Identifying the Hidden Costs in Your Defined Contribution Plan

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The defined contribution plan market is the fastest growing segment of the retirement plan market. Intense competition among traditional plan providers and new entrants to the market has caused a precipitous drop in prices coupled with an escalation in state-of-the-art recordkeeping and technology. By conducting a comprehensive cost analysis of your DC plan in relation to comparable plans, you may be rewarded with substantial cost savings. If your plan was implemented or last modified over three years ago, competitive market pressures should enable you to benefit handsomely from a cost audit of your plan.

Every plan sponsor has a fiduciary responsibility to review and document the "reasonableness" of DC plan expenses.

Before you begin an analysis of your plan, it is essential that you understand the type of plan you have and the features of that plan. A DC plan can be established as a bundled, unbundled or hybrid arrangement. Bundled plans use a single, full-service provider for complete plan design, installation, documentation, administration, record-keeping, investments, communications, and trustee functions of the plan. This is true if all of the revenue-sharing fees are disclosed and understood. Conceptually, the advantage of one full-service provider is the substantial cost savings that can be achieved by eliminating cost duplication that arises from independent providers who must each realize a profit for their services.

Full-service providers can realize economies of scale and recordkeeping service at a significant discount to fees charged by independent plan administrators and record keepers. In the institutional market, bundled providers have achieved economies of scale through their automated systems which have dramatically reduced their transaction processing costs. Problem resolution is simpler for employers because it entails interacting with only one organization which is clearly accountable for all aspects of the plan thus minimizing hassles and confusion.

Unbundled arrangements use a variety of unrelated, specialized service providers to fulfill the key functions of the plan. By using a team of independent specialists for administration, recordkeeping, trusteeship, education and investment management, a plan sponsor gains the flexibility to change the components of the plan without discarding the entire plan. Troubleshooting and identifying accountability may become blurred, requiring a plan sponsor to deal with different client contacts to resolve a problem.

A hybrid plan prepackages the services of multiple providers under one umbrella. It is similar to a bundled plan but participants can change some of the service providers.

Conducting a Cost Audit

Dalbar Surveys, Inc., a mutual fund research, consulting and publishing firm, recently ranked about 400 providers of DC plans and found that there are no consistent patterns for charging fees. In fact, there are many hidden fees due to the different regulatory disclosure requirements for various financial institutions such as banks, insurance companies, investment managers, brokerage firms and mutual fund companies.

Most plan sponsors scrutinize every penny charged to the company but have less of an understanding of the charges netted against participant accounts which are typically complex and unclear.

It is important to understand a full array of pricing structures used by different financial institutions in deciphering their hidden costs. In fact, a Dalbar survey found that there are over 80 different ways in which providers charge for services. We will attempt to address the most commonly used costs.

Where to Look for Those Hidden Costs in Your DC Plan

Hidden costs are found in the original contracts between your company and the providers, bills, management reports, fund prospectuses and the original pricing proposals. Most of the hidden costs will be found sprinkled throughout the proposals and prospectuses in footnotes. These hidden costs appear as incidental expenses which, when aggregated, can significantly affect participant returns or administrative expenses.

Many small charges are netted against assets, which makes it difficult to track on an ongoing basis. The majority of

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hidden expenses can he found in expenses netted against participant returns. Most plan sponsors scrutinize every penny charged to the company but have less of an understanding of the charges netted against participant accounts which are typically complex and unclear. Every plan sponsor has a fiduciary responsibility to review and document the reasonableness of plan expenses.

Role of a Plan Consultant

To further understand the dynamics of your cost structure, compare your plan expenses to a universe of similar plans which have been priced. It is useful to develop detailed spreadsheets that compare your costs to those of plans of similar participant levels, asset size, services, and characteristics. Your plan consultant can provide comparative data that are specific to your plan asset size, participation levels, features, and requirements from a number of plan providers that are relevant comparisons for your plan.

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An experienced consulting firm can conduct a comparative expense survey, which provides data that are comparable for your plan. General surveys are also available but not as helpful because they do not reflect the unique features and requirements of your plan. An experienced plan consultant can provide valuable insights as to the state-of-the-art technology available, Internet uses, plan design enhancements such as integrated nonqualified plans, and innovative design. The consultant can also show you how to revitalize your plan, and document the reasonableness of your plan expenses.

The generic descriptions of services provided by different providers sound almost identical and their nuances can be discerned only by experienced professionals. These subtleties, however, can mean significant variances in levels of service, accuracy, and compliance, which may later plague a plan sponsor. A consultant can re-evaluate your plan services and determine what new services are available.

Keeping the Plan Current

Conduct a review of the plan, costs, and services once per year to keep your plan updated. As your plan assets grow, you may qualify for enhanced services from your current service providers. By conducting a cost analysis, you may even be able to enhance services and reduce overall plan costs.

Once you have gathered both competitive price structures and your own plan costs, you can use the pricing information you have gathered to renegotiate a better arrangement with your plan providers.

