

Managing Plan Cost

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A plan sponsor's ability to positively affect total plan cost has dramatically increased over the last several years and the main reason is *disclosure*. Plan sponsors today are in a better position to negotiate with their service provider once they understand how a service provider gets compensated.

Up until now, few plan sponsors have held service providers accountable for their overall fee structure. Over time, market appreciation and new contributions cause plan revenues to grow at a rate far greater than the cost to administer and recordkeep a plan. As a result, service provider's margins have been able to grow unchecked. This in turn begs the question, "Whose money is it anyway?"

Responsibilities under ERISA

Under ERISA, a fiduciary has the responsibility to discharge his/her duty for the exclusive purpose of:

- Providing benefits to participants and their beneficiaries
- Defraying reasonable expenses of administering the plan

According to the DOL, "ERISA places substantial responsibility on plan fiduciaries charged in overseeing the administration and investments of retirement plans to understand the total amount of fees paid to a service provider to ensure reasonableness and also to understand the revenue sharing arrangements between the various providers." Bottom line: It's the plan fiduciaries who are responsible for policing their service provider and ensuring that plan assets are being used exclusively for the benefit of plan participants.

Managing Plan Cost

That's a pretty tall order. How does a plan fiduciary get access to a service provider's cost information especially when this information is proprietary and service providers are not legally obligated to provide such information? Second, even if a sponsor can get such information, who decides if the cost structure is "reasonable?"

Understanding Revenue Sharing

Before answering those questions it's important to clarify "service provider" and "revenue sharing." For the purpose of this discussion, we identify service providers as the entity that performs the record keeping and administration functions. Revenue sharing occurs when an investment manager shares a portion of its asset management fee with the service provider. Despite its negative connotation, revenue sharing itself is not necessarily a bad thing. For example, when revenue sharing is being used to defray reasonable costs associated with recordkeeping and administering the plan, most people would say that's a good thing.

Often, when the media talks about revenue sharing fees they refer to them as "hidden." While they may not be well defined, they are not hidden. For instance, by looking at a mutual fund prospectus, you might see an investment management fee of 1 percent (100 basis points.) From that 1 percent, the mutual fund company may have agreed to share .25 percent (twenty-five basis points) with the service provider to help cover record keeping and administration costs, thereby netting only .75 percent or 75 basis points of revenue. Different funds have different sharing agreements and various recordkeepers may have different revenue sharing agreements with the same investment management firms, so there is no "one size fits all" approach that works.

Managing Plan Cost

Determining “Excess” Revenue

The key to managing plan costs is in recognizing the “excess revenue” generated by the plan. Excess revenue is the difference between how much a service provider receives in revenue sharing versus how much the service provider requires in order to cover its cost including its profit margin. Simply put, sponsors can control plan costs by controlling excess revenue.

The way you obtain your service provider’s cost structure is simple -- You ask. It’s not public information, and it’s not disclosed anywhere. Yet many service providers will disclose their revenue sharing arrangements when asked. Common terminology used to describe revenue sharing includes Sub-Transfer agency fees, 12-b1 fees, and Wrap fees. Regardless of the words the service provider uses to describe their revenue sharing process, a plan sponsor wants to learn how much revenue the service provider requires to administer the plan including margin and how much revenue is actually being received. If the amount received is greater than the amount required, there is excess revenue.

Historically, any excess revenue generated by a plan has been kept by the service provider. Why? It’s analogous to buying a beer at Wrigley Field, if you don’t ask the vendor for your change you are not going to get it! But when your talking about a large 401(k) plan, that’s a lot of change. Echoing the DOL, it’s the sponsor’s job is to make sure the revenue sharing fees are reasonable.

Driving Down Total Plan Costs

So far our discussion has focused primarily on the cost to record keep and administer a plan (i.e., required revenue). This figure is typically very small when compared to “total plan cost”. Total plan cost equals all hard dollar fees paid by the plan plus all asset-

Managing Plan Cost

based fees. Reducing total plan costs is the objective. Managing excess revenue is the mechanism.

Most plan sponsors want to drive down total plan costs but are ineffective because they are in a weak position to negotiate. As in most other buying situations, when you know how much it costs to manufacture something, you are in a better position to negotiate the difference between price the seller wants and the price you are willing to pay. For instance, if you had prior knowledge that a car cost \$10,000 to manufacture, you would be reluctant to pay the full sticker price of \$20,000 asked for by the dealer. The same idea holds true here.

Once excess revenue has been identified, the most efficient way to shrink it is to select more cost-effective share classes. For instance, a mutual fund will often come in several different share classes. An “A” share will typically pay more in revenue sharing than an institutional or “I” share class, but it also has a higher asset management fee. By replacing an “A” share with an “I” share, you reduce the amount the record keeper receives and simultaneously drive down the cost of the investment portfolio due to the lower asset management fee. ([Case Study](#))

There are also several service providers who routinely go through the process of identifying excess revenue and returning it to the plan by directly crediting participant accounts. In other cases, a plan sponsor may choose to establish an account where the excess revenue can be deposited into an “ERISA-eligible” account which then can be used to help cover the cost of various ERISA eligible expenses such as employee education.

Conclusion

Many plan sponsors assume their service providers have their best interest in mind. Service providers are for-profit companies whose main purpose is to maximize revenue

Managing Plan Cost

for their organizations. The sooner plan sponsors understand basic service provider economics and begin to leverage their plan assets, the sooner they will drive down total plan costs and meet their fiduciary responsibilities under ERISA. Identifying excess revenue is an essential step in this process. Again we ask the question, “Whose money is it anyway?”