

The "Free" Fallacy

Why "Free" 403(b) Third Party Administrators Are A Bad Idea

With the release of the Final IRS 403(b) regulations school districts across the country are and should be asking themselves many questions. How do I create a plan document? How do I ensure I don't run afoul of Universal Availability rules? What the heck is "meaningful notice"? How do I know when to approve or not approve loans, hardships, transfers, rollovers, and distributions? Do we have the resources to handle these new requirements? Can we hire someone to do this work for us?

These are all good questions, especially the last one. With the increased administrative burden placed on school districts due to new 403(b) regulations it might now be prudent to think about hiring a Third Party Administrator (TPA) to ensure your school district (community college, County Office of Education, non-profit, or church organization) doesn't run afoul of the new rules that will soon apply (1/1/2009) in the 403(b). Many School Administrators are now fielding calls from TPA service companies across the country who want to provide Compliance. In fact, these companies are calling and offering their services for free. That's right, no cost to the school district.

So what's the catch?

As the old saying goes – "There ain't no such thing as a free lunch" – you should be wondering what the catch is. The catch is that these company's primary business (where they earn the majority of their revenue) does not come from providing compliance services, it comes from pushing 403(b) and 457(b) products.

These companies will use "compliance" services as a loss leader in order to get into a school district and sell high cost 403(b) and 457(b) products. Usually the requirement for free compliance services is that the company's 457 plan must be offered and be the sole offering, though this may not always be the case. Companies that offer free compliance services in conjunction with a 457(b) plan are almost always more expensive in terms of the cost of the 457(b). Here is the scheme from the viewpoint of the company trying to get your business:

1. Approach district and scare them about 403(b) compliance (usually by using some letter sent by the IRS)
2. Tell the district they (the company) can help and will do it for free, the district need only make them the sole 457(b) provider
3. Once approved by the board (who will rarely do any due diligence on the 457(b) plan and its expenses – mostly because they don't know how or where to look to see the cost) start doing education workshops on 457(b)

Note: A 457(b) plan has education requirements, that is why they want to be the provider

4. At the education workshops they recruit teachers into their 457(b) plan and use the workshop as a way to talk about 403(b) products
5. Use the district endorsement at the workshop to get employees comfortable with the company, then get employees to transfer all their 403(b) products to them.

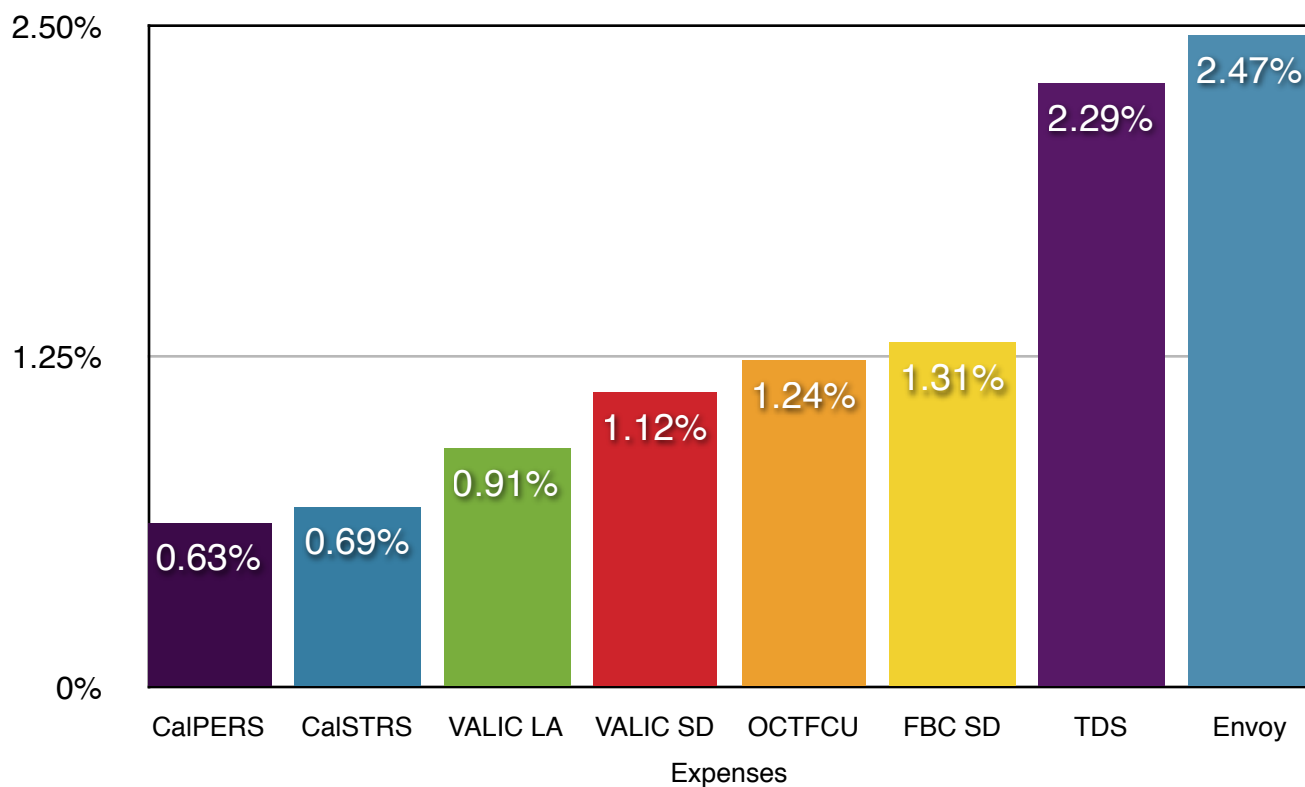
The real money is not in 457(b); however, by being the 457(b) provider the company gets to put on workshops "educating" the employees, the real goal is to entice them to switch all their 403(b) accounts over to their 403(b) products that have high fees.

