FEDERAL RETIREMENT THRIFT INVESTMENT BOARD

77K Street, NE Washington, DC 20002

November 4, 2014

MEMORANDUM FOR: EMPLOYEE THRIFT ADVISORY COUNCIL

FROM: GREG LONG
Executive Director

SUBJECT: Mutual Fund Window Option

The Thrift Savings Plan (TSP) Enhancement Act of 2009 (P.L. 111-31, Div. B, Title I § 104) (Act) was signed into law on June 22, 2009. The law granted the Board the authority to establish a Mutual Fund Window (MFW) in addition to the Plan's current investment offerings of five core funds and five Lifecycle funds.

The fiduciaries charged with establishing TSP investment policy will make the decision as to whether to establish a MFW. The fiduciaries will rely on my team's input in making this decision and are also keenly interested in the opinion of the Employee Thrift Advisory Council (ETAC) in this matter. I seek a sense of the ETAC's collective opinion on the MFW concept so that I can share these views with the TSP fiduciaries at our next meeting on November 17.

My intent, based on data presented last May in addition to results of recent research, is to recommend that the fiduciaries; 1) adopt a resolution demonstrating conceptual support for creating a MFW in the TSP, but withhold final approval until additional data on the cost, risks, and schedule for implementing a MFW are provided; 2) request my team to dedicate resources to create a detailed MFW implementation plan including substantial specificity on costs, risks and project schedule; and 3) review this plan and reach a decision at some point in 2015.

BACKGROUND

In May 2014, we presented the findings of a cross-functional team charged with assisting the Plan in determining whether adding a mutual fund window to the TSP would be beneficial and prudent. The study provided insight into industry offerings, participant interest, implementation costs, and operational considerations.

Since the May report, we conducted additional research to better understand the possible influence of a MFW on account retention, to identify the impact of fund screening, and to outline fiduciary issues associated with selecting/screening funds inside the MFW. In addition, this report addresses the operational concerns raised by members of the ETAC following the May 2014 presentation. This information is being presented to the ETAC to get feedback on the potential implementation of a MFW. That feedback will then be provided to the TSP's fiduciaries. This examination along with the original report provides the foundation of the Agency's recommendation on the mutual fund window.

ACCOUNT RETENTION

We previously reported that 45% of participants who separated from service in 2012 withdrew all TSP funds and closed their accounts by the end of 2013. In 2013, these withdrawals caused nearly $10 billion to leave the TSP, with almost 72% of that amount being transferred to another financial institution or employer plan. We wanted to better understand the drivers behind this activity, and consequently we surveyed 30,000 participants from a total of 96,500 participants who took a post-separation partial or full withdrawal in the first half of 2014. We also surveyed all 10,200 participants who made an in-service age-based withdrawal during that same period. In addition to the survey, we conducted focus group sessions with nearly 70 participants to obtain additional color on their survey responses.

Among those participants who took a post-separation withdrawal and responded to the survey, the top reason[1] for withdrawing money was to access funds for a major expenditure or life event (36%). Interest in withdrawal flexibility not currently available through the TSP was mentioned as a reason by 27% and interest in additional investment options was cited as one of the top reasons by 23% of respondents. About one-fifth said they withdrew their money because they wanted a managed account; wanted investment advice; received a recommendation from a financial advisor to make the withdrawal; or had other reasons, such as account consolidation or a required minimum distribution.

Participants who took an age-based withdrawal also cited access to funds for a major expenditure or life event (52%) as one of their top withdrawal reasons. Interest in withdrawal flexibility not currently available in the TSP was mentioned by about almost one-third of respondents, while 23% said they wanted investment flexibility not currently offered in the TSP and 23% also indicated their financial advisor recommended they make a withdrawal.

The survey also examined the demographics of those participants who cited additional investment flexibility as the reason for withdrawing after separation from service. Interest in additional flexibility was evenly cited in the range of 18 - 22% among all three retirement systems (uniformed services, FERS and CSRS). This relatively even distribution also held true when looking at the participants by age or tenure.

Our conclusions from the survey are that we have three (3) plan-design related opportunities to improve account retention. We can improve retention through more flexible withdrawal options, through improved services related to investment guidance and advice, and (specific to the subject at hand) through the creation of greater investment flexibility. The creation of a MFW would reduce concerns of limited investment flexibility expressed by 23% of those participants that executed post-separation and age-based in service withdrawals. However, a MFW in the TSP will not address the most common reason for making a TSP withdrawal (need for cash now for major expenditure), nor will it resolve all concerns associated with transfers of TSP accounts to higher-fee IRA's.

