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403(b) Plans Should Get Much Better Soon

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Last year IRS issued the long-awaited final regulations for sweeping reform of 403(b) plans, including new rules that will make these plans look and act more like 401(k) plans. The changes will require plan sponsors of these historically loosely regulated plans to take on far greater oversight and administrative responsibilities. While the new mandates for employers may initially be perceived as unwanted and burdensome, the end result will certainly make the plans much more attractive and beneficial for participants.

The IRS proposed their intentions to overhaul 403(b) plans in 2004, anticipating final regulations would be issued by the beginning of 2006. However, the final regulations were not issued until July of last year and become effective January 2009. These regulatory changes, which are the first significant revisions to the code in over 40 years, will force much needed improvements by requiring plan sponsors to become more responsible stewards.

The 403(b) plan is generally a supplemental retirement savings plan offered to employees of non-profit groups such as K-12 schools, universities, health care providers, religious organizations and other non-profit entities. Historically, these employers have enjoyed an exemption from many of the compliance and oversight responsibilities expected of their 401(k) and 457 counterparts. As a result, it is commonplace for employers to entrust vendors with administrative compliance and control of plan design without any input or oversight. This liberal regulatory environment has virtually encouraged employers to function only as a payroll deduction conduit, and has discouraged any meaningful involvement. Accordingly, employers tend to avoid interference, and it's quite common for them to allow products from multiple providers, which leaves all of the decision making to the participants.

Considerations for Plans with Multiple Providers

Many school districts offer 50 or more plans to their employees under the guise of "non-obstruction" by providing virtually unconstrained participant choice and control. However, this hands-off approach has a detrimental impact on the appeal, effectiveness and efficiency of the plans. Multiple provider arrangements lack objective monitoring of the performance or appropriateness of investments offered to participants, and the underlying fees and expenses are typically ignored. By offering an unconscionable number of investment choices to employees this environment perpetuates confusion and ultimately impedes participation.

The new regulations encourage consolidation to a single provider by requiring employers to demonstrate ongoing oversight of the plan and its providers. Under the new rules employers will have to maintain a written plan that includes a description of investments offered through the plan and the responsibilities of all affiliated vendors. Even though the written plan may be provided by the selected vendor(s), this document forces the employer to acknowledge the underlying investments, expenses and services offered to employees. Therefore, compliance with the revised code would be virtually impossible for employers continuing to offer investments through multiple providers.

Reducing Expenses

The average expense structure of most 403(b) plans is alarming compared to that of the typical 401(k) or 457 plan. The underlying fees charged by some 403(b) providers would give you the feeling that their products are being sold from a hotel mini-bar! This comparatively expensive structure is, in part, due to the nature of the typical investment products offered to participants, along with the inherent problems associated with multiple providers.

The marketplace is currently dominated by large insurance companies that typically sell fixed and variable annuity products. Fixed annuities offer a guaranteed investment return during the accumulation phase, and typically, during the distribution phase as well. With a variable annuity participants self-direct their investments among a variety of mutual funds, and the distribution amount is dependent upon individual investment performance. Compared to mutual funds and similar investment options, these annuity products are generally more expensive, and are sometimes loaded with hidden fees that result in total expenses ranging from 2% to 5%. Their dominance in the industry stems from the original regulations, which allowed only insurance company investment products in these plans from 1958 until 1974, which is when mutual fund companies entered the 403(b) marketplace. Despite lower inherent fee structures of many mutual fund providers, insurance companies continue to control the majority of 403(b) plan assets, which exceeds $700 billion.

Employers that offer plans with multiple providers are partially responsible for higher costs to participants, because the assets are spread out among so many different vendors. Accordingly, the providers often view the contracts as individual, rather than group, and charge higher expenses. By using a single provider employers can take advantage of economies of scale to reduce overall expenses.

Continued on next page...

The CONTRIBUTOR

summer 2008

Continued from previous page...

