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Improving investment outcomes for 403(b) plan participants


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Retirement security continues to be an important financial priority for every American. The Setting Every Community Up for Retirement Enhancement Act (SECURE Act), enacted in late 2019, took several important steps to strengthen retirement security, especially across the defined contribution landscape. In recent months, market turbulence and economic headwinds resulting from COVID-19 have created challenges for many trying to save for retirement. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act), a bipartisan COVID-19 stimulus package enacted at the end of March 2020, included provisions designed to give retirement savers more flexibility to access their defined contribution retirement savings to help cover short-term spending needs during this crisis. Building on the SECURE Act and the flexibility provided by the CARES Act, policy makers can take additional steps to enable plan participants to achieve better retirement outcomes. In this *ViewPoint*, we highlight a relatively easy step that would expand choice for 403(b) plan sponsors in selecting investment vehicles and be cost effective for plan participants.

Today, plan sponsors of 401(k) plans can select mutual funds, annuities, collective investment trusts (CITs), or separate accounts to offer investment choices to plan participants. In contrast, most plan sponsors of 403(b) plans – which are defined contribution plans used by hospitals, universities, and other educational organizations – are precluded from selecting CITs, sometimes referred to as collective trust funds.[1] Of the 6.1 million participants in 403(b) plans governed by the Employee Retirement Income Security Act of 1974, as amended (ERISA) – which governs about half of all 403(b) plan assets[2] – 3.7 million participants work at hospitals or other healthcare businesses.[3] Interestingly, current applicable law and regulations allow 403(b) plans that are "Church Plans" to invest in CITs[4] – giving participants in those plans access to these vehicles – but the remainder of 403(b) plans are not permitted to provide their participants with that same opportunity. BlackRock supports legislative efforts to modify the Internal Revenue Code (IRC) and the federal securities laws to allow 403(b) plans to invest in U.S. bank-maintained CITs in addition to mutual funds, as already permitted by current law.

In this *ViewPoint*, we provide an overview of the features of CITs, why plan sponsors use CITs in 401(k) plans, the potential cost savings for 403(b) retirement savers if CITs were permitted as an investment option in all 403(b) plans, and ongoing legislative efforts to change the law, including the IRC, to allow all 403(b) plans to have the option to invest in CITs.

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Key observations and recommendations

1. Today, 401(k) plans are permitted to invest in U.S. bank-maintained CITs; however, most 403(b) plans are not.
2. CITs are highly regulated and have the potential to provide many benefits to plan sponsors and their plan participants saving for retirement. CITs can offer pricing flexibility, can be used to customize investment options, can provide access to a broader range of asset classes and investment strategies, and can experience lower portfolio turnover, which can result in lower transaction costs.
3. BlackRock believes that all 403(b) plans should be permitted to invest in CITs, as 403(b) plan sponsors should have the same ability as 401(k) plan sponsors to select these investment vehicles if they believe this selection could improve outcomes for their participants.
4. BlackRock encourages Congress to enact legislation that would permit all 403(b) plans to invest in CITs.

Overview of CITs

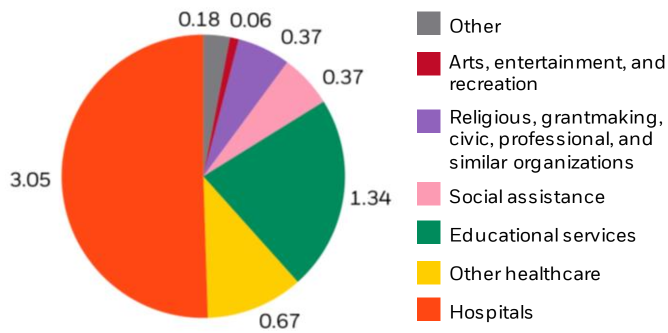
A CIT is a bank-sponsored pooled investment vehicle organized as a trust. The sponsoring bank, which may be nationally or state chartered, is the CIT trustee and often is also the CIT investment manager. Unlike a U.S. mutual fund, a CIT is exempt from registration under the Investment Company Act of 1940, provided it complies with certain requirements, including restrictions on the types of eligible investors. A CIT's eligible investors are different types of retirement plans that meet specific requirements under the IRC, federal securities laws, and banking law. CITs are highly regulated. A CIT's primary regulator is either the Office of the Comptroller of the Currency (OCC) (in the case of a sponsoring bank that is nationally-chartered) or the applicable state banking regulator (in the case of a sponsoring bank that is state-chartered). Unlike U.S. mutual funds, a CIT is also subject to ERISA (and U.S. Department of Labor oversight) if any ERISA plan assets are invested in the CIT.

