Aon Hewitt
Retirement and Investment

How 403(b) Plans are Wasting Nearly $10 Billion Annually, and What Can Be Done to Fix It

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Executive Summary

- 403(b) plan sponsors can dramatically reduce participant-borne costs while improving employees' retirement readiness by:
  - Reducing the number of investment options, utilizing an "open architecture" investment menu, and packaging the options within a "tiered" structure.
  - Consolidating recordkeepers to improve efficiencies and reduce compliance-related risks.
  - Leveraging aggregate plan size and scale to negotiate competitive pricing.
- In addition, legislators can assist by:
  - Supporting employer-sponsored 403(b) master trusts and prohibiting recordkeepers from issuing individual contracts or custodial agreements in employer-sponsored plans.
  - Allowing 403(b) plans to be eligible investors in lower-fee investment vehicles, particularly collective investment trusts (CITs).

Background

Retirement plans established for certain tax-exempt organizations under Section 403(b) of the Internal Revenue Code are commonly referred to as tax-sheltered annuities (TSAs) or 403(b) retirement plans.[1] Many of these plans are structured differently from the defined contribution (DC) plans of for-profit entities in that they:

- Offer participants more than 30 investment options;
- Limit investment options to mutual funds and fixed or variable annuities; and
- Endorse multiple administrative recordkeepers.

As a result, the 403(b) market currently is unique, resulting in distinctive challenges for its sponsors and participants.

403(b) retirement plans allow tax-deferred salary reduction for the employees of certain church ministries, public school systems, colleges, universities, and tax-exempt employers. Historically, employers transferred salary deferrals into an annuity contract for the benefit of each individual employee. Taxation was deferred until these savings were withdrawn as supplemental retirement funds. In effect, 403(b) plans were historically designed as personal supplemental pension plans, posing very little burden on employers. Because of this, Department of Labor regulations under ERISA provided an exemption from ERISA for 403(b) salary reduction arrangements meeting certain requirements for minimal employer involvement.[2]

[1] Private employers that are tax-exempt under any subsection of Section 501 other than 501(c)(3) were not, and are still not, eligible to sponsor a 403(b) plan. TAA 58 § 23(b)(1)(A), 72 Stat. at 1620 (codified as amended at IRC § 403(b), (1) (2006)).

[2] 29 CFR § 2510.3-2(f).

Over the years, 403(b) plans have been transformed through a series of legislative and regulatory changes. Here, we highlight several of these changes:

- In 1958[3], 403(b) plans first became law, predating for-profit employer sponsored 401(k) plans by roughly 20 years.
- From 1958 until the inception of ERISA in 1974, annuities were the only investment vehicle available within 403(b) plans. An amendment to ERISA in 1974 allowed for the creation of 403(b)(7) custodial accounts that were permitted to invest in mutual funds.
- The Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") enacted Code Section 403(b)(9), giving church organizations the option of maintaining a "retirement income account" as the funding vehicle for a 403(b) plan. As a result, church employers—and only church employers—can fund 403(b) plans through investment vehicles other than fixed or variable annuity contracts or mutual funds.
- The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") simplified 403(b) contribution calculations and increased annual contribution limits to align with for-profit employer sponsored 401(k) plans.
- The primary purpose of the Pension Protection Act of 2006 ("PPA") was to enact new funding rules for defined benefit plans. However, numerous provisions affected for-profit 401(k) plans and 403(b) plans as well. These provisions included expanding the scope of Section 404(c) fiduciary protection along with 409(a) hardship requirements.
- In 2007, the issuance of Internal Revenue Service (IRS) regulations provided the most comprehensive update to historical 403(b) regulations. These modifications introduced new requirements for employers and service providers, including requiring a written plan document, monitoring and enforcing all of the IRS's plan limits, and administering and approving participant activity such as loans and distributions.
- In 2015, Section 336 of the Protecting Americans from Tax Hikes ("PATH") Act contained a number of provisions affecting church plans including an allowance to offer automatic enrollment accounts and transfers between 403(b) and 401(a) plans. Additionally, the provision allows church plans to invest in CITs.

While these regulatory changes have gone a long way to place the traditional 403(b) plan on the same standing as for-profit employer sponsored 401(k) plans, the following differences still remain:

1. Limitations on the types of employers and employees to which a 403(b) plan is available.
2. Restrictions on the types of available funding vehicles.
3. Variations on the applicability of nondiscrimination testing (ADP or universal availability).