Improving Investment Selection

In addition to extraordinary fees, many of the variable annuities, which offer mutual funds as the underlying investments, contain poor-performing products and/or expensive share classes. This is sometimes a byproduct of their selection process for underlying options, which may be based upon the revenue sharing arrangement with investment managers, rather than choosing funds based upon performance relative to their peers.

Likewise, another problem with the multiple vendor approach is the absence of any structured, objective investment selection and monitoring process. Many of the investment menus have far too many options, and often include multiple funds in the same asset class, which makes them redundant. The employers have essentially allowed the vendors to control selection and monitoring of underlying investments, which obviously lacks objectivity. Meanwhile, many single-provider plans have adopted procedures to create a sensible investment menu, monitor the performance of individual options, and evaluate applicable fees and expenses. This formal process demonstrates due diligence on behalf of the employer while easing the burden of investment management for participants.

Improving the Effectiveness of the Plan

In addition to the symptoms of greater fees and convoluted investment menus, plans with multiple providers have created a number of other problems for participants. The overwhelming number of investment options offered through numerous different vendors makes the already daunting process of investment selection and management even more confusing. Vendor representatives tend to focus on selling their respective products rather than helping participants become better savers and investors. Many times the vendor with the best pizza party wins the majority of the 403(b) business.

While 401(k) and 457 plans have experienced vast improvements with their employee education and communication programs, the multiple-vendor 403(b) plans have found it nearly impossible to conduct an effective campaign. Some employers have prohibited on-site education because there are so many vendors to accommodate, and if they allow on-site education and solicitation with one vendor they would really have to allow all of them the same gratuities. In fact, vendor consolidation alone will likely improve the effectiveness and increase the perceived value of the plan by creating a much better experience for the participant.

The Opportunity to Make 403(b) Plans Better

Much of the impending reform appears to target welcomed improvements for the 403(b) participant. While the regulatory changes will impose greater responsibility and liability on behalf of the employer, these requirements present an opportunity for employers to create a much better plan. This is an opportunity for employers to abolish the "more is better" and "anything goes" approach, in exchange for a plan design that is based upon the premise of catering to the best interests of the participants.

Suggested Next Steps

1. Form an advisory board or committee to determine the type of plan that would best suit the participants and oversee the entire development process. Board members might include employees from HR, finance and legal departments.

2. The advisory board should first decide if it is appropriate or necessary to hire an independent consultant to provide guidance and assistance with plan design, vendor selection, communications strategies, etc. Hiring a professional consultant is generally advisable, particularly for larger plans. The consultant should be experienced in the vendor selection and negotiation process, and be able to provide references for several recent searches. This demonstrates their ongoing activity and familiarity with current pricing structures. Ideally, the consultant would be independent of any providers, and would offer objective, conflict-free advice.

3. Create an employee communications plan to keep participants informed during the entire conversion process. They should be informed of your intentions and expected benefits before any decisions are made, your ongoing progress, and the key points considered in your final evaluation. Failure to effectively communicate your intentions and process will result in a very unhappy group of employees. They need to understand that your purpose is to provide an improved benefit.

4. Develop a draft of the ideal 403(b) plan for your employees. This would include services, the types of available investments, expenses, and any other preferences. This will provide the foundation for your required written plan. You may also wish to develop an Investment Policy Statement that specifies the types of investments to be offered, along with selection and monitoring criteria.

5. Gather information from your current vendors regarding services, investments, and expenses. Compare this data with your expectations. Your consultant can help you benchmark your current arrangement with that of similarly sized pans.

6. Prepare an RFP and begin the competitive bidding process. Document the process and your final evaluation.

7. Select your final vendor and develop an implementation and communications strategy.

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8. The advisory board should periodically monitor the performance of the vendors, prudent experts, and investment options.

By using a single provider, employers can focus on the quality of the investment menu offered through their plan and take advantage of economies of scale to reduce overall expenses. Additionally, your vendor can focus on helping participants effectively utilize the plan, rather than selling products.

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