While survey data indicates the creation of a MFW in the TSP will improve account retention, and therefore cause fewer participants to pay substantially higher fees elsewhere, the question of how much it will improve the rate of retention is difficult to answer. Considering that in 2013 the TSP experienced about $12 billion in post-separation and in-service age-based withdrawals, an incremental improvement will lead to substantially more dollars being retained in the TSP. For example, if a MFW were available in 2013 and it caused just 10% of distributed dollars to

[1] Respondents were allowed to select more than one reason for making a withdrawal from the TSP.

stay at the TSP, the additional $1.2 billion in balances would have resulted in lower administrative fees for *all* TSP participants.

FUND SCREENING

Some concern was expressed by ETAC about the potential cost of the funds available in the MFW option. In response to this concern we discussed the possibility of placing a screen on funds based on costs, i.e., funds with expense ratios above 1.00% (100 basis points) would fail a screening test and be designated as unavailable for purchase.

To determine the viability of a screening process, we inquired with the MFW platforms as well as plan sponsors about the use of screens and also examined the potential impact of placing a screen based on expense ratio. The MFW providers stated that the funds they offer on their platforms are ERISA compliant, and their clients generally do not further restrict offerings in the window. They noted that sponsors did not want funds in the mutual fund window to become "designated investment alternatives," within the meaning of ERISA, and did not want to be seen as "approving" individual funds within the window. The providers further explained that if funds are screened from the fund line-up, the participant will not know this until a purchase is attempted. That is, a participant will still see the entire platform of funds; will conduct research; identify which fund to buy; attempt to execute the purchase, and at that point the participant will receive a message that the fund is not available. The MFW providers generally are not able to customize the list of funds visible to the participant on a plan-by-plan basis.

Finally, we examined the impact of a screen to restrict the MFW to only those funds that have expense ratios of 1.00% and below. We focused particularly on those sectors where participants and/or advocacy groups have indicated an interest in adding a particular fund to the TSP's core line-up. The chart below illustrates the impact of that screen:

Potential Impact of Restrictions on Fund Offerings

SECTOR	FUND RESTRICTION	
	No Restriction	Net Expense Ratio 1% or less
Emerging Markets	221	9
Real Estate	95	14
Socially Responsible	85	15

The result of placing a screen on expense ratios was meaningful and limits the availability of funds in some of the primary sectors we are seeking to make available. The conclusion from this research is that adding a screen is not desired.

FIDUCIARY ISSUES

The interviews also revealed that the prevailing reason for the lack of fund screens was associated with fiduciary liability concerns. The status of mutual fund windows under ERISA and DOL rules is currently unclear, so by taking a hands-off approach, plan sponsors believe that they lessen the chance of being liable for outcomes from MFW investments. However, the TSP is not subject to ERISA, and FERSA contains language directly on point regarding the mutual fund window.

FERSA protects the plan fiduciaries from the investment decisions made by participants by requiring an "acknowledgement of risk" from participants before allowing them to invest in any funds with the potential of loss. That section, found in 5 USC §8439(d), not only provides that investments in other than the G Fund are made at the participants' own risk but also provides that the participant is "not protected by the Government against any loss on such investment, and that a return on such investment is not guaranteed by the Government."

Second, it should be noted that, up until the authorization of a mutual fund window for the TSP, the types of funds to be offered by the TSP were established by statute, and the fiduciaries thus had no discretion to select investment options that were not already approved by Congress. Therefore, exercise of their fiduciary responsibilities was primarily a matter of selecting the criteria (including the indexes) for implementing the approved investment options and then monitoring them to ensure that they were being managed appropriately. The statute explicitly made the Board members responsible for establishing "investment policies" for the Thrift Savings Fund (5 USC §8472(f)). In section 8475, they further required the Board to "develop investment policies under section 8472(f)(1) of this title which provide for (1) prudent investments suitable for accumulating funds for payment of retirement income; and (2) low administrative costs."

With the approval of the mutual fund window as part of the Thrift Savings Plan Enhancement Act of 2009, the process for selecting potential investment options through a mutual fund window was changed significantly. Now the plan fiduciaries are potentially responsible for selecting among a virtually unlimited number of investment options and monitoring those options. In recognition of this change, the Act included several provisions explicitly addressing the issue of Board and fiduciary responsibility for investments made through the window. First, in the new section 8438(b)(5), it provided that: "The Board may authorize the addition of a mutual fund window under the Thrift Savings Plan if the Board determines that such addition would be in the best interests of participants." Significantly, the same section also provided that "(t)he Board may establish such other terms and conditions for the mutual fund window as the Board considers appropriate to protect the interests of participants, including requirements relating to risk disclosure." The Act also amended the fiduciary liability section of FERSA (5 USC §8477) in relevant part as follows:

> A fiduciary shall not be liable . . . and no civil action may be brought against a fiduciary–(III) for allowing a participant to invest through the mutual fund window or for establishing restrictions applicable to participants' ability to invest through the mutual fund window.