You should begin with a comprehensive worksheet to capture all of the costs, both apparent and hidden, from all of the different providers of the various components of your plan. Organize the data into these categories:

- Recordkeeping & Administration
- Trustee Services
- Investment Options
- Communications

Plan Administration and Recordkeeping

Plan administration and recordkeeping expenses are usually billed directly to the plan sponsor. These expenses are typically shown as a base fee plus a range of itemized transactional charges which are often difficult to decipher. Typical administration services include participant daily account recordkeeping, interactive voice response, contribution processing, switching and quarterly participant statements. The record keeper performs all of the discrimination testing required by the IRS and Department of Labor to keep the plan in compliance. The record keeper also provides annual valuation reports, plan design, compliance review, forfeiture allocations, summary annual report, vesting calculations, profit sharing allocations, participant distributions, loans, top-heavy testing and government reporting. Within all of the services listed above, there may be partial services included in the base fee with some features treated as additional services which are itemized separately.

Plan set-up fees or plan conversion fees are installation expenses paid up front in the first year for plan design and documentation. The base annual fee is paid to the plan record keeper or third party administration firm which provides recordkeeping services. Many a plan sponsor has dramatically reduced his recordkeeping costs from an "expensive" yet comprehensive record keeper to a low-cost provider only to find out too late that the services quoted were incomplete, inadequate or not part of the standard pricing.

On an item-by-item basis, the new provider may actually prove to be more expensive or inadequate for the plan's level of required sophistication and complexity. Clearly understand the importance of each plan service and feature when comparing services.

In addition to the base annual fee typically paid by the sponsor, there is a full range of itemized expenses, which are necessary to operate the plan properly and need to be added to the total cost of the plan. Some of these charges include employee loan origination and annual loan maintenance fees. An administrative service fee is quoted as a percentage of assets and is in addition to the base annual fee. This fee is usually well-disguised and netted against participant accounts for the life of the plan.

The number of employee contributions permitted will influence this pricing, separate charges for employee terminations and withdrawals, employee distributions, and finally employer contributions. Very often these individual charges are identified on a per transaction basis requiring that you estimate the frequency and estimate an annual charge which is added to the annual base fee. Administration

/recordkeeping fees are paid by the plan sponsor for small plans and sometimes shared with participants in larger plans.

Another area of confusion will be in the types, number and frequency of discrimination testing which will vary with the plan's complexity, workforce demographics, and savings patterns. Discrimination testing, sometimes referred to as nondiscrimination testing, refers to a series of complex, technical formulas and testing requirements set forth under DC regulations. The goal is to ensure that senior management does not create a plan that discriminates in favor of, or offers more attractive benefits to senior management.

If you are conducting a comparative pricing survey, it is important that you be specific as to the exact requirements and specifications of your plan in order to make accurate comparisons.

If outside funds, employer stock or a brokerage window are offered as non-standard options, there may be additional recordkeeping fees assessed and high retail expense ratios.

Trustee Services

It is advisable to use a third-party trustee for your DC plan and not self-trustee the plan assets in order to further reduce the plan sponsor fiduciary liability. Trustee fees are typically quoted as a percentage of assets assessed annually with a minimum fee regardless of the asset base. Depending on the services required by your plan, some trustees may negotiate a maximum fixed fee once plan assets reach a predetermined threshold.

Plan Level Expenses

Plan level expenses are costs associated with the entire plan and are assessed against the total plan assets. These expenses occur when a plan sponsor terminates a provider and hires a new service provider. Examples of these expenses include the plan termination cost which may consist of a flat charge or a percentage of outstanding assets. There may also be a participant termination charge assessed at the time that the plan is terminated with a provider. Insurance sponsored bundled plans typically have plan surrender charges which are graded asset-based charges which decline generally by one percentage point over the life of the plan.

Investment Options

The greatest confusion about fees exists in the area of investment management. Another Dalbar Survey found that only 22 percent of plan sponsors could identify all of the investment management related fees in their plan correctly. Because service providers fall under differing levels of regulatory scrutiny and disclosure standards, it becomes difficult to fully understand all of the expenses that may not be fully disclosed.

The investment management fee is charged as a percentage of assets under management and is paid to the investment manager for the portfolio management of the assets. This fee does not include internal operating expenses, service charges, and transactional costs. Registered mutual funds, insurance company separate accounts, and variable annuities include internal fund operating expenses which are intended to cover the expense of legal fees, fund accounting, service fees, and transfer agent fees. These fees may not always be apparent or fully disclosed and tend to be overlooked by plan sponsors.

Variable annuity and mutual funds have expense ratios expressed as a percentage of assets which include the investment management fee and operating fund expenses. Each fund option in the plan will have different ratios which are netted against fund assets and affect performance. Each fund will also have differing 12b-1 fees which are assessed throughout the life of the investments and netted against fund assets. A 12b-1 fee is disclosed in a mutual fund prospectus and is a percentage of fund assets used for marketing expenses.

