Hidden costs: Are 401(k) fees taking a bite out of retirement savings?

Jeffrey T. Marzinsky, CPC, CIMA

"Fiduciary" is the word of the decade in financial services, as many businesses have been scrutinized for lack of disclosure and conflicts of interest. Now companies with 401(k) plans are being criticized for the fee structures used to pay for plan administration. Particularly if a 401(k) provider "bundles" recordkeeping fees with fund expenses, it can be nearly impossible to determine the actual costs and know the true expenses of the plan. How much is being paid for recordkeeping? Is the plan sponsor getting the best price for mutual funds? Who is paying for what?

When Congress passed the Tax Reform Act of 1978 and created the 401(k) section of the Internal Revenue Code, it established a new playing field in retirement planning—one that could provide a savings vehicle for employees of almost any size of business. Today, roughly two-thirds of the private sector workforce participates in a 401(k) savings plan.

However, where fees are concerned, it has become increasingly clear that for many plan participants and plan sponsors, the playing field is not a level one.

Given the variety of 401(k) vendors and pricing strategies, two participants investing in the same mutual fund but through different 401(k) plans can earn disparate returns. Vendors boasting of a "no-fee" plan may bury the recordkeeping costs in the fund expense, while other vendors may bill the plan sponsor directly for recordkeeping costs. Hidden fees are troublesome because, over a lifetime of contributing $5,000 a year, assuming an annual gross rate of return of 9%, a participant paying an additional fee of just 1% would retire with $1,918,678 rather than $2,448,895, or $530,217 less. That 1% difference in fees could wipe out 26% of the employee's retirement nest egg.[1]

Plan sponsors who establish and administer their company's 401(k) plans need to uncover and understand how different costs and benefits play out; as fiduciaries to the plans, they and their companies can be held responsible for making sure that plans work to the exclusive benefit of participants and that fees are reasonable in terms of the level of quality and services provided.

A growing number of companies now face lawsuits alleging they failed in their fiduciary duties to properly administer their 401(k) plans under the law governing private-sector retirement plans, the Employee Retirement Income Security Act of 1974 (ERISA). The Securities and Exchange Commission and the Department of Labor (DOL) have launched several high-profile investigations and media scrutiny is on the rise, including a recent review of 401(k) plans by Forbes magazine under the headline "Retirement Rip-off."[2]

Revenue Sharing

In general revenue sharing (i.e., expense reimbursement payments) represents amounts made available by fund companies to pay for shareholder services that are provided to a plan and its participants. For example, shareholder services could include recordkeeping and accounting services, processing mutual fund sales and redemption transactions, custodial/trustee interface services to the plan, and the development of enrollment materials for plan participants. While many recordkeepers receive revenue sharing from the fund companies, any such revenue should be used for the exclusive benefit of the participants of the plan.

The true cost of a "no-fee" plan

While many plan participants and sponsors are increasingly concerned with their plans' fees, they struggle to understand them. Bundled plans (where one vendor provides both the recordkeeping and investment services) emerged years ago as a response to concerns by plan sponsors that 401(k) plans offered by unbundled providers (which required multiple vendors for recordkeeping, compliance, custodial, and other services) were difficult to manage. Bundled plans were presented as a less complicated alternative, offering sponsors a single point of contact for the required plan services.

1 This example assumes the following:
- annual contribution made midyear, with a 3% CPI increase each year
- 9% annual return, reduced by expenses at the time earnings are credited
- 40-year time horizon

2 Neil Weinberg, "Retirement Rip-Off," Forbes, December 12, 2006.

THE TRUE COST OF HIDDEN FEES

The potential cost to the plan participant can be difficult to discern because it requires a multi-faceted analysis of the costs. First, consider the different share costs built into this hypothetical example:

SHARE CLASS	12(B)1 FEE	SERVICE FEE	EXPENSE RATIO
Institutional	0.00%	0.00%	0.50%
Investor	0.00%	0.10%	0.60%
Trust	0.25%	0.25%	1.00%
Class A	0.25%	0.50%	1.25%

Next, apply the expense ratios from the different share classes to a typical $50 million plan:

COST FOR A $50 MILLION PLAN	12(B)1 FEE	SUB T/A SERVICE FEE	TOTAL FUND EXPENSE RATIO
Institutional	0.00	0.00	250,000.00
Investor	0.00	50,000.00	300,000.00
Trust	125,000.00	125,000.00	500,000.00
Class A	125,000.00	250,000.00	625,000.00

Depending on the size of a participant's account, a difference in share classes can result in a significant discrepancy in fees:

COST TO A PARTICIPANT	INSTITUTIONAL	INVESTOR	TRUST	CLASS A
$25,000 Account Balance	125.00	150.00	250.00	312.50
$50,000 Account Balance	250.00	300.00	500.00	625.00
$100,000 Account Balance	500.00	600.00	1,000.00	1,250.00
$150,000 Account Balance	750.00	900.00	1,500.00	1,875.00
$150,000 Account Balance	1,250.00	1,500.00	2,500.00	3,125.00

Thousands of dollars in participant assets can disappear if a plan is not using the appropriate share class. In the current environment, plan sponsors who are not making their fee structure transparent are likely to have their motives called into question.

