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403(B) Plans Should No Longer Be Ignored

By Richard Todd, Managing Principal Innovest Portfolio Solutions

The 403(B) plan is on the radar screen of the IRS and the legal community. Recently, the IRS has targeted 403(B) plans of public school districts to determine their level of compliance with the Internal Revenue Code. The 403(B) plan is only available to non-profits and governmental entities and the large majority of the employers that offer these plans are in education – public schools, grades K-12, and colleges and Universities; and in the hospital market.

In most cases, these employers have considered 403(B)s as supplemental to other plans offered (like defined benefit plans) and many have chosen to provide access to any provider licensed to sell a product. Morningstar call this the "hog wild" model. While there may be some cursory criteria to be "approved" by the employers, it is typically an elementary analysis as compared to what a typical retirement plan sponsor is legally required to conduct for ERISA (Employee Retirement Income Security Act) plans such as corporate 401(k) and pension plans.

Fred Reich, a well regarded pension attorney of the firm Reish Luftman Reicher and Cohen in Los Angeles believes that the hands off approach with 403(B) plans is a big mistake for employers. "Exempt 403(b) plans and government 457(b) and 403(b) plans are also subject to legal requirements, just not ERISA's. Instead, they are subject to the laws of the states in which the plans are established. Many state fiduciary laws are based on principles similar to those underlying ERISA – such as modern portfolio theory, the prudent man rule, and the use of generally accepted investment principles – and a number of state statutes use language identical to the provisions of ERISA."

The primary problem is that 403(B) investment costs are extremely high as compared to the 401(K) market where the plan sponsor typically uses one provider for the plan. Morningstar estimates 403(B) internal costs from 3.75% per year to 4.60% per year. Although Morningstar's estimate may be high, fees in this market can at times be almost egregious. In many cases, the employer/plan sponsor is seemingly ignorant and unaccountable about vendor costs. However the employee/participant can often feel comfortable since the product was "approved."

Another common problem is the steep surrender charges that participants may be forced to pay in the event that they change their mind about a product or vendor. Surrender charges are typically tied to commissions that the salesman receives. If the participant was to leave the vendor relationship, these charges recoup the vendor for the large commissions paid. The longer and higher the surrender charge, the more the commission paid to the salesman.

403(B) providers argue that competition brings down prices. This is absolutely true, but only if the competition occurs at the plan sponsor level. In a multiple vendor environment, participants lose all economies of scale that come with a consolidated plan level account. If 403(B) employers actively negotiated on behalf of participants (like 401(K) employers) participants would receive increased services and much lower costs. Participants could easily save 1% per year in fees by moving from a high cost "retail" solution, most common in the 403(b) market, to an institutional solution.

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For a participant saving $5,000 per year for 25 years, a 1% fee savings equals nearly $60,000 – and that is just for one participant.

Services to employees can also be improved in a single vendor environment. Meetings with employees become less focused on which company is better (or has a better salesperson or has the better food at their meetings), and becomes more focused on education employees which investment vehicles will meet their goals. This change in focus is significant. Gone are the rumors and the water-cooler conversations of who is the cheapest vendor, who has the best investment products, and who has the best information. Replaced is an environment where the employee feels comfortable that they are getting great service and great pricing, and can instead focus on designing the right investment portfolio and achieving retirement goals.

Jefferson County Public Schools, the nation's 26th largest school district, took a big step last year and consolidated 55 vendors into a single provider.

Lorie Gillis, CFO of Jeffco explained, "it became quite clear that our employees didn't know what fees they were paying and the district was concerned about the complexity and prudence of dealing with 55 vendors." Although participants were initially concerned about having "choice", it is estimated that each Jeffco participant will save between $10,000 and $100,000 with the new vendor by the time each participant retires. While huge strides were made by Jeffco, not everyone was happy – namely 54 vendors that were displaced. However, participants no longer have to play the investment guessing game and their employer has acknowledged their responsibility to their employees.

The time is ripe for employers to revisit their 403(B) plans. Participants should ask employers about their due diligence process and employers should come to grips with their fiduciary responsibility.