The real money is in selling and transferring 403(b) accounts. As you can see, the whole point of providing compliance for a school district for free is solely to generate revenue through high cost 403(b) products that are sold to the employees. Even if the entity is forbidden from selling 403(b) products, the cost of the 457(b) plan will in nearly all cases be significantly higher than a 457(b) plan that is not subsidizing a compliance service.

To prove our case about 457(b) plans offered by compliance services being more expensive, we compiled some statistics from a few of the 457(b) plans available in California for Public Schools. The starred providers are those that subsidize "free" compliance with product sales.

Provider	Account Fee	Avg. Annual Cost	Professional Management
CalPERS	\$0	0.63%	N/A
CalSTRS	\$0	0.69%	No Additional Fee
VALIC LAUSD*	\$0	0.91%	Up To 1.25%
VALIC San Diego*	\$0	1.12%	Up To 1.25%
OCTFCU*	\$0	1.24%	N/A
FBC - San Diego*	\$18	1.31%	0.65%
Envoy/Keenan*	\$15	2.47%	Included
Tax Deferred Services - Security Benefit*	\$20	2.29%	N/A

Average Annual Expense Ratio



Average expenses taken from each company's published materials

As you can see, nothing is free. A company that provides "free" compliance is making its money elsewhere, by charging a higher fee on the 457(b). Keep in mind that in most districts the 457(b) provider is allowed to sell 403(b) products and those products may be even more expensive, they certainly won't be less expensive. After running the numbers, we determined that "Free" services are in fact cheaper in the short term; however they can be very expensive in the long run.

The new regulations have also brought a twist on the above scheme. Some districts are not allowing the "Free" compliance company to be the 457(b) provider, but are still allowing them to sell 403(b) products and provide compliance. With the new regulations comes a new provision called "meaningful notice" which requires a school district to notify every eligible employee each year that they may contribute to a 403(b). The "Free" compliance company gets to provide this notice on district letterhead and includes advertising that makes it look like they are the exclusive or endorsed provider (they also allude to the state teachers retirement system to give them more credibility), this leads to inquiries from employees and sales of high cost products.

There is another way to purchase Compliance services that will not require you to forsake your employees by installing a poor 457(b) retirement plan and forcing greedy sales agents on them that are trying to sell everything from 403(b)'s to life and long term care insurance.

The other method is called Fee-For-Service. There are firms in the United States whose sole mission is 403(b) and 457(b) compliance. They charge a fee for that service and do not require (and in fact do not

sell) the use of a proprietary 457(b). These providers do not depend on product sales to subsidize compliance.

