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The 403(b) Market after Tax Reform

The 403(b) market will change greatly in the months following passage of the Economic Growth and Tax Relief Reconciliation Act of 2001. This new tax law opens the door to major new players, large securities firms in particular, because it increases the inducement and reduces the costs and risks involved in serving the 403(b) market. This raises important questions, both for companies entering the market and for those already established in it:

- **How will the 403(b) market change in the next year or so?**
- **Will compliance continue to be a key issue?**
- **Where will new and existing market players find competitive advantages?**

Please note that we will not be addressing every tax law change that affects 403(b) plans. Rather, we will try to analyze those elements that will affect the way 403(b) plans are marketed, and that will affect who the new winners and losers will be.

How will the 403(b) market change after tax reform?

Four important changes can be anticipated as new tax rules go into effect in 2002:

1. Compliance will become less a barrier to entry for new competitors.
2. Increasing contribution limits, added to other stimulants to market growth, will attract potent new competitors.
3. The new "Roth 403(b)" option will eventually put added pressure on all competitors.
4. The future will generate an increasingly tense and closely matched struggle between low-cost securities firms and service-oriented insurance companies.

Compliance becomes less of a barrier to entry

Before Tax Reform: About 85% of the 403(b) market is controlled by insurance companies marketing annuities as funding vehicles; most of the remaining 15% is mutual fund business. Among the insurance firms, all those with over 1% market share provide their clients with Maximum Exclusion Allowance (MEA) calculations upon request. Increasingly, these insurers have been required by their clients to sign Hold Harmless agreements, which, in effect, guarantee the accuracy of their compliance calculations. The larger insurance companies have generally agreed to accept this liability, while many smaller players in the market have either been highly selective about which agreements they will sign, or have refused to sign them at all.

Securities companies, in contrast, have generally refused to perform compliance testing or to sign Hold Harmless agreements. Although there are exceptions to this generalization, in many recent cases, providers of no-load funds in particular have been eliminated from the list of authorized product vendors in school districts, either because they have not been helpful during IRS audits or because they have refused to sign Hold Harmless agreements. Until now, in fact, most mutual fund companies have either stayed out of the 403(b) market altogether, have accepted only transfers and rollovers (not new money), or have participated in only a limited, half-hearted fashion. The main causes of this diffidence have been the difficulty and liability involved in IRS compliance, particularly concerning contribution (MEA) limits.

After Tax Reform: The new law significantly lowers the barriers to market entry in two ways:

First, it considerably simplifies the IRS rules pertaining to 403(b) plans. Combined with recent regulations simplifying Required Minimum Distributions and other statutory and regulatory changes in the last few years, the administrative and compliance differences between 403(b) and 401(k) plans have vastly diminished. This means that the huge administrative and marketing apparatus built by the securities industry for 401(k) plans can now be much more easily adapted to the 403(b) market.

401(k) providers can now apply their existing systems and services more easily to the 403(b) market.

Second, the new tax reform bill reduces liability. This reduction stems in part from simplification: simple rules are easier to understand, calculate, explain, and enforce. Companies that never mastered the complex old rules will now be only a little way behind those who have invested many years in building up compliance expertise. Furthermore, the new rules are more liberal, particularly regarding contributions. Only a small percentage of plan participants will need to give the limits even a passing thought. The upshot: liberalization means that fewer situations will demand contribution limit calculations, and simplification means that those situations will generally be far easier to deal with. There is still a bar, but it is much closer to the ground!

Will those companies, both securities firms and insurance companies, who have been reluctant to take responsibility for 403(b) compliance now find it safe to do so? Certainly, some will not. But many who have held back from the market, including some of the largest securities firms, will now leap into the 403(b) market – some with both feet, others more cautiously.

Increased opportunity stimulates greater competition

Before Tax Reform*:* For the past decade or so, securities firms pretty much have owned the 401(k) market, while insurance companies have dominated the 403(b) market. There are many reasons for this division, but in the end, it has probably been mostly a matter of fit: 401(k) plans are sold to employers, and relatively low-cost products have been an essential feature of the sale; whereas 403(b) funding is usually sold directly to plan participants, who often require the personal touch that insurance companies provide through their agents and brokers.

