Understanding and Evaluating Retirement Plan Fees

Michael Volo
Senior Partner, Cammack Retirement Group

With retirement plan fees serving as the centerpiece of ERISA fiduciary breach lawsuits, understanding the dynamics of retirement plan fees is critical for plan sponsors and fiduciaries. Regardless of plan size or defined contribution plan type (401(k), 403(b) or 457(b)), fees have become a primary focus and concern of plan fiduciaries.

The Department of Labor (DOL) has been very clear about a fiduciary's responsibility: "Understanding and evaluating plan fees and expenses associated with plan investments, investment options, and services are an important part of a fiduciary's responsibility . . . Among other duties, fiduciaries have the responsibility to ensure that the services provided to their plan are necessary and that the cost of those services is reasonable."

This article takes a holistic approach by exploring the three types of fees that retirement plan fiduciaries need to understand and evaluate:

1. Investment fees
2. Recordkeeping and administrative fees
3. Other service provider fees

For plan fiduciaries, it is prudent that the process for reviewing and managing fees be documented and addresses items such as:

- Benchmarks to be used when evaluating fees
- Frequency with which fees will be reviewed
- Method for allocating various fees (i.e., Will the fees be borne by the employer or the plan/participants? How will the costs be allocated?)

INVESTMENT FEES

It is important that investment fees *and* performance be reviewed on a regular basis—at least annually, with quarterly reviews most common. As part of this review, it is important that investment fees not be evaluated in isolation, but in conjunction with performance.

The criteria for fee and performance reviews should be contained in the plan's investment policy statement (IPS). While nothing in ERISA requires an IPS, it is highly recommended that one be adopted to provide a framework for investment oversight.

Elements of a typical IPS include:

- Guidelines for the asset classes the plan will contain
- A process and criteria for reviewing and selecting investments
- A description of how costs will be measured

Investment fees should be compared to peers in the same investment category (e.g., large cap blend), and in conjunction with investment performance versus the category and the index (e.g., S&P 500 for a large cap blend fund). In some instances, the fund may have a custom benchmark defined by the investment manager which should be used for comparison purposes.

Reviewing quantitative data on fees and performance serves as a good starting point for plan fiduciaries when monitoring investments. There are also qualitative aspects to analyzing a fund, which is typically part of an investment advisor's process. Quantitative and qualitative analysis is particularly relevant for actively managed funds, as opposed to index funds. With index funds, oftentimes it is best to simply use the fund in the category with the lowest fees. (Tracking error is also important.)

Share Class Review

As part of a fiduciary's responsibility to review investment fees, it is important that the share classes of the investment options be evaluated in an effort to attain the share class with the lowest net investment fee—which may not necessarily be the share class with the lowest expense ratio.

There is an alphabet soup of share classes for mutual funds (e.g., A, Investor, Institutional, R1-R6, etc.) available to retirement plan sponsors. This plethora of share classes was developed to provide various pricing mechanisms (and expense ratios) and allow plan sponsors to use a portion of investment expenses to pay for recordkeeping and administration services.

A fund's expense ratio is comprised of two primary components:

1. Revenue sharing, which is revenue available to offset administrative expenses, or an "administrative revenue allowance"
2. Net investment fee

What is the net investment fee? It can be determined by subtracting the revenue sharing from the fund's expense ratio (i.e., Expense Ratio – Revenue Sharing = *Net Investment Fee*).

Because some fund families institute a disproportionate amount of revenue sharing across share classes, the share class with the lowest expense ratio may *not* be the share class with the lowest net investment fee. Exhibit 1 is an example of this.

EXHIBIT 1:

Fund Name	Expense Ratio (%)	Revenue Sharing (%)	Net Investment Fee (%)
ABC International Fund - Institutional Class	0.95	0.00	**0.95**
ABC International Fund - Investor Class	1.19	0.40	**0.79**

Many ERISA attorneys believe that, from a fiduciary perspective, choosing the investment option with the lowest net investment fee is most prudent. With revenue sharing being used to pay for recordkeeping and administrative fees, or in the case of fee levelization the revenue sharing being credited to participants invested in the fund, choosing the fund's share class that has the lowest net investment fee appears to be a sound fiduciary decision.

RECORDKEEPING AND ADMINISTRATIVE FEES

Recordkeeping and administrative fees should be reviewed regularly to assess whether fees are reasonable for the quantity and quality of services being provided. The plan sponsor clients we service have these fees and services benchmarked annually, and we suggest conducting a more formal recordkeeper search and selection process approximately every three to five years.

Benchmarking Fees

Recordkeeping and administrative fees should be evaluated and compared to plans of similar size and type that are receiving analogous services. While each plan is unique, making an "apples to apples" comparison imperfect, evaluating fees against similarly situated/sized plans provides a good reference point in helping to determine if plan fees are reasonable.

