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Labs: Defined Contribution

ADVISORS WANTED:

Untapped Opportunity, Familiar Territory

August 2018

Highlights

+ The 403(b) market represents a $1 trillion opportunity today and is expected to reach more than $2 trillion by 2020
+ Tighter regulations and increased competition have caused 403(b) features and plan designs to more closely resemble those of 401(k) plans
+ As they work to meet their increased fiduciary responsibilities, 403(b) plan sponsors are turning to advisors in greater numbers
+ Differences between 403(b) and 401(k) plans have more to do with legacy issues and the nonprofit culture
+ 403(b) plan sponsors need advisors who can share best practices and their expertise in a variety of areas, including:
  - Investments
  - Fiduciary Compliance
  - Plan Design
  - Participant Education
  - Retirement Readiness

Applying Your 401(k) Expertise to the World of 403(b)s

Say "retirement plan," and most people today think 401(k). 403(b) plans are generally considered the exception or the anomaly, and until several years ago, they really were quite different from 401(k) plans. Retirement saving plans in the 403(b) space were often unwieldy, less structured, and less understood — and even those advisors who were successful in the 401(k) space tended to shy away from them.

But the times, they are a changin'.

Beginning with regulations that became effective in 2009, many 403(b) plans of today look remarkably similar to 401(k) plans – or are moving rapidly in that direction. If you're a 401(k) advisor looking for new opportunities, these trends provide a real window. And you may be surprised by the relatively few real differences between the two types of plans.

Today, increased regulation and the rapid pace of change within the retirement market (driven largely by 401(k) plans) have generally created confusion and a sense of urgency among 403(b) plan sponsors. And that breeds opportunity.

On the pages that follow, we'll provide a brief primer into those segments of the 403(b) plan marketplace that offer the best opportunities for advisors to make a real difference.

Size and composition of the 403(b) market

To be clear, only nonprofit organizations (public schools, 501(c)(3) tax-exempt organizations and churches) can sponsor 403(b) plans. However, since many nonprofits increasingly choose to sponsor 401(k) plans, 403(b) plans are a subset of – not synonymous with – the nonprofit retirement plan marketplace. That said, the two are closely intertwined. Because of the long history of 403(b) plans, advisors would be wise to familiarize themselves with certain legacy issues of 403(b)s as well as cultural nuances of the nonprofit world.

The 403(b) retirement plan market today represents more than $1 trillion of opportunity across a variety of organizations ands according to Cerulli, is expected to grow to more than $2.4 trillion by 2020.

	2014	2009
K-12	**$319 Billion** (30%)	**$220 Billion** (29%)
Higher Education	**$493 Billion** (46%)	**$348 Billion** (46%)
Health Care	**$227 Billion** (21%)	**$154 Billion** (20%)
Other	**$37 Billion** (3%)	**$29 Billion** (4%)
Total	**$1,076 Billion**	**$751 Billion**

Source: 403bwise.com and Spectrem Group (http://www.403bwise.com research/403bmarket.html). Numbers are as of 12/31/15.

For purposes of this paper, we'll focus our attention on the higher education and health care segments, which represent the best opportunities for advisors. These two segments account for two-thirds of 403(b) assets and are concentrated in a relatively small number of organizations. The remaining segments present additional complexities: K-12 because of its highly decentralized nature and the fact that many of these operate in the public space; and the "Other" category (which includes museums, charitable and religious organizations) because of its small size and less unifying characteristics.

A few additional observations:

+ The composition of the 403(b) market has remained fairly constant over the past five years, even as assets have grown by almost 43%, from $751 billion at the end of 2009 to more than $1 trillion at the end of 2014.
+ While 403(b) plans are still the most common type of retirement plan in the nonprofit market, the number of 401(k) plans in this space continues to rise as organizations develop more competitive benefit programs versus their corporate counterparts to attract talent and seek to simplify their retirement plan using the more established 401(k) model.
+ Most 403(b) plans conform to ERISA; however, certain plans can be exempt from ERISA requirements (such as Form 5500 reporting and external audits):
  - Governmental plans
  - Church plans
  - Plans with limited employee involvement

A brief historical context of 403(b) plans

Prior to 2009, 403(b) employers were viewed as gatekeepers and many took a hands-off approach with respect to helping their employees save for retirement. With little regulation and even less plan identity, employees could make contributions to any number of vendors that were viewed merely as “payroll slots,” which created stiff competition for employee dollars among providers.