Bundled, "no-fee" plans were also supposed to be less expensive. And for many plan sponsors they have been, because fees are based on plan assets and primarily paid by participants. ERISA allows certain plan-related expenses to be charged directly to plan participants (see sidebar, "401(k) Plan Expenses Allowed by ERISA"). But as more and more 401(k)s have adopted a bundled approach, it has become increasingly difficult for plan sponsors and participants to determine how much they are paying in fees and whether those fees are reasonable according to the standards established by ERISA.

Why is this? The origins are complicated. All mutual funds have an expense ratio that differs depending on the type of fund (equity, bond, fixed income) and the management style (passive or active). Some index funds are computer-driven, and thus have a low expense ratio. Low expense funds seldom offer "revenue sharing" or 12(b)1 fees. However, other funds—those that are actively managed—typically have a higher expense ratio and part of that expense ratio may be used to provide revenue sharing or 12(b)1 fees. The availability of revenue sharing and 12(b)1 fees makes the fund more attractive to plan sponsors, vendors, and brokers because the sharing of revenue will reduce their costs, or a broker will be paid directly from the fund company rather than the plan sponsor to provide services to the plan.

Commissions are paid to whoever sells the mutual funds, typically in the form of 12(b)1 fees paid to brokers. Subtransfer agency payments are also paid to third-party administrators for recordkeeping, communications, and other services. This payment of commissions and revenue sharing may become a problem if not disclosed.

Plan sponsors should demand full disclosure of the amount and distribution of the revenue generated by their plans, as well as the associated recordkeeping costs. While more and more vendors are providing this information, many service providers still offer very little information about fees, 12(b)1s, and revenue sharing; and what they do provide is sometimes not easily understood by plan sponsors or participants. Moreover, when plan sponsors ask their providers about recordkeeping costs, they are often told that plans are "free."

The guidelines on disclosure, while not necessarily prescriptive, are at least clear. The DOL, which oversees plan compliance and serves as a resource to participants and sponsors, holds an unambiguous position on fiduciary responsibility. It places the burden solidly with sponsors, explaining that they have "a specific obligation to consider the fees and expenses paid by the plan." Among other things, this means that employers must ensure that fees paid to service providers and other expenses of the plan are reasonable in light of the level and quality of service.[3]

But when fees are investment-based and calculated as a percentage of the plan's assets, they can mushroom over time as the plan grows and can open up the potential for fiduciary conflicts.

When fees are charged as a percentage of plan assets, plan participants do not necessarily benefit from built-in economies of scale. Plans may be eligible for a cheaper share class (priced at a percentage of fees depending on the size of the plan) than what is being charged to participants. For example, a $20 million plan may qualify for lower-cost institutional funds but still buy higher-cost retail funds to pay for plan recordkeeping. The disparity between the true cost of investment management and what is being charged is "shared" with the plan sponsor to pay the recordkeeping costs.

The potential fiduciary conflict inherent in revenue sharing is one of the business practices currently under scrutiny. Is additional revenue being used to the exclusive benefit of plan participants, as required by ERISA, or is it being used to the benefit of the sponsor?

Sharing the wealth (revenue sharing)

