January 2012

Assessing reasonableness of 403(b) retirement plan fees:

Best practices for defining *Who, What, How and Why*

While more information is a good thing, with greater transparency comes greater responsibility. How can plan sponsors "reasonably" evaluate what is reasonable?

Making sense of retirement plan fees — and determining if they are reasonable — will place new demands on the already busy shoulders of retirement plan sponsors. While plan sponsors under ERISA have a long-standing fiduciary obligation to monitor fee reasonableness, they may not feel fully prepared to address the tasks associated with the Department of Labor's new 408(b)(2) fee disclosure requirements.

The not-for-profit market has its own set of unique challenges and practices. Factors such as portability of retirement plan assets, limited employee benefits resources, and the presence of multiple providers within a single plan have historically challenged these plan sponsors in managing their fiduciary responsibilities.

Executive summary

While every plan sponsor and organization is different, they share a common goal — the desire to pay a fair and competitive price for the retirement plan services they receive. The following considerations may help plan sponsors determine reasonableness:

- Using a prudent process and best practices will assist plan sponsors in organizing and evaluating information on services, investments and fees, while helping meet fiduciary responsibilities.
- Plan sponsors should consider an "all-in" or total fee, which combines all administrative and investment fees into one figure, regardless of whether they are paid at the employer, plan or participant level. This comprehensive fee total can improve their understanding of what is included in their service bundle and their ability to make meaningful comparisons.
- Plan sponsors are required to look beyond fees and determine whether the plan is receiving value for the fees paid. This should include an evaluation of vital plan outcomes, such as retirement readiness, based on their organization's values and priorities.
- In addition to the impact of fees, there are key factors critical to achieving retirement success: effective plan design, strategically constructed investment menus, solid long-term investment performance, targeted participant education, and objective advice. Plan sponsors should look for ways to simplify decision making and help participants transition from accumulating savings to receiving income in retirement.

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Financial Services

Fiduciary best practices to review fees

"Plan fiduciaries should be able to demonstrate a process for determining four factors impacting fee reasonableness: *Who*, *What*, *How* and *Why*."

– Donald Trone, CEO, 3ethos.

In an environment of change, adopting best practices for a disciplined and prudent process can help your organization evaluate fee reasonableness and provide a practical defense against fiduciary liability. Whether you have a 403(b) or a 401(a) plan, this process should include identifying the individual(s) at your organization responsible for evaluating plan fees and service quality.

Best practices to help provide confidence that your organization has a solid plan for fiduciary compliance include: documenting policies, taking meeting minutes and drafting or updating a formal investment policy statement.

While the law does not require a plan sponsor to select the lowest-fee provider, very often, fees take on a primary focus. Although a low cost for plan services and investments is desirable, fees are just one part of the story. The extent and quality of the services must be considered, and importantly, whether a plan is receiving *value* in exchange for fees.

Fiduciary expert Donald Trone, founder and CEO of 3ethos, a fiduciary consultant in Mystic, CT, suggests that plan fiduciaries should be able to demonstrate a process for determining four factors impacting fee reasonableness: *Who*, *What*, *How* and *Why*.[1]

- ***Who*** is receiving compensation from your plan?
- ***What*** are the fees and expenses associated with your plan?
- ***How*** do your fees and expenses compare to other service providers or investment options?
- ***Why*** is the compensation warranted?

Who is receiving compensation from your plan?

Your first step should be to identify and make a list of all "covered service providers." Covered service providers may include any plan fiduciaries, investment advisors, recordkeepers, brokers – and providers receiving "indirect compensation,*" such as investment or plan consultants.

With a sound fiduciary process in place, your organization should be able to easily identify and evaluate the covered service providers, following the steps in Figure 1. The 408(b)(2) service and fee disclosures you receive from each provider should further clarify and validate your list of *Who* is being compensated.