Throughout the remainder of this paper, we identify how 403(b) plans are wasting nearly $10 billion annually and what can be done to fix it.

[3] Technical Amendments Act of 1958, Pub. L. No. 85-866, § 23, 72 Stat. 1606 (1958) (now codified in IRC § 403(b)).

Plan Sponsor Call to Action

As illustrated in Exhibits 1 and 2, 403(b) plan assets have grown by over 7% annually since 2010 and funds in excess of an estimated $1.0 trillion are currently held for investment. Of that, approximately 43% is held within fixed annuities, 33% is held within variable annuities, and 24% is held within mutual funds.[4]

Exhibit 1: $1,075M 403(b) Market by Industry

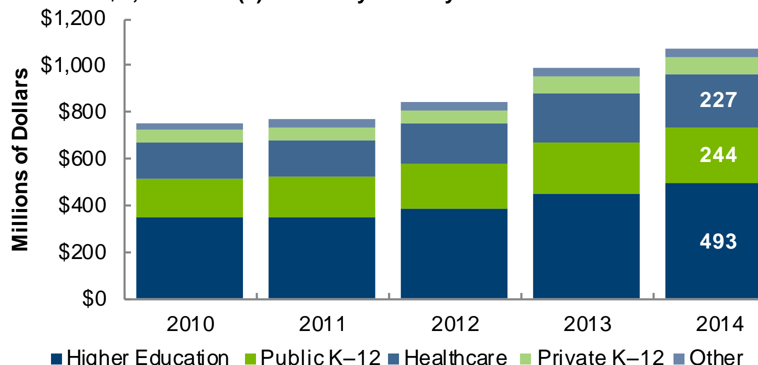
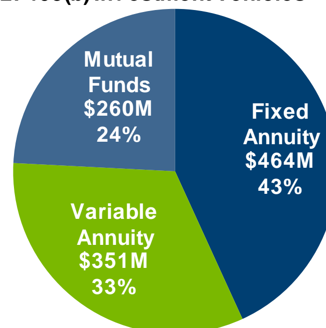


Exhibit 2: 403(b) Investment Vehicles



Source Data: Spectrem Group

The traditional 403(b) plan has historically been implemented through a multi-provider recordkeeper platform where employees choose their investment options from a "menu" of retirement plan providers. Based on our experience and research, this traditional model is flawed in two very basic ways:

- First, too much choice is not in the best interest of participants because it leads to confusion and adverse choices.
- Second, sponsors are unable to leverage aggregate plan assets to negotiate competitive pricing (like for-profit employer sponsored 401(k) plans), which is inefficient from a cost perspective.

Through the ERISA governance process, the for-profit employer sponsored 401(k) market has worked for years to rectify these problems. For example, it allows for institutional investment vehicles such as CITs, streamlined investment lineups, single recordkeepers, and group master trusts. As a result, even non-ERISA 403(b) sponsors can benefit from the following "lessons learned" to effectively improve the retirement readiness of their participants.

Avoid "Choice Overload"

Behavioral finance studies have demonstrated that when employees are given too many choices (including choices in selection of administrative recordkeepers and investment options), they feel overwhelmed. More important, evidence has shown that a large number of investment choices neither helps DC plan participants build better portfolios nor save for retirement.[5]

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[4] Spectrem Group.
[5] Journal of Public Economics 94 (2010) 530-539: "Choice proliferation, simplicity seeking, and asset allocation," Iyengar and Kamemica, 2010.

In our work with a growing number of 403(b) plan sponsors, Aon Hewitt believes a best-in-class investment structure is distributed across several "tiers" designed to meet diverse investment goals. Exhibit 3 illustrates an investment structure that reflects industry best practice.[6]

Exhibit 3: Sample Tiered Investment Structure

Possible Tier	Characteristics
Target Date Funds	▪ Intended for participants seeking asset allocation simplification. ▪ A suite of professionally managed asset allocation options that become more conservative as a participant nears retirement.
Core Funds	▪ Intended for participants empowered to make asset allocation and investment manager decisions. ▪ Limited number of options covering the key objectives and asset classes. ▪ Implemented through passive funds, active funds, or a combination of both.
Self-Directed Mutual Fund Window[7]	▪ Intended for participants wanting extreme levels of choice without plan sponsor oversight. ▪ Includes all available mutual funds on a service provider's brokerage platform.

