THE EXCELLENT FIDUCIARY

How Excessive Fees Impact Retirement Plans

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A CRISIS IS BREWING FOR HUMAN RESOURCES MANAGERS

Complaints about excessive fees are high on the list of reasons that employees file complaints against their employers with the U.S. Department of Labor. A new era of employee activism is underway in which plaintiff lawyers are finding fertile ground for litigation opportunities, catching many employers unprepared.

A crisis among retirement plan sponsoring enterprises is unfolding. The challenge facing their leaders is to ensure that operations managers are equipped with the training, guidelines, controls, and tools that elevate fiduciary risk management to its proper priority.

Organizations that have achieved advanced levels of governance, risk management, and compliance have realized significant benefits in their costs, employee satisfaction, and regulatory readiness.

While developing a comprehensive methodology to measure the impact of an internal controls framework for fiduciary organizations, Roland¦Criss found even greater benefits were linked to the usage of automation, rather than with written procedures and spreadsheets alone. We also found that benefits are not just economic but they also ensure peace of mind for those executives and managers who bear the brunt of fiduciary risk.

Six key factors underscore the challenge for human resources managers.

- A federal regulation became effective in 2012 that placed an unprecedented spotlight on fees paid by retirement plans for investment and ministerial services—the so-called **Fee Disclosure Rule**.
- The Fee Disclosure Rule impacts plan sponsors equally, if not more than their service providers. It introduced a sea change in the role of a retirement plan fiduciary, which many employers have largely ignored. An overhaul in the approach used

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by human resources managers to perform formerly rote fiduciary activities is vital.

- Lawsuits against many employers alleging that they permitted excessive fees to be paid to retirement plan vendors emerged in 2016. Those cases, and many more that continue to be filed, focused attention on the need to take compliance with the Fee Disclosure Rule seriously.
- Due to the complex nature of vendors' pricing structures and service models, it is often difficult for human resources managers to discern exactly what fees are being charged for which services, as well as if the fees are appropriate.
- The lack of careful attention to vendor compensation management opens the door to serious legal trouble for employers and the executives who serve as their retirement plans' fiduciaries.
- Standardized internal controls now exist that ensure compliance with the Fee Disclosure Rule in both manual and automated frameworks.

DEFINING EXCESSIVE FEES

Enterprises that sponsor retirement plans are required to protect their employees from excessive fees associated with their 401(k) and 403(b) type plans. Failure to do so is a breach of their fiduciary duty and a violation of the Employee Retirement Income Security Act ("ERISA").

Compensation paid to retirement plan vendors generally spans three categories:

- **Plan Administration**—These costs can include charges for independent fiduciary, accounting, recordkeeping, legal and trustee services, plus customer-related conveniences such as telephone voice response systems, customer service representatives, educational programs, retirement planning software, investment advice, electronic access to plan information, daily valuation, and online transactions.
- **Investment Management**—These are generally the largest costs incurred and are comprised of charges for investment management from mutual funds.
- **Investment Advisory**—Charges in this category can vary widely based on whether the plan hires an investment consultant to advise the fiduciaries and if the plan offers financial planning to participants.

The Fee Disclosure Rule states that once responsible plan fiduciaries receive their vendors' fee disclosures, they have a duty to evaluate the disclosures, assess the adequacy of the disclosures for analysis purposes, and determine the reasonableness of the vendors' arrangements and fees. *An unreasonable fee is an excessive fee*.

We believe the reasonableness of a plan's fees can be measured across four critical attributes:

- Pricing structure (auto escalation vs. flat rate)
- Market pricing (the "going rate" factor)
- Service agreement (integrity of the deliverables)
- Quality of service (satisfaction of the stakeholders)

To measure the impact of excessive fees, we created an assessment program that consists of those four critical attributes. Embedded in the program is our proprietary **Vendor Value Index**(tm), which isolates fees from services

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actually delivered, and scores each component separately.

UNDERSTANDING FEE INDEXING

Comparing subjective items like service quality to objective items like dollars and cents can be like comparing apples to oranges. In order to make such a comparison accurate and meaningful for fiduciaries, the Vendor Value Index scores the quality of the services delivered by a vendor. That score is converted to a *servicing index*.

An algorithm combines market data with the fees charged by a vendor to produce the *fee index*.

A vendor whose servicing index equals or exceeds its fee index is deemed to be reasonably compensated.

We have found that human resources executives and risk managers benefit from fee indexing in six key ways:

- hard to evaluate services are converted into numeric values;
- unbiased and impartial analysis produces the servicing index;
- inappropriate pricing structures are revealed;
- illustrates how to correct deficiencies;
- makes apples-to-apples comparisons of vendors a reality; and
- eliminates confusing jargon.

APPLYING THE INDEXING METRICS

After describing the methodology to determine whether an ERISA plan's fees are reasonable, the next step is to provide real world illustrations of the contribution of fee indexing to a plan's compliance culture, operations, and effective governance.

Our analysis confirms that fee indexing has a material impact, which we assessed with three variables: growth in assets available for investment, improvements in vendors' service quality, and risk management culture.

THE REAL WORLD BENEFITS OF REASONABLE FEES

In a recent case study, newly appointed benefits committee members of a 403(b) plan began to pose "tough" questions, regarding the plans' service providers' business models and approach, which led to an assessment of the vendors' deliverables and fees.

