Emulating ERISA: Providing a safety net for public K–12 educators

There are 7 million public K-12 educators across the nation deserving of a comfortable and secure retirement. For these individuals, supplemental savings programs, like the 403(b) plans offered through their local K-12 school districts, have been a positive addition to the important security that could be provided by basic defined-benefit programs and Social Security arrangements that are common to public employees in most states.

However, an awakening is taking place around the relative benefits of saving and investing in these programs because of how these plans are designed and overseen at the K-12 school district 403(b) plan sponsor level. Educators' retirement savings need to be protected from conflicts of interests and structures that may provide hidden benefits to third parties without the clear understanding and knowledge of plan sponsors and participants. The Department of Labor (DOL) offers two important pieces of guidance designed to protect the retirement security of plan participants.[1] Plan administrators should:

- offer truly objective advice to participants (although it is important to note that the DOL does not require objective advice, it does classify education as a non-fiduciary function and considers advice a fiduciary function)
- provide for diversification among broad investment categories to help achieve an appropriate balance of risk and return.

Participants in any retirement savings program constructed without those two key elements of protection in place are at risk of having their savings eroded by high costs and underperformance associated with the program. Because public K-12 403(b) plans are exempted from the Employee Retirement Income Security Act of 1974 (ERISA), a federal law governing most private sector retirement plans, vendors are in many cases unregulated in key cost, investment and fiduciary areas of plan management. This leaves them in many unfortunate circumstances free to market questionable products on educators, in some cases with hidden and hefty fees. In the investing world, working without the twin safeguards of objective advice and portfolio diversification is the equivalent of driving down the freeway without safety belts and airbags.

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Plan sponsors overall have the best interests of their employees at heart, and they are becoming more engaged on this issue every day. As a result of their efforts, 403(b) plans are increasingly guided by the principles of objectivity and investment diversification, even if they aren't legally bound by the same rules governing many retirement plans in the private sector. Taking this approach could generate significantly higher retirement savings for plan participants—as much as $600,000 over the course of an educator's lifetime, calculations and industry experience show.[2] It could also offer a much-needed alternative to some of the business models that may have been "unfriendly" to the education community from a retirement outcome perspective.

Seizing this opportunity takes an understanding of why investments in public K-12 403(b) plans don't enjoy these basic protections—and how some financial product providers are taking advantage.

The costs of operating without ERISA's best practices

As previously mentioned, most retirement plans in the private sector today are governed by ERISA. The law was designed to help protect private sector employees' retirement savings plans by forcing plans to commit to a number of basic protections. These included the vesting of employees' retirement plan benefits over a number of years, minimum funding requirements, and for defined benefit plans, federal insurance in the event of insufficient funds to cover plan liabilities.

When ERISA was enacted, Congress intentionally excluded government retirement plans from certain sections, as it didn't see a need at that point for their regulation. Even though Congress later found deficiencies in areas such as funding, reporting and disclosure, public K-12 and other areas of governmental employer plans are by and large still exempted from many of ERISA's requirements.

The ERISA exemption may appear to be a benefit for public K-12 403(b) plan sponsors: They do not need to comply with ERISA's reporting and disclosure requirements, and more importantly, plan sponsors are not deemed fiduciaries under ERISA, meaning they can't be personally held liable for the performance of investments in employees' retirement accounts. Although K-12 403(b) plan sponsors are exempted from many of ERISA's requirements, it is important for plan sponsors to also understand how individual states treat these exemptions.

But being exempted from ERISA also means that public K-12 plan sponsors' employees are operating without the safety nets the law provides, which may ultimately leave them less prepared for retirement. One of these protections is called the "prudent expert rule," which holds that a fiduciary must act "with the care, skill, prudence and diligence" in administering plans under the law that a reasonable person "familiar with such matters" would use. Another key provision is the "exclusive benefit rule," which states that a plan's fiduciary must act solely in a participant's or beneficiary's best interest. Combined, these rules help assure that plan sponsors are making available the necessary education and guidance for participants to make appropriate investment selections and not steer them into one investment option over another.

A third safeguard, the "diversification rule," mandates that a plan sponsor must diversify investments in order to minimize the risk of loss. This goes to a basic principle of investing—that by not putting all your eggs in one basket, you reduce the risk that a decline in one asset will hurt you inordinately. ERISA wisely provides that each core investment alternative must have materially different risk or return characteristics.

These three critical participant safeguards, among others, protect employees from a variety of issues in plan design or plan management. These can, in the worst circumstances, have a significant impact on employees' ability to retire successfully.

