A Primer on Plan Fees

A guide to the different plan fee pricing models and the steps to take to ensure fees are reasonable.

By Jean Martone

One of the many duties plan fiduciaries have is to understand the fees and expenses charged to their employer-sponsored defined contribution plan. While ERISA does not provide specific guidance pertaining to fee amounts, it does require that fees charged to a plan be "reasonable." As a result, fiduciaries must carefully monitor fees being charged to ensure that expenses are reasonable relative to the services and investments provided.

The Derivation of Plan Fees

Generally, there are three types of defined contribution plan fees and expenses:

- **Plan administration fees** — service fees charged to the plan such as recordkeeping fees, compliance testing fees, trustee fees, etc.
- **Investment management fees** — operating expense ratios, which include investment management fees and various operating and administrative expenses
- **Individual service fees** — loan fee, distribution fee, etc., typically paid by plan participants

On July 1, 2012 the Department of Labor (DOL) finalized regulations under Internal Revenue Code (IRC) Section 408(b)(2) requiring that service providers to employer-sponsored retirement plans disclose information to assist plan fiduciaries in assessing the reasonableness of service contracts or arrangements, including the reasonableness of the service provider's compensation and potential conflicts of interests. Within such contracts or arrangements, revenue sharing, the fees paid by mutual funds to providers who perform the recordkeeping functions for participant-directed plans, should be outlined

Plan Administration Fees

Plan administration fees include fees that encompass the recordkeeping of plan participant accounts, interfaces with the client, compliance services including non-discrimination testing, employee education materials, website and mobile technology, call center support and any trustee fees. Plan specific variables, such as plan assets, number of participants, average account balance per participant, number of payrolls and frequency of data transmissions, and inclusion of company stock (whether offered on a share basis or unitized) impact the cost of plan administration. Revenue sharing available to the service provider through the investment options can serve to offset the recordkeeping costs. At a minimum, such fees should be evaluated in concert with the annual required disclosures, with special attention in the event of any marked change in plan variables or changes to the funds offered within the plan.

Investment Fees

The largest, and perhaps most involved component of fee analysis concerns investment-oriented fees. Such fees vary by investment vehicle and involve different components — namely management fees, administrative fees, revenue sharing available, and custodial fees. Mutual funds are most prevalent among defined contribution plans, however, collective investment trusts (CITs) and separate accounts may be offered based on plan size and assets according to mandate. Such non-registered investments may involve other layers of fees, such as unitization and other accounting fees. Funds-of-funds vehicles — most of the target date funds in the marketplace — present the more complex task of analyzing the layers of fees represented by the component funds.

Regardless of the types of investments offered within a plan, plan sponsors should regularly monitor the investments, from performance and fee perspectives, conducting an analysis inclusive of comparable funds and appropriate indices, as well as ascertaining the appropriateness of the fund share classes to determine suitability. Upholding this fiduciary responsibility will re-affirm investment offerings within the plan, and provide documentation in the event of any lawsuit.

Individual Service Fees

Fees such as loan initiation and servicing fees, withdrawal and distribution fees, and fees for utilization of advice or managed account services, are typically borne by the plan participants. Assessment of such fees should be performed as they apply to each participant as well as in aggregate according to annual transaction activity. Such an exercise will promote fiduciary compliance.

Pricing Models

Each service provider may offer different ways to price the administrative services for a plan. The three most common models are bundled, per participant, and basis point pricing. There are no guidelines stating which model a service provider must or should offer, or which one a plan sponsor should adopt. Plan sponsors must weigh the pros and cons of each model as it applies to their particular plan and company circumstances.

Bundled Pricing

In the *bundled* model, the service provider collects all of the revenue sharing from the plan's investment options. Generally speaking, in favorable market conditions, the service provider will receive more revenue, and conversely, in declining markets, the service provider will receive less revenue. Revenue received is impacted by both market conditions, and participant behavior in light of those conditions. A revenue target or threshold may be communicated to the plan sponsor, not necessarily a required revenue figure; therefore, the plan sponsor is not necessarily aware of the exact revenue need, or the shortfall or excess revenue incurred by the service provider.

Implications

Pros:

- The service provider will typically assume market risk. Historically, providers have not assessed fees in down markets, even during the downturns of 2008 – 2009.
- In general, the plan will not incur hard dollar fees if the plan's revenue target is not met due to participant behavior and/or negative market conditions.