Fee-For-Service provider services are not dependent upon the sale of a product and they are profitable solely from the fees they receive from school entities who hire them. But what if you can't afford to pay a Fee-for-Service provider? No problem, many states allow compliance costs to be passed onto the employee (in California the legislature passed a bill last year that allows school districts to pass the costs of compliance on to the employees). Thus, in essence, the Fee-for-Service model becomes free to the school district and a lot of conflicts and costs are eliminated.

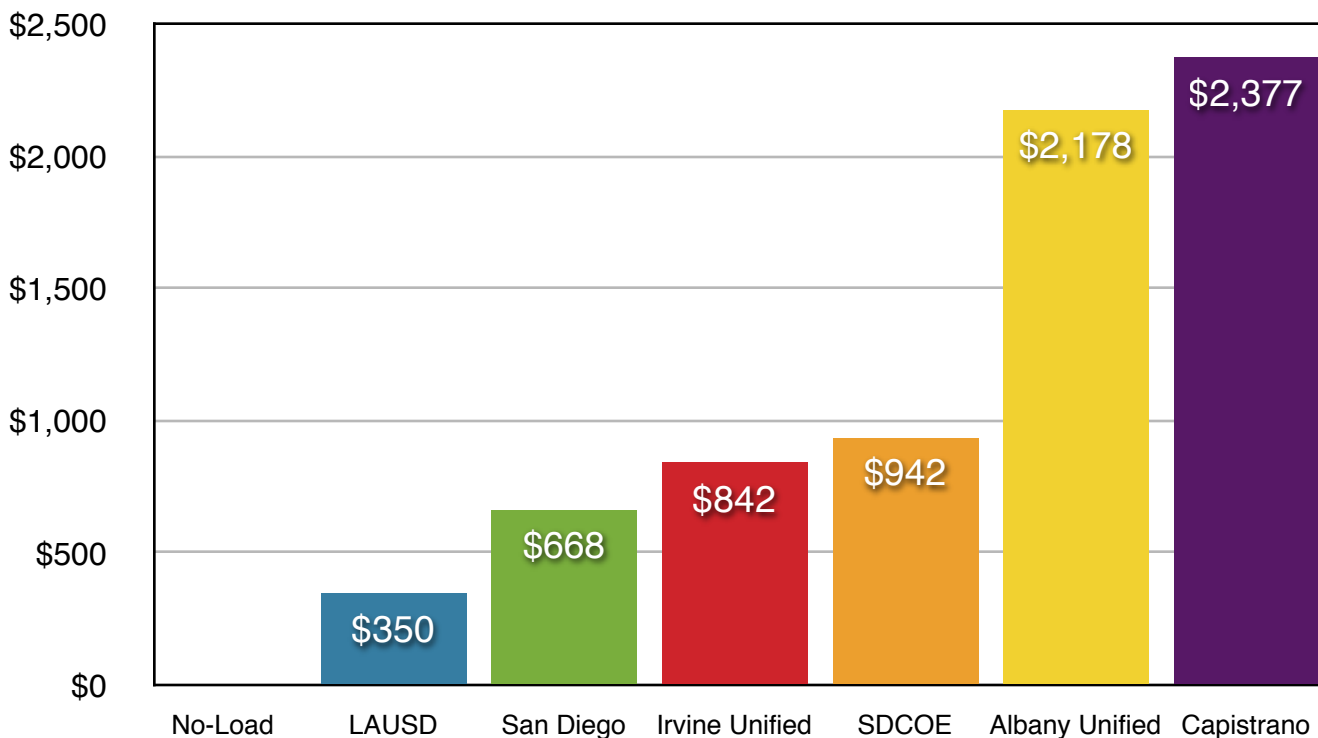
The rest of this paper examines why hiring a Fee-For-Service (FFS) provider is a wise decision for a school district.

Employee Cost Savings

It is difficult to pinpoint the exact savings of utilizing a FFS provider versus a "Free" provider, to do so requires a lot of assumptions. The easiest way to do this calculation would be to compare individuals who invested the same amount of money over their lifetime with different providers, earning the same return before expenses. How much extra per year would it cost the employee who chose a provider other than the "Free" compliance provider. To make the comparison I'll utilize a no-load product available in California that does not subsidize any compliance programs.