All that changed when the sweeping regulations took effect. The most impactful changes now mean that:

+ All 403(b) plans, including non-ERISA plans, are required to have and follow a written plan document.
+ With the exception of non-ERISA 403(b) plans, nondiscrimination rules apply to employer-funded 403(b) plans.
+ 403(b) plan sponsors must oversee all providers and the tracking and administering of plan-level limitations (on contributions and loans, for instance).
+ Loans and hardships are subject to tighter regulations.
+ ERISA-based 403(b) plans must file 5500 reports, and large plans (more than 100 eligible employees) must conduct an annual audit.

Unlike 401(k) plan sponsors that have long been subject to stricter regulations and are quite accustomed to them, 403(b) plan sponsors face a new world of regulations. They now have the unenviable task of getting their hands (and heads) around legacy plan arrangements that had been decades in the making while also ensuring compliance with policies and procedures that feel quite foreign.

Both the Internal Revenue Service (IRS) and the Department of Labor (DOL) have useful resources on their websites to help you and the plan sponsor better understand rules and regulations that apply to 403(b) plans. In the appendix of this report, you will find an IRS checklist for 403(b) plans.

Important technical differences between 403(b)s and 401(k)s

Although 403(b) plans increasingly resemble 401(k) plans, there are a few key technical differences that remain, and advisors who are considering working with 403(b) plans should be aware of them.

Investment vehicles

403(b) plans are permitted to only use mutual funds and variable annuities. Collective trusts are not allowed, so advisors who typically recommend using these lower-cost alternatives in fund lineups should be forewarned.

Universal availability

Elective 403(b) deferrals are NOT subject to discrimination testing; instead, 403(b) plans must be made available to all employees. In other words, with very few exceptions, no age and service restrictions are allowed for employee deferrals. This provision has implications for plan metrics since, for instance, participation and contribution rates are historically lowest among the youngest employees.

In addition, regulators have demonstrated strict enforcement of the universal availability standard. On at least an annual basis, plan sponsors must provide employees with an effective opportunity to make or change contributions to the plan, and they must make a sufficient effort to communicate that opportunity.

15-year catch-up rule

In addition to the catch-up provisions for participants age 50 and over (identical to 401(k) provisions), 403(b) plan sponsors may include a special lifetime catch-up provision for participants with at least 15 years of service. To be eligible, employees have to have made contributions of less than $5,000 per year on average. Catch-up contributions are limited to $3,000 per year and $15,000 per lifetime.

The non-ERISA paradox

While there are benefits to being a non-ERISA plan (less onerous reporting requirements, etc.), by definition, being a non-ERISA plan allows only limited involvement from the employer. However, the 2009 403(b) regulations – applicable to ERISA and non-ERISA plans alike – require greater employer involvement, thus increasing the likelihood that a plan would in fact be subject to ERISA. If that sounds confusing, it is. And it’s one reason why many employers have decided to bite the bullet and become ERISA plans.

So, What's the Big Difference?

While you may be pleasantly surprised at the few real technical differences between 401(k)s and 403(b)s, legacy issues and the nonprofit culture itself will be more of a distinguishing feature in working with the nonprofit organizations that sponsor these plans. However, none of these issues are insurmountable, and in fact, they suggest real opportunities for advisors. Since they have implications for the complexity and length of the sales process, which is often twice as long as the typical 401(k) plan sale, they are important to recognize in advance.

Legacy 403(b) issues

Individual contracts and contract exchanges

Historically, 403(b) arrangements consisted of agreements between providers and individual employees rather than between providers and employers. Many of these legacy contracts still exist, which can complicate plan-level decisions around plan providers. Specifically, the employer's authorization to transfer assets at the plan level does not extend to assets in these individual contracts, which can only be moved from one provider to another based on the individual employee's direction. Assumptions about plan size, therefore, should always account for assets that may be held in individual contracts.

Information sharing

All providers must provide 403(b) plan sponsors with information that allows for complete and timely plan oversight and administration. Shortly after the 403(b) regulations were issued, the industry collaborated with the SPARK Institute to create standards that facilitate this process. Because of these information-sharing requirements, many 403(b) plan sponsors limit transfers only to those investment options in the plan lineup.