Securities firms have been more or less content with the 401(k) market, since it is several times larger than the 403(b) market, and has experienced unparalleled growth in the 20 years it has existed. Although the 403(b) market has also grown, its growth rate has been far slower. Given the barriers to entry into the 403(b) market, most securities firms, as we've seen, have held back.

After Tax Reform: Several changes are in the wind, some related to the new tax law, some not. In combination, though, they make the 403(b) market much more attractive than it was:

First, growth rates in the 401(k) and 403(b) markets will be much more similar in the next ten years than they have been in the last ten years. Why? For one thing, the 401(k) market (except in the small company segment) has neared saturation: most decent-sized companies who are eligible to establish 401(k) plans have already done so. Furthermore, 403(b) plan growth is particularly favored by demographics. As a second baby boom works its way through childhood, the ranks of teachers, and eventually of college professors, will expand much faster than employment in the for-profit sector. Furthermore, as the original baby boom generation ages, and as health care improves, the over-50 population will grow rapidly and the need for health care professionals will continue to increase. Since education and health care are the principal markets for 403(b) plans, the future for such plans is bright.

While the 401(k) market is pretty well saturated, demographics favor future growth in the 403(b) market.

Second, tax law changes provide opportunity for accelerated asset growth in both markets. Increased contribution limits mean more revenues for 403(b) providers. Lower Required Minimum Distribution amounts mean reduced withdrawals. Although these changes will help at least as much in the 401(k) market, they do make the 403(b) market increasingly attractive.

Tax law changes will stimulate asset growth in the 403(b) market, thus increasing the incentive to enter, and reduce the obstacles.

Third, as we've already seen, easier compliance requirements remove much of the reason that new competitors have stayed away from this market, and that many relatively quiet players have held back from more vigorous efforts.

So where will the new competition come from?

1. **Large mutual fund companies** who have thrived in the 401(k) market but have held back from the 403(b) market in the past.
2. **Securities firms that have been accepting 403(b) transfers and rollovers**, but not new contributions. They have already mastered many of the administrative peculiarities of 403(b) plans, and are well positioned to begin accepting new money as well.
3. **Large insurance companies who have not aggressively pursued 403(b)** business in the past. Many of them, over the past 40 years, have almost inadvertently accumulated substantial 403(b) assets – sometimes billions of dollars worth. But compliance issues have kept them ambivalent about this market. That may change now.
4. **Smaller companies seeking high-potential specialty markets** can now move into the 403(b) arena without having to develop sophisticated compliance capabilities or worry about taking on excessive liability.

The Roth 403(b) Account: a rose with a sharp thorn (effective 2006)

Before Tax Reform*:* One of the unique but constant problems in the 403(b) market is competition for "payroll slots." Since, in most cases, the employer has to segregate salary deferrals and forward them to the various product providers, each provider needs a "payroll slot" through which contributions pass. Many plan sponsors, in order to simplify their task or because of system limitations, restrict the number of payroll slots. Even in today's environment, competition for payroll slots can be brutal in such situations.

After Tax Reform: The new law authorizes for the first time contributions to "Roth"-type 403(b) accounts – i.e., contributions go in on an after-tax basis, and all future withdrawals are tax-free, assuming the rules are followed. No one is *required* to offer Roth accounts. However, it seems likely that plan sponsors will find this option attractive when it becomes available, especially since Roth plans will be most beneficial to higher income participants, including the administrators who make the decisions.

Among the problems created by this opportunity is the requirement that pre-tax and Roth monies be held in different accounts. Setting up separate payroll slots for Roth accounts will be the easiest way to implement this. But then the number of needed payroll slots will double for each product provider offering a Roth option. In most cases, employers are unlikely (or will even be unable) to handle such an increase in payroll slots. In order to offer Roth accounts, therefore, many plan sponsors will probably reduce the number of providers.

In most cases, the new Roth 403(b) option will require another payroll slot. As if the competition was not bad enough already . . . .