Cons:

- A Plan Expense Reimbursement Account (PERA) (sometimes referred to as an ERISA budget) is often not available as the service provider retains any excess revenue. However, some providers may circumstantially permit excess revenue to be used to reduce plan expenses or rebate participant accounts. In cases in which both options are available, the plan sponsor must decide how the excess is to be applied. The plan sponsor needs to monitor the balance maintained in the ERISA budget and determine which plan expenses are eligible for payment.

Basis Point and Per-Participant Pricing

In the *basis point* pricing model, the service provider sets a revenue requirement expressed as a percentage of plan assets, in basis points, whereas, in the *per participant* pricing model, the provider sets a revenue requirement expressed as a fee per each participant with a balance in the plan.

Implications

Pros:

- The plan assumes any excess revenue generated by the plan investment lineup and may have the option to create a PERA to assist with eligible plan expenses or, alternatively, rebate participant accounts. The future cost for plan administration can perhaps be better estimated given the communicated revenue requirement and excess/shortfall.

Cons:

- The plan assumes any hard dollar fee resulting from revenue shortfall due to participant behavior and/or reaction to down markets.

Paying for the Plan

Once the plan sponsor determines the optimal pricing model for the plan, then a decision must be made on how to pay the service provider. Historically, revenue sharing has been used to take care of those costs. However, plan sponsors are beginning to consider if this method is the most equitable way to pay for the plan.

Revenue sharing or hard dollar fees?

Using revenue sharing: Plan revenue is a function of assets invested in each investment option offered within the plan. Different funds and share classes of funds offer different revenue sharing. Generally speaking, the funds with higher operating expense ratios tend to offer more revenue sharing to the service provider. Notably, participants who invest in the funds paying the highest revenue-sharing amounts are likely paying a disproportionate share of administrative plan expenses (verses those participants investing in lower revenue-sharing funds offered within a plan, such as index options for example).

Assessing a hard dollar fee: Each participant, regardless of allocation of his/her investments and retirement plan balance, will incur the same cost, so that there is no disparity among the participant population in that regard. If some of the funds in the plan are paying revenue sharing, the revenue can be rebated back to those participants in an effort to have all participants pay the same fee.

Recent Trends

With respect to pricing models, many service providers have migrated from bundled arrangements to either per-participant or basis point pricing over time. More recently, the per-participant model has become prevalent as providers bid on new business. Service providers may not be as willing to assume the risks, perhaps due to the volatility of the markets over the last several years. In addition, plan sponsors are examining whether a service provider should be able to earn more dollars just because of growth in a plan as opposed to delivering more services to participants.

With the rash of litigation concerning defined contribution plan fees and the emphasis on fee disclosure, there is increased pressure to lower investment expenses incurred by participants by switching to lower-cost vehicles or share classes that offer little or no revenue. In addition, an argument can be made that there is a fixed cost to recordkeeping and participants should not be paying based on account size.

Further, although ERISA contains no provisions specifically addressing how plan expenses may be allocated among participants and beneficiaries, there is rightfully greater concern about equitable application of fees, so that all participants in effect bear the same cost.

Actions to Safeguard Good Fiduciary Standing

It is important to work with your assigned central point of contact, or relationship manager with your plan service provider, your consultant (if you have hired one), and ERISA counsel to review and monitor plan fees annually. This exercise can be prompted by issuance of the required fee transparencies provided by your plan service provider. Items to consider include:

- Ensure understanding of the different fee models available to you as a client, and implications to the plan and participants.
- Ask your service provider to show how your plan compares to others in your industry in terms of plan design features, investment options offered, and fees, and how your plan compares to similar plans within the client base.
- If not initiated by your central point of contact, facilitate a discussion about the impact of the current fee model on the allocation of plan fees. Inquire about the different methods of allocation, as many service providers are investigating or have recently instituted fee-leveling services that could impact the proportion of fees incurred by each participant.

A deeper dive is warranted periodically, however, to determine the reasonableness of all plan fees. It is quite an undertaking, but essential to ensure fair plan pricing in the marketplace. Such an exercise would involve working closely with your current service provider to gather timely plan data that is deemed essential to pricing the plan, encapsulating administrative, investment management, and participant servicing fees, as outlined previously. Such data would be supplied to several service providers that offer comparable services so that they can in turn provide pricing for the plan so that a comparable analysis can be conducted. Proper documentation of this process, analysis, and results can help support the rationale and soundness of fiduciary decisions involving plan fees, deter lawsuits and, in the event of any lawsuit, afford protection. There are many fiduciaries who have elected to conduct fee studies such as this through third-party investment/retirement plan consultants and they have proved beneficial to fee negotiations with current service providers and, in some cases, substantiating the need to engage in an RFP process for plan servicing.

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