Leaving Your 401(k) Past Behind -- Concerns Over Terminated Participants With An Account Balance

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I have noticed a bothersome trend recently with retirement plan clients we are bringing on with a significant number of terminated participants maintaining an account balance. This situation makes the conversion process a little more complicated in dealing with these extraneous participants. It seems like all parties involved – plan sponsor, recordkeeper, and advisor – are aware of the numbers, yet no one sees it as a high priority. As a result, the issue gets pushed off to the side, and the numbers continue to grow each year. This has given me pause as to why this occurs, does it matter, and if so, what can advisors do to help plan sponsors manage this issue?

Of course my most immediate notion is to remind myself any time you have participant inertia combining with plan sponsor apathy, things are likely to get bogged down. This is most evident upfront in the enrollment process. As service providers we spend enormous resources to educate both parties that participation in the plan helps everyone. That same reluctance for some to enroll initially just might be an equal but opposite force for employees that move on and leave their vested balance intact. Much like the eligible employee not contributing, terminated participants are aware the money is there, but cannot seem to find a compelling reason to take action and roll their balance into a new employer's 401(k) or IRA. Plan sponsors, on the other hand, are more focused on managing employee benefits for current employees, and aside from the occasional awkward contact from a terminated participant, see it as no big deal to allow these inactive account balances to continue to drift along. I believe changes in the regulatory and disclosure rules, along with new ways recordkeepers are pricing their services, should cause plan sponsors to rethink their position and adopt a more aggressive posture in dealing with this issue.

The Dilemma: Costs and Risks

The most obvious reason to minimize the number of terminated participants with a balance has to do with cost. The new 404(a)(5) disclosure delivery requirement, added to an already long list of other mandatory disclosure documents, is a direct expense for all participants that must be paid for by the plan sponsor or plan trust. There is also the time and opportunity cost of tracking former employees, keeping in mind these folks are typically not as proactive as current employees with updating address changes. Then there is the cost of preparing the IRS form 8955-SSA each year, which requires an updated list of the terminated participants to be filed with the Social Security Administration. Lastly, these terminated participants are included in the total count for the purpose of determining whether a plan meets the plan audit exemption. This detail is especially significant to a plan that has never been above the threshold of 120 participants and unaware of the added cost of the independent audit, should they go over.

There is also a risk associated with maintaining a number of terminated balances. Failure to provide any of the mandatory disclosure documents is a breach of their fiduciary duty. An expanding list of terminated participants is undoubtedly increasing the chance that something or someone gets overlooked. You might try asking any one of your plan clients if they sent a copy of the last notice about a fund change to all terminated participants, and pay attention for that look of “I have no idea” projected from their face.

Some have argued in the past that encouraging terminated participants to roll out of the plan reduces the total level of plan assets, and potentially increases the plan costs. This might have been true in the days of asset-based pricing with breakpoints, but in today’s environment most recordkeepers have established a more flat cost structure based on the number of participant balances, or possibly on average account balance per participant. Neither of these pricing methods will be helped by stagnant participant accounts with low balances.

So What Can Advisors Do?

As is the case with most issues that fall between the plan sponsor, participant, and recordkeeper, advisors are in a perfect position to take the lead in developing a process to address this issue. Advisors who can educate plan sponsors on the inherent costs and risks associated with maintaining terminated participant accounts will clearly demonstrate their expertise in understanding the real nuances to this business. Furthermore, once you have a plan sponsor “buy in” to try to reduce this number, you will create a brand new metric that can measured each year and reinforce your value as a service provider.

I would like to suggest a four step outline to building such a process:

- Step 1: Review with your TPA or bundled provider the rules in the plan document that pertain to participant force-outs. Plan sponsors are allowed to process distributions directly to terminated participants with a vested balance of under $1,000, and process IRA rollovers directly to a custodian when participants have a vested balance between $1,000-$5,000. Do not assume the plan currently allows for both of these options, as some providers do not have a direct IRA rollover solution in place and consequently have left that language out of the document. There is no good reason to exclude both force-out provisions in the plan, so coordinate dialogue between the plan sponsor and plan provider if changes in the document need to take place.

- Step 2: Request from your recordkeeper a list of all terminated participants with a balance, preferable in a spreadsheet format. Make sure you make note of how this list was obtained, since you will be going back to them on a regular basis for an updated list. The list should include name, mailing address, and vested balance at a minimum. Upon receiving the list, sort the names in to three groups based on account balance (i.e. less than $1k, between $1k and $5k, and more than $5k).

- Step 3: Work with the plan sponsor to draft a notice to participants that are eligible for force-outs, informing them their plan balance will be either be paid in cash (less tax withholding) or rolled to an IRA. Your recordkeeper may be able to assist you with the language to use and the timeline to follow (30-day notice is necessary). If a participant falls into this category and has no current address on file, your recordkeeper can guide you through the "lost participant" process.

- Step 4: This is the most challenging step, because you are dealing with participants that enjoy the same benefits, rights, and features as any active participant. They cannot be forced to move their balance out of the plan, and if you try to coerce them by passing along more than reasonable costs to maintain their balance, you may end up a much bigger problem involving discriminatory practices. What you can do is compose a letter along with communication materials to send that outlines the advantages of control and investment flexibility with an IRA rollover. You can also explain the ease of a direct rollover to a new custodian, as well as the freedom to roll to another IRA custodian of their choosing. If you are not comfortable with facilitating this step because of a conflict of interest with your fiduciary role, consider outsourcing this task to a non-fiduciary advisor. There are also custodial firms like Schwab and Fidelity that have created custom marketing materials and a sales desk to address any participant questions.

Final Thought

Much like eligible employee not deferring, you need to be mindful that it may take multiple correspondence over a number of years to overcome the inertia and see terminated participant balances rolling out of the plan. Remember the key is not necessarily in how many ultimately decide to move their plan asset. The key is creating a repeatable process of managing the terminated participant roster, and thereby inserting another layer to your value proposition.

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