I assumed that a 25 year old employee began contributing \$1,000 per year and raised that amount by 5% annually, retiring at age 62 and earning a return before fees of 7.5%. How much extra a year would the "free" compliance services cost that employee? The following chart provides details. I utilized the costs from different California School Districts providers whose information was publicly available.

Comparison: Annual Additional Compliance Costs



The extra fees of the "free" provider compound over time and end up being much higher than had a district simply hired a Fee-For-Service provider who charges the district (or the districts employees) an annual fee for their services. Employees may not be happy about paying the fee, however they have the opportunity to save money in the long term and eliminate a host of conflicts of interests.

The worst part of utilizing a "free" provider is that the only people paying for compliance are those who signed up for the "free" option, in effect they are subsidizing everyone else, this is a fiduciary problem we will address later.

The "Free" providers dirty little secret is that they know school districts won't monitor them and won't ask about their fees, mostly, as we said before, because they don't know where or how to look for them. The TPA knows they will lose a little bit of money in the first few years, but they also know that in the long run they will make way more money by using hidden and high fees to subsidize compliance.

The 457(b) Exclusivity Arrangement

Another problem with the "free" providers is that they usually require that you offer their 457(b) plan and only their 457(b). As you'll later see, this is a conflict of interest and a problem for district procurement rules (which many times require a separate bidding process).

Our contention is that getting "free" TPA services in exchange for 457(b) exclusivity is harmful to your participants because it prevents competition (rarely is a bid done to find the best 457(b) plan). A sole provider for a 457(b) is probably a good idea, however there are times when having more than one provider may make sense. The problem is that many "Free" TPA's will not allow a school district to offer another 457(b) program, even if it's in the best interest of the employees.

Currently, in Orange County, California, a certain "free" TPA will not allow the school districts it services to utilize a 457 Certificate of Deposit program at the local credit union which is paying a guaranteed rate of return of up to 7%. The employees clearly should have access to this program, however the TPA will not allow it, there is no good reason given. Competition is the reason. This "free" TPA doesn't want money that they could capture and charge fees on (very high fees in our opinion) to go to the credit union. This represents not only a conflict of interest, but a possible breach of fiduciary duty on behalf of the TPA (and its districts). The credit union in this case is not innocent either, they also offer a TPA program and they know that by offering the high yielding Certificate that more districts will adopt their plan exclusively and that a large amount of assets will actually flow to their more expensive 457(b) program.

An independent TPA, with no products to sell and no requirements on providers has a unique advantage in that they can keep your plan in compliance regardless of if there is one provider or more. We believe it is preferable to have one provider, however there are instances where having multiple providers can make sense. If your "free" TPA locks you into an exclusive arrangement, you may be selling your participants short. You need a compliance entity that works in the best interest of the participants, not the best interest of a financial services company selling products.

Employee Hassle Savings

A Fee-For-Service provider will not be on your campuses harassing your employees in an attempt to sell high-cost commission based products. In fact, an FFS provider should help institute policies that police the sales reps that currently troll the halls of your campuses. A FFS company is more likely to be

impartial, meaning less of a chance of sales agents calling the district claiming unfair competitive practices.

Fiduciary Responsibility

Most districts are unaware of their Fiduciary Responsibilities when it comes to 403(b) and 457(b) retirement plans. While it is not clear what Fiduciary Responsibility a district has in a 403(b), it is clear that the district, when paying for compliance services has a responsibility to not allow one set of employees to subsidize the compliance costs for another set of employees. When a district hires a "free" provider to provide compliance, the costs of that compliance are born by those employees who choose to sign up for that providers product offerings.

Those employees who choose not to participate in a 457(b) or choose to participate in another providers 403(b) bear no burden of paying for the compliance cost. In effect only those who sign up for the "free" TPA provider's products pay the compliance costs. These individuals subsidize those who choose other products. This is a breach of fiduciary responsibility for both the 403(b) and the 457(b) in my opinion.