The Thrift Savings Plan Enhancement Act makes explicit the Board's responsibility to consider all terms and conditions of the MFW in light of their fiduciary obligations. The statute protects the fiduciaries from liability for the investment decisions made by participants in the window, and protects them from liability for "establishing restrictions applicable to participants' ability to invest through the mutual fund window." However, the Act did not amend section 8475. Thus, the Board still must ensure that all investment options, including those found in the MFW, are "prudent investments suitable for accumulating funds for payment of retirement income" and that they have "low administrative costs."

It is virtually impossible for funds in the MFW to match the low costs provided by the TSP's core funds. While cost must certainly be a factor that is considered, the Board is not prohibited from approving the creation of a MFW which will enable access to funds with higher expense ratios than the funds available in the TSP's core menu.

From this research we conclude that the Board must therefore balance these issues: 1) participant desire for increased investments options, as evidenced by both surveys and action (withdrawals from the TSP); 2) the impact on the MFW offerings by potentially imposing a cost screen; and 3) the requirements that the funds in the MFW be prudent investments suitable for accumulating retirement funds.

ADDITIONAL ISSUES

Platform Integration: We learned through our market research that many of the MFW providers have experience integrating with defined contribution recordkeeping systems, and specifically system using SunGard's OmniPlus software, the recordkeeping software used by the TSP. The ability to integrate with the TSP's recordkeeping system and experience doing so would be important requirements for any MFW platform that might be offered.

Implementation Costs: In our earlier report, we provided a rough-order-of-magnitude (ROM)[2] estimate in the range of $6-$10 million to make the required systems modifications to implement a MFW. Once implemented, we anticipate maintenance costs of about $1 million annually. It is important to note that other potential technology requirements (e.g. web and accounting integration) have not yet been estimated and may therefore impact the above estimate.

If the Board members support the MFW in concept, we will establish a team to create a formal project plan with substantially greater specificity on costs. Thus, both the ETAC and the Board members will have at least one additional opportunity to influence and eventually decide whether to implement a MFW in the TSP.

In the past, when implementing new services it has been our practice to charge the implementation costs to all participants, but have a separate and individual usage charge. For example, when we modified the loan program, the costs to implement the changes were shared by all participants, but only the participants who request a loan are charged the $50 loan transaction fee. With the MFW, we would use a similar methodology, spreading the implementation cost over the entire participant population as all participants may avail themselves of the new feature, and have a separate fee (to be determined) for individuals who access the MFW.

[2] A ROM or Rough Order of Magnitude is an estimate that will have an accuracy of about plus or minus 50%.

Participant Education and Communications: Education of participants about the pros and cons of the MFW would be an important element of implementation. Messaging that the MFW is not a core investment option, but one that is suited to the more sophisticated/do-it-yourself investor would be critical. An additional critical communication requirement would be the provision of clear and unambiguous messaging on the costs and potential risks associated with investing in the MFW. TSP print and electronic media would be similarly updated to address the introduction of the window.

RECOMMENDATION

As stated earlier, my intent, based on data presented last May in addition to results of recent research, is to recommend that the fiduciaries; 1) adopt a resolution demonstrating conceptual support for creating a MFW in the TSP, but withhold final approval until additional data on the cost, risks, and schedule for implementing a MFW are provided; 2) request my team to dedicate resources to create a detailed MFW implementation plan including substantial specificity on costs, risks and project schedule; and 3) review this plan and reach a decision at some point in 2015.

The factors from current and previous research that support this recommendation are as follows:

- A MFW is responsive to customer demand. We have heard requests for greater investment flexibility in all of the surveys we have done over the last 8 years and we commonly hear this same viewpoint through all of our customer contact channels.
- A MFW will allow participants to invest according to their conscience as funds supporting a variety of social, environmental and political goals will be available.
- A MFW will allow more sophisticated "do-it-yourself" investors the ability to further diversify and fill a small "gap" in the existing core funds, as emerging market, commodities, and a variety of niche funds will be available.
- A MFW protects the simplicity of the TSP by sharply reducing the risk of a legislative effort to force additional funds into the TSP's core line-up.
- A MFW will have a positive impact on account and asset retention, and as a result all participants will benefit through a lower cost structure.

With consideration of the issues addressed in this memo and the May, 2014 memo, I recommend approval to start planning for the implementation of the MFW. The planning phase will allow us to start formal requirements gathering and procurement work that will get us to a final cost estimate for the mutual fund window. At that time, we would seek final input and approval from ETAC and the Board. We anticipate the next planning phase will take 6-9 months. The MFW implementation phase, while yet to be determined, is likely to take an additional 18-24 months.