How to Spot Hidden Provider Costs

by Corie Russell, Pathfinder

PLAN SPONSORS CAN AVOID PAYING HIDDEN PROVIDER COSTS BY ASKING DETAILED QUESTIONS.

The Department of Labor's (DOL's) 408(b)(2) regulation requires retirement plan providers to give plan sponsors information about the costs associated with recordkeeping and administering their 401(k) plans. Employers now have the means to fulfill their fiduciary duty in understanding the true cost of plans, and some may consider changing providers as a result.

But sponsors should beware when evaluating other potential providers that hidden costs may exist. "When plan providers submit proposals for a company's retirement plan business, they may not be clear about the revenue they receive from the companies that provide the investments and the actual cost of services provided with the plan," said Brandon Bellin, senior associate actuary at Securian Retirement.

At the time of the proposal, there is no obligation for providers to show 408(b)(2) information—rather, the information may be provided at the point of signing the provider documents, Bellin told PLANADVISER.

Bellin explained the "games" providers can play with hidden costs, and the questions plan sponsors and advisers can ask to ensure they have the proper information.

- **Game #1: Revenue sharing.** Retirement plan providers receive payments, called revenue sharing, from investment companies for including their funds in the provider's investment selection. Providers may show plan sponsors initial proposals that include investment options with low revenue sharing, and therefore lower total cost, implying they are less expensive and a good value. Later, the provider may suggest a "better" lineup that pays higher revenue sharing and drives up plan costs.

What to ask: Does your pricing depend on the investments chosen? If the provider says yes, that is a warning sign that it makes more money on certain investments than others, Bellin explained.

- **Game #2: Proprietary target-date funds (TDFs).** Plan providers can generate additional revenue by offering TDFs from an affiliated asset manager. In these cases, investment management expenses can be unreasonably high for the underlying funds. For example, many TDFs that invest in passive index funds have expense ratios more typical of funds with active managers. This additional revenue allows the provider to make its base recordkeeping pricing appear lower. "People don't generally ask what the TDFs invest in," Bellin cautioned.

"From a provider perspective, it's a place to bury the extra revenue."

What to ask: Do you offer proprietary funds? If so, do you offer TDFs from an affiliated investment company, and what mix of passive and active funds do those funds invest in? If the provider does have proprietary funds and mixes passive and active funds, the sponsor or adviser can compare the expense ratio to alternatives in the market that have similar investment styles, Bellin said.

- **Game #3: Managed accounts.** For an additional fee, employees can purchase "professional management" services for managing the assets in their retirement accounts. These fees can be large and may exceed the actual cost of providing managed accounts, allowing the provider to reduce base recordkeeping fees. Providers may even require employers to offer managed accounts to receive the "lower" pricing offered in the initial proposal.

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What to ask: Are you affiliated with an investment manager? If so, this is a potential warning sign that the provider may try to drive additional revenue. The sponsor or adviser should also ask if the pricing depends on offering the managed accounts. If the provider is receiving more money on certain investments than others, this is a red flag. Even if the provider is not affiliated with an investment manager, managed accounts are provided at a cost for the participants and the plan. While Bellin said there is nothing wrong with these costs, they should be included in the analysis of total costs from the provider.

"Plan sponsors who are unaware of the hidden revenues and fees associated with a particular retirement plan provider's proposal put themselves at risk if they move their plans to that provider," Bellin said. "It's important that they demand full fee disclosure from any retirement plan provider and that they ask the provider to confirm that its revenue does not vary based on the investments chosen."

Ultimately, the plan sponsor should be comfortable with the provider choice from a fiduciary perspective and should choose a provider without red flags that is neutral with investment selection, Bellin said.

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