BMO DCIQ™

ARTICLE 1.1
PLAN DESIGN: Automatic Features

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BMO Defined Contribution IQ™: Automatic Features (Part 1 of 3 on Plan Design)

We now know from independent research that implementing automated features within a defined contribution plan results in increased employee participation — and likely improved outcomes — for most organizations. Plan sponsors seeking to improve their "DC IQ" need to address the following five questions:

1. Which employees should be automatically enrolled?

Plan sponsors who are considering whether to automatically enroll employees need to determine whether to auto enroll new employees only, or new and existing employees.

In addition, plan sponsors need to decide whether employees who have opted out during a prior plan period may be automatically re-enrolled in future years.

Best practices suggest that participation in the retirement plan be treated in the same manner that plan sponsors treat other benefits. Everyone who is eligible is included. During the annual benefits enrollment, plan sponsors simply inform employees that, unless they opt out, they will be enrolled in the 401(k) plan at the beginning of the new benefits year.

Although your benefits team may disagree with this practice, and suggest that employees will balk at being forced to opt out each year, BMO Retirement Services believes that treating the retirement plan like any other benefit provides a defense against any claim that an employee did not realize that there was a retirement plan available. Nearly all employees become aware over time that they need to save for retirement, and having this policy in place virtually ensures that, when that realization occurs, the participant will be enrolled.

What's your DC IQ?

To help plan sponsors identify intelligently designed and thoughtfully implemented plans, BMO Retirement Services has identified nine key DC IQ attributes across three broad categories:

- PLAN DESIGN
- PARTICIPANT UTILIZATION
- OPERATIONAL EFFICIENCY

Plans with a higher DC IQ are more likely to provide participants with greater retirement security.

Within plan design, we examine **automatic features**, **rollovers** and **investments**.

2. At what deferral level should participants be auto enrolled?

Many early adopters of this practice auto enrolled new participants at 2 or 3 percent of salary, a level that, while initially regarded as unobjectionable to employees, was unlikely to produce sufficient retirement savings. As automatic enrollment has become more widely accepted, however, employers are finding that participants are more amenable to accepting higher initial contribution levels.

Our experience has shown that a deferral level as high as 6 percent for automatic enrollees does not increase the number of participants opting out. As a result, we typically recommend plan sponsors automatically enroll participants at their maximum matching level, up to 6 percent.

3. What annual auto-escalation rate should be adopted?

Knowledgeable advisors typically recommend a lifetime deferral rate of 10 to 15 percent. We therefore recommend that plan sponsors strive to help participants achieve that level reasonably quickly, without increasing opt-out rates. In our view, an annual escalation of 1 or 2 percent seems reasonable. If the employer can time this escalation to coincide with any annual salary increases, participants may not see any significant reduction in take-home pay.

4. What is the auto-escalation cap?

The auto-escalation cap is the upper limit that plan sponsors place on auto-escalation arrangements. In determining where to set the auto-escalation cap, we suggest carefully considering workforce demographics and selecting a ceiling that prevents auto escalation from materially impacting employees' current lifestyles. Where applicable, plan sponsors should also carefully consider the impact of this decision on employer contributions over time.

5. Which default investment option should be used?

Conventional wisdom regarding the qualified default investment alternative (QDIA) decision has changed significantly over time. At one point, a principal-safe investment was deemed to be the optimal QDIA choice because it supposedly eliminated risk. Today, that concept has largely been repudiated. Principal-safe investments, which have a strong fixed income bias, rarely generate enough earnings over time needed to support a secure retirement.

A carefully selected target-date fund[1] may be the best option for the QDIA. While such a fund may have the potential for loss of principal, it also has the ability to generate the earnings over time needed to support the lengthy retirement period today's generally healthier workers can expect.

Considerations in selecting a family of target-date funds include:

- Who is monitoring the fund's asset allocation models?
- What is the defined glide path?
- Is the investment appropriate for the employee population?

Because most target-date funds use a fund-of-funds approach, plan sponsors should select a fund family whose managers actively monitor to ensure that no individual stock comes to represent an overly significant percentage of the total fund holdings, due to their weightings in potentially overlapping funds.

One final consideration

Most target-date funds comprise multiple funds from a single investment organization. This likely means they are based on similar research and invest within the same pool of stocks and bonds. In contrast, an open-architecture approach can employ several investment firms and may offer plan sponsors the ability to select best-in-class funds from multiple managers.

[1] The principal value of a target date fund is not guaranteed at any time.

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