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INSIGHTS

Overcoming Challenges in the 403(b) Tax Exempt Market

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Rocaton Investment Advisors is pleased to present this Rocaton Insight focused on the 403(b) tax-exempt market. In this paper, we explore the challenges faced and enhancements made by many 403(b) plan sponsors in recent years and offer key takeaways for 403(b) plan sponsors going forward. Future Rocaton Insights focused on defined contribution more broadly and 403(b) specifically are planned for later this year.

Executive Summary

- IRS regulations released nearly a decade ago had a positive influence on 403(b) plans.
- Fiduciary oversight and governance, while once limited, has progressed and prompted changes to investment lineups and administrative/recordkeeping structures.
- Many 403(b) plan investment menus have embraced best practices of the 401(k) market including open architecture, tiering of the investment menu, rationalization of the number of funds offered to participants, lower fee investment vehicles, and an increased adoption of mutual funds.
- Compliance and complex data consolidation requirements have resulted in a consolidation of service providers/recordkeepers, lower administrative fees, and potentially improved participant decision-making.

In light of the many enhancements 403(b) plans have undergone, Rocaton offers several key takeaways for 403(b) plan sponsors:

- Plan fiduciaries should be diligent in fulfilling their fiduciary duties, documenting processes, meeting regularly, and adhering to plan documents, particularly given the uptick in litigation in the 401(k) segment of the market.
- Further legislative action is needed to provide 403(b) plans access to the variety of lower fee investment vehicles typically available in the 401(k) market.
- The presence of individual annuity contracts continues to challenge plan sponsors from making further improvements.
- The use of multiple recordkeepers, while less prevalent and much improved, continues to present challenges and should be revisited.
- For plans that haven't yet embarked on fund and provider consolidation, there remain opportunities to build participant friendly and cost-effective designs.

Introduction

In 2007, the IRS issued regulations that effectively made 403(b) plans more similar to 401(k) plans. The regulations had a dramatic impact on 403(b) plans, resulting in (1) greater focus on fiduciary oversight, (2) improved investment lineups, and (3) consolidated administrative platforms (i.e. recordkeepers/vendors). Despite these changes, in many ways the 403(b) market continues to differ meaningfully from the 401(k) market. The balance of this paper highlights the "then" and "now" with respect to these three main areas, and offers Rocaton's key takeaways for 403(b) plan sponsors to consider going forward.

Fiduciary Oversight / Improved Governance

New regulations required greater oversight of 403(b) plans and their investments, particularly for plans covered by ERISA.

Then

Prior to 2007, the typical 403(b) plan had multiple administrative service providers (i.e., recordkeepers, vendors), more than a hundred investment funds, and a modest level of fiduciary oversight. Choice was considered paramount and it was common to have all of an investment company's funds[1] made available to plan participants. In fact, illustrating the modest role of the plan sponsor in making investment decisions on behalf of the plan, plans were often referred to by the investment company's name as opposed to the name of the plan and it was not uncommon to have in excess of five different recordkeepers and more than 300 investment choices. Further, professional investment advice was not conflict-free and was often provided by the same entities that managed the investments. Generally speaking, fiduciary oversight of 403(b) plans was limited. Plan sponsors typically added new investment funds and recordkeepers based on participant' requests with limited regard to their appropriateness as a retirement investment. Investment committees were typically non-existent and responsibility for the plan was thought to be the administrative service provider's responsibility.

Now

Plan sponsors have recognized their roles as plan fiduciaries and independent, third-party investment advisors have been hired to provide guidance and non-conflicted investment advice. Investment/administrative committees have been formed and committee members have been educated on their roles and responsibilities as plan fiduciaries and on best practices with regard to defined contribution plan practices. Administrative service provider/recordkeeper services and fees have been evaluated and, in most cases, consolidation has occurred, typically resulting in the plan using only one or two recordkeepers. Consolidation was needed in order to be compliant with the IRS' regulations, to eliminate inefficiencies, and reduce fees. Investment Policy Statements have been developed outlining the roles and responsibilities of the plan's fiduciaries, the process for the selection and/or elimination of investment options, and ongoing monitoring of the plan.

