The Need for a Better K-12 403(b) Plan Design

By Rebecca Moore EDITORS@PLANSPONSOR.COM | July 22, 2015

Lack of awareness, pressure by vendors that want to maintain the status quo and limited provider choice are hindering K-12 403(b) plan sponsors from consolidating vendors and improving their plans.

The traditional design of 403(b) plans as individual annuity contracts or custodial accounts for participants resulted in many plans having an unwieldy number of vendors associated with the plan.

This is especially true in 403(b) plans sponsored by K-12 public school systems. Although these plan sponsors may not have the same concerns about this plan design as do sponsors subject to the Employee Retirement Income Security Act (ERISA) and heightened responsibility dictated by the 2007 Internal Revenue Service (IRS) regulations, having so many plan vendors can be an administrative headache, and K-12 school systems are realizing it may not be best for participants.

There is a small army forming of third-party administrators, plan advisers and K-12 403(b) plan sponsors that want to show K-12 school systems a better way.

David Hatter, president of advisory firm Invest-N-U, in Alpharetta, Georgia, says he has been traveling for the past several years telling K-12 403(b) plan sponsors they can improve both participant and employer outcomes, but they have to want to do it. Hatter points out that in the traditional, multiple annuity model, employees with little or no interest in becoming investment experts are in charge. Each individual employee must evaluate multiple service providers, scrutinize investment managers, and benchmark fees and expenses. No doubt that without the time, resources or interest in the subject, most employees are ill-equipped to chart an efficient course to their desired destination: Retirement. “Because they are not subject to ERISA, we can’t say to plan sponsors [making these changes] is the law, but we can say, ‘If you care about your employees and the future of your district, you should consider this,’” he tells PLANSPONSOR.

Hatter says many K-12 school systems are not aware that they can make substantial changes legally, and they have historically maintained a hands-off approach to their plans. In addition, some have fear - sometimes from scare tactics used by service providers interested in protecting the status quo, according to Hatter - that they may make employees or unions angry. That this widespread problem needed to be addressed came to Hatter after working within the status quo with several school systems in Georgia.

NEXT: Bentonville Public Schools finds a better way.

Dr. Sterling Ming, former director of finance with Bentonville Public Schools, tells PLANSPONSOR that before he came to Bentonville, he worked at a district where there were 57 vendors that employees had to choose from for their 403(b) accounts. When he came to Bentonville in January 2006, he knew the district could do better for their employees. Additionally, he says the Bentonville Public Schools as a whole was not pleased with the products and service to participants. The agent servicing all the individual contracts sold multiple annuities, and they were from several different companies, so the annuities were not the same for all employees, and sometimes, after several years, the agent would change participants’ annuities to something different.

The school district also had administration issues with this model, according to Ming. It had to write multiple checks to multiple vendors, and the agent servicing the contracts did not leverage technology. Everything was handwritten and arrangements had to be made to get paperwork from the agent which was a 30-minute drive away. There were also problems with reconciling accounts; the school system would try to reconcile, but communication between the system and the service providers was very difficult, Ming says.

Ming put out a request for proposal for employee benefit advisers interested in assisting the district their employee benefit plan. Though this process, Ming and Invest-N-U connected and began by setting up a committee consisting of one representative from each school and one from each department. After completing several hours of training and education, the committee decided they wanted a single source for employees and a provider to directly serve the school district. Hatter released information that the system was looking to consolidate to one provider, and only a few providers responded. He says he had a difficult time finding plan providers in the marketplace with the same vision about where the school system wanted to go with its plan design.

Hatter says it is still difficult today to find providers willing to work with school systems to try to move from individual contracts to a single platform of mutual funds. He explains that school system 403(b) plans have low participation (on average, less than 20%) and low account balances, so the profitability is not there for a provider in the beginning. "A vendor has to forego near-term profit for potential long-term gains," he says. Only two providers responded to the Bentonville Public Schools' request for proposals (RFP), and the one the system picked dropped the business after 18 months.

NEXT: A provider with a vision helps improve outcomes.

After performing another provider search, Bentonville Public Schools selected Lincoln Financial Group as the new 403(b) plan provider.

The plan uses a three-tier investment approach; participants can choose from a suite of target-date funds (TDFs), from five different model portfolios ranging from capital preservation to aggressive, or from a menu of 17 funds with which employees can build their own portfolios. Ming says employees have the option of transferring assets from their individual annuities into the plan with very little difficulty; some have done so, while some still maintain their annuity contracts.

Hatter says Lincoln has information-sharing agreements with most of the prior vendors, but some would not cooperate. Lincoln also offered surrender reimbursement when they took over as recordkeeper, a provision with which participants can transfer their annuity contract assets into the plan and Lincoln will reimburse them for any surrender charges incurred.

Since the change, participants are better diversified to meet their retirement savings objectives, and costs are lower. According to Hatter, the average cost per employee per annuity was around 2.5%, and this did not include punitive surrender charges that can be as high as 15%. Employee costs are now around 1.25%, which includes administration and investment management. He notes that K-12 school employees are completely unaware of what they are paying for individual annuities; many think they pay nothing. Expense information for annuities are buried in complicated prospectuses, but Bentonville Public Schools employees now have full disclosure on the fees they are paying in the plan on their quarterly account statements.

Hatter says, in 2006, the plan's participation rate was 7% or 8% (employees are also covered by a state defined benefit plan), and now it is greater than 90%. He notes that vendors trying to stop progress will say that moving to a single provider does not increase participation. "It is true that, by itself, it does not, but it is one of many ingredients that when combined can really move the needle," he says. Over the years, the school system has also ***added auto features*** to the plan.

As for administration, Ming says the transfer of information between the school system and Lincoln is "so seamless electronically." He adds that, "When we send a reconciliation report, they verify it and send it back."

NEXT: Getting the board on board helps.

Ming says the school system superintendent was on board with the desired changes to the 403(b) plan and did a good job of educating the school board about the problems with the old plan design. Bentonville Public Schools didn't have a problem moving forward with the change, and the district has no teachers' union; the members of the committee set up by Ming are its voice.

But, Hatter notes that the desire to make a change is not well-supported by leadership for many school systems; politics and the decision-making hierarchy can create obstacles. Further, many systems cannot make decisions without the complications of labor agreements.

According to Hatter, on a fairly regular basis, Bentonville Public Schools' staff receive inquiries from vendors interested in moving it back to a multiple vendor arrangement. "They attempt to scare school officials that don't know how to defend it," he says. "If it weren't for the senior administration support, the system's efforts wouldn't have stood." In addition to ongoing investment supervision, leading committee meetings and providing education to employees about saving for retirement, Invest-N-U assists leadership in defending the new plan design.

According to Ming, moving to a single vendor takes someone who is committed to the process and will devote time to employees. Administrators and the school board will need to be committed to it.

Hatter adds that success for K-12 plans in improving outcomes requires strong support from senior administration for both implementation and ongoing maintenance. In addition, it takes an adviser and recordkeeper that are willing to forego near-term profit for long-term potential. "It takes a lot of experience and knowledge about how employees think about these plans and what questions they will ask," he says.

Ming concludes: "The magic is not consolidating to one vendor. What school districts need to do is decide what they want to accomplish. If moving to a single vendor helps accomplish it, then do so. We wanted to improve service and investment products, lower fees, and provide the best opportunity for employees to be able to retire."