Fee indexing during the assessment revealed overpricing by vendors that cost the institution's employees over $11 million in lost value. The cost improvements resulted in sustainable savings ongoing (*see Exhibit 1*), transformed more of the employees' contributions into investable assets, and reduced greatly a fiduciary risk for the institution.

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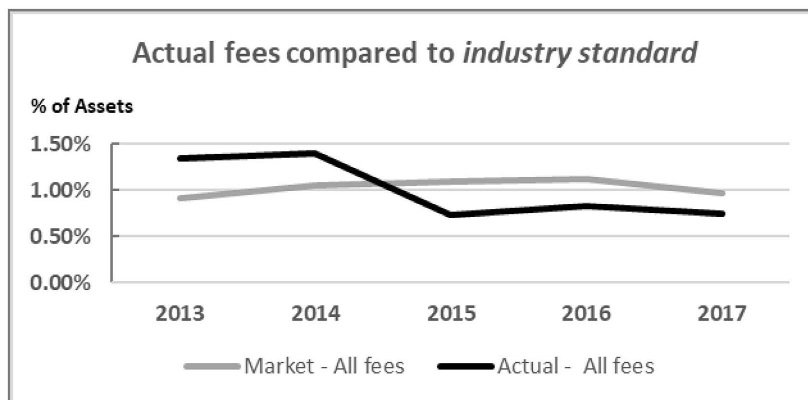
EXHIBIT 1

The Positive Impact of Fee Indexing



A chief financial officer who chaired the investment committee for a 401(k) plan became concerned about reports from federal regulators regarding the erosion of performance in defined contribution plans caused by excessive fees paid to vendors. He authorized an operations assessment to determine the status of the firm's plan.

The impact of the assessment resulted in governance, service quality, and economic improvements for the employer and the retirement plans' participants. Following implementation of the economic related improvements identified in the assessment, a $50,000 contribution to the plan will grow to an amount 27% greater than under the pre-assessment fee structures. The improved performance amounts to nearly $300,000 over a 30-year time horizon (*see Exhibit 2*).

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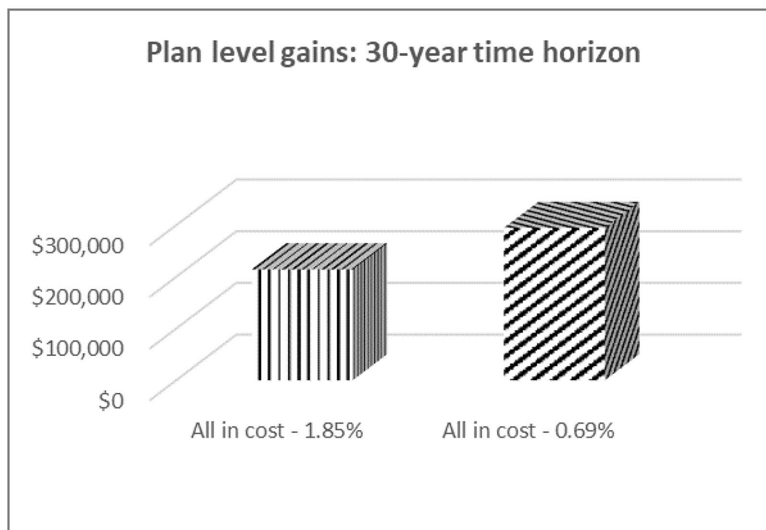
EXHIBIT 2

Impact of an Operations Assessment on Fees



FIVE MANAGEMENT IMPERATIVES

We believe enterprise leaders should incorporate five imperatives into their management practices to execute their organization's fiduciary mission successfully.

- **Imperative One**

  Get training: CFOs and human resources managers should implement a training policy that covers all four disciplines in ERISA's fiduciary standard of care. Successful completion of a risk management training course that focuses on ERSIA should be a prerequisite for participation on an investment or benefit plan committee.

- **Imperative Two**

  Conduct a risk assessment: Commission a qualified, independent, third-party firm to conduct a review of your operations workflows and investment committee's governance practices.

- **Imperative Three**

  Adopt an automation philosophy: Address the convergence of information technology with error prone manual compliance and management reporting methods.

- **Imperative Four**

  Enable sustainable controls: Implement a framework of internal controls that empowers operations personnel to avoid errors.

- **Imperative Five**

  Cut costs and improve service quality: Annually examine fees paid to vendors and the quality of services they deliver—adjust vendors' fees to maintain reasonable levels of compensation for their services.

CONCLUSION

It has been clear to risk management experts for several years that retirement plans are underperforming. A key culprit is *industry standard* pricing, which extracts unreasonable fees from the retirement accounts of American workers.

Gaining control of costs has the potential for dramatic economic and risk improvements for employees and their

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employers. Anecdotal evidence abounds: the U.S. Department of Labor has warned fiduciaries about findings it has uncovered during thousands of enforcement audits; advocacy groups for workers have published studies that reveal how investment outcomes are not likely to support workers' life style expectations in their retirements; and activist employees are using the courts in an attempt to force their employers to pay for underperforming 401(k) and 403(b) plans due to their belief that plan fiduciaries are failing to perform their duty to authorize only reasonable fees for service providers.

Knowledgeable employers are enthusiastic about the opportunity to regain control of their retirement plans' cost structures, and many are committed to action. Eliminating excessive fees is essential if ERISA qualified plans are to deliver on their potential.

Roland|Criss conducts operations risk assessments. They may be contacted at 800-440-3457 or by email at admin@rolandcriss.com.

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