Going Forward

While fiduciary oversight and governance have vastly improved among 403(b) plan sponsors, we continue to witness an unprecedented uptick of activity in litigation in participant driven retirement plans. For now, the activity has mostly been focused on the 401(k) segment. However, the 403(b) segment is not immune. Rocaton suggests that fiduciaries continue to be diligent in documenting governance processes, meeting regularly, and adhering to plan documents. Best practices continue to evolve and plan fiduciaries must strive to remain informed and diligent.

Investment Menu

The improvement in fiduciary oversight and governance processes resulted in significant enhancements to 403(b) investment menus. As committees were formed and responsibilities defined, fiduciaries were educated on best practices with respect to the investments and improvements to the investment lineup naturally followed.

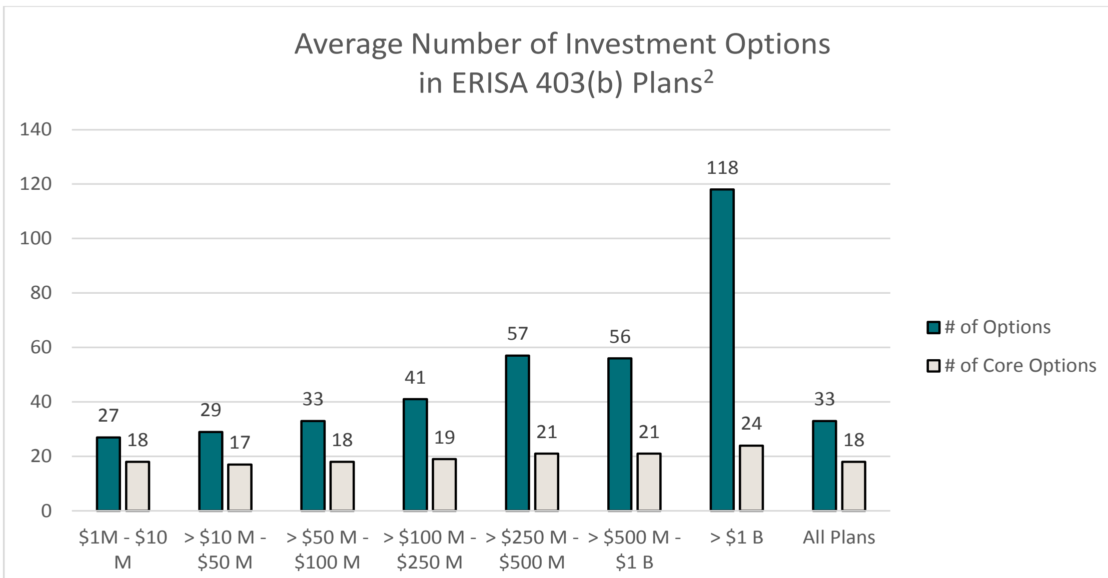
Then

Plans typically had in excess of 100 investment options and, in many cases, in excess of 300, often correlated with the number of administrative service providers in the plan. In many cases, all of the funds available were the vendors' proprietary investment products. For mutual fund providers, this typically resulted in the inclusion of virtually every mutual fund available on the vendor's platform. Participants were provided a large assortment of sector and country funds, as well as funds with little to no track record or assets. In many cases, these funds were managed exclusively by the mutual fund provider. For insurance providers/administrators, the investment menu often consisted exclusively of fixed and variable annuities. An incremental complication was the presence of individual contracts where participants often had full discretion over their money. With the plentitude of investment alternatives available residing on a number of administrative platforms and, in the case of annuities, individual contracts, plan assets tended to reside in high priced investment vehicles, since asset aggregation was virtually impossible. Investment menus, in many cases, contained investment strategies that were arguably not appropriate for the vast majority of plan participants, either due to the strategy, performance, or fees.