Surrender fees

Many annuity products sold to employees of nonprofit organizations in the past have significant surrender periods and fees. These can pose real challenges – and cause frustration – to participants wanting to move to newly available investment options, including mutual funds. In some cases, it is to the employee's benefit to delay transferring assets from the old annuity contract until that surrender period is over.

Multi-provider environments

Given the historical structure of 403(b) arrangements, many plan sponsors continue to use multiple providers for their plans. While much consolidation has taken place, resulting in greater efficiencies for both plan sponsors and participants, some plan sponsors prefer the greater choice that multiple providers bring. Such environments pose additional challenges (including for advisors accustomed to the single-provider environment) and require strong relationships and clear communications among all parties involved.

Health care opportunity or challenge?

There's no question that the Affordable Care Act has launched a revolution among health care providers of all shapes and sizes. The merger and acquisition frenzy represents real advisor opportunity since benefit programs are frequently modernized during the process. At the same time, advisors should be mindful that benefit programs of acquired organizations are often merged into those of the larger firms (or the firms doing the acquiring).

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The faculty factor in higher ed

Faculty members are paid to have an opinion, so it's imperative that they be included in any major decisions affecting their retirement savings plan. Often highly suspicious of the administration's intentions, faculty will likely demand full transparency, so it's best to communicate early and often. Holding town hall meetings and engaging decision makers outside of the committee can prove particularly effective, and as an advisor, you can be helpful in encouraging such efforts.

Understanding the nonprofit culture

Shorter history as fiduciaries

Compared to 401(k) plan sponsors, 403(b) plan sponsors have had less experience to internalize (and institutionalize) what it means to be a fiduciary. Whereas most corporate plan sponsors, for example, have long since established formal investment and administrative committees and intuitively comprehend the Prudent Man Rule, nonprofit employers are still struggling to help their organizations uniformly and consistently act as plan fiduciaries. In fact, according to a recent survey, when asked whether theirs was an ERISA plan or not, 27% of higher education plan sponsors admitted they were unsure.[1]

Greater sense of paternalism

Compared to their corporate counterparts, 403(b) plan sponsors often have a more paternalistic attitude toward their employees. This seems especially true in health care, as evidenced by the long-standing and widely accepted model of making onsite, often full-time, education counselors available to employees.

Decision-making processes

In the corporate world, decisions are often made at the top and communicated down and throughout the organization. By comparison, decisions in the nonprofit world more likely require consensus among multiple stakeholders, lengthening timelines and requiring more compromise. This is true in the ongoing operation of the plan, since the organization may require multiple sign-offs, and in the sales process, which may involve an external board.

Less staff dedicated to retirement plans

Nonprofit organizations are stretched for resources more than ever. Within the HR function, retirement plans represent the smallest part of the job. Payroll systems are often disjointed, and fewer IT resources are available to support or address benefit issues. This means that organizations will be looking for help and guidance with respect to plan administration, especially with the added demands of having to comply with 403(b) regulations (and/or ERISA, if applicable).

Less uniformity in plan design

403(b) plans first appeared in 1958, and the plan designs that grew up in this previously unregulated market were largely created to satisfy very specific needs of particular organizations. There are, therefore, many more variations on a theme in the nonprofit benefit plan world, and anyone coming from the relative homogeneity of the 401(k) space may be overwhelmed. That said, this presents considerable opportunity for advisors to share best practice plan designs.

Greater diversity of employees

While most organizations grapple with the challenges of having to meet the retirement saving needs of different employee types, the diversity within nonprofit organizations can be even more complex. Within health care, for example, employees will range from highly paid administrative staff to highly revered physicians who are short on time to janitorial staff and cafeteria workers. Consider, too, that hospital employee populations are typically 70%-80% female, which means that large percentages of the employee base could be less prepared for (and less confident about) retirement due to lower salaries and careers that often include interruptions or long stretches of part-time work.

Image and identity

Many nonprofit organizations are highly focused on missions that define and permeate their cultures. Advisors should be respectful of those missions and consider how their interactions will be perceived.

Hospital systems are largely extensions of the communities in which they operate, and they take their responsibility to their surroundings very seriously. That sense of community may be a little more insular among colleges and universities, where there is often a deep sense of identity with the institution itself, especially among long-tenured employees.