Addressing the fear of fiduciary responsibility

Investment product vendors who don't want things to change are trying desperately to convince public K-12 403(b) plan sponsors that if they take more control over their plans, they are likely to cross the line and become true fiduciaries under ERISA.

The truth is there is little risk of K-12 403(b) plan sponsors becoming fiduciaries under ERISA. Plan sponsors can potentially realize better outcomes for educators by simply emulating the best practices of those deemed fiduciaries under ERISA. What's more, employing these best practices will generally grant plan sponsors more legal protection rather than less, since many already have a fiduciary status under state statute, common law and trust law. Many district administrators—with the help of their consultants—are already implementing these ERISA-modeled participant safeguards without the fiduciary risk. Of course, such changes need to be carefully thought out, and they are best made with the advice of legal counsel.

Improving outcomes and saving money for educators

With the absence of ERISA protections, K-12 403(b) plan vendors are free to sell high-priced financial products that may be unsuitable, not diversified, and generally not in the best interest of participants. Many insurance providers offer fixed annuity products—insurance contracts that make guaranteed fixed dollar payments to the account holder for the term of the contract—that are fairly priced and appropriate for a retirement plan. But the sale of high-cost fixed annuities, when low-cost products with similar or better pay-outs are widely available, serves as a prime example of the need for greater participant safeguards.

The reality is that fixed annuities do belong in a retirement portfolio and help K-12 educators save and prepare for retirement. Fixed annuity options, when used appropriately, play a very important role in a well-designed and diversified retirement investment strategy and they can both improve overall portfolio performance and decrease risk to a well-diversified portfolio. However, when fixed annuities stand alone as an investment strategy, employees lack diversification and long-term risk management benefits. As a result, employees should take into account their retirement goals, needs and personal situation when allocating fixed annuities to a retirement portfolio.

For example, other than in extreme cases, it would likely be improper to recommend a 100% fixed annuity allocation to an employee covered by a defined benefit plan, Social Security or both. Educators with this type of guaranteed income coverage will most likely also need additional savings to meet their retirement income needs and goals. To achieve these goals, plan sponsors can help employees create balanced and diversified portfolios consisting of both fixed annuity products and other investments.

It is common for public K-12 403(b) plans to offer their employees a much larger number of fixed annuity products than other investment options. Unfortunately, this practice can result in participants failing to achieve a well-diversified investment strategy. In the State of California, 403(b) Compare—a web-based registration platform for 403(b) products offered in K-12 and community college districts—shows that as of October 2013, 113 of the 230 products available to participants in 403(b) K-12 plans were fixed-annuity only products (see Exhibit 1). This accounts for nearly half of all the products sold in that state. A more balanced and streamlined investment offering between fixed-annuity products and market-based investments could help improve participant outcomes.

Exhibit 1: 403(b) Compare data of K-12 products offered in California (by type)

Product Category	Number of Products	% of Overall Products	Market/ Diversification Access
Mutual Fund/Custodial Programs	51	22	Yes
Variable Annuity Programs	66	29	Yes
Fixed/Indexed Annuity Only Programs	113	49	No
Total	230	100	

Source: TIAA-CREF analysis of 403(b) Compare data

Doing some math on educator retirement outcomes

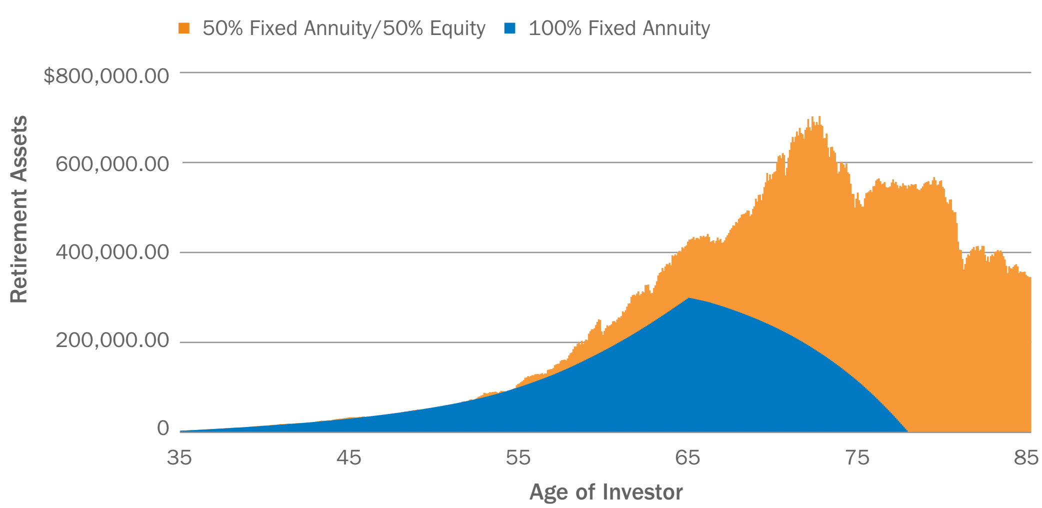
As we mentioned earlier, most public K-12 employees will need additional retirement savings beyond the income provided by State Defined Benefit plans and Social Security. Through supplemental plans that offer truly objective investment advice and diversification, plan sponsors can help employees close that retirement savings gap.