*Indirect compensation: Payments, in the form of compensation, received from sources other than directly from the plan or plan sponsor in connection with services rendered to the plan. Examples include finder's fees, "soft dollar" revenue, float revenue, and brokerage commissions or other transaction-based fees for transactions or services involving the plan that were not paid directly by the plan.

Use procedural prudence when selecting a new provider or evaluating an existing one.

Figure 1. Services and fees review – best practices

Task	Best practice considerations
1. Identify all "covered service providers."	▪ Includes fiduciaries, investment advisors, recordkeepers, brokers, and providers receiving "indirect compensation," such as consultants
2. Gather complete information regarding your providers, services and fees.	▪ Provider qualifications ▪ Scope and quality of services ▪ Fees charged for services and investments
3. Consider indirect compensation when evaluating investments and services.	▪ Require disclosure of all compensation arrangements ▪ Understand any potential conflicts of interest
4. Use procedural prudence when selecting a new provider or evaluating an existing one.	▪ Thoroughly review and document the process ▪ Regularly monitor the reasonableness of fees ▪ Review total cost plus individual fee components
5. Conduct fiduciary reviews regularly and maintain supporting documentation.	▪ Periodically audit invoices to assure compliance with agreed-upon fees ▪ Ask for thorough itemization if necessary

What are the fees and expenses associated with your plan?

The next step is determining *What* fees and expenses you are paying. A variety of fee arrangements exist to pay for the wide range of services used by defined contribution plans — and they are charged in different ways, including per-participant fees, per-plan fees, or as a percentage of total plan assets.

Understanding the basics of fees and fee arrangements

Despite the variables, reviewing three basic categories of services for the typical employer-sponsored retirement plan can help simplify your analysis: 1) administrative services; 2) individual services; and 3) investment services.

1. **Administrative services**
   Administrative services include recordkeeping, accounting, legal and trustee services, website, customer service phone lines and participant communications – all necessary for daily plan administration.

Plan participants typically pay these expenses, particularly in the 403(b) market. However, fee arrangements may vary by provider. For example, some administrative costs may be borne by the investment options themselves (typical in the 403(b) market), while others can be captured as a per-head fee deducted from participant accounts.

2. **Individual services**
   Fees apply to specific transactions requested by participants. If your plan allows loans, for example, participants may pay a one-time loan initiation fee and/or annual loan maintenance charge. There may be fees for other services, such as a qualified domestic relations order (QDRO) or wire transfer. These service fees can be bundled with the total service package or charged directly to a participant's account.

A variety of fee arrangements exist to pay for the wide range of services used by defined contribution plans.

3. **Investment services**
   Investment management fees typically represent the largest portion of a plan's expenses and are paid by participants through a reduction in net return on investments in their accounts. Known as the expense ratio, these fees support expenses associated with investing participants' assets. Expenses can vary widely depending on type of investment or retirement plan product (actively managed vs. indexed, fixed income vs. equities, annuities vs. mutual funds, etc.) and the size of plan assets.

Other considerations — recordkeeping offsets (revenue sharing)

Your evaluation should also factor in any recordkeeping offset (also known as revenue sharing). Under this arrangement, the manager of an investment option may agree to rebate a portion of its investment fee to a service provider — in the case of 403(b) plans, generally the recordkeeper. This amount helps to offset the cost of administration provided by the retirement service provider that would otherwise be charged directly to the plan, the plan sponsor and/or participants.

This adds important considerations for fiduciary evaluation of fees:

- In the majority of 403(b) plans, administrative fees are typically covered in whole or in part by a recordkeeping offset agreement between investment providers and the plan's recordkeeper. Total recordkeeping offsets from the plan's investments — and the range of services they pay for — are important considerations for plan sponsors when benchmarking fees.
- Recordkeeping offsets vary widely in practice, depending on individual plan economics and individual investment manager practices. The agreement between the plan sponsor and service provider should disclose whether any funds are used to offset administrative expenses charged by your recordkeeper — and whether the recordkeeper is entitled to these credits under plan rules.
- Any amounts that the plan receives from providers as revenue offsets can serve to lower plan costs for participants.
- Ultimately, plan sponsors may want to consider an all-in – or total – fee, which combines all fees into a single figure, expressed as a percentage (see Figures 2 and 3). Any amounts returned as recordkeeping offsets to the plan or its participants should be considered when determining the all-in fee.