Working environment

The different hours of operation among nonprofit organizations (especially hospitals) may be obvious, but advisors should understand that these differences will require (at least some) education meetings in the middle of the night to accommodate the 24/7 environment. In addition, education meetings and one-on-ones need to be portable so that they can be conducted wherever staff is located, since many cannot leave their stations.

Adding Value in the 403(b) Market

As of 2015, only 46.7% of 403(b) plan sponsors are using the services of an independent retirement plan advisor, and the usage rate is even lower (25.8%) among plans with fewer than 50 participants.[2] One survey found that among higher education organizations, although 41% used the services of an advisor, only 24% planned to hire one in the coming year.[3] While health care organizations are more likely to have ongoing advisory relationships, in higher education the work is often more project- and fee-for-service oriented. Overall, the most common services for which 403(b)s use advisors include investments (73.6%), plan design (64.4%), participant education (60.3%) and provider selection (52.3%).[4]

403(b) plan sponsors have made great strides in meeting the regulations that were introduced in 2009, but the effort is ongoing, and gaps still exist. If you are an advisor who has been successful in the 401(k) market, you can apply that same experience and expertise to the 403(b) market. By sharing 401(k) best practices, you are well positioned to bring real value to 403(b) plan sponsors and their participants.

Investments

403(b) plan sponsors are often less interested than their corporate peers in selecting and monitoring investments, so this is a natural place for advisors to demonstrate and deliver on their expertise. Advisors can be helpful not only in selecting and monitoring investments (roughly half of nonprofit plan sponsors review funds only on an annual basis)[5] but also in developing investment policy statements, since roughly only half of all 403(b) plan sponsors (and only a third of smaller plans) have an IPS in place.[6]

Best practices that have become fairly standard in the corporate market have not permeated the nonprofit world. For instance, the average number of investment options for ERISA 403(b) plans is 41, with larger plans offering more options than smaller ones.[6] Well-established research has shown that participants feel overwhelmed by too many options.[7] On the issue of default funds, some 403(b) plans continue to rely on money market or stable value funds, even while target-date funds have become the norm; and for their broader investment menus, many have not yet taken full advantage of the benefits of open architecture.

Advisors can assist plan sponsors in modernizing their fund options, which may result in better performing and less costly funds, and in choosing Qualified Default Investment Alternatives (QDIAs) that are more in keeping with best practices. (The DOL's tips on target-date funds are a good reference: www.dol.gov/ebsa/newsroom/fstdf.html.)

Fiduciary responsibilities, administration and compliance

Many nonprofit organizations are still not fully in compliance with the 2009 403(b) regulations, and advisors can play a valuable role in helping to bring a plan into compliance. Increasing awareness of fiduciary responsibilities also means that nonprofit organizations are more focused than ever before on issues such as fees and proprietary funds. Specifically, advisors can use their experience from the 401(k) world to help plan sponsors:

+ Consolidate and/or update the plan document and help ensure that the document is adhered to.
+ Share best practices in terms of committee structure and oversight.

Advisors can also play an important role by offering meaningful help and guidance with respect to plan administration, especially with the added demands associated with 403(b) regulations (and/or ERISA, if applicable). Advisors who are more familiar with the 401(k) world, and more comfortable working with the financial executives of the firms, will find in the 403(b) space that it is equally (if not more) important to build relationships with the benefit administrators.

403(b) fiduciary compliance

Additional insights about how 403(b) plan sponsors are meeting their fiduciary responsibilities can be gleaned from the Profit Sharing Council of America's 2015 403(b) Snapshot.

www.psca.org

Identifying opportunities

One of the most valuable tools in identifying the opportunities among nonprofit plans is the Form 5500, which ERISA 403(b) plans must now file each year. These forms can provide information on plan assets, numbers of participants, provider information, investments, etc. For information on nonprofit organizations that are not required to file a Form 5500, you may want to refer to the Form 990.

Plan expenses

Like their corporate counterparts, nonprofit plan sponsors are concerned about fees that they and their participants pay. Benefit budgets often mean that plans are having to absorb more costs, and employers' increased sense of fiduciary responsibility requires that they ensure that their participants are getting good value. Advisors can help plan sponsors by conducting benchmarking reviews to ensure that fees are competitive. Additionally, advisors should discuss different sources that can be used to pay for expenses and promote the benefits of implementing revenue equalization, which ensures that participants are paying only for the funds in which they're invested.