Recordkeeper Search and Selection Process

There are two primary approaches to conduct a recordkeeper search and selection process: 1. Request for Information (RFI), and 2. Request for Proposal (RFP). Conducting an RFI is a streamlined approach for soliciting fee and service proposals from recordkeepers, where plan information and service requirements are provided to the recordkeepers, along with perhaps a handful of questions and a request for pricing (for whatever scenarios are requested). Conducting an RFP is a more extensive process that contains the same elements of an RFI, along with a more thorough questionnaire and due diligence process, including likely conducting interviews with the finalist candidates. This process should be undertaken if a plan sponsor is seriously considering moving to a new recordkeeper.

Establishing a Fixed Fee for Recordkeeping and Administrative Services

We believe it is important that plan sponsors establish a fixed fee for recordkeeping and administrative services. The term typically used for this fixed fee is "recordkeeper required revenue." The fixed fee should be requested from the recordkeeper(s) in the form of both a pro rata fee (i.e., a percentage of plan assets) and a per capita fee (also known as a per-participant, or per-head, fee). Plan fiduciaries continue to grapple with which method (pro rata or per capita) may be best for their plan. While this topic has been raised in the fiduciary breach lawsuits brought against several large universities, the Department of Labor (DOL) has not opined on one methodology being better than the other.

Allocating Plan Fees

The traditional approach to allocating plan fees incorporates the use of a revenue credit account (also known as an expense reimbursement account or ERISA budget account). In the traditional approach, the revenue sharing from the plan's investment is used to offset the recordkeeper's required revenue.

If the total revenue sharing is insufficient to meet the recordkeeper's required revenue, the shortfall in fees must be collected. The organization may elect to pay this amount directly or to pass it on to participants. If the total revenue sharing exceeds the required revenue, the excess amount is allocated to the plan's revenue credit account. The plan fiduciaries can elect to use this excess revenue sharing captured in the revenue credit account to pay for qualified fiduciary expenses, such as auditors, legal counsel, advisors, communication initiatives, and other plan expenses, or return the excess amount back to participants.

Many fiduciaries believe that having each participant pay their portion of recordkeeping fees is a more transparent and equitable approach to fee allocation (versus the traditional approach described above). While each methodology has its merits, it is important that retirement plan committees understand their options. When using the more transparent approach, a per capita fee may be the simplest for participants to understand; however, it is inconsistent with how investment management fees are charged and is a regressive fee (i.e., lower balance participants pay a greater proportion of fees). Conversely, a pro rata fee is consistent with the methodology of investment management fees and is a progressive fee (i.e., the larger the participant's balance, the larger the fee for that individual).

When adopting pro rata fees, many opt to "levelize" fees at the participant level. In the fee levelization model (also known as revenue equalization), the recordkeeper applies the required revenue to each individual investment option. If the investment has exactly the required revenue amount (0.20% in our example) in revenue sharing built into its expense ratio, then the fees match. If revenue sharing in the fund exceeds required revenue (e.g., 0.25%), the recordkeeper credits each participant who has assets in the fund with the amount of the excess (in our example, 0.25% - 0.20% = 0.05% credit returned to participants). If the investment provides less than the required revenue amount, the recordkeeper adds a “wrap” fee, in the amount of the shortfall, to the accounts of each participant using the investment. A participant with several different investments might experience multiple credits and debits based on the revenue sharing in each investment, relative to the required revenue.

Fee levelization addresses the issue of participants invested in higher revenue sharing funds subsidizing the recordkeeping fee for participants invested in low/no revenue sharing funds (e.g., index funds or institutional share classes). It also allows plans to use the lowest net investment fee options, as no revenue sharing is needed. It is important to note that the methodology selected for recordkeeping fees (pro rata or per capita) can be different than the methodology used to actually allocate the fees to participants. For example, some plan sponsors take a hybrid approach, electing a per-participant cost for calculating recordkeeping fees, but allocating the total fee to participants on a pro rata basis, based on the participant’s account balance. Recordkeeper capabilities vary, so the hybrid approach may not be available based upon the service provider you utilize.

OTHER SERVICE PROVIDER FEES

Other service provider fees should be evaluated on an annual basis, including audit fees, legal fees and investment advisory and consulting fees. Similar to recordkeeping and administrative fees, if there are concerns regarding the quality of service being provided or the level of fees being paid an RFI or RFP should be conducted.

Ultimately, having a sound fiduciary process is what’s most important. Conducting regular reviews, documenting the process and details that lead to decisions and having a regular forum to discuss plan issues and consider alternatives protects fiduciaries and benefits plan participants.

ADDITIONAL RESOURCES

- Retirement Plan Fees: Top 3 Questions Answered
- Mutual Fund Share Class Evaluation: A Focus on “Net” Costs
- Best Practice: Conduct a Vendor RFP Every 3-5 Years
- Four Steps to Selecting a Retirement Plan Advisor
- Fee Allocation in Retirement Plans

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For more information on our services, please contact **Mike Volo,** Senior Partner, at **781.997.1426** or **mvolo@cammackretirement.com**.

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