Kamp Consulting Solutions, LLC

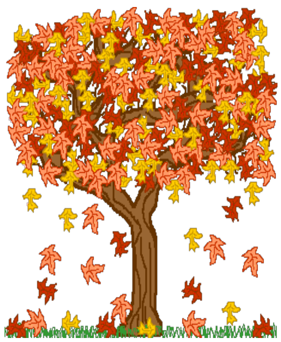
KAMP INSITE
Fireside Chat

Your Monthly Update from KCS

October 2013

403 (b) Plans: Oldies but Goodies!

Many of our friends and colleagues play important roles for non-profit organizations and religious institutions. These positions may be full-time or voluntary, mainly with finance or board of directors' responsibilities. These organizations are challenged to provide competitive benefit packages, including retirement plans, to retain valuable employees. Many of these organizations were unable to offer defined benefit plans, so the employees generally save for retirement through 403(b) or 457 plans.



As we discussed in a recent ***Fireside Chat***, a joint research study by Boston Research Group and Dimensional Retirement polled 200 plan sponsors in 2012, and asked how confident they are that their participants are prepared for retirement. A staggering 45% of the sponsors responded that they are not confident in their participants' retirement preparedness. In addition, ***more than half*** the plan sponsors are not confident that participants can convert their retirement savings into income to last over their lifetimes.

The U.S. retirement industry is undergoing a dramatic funding change from the employer maintaining the fiduciary liability and funding (defined benefit plan) accounts for their employees to the employee contributing the yeoman's share of their retirement assets and managing the account through a defined contribution structure (403(b), 401(k) and / or 457). We'll explore the history of 403(b) plans, the types of investment platforms, updated regulations and sponsor / committee considerations over the long-term to ensure plan sponsors provide their employees with an environment to maximize this benefit.

Inside This Issue

In the Beginning

A Section 403(b) plan is a retirement vehicle offered by educational institutions, not-for-profit organizations and 501(c)(3) organizations including hospitals, foundations and service organizations. The original 403(b) programs began in 1958 for public school employees to save for retirement via an annuity vehicle. In 1974, mutual funds became an option when the internal revenue code added individual custodial accounts. In 1986, 403(b) programs began to resemble their 401(k) counterpart with the institution of early withdrawal penalties, annual contribution limits and required minimum distributions. In 2001, pension portability was achieved via coordination to other elective plans such as 401(k), 457 and IRAs.

The major changes affecting plan sponsors took place in 2009 when the final 403(b) regulations became effective. For the first time, employers were required to have a written plan document and to comply with IRS rules.

In the Beginning (cont'd)

Disclosure rules and reporting requirements for investment vehicles were added in 2012 which further aligned 403(b) plans with other defined contribution plan types.

Plan Benefits

"According to IRS statistics, it is estimated that 403(b) plans comprise more than $750 million of the $5 trillion invested in defined contribution plans."

Both employers and employees can benefit from maintaining a 403(b) plan or account. Some advantages for the employer are attractive benefits to retain high-quality employees and a shared cost of funding between employers and employees (in some cases, only employees contribute to the 403(b) plan). For the employee, there is reduced taxable income through pretax contributions and tax-deferred earnings on plan contributions. If the contributions are made to a Roth 403(b) account, earnings can be tax-free. In addition, the likelihood of paying less tax on assets as distributions usually occur during retirement, when an employee may be in a lower tax bracket. Furthermore, there is the ability to take loans or hardship withdrawals. According to IRS statistics, it is estimated that 403(b) plans comprise more than $750 billion of the $5 trillion invested in defined contribution plans.

403 (b)(1), (b)(7), (b)(9) … Bingo!

Participant accounts under a 403(b) plan are generally one of these types:

- A 403 (b)(1) annuity contract usually offered by insurance companies, also known as tax-sheltered annuities (TSAs) and tax-deferred annuities (TDAs), where underlying investments in subaccounts may include mutual funds.
- A 403 (b)(7) custodial account provided through a retirement account custodian in which investments are limited to regulated investment companies, such as mutual funds.
- A retirement income account 403(b)(9), for which there is usually no restriction on investments.

The sponsoring organization usually determines the financial institution(s) at which individual employees may maintain their 403(b) accounts, which in turn determines the type of 403(b) accounts that the employees may fund.