It seems likely that some of the new entrants to this market, particularly mutual fund companies who have been doing a lot of business in the Roth IRA market, will be quick to seek payroll slots for both pre-tax and Roth accounts. The fact that such entrants are equipped to offer the Roth option, and many of the traditional 403(b) companies could lag in this regard, may give employers a good reason to accommodate a newcomer – perhaps at the expense of *two* less nimble companies who already have slots. Existing slot-holders who have many contributors are probably safe. Companies not taking much advantage of their slots, however, will lose them.

Perhaps more importantly, though, companies who are slow to offer the Roth option may find themselves unable to come late to the dinner table. All the chairs will be taken! Since the Roth option does not become available until 2006, however, there is time for everyone to get ready – but there may be a terrifically fierce contest once the doors open.

Battle of the Titans: securities firms vs. insurance companies

Before Tax Reform*:* As we've seen, insurance companies have been dominating the 403(b) business (although securities firms have made significant inroads since 1974). Will this change?

After Tax Reform: At the very least, competition will become more fierce. It is unlikely that the insurance industry will give up its majority position any time soon, as it did in the 401(k) market during the 1980s. As long as the individual continues to own the product and make the investment decisions, as occurs with most 403(b) contributions, reaching these individuals is a labor-intensive activity that favors the companies who can send representatives to homes and workplaces. The insurers are overwhelmingly better positioned in this regard.

At the same time, mutual funds generally have a distinct cost advantage over annuities – in large part because of a far less costly distribution and support system. They also often have greater acceptance with the public.* Plan participants who feel that they do not need much help in determining their own financial needs are particularly likely to select mutual funds – and will become more likely to do so as more fund options become available.

It is hard to imagine anything other than increased hardening of the competitive forces: lower-cost, lower-service providers on the one hand, and higher-cost, higher-service providers on the other.

* A brand new, first-time study of the reputation of financial services companies by *American Banker* puts only two insurance companies in the top 20. Sixteen of the top 20 are securities firms of some kind.

The likely outcome is further hardening of the competitive lines in the 403(b) market: lower-cost, lower-service providers on the one hand, and higher-cost, higher-service providers on the other.

But won't the low-cost market continue to constitute only a modest percentage of the total, since most eligible employees don't know enough or don't care enough to participate effectively without personal guidance? If so, we would see increased competition among securities firms fighting for the smaller piece of the pie, while insurance companies still command the lion's share. While this is possible, we think for several reasons that it will be less and less true over time:

1. Consumers are becoming smarter about their finances in general; and are increasingly experienced in understanding and investing in mutual funds in particular.
2. The kind of computer-based employee education and advice that has increasingly and effectively been made available in the workplace to 401(k) plan participants will begin to appear, and perhaps rapidly spread, in 403(b) workplaces. With the simplification of 403(b) rules, companies adept at 401(k) sales and administration can make pretty sophisticated 403(b) tools available at pretty modest cost by using internet technologies.

> ***Companies adept at 401(k) sales and administration can make pretty sophisticated tools available at pretty modest cost by using internet technologies.***

3. The new entrants to the 403(b) markets are experienced and savvy marketers. Existing players will need new approaches to keep up with their new rivals.

Will 403(b) compliance still matter?

Compliance will certainly be easier under tax reform, but it will not go away. Employers in all markets, especially public school districts, have become highly sensitized to compliance issues as a result of recent IRS audits. This will not change, and it may even intensify. Why?

1. The IRS has stated its intention of continuing to audit plans, notwithstanding changes in the tax rules. Furthermore, now that the rules will be simpler, compliance monitoring will be simpler, which may let the IRS audit more institutions without increasing staff.
2. Even without continued (or even increased) IRS pressure, there is simply no motivation for plan sponsors to reduce their requirements under the new tax law. Those who have been getting free compliance support from their providers will still demand it, regardless of whether it is hard or easy.
3. Since compliance will be easier and less risky, more companies will be willing to provide it, and plan sponsors will be in a stronger position to insist on it. Less worried about losing desired product vendors, they will be freer to insist on Hold Harmless agreements. We expect such requirements to increase, rather than diminish.
4. The IRS has generally been very lenient about errors, rarely imposing penalties beyond payment of back taxes and interest. Most likely, this leniency stems from their awareness that the rules governing 403(b) plans have been so complex that even experts often make mistakes. However, now that the rules will be reasonably simple to understand, the excuse is gone. It will be interesting to see whether then IRS continues its forgiving ways.