Provider due diligence (including selection and consolidation)

Since many nonprofit organizations have not conducted a thorough review of their provider(s) in more than five years (if ever),[8] due diligence may be long overdue. There is much to be gained from going through this exercise – especially given all the changes in the 403(b) retirement plan market – which can result in better funds, lower fees, enhanced services and more administrative support. And while most plan sponsors have consolidated the number of providers, 33% of higher education organizations and 10% of health care organizations continue to use a multi-provider structure and could reap the benefits of consolidation.[9]

Regardless of whether consolidation is on the table, advisors can be instrumental in helping plan sponsors with the entire due diligence process – issuing RFPs, benchmarking fees and services, conducting finals meetings and negotiating with prospective providers.

Education

Especially in the health care arena, which traditionally favors in-person, on location, one-on-one services, advisors have an opportunity to orchestrate, if not own, the retirement education offering made available to employees. By contrast, institutions of higher education tend to lean more heavily on electronic education solutions, translating into less opportunity for direct interaction with participants.

Given the legacy of 403(b) plans that allowed providers (particularly insurance companies) to sell other products to employees (and often focus on the high-salaried employees who represented greater financial rewards), advisors have an opportunity to bring greater objectivity to retirement education and to help ensure more consistent delivery of the service to all employee groups. Advisors can work directly with participants who are often overwhelmed by the decisions they need to make. And when contract exchanges are part of the equation, advisors can be instrumental in helping participants understand the pros and cons of consolidating their assets with a single provider.

Learn from those in the know

Some of the best teachers of 403(b) specifics are the recordkeeping firms that serve this market. There are fewer of them, so you can likely command a lot of their time and attention. These providers understand the value that advisors can bring and can provide a wealth of information to help you be as successful here as you have been in the 401(k) world.

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Focus on outcomes: retirement readiness and/or financial wellness

Plan sponsors in the health care space, who are acutely aware that many of their employees are not ready to retire, understand how this issue threatens to undermine their workforce management efforts. They are therefore very focused on participant outcomes, particularly retirement readiness, and many are now taking a more holistic view to focus on the overall financial wellness of their employees. This trend is also indicative of a more paternalistic attitude toward employee benefits.

By contrast, higher education plan sponsors have been less outcome-oriented to date. This may have to do with the effects of the multi-vendor environment, where communications are less coordinated or participant-focused, but could also be because employees in this space appear to be better off. Advisors new to this space may be surprised to learn that within higher education, organization contributions of 10% are not unusual, giving employees a significant leg up when it comes to retirement preparedness.

Advisors working with nonprofit organizations have an important role to play in turning the conversation – with plan sponsors as well as with participants – to retirement outcomes. The retirement crisis is playing out on the national stage, and employers of all types would do well to ensure that their plans are keeping pace. Advisors can help plan objectives evolve from one-dimensional measures of plan health (such as average participation or contribution rates) to more holistic measures such as retirement readiness (and even financial wellness). These concepts are often part of the evaluation in provider selection decisions and are increasingly viewed as best practices and integral to a plan sponsor's fiduciary responsibilities.

Plan design

While some 403(b) sponsors have worked to modernize their plans and to bring them more into alignment with the designs typically seen in the 401(k) market, generally speaking they still lag behind. These trends represent tremendous opportunity for advisors, with the following as just a few examples:[10]

+ Largely thanks to the Pension Protection Act, automatic enrollment and automatic escalation features are acknowledged as powerful tools in helping more participants become retirement ready. Currently, more than 50% of corporate plans have adopted these practices, yet among nonprofit organizations, adoption rates are much lower: 37.2% for hospitals, 18.9% for health care organizations and only 12.7% for higher education.
+ More than half of 401(k) plans permit participants to make Roth contributions, yet among 403(b) plans the rate is considerably lower: 38.6% for higher education, 36.4% for hospitals and 24.1% for health care.
+ Fear of retirement plan fund leakage through participant loans has helped many 401(k) sponsors reduce the number of allowable loans, although one could argue that more should be done. But while the percentage of 401(k) plans allowing three or more loans is 8.6%, for 403(b) plans the percentage is 19.7% (and of that, 7% have no limit!).