How do fees and expenses compare to other service providers or investment options?

While an all-in fee may help improve your understanding of what you are paying, your evaluation should also factor in any recordkeeping offset (also known as revenue sharing).

The third step is to determine *How* your fees and expenses compare with industry standards. Most often, organizations turn to various forms of benchmarking, which should be part of a broader, prudent review process carried out by your organization.

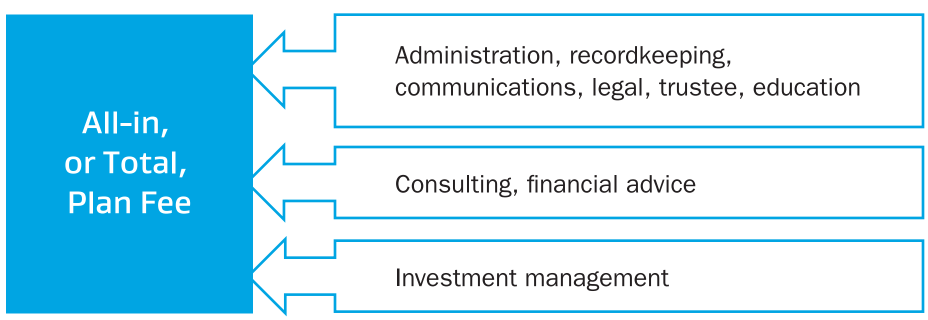
Comprehensive benchmarking can help your organization to make informed plan decisions, although the process has limitations. David Richardson, Principal Research Fellow at the TIAA-CREF Institute, believes that benchmarking should balance fees with service quality and retirement outcomes. "Very often benchmarking focuses on a cost minimization algorithm. But this doesn't look at the full picture, nor does it take into account that provider services vary," Richardson says. "The objective of the plan should be that your employees are accumulating adequate retirement income so they can eventually retire."[2]

Although ERISA does not require a plan sponsor (or a non-ERISA plan sponsor who chooses to voluntarily comply) to select the lowest-fee provider, fees often become the primary focus in today's cost-conscious environment. Tom Kmak, CEO, Fiduciary Benchmarks, points out that determining the quality and value of services provided is just as important as evaluating fees. "Given that the retirement plans industry is far from a commodity, one cannot benchmark fees without benchmarking value," Kmak says.[3] "The law emphasizes the quantity and quality of service in several places, clearly recognizing that not all service providers deliver equal value."[4]

The all-in fee concept

Research suggests that using an all-in fee can be helpful as a measure of reasonableness. This can facilitate an apples-to-apples comparison by correcting for variation in fee practices and differences in allocating major expense categories (such as investment versus recordkeeping) among participants, the employer and the plan. In the Deloitte/ICI 2011 Defined Contribution/401(k) Fee Study, the all-in fee includes all administrative fees and investment fees (i.e., the total expense ratio) whether assessed at the plan, employer or participant level. It *excludes* individual service fees, such as loans.[5] The all-in fee concept is illustrated in Figure 2 below.

Figure 2. All-in, or total, fee



Based on a sample of 525 401(k) plans, the median participant-weighted all-in fee was 0.78% (or $7.80 per $1,000), according to the Deloitte/ICI study. Fees ranged from 0.28% for plans at the 10th percentile, to 1.38% for plans at the 90th percentile (see Figure 3).