[1]Also referred to as a proprietary lineup where all the funds are managed by a single entity, typically the recordkeeper.

Now

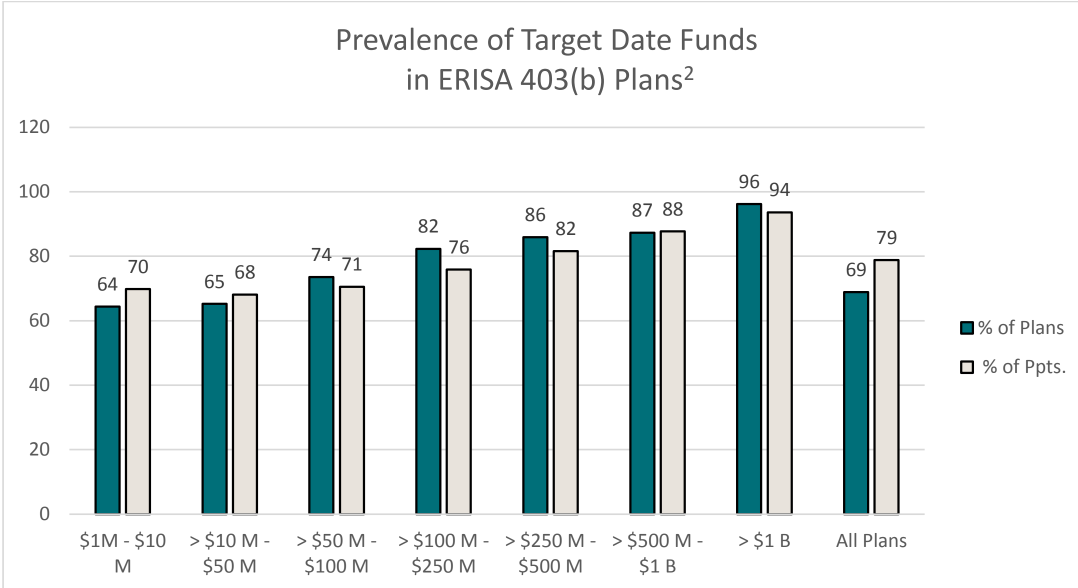
There has been dramatic improvement in 403(b) investment programs. Typically working with an independent investment consultant, many plan sponsors have restructured the investment menu, dramatically reduced the number of investments offered, transitioned to lower fee investment vehicles, expanded the use of mutual funds, and embraced open architecture through the addition of non-proprietary investment options. Investment menus that once had hundreds of mutual funds now contain as few as four to six investment options. According to the most recent BrightScope/ICI Survey, the average number of investment options for all 403(b) plans is 33 (counting the entire suite of target date funds as one option).[2] This compares to an average of 19 funds for all 401(k) plans.[3] In contrast to the continued streamlining of investment options among larger 401(k) plans, larger 403(b) plans tend to offer more investment choices than smaller plans. In fact, according to the same BrightScope ICI Survey, for plans with more than $1 billion in assets, the average number of options offered was 118. When looking only at core investment options (defined as those holding at least 0.5% of total plan assets), the average number of investment options across all plans is fewer (18), which is more in-line with 401k plan averages. Again, this number is slightly higher for larger plans (24 options with more than 0.5% of assets for plans with more than $1 billion in assets).



Most 403(b) plan sponsors have also embraced the best practice of "tiering" the investment menu that is prevalent in 401(k) plans. Tier 1 options typically consist of target date funds and is most often designated as the plan's Qualified Default Investment Alternative ("QDIA"), Tier 2 options typically consist of a select number of active and passive funds, and Tier 3 options typically include a self-directed brokerage account that permits access to a much broader universe of mutual funds. There has also been an increased prevalence of target date funds in 403(b) plans. According to the BrightScope/ICI Survey, nearly 70% of all 403(b) plans now offer target date funds and nearly 80% of participants have access to target date funds. These statistics are much higher for large plans with over 96% of plans above $1 billion offering target date funds.