When investing in mutual fund options, understand in which share class, institutional or retail, you are investing and all of the expenses associated with the fund. Some funds may carry high 12b-1 fees throughout the life of the investment and high redemption fees or deferred sales charges which are assessed if the fund option is changed in the plan.

Additional fund options outside the standard bundled selection of funds may be assessed an additional recordkeeping expense in the form of a fixed annual fee or as an asset charge in addition to the normal fund expenses assessed by that outside fund.

Hidden costs appear as incidental expenses which, when aggregated, can significantly affect participant returns or administrative expenses.

Some investment funds that are purchased at NAV (net asset value) may carry contingent deferred sales charges (CDSC) which are assessed against the total balance at the time the money is withdrawn from the fund or the plan. CDSC may be in the form of a graded deferred sales charge which declines as a percentage of assets over a predetermined time. In some cases, this charge applies to the prior 12 months of contributions made.

Transaction fees may be assessed to limit the frequency and number of times participants can switch among investment options throughout the year. These fees are typically netted against participant accounts. Asset management fees or daily asset charges are assessed daily on the total assets of the plan for the life of the plan. These are typically netted against participant accounts. The daily asset charge does not include the investment advisory fees or other fund operating expenses. These separate expenses need to be added together to determine the total cost of the investment option.

Deposit charges (cash flow charges) are less onerous to a plan's performance but are often confused with daily asset charges which are assessed to the total, assets. Deposit charges are an up-front charge assessed as a percentage of the contributions or new dollars flowing into the plan and not on the total assets of the plan.

Annual participant maintenance fees are typically a flat charge per account that is netted against participant accounts or paid by the plan sponsor. Mortality risk charges are found in variable annuity contracts as a percent-age of the fund assets. Although the name implies a degree of insurance in this investment option, this is purely another source of income for the provider.

Communications

Participant communications expenses may include travel expenses for trainers, per-seminar charge, cost for customized educational materials, videos, asset allocation software customization, and per diem seminar charge for multiple, geographically dispersed locations. Participant statements and newsletters may have handling and mailing charges.

Internet access to asset allocation software and participant statements bring great cost savings to the provider that in turn should he passed on to you, the plan sponsor. There may be IRA rollover charges for employees leaving the plan who roll assets into an IRA with the provider. Most providers will tend to waive this charge in order to capture assets that would normally leave the investment manager.

Stiff competition among providers is leading to compression fees. It pays to check pricing periodically and negotiate your contract with your providers. Stay current with new developments, products, and services. Approach your provider relationships as a partnership and set clear provider expectations. As plan assets grow, fees decrease.

Conclusion

There continues to be limited plan sponsor awareness of total plan costs. Part of the reason is that there is great confusion but also little incentive to carefully evaluate plan costs paid by participants. Once calculations of the plan costs have been determined, you need to put these costs in perspective with competitive plan providers and the reasonableness of these expenses with respect to the plan costs available to the type and size of your plan.

A market perspective as to the reasonableness and adequacy of the plan features can be invaluable. Peer group comparisons of competing providers and services are important to benchmark your plan's cost to similar plans. A cost analysis produced in a vacuum of comparative information needs to be complemented by a market survey in order for it to be an effective tool for renegotiation or for enhancing your plan's features.

Bridgebay Financial, Inc.
Investment Consultant Services

Bridgebay has been redefining the standard of excellence in institutional investments and retirement plans since 1987. As an independently owned, investment consulting firm, Bridgebay has advised premier technology and biotech companies on their retirement plans and balance sheet investments.

Our highly experienced consultants pursue a strict policy of full disclosure and avoid all potential conflicts of interest that could compromise our impartiality. Our sole business is investment and retirement plan consulting. Bridgebay does not manage assets, underwrite, trade securities, sell financial products nor have a direct or indirect ownership interest in any fund or investment management firm.

Each consultant has over 25 years of institutional investment experience in advising corporations and retirement plans. Our professionals are CFA charter holders, and have the practical experience gained at major institutions that enable them to provide pragmatic solutions to our clients.

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Ms. Benjamin has more than 15 years of experience in the biotechnology industry. She has managed and overseen various functional areas at start-up companies such as Microcide where she was responsible for establishing the Human Resources Department. While at Chiron Corporation she was involved in the integration of the HR functions after the Cetus merger. Her responsibilities include employee benefits, non qualified deferred compensation plans, DC plans and administration management.

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Prior to founding Bridgebay, she advised institutional clients at Salomon Brothers, Inc., a Wall Street investment bank, and Citicorp.

She has authored numerous professional articles in financial publications and has been a frequent speaker at conferences sponsored by Phoenix Hecht, IBC Pension Seminars, Dr. Frank Fabozzi, Treasury Management Association (TMA). Topics include benchmarking DC plans, pension investing, mutual fund and manager selection, custodian selection, provider evaluations, and plan fee analysis.

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