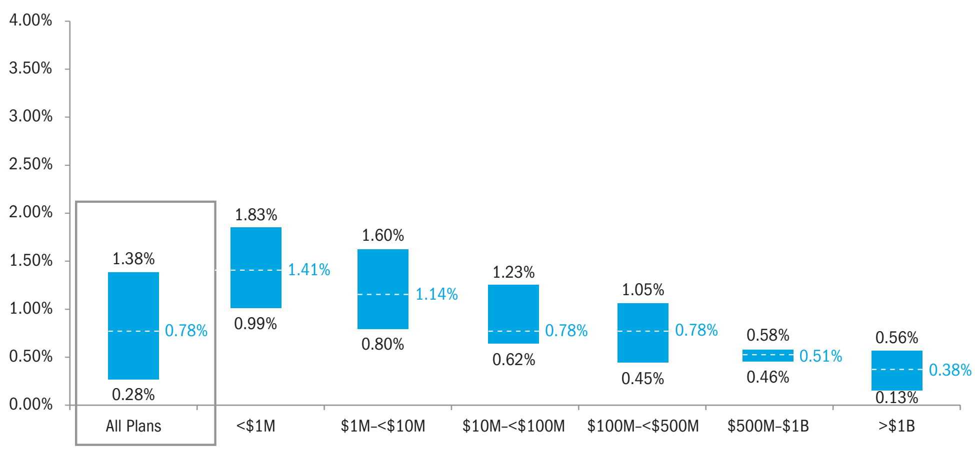
While it is important to note the Deloitte/ICI study's sample was based primarily on 401(k) plans due to a lack of similar available data for 403(b) plans, it can be helpful for plan sponsors to consider an all-in fee to make sense of their own fees. Once you understand your plan's total fee, your organization can make meaningful comparisons with other providers.

"Very often benchmarking focuses on a cost minimization algorithm. But this doesn't look at the full picture, nor does it take into account that provider services vary."

– David Richardson, Principal Research Fellow, TIAA-CREF Institute

Figure 3. All-in fee range (% of Assets)

The upper figure represents the 90th percentile, the dotted line represents the median, and lower figure represents the 10th percentile of participants by plan asset size segment (participant weighted)*



Source: Inside the Structure of Defined Contribution/401(k) Plan Fees: *A Study Assessing the Mechanics of the 'All-In' Fee*, Deloitte/ICI 2011 Study, November 2011

This graph is for illustrative purposes only and is drawn from information published in the Deloitte/ICI 2011 Defined Contribution/401(k) Fee Study in November 2011, and based on over 250 plan-specific data elements gathered from each plan, covering plan design, investment options and plan, participant and investment fee information between January and August 2011.

This data may change over time due to the impact of the 408(b)(2) regulations. Your own plan and fee situation may differ. Some or all of these recordkeeping or administrative fees may be paid through a portion of asset-based investment expenses (e.g., in the form of 12b-1 fees, shareholder servicing fees or administrative servicing fees), which is often referred to as revenue-sharing or recordkeeping offset.

Bear in mind the survey does not evaluate quality or value of services provided — both of which can impact fees. Quality of service varies. Qualitative differences in services may affect fees but are not easily quantified and were not addressed in this Deloitte/ICI study.

* When a survey sample is drawn from a population, the proportions of segments within the sample may not match the distribution of those segments within the population. In the normal course of survey work, researchers will determine the appropriate variables on which to "weight" their survey observations, in this case, participants.

The 403(b) environment involves the complexity of multiple providers and numerous participant choices. With more choice, the need for employee education and advice becomes even greater.

Factoring in the 403(b) difference

An important consideration when comparing services and fees is the difference between the 403(b) and 401(k) environments, which adds to fiduciary complexity in evaluating plan fees and all-in charges. For example, annuity options can be additional cost drivers in 403(b) plans. The 403(b) environment also typically involves the complexity of multiple providers, which may warrant strategic investment tiering designed to rationalize the investment lineup, reduce fiduciary risk, and simplify participant choice.

With numerous participant choices, the need for employee education becomes even greater because the participant is required to make two decisions: 1) What provider to select, and 2) How to invest their retirement savings. As a result, plan sponsors have traditionally placed a higher value on the availability of targeted participant education and advice programs to promote financial literacy and informed decision making.