In some school districts in California, we're seeing many teachers just beginning their careers with very long-term investment time horizons being irresponsibly placed into 100% fixed annuity products that are currently offering low single-digit returns. Recent data show that more than 32,000 of the 54,430 403(b) plan participants in the Los Angeles Unified School District have been sold fixed annuity-only products with no direct access to market-based investment alternatives. The assets in these products exceed $1 billion of the $2.03 billion in participant-invested assets in the 403(b) program as of August 2013.[3]

With no exposure to equities, educators in these plans are missing out on the potentially better returns that stocks typically provide over the long run.[4] Take the hypothetical case of two California teachers, both aged 35, who save 5% of their income each year and at age 65 begin taking monthly withdrawals of $2,500. The first has 100% of her assets in a fixed annuity product. The other is in a portfolio that has an evenly split allocation between fixed annuities and equities (the 50/50 portfolio), with periodic rebalancing to maintain that allocation. A set of calculations—based on actual results of the equity and fixed income markets—shows how two educators may do over their working years and into retirement (see Exhibit 2). The 50/50 portfolio generates $427,000 by the time that teacher retires at 65. The 100% fixed annuity solution? Only $296,000. That $130,000 difference represents approximately 40% more in retirement assets and widens even further to more than $600,000 by the time the teachers reach age 77, at which time the 100% fixed annuity investor is projected to run out of money.[5]

Clearly, the lost retirement savings are significant—enough to force the first teacher to possibly put off retirement or realize only a shadow of the retirement income they were hoping for themselves.

Exhibit 2: Diversification from supplemental plans is critical for asset accumulation and income in retirement



Source: TIAA-CREF actuarial calculations

Change is afoot

The prospect of underprepared employees should cause plan sponsors more concern than the fear of the “fiduciary” threat being held over their heads by vendors. Thankfully, more public K-12 plan sponsors are seeing these threats for what they are. As a result, 403(b) plan administrators across the country are stepping out and taking a more active role in the defined contribution world, leading to better outcomes for educators.

When in doubt, plan sponsors of 403(b) plans only have to remind themselves of the duty they have to help millions of educators who are counting on them to reach strong retirement outcomes. On a basic level, it comes down to doing right by those who already do so much good for us and our children. These folks deserve the best retirement savings programs we can give them. By using ERISA as a guide—although not binding on a governmental employer—public K-12 plan administrators can help ensure these important educators get the objective advice and asset diversification they need to protect and enjoy their hard-earned savings.

[1] The Department of Labor does not regulate public K-12 plans although ERISA regulations are viewed as a best practice.

[2] Assumes annual contribution rate of 5% applied to a salary ranging from $36,418 to $62,245 over a 30-year career consistent with merit and cost-of-living increases. S&P 500 market data (provided by Ibbotson Associates) and actual historical TIAA fixed annuity return data were used with the following assumptions: data from 1963 to 1992 for growth in the accumulation phase (30 years) and from 1993 to 2012 for the retirement distribution phase (20 years). Spend down started at $2,500/month and increased 3% per year. Investment comparisons demonstrate differences between a 100% fixed annuity and a 50% fixed annuity/50% equity portfolio.

[3] Source: LAUSD 403(b) Committee 403(b) Asset Report from TSA Consulting Group, INC

[4] Please note that equities are subject to higher volatility.

[5] Assumes annual contribution rate of 5% applied to a salary ranging from $36,418 to $62,245 over a 30-year career consistent with merit and cost-of-living increases. S&P 500 market data (provided by Ibbotson Associates) and actual historical TIAA fixed annuity return data were used with the following assumptions: data from 1963 to 1992 for growth in the accumulation phase (30 years) and from 1993 to 2012 for the retirement distribution phase (20 years). Spend down started at $2,500/month and increased 3% per year. Investment comparisons demonstrate differences between a 100% fixed annuity and a 50% fixed annuity/50% equity portfolio.

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