CITs invest across a variety of asset classes (e.g., stocks, bonds, cash, and alternatives, such as real estate and commodities) with focused or multi-asset exposure, pursuant to both index and actively-managed strategies. The indexes that are used as benchmarks in CIT strategies include the same indexes that are used as benchmarks in mutual fund strategies.

Use of CITs in Retirement Plans

Today, many types of retirement plans, including 401(k), 457(b), and defined benefit retirement plans, are permitted to invest in CITs. Many of these plans choose to invest in CITs due to their flexibility and generally lower expenses as compared to other available investment vehicles. Under current law, 403(b) plans, however, are generally limited to investment in mutual funds or annuities. This limitation prevents most 403(b) plan participants from access to CITs, which is a distinct disadvantage relative to 401(k) plan participants.

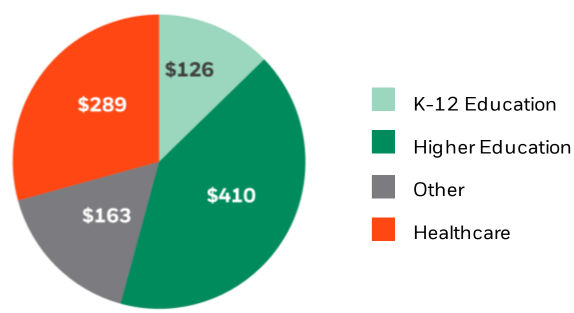
Exhibit 1: Participants in ERISA 403(b) Plans (millions of people)



Source: The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at ERISA 403(b) Plans, 2016 (published April 2020), Exhibit I.3, available at https://www.ici.org/pdf/20_ppr_dcplan_profile_403b.pdf. Note that 403(b) assets governed by ERISA represent approximately half of total 403(b) assets (see endnote 2).

Exhibit 2: Total 403(b) (ERISA and non-ERISA) Assets by Sector ($ billions)

Total Assets: $988 billion



Source: Cerulli US Retirement Markets, 2019, data as of 2018.

There are current provisions under applicable law that together allow 403(b) plans that are "Church Plans" to invest in CITs.[5] Participants in those plans have access to these vehicles, but the remainder of 403(b) plans are not permitted to provide their participants with that same opportunity under current law.

CITs can offer many benefits to plan participants, which may explain why it is estimated that nearly 28% of total 401(k) assets ($1.5 trillion) is invested in CITs,[6] with a comparatively high concentration among larger employers. 401(k) CIT assets grew an annualized 28% from 2013-2018, versus 2% annually for 401(k) mutual fund assets over the same time period.[7] Some of the key features that have made CITs a popular choice among 401(k) plan sponsors are described below.

