorney Maatman. He advises CFOs to brace for more such lawsuits this year. Robert Walter, a principal at Buck Consultants, concurs. "As the economy deteriorates, the likelihood of claims by participants goes up," Walter warns. "This is not the time to forget the niceties of 401(k)-plan governance."

Dismal investment returns alone don't expose a sponsor to liability. ERISA doesn't set a market-performance standard, and indeed, none of those large settlements last year were directly linked to the plunging Dow. But lawyers may well see new opportunities, and as fiduciaries plan sponsors

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must offer a range of suitable, reasonably priced investments and disclose their relative risks and costs—or suffer the legal consequences. And that fiduciary liability rests squarely with plan sponsors, no matter who administers the program, warns Robyn Credico, a defined-contribution practice leader for Watson Wyatt.

Therefore, many companies are quickly brushing up on 401(k)-plan governance. Two-thirds of midsize-to-large employers say they now intend to benchmark 401(k) administration and procedures to best practices, Hewitt says, up from 56 percent last year. (For a list of key governance tips, see facing page.)

Even as they address governance, many plan sponsors will need to keep an eye on a raft of proposed changes. Last year just weeks after the September market plunge, the House Education and Labor Committee held hearings

to explore possible modifications. There were several varieties of “universal” accounts proposed, which would cover all workers. Under one plan the federal government would make contributions to such accounts and guarantee a baseline rate of return. A different plan is based around an index fund of both stocks and bonds that would shift toward a more conservative mix as a worker neared retirement.

Indeed, the chorus is growing louder by the day as new groups are formed with the intent of either overhauling the 401(k) system or making substantive enough changes that an outright overhaul is forestalled. Retirement USA, a project backed by the Service Employees International Union, the Economic Policy Institute, the National Committee to Preserve Social Security and Medicare, and the Pension Rights Center, is advocating for “a new visionary system” that would combine elements of a pension plan (such as pooled professional investment and lifetime pay-out) with portability and simplicity.

“I don’t see how 401(k)s can improve enough to be the only retirement vehicle besides Social Security,” says Alicia H. Munnell, director of the Boston College Center for Retirement Research. She favors a new tier of retirement saving that is mandatory, that supplements Social Security, and that is protected against market fluctuations—perhaps with a collar from the government guaranteeing a lifetime average rate of return between 4 and 6 percent (assuming the government can bear more risk than the private sector). Such a new tier might transform current 401(k)s into an ancillary benefit for higher-paid employees.

Others, such as former Treasury Department official Mark Iwry, of the Retirement Security Project, say that changing the ways in which participants can take money out of 401(k) plans is just as important as how the money goes in. He and others have proposed a system in which retirees could “test drive” an annuity as a way to become comfortable with an option that only a small percentage takes advantage of today.

Most likely to be adopted sooner rather than later is an “automatic IRA” designed for small companies, which often have no 401(k) plan at all due to the administrative expense. Under this scheme, employees could have IRA deposits automatically deducted from their pay, and companies would receive a small tax credit for setting up such programs.

Another proposal, called SuperSimple, is modeled after a system that will go into effect in the United Kingdom in 2012. It eliminates much of the legal baggage that accompanies corporate-run 401(k)s, such as compliance tests that measure the breadth of participation across a workforce, and adds a government contribution to accounts. It would give employees the chance to opt out, but would feature automatic enrollment and perhaps an automatic escalation of their contribution (as a percentage of pay) over several years.

There are other ideas on the table as well, and it is

unclear at this point which ones, aside from those aimed at helping small companies offer some kind of modest defined-contribution plan, will gain real traction in the months ahead. Companies would no doubt love to be disentangled from 401(k) plans, but the prospect of a government-run system faces plenty of political roadblocks and lobbying resistance. “The best thing the government can do for retirement security is to revive the economy and lower the cost of health care,” says Walter.

Those steps could help avert a potentially painful side-effect of the current situation: workers who stay on the job longer than they (or their companies) want, due to underfunded retirement accounts. “We’re going to see a lot of demoralized people doing the minimum and staying as long as they can,” predicts Steven Vernon, president of Rest-of-Life Communications, a retirement-planning advisory firm. Companies, he says, “should have a good performance-management system so you can move them out without getting sued for age discrimination.”