When a sponsor reduces the number of investment options available in the core funds tier, the goal is to provide participants with a sufficient range of choice to form well-diversified portfolios across a range of objectives. The ideal number of funds varies based upon each sponsor's individual circumstances. Our experience and research conclude that offering a target date fund tier, plus a core funds tier with as few as four to six[8] investment options, allows for effective control of costs and maintenance without compromising sufficient breadth of investment offerings for the participant.

By streamlining the number of investment options within the core funds, sponsors are able to more easily monitor the selected options in order to ensure their continued viability and integrity—increasing the likelihood that participants will earn better long-term risk-adjusted performance. Additionally, streamlining can be staggered over multiple phases, helping sponsors incrementally improve participant outcomes and plan governance, as opposed to a one-time change that may result in significant disruption.

A growing number of 403(b) sponsors are also starting to utilize "open architecture" investment menus. Open architecture allows sponsors to offer investment options managed by multiple fund families instead of only proprietary investment options affiliated with their administrative recordkeeper(s). Participants remain in full control of their own investment decisions, but sponsors are able to offer participants a more user-friendly menu with a better range and quality of investment options. Our experience and research[9] conclude that open architecture is in participants' best interest, since no single investment manager has been identified that can offer compelling proprietary investment options across all asset classes.

[6] "Customize DC Investments for Participant Success: How custom investment options improve participant outcomes," Aon Hewitt, 2015.
[7] Whether a self-directed brokerage window is appropriate for the participant population is a fiduciary decision for each plan sponsor to consider.
[8] "Customize DC Investments for Participant Success: How custom investment options improve participant outcomes," Aon Hewitt, 2015.
[9] Center for Retirement Research at Boston College, August 2015, Number 15-13: "Are 401(K) Investment Menus Set Solely for Plan Participants?" Veronika K. Pool, Clemens Sialm, and Irina Stefanescu.

Improve Efficiency and Reduce Compliance-Related Risks

The traditional 403(b) plan service model is inefficient from an administrative and cost perspective, because it:

- Requires the use of mutual funds and fixed or variable annuities.
- Divides participant assets into individual accounts held at separate service providers, thereby limiting a sponsor's ability to negotiate lower pricing based on aggregate assets.
- Requires extensive coordination across multiple recordkeepers in order to meet Internal Revenue Service (IRS) and Department of Labor (DOL) regulatory compliance requirements.

The benefits of consolidating 403(b) recordkeepers to a single or reduced number of providers include lower administrative costs, improved regulatory compliance, and a more effective plan governance structure. Effective plan governance and oversight have the potential over time to increase participant satisfaction and improve retirement readiness for participants.

The perception of many sponsors is that continuing with the traditional 403(b) plan structure is ideal, because eliminating a "preferred" recordkeeper or investment option will upset participants. Aon Hewitt's experience shows that clear communications—complemented by an open architecture investment menu, unbiased planning tools, and a competitive fee arrangement—are in the best interest of participants, and the change is typically well received by the vast majority of participants.

How Legislators Can Help

Further legislative action is required to position 403(b) plans on an equal footing with other tax-exempt employer-sponsored DC plans, such as for-profit 401(k) plans established nearly 20 years later.

Expand 403(b) Plan Eligibility to Utilize CITs

Under ERISA requirements, for-profit employer sponsored 401(k) plans are structured within master trusts, making them "qualified investors" eligible to fund CITs. Unless a 403(b) plan is a "Church Plan," the types of funding vehicles currently available to participants are limited to mutual funds and fixed or variable annuities. Consequently, for-profit employer sponsored 401(k) plans tend to enjoy lower fees and a more efficient plan governance structure than traditional 403(b) plans. In addition to fee savings, updated legislation would provide all 403(b) plans with access to more mainstream investment options such as stable value and custom target date funds—two additional "best-in-class" investment options commonly used by many for-profit employer sponsored 401(k) plans.

