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Meeting the Challenges of the New Fee Environment

- 401(k) plan fees have been a key focus for the industry, with mounting regulatory and legal pressures on plan sponsors to improve their fee analysis and disclosures.
- Accurate fee assessment, monitoring and disclosure will be of growing importance for plan sponsors going forward.
- In this paper, Callan Associates provides plan sponsors with a comprehensive overview of the current environment.
- Through two case studies, we illustrate Callan's step-by-step approach to working with our clients to develop better fee analysis, benchmarking and disclosure.

How Did We Get Here?

The fee environment facing plan sponsors today effectively began in 2004 with the ERISA Advisory Council Report on Fee Disclosures to Participants. The report contained a number of key recommendations, many of which were later enacted through regulation. These recommendations included: avoiding vendors who refused to disclose fees; requiring a detailed written analysis of fees and compensation; and several other measures intended to boost transparency and disclosure around fees. The Government Accountability Office followed in 2006 with its own report on fees and disclosures.

The government's heightened interest in the transparency and appropriateness of plan fees has coincided with a surge in class action litigation surrounding the issue. Among the charges leveled, some have alleged that plan sponsors failed to discharge their fiduciary obligations by not properly establishing or monitoring plan fee structures. Some of the lawsuits alleged plans were using misleading benchmarks, and failed to properly and adequately dis-

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About Callan Associates

Founded in 1973, Callan Associates Inc. is one of the largest independently owned investment consulting firms in the country. Headquartered in San Francisco, Calif., the firm provides research, education, decision support and advice to a broad array of institutional investors through five distinct lines of business: Fund Sponsor Consulting, Independent Adviser Group, Institutional Consulting Group, Callan Investments Institute and the Trust Advisory Group. Callan employs more than 170 people and maintains four regional offices located in Denver, Chicago, Atlanta and Florham Park, N.J.

About the Callan Investments Institute

The Callan Investments Institute, established in 1980, is a source of continuing education for those in the institutional investment community. The Institute conducts conferences and workshops and provides published research, surveys and newsletters. The Institute strives to present the most timely and relevant research and education available so our clients and our associates stay abreast of important trends in the investments industry.

close to participants fees as well as cash holdings in company stock funds. Other suits alleged that overall fees were too high for certain plans using retail mutual funds rather than lower-cost institutional share classes of mutual funds. Similarly, plans using active rather than passive funds have come under fire for underperformance or insufficient outperformance given the fees charged by the investment managers.

In 2007 alone, the federal government proposed four measures which are making their way through both houses of Congress. Several bills proposed direct amendments and/or changes to ERISA itself, while others focus more broadly on mutual fund fees. The Department of Labor has increased regulation as well through Form 5500 and section 408(b)(2), which are primarily focused on disclosure of direct and indirect fees. In all cases, there is clearly a push in Washington toward mandating more explicit and useful disclosure of fees and related information.

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Plan Sponsors: A Growing Interest in Fees

With plan sponsors being held to a higher standard than ever before, it is not surprising that many are increasingly focused on understanding their fee structures and benchmarking it against their peers. Callan recently surveyed large DC plan sponsors,[1] and found that just under half of the respondents planned to do some form of fee analysis in the coming year. An additional 17% had already done such an analysis in the past year. In another Callan survey,[2] roughly 40% of plan sponsors said they would be willing to incur a per-participant fee to reduce overall plan fees.

The question then becomes one of implementation, and selecting the best provider of this kind of analysis. Although a growing number of recordkeepers are providing their own fee transparency reporting, most of the analysis lacks two key components: objectivity and benchmarking. By having an outside third party do the auditing, there is greater assurance for objective, full and accurate disclosure. Secondly, in our view, the fee analysis provided by recordkeepers does not provide objective benchmarking. It is one thing to know what the fees are, but quite another to be able to assess whether or not they are reasonable.

We believe that the optimal approach to DC fee analysis is one which meets three related objectives: 1) Create a complete picture of defined contribution costs being paid, 2) Provide documentation that the plan sponsor is properly monitoring and evaluating plan fees, and 3) Potentially provide leverage to negotiate more competitive terms with recordkeepers. In the current environment, meeting all three objectives is necessary and prudent.

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1 *Impact of the PPA: Defined Contribution Plan Sponsor Survey*, Callan Associates Inc., February 2008

2 *2007 Defined Contribution Survey*, Callan Associates Inc.

