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Whither Goes the 403(b) Market in 2008?

Some might suggest that "Wither" makes more sense here than "Whither." Don't the new IRS permanent regulations on 403(b) plans spell the end of this market as we have known it for decades? Despite all the excitement, we believe that *fundamental* changes are unlikely – but there will indeed be important adjustments. Therefore, plan sponsors and product and service vendors have key strategic decisions to make.

As compliance software vendors, we have been actively involved with 403(b) plans since 1995, yet we are probably less affected by the regulations than most other parties. We can therefore offer analysis that is reasonably dispassionate.

What's a plan sponsor to do?

This is the central question, because the actions of plan sponsors will also define what product and service vendors need to do. Their actions are hard to forecast, however, because the number and variety of plan sponsors is enormous, their range of options is quite large, and the plan sponsors themselves are currently perhaps in the worst position of anyone to say what they will do, because for the most part they lack expertise in this area and they have not had time to fully evaluate the new regulations.

But they need to make decisions during 2008. The regulations impose specific documentation and compliance obligations on plan sponsors, well beyond previously defined responsibilities (except for plans that are already ERISA plans). These obligations create both administrative tasks and potential liabilities. It is easy to overstate the weightiness of these tasks and liabilities, though, and in the end, the new regulations will *not* be hugely burdensome for most plan sponsors. Still, they must be dealt with in some way.

There are five likely responses:

Option 1: Do nothing (much)

For some small plans, this may seem at first like a rational response. Spend a few hours drafting (or adapting) the necessary written plans and policies, then cross your fingers. Chances are that the IRS won't audit your plan, and if they do, you might be OK.

However, if the IRS does audit the plan, and discovers that you have done little or nothing to comply with the regulations, they will probably be in a punitive mood. Even worse, some violations can lead to disqualification of the entire plan.

Undoubtedly, many plans will not be in full compliance by the end of 2008, due to inertia, confusion, or other problems. But this is not a good strategy to deliberately adopt.

Option 2: Eliminate the plan

Simply getting rid of a 403(b) plan is now possible under the regulations, and some plan sponsors may opt for this. But it is a gross over-reaction, unless they already have other reasons to want out of the plan. Much less drastic strategies are available, and the main benefits of a 403(b) plan are still as valid as they were before the regulations.

Although there has been speculation about rampant plan terminations, therefore, we will be very surprised if this happens more than sporadically.

One temptation, though, will be to substitute a different kind of plan, usually a Section 457 plan or a 401(k) plan. Each of these has certain advantages and disadvantages vis-à-vis 403(b) plans, and in particular instances such a switch might make sense. But if the object is to sidestep administrative problems, these options only make matters worse – in part because each of them has significant burdens of its own, and in part because the nuisance and cost of terminating one plan and starting another will be substantial.

Where an alternative plan already exists, of course, it would be easier to drop the 403(b) plan. But 403(b) plans have contribution limits apart from other plans, and for people who want to contribute as much as possible (a group that usually includes key decision-makers, and other influential parties), eliminating the 403(b) plan is a big loss.

So this is another option that will probably not be widely adopted.

Option 3: Simplifying the plan

Meeting the plan document requirement should not be hard – sample plan documents will be plentiful. The challenging part of the regulations will be establishing administrative and compliance procedures dealing with contributions, transfers, loans, and withdrawals.

One way to minimize these issues is by forbidding transfers and loans, and by restricting contributions to the basic limits (no catch-ups after 15 years of service, or age 50). Only product vendors willing to agree to these restrictions would then be approved.

Many 403(b) products already lack loan provisions, and many plan sponsors already limit contributions more than the IRS requires. In such plans, adding a few more restrictions may be the easiest and best way out. But where loans and transfers and catch-up contributions have long been available, new limitations could create resistance – again, especially among decision-makers who are more likely to use such options.

Even so, we expect that this strategy will be fairly widely adopted.

Option 4: Scaling down to a single provider

A plan sponsor can easily maintain a robust plan if only one product vendor is approved for the plan, and if that vendor agrees to handle all administration. If a Hold Harmless agreement is part of the package, the plan sponsor is, for practical purposes, entirely off the hook, perhaps at no cost to itself. Some product vendors surely will agree to provide free administration in exchange for exclusive access to the participants.

Furthermore, compliance will be relatively easy even for the product vendor. Transfers are no longer an issue, and contributions, loans, and withdrawals are all taken care of without regard to other vendors, since there are none.

Unfortunately, a single-provider solution has serious disadvantages:

- In the 403(b) world, one size does not fit all. There tends to be a dichotomy in products between lower-cost mutual fund providers and high-service annuity providers. The low-cost products are better for self-motivated and financially savvy participants, because the investment choices are varied and the participant does not pay for unwanted on-site marketing and customer services. But the majority of participants need more hand-holding than that and are better served by companies that charge more but deliver more. In particular, companies with on-site representatives are in a position to persuade non-participants to sign up, or to persuade small contributors to save more. Despite the cost of such services, participants who respond to them end up with more retirement savings – which is, after all, the goal of the plan. So both kinds of products are valuable, and adopting only one leaves part of the employee group ill-served. And choosing only a compromise vendor somewhere in the middle may leave almost everyone ill-served.
- There is a fiduciary issue here as well. A plan sponsor who allows only a single vendor and therefore withholds choice from participants, can be held liable for the suitability of that choice. Since almost inevitably, any one vendor is going to be inappropriate for a significant segment of the employee population, this strategy is dangerous. (Note that this is not a problem for 401(k) plans, where a single vendor is necessary and therefore acceptable.)
- Where multiple vendors currently are approved, it may be difficult to drop down to just one. Too many plan participants, probably including some influential ones, will not want to switch providers. Even if a new vendor is acceptable, participants will have to face either terminating their existing individual contracts and transferring to the new vendor – possibly incurring back-end charges in the process – or else having to keep their retirement funds divided, with multiple product statements and perhaps multiple sales reps to deal with.