Modernization of plan design goes hand-in-hand with many of the other opportunities in the 403(b) plan space since simplification can increase cost effectiveness, enhance plan features and help participants make better decisions.

403(b) plan sponsors want and need your help

The world of retirement savings plans has witnessed incredible transformation over the past decade. Given that 403(b) plans historically operated separate and apart from 401(k) plans, compliance with regulations and best practices has presented a significant challenge. Although nonprofit plans look increasingly like their corporate counterparts, their legacy and unique characteristics offer real opportunities to advisors.

403(b) plan sponsors will be a receptive audience to advisors who can lend their expertise. Like 401(k) plan sponsors, they are looking for ways to enhance their benefit programs, lower fees, reduce administrative burdens and impact the retirement readiness of their employees. Research has shown that advisors can help drive these changes.[11]

403(b) plans can help diversify your business and expand your own knowledge of retirement savings plans. With more than $1 trillion in assets and growing, what are you waiting for?

Appendix – IRS Checklist for 403(b) Plans

403(b) PLAN CHECKLIST

IRS

This Checklist isn't a complete description of all plan requirements, and shouldn't be used as a substitute for a complete plan review.

For Business Owner's Use

(DO NOT SEND THIS WORKSHEET TO THE IRS)

Every year it's important that you review the requirements for operating your 403(b) retirement plan. Use this checklist to help you keep your plan in compliance with many of the important rules. For additional information (including examples) on how to find, fix and avoid each mistake, click on "(More)." See www.irs.gov/retirement and click on "Types of Retirement Plans" for Fix-It Guides and other resources for 403(b) and other plan types.

1. Is your organization eligible to sponsor a 403(b) plan? Yes ☐ No ☐
A 403(b) plan may only be established by public educational institutions and IRC Section 501(c)(3) organizations.
(More)

2. Has your organization adopted a written 403(b) plan? Yes ☐ No ☐
403(b) plan sponsors were required to have adopted a written plan by December 31, 2009.
(More)

3. Are the plan operations based on the plan document terms? Yes ☐ No ☐
Failure to monitor the operation of the plan may lead to a failure to follow the terms of the written plan.
(More)

4. Have all the organization's employees been given the opportunity to make a salary deferral to the 403(b) plan? Yes ☐ No ☐
Universal availability requires all employees be given the opportunity to make salary deferrals unless the plan specifically excludes a permitted category of employees. "Part-time" employees aren't a permitted category that may be excluded, but employees who normally work fewer than 20 hours per week are.
(More)

5. Are total contributions limited to comply with tax law? Yes ☐ No ☐
Total employee and employer contribution made to any plan participant can't exceed the lesser of $53,000 (for 2015) or 100% of includible compensation.
(More)

6. If an employee makes "15 years of service catch-up" contributions, does the employee have 15 years of full-time service with the same employer? Yes ☐ No ☐
Even if this requirement is met, a calculation must still be made to determine the level of available catch-up.
(More)

7. Are elective deferrals, including any catch-up and Roth contributions, within the limits of the tax law? Yes ☐ No ☐
Failure to limit deferrals to the legal limit may result in additional taxes and penalties to the employee and employer.
(More)

8. If your 403(b) plan offers a 5-year post severance provision, are amounts contributed through a non-elective method? Yes ☐ No ☐
Amounts contributed to a 403(b) plan that an employee had an option of receiving in cash are considered elective deferrals and aren't eligible for the 5-year provision.
(More)

9. Are you and your 403(b) vendors enforcing participant loan repayments and limiting aggregate loan amounts? Yes ☐ No ☐
If not, the loan may be deemed a taxable distribution and reported as income to the participant.
(More)

10. Are you and your 403(b) vendors requiring evidence that hardship distributions meet the plan hardship definitions and requirements? Yes ☐ No ☐
Hardship distributions must meet the requirements of the income tax regulations, the terms of the individual annuity contract/custodial account, and starting in 2009, the written plan document terms.
(More)

If you answered "No" to any of the above questions, you may have a mistake in the operation of your 403(b) plan. This list is only a guide to a more compliant plan, so answering "Yes" to each question may not mean your plan is 100% compliant. Many mistakes can be corrected easily, without penalty and without notifying the IRS.

- contact your tax advisor
- www.irs.gov/retirement
- call the IRS at (877) 829-5500

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