An annuity option

Identifying a low-cost annuity option may be important for plan sponsors who place a value on offering participants the opportunity to receive guaranteed lifetime income. If your provider offers annuities, it is important to review the fees against a similar universe to ensure they are competitive. Not all annuities are the same, and annuities have additional expenses not associated with mutual funds. Plan sponsors should consider:

- What is the expense ratio of the annuity option? Evaluate expense ratios against independent, objective sources using a broad sample for comparison, such as Morningstar.
- What is the mortality and expense fee (M&E) charged by an insurance company to cover the cost of death benefits? What other fees exist?
- Does the annuity provider have a strong insurance rating from major independent ratings agencies? Does it generate the return needed to pay sufficient retirement income throughout participants' lifetimes?
- What are the interest rates and other benefits offered by the annuity?

Annuities can help address the risk of employees outliving their income.* If employees are able to contribute to an annuity during the accumulation phase, they may also benefit from less volatility, diversification and dollar-cost averaging. In addition, research has shown that participants who save in an annuity during the accumulation phase are more likely to create a lifetime stream of income at retirement. According to Richardson at the TIAA-CREF Institute, the presence of annuities helps to educate participants about the benefits of receiving retirement income they cannot outlive.

*All guarantees are subject to the claims-paying ability of the issuing company.

"The presence of annuities during the accumulation phase is a strong indicator that you can socialize people to the lifetime income concept. Moving from a stockpile of assets during the accumulation phase to a flow of income during retirement is an easier transition," Richardson says.[6]

Ensure you understand your providers' fee practices and any investment-related expenses beyond the total expense ratio.

Figure 4. Comparing providers and services

Tactic	Considerations
Benchmarking	▪ Understand the metrics' relevancy, realizing your plan may not align perfectly. ▪ Ensure you understand your providers' fee practices and any investment-related expenses beyond the total expense ratio. Consider an all-in fee for a meaningful evaluation (see Figures 2 and 3).
Request for proposal (RFP)	▪ Issuing an RFP is not required, but can help your organization compare services and plan pricing. ▪ Are you prepared for the cost, time and resource-intensive effort required?
Using professional services	▪ If your organization lacks internal expertise, a knowledgeable plan consultant can facilitate a thorough review of fees and services, although it is up to you as plan fiduciary whether to act on the advice. ▪ Make sure you understand the consultant's analysis and assumptions before adopting recommendations. ▪ Understand the sources of consultant compensation and any potential conflicts of interest. Any indirect compensation should be disclosed and reviewed.
Reviewing third-party data	▪ There is a wide array of independent information available to plan sponsors. Choose objective sources that include meaningful samples. ▪ Some third-party studies use a template that may not match your plan structure or needs.

According to the Department of Labor, "cheaper isn't necessarily better." The DOL regulations clearly emphasize that quality and value of services be considered.

Why is the compensation warranted?

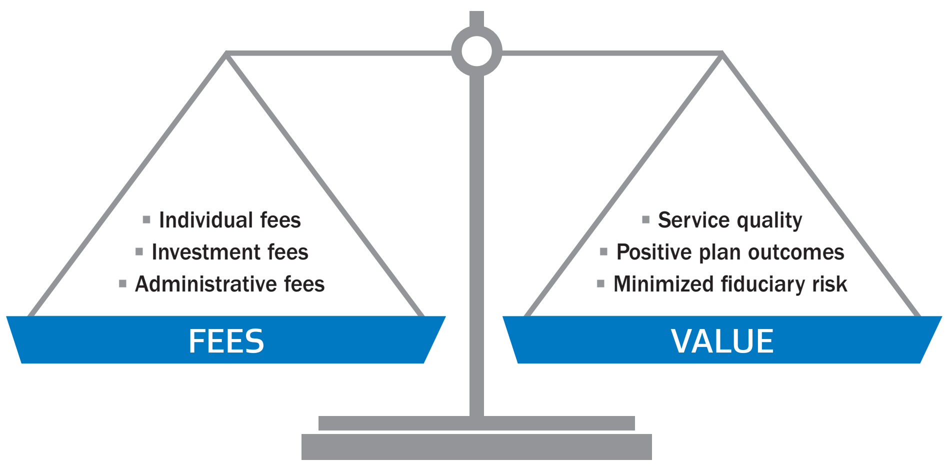
After reviewing your total service fee and performing relevant benchmarking, you are ready to ask the most important question: *Why* is the compensation warranted? Does it represent a good value? There are strategies plan sponsors may wish to consider to help determine the answer.