ERISA's Role

The Employee Retirement Income Securities Act of 1974 (ERISA) outlines the duties and responsibilities borne by organizations that establish and maintain employee benefit pension plans. While some 403(b) plans are not subject to ERISA (governmental employers and churches), many employers are finding that the effort it takes to avoid ERISA requirements are not worth the potential organizational risks. Embracing ERISA enables sponsors to design a plan to benefit both the employees and the organization. More 403(b) plans are becoming subject to ERISA because employers are making contributions other than elective deferrals (i.e., matches and non-elective contributions) and employers are taking discretion over plan administration in the areas of distributions, hardship withdrawals, plan-to-plan transfers and enforcement of loan provisions.

Sponsor Considerations

Organizations whose plans are either subject to or desire to follow ERISA should be aware of platform characteristics, fees, participant needs and fiduciary responsibilities when offering 403(b) plans. The 403(b) plan landscape is different than it was even just a few years ago. Legislative and regulatory actions have put employers squarely in the center of responsibility for 403(b) plans. The changes have made 403(b) and 401(k) plans similar in many ways.

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Bundled or Unbundled?

The traditional bundled 403(b) plan has all services provided by one single vendor, including investment, recordkeeping and administrative services. An insurance company is usually the recordkeeper/administrator who selects the underlying mutual funds. Under certain contracts, the insurance company also controls mutual fund changes which some sponsors prefer. Some 403 (b) custodial accounts offered by mutual fund companies may also have bundled characteristics. The mutual fund company usually offers a proprietary lineup of mutual funds and also handles participant servicing.

With the advent of disclosure regulations and reporting requirements similar to 401(k) plans, unbundled platforms are beginning to find their way into the 403(b) space. In an unbundled model, the plan sponsor (employer) becomes the "bundler." Plan sponsors obtain services through a combination of in-house staff and independent service providers for each critical task. In other words, a plan sponsor could have recordkeeping, fund management and administration & compliance performed by separate vendors. This approach can allow for maximum control and the ability to pick some of the best service providers and high-quality investment options from a very large universe of funds.

Regardless of platform used, plan sponsors need to take an active role to ensure it meets the participants' needs at a competitive cost. Investments should be reviewed at least annually to ensure adequate choices are available for participants and fund performance is reasonable relative to benchmarks and peer groups over all the funding vehicles offered. In addition, vendor services should be reviewed to ensure they are meeting both participant needs and administrative standards.

Fees

403(b) plans may be offered as a variable annuity or a collection of mutual funds. Variable annuities invest in subaccounts of underlying portfolios that usually contain a diversified lineup of mutual funds. They offer participant death benefits that charge an additional fee called a mortality and expense (M&E) risk charge in addition to the mutual fund fees. As the account grows, the M&E declines over time. There may be surrender charges that may last for up to seven years if withdrawals are taken before the surrender period ends. Mutual fund platforms tend to be less expensive than their variable annuity counterparts since they do not provide the death benefits. In light of the 2012 regulations regarding participant fee disclosures for ERISA plans, sponsors should review their fund expenses and total plan costs at least annually to ensure they are competitive with their peers.

Education is Essential

Understandably, many employees are not comfortable with the newfound responsibility for managing their retirement assets, as in most cases they don't have a formal education in the investment field. Getting employees to contribute enough to their plans is a challenge unto itself, but once the money is invested, creating an asset allocation that will meet their future retirement goals and investing those assets in the appropriate funds is an entirely different problem.

Plan participants are prone to biases that negatively impact investing programs. Many investors fall prey to investing in the "hot fund". In many cases, the performance of that above average fund has been influenced by market forces and not necessarily driven by manager skill so it is imperative that participants receive investment education to understand asset allocation basics and asset classes. Sponsors need to invest time and resources for employee education as participants are controlling their retirement destiny and account balances are continuing to increase.

> *"Whether an ERISA plan or not, you can help your organization act in the best interests of participants by having your 403(b) committee follow ERISA's guidelines of loyalty, prudence, diversification and duty to follow plan documents, which protects both the plan participants and plan sponsors."*

Fiduciary Responsibilities

The new 2009 IRS Regulations hold employers responsible to 403(b) plan operational compliance. As stated earlier, church, public education and governmental 403(b) plans are still not subject to ERISA. Even though ERISA may not apply to certain plans, most plan sponsors have some fiduciary responsibility imposed by state laws. Whether an ERISA plan or not, you can help your organization act in the best interests of participants by having your 403(b) committee follow ERISA's guidelines of loyalty, prudence, diversification and duty to follow plan documents, which protects both the plan participants and plan sponsor.

Reach Out

As 403(b) plan assets continue to grow, plan sponsors or members of the plan committee may want to consider the services of an investment or pension consultant to assist with plan compliance. They can help plan sponsors with establishing a governance structure, fee disclosure, platform selection, investment analysis, fiduciary review and vendor selection and monitoring.

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@ RussKamp
@ KampConsulting

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