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What's a Plan Sponsor to Do?

401(k) fees are not an easy issue, but there are many options available to employers that they might not be considering.

By Lori Lucas

Imagine being told that you can buy any car you want, as long as you understand not only the price of the car, but the individual price of the engine, chassis, emissions system, etc.

That, in essence, is the challenge facing 401(k) plan sponsors as they determine what they are paying in record-keeping fees in light of recent fee litigation, upcoming Department of Labor regulations and potential legislation.

When it comes to 401(k) fees, there is no doubt that transparency is important. Most people would agree that the consumer who knows a car's Kelley Blue Book value is likely to get a better deal than the consumer who doesn't. Simply put, greater transparency can lead to lower pricing.

Yet the challenges of achieving such transparency can be significant, especially when it comes to 401(k) plan revenue-sharing arrangements. Revenue sharing is the practice of defraying some or all defined-contribution administration costs through a portion of the asset-based fees of mutual funds in the plan.

For example, a mutual fund with an expense ratio of 0.65 percent might share 0.15 percent in revenue with the record keeper. That means that if a participant in the plan has $100,000 in that fund, that participant is paying $500 in investment management fees and $150 in administration fees per year for that fund.

Revenue sharing can be fraught with ambiguities. Say the mutual fund described above is the XYZ Fund, and XYZ is also the record keeper. Does it really cost $150 (the amount of revenue sharing being accrued in this case) to administer the account? Perhaps it really costs $100. If that's the case, the plan is overpaying for administration in the current revenue-sharing arrangement.

Further, without knowing the true cost of administration, how does the plan sponsor know it is using the right share class of the XYZ Fund? Perhaps there is a share class with a 0.40 percent expense ratio, but that only shares 0.10 percent for record keeping.

If the cost for administration is, in fact, $100 in the case above, the cheaper fund should be used. If not, perhaps the original share class can be deemed reasonable.

The definition of "reasonable"

"Reasonableness" is the standard that plan fiduciaries are held to. The funds in the plan do not have to be the lowest-cost—just reasonably priced for the services being provided. But what does that mean? It may be argued that whatever the administration costs are, the important thing is that XYZ Fund's overall expense ratio is reasonable.

Others might contend that each individual expense must be reasonable: Even if the overall fund expense ratio seems reasonable, the plan should still not overpay for record keeping. This gets us back to the need for transparency.

An alternative

Another way to pay plan administration expenses through revenue sharing is to either charge an explicit fee to participants or to invoice administration expenses directly to the plan sponsor. This approach involves incorporating institutional share classes of mutual funds in the plan (with no revenue sharing), collective trusts and/or separately managed accounts.

Direct payment of administration expenses offers greater transparency, but it also offers its own set of challenges. Charging administration costs directly to plan participants causes a potential communication issue.

Plan participants who are accustomed to having the administration costs of the plan embedded in fund expense ratios may mistakenly believe that the cost of administration of the plan has increased when they suddenly see an explicit dollar fee on their statements.

Likewise, direct payment by the plan sponsors can be cost prohibitive: The plan sponsor may simply not have the budget to pay for plan administration. Just 35 percent of large plan sponsors pay for 401(k) record-keeping services today, according to a recent Profit Sharing/401(k) Council of America survey.

Still, a fully unbundled solution that results in little or no revenue sharing has merits beyond fee transparency. Structur-

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ing the plan so that each participant pays a certain amount for administration can be more equitable.

In a recent defined-contribution survey by my organization, Callan Associates, just 26 percent of plan sponsors report that all plan assets contribute in terms of revenue sharing. That means that if Participant A is invested in funds that share revenue, and Participant B is in funds that do not, Participant A is effectively shouldering the administration costs for Participant B. However, both Participant A and Participant B are benefiting from the administration of the plan.

Investment flexibility is another important consideration. In the Callan survey, 38 percent of plan sponsors say that revenue sharing had some impact on the selection of investment managers within their 401(k) plan.

And, of course, it is also possible that the fee transparency gained through fully unbundled solutions with little or no revenue sharing can result in fee savings.

Overcoming the obstacles

So what does a plan sponsor do? If the intention is to have participants pay an explicit charge for administration, plan sponsors may wish to start a communication campaign before the change that explains the dollar cost implied within an expense ratio.

Once the newly unbundled plan is rolled out, the communication campaign can focus on how the fees are now shown on statements. Ideally, it can focus on reductions in cost as well.

If the intention is to have the plan sponsor pay some or all of the administration costs, it may need to come as a result of reductions elsewhere, such as a reduction in the matching contribution. This, of course, also necessitates communication with employees. Again, the key will be to demonstrate how—economically—the change doesn't reduce the benefit to employees; it only shifts how the benefit is being paid (e.g., through plan expenses, not through the match).

Granted, both are difficult conversations to have with employees, especially in an environment where health care costs are increasing, retiree medical benefits are going away and many employees are losing access to defined-benefit plans. At the same time, upcoming regulations by the Department of Labor and potential legislation may soon make more comprehensive fee conversations mandatory.

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