The question of value

Measuring value can be elusive. It has been said: "Reasonableness is in the eye of the beholder and, of course, the regulator."[7] According to the Department of Labor, "cheaper isn't necessarily better."[8] It would be a mistake to focus exclusively on fees as a result of the new regulations. Instead, the DOL regulations clearly emphasize that quality and value of services be considered.

Ultimately, what does your organization need and value the most? And what are you and your participants willing to pay to get it?

Figure 5 — Balancing fees and value



Kmak of Fiduciary Benchmarks suggests plan sponsors focus on three key value metrics to determine the reasonableness of plan fees. "Good, timely, accurate recordkeeping; protecting plan sponsors as fiduciaries; and really helping participants retire."[9] Your value analysis should consider these factors: 1) Your overall plan objectives; 2) Results you expect from the provider; and 3) Priorities that your organization weighs most heavily. To simplify your task, narrow your list to what you consider the essentials.

For example, your organization may value a provider that can provide "high touch" service for your employees. This may be closely followed by cost considerations or investment menu design, such as the ability to offer nonproprietary mutual funds or in-plan annuities that take your participants to and through retirement. The reputation and experience of your provider may also be key factors. What is important is that you articulate and document your priorities.

"While plan sponsors need to understand what is in their service bundle, a 'rich' service bundle does not necessarily translate to a high fund expense ratio."

– Brigitte Madrian, Professor of Public Policy and Corporate Management, Harvard University

After you determine your plan priorities, the question becomes: How well does your provider deliver on them? This decision process ultimately becomes your road map for measuring value. Only your organization can decide how to rank your priorities.

Figure 6. *What* does your organization value most?

Plan sponsor priority	Value priorities/potential measures
Participant outcomes	▪ Does your plan reflect high income replacement ratios over a working career? ▪ Does your provider measure its success by the success it creates for your participants? ▪ Does your provider offer *objective* advice for your participants?
Service quality and plan consultative support	▪ Does your provider meet or exceed your service level expectations, including high levels of timeliness, accuracy and participant satisfaction? ▪ Does your provider offer a high level of consultative plan support to help you target areas for improvement?
Minimizing fiduciary risk	▪ Do you receive robust support to help meet fiduciary obligations?
Managing cost	▪ Do you understand exactly what services are included in your offering and the cost drivers? ▪ Ask what changes can be made to lower your plan costs, such as reducing manual processes.
Provider experience	▪ How experienced and focused is your provider in the relevant market? ▪ With added complexities of the 403(b) environment, are you confident your provider is up to the task?

Are your fees buying the right things?

While the emphasis on fees is understandable in a cost-conscious environment, plan sponsors would do well to consider this advice: "Let's not lose sight of the forest for the fees." The purpose of a retirement plan is to provide the means for participants to save enough money for a secure retirement. The ultimate test remains the ability of your employees to retire with a high probability of achieving this goal. With that premise, it is logical that a significant portion of a plan sponsor's total fee should pay for services supporting that primary objective.

Plan sponsors should understand that high-value services don't necessarily require high fees paid by participants, according to Brigitte Madrian, Professor of Public Policy and Corporate Management at Harvard, and award-winning author of a study on fees.