CITs are bank-administered trusts holding commingled assets that meet specific criteria established by regulations of the Office of the Comptroller of the Currency.[10] CIT providers are held to ERISA fiduciary standards of care for their investors that are similar to the standard for eligible sponsors that offer CITs to their participants. CITs are exempt from registration with the Securities and Exchange Commission and from Section 3(c)(11) of the Investment Company Act of 1940 (more commonly referred to as the "40 Act"). These exemptions are the key factor that reduces the administrative burden on CIT providers, thereby facilitating lower fees. In many cases, investment managers use similar investment strategies in both 40 Act and CIT vehicles, with the CITs having substantially lower fees.

[10] 12 CFR 9.18.

To demonstrate the CIT fee savings, in Exhibit 4 we compare the average expense ratio of various asset class categories using data from Morningstar and eVestment Alliance.

Exhibit 4: Average Expense Ratio Comparison (as of 6/30/15)

Investment Category	Avg. Mutual Fund Fee[11]	Avg. CIT Fee[12]	Difference
Pre-Mixed Funds (e.g., TDFs)	0.78%	0.45%	33 basis points
Diversified Bond Fund	0.84%	0.31%	53 basis points
Large-Cap U.S. Equity Fund	1.04%	0.59%	45 basis points
Small-Cap U.S. Equity Fund	1.24%	0.84%	40 basis points
International Equity Fund	1.12%	0.73%	39 basis points
Asset-Weighted Average	**0.97%**	**0.53%**	**44 basis points**

Using our survey data, we established that the asset-weighted allocation (excluding employer stock) across DC plans is roughly 17% pre-mixed, 25% fixed income, 41% large-cap U.S. equity, 8% small-cap U.S. equity, and 9% international equity.[13] When we apply the fee differentials for the various asset classes highlighted in Exhibit 4, the asset-weighted fee differential comes to roughly 44 basis points, or 0.44%.

Applying the 44 basis point differential to the $260 billion of 403(b) plan assets invested in mutual funds, we estimate (Exhibit 5) that participants are paying $1.1 billion more per year than they need to. This analysis illustrates only a small portion of the potential savings. When we include assets held within both variable and fixed annuities, the potential for participant savings becomes even greater.

Exhibit 5: Total Participant Fee Savings (as of 6/30/15)

Investment Vehicle	Today	Future[14]	Basis Point Savings	Dollar Savings
Mutual Funds	0.97%	CITs 0.53%	44 basis points	$1,144M (44 basis points * $260B)
Variable Annuities	2.25%[15]	CITs 0.53%	172 basis points	$6,037M (172 basis points * $351B)
Fixed Annuities	1.15%[16]	CITs 0.53%	62 basis points	$2,877M (62 basis points * $464B)
Weighted Average	**1.47%**	**CITs 0.53%**	**94** basis points	**$10.058 billion**

It is important to note that an investment with high costs must perform better than a low-cost investment in order to generate the same return for a participant. Even small differences in fees can translate into large differences in a participant's account balance over time. For example, consider in Exhibit 6 how the terminal wealth of a $100,000 account returning 5% annually, gross of fees, can be dramatically different after the impact of fees:

[11] Morningstar.
[12] eVestment Alliance with $50 million in assets.
[13] Aon Hewitt 2015 Trends and Experience in Defined Contribution Plan Survey.
[14] Aon Hewitt 2015 Trends and Experience in Defined Contribution Plan Survey.
[15] http://www.403bwise.com/participants/getwise_403b_cost.html
[16] http://www.403bwise.com/participants/getwise_403b_cost.html

Exhibit 6: Impact of Fees

Total Costs			Account Balance		
	5 Years	10 Years	20 Years	30 Years	40 Years
0.00%	$127,628	$162,889	$265,330	$432,194	$703,999
0.50%	$124,618	$155,297	$241,171	$374,532	$581,636
0.75%	$123,135	$151,621	$229,891	$348,564	$528,497
1.00%	$121,665	$148,024	$219,112	$324,340	$480,102
1.50%	$118,769	$141,060	$198,979	$280,679	$395,926

Under Aon Hewitt's proposed model, participants would invest in lower-fee CITs throughout their preretirement years, thus avoiding the need to invest in products with higher fees. At the point of retirement, participants who want to convert a portion of their retirement account into a reliable income stream could utilize an annuity purchase platform outside the 403(b) plan to obtain competitively quoted retirement income options priced on an institutional basis. As a result, out-of-plan annuity platforms could complement—or even replace—403(b) annuity investment options. Moreover, the consequential diversification of business risk resulting from the separation of investment management and insurance provider affords participants a layer of financial protection in addition to the potential for fee savings.

