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IRS is watching 403(b) plans more closely than before

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The Internal Revenue Service and the legal community are watching 403(b) plans, which are defined-contribution retirement plans.

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 available only to nonprofits and governmental entities.

The large majority of 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 (such as defined benefit plans), and many have chosen to provide access to any provider licensed to sell a product. Morningstar calls this the "hog wild" model.

While there may be some cursory criteria for employers to approve, it's typically an elementary analysis, 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.

One big problem is that 403(b) investment costs are extremely high compared to the 401(k) market, where the plan sponsor typically uses one provider. Morningstar estimates 403(b) annual internal costs run between 3.75 percent and 4.60 percent of plan assets.

Although Morningstar's estimate may be high, fees in this market can be almost egregious. In many cases, the employer/plan sponsor is seemingly ignorant and unaccountable about vendor costs. However, the employee/participant often can feel comfortable since the product was "approved."

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

Providers of 403(b) argue that competition lowers prices. This is 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 negotiated on behalf of participants (like 401(k) employers), individuals would receive increased services and much lower costs. Participants could easily save 1 percent per year in fees by moving from a high-cost individual approach which is most common in the 403(b) market, to an institutional solution. For a participant saving $5,000 per year for 25 years, a 1 percent fee savings equals nearly $60,000 -- and that's just for one participant.

Services to employees also can be improved with a single vendor. 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 educating employees about 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.

Instead, the employee feels comfortable that they're getting great service and great pricing, and instead can 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.

"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," says Lorie Gillis, chief financial officer of the school district.

Although participants were initially concerned about having choice, it's estimated that each Jeffco participant will save between $10,000 and $100,000 with the new vendor by the time they retire.

While Jeffco made huge strides, not everyone — namely the 54 vendors that were displaced — was happy. However, participants no longer have to play the investment guessing game, and their employer has acknowledged its responsibility to its 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.

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