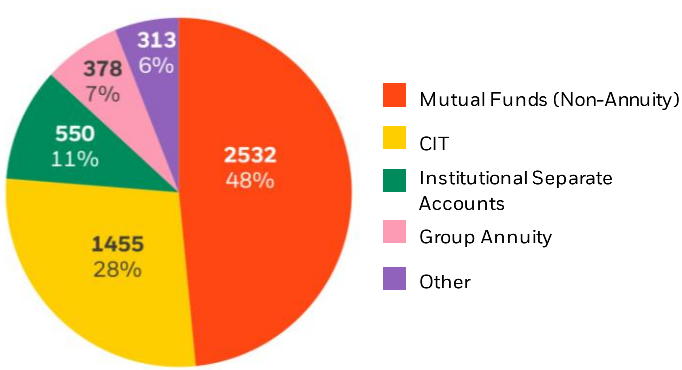
1. **Pricing flexibility and lower fees**. CIT pricing can be tailored to a plan, providing flexibility. CITs offer different opportunities to structure fees based on plan needs (e.g., fees accrued and reflected in a CIT's net asset value per unit (NAV) or fees invoiced directly to the plan). Because CITs are privately offered to plans that are eligible investors, they typically have lower administration and marketing and distribution costs, which often translates to lower expenses relative to other comparable investment vehicles.
2. **Effective means for delivering customized investment options**. CITs can be used to tailor an investment option (or a menu of investment options) to optimally fit the needs of a particular plan. For instance, 401(k) plan sponsors have used CITs to offer participants a target date investment option with a glidepath that has been customized to better meet the needs and demographics of a particular employee population.[8] A plan sponsor may wish to include an investment option or an asset class that is consistent with the economic interest of plan participants and reflects the values of the employing organization (e.g., by using environmental, social, and governance (ESG) considerations). CITs can also offer the flexibility to adopt a customized benchmark that meets a given plan's requirements.
3. **Breadth of asset classes and investment strategies**. The benefits of diversification in the context of retirement investing are commonly understood. Certain diversifying asset classes and/or strategies may be available only through a CIT (e.g., alternatives, such as commodities and real estate).
4. **Performance**. Because CIT assets are typically retirement plan assets with a long-term investment horizon, CITs tend to have more predictable cash flow patterns. As a result, CITs typically have lower portfolio turnover than other comparable investment vehicles that are open to a broader cross-section of investors, which can reduce transaction costs. In addition, more predictable plan-directed contribution and withdrawal patterns allow CITs to limit cash balances maintained to meet potential significant redemptions, which can potentially avoid the drag on performance that can result from maintaining larger cash balances.

Providing 403(b) Plan Participants the Same Options to Invest in CITs as 401(k) Plan Participants

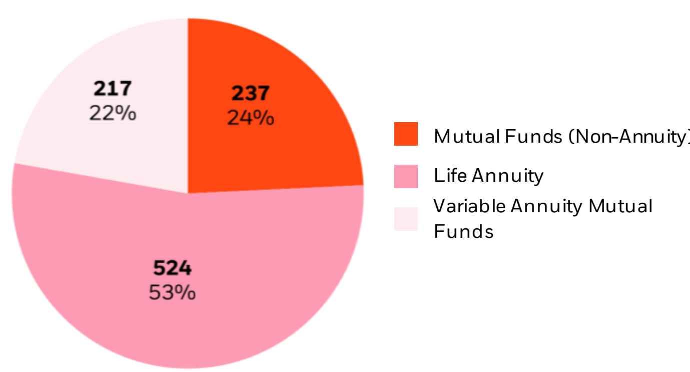
Today, the 403(b) plan market represents $988 billion in assets, with 24%, or $237 billion, invested in mutual funds and the remainder in annuities.[9] The 403(b) market is expected to grow 6% annually going forward, vs. 4% for the 401(k) market (2019E-2024E).[10]

Exhibit 3: 401(k) and 403(b) Investments by Asset Type

401(k) by Investment Account ($ billions)
Total Assets: $5229 billion



403(b) by Investment Account ($ billions)
Total Assets: $988 billion



Source: Cerulli US Defined Contribution Distribution, 2019, data as of 2018; Cerulli U.S. Retirement Markets, 2019, data as of 2018. Life Annuity assets represent assets in annuity reserves, including deferred annuities. Data may not sum to 100% due to rounding.

Providing 403(b) plan sponsors with the same choice that 401(k) plan sponsors have to include CITs as investment options would give 403(b) plan sponsors more flexibility to meet the needs of their plan participants and could bring cost saving benefits to 403(b) plan participants. A number of reports estimate that CITs have generally lower expense ratios as compared to mutual funds with similar strategies.[11] Based on the estimates in these reports, if one were to assume a 20 basis point expense ratio difference between a CIT and a comparable mutual fund, then allowing more 403(b) plans access to CITs could result in more than a hundred million dollars in aggregate savings per year for those 403(b) plan participants[12] (although actual cost savings would depend on specific CIT expense ratios and the proportion of plan assets that is invested in CITs, which would be determined by 403(b) plan sponsors based on the best interests of their plan participants). Using this example, those lower fees could potentially translate into thousands of dollars in increased savings for an individual 403(b) plan participant invested in a CIT over the course of his or her career. Cost is one of many factors that plan sponsors consider in selecting investment vehicles for a plan.