Fortunately, the area of compliance that the IRS has identified as causing the biggest problems, 403(b) contribution amounts, is the area of the tax code most radically simplified by the new tax law, and among the areas most liberalized. The complicated Maximum Exclusion Allowance calculation is entirely repealed, along with most of the catchup provisions. Increased limits under

Internal Revenue Code sections 415 and 402(g) mean that fewer participants will want to contribute anywhere near their maximum permissible contribution amounts.

Of course, there are still areas in which 403(b) compliance is trickier than 401(k) compliance: there is still a special catchup provision for elective deferrals under 403(b) plans, and a special §415 alternative for church employees. Mandatory contributions to state retirement systems still reduce includible compensation under §415, and other defined contribution plans offered by the employer now need to be aggregated with 403(b) plans. In addition, both 401(k) and 403(b) plans now have special catchup provisions for participants age 50 and over.

> ***Compliance will now be much easier, but it remains a pitfall for any who think that they can disregard it altogether.***

All this creates a danger: now that perhaps 90-95% of participants won't be anywhere near their legal contribution limit, providers may be lulled into complacence. If so, they will stumble over that small percentage of situations where the rules still need to be tested. If those tests are not done, opportunities for additional contributions will be missed. Much more seriously, excess contributions may be made, exposing all parties to IRS sanctions.

So, while compliance will be much easier, it still matters, both because the IRS and plan sponsors will continue to require it, and because there are still opportunities and traps connected with it.

Finding a competitive edge in the 403(b) market

If, indeed, the 403(b) market becomes much more competitive over the next year or so, everyone is going to be looking for an edge. Companies who are well established in the market clearly start out with an advantage, but they may have to work extra hard just to stay put.

We have hypothesized that the market competition will increasingly congeal around two opposed strategies: low-cost, low-service providers vs. high-cost, high-service providers. In reality, of course, these are just two poles of a continuum. Winners can be anywhere along that continuum. Losers will be those who wander off of it: providing low service at high cost.

There are other elements to success, of course, and particular companies have special advantages such as superior name recognition, crossover from other financial services provided in the same markets, the financial strength required to invest in pumping up market share, and/or unusually large or unusually potent distribution systems. But most competitors, whether new or old, will probably concentrate on one of the two main strategies we have identified.

The low-cost, low-service strategy

The way to win with this approach is: (1) to have a low-cost product (ideally, a no-load, high-performing fund), and (2) to provide the best service possible consistent with low cost. Let's focus on the second element: what will low-cost providers need to do in order to offer minimum clearance over the lowered compliance bar and, preferably, also offer something else that will put at least a little flesh on the service bones, without incurring high costs?

> ***Companies with state-of-the-art 401(k) marketing and administrative support will find most of it adaptable to the 403(b) market. But it <u>will</u> need to be adapted, and a compliance module will need to be added.***

Compliance will not necessarily be an expensive proposition. We would recommend a two-step, low-cost approach. First, institute a threshold at which compliance will need to be tested. Under the new rules, this can be a high threshold – for example contributions that are more than $11,000 and/or more than 25% of salary. (A more stringent rule would be required, however, if a 401(a) or 401(k) plan were also offered by the employer.) Second, offer a web-based compliance calculator for any individuals above those limits. Data could be input by the plan participant. As long as the calculator is programmed correctly, the compliance burden would automatically be lifted, in most cases, since in most Hold Harmless agreements incorrect data provided by the client gets the product vendor off the hook. Furthermore, results of the calculation could be captured directly off the web server, and forwarded to the system that accepts or rejects new contributions.

Companies with experience in the 401(k) market will often already know how to provide other services at low cost, including participant education, enrollment, advice on asset allocation and rebalancing, on-line fund transfers, and the like. Such services can add substantial value to a 403(b) plan, especially since even many of the higher-cost providers do not deliver them effectively. In fact, adding a fairly simple contribution limit compliance module to a package of 401(k) systems and services lightly adapted to the 403(b) market will probably give many securities firms a running start with 403(b) plans. A large investment is not necessarily required.