Plan sponsors should work with providers to ensure their fees include services shown to improve plan outcomes.

"The plan sponsor needs to be thinking about choosing an effective plan design, education program and investment menu that gets individuals to a good place, and sets them up for success," Madrian says. "While plan sponsors need to understand what is in their service bundle, a "rich" service bundle does not necessarily translate to a high fund expense ratio."[10]

Madrian maintains that strategies such as automatic enrollment, a well-designed and easy-to-understand matching contribution structure, comprehensive participant education and a simplified menu of carefully screened investment choices have been shown to increase the odds of retirement plan success.

Plan sponsors should work with providers to ensure their fees include services shown to promote positive participant action and plan outcomes. Does your provider offer, for example, objective advice for your employees? And does that advice drive higher contribution and deferral rates, and greater diversification? Your service package should include programs expected to improve plan outcomes, even if including those services would lead to a reasonable increase in plan fees.

Conclusions

Today's plan sponsors need to look at both the forest and fees for the broader picture. While plan sponsors will approach the fee reasonableness test from many different viewpoints, they share a common desire to be treated fairly.

- Using a disciplined, best practices approach will help you organize and understand the information available to your organization, while supporting your fiduciary obligations.
- Consider an all-in, or total, fee for a more inclusive and meaningful comparison, factoring in your provider's fee practices, any recordkeeping offset and your plan's cost drivers.
- Conduct a robust dialogue with your providers about fees and ask questions. Understand specific components in your service bundle, if applicable. In the transition to fee transparency, plan sponsors will expect answers – and providers must be ready to give them. Your plan advisor can assist in identifying fees, assigning value and validating reasonableness.
- Look beyond fees to understand the value delivered and measure your providers against your organization's priorities. Insist on a well-constructed plan that reflects your organization's needs. Plan sponsors may choose to place a higher value on education programs tailored to participants' evolving needs and easy-to-execute objective advice programs shown to deliver better plan outcomes.
- Remember, achieving the lowest fee is not a requirement. Plan fiduciaries are required to determine whether fees are "reasonable" for the services provided and that the services support their plan goals.

In the end, following a deliberative fiduciary process for assessing *Who, What, How* and *Why* will help your organization fulfill its obligations in determining the reasonableness of fees.

We invite you to learn more

TIAA-CREF is committed to helping you meet your fiduciary obligations. If you have any questions, please contact your Relationship Manager. If your plan is serviced by the Administrator Telephone Center, you can speak with a representative at **888 842-7782**, Monday through Friday, 8 a.m. to 8 p.m. (ET).

You may also learn more online by visiting **www.tiaa-cref.org/plansponsors**

[1] Donald Trone, "Procedural Checklist for Fees and Expenses," 3ethos, 2011

[2] Interview with David Richardson, Principal Research Fellow, TIAA-CREF Institute, December 13, 2011

[3] "RETIREMENT PLAN ADVISORY FEES: Benchmarking Cost vs. Value," Center for Due Diligence, April 18, 2011

[4] Zachary Shess, "Peer Review: The Case for Benchmarking," DC Focus, Summer 2011

[5] Deloitte Consulting LLP, "Inside the Structure of Defined Contribution/401(k) Plan Fees: A Study Assessing the Mechanics of the 'All-In' Fee," Deloitte/ICI 2011 Defined Contribution/401(k) Fee Study, November 2011

[6] Interview with David Richardson, Principal Research Fellow, TIAA-CREF Institute

[7] "Reasonableness versus Fairness," Plan Adviser, September-October 2011

[8] "A Look At 401(k) Plan Fees," U.S. Department of Labor, October

[9] "A Q&A with Tom Kmak of Fiduciary Benchmarking and David Witz of Fiduciary Risk Assessment," The SPARK Journal, First Quarter, 2011

[10] Interview with Dr. Brigitte Madrian, Aetna Professor of Public Policy and Corporate Management, Harvard University, December 21, 2011

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