Legislative Efforts to Facilitate the Inclusion of CITs in 403(b) Plans

On March 12, 2020, Representatives Jimmy Panetta (D-CA), Ron Estes (R-KS), Brendan Boyle (D-PA), Darin LaHood (R-IL), Madeleine Dean (D-PA), and Andy Barr (R-KY) introduced H.R. 6257, "The Public Service Retirement Fairness Act of 2020", which would enable the use of CITs by all 403(b) plans. A Senate companion provision is included in S. 1431, "The Retirement Security and Savings Act", introduced in 2019 by Senators Rob Portman (R-OH) and Ben Cardin (D-MD). This legislation would amend Section 403(b) of the IRC and make conforming amendments to the Investment Company Act of 1940, the Securities Act of 1933, and the Securities Exchange Act of 1934, to put 403(b) plans on the same footing as plans created under IRC Section 401(a). This provision could benefit millions of retirement savers and would not result in any additional costs to the federal government.

BlackRock is supportive of legislation that would permit all 403(b) plans to invest in CITs, as 403(b) plan sponsors should have the same ability as 401(k) plan sponsors to select these investment vehicles if they believe this selection could improve outcomes for their participants. We encourage Congress to enact legislation this year that would provide access to CITs for 403(b) plan participants.

Endnotes

1. Based on press coverage, there appears to be at least one exception with unique facts, including a private letter ruling from the Internal Revenue Service.
2. In 2018, ERISA covered $502 billion of the $988 billion in total 403(b) assets. Many of the non-ERISA assets are K-12 education and public universities. See Cerulli, U.S Retirement Markets, 2019, Exhibit 5.03.
3. The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at ERISA 403(b) Plans, 2016 (published Apr. 2020), Exhibit I.3, available at https://www.ici.org/pdf/20_ppr_dcplan_profile_403b.pdf.
4. Section 403(b)(9) of the Internal Revenue Code of 1986, as amended; IRS Revenue Ruling 81-100, as amended; Section 3(c)(11) of the Investment Company Act of 1940, as amended; Section 3(a)(2) of the Securities Act of 1933, as amended; and Sections 3(a)(12) and 12(g)(2)(H) of the 1934 Act, as amended.
5. Ibid.
6. Cerulli, U.S. Defined Contribution Distribution, 2019.
7. Cerulli, U.S. Defined Contribution Distribution, 2014-2019.
8. For example, see the DoL Fact Sheet on Target Date Retirement Funds - Tips for ERISA Plan Fiduciaries (Feb. 2013), available at https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/fact-sheets/target-date-retirement-funds.pdf.
9. Cerulli, U.S Retirement Markets, 2019.
10. Ibid.
11. Cost savings estimates vary and have been estimated up to ~50 basis points (bps). For example, DST Systems (now SS&C) estimates that CITs cost ~10-30 bps less than mutual funds with similar strategies, Legg Mason estimates ~20-25 bps, and Aon Hewitt estimates ~33-53 bps. See DST, (now SS&C), Collective Investment Trusts: A Perfect Storm (2017), available at https://www.ctfcoalition.com/portalresource/AM-WP-CollectiveInvestmentTrustsAPerfectStorm-030317.pdf; Aon Hewitt, How 403(b) Plans are Wasting Nearly $10 Billion Annually, and What Can Be Done to Fix It (January 2016), available at https://www.aon.com/human-capital-consulting/thought-leadership/retirement/2016-retirement-whitepaper-series.jsp; Legg Mason, Understanding Collective Investment Trusts (2018), available at https://www.leggmason.com/content/dam/legg-mason/documents/en/insights-and-education/brochure/understanding-collective-investment-trusts.pdf.
12. For example, using numbers from Exhibit 3, total annual cost savings would equate to ~$130M if one assumes 28% (the same percentage of total 401(k) assets invested in CITs) of 403(b) assets that are currently invested in mutual funds was instead invested in CITs, and a 20 bps difference in expense ratio between CITs and mutual funds.

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