Callan's Approach to Fee Analysis: Assessing the Entire Picture

Sound fee transparency analysis looks at fees in the aggregate and in component parts.

Total plan fees vary widely, both at the aggregate and component levels. This fee variation is driven by administration service levels used by plans and a wide array of structures, such as fund line-up, active versus passive funds, mutual funds versus collective trusts, etc. Sound fee transparency analysis looks at fees in the aggregate and in component parts. It starts with understanding the weighted average expenses of the plan, which include not only funds' expense ratios, but per-participant dollar fees, fees related to company stock administration, additional communication fees, etc. For unbundled plans, it can also take into account staff costs, the impact of securities lending, auditing and legal costs.

Typically, investment management fees are the single largest driver of costs associated with defined contribution plans, varying from as low as 50% of total plan fees to as high as 80%. In contrast, administration fees can account for 15% to 45% of typical plan fees, according to a study by Hewitt Associates.

Accounting for administration fees is complicated by the fact that many plans pay for administration through revenue sharing (although they are sometimes paid by the plan sponsor through direct fees, and/or by participants as a direct explicit charge). Revenue sharing is the practice of allotting a certain portion of a mutual fund's expense ratio to the recordkeeper to pay for plan administration. A given fund may have many share classes, some of which pay revenue sharing and some of which pay no revenue sharing. Revenue sharing can come from proprietary funds of the recordkeeper or outside funds.

Benchmarking: Creating Context

Given how different one plan may be from another, the best approach to fee benchmarking is to survey similar providers.

Once fees are accounted for, the next important step of fee analysis is benchmarking. Given how different one plan may be from another, the best approach to fee benchmarking is to survey similar providers and determine what they would charge to administer a plan with all the same features, including the size of the plan, number of underlying plans, payroll feeds, cash flows and loans. Other factors that will influence plan fees include level of customization, likely merger and acquisition activity and whether the plan has automatic enrollment. The latter means the plan is likely to grow, and therefore be attractive from an asset-growth perspective.

While the bids obtained as part of this exercise may not be exact, they do give a fairly accurate estimate of what the recordkeeper would charge. In some instances, it may be necessary to ask for a bid on alternative structures to determine whether changing the plan's structure would lower costs.

Through this process, we have found that bids can vary considerably and, while total fees do typically decline as plan assets grow, plan size is not always the primary driving force of the level of administration fees. For example, a plan may be very large but have very low average plan balances, which can be a significant factor in pricing.

Investment Options:

Exploring Alternative Structures

Given the benchmarking analysis, if fees are determined to be outside the range of what appears to be reasonable, there are a number of alternatives the plan sponsor may typically pursue. Sometimes the solution may be tactical, such as eliminating or reducing an excessive per participant fee, or swapping out higher-cost share classes with lower-fee share classes of the same funds.

Another approach is to rethink the fee structure. For example, plan sponsors may wish to move away from the revenue sharing model altogether, and implement a more unbundled approach that strictly involves institutional mutual funds, collective trusts and separate accounts. Payment of fees could be accomplished under the unbundled approach through either a non-asset-based per participant fee, an asset-based add-on (wrapper) fee, plan sponsor fee payment, or some combination of the above. The advantage of either a per participant fee or an add-on fee is that it makes the payment of plan fees more equitable. Too often there are some funds within a plan with high revenue sharing and some with no revenue sharing. Effectively, participants who choose the no revenue sharing funds are not contributing to the payment of plan administration. Instead, if the plan implemented a structure where each fund is assessed, for example, a 10 basis point administration fee, then every participant in the plan would contribute to the payment of administration costs.

Callan believes that any plan with assets of $1 billion or more should seriously consider some of these alternative structures. Use of collective funds and separate accounts is increasingly facilitated by such features as daily valuation and liquidity, as well as Morningstar ratings and fund fact sheets.

Plan sponsors may wish to move away from the revenue sharing model altogether, and implement a more unbundled approach.

For some large plans that might not find the unbundled approach feasible, there are other methods available to reduce fees and keep revenue sharing in place.

Of course, even some large plans may not find the unbundled approach feasible. For such plans, there are other methods available to reduce fees and keep revenue sharing in place. One of these is to put the excess revenue sharing into an ERISA account and use it to pay other plan expenses or, alternatively, to reimburse plan participants. However, there are a few things to be aware of when considering these options. While the ERISA account is valuable if you have other plan expenses that need to be paid, it only reduces administrative costs, not total costs. If a plan sponsor does not spend down the ERISA account, it generally reverts back to the recordkeeper at year-end. It is also important to recognize that some recordkeepers simply will not reimburse participants. For those who will, determining how to equitably distribute the reimbursement can be complicated.