In the case of the 457(b) plan you have a situation where participants in the plan are paying higher fees in order to subsidize compliance costs in a completely unrelated retirement plan (the 403(b)), this is an improper use of plan assets as those assets may only be used for the benefit of those in the 457(b).

These "free" arrangements abound in California and across the United States, they are a clear breach of fiduciary responsibility, it is only a matter of time before someone sues a district claiming they were damaged. Regardless of cost savings, for fiduciary reasons alone a school district should utilize a Fee-For-Service provider. Many school districts have no idea they are breaching their fiduciary responsibility, they think that by hiring a "free" compliance entity they are fulfilling their responsibility and saving money that can be used elsewhere, they are mistaken. In the long run the legal ramifications could be large.

Conflicts of Interests

Hiring a "free" compliance entity whose revenue is dependent upon pushing products presents many, many conflicts of interest that districts need to be aware of. It literally is like letting the fox watch the hen house. What follows are six common conflicts of interests that exist with "free" TPA's:

- The most obvious conflict of interest is the fact that it is in the best interest of the product pushing compliance entity to limit its competition. "Free" providers will limit competition in many ways, but the most common method is making the Hold Harmless Agreement (the agreement between the district and vendor) very onerous in an attempt to prevent the other vendors from signing up with the school district. These "free" vendors may require unreasonable communications from the company or use any arbitrary provision to disallow a competitor. The interest is in limiting competition, not providing compliance. One TPA in California recently started requiring vendors to run approvals for Required Minimum Distributions through them. This creates a situation where the district now has liability for retired employees, not smart, however it creates a situation where a vendor will not sign the agreement, thus fewer competitors.
- Another less obvious conflict is that the "free" compliance entity can apply rules that arbitrarily benefit the TPA. Since most of these "free" TPA's generate their revenue in the form of asset based fees they have an incentive to not allow money to move out of their products, even if for perfectly legal and prudent reasons. The longer they can hold onto the money, the more they earn in fees.

This is a major conflict of interest that can be very simply avoided by hiring a fee-for-service provider.

- When a district employee calls up the "free" TPA to ask about what 403(b) or 457(b) plan they should invest in they are not going to get an unbiased answer. That person will immediately be transferred to a sales agent of the TPA and sold a product. The TPA has no interest in providing unbiased information to your employees. They are in this to make money.
- A huge conflict of interest is inherent in the "free" TPA service. As a fiduciary of a school district 457(b) plan, the business officials have a duty to seek out the best plan. Fees don't have to be the lowest, but they do have to be reasonable in light of the services provided. If a school district automatically excludes 457(b) providers who don't provide a bundled 403(b) compliance solution, they are breaching their fiduciary responsibility and this represents a major conflict of interest on behalf of the school district.
- Sales agents of the "free" TPA are almost always given more rights than other sales agents. All sales agents should be required to abide by the same set of rules, this is not the case with TPA's that employ sales agents. The TPA is conflicted because they make more money when their agents are given special access. An FFS option creates a standard set of rules for all sales agents and doesn't favor one over the other.
- The new regulations could be interpreted to mean that all existing 403(b) contracts are "discoverable", meaning a district might need to find out from each employee where their 403(b) money is at. What company is the money held with, how much money, and contract details may have to be provided to the school district. If the district hires a "free" product based TPA, all of this information, including a lot of private information will be held by the TPA. What are the chances that the TPA doesn't share that information with their sales agents (even though they publicly will say the don't). The odds are overwhelming that the employees with the highest account balances will be targeted by the TPA's sales agents. This conflict can easily be eliminated by hiring a Fee For Service provider that doesn't sell products.
- "Free" TPA's don't make money from providing Compliance, they make money from selling products. The Compliance work is secondary and it is a cost center. This provides an incentive to cut corners with compliance in an attempt to save money.

Competency

An entity looking to hire a Third Party Administrator should inquire as to what is the primary mission of the TPA. Furthermore they should dig in deep and verify the truth of whatever statement they receive. The primary mission should always be to ensure compliance for the district, not to sell products. Of course, most "free" TPA's will say that their primary mission is to provide compliance, however if you ask them where their primary revenue comes from you will find it comes from product sales, not providing compliance. If a TPA receives more revenue from product sales than providing compliance you should seriously question their competency as compliance is probably being used as a bait and switch to sell your employees products.

