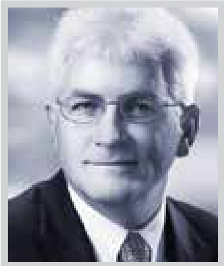
Fiduciary Flags

How to effectively manage your retirement plan fees



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If your organization offers retirement plans as an employee benefit, you're subject to the provisions of the Employee Retirement Income Security Act (ERISA), a federal law that covers administrative aspects of these plans. Recently, ERISA litigation has been grabbing headlines, and they seem to have a common theme: retirement plan fees.

The courts do not suggest lowest cost is a safe haven. Instead, precedent points to the fiduciary's duty to maintain a reasonable cost structure with evidence that oversight of participant fees occurs. If you're one of the chief people responsible for the oversight of your organization's plan, what should you do?

By understanding the components of your plan's cost structure and applying current best practices, you can prudently manage participant fees and help boost account balances in the process.

Understand the types of fees paid

The three largest expenses associated with the operation of your retirement plan are asset management, plan administrative services (record keeping) and advisory services. Before offering tips on effectively negotiating and managing these costs, let's understand each expense.

Asset management: This is the largest single cost to the plan and, therefore, your participants. The stated expense ratio of the investment vehicles you make available to your participants often includes more than the fees required by the asset management firm. The "more" refers to revenue sharing (loads and 12b-1 fees) and represents an addition to the expense ratio that is used to provide compensation to other plan service providers. In fact, plan sponsors commonly use revenue sharing to pay for plan advisory and record keeping services. Remaining revenue-sharing dollars may be used to purchase additional plan services, such as participant communication and education. As the revenue-sharing amounts are included in the fund's stated expense ratio, they represent a concealed cost. Additionally, because these fees are asset based, they grow as the invested assets increase from market appreciation and contributions. This means automatic annual pay raises for any provider compensated through revenue sharing.

Record keeping: The plan's record keeper performs a host of critical daily administrative functions for the plan, including maintaining the individual participant accounts, safeguarding the plan's assets, providing plan documents and performing compliance testing. Historically, record keepers' compensation was derived from a combination of asset management fees, revenue sharing

and participant charges for transactions such as loans or distributions. Consequently, much of their compensation lacked transparency.

Advisory services: Many plan sponsors utilize an adviser to assist with the selection and monitoring of investments and to provide education services to the plan participants. It is a common industry practice for the adviser to be compensated by the annual stream of revenue sharing generated by the plan's assets.

Negotiate efficient fee arrangements

Now that we've identified the primary types of expenses you might encounter, let's develop a framework to best manage and control these costs.

While asset management costs are asset based, the plan sponsor may choose from a wide selection of share classes and cost structures. Our recommendation is to seek the lowest possible cost shares for which your plan will qualify, eliminating share classes with revenue sharing built into their pricing. By doing so, you will improve transparency and obtain greater control over the plan's overall cost structure.

Inevitably, your investment menu will continue to generate some revenue sharing. Current industry best practice suggests instructing your record keeper to return these amounts to the specific participant accounts invested in the funds creating the revenue.

For your plan record-keeping costs, the elimination of revenue sharing will require negotiation of an independent fee for the plan record keeping services. Require your provider to establish a fixed-dollar fee based on the number of participant accounts record-kept. This fee, a per-participant fee, will vary as the number of plan participants changes, aligning costs more closely to services provided. When discussing fees, inquire about other direct and indirect sources of revenue received based on your plan. Examples of additional compensation record keepers receive include shareholder servicing fees (negotiated between the record keeper and investment manager) and platform or shelf-space fees.

Similarly, remember to address advisory costs, which may also be tied to the asset values of your plan. Instead, require a fixed-dollar fee arrangement.

Equitably allocate costs to your participant base

Most plan sponsors elect to charge all plan-related expenses to the plan. Historically, cumulative costs were shared across the plan on a pro-rata basis based on plan assets. With a pro-rata allocation, however, participants with large account balances pay a greater share of the plan administrative costs than participants with smaller balances. The large account holders may feel as though they are subsidizing the costs for those saving less diligently.

An alternative method is to divide the costs equally among the participants in the plan in the form of a fixed, per-participant charge. Allocation on a per-participant basis establishes a uniform cost across all participants. On the other hand, it results in the low balance accounts paying a meaningfully larger percent of their account each year for plan services, hindering their ability to grow their accounts.

Recognizing these concerns, an increasingly popular strategy is a fee allocation methodology that incorporates elements of pro rata and uniform costs. A fixed per-participant fee ranging from $40–$80 per year is assessed to every participant, regardless of account balance. The remaining money necessary to pay administrative costs is allocated on a pro rata basis according to the participant's account balance. This methodology provides participants with greater transparency and effectively communicates a base cost of participation in the plan, regardless of account balance.

Your participants have a right to fully see and understand the cost of participating in your retirement benefit. Your responsibility as a plan fiduciary, and your desire to assist them in building retirement wealth, will be well served by having a prudent process to monitor and manage the ongoing cost profile of the plan. Implementation of the strategies described won't exempt you from a potential ERISA claim, but you will be well positioned to construct your defense.

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TOPP'S COST TIPS

- Utilize lowest-cost share class funds.
- Drive out revenue sharing.
- Return remaining revenue sharing to participants.
- Request fixed-dollar per-participant record keeping fee.
- Establish fixed-dollar adviser fee.
- Develop transparent participant cost allocation methodology.
- Monitor and benchmark all plan costs annually.