Given the current environment, Callan has been increasingly focused on working with our clients to help them better understand and manage their plan fees. As the following case studies illustrate, we have been successful in helping our clients not only develop better fee analysis, but reduce fees as well.

CASE STUDY 1

PLAN SPONSOR A: $2 BILLION CORPORATE 401(k) PLAN	
TIER 1	Target date mutual funds
TIER 2	Passive and an active sleeve for each of the major asset classes
TIER 3	More specialized funds

Although investment fees across the three tiers were reasonable, recordkeeping fees were above average due to the large amount of assets in a few of the recordkeeper's proprietary Tier 3 funds. Therefore, there was a considerable amount of revenue sharing being generated even as plan assets were growing in a very meaningful way. Moreover, some of the Tier 3 funds duplicated the core investment options in Tier 2, making them a bad fit for the overall plan structure.

Our recommendations, ultimately instituted by the client, were to: 1) Replace the current target maturity options with lower fee versions; 2) Change the large cap value mutual fund to a separate account with the same investment strategy; and 3) Eliminate one of the Tier 3 funds for performance reasons, mapping those assets to the plan's S&P 500 fund, which allowed the opportunity to move to a lower fee share class. We also moved a small cap growth mutual fund to a collective trust and shifted international equity from a retail share class to an institutional share class. Lastly, we negotiated further expense credits with the recordkeeper. The result: the per-participant recordkeeping fees were reduced from $240 to $150.

As this plan continues to grow, we will continue to look for additional ways to reduce administrative fees, such as moving some of the active funds in Tier 2 into separate accounts using the same managers, and generically labeling the fund options so they can more easily be moved into separate accounts over time.

CASE STUDY 2

PLAN SPONSOR B: $5 BILLION CORPORATE 401(k) PLAN	
TIER 1	Risk-based asset allocation funds
TIER 2	17 core options
TIER 3	Several specialty options

Participant use of the Tier 1 and Tier 2 options was quite limited with 87% of plan assets were in Tier 3. When we analyzed the expense ratios, we found that fees associated with the first two tiers were generally below the median, but the expense ratios associated with many of the specialty options in Tier 3 were above the median. Many of these specialty funds were retail share classes rather than institutional share classes, so we recommended the client eliminate all the specialty options and map those assets into the Tier 2 core options. For those participants seeking a broader array of options outside of what the plan structure offered, we recommended that the plan sponsor add a mutual fund window.

These changes significantly boosted Tier 2 assets creating potential economies of scale. Therefore, we suggested shifting from mutual fund structures into either separate accounts or commingled funds. We also recommended creating generically labeled broad asset class options that utilized the existing underlying managers which will help participants stay focused on their asset allocation decisions rather than selecting funds for their current performance or brand name. It will also help to create administrative efficiencies in the event there is a change to the underlying managers.

Additionally, the client was able to build customized asset allocation funds in Tier 1 because of its size and, prompted by recent QDIA regulations, opted to move from risk-based funds to target maturity funds that allow participants to more easily select the appropriate fund based on their age.

Looking Ahead:
Best Practices for Plan Sponsors

We are seeing growing interest in fee disclosure to participants. In fact, a recent survey Callan conducted found that nearly one-third of plan sponsors surveyed said they intended to increase their fee disclosure even if it is not required. While the regulatory environment remains in flux, we have begun to see an emerging set of "best practices" toward which we are guiding our clients. The most effective fee disclosures do not include an itemized list of every expense, which would likely overwhelm participants, but rather provide a comprehensive sense of the various applicable fees including investment management, administration and transaction fees. These disclosures may also include an explanation of how revenue sharing works, and consistent fund fact sheets with fee information on funds, collective trusts, separate accounts and company stock to ease comparisons between options for participants. Instructions on how and where to find additional fee information are also included for those wanting more disclosure.

While monitoring, evaluating, and communicating fees are challenging, we believe the trend toward greater disclosure is likely to continue, particularly in light of the new Department of Labor regulations. As the fee environment comes under ever greater scrutiny, accurate analysis and benchmarking will also become increasingly important. Callan is committed to helping our clients meet these challenges not just through in-depth fee analysis, but also by seeking creative ways to reduce fees and gain investment flexibility.

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