[2]Source: BrightScope/ICI Defined Contribution Plan Profile: A Close Look at ERISA 403b) Plans, published May 2016, reflecting 2013 data

[3]Source: PSCA's Annual Survey of Profit Sharing and 401(k) Plans: 58th Annual Survey, Reflecting 2014 Plan Experience



Other Improvements

403(b) plan sponsors have embraced open architecture in an effort to improve the quality of the investments and lower the investment fees paid by plan participants. Investment menus that had once been exclusively annuities now often include a combination of institutionally-priced mutual funds and annuities. In fact, the BrightScope/ICI survey outlines the distribution of investment vehicles in 403(b) plans, defined as mutual funds, variable annuities and fixed annuities and cites that, across all plans, 49% of asset reside in mutual funds, 28% in variable annuities and 23% in fixed annuities.[4] Brokerage accounts (more specifically mutual fund windows) are much more prevalent in 403(b) plans than 401(k) plans. This is likely due to the historically large number of funds that participants had access to in the past and the use of brokerage options as a way to mitigate disruption for plan participants when streamlining the core investment menu.

Going Forward

While we cannot discount the success that 403(b) plan sponsors have achieved with respect to the investment program, Rocaton recognizes that there is still much to be done. The laws governing the types of investments permissible in ERISA governed 403(b) plans have not changed. Today, 403(b) plan sponsors continue to be limited to the use of mutual funds and annuities and do not have access to the variety of lower fee investment vehicles (namely collective trusts) available in the 401(k) market. Legislative action is needed to facilitate further improvements in this area. However, while recognizing this limitation, plan sponsors should continue to be diligent in evaluating investment management fees, aggregating plan assets, and transitioning to lower fee share classes whenever possible and should ensure that fees are transparent and equitable among all plan participants.

Self-directed brokerage accounts are more commonly held in 403(b) plans than 401(k) plans. The reason for this is two-fold: 1) to allow participants to invest in the funds that they once had access to; and 2) to minimize participant disruption. Many 403(b) plan sponsors facilitated one-time in-kind transfers to the brokerage window during the transition to the new investment menu as a way to permit participants to continue to invest in favorite funds. While understanding the rationale for this and the need for plan sponsors to obtain buy-in from key stakeholders, Rocaton suggests that plan sponsors that have yet to restructure the investment menu evaluate the pros and cons of such an action for all plan participants. Such brokerage or mutual fund windows may be seen as perpetuating the issues of complexity and higher fees that the redesign of the investment menu is intended to address. In addition, annuities, while virtually non-existent in the 401(k) market, are much more commonplace in the 403(b) market. Individual annuity contracts, however, continue to present a challenge to 403(b) plan sponsors in making further improvements with respect to the fund lineup, reducing investment and administrative fees, and consolidating to a single administrative service provider.

[4]Source: BrightScope/ICI Defined Contribution Plan Profile: A Close Look at ERISA 403(b) Plans, published May 2016, reflecting 2013 data. The entire suite of target date funds is counted as a single option. The number of Core Options refers to those investments with options holding at least 0.5% of total plan assets.

Recordkeeper Consolidation

New regulations introduced in 2007 required monitoring and enforcing all of the IRS's plan limits and administering and approving participant activity such as loans and distributions, among other things. Complex data consolidation across multiple recordkeepers made the task not only financially burdensome, but almost impossible to complete error free. Consolidation was a necessity and a select number of service providers stepped up and assumed a new role as "Master Consolidator or Master Administrator" to facilitate data aggregation across the platforms in order to comply with these regulations.

