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Understanding and Evaluating Retirement Plan Fees | Part Three: Fee Allocation

In part three of CAPTRUST’s Understanding and Evaluating Retirement Plan Fees series, industry gurus John Leissner and Jennifer Doss are back to explore a few common methodologies for allocating fees to participants.

Today’s 401(k) industry has grown to more than 60 million participants, $3 trillion in participant assets, and a whopping $30 billion in annual fees, according to the Plan Sponsor Council of America. With numbers like that, it should come as no surprise that the way plan sponsors assess those hefty service provider fees is receiving a lot of attention.

In this article, we look into several options that exist for plan sponsors considering how service provider expenses are to be paid by participants. Each has its own attributes and potential benefits. The three most common methods include:

- A built-in method where provider costs are covered through revenue sharing;
- An institutional method in which participants are assessed a flat fee, and revenue sharing is removed from the investment lineup; and
- A fee-leveling method where revenue sharing is credited to each participant, and a flat fee is assessed.

Let’s take a deeper dive into each.

Built-In Method

The built-in fee allocation model uses fund revenue—known as *revenue sharing*—to pay for recordkeeping fees. Revenue sharing consists of 12(b)-1 and sub-transfer agency fees built into the expense ratios of a plan’s investments. These fees are collected by the investment managers, paid to the recordkeeper, and used to offset plan expenses, typically for recordkeeping fees. In this fee allocation method, the total fund revenue is collected by the service provider and aggregated at the plan level.

The total amount of revenue sharing in a plan is often enough to cover the entire recordkeeping fee. If not, the recordkeeper charges an additional fee to cover the gap. When revenue sharing exceeds the amount owed to a recordkeeper, the surplus can be used to cover other qualified plan expenses or rebated to participant accounts.

Sometimes, the revenue sharing amounts are equal for different investments. However, it is more common for these amounts to vary by investment manager or fund family. This disparity can create issues since participants in higher revenue funds end up paying more, all things equal, than participants in lower revenue funds.

Institutional Method

Another method for covering recordkeeping fees is to offer a menu of institutional share class funds that do not pay revenue sharing and charge each participant a dollar or basis-point amount. The recordkeeper deducts the amount from each participant's account either annually or quarterly. The fee is stated clearly on participant statements and in the fee disclosure. This approach is straightforward to implement, transparent, and easy to explain to participants.

While simple in execution, the institutional method can be met with some challenges. The most common issue occurs when a fund company does not offer a share class with no revenue sharing, resulting in a fund lineup with some funds paying revenue sharing and others not. In this scenario, plan sponsors must decide where the revenue received goes and how it will be used to offset service provider fees. Because of this potential issue, a third methodology, called *fee leveling*, is gaining traction.

Fee-Leveling Method

Fee leveling is an allocation approach that rebates any revenue sharing back to the participants who paid the fee. Typically, this revenue is distributed on a monthly or a quarterly basis. Then, each participant is assessed a dollar or basis-point amount for the services provided.

In another version of the fee-leveling method, the recordkeeper assesses a fee or rebates revenue at the individual fund level for each participant. If the investment has exactly the required revenue amount in revenue sharing built into its expense ratio—let's say 0.20 percent (or 20 basis points), as an example—no additional fees or rebates are needed.

If revenue sharing in the fund exceeds required revenue—we'll call it 0.25 percent (or 25 basis points)—the recordkeeper credits each participant who has assets in the fund with the amount of the excess. In this example, the revenue sharing would exceed required revenue by 0.05 percent, resulting in a 5 basis-point credit returned to participants. Meanwhile, if the fund provides less than the required revenue amount, the recordkeeper adds a billed fee in the amount of the shortfall to the accounts of each participant using the investment.

The benefit of either fee-leveling approach is that a plan sponsor can ensure that participants are sharing an equitable amount of the service provider's fees. While this is a newer allocation method, most recordkeepers can accommodate fee-leveling scenarios for clients. However, each service provider offers its own accounting methodologies based on its system's capabilities.

Plan Sponsor Considerations

Each methodology has its own advantages and potential challenges. Depending on the scenario, allocation approaches vary in execution complexity, fee equity, and total plan cost for participants. For example, investments with revenue sharing included in the expense ratio may be a cost-effective way of paying expenses, since leveraging these funds may result in lower net investment management fees and total plan cost when compared to the use of institutional share classes.

With the fee-leveling method, participants pay an equal share of the recordkeeping fees. Additionally, removing all revenue sharing from the investment lineup can create an equitable approach to service provider payment and allows the organization to offer low-cost share classes. With these advantages in mind, more plan sponsors gravitate to these two models. Since each participant has the same access to the recordkeeper services, it is easy to justify everyone paying an equal amount, whether as a percentage of total assets or a flat dollar fee.

Figure One: Fee Allocation Methods—Benefits and Considerations

Built-In Method (Revenue Sharing)	**Institutional Method** (No Revenue Sharing)	**Fee-Leveling Method** (Revenue Sharing Rebate)
Explicit fees are minimized	Lowest-cost expense ratios are offered	Can be beneficial from a net cost perspective
Can be beneficial from a net cost perspective	Equitable fees paid by each participant	Equitable fees paid by each participant
Fees increase as assets grow	Ability to assess pro-rata or per-head fees	Ability to assess pro-rata or per-head fees
Limited cost transparency provided to participants	May be difficult to eliminate all revenue sharing	May blend retail and institutional share classes
Payments to service provider can vary by participant	Fund and share class availability across platforms can vary	Debits and credits on statements add complexity
		Capabilities may vary by recordkeeper and plan size

There is no single correct approach to fee allocation. In most cases, philosophical perspectives will drive an organization's fee allocation decision. Figure One illustrates some of the considerations to select the most appropriate allocation method. Plan sponsors should speak with their advisors about what fee allocation model makes the most sense for their organizations. Contemplating a consistent approach to pay for fees can assist fiduciaries in fulfilling their plan oversight responsibilities while providing continuity in future decision making.

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