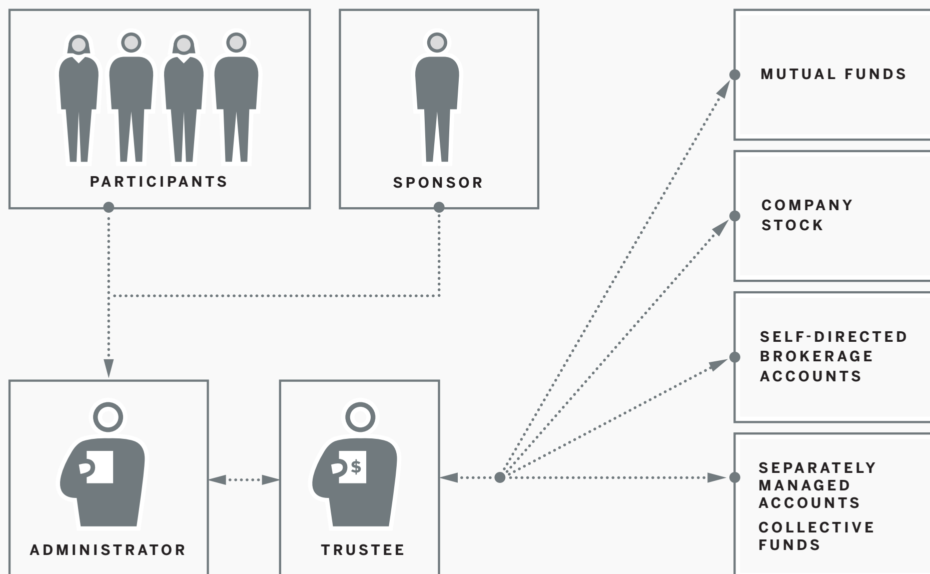
In addition to tracking the actual cost of services, sponsors and participants in bundled plans face other challenging questions: In what share class is revenue sharing paid? How much revenue sharing is paid? It's important to note that a mutual fund share class does not describe the quality of the fund, but simply what is paid for the fund. The tabular example above outlines four share classes of the same fund that one might find in a 401(k) plan.

Share classes are sometimes determined by the size of a plan's assets. For instance, plans with significant assets qualify for a better share class because of their size. A better share class may mean one with a lower expense ratio on the investment (and often a lower amount of revenue sharing paid). But just because a company or organization qualifies for a better share class does not guarantee that its plan will include that share class. Moreover, the additional revenue is used to compensate advisors, brokers, and/or plan administrators and is not always disclosed.

3 Department of Labor booklet, A Look at 401(k) Fees.

THE "BUNDLED UNBUNDLED" SOLUTION

What does this architecture entail? The graphic below provides an example of a "bundled unbundled" approach. This approach is unbundled — pulling from different funds and accounts — but is delivered in a bundled fashion thanks to the sophistication of the trading platform. The sponsor and participant deal directly with their administrator and receive an integrated experience that belies the complexity of the actual architecture.



Plan sponsors and participants should know what share class their plan qualifies for because, over time, those additional costs can significantly erode retirement savings. It also is important to make sure that, as a plan's assets grow, it moves up to a better qualifying share class.

Timeline: Major changes to the IMD exclusion

- Fees for outsourced administration, communication, and recordkeeping of the plan
- Expenses for amending a plan and obtaining an IRS letter of determination
- Investment management fees
- Fees for 401(k) testing and coverage testing

In addition, certain plan-related expenses can be charged directly to plan participants

- Distribution and hardship withdrawal fees
- Loan processing fees
- Fees for calculating benefits under different distribution options
- Investments-related fees in participant-directed plans
- Administrative fees for terminated participants
- Qualified domestic relations order (QDRO) processing

A good plan

Bundled plans were originally supposed to simplify 401(k) management. However, plans have become increasingly complex as the ways in which fees can be calculated have evolved over the years. In fact, the Department of Labor 401(k) Fee Disclosure Form lists 38 definitions for fee terms.

But it doesn't have to be this complicated. There are essentially four parties that deliver services to 401(k) plans: recordkeepers, trustees, fund companies, and investment advisors. With today's technology and integrated platforms, all of these services can be overseen by a single, unbiased point of contact. In fact, there is now another alternative to bundled and traditional unbundled approaches, one we call the "bundled-unbundled" solution. Innovations in technology have allowed plan administrators to bring together unbundled service providers in an integrated electronic platform that, from a service perspective, resembles a bundled approach. The bundled-unbundled approach uses an open architecture to integrate competitive pricing practice and industry-leading financial service options.

The scrutiny is just beginning

The movement to require fuller and clearer disclosure is under way. The Government Accountability Office (GAO) recently released a 43-page report arguing for disclosure of fees by both plan sponsors and plan providers. Specifically, the GAO wants Congress to amend ERISA so that plan sponsors are required to disclose all fees, including investment management fees, to participants. The GAO also wants this information reported to the DOL.[4]

In the meantime, plan sponsors can request an unbiased audit of their existing plans. If changes are necessary, there are options available now for creating more transparent plans—ones that assure ERISA compliance and make sure 401(k) plans benefit the people they were designed to serve.

4 U.S. Government Accountability Office, Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees, November 2006.

Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

milliman.com

CONTACT

Jeffrey T. Marzinsky
jeff.marzinsky@milliman.com

©2016 Milliman, Inc. All Rights Reserved. The materials in this document represent the opinion of the authors and are not representative of the views of Milliman, Inc. Milliman does not certify the information, nor does it guarantee the accuracy and completeness of such information. Use of such information is voluntary and should not be relied upon unless an independent review of its accuracy and completeness has been performed. Materials may not be reproduced without the express consent of Milliman.