Governance Guidance

COMPANIES SHOULDN’T WAIT TO SEE WHICH, IF ANY, laws will be changed, let alone what demographic bubbles may inflate. But they should shore up defenses now, through improved governance practices, because that can forestall legal actions and ensure that current 401(k) plans are being run as optimally as possible. The keys to good plan governance are:

1 Analyze all plan investments thoroughly. Fiduciary duty compels employers to examine underlying investments and identify the risks, even in funds broadly tailored to risk or age categories. “You don’t want to give the impression, even inadvertently, that employees should invest in a fund based on their age or retirement date without considering [all of] their risk preferences,” says Walter.

2 Actively monitor performance. Adhere to written guidelines and stay alert, Credico warns. Vendors should not benchmark their own funds, a common trap. Likewise, follow courses of action that guidelines indicate. Astute plan sponsors should notice how benchmarks sometimes shift when investments aren’t performing well over an extended period of time, says Credico. “But sometimes, they don’t do anything about it.”

Investment menus should reflect a full risk/return spectrum. Imbued with a bull-market outlook, 401(k)s offer comparatively few conservative options. Last year, a money fund or a stable-value bond fund supplied the only refuge from a plummeting stock market, says George Na-

set, retirement-plan services practice leader at 401(k)-plan administrator TRI-AD. "Sponsors discovered that employees who wanted to switch to a more conservative mix didn't like being constrained to a single choice," he says.

3 **Disclose fees.** This is big. Although plans customarily post fees associated with investment choices, they often don't disclose—or always know about—common **revenue-sharing arrangements** between plan providers. In these arrangements, investment managers share their revenue with plan administrators and other service providers. **The arrangements have spawned litigation against more than a dozen plan sponsors.** To date, such charges have not prevailed, but few observers expect the controversy to fade away. "Wall Street firms collect more than \$40.5 billion annually in 401(k) fees, yet brokers and human resources often tell workers the fees on their accounts are zero," Teresa Ghilarducci, an economics professor at The New School for Social Research, told a congressional committee late last year.

4 **Be wary of company stock.** **ERISA litigation knows no fury like workers burned by company stock.** "If a company plans on investing 401(k)-plan assets in its own stock, it had better be aboveboard with full disclosure," says Maatman. Be scrupulous to a fault. If plaintiffs can connect a falling price to fraud, massive settlements loom. The Big Daddy in this unfortunate category is General Motors. It paid \$37.5 million to settle claims that it breached fiduciary duties by not disclosing its true financial condition to employees who invested in GM stock. Also, long before its current problems surfaced, AIG settled a similar case for \$24 million, as did Dynegy for \$18 million.

5 **Talk to employees.** **Suspending a match program is hard for employees to swallow,** but it can be pitched as unavoidable in the current economy. A bigger challenge lies in persuading them

ABOUT THIS BUYER'S GUIDE

The chart of 401(k) plan providers that begins below comprises companies whose names begin with the letters A through L. Part 2 (M–Z) will appear in the May issue. The data presented for each company represents just a fraction of what was collected. You can see the full listings at www.cfo.com/401k.

Note: The Website ratings shown in this year's charts differ from Dalbar Inc.'s standard 401(k) Website evaluations. These ratings are based only on essential plan features and are not the in-depth analysis otherwise performed by Dalbar. The categories, system of scoring, and weighting given to various capabilities also differ. For more information, visit www.cfo.dalbar.com, or contact Dalbar at (617) 723-6400. Special thanks to Dalbar for its help in creating this survey.

to continue saving for retirement. The best inducement, say experts, is an automatic plan—even though it may up the cost of employer matching funds. "Ninety-four percent of the people who are auto-enrolled in a 401(k) plan are still participants one year later," says Cynthia Egan, president of retirement-plan services at T. Rowe Price. Egan says employees who had been automatically enrolled were also less likely than other plan participants to try to make changes in their accounts last September. "In other words, they were less inclined to make investment mistakes."

These days it's much less clear what exactly constitutes a mistake, of course, as short-term considerations threaten to crowd out long-term goals. In the short term, companies may be tempted to put 401(k) considerations on the back burner. But with so much at stake, and so many potential changes in the offing, that would clearly be a mistake. **CFO**

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