Audits

The primary reason you hire a TPA is to ensure that if you are audited by the IRS that you will pass that audit with flying colors. The second reason you hire that TPA is because they will commit to you that they will be with you every step of the way before, during and after an audit. Your TPA should commit to you that they will be present and will conduct the audit meeting with the IRS.

Most "Free" TPA's will not represent you in an audit, they will simply retrieve documentation that you or the IRS ask for, this is unacceptable. Your TPA should have experience in IRS audits and be able to show proof by providing "Closing Letters" from the IRS from audits they've been involved with. You should get in writing that your TPA will represent you for NO ADDITIONAL FEE and will be with you every step of the way if you are audited.

Float

Will your "Free" TPA ensure that deposits are made to your employees retirement accounts in a timely fashion? We know of at least one TPA in California (a "free" one) that has as its standard operating procedure that they will hold district funds for a minimum of 14 days before forwarding to the vendors. This is called "float" and the "Free" TPA company is able to invest that money at about 5% (on an annual basis) during those 15 days and earn interest on it, this is theft as that money should be in your employees account earning interest as soon as possible. Imagine if a company remitted around \$100 million a month for various school districts, if they held the funds for 15 days each month they would earn about \$2.5 million in interest. Not only does this open up the school district to liability (charges by employees that someone else is benefiting from their money) it is unethical and under the new regulations for 403(b), quite possibly illegal. If your "free" TPA is not immediately remitting funds to your employees accounts, they should be dismissed.

Experience

Many "Free" TPA's have suddenly popped up from nowhere. Three years ago they didn't exist. Many product sales companies that have been around for a long time have suddenly added TPA services, however they have very little experience in providing these services. If a district asks about experience they are usually given the experience of the company, not of the individuals who will be running the compliance TPA services. If a compliance entity (or unit of that entity) hasn't been in business making money for at least five years then they should not be considered. You want a firm that has been immersed in providing compliance and compliance only for a long time.

Common Remitter or Compliance Expert

Common Remitting is one function of a TPA. A school district will send money to the TPA, usually a single check, wire or ACH and the TPA will then remit the funds to the vendors and do the follow up work necessary to ensure the money is properly credited. Some "Free" TPA's are really just common remitters in disguise. They will do common remitting and very little other compliance. They make money on the float and by selling products, but they rarely provide the full services that are needed to truly do compliance. There is a big difference between an entity that only does common remitting, versus one that does true compliance. You need to ensure that you are hiring a company that will keep you in compliance, not one that could place you into litigation. Recently, a free TPA in California who is basically just a common remitter and a product sales organization told a group of district administrators that "compliance

is easy, anyone can do it." Perhaps that was true before the new regulations (it isn't), but it is not true now. Any company representing compliance as easy is not a company that should be hired.

Recent Developments

The latest twist on "Free" compliance services are product driven compliance TPA's who now also charge a fee. That's right, they sell products and charge a fee. I can't think of a good reason to hire a company that charges you for compliance and then offers your employees excessively expensive products. When hiring a TPA, make sure that if the TPA says they are fee-for-service that they don't also have high cost products to sell.

Conclusion - There is No Free Lunch

Famed economist Milton Friedman made famous the phrase "There ain't no such thing as a free lunch" and though he wasn't talking about the market for Third Party Administration services for Compliance, the phrase still rings true. A district must ask themselves whether they are willing to sacrifice their employees in order to receive "free" TPA services.

Furthermore a district must ask whether or not they are willing to go through the costly litigation that could follow if they choose a "free" TPA service and it doesn't work out as promised.

Don't get caught using a "free" TPA when there are much better options available.

Scott Dauenhauer, CFP, MSFP, AIF is a fee-only financial planner and consultant to government institutions on how to best structure their retirement plans. Recently Scott has worked with the California State Teachers Retirement System to revamp their 403(b) offering, add a 457(b) plan and start a Fee-For-Service compliance entity that will service California School Districts 403(b) and 457(b) retirement plans. His website is www.meridianwealth.com and his e-mail is scott@meridianwealth.com. He also publishes The Teachers' Advocate blog, <http://teachersadvocate.blogspot.com>.