Converting to a single vendor will be a loudly hyped option in 2008. It is clearly a big boon to any product vendor who can make the case for being the sole provider, it is a big boon to any Third Party Administrator (TPA) because it makes their job a lot easier, and it has an immediate appeal to plan sponsors. For the reasons given above, however, we believe that this is not a good option, except in ERISA plans and other unusual cases, and we suspect that any trend in this direction during 2008 will eventually be reversed.

Option 5: Keeping multiple providers (though perhaps reducing the number of them) and biting the bullet on administration (with or without outside help)

For plan sponsors who either want to maintain multiple product options or can't agree on a single provider, multiple vendors will remain a reality. In most cases, however, the number of vendors will be reduced, either because some vendors will drop out of the market or not agree to specific plan sponsor requirements, or because plan sponsors feel that life will be easier with fewer vendors.

Undeniably, it will be easier to deal with, say, four vendors instead of fourteen. In certain ways it is *not* much easier, though: if you have more than one, you will need systems and procedures to collect and merge data from multiple sources, and once you are set up to do it for two, it isn't that much harder to do it for three, or four, or five, or maybe more.

Plan sponsors will probably limit their vendor list by:

- Eliminating providers who will not fully comply with the plan sponsor's new administrative requirements (or who are voluntarily dropping out of the market).
- De-listing companies serving no existing participants in the plan.
- Phasing out providers with only a few participants, especially if those individuals are close to retirement, by not allowing other participants to select those vendors.
- Identifying providers with very similar products and services, and narrowing the list to one or two in each category.

Still, even with a smaller list, administrative work needs to be done. There are four approaches plan sponsors can take (apart from ignoring it and hoping to not get caught):

- The plan sponsor can do the administrative work – which, except in the largest organizations (that can afford appropriate training and back-up), or in the smallest ones (where the job is simple), probably means that errors will be made.
- The plan sponsor can hire a TPA to do it, which probably carries the highest out-of-pocket cost but should result in top quality work, without strings attached.
- A product vendor may offer free services, either in the home office of a large financial product provider, or in a local or regional marketing organization willing to trade administrative services for continued (maybe exclusive) access to employees. If the vendor is reliable, this could be the easiest and cheapest way out.
- Some plan sponsors are looking into forming local consortia to deal with the administrative issues that the new regulations raise. Our guess is that such groups will work well for information sharing, but not for actual administration.

Living with multiple vendors would be easier if there were an industry standard for the frequency and format of reporting participant information, and we ourselves are co-chairing a National Tax-Sheltered Accounts Association group to help develop them. (If you want to be involved, too, contact us at the address at the end of this document.)

Should this effort be successful, uniformity in data sharing will make it possible to support even a fairly long list of vendors. But even in the absence of such standards, we expect that having multiple providers will continue to be the norm for 403(b) plans.

Strategies for Product Providers

Product vendors in the 403(b) market need to be make important decisions fast, and many of them have started doing so. The principal options, as we see them are:

Option 1: Drop out

It appears that quite a few providers may do this, particularly ones for whom the 403(b) market has been something of an afterthought. As secondary players even in most of the

plans where they have any presence at all, they expect to be weeded out as plan sponsors reduce the number of vendors. And it is not worth it for them to fight for the business.

Option 2: Become the low-cost provider

Many mutual fund companies, and a few annuity providers, have established themselves as low-cost alternatives. Low cost usually means less service, but low fees typically improve long-term returns, and consumer advocates often favor such plans. Over the past ten years, this has probably been the fastest growing "niche" in the 403(b) marketplace.

Option 3: Become the high-service provider

Most annuity providers have product pricing and on-site distribution systems that make it impossible to compete on cost. But since the majority of employees in 403(b) plans lack either the time or the inclination to become financial experts, they need the kind of hand-holding that only a higher-cost company can deliver. Furthermore, the new regulations now provide an opportunity to offer new services, with benefits that appeal directly to the plan sponsor's own interests. This strategy could be a big winner.

Option 4: Become a one-stop shop

Many large financial firms already have both insurance and securities arms – but these rarely work effectively together. If, as we expect, the dichotomy between low-cost and high-service providers continues to solidify, the new regulations create a big opportunity for firms that can get their annuity and mutual fund operations to coordinate. They could offer the benefits of multiple providers and those of a single provider in one package.

Option 5: Do nothing – wait and see what happens

This may not be the best strategy, but it could become the most common one. And it *might* make sense. The 403(b) market could develop over the next few years in surprising ways. For example, if a Democratic administration and Congress are in place in 2009, the Republican goal of gradually turning 403(b) plans into 401(k) clones might be reversed – the new regulations could even be rescinded. Not that we are predicting this, but for medium-size players, a cautious approach may be sensible, or even necessary.

More questions than answers

Although we intend and hope that this analysis is helpful, we do not pretend to have all the answers. Our goal is to advance the discussion. If you have additional thoughts on these matters that you would like to share, we would like to hear from you. If we get enough interesting responses, we will update this analysis later with new ideas.

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