Of course, caution is in order here. There are many differences between the two markets, even though the differences in the plans themselves have greatly diminished. New entrants should not assume that 401(k) strategies always carry over automatically and easily. They don't.

The key to success with the low-cost, low-service strategy will be to make the option highly visible and to make the support, automated or otherwise, readily available. Employer involvement in the 403(b) market is much more passive than in the 401(k) market, since participants usually own and control their own funds. Low-cost providers need to find ways to get their message to participants with little or no help from the employer. Those who learn to do it will be well repaid.

The high-cost, high-service strategy

In the past, this strategy has succeeded because most people, in fact, do need or want help, and will not participate in a pension plan (or will participate only at a low level) unless someone actively persuades them otherwise. Human nature being what it is, there is no reason to expect this behavior to change soon. However, there is no room for complacency here, because:

1. there will be increased competition in this part of the market, too;
2. the 401(k) companies moving into the 403(b) business will bring increasingly effective sales and support with them, and will capture a bigger share of those employees who are willing to take just a little initiative, or who get strong referrals from fellow workers. To put it another way, more of the "easy" sales will go to the low-cost companies;
3. better technology, and a workforce increasingly acclimated to technology, will make low-cost web-based support more competitive with old-fashioned face-to-face sales and service. Companies willing to spend on face-to-face service are going to have to increase the value of that service to stay ahead.

High-cost companies often don't have the level of automated support that low-cost companies offer – this level should be considered a minimum. But in addition, they need to offer extra services to both the individual participant and the plan sponsor.

The most successful high-service companies in the future will probably at least match the service levels of the best low-cost companies, then add more to the mix. This sounds obvious, but that doesn't make it easy. Many of the high-service companies have relied on providing face-to-face service only. But in the eyes of many customers, web-based support is better support: it is available any time day or night without an appointment; it can be very fast and easy, virtually or actually paperless, and does not require clients to interact with a live person when they don't want to. This is not to say that automated support is better, but it may need to be an available option.

In addition, high-service providers must offer support above and beyond the competition. Such support needs to be directed to both the individual plan participant and the plan sponsor.

For the individual participant, sample additional services can include:

- help determining retirement planning needs (and other family financial needs).
- hand-holding on 403(b) compliance.
- expertise (including free benefit calculations, evaluation of years-of-service buyback offers, and the ability to answer technical questions) on the state retirement system and/or other available benefit plans.
- advice on savings levels and asset allocation that takes into account personal desires and unusual family circumstances, not just boilerplate allocations or mathematical models.
- pro-active help in reviewing needs and opportunities when circumstances change (when a raise occurs, when federal contribution limits increase, when family circumstances change, when retirement approaches, etc.).

For the plan sponsor, sample additional services can include:

- free educational services that will encourage plan participation.
- explanations of plan provisions and tax rules to both clients and non-clients.
- compliance services for the entire employee group.
- common remitter services for the entire employee group.
- free consulting to employers on how to use the 403(b) plan to attract, retain and reward key employees (especially in public schools, state-owned institutions, and church-related organizations not subject to non-discrimination testing).

Conclusion

We strongly believe that any company that identifies its desired position in the market and develops the products, tools and methods suitable to that position can greatly increase assets under management and profitability in the next few years. This market is primed for growth; there will be many winners. The losers will be those who think that they can do nothing, or do only what they have always done. The new tax law announces a sea change in the market. Those who trim their sails accordingly will have a profitable voyage. The rest will get swamped.

It is our fervent hope that our clients and friends will be those who not only survive the change, but prosper from it. As always, we remain committed to our clients' success in this market and are ready to work with those who want the tools and services to ensure that success.

Still River Retirement Planning Software, Inc., provides both web-based and desktop software to help with 403(b) compliance, calculations relating to state retirement systems, and other specialized calculations dealing with 403(b) and other types of retirement plans. However, we do not offer web-based sales, enrollment, or administrative systems for either 401(k) or 403(b) plans, nor do we offer general consulting services regarding the establishment or maintenance of such plans.

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