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Are Your Largest Participants Paying Thousands Each Year To Be In Your Plan?

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While there has been a great deal of focus on the amount of fees retirement plan participants pay, little attention has been given to *how* those fees are being paid. Despite the disclosures required by the recent fee legislation, participants still question how much they are paying. For the participants with the largest balances in a plan, they are likely to be unpleasantly surprised by the answer.

For purposes of this article, we will divide fees into three categories; fund management fees, plan level investment fees and plan level operational fees.

- **Fund Management Fees** are those fees charged by the fund companies for the management of the fund. These are almost always asset based.
- **Plan Level Investment Fees** are those fees that relate to investment guidance given to the plan and/or the plan participants by an adviser/broker. These are usually asset based.
- **Operational Fees** are those fees associated with the ongoing administration and operation of the plan. These fees can either be charged on a flat per participant basis or an asset basis.

Regardless of which of the above methods is utilized, when the majority of a plan's fees are charged on an asset basis, the participants with the largest balances will pay a larger portion of the fee. This may seem logical, but is it fair? When you consider that for at least a portion of the fee, the Operational Fees, each participant in the plan receives the same service, the answer is no. What is actually happening is the largest balances are subsidizing the Operational Costs for the smaller balances. This is called Cross Subsidization.

Consider the following example of a recent plan we reviewed:

Plan Asset Size:	$47 Million
Number of Participants:	662
Total Plan Costs (excluding mutual fund costs):	$164,553 (.35%)

If fees were deducted from this plan on a per participant basis (total fees/number of participants), each participant would pay $255 per year. If fees were deducted proportionately based on asset value (participant assets/total assets x total fee), the participant with the largest balance in the plan would pay **$6,100** and the participant with the smallest balance in the plan would pay **$0.13**. The largest 5% of the balances in this plan would pay 50% of the fees and the largest 10% of the balances would pay 75% of the fees.

WHAT'S THE SOLUTION?

Unfortunately, there is no perfect solution. If a per participant fee is used, the smallest participants pay a disproportionate fee in relation to their balance, further dis-incentivizing those participants from saving. Imagine a new participant with a balance of $500 in the plan being charged $255 for their account. On the other hand, the participant who is paying $6,100 using the asset based approach is clearly subsidizing the other participants in the plan and reducing his/her savings in the process.

Here are some tips to avoiding this problem:

1. While there is no ideal solution, a good approach is a balance of the two methods: per participant and asset based.
2. Do not allow the service providers to artificially increase the costs of the investment funds in the plan. By forcing the provider to utilize the lowest expense ratio share class for each fund, you avoid unintended subsidization between participants.
3. Separate plan level investment fees and plan level operational fees.
    a. **Charge investment fees on an asset basis -** Charging investment fees on a proportional basis can be justified when you consider the potential benefit the participant receives, in the form of higher returns; will be proportional to their asset value as well.
    b. **Charge operational fees on a per participant basis -** The benefit each participant receives is the same. They receive the same statement, use the same website, etc.
4. Both types of fees should be deducted from the participant accounts in a transparent fashion.

Using our example from above, the difference can be significant:

	Before	After
Total Fees Paid *(ex. fund management fees)*	$164,553	$164,553
Largest Participant Pays	$6,169	$3,223
Smallest Participant Pays	$0.13	$138
Percentage of Fee Paid by Top 5% of Participants	54%	30%
Percentage of Fee Paid by Top 10% of Participants	75%	43%

This hybrid approach better distributes the fee responsibility amongst the participants and makes the fees transparent. As importantly, your policy on fees can be justified to inquisitive participants and regulators. Addressing this issue proactively can help to avoid an unpleasant conversation with your key employees who suddenly realize that they have been overpaying by thousands each year. ▪

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