Then

Multiple recordkeepers/plan administrators were common practice in the 403(b) market, often with each offering proprietary investments line-ups. Participants were, and in many cases, still are, required to select a vendor/administrator before determining how to allocate assets among the investment options. In many instances, participants were permitted to invest with more than one provider and, in some cases, where a default vendor was needed, allocated equally among them. Many plans had five or more recordkeepers and, among some public plans, state law may require a specific number of providers. Administrative costs continue to be higher for 403(b) plans than for 401(k) plans due to a variety of factors, but the need to administer multiple accounts for a single participant is certainly a contributing factor.

Now

While there has been a lot of progress in consolidating service providers in the tax-exempt market, there is still room for further improvement. The use of more than one recordkeeper continues to be prevalent, despite the action taken by many to consolidate. While there are a number of plans that have been successful in moving to a single recordkeeper environment, the vast majority of plans still employ a multi-vendor environment, albeit with a more limited set of providers. Many 403(b) plans continue to retain more than one (typically two or three) recordkeepers so as to facilitate the continued use of legacy annuity investments for plan participants. Certain annuities and particularly individual annuities may be limited to the provider's platform, thereby handicapping a plan sponsor from consolidating further.

Going Forward

Plan sponsors should evaluate their current recordkeeper model relative to the needs of the plan and strive to understand whether a multi-vendor environment serves the best interest of plan participants in the future. Based on this assessment, the sponsor should consider alternative models that may help streamline the plan's administration, provide opportunities to achieve higher levels of service and improve the ease of participant decision making. These strategies may include moving to a single recordkeeper or taking an interim step with a dual recordkeeper model or "Master/Lead" relationship. In the case where individual annuity contracts are present, the sponsoring insurance provider typically will serve as one of the recordkeepers, unless the insurance provider is selected as the sole recordkeeperkeeper. Having more than a single recordkeeper poses additional challenges and may involve manually intensive transactions across administrative platforms. However, it should be noted that certain recordkeepers have advanced their capabilities in this area significantly in recent years.

Conclusion

Despite improvements in governance, overall investment structures, and administration of 403(b) plans, challenges still exist in the 403(b) marketplace. In order to confirm that plan sponsors are implementing best practices, Rocaton recommends the following important steps when working with 403(b) plan sponsors in order to address these remaining challenges.

Steps	
1	**Fiduciary Governance / Education** - Establish a committee and educate on roles and responsibilities - Define objectives
2	**Administrative Service Provider Review** - Review current situation (# of recordkeepers, # of plans administered, participant usage, etc.) - Review recordkeeper responsibilities and services - Understand administrative fees and pricing methodologies
3	**Investment Education and Investment Program Design** - Reaffirm objectives - Review current situation, analyze demographics - Educate on best practices and trends (# and types of funds, active vs. passive, self-directed brokerage, fee methodology) - Discuss investment structure alternatives and pros and cons - Review the role of annuities in the investment program and potential impact on recordkeeping requirements - Review/determine contract types (individual vs. group)
4	**Initiate RFP for Administrative Service Provider (Vendor Consolidation, if needed)** - Define objectives - Issue RFI/RFP - Evaluate Responses (Services and Fees)
5	**Investment Structure Design / Fund Selection** - Review/Validate/Select qualified default investment alternative ("QDIA") - Search and select new and/or replacement funds (as needed) - Review alternative implementation approaches (re-enrollment, asset mapping strategies, etc.) - Determine fee methodology
6	**Implementation and Monitoring** - Develop and approve a written investment policy - Implement the new investment structure - Ongoing monitoring, due diligence and education

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Performance Information and Return Expectations

The analysis contained in this document may include projections of long-term return and risk expectations. There is no guarantee that the projected returns or risk will be realized. The projections are based in part on historical performance of various asset classes, and past performance is no guarantee of future performance. The projections include assumptions, including those regarding risk and return. These assumptions are used for modeling purposes only and may not be realized. Because the analysis is based on assumptions and projections, there can be no warranties or guarantees.

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