A two-step legislative reform would be required to allow traditional 403(b) plans access to the same lower-fee CIT investment vehicles that have been available to for-profit employer sponsored 401(k) plans for decades:

1. First, reform Section 403(b) to allow these plans to be constructed as group or master trusts, making them qualified investors.
2. Second, amend CIT eligibility rules to allow new master trust 403(b) plans to fund CITs.

As detailed below, the individual contract structure of 403(b) plans prevents them from being considered qualified investors under CIT eligibility requirements.

Eliminate Individual Contracts and Agreements

One of the most inefficient aspects of 403(b) plans is the number of different types of contracts or agreements that are typically available. Unlike for-profit employer sponsored 401(k) plans, for 403(b) plans the ability to change investment options when existing options become imprudent or cost-inefficient is limited by the existence of individual contracts between the participant and the recordkeeper(s). This can create an ERISA fiduciary risk for sponsors of 403(b) plans subject to ERISA and, in many cases, a fiduciary risk under state law for those with 403(b) plans not subject to ERISA. Whereas a 401(k) plan sponsor can generally "map" participant assets to different, more prudent and cost-efficient investments, individual contracts or custodial agreements prevent the 403(b) sponsor from taking such action on behalf of participants. Under an individual contract or custodial agreement, each individual participant must take action to transfer his/her assets to another investment option. Consequently, participant inertia tends to cause participants' assets to remain invested within legacy investment options with limited fiduciary oversight.

Then, there is the issue of plan administration. The existing paradigm of individual contracts and custodial agreements tends to create an inefficient and costly situation wherein multiple contracts must be record-kept for the sponsor. Our experience shows that participants in group contracts or custodial agreements

enjoy significant advantages over those in individual contracts. For example, one contract rather than many increases plan efficiencies, improves purchasing power, and lowers administrative expenses. While our experience has shown that some vendors will retroactively convert individual custodial agreements to group contracts upon request of the sponsor, many will not.

Legislation that prohibits recordkeepers from issuing individual contracts or custodial agreements within employer-sponsored 403(b) plans would go a long way toward reducing costs and improving administrative efficiencies for ERISA and non-ERISA 403(b) plans. It would also improve plan governance and participant outcomes by ensuring the continued viability and integrity of the investment options available to participants, thereby increasing the opportunity for participants to earn better long-term risk-adjusted performance.

However, garnering these legislative changes for 403(b) plans could mean foregoing their state-governed non-ERISA status. Moving all 403(b) plans under ERISA governance would certainly increase the burden on sponsors; for example, through the expense of additional hours and dollars on ERISA regulatory reporting such as Form 5500 filings. Although we acknowledge these new implicit and explicit costs would be levered against the sponsor, Aon Hewitt continues to believe that the total net cost borne by participants would actually decrease.

When looking at the all-in costs borne by DC plans, administrative and operational costs tend to be fixed, while investment manager fees are a percentage charged against assets. Administrative fixed costs will diminish over time as 403(b) plans increase their headcount, spreading these fixed costs across a larger participant base. In addition, technological improvements will continue driving down the costs of administration. However, the investment management variable cost will continue to grow as the plan naturally increases in size through ongoing contributions and market appreciation. That variable investment management fee dominates the total cost burden on a DC plan and its participants. So, moving 403(b) plans to a governance structure similar to ERISA may increase fixed administrative costs, but the ability to move to a CIT investment structure should drive down the variable costs by far more than the fixed costs would increase.

Conclusion

Today's 403(b) plans are showing their age with outdated plan designs imposed by regulations that predate their for-profit employer 401(k) plan peers by roughly 20 years. Most notably, their existing multi-provider recordkeeper platforms, outsized investment menus, and inability to utilize more institutionally focused investment vehicles have created an environment that impairs retirement outcomes for participants.

While it may be difficult to eliminate all of the nearly $10 billion in excessive fees borne by 403(b) plan participants annually, this paper's recommendations begin to address many of the issues. As a first step, 403(b) plan sponsors could adopt several of the best practices utilized in the for-profit employer sponsored 401(k) market. Seeking clarifying regulatory guidance consistent with for-profit employer regulations to obtain equal access to lower-cost investment vehicles would further result in improved retirement readiness for participants.

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