Debunking the Myth of Free 401(k) Administration

By Ary Rosenbaum, Esq.

An urban legend is a form of modern folklore consisting of stories usually believed by the teller of them to be true. Whether it's Proctor and Gamble being Satan worshippers because of an old logo or Kentucky Fried Chicken changing its name to KFC because of some Kentucky state tax, there are stories that are propagated as true that are clearly not. We see these urban legends circulated by chain e-mails and sometimes even passed off as true by the media and we are amazed as to how intelligent people can be conned into believing such fabricated stories. When it comes to the retirement plan industry, the biggest urban legend out there, the Loch Ness monster, the abominable snowman, or drugged travelers harvested for their kidneys legend, is the myth of free 401(k) administration.

The myth of free 401(k) administration is the idea that since the plan provider such as a third party administrator (TPA) charges a nominal up front charge or nothing at all, that is all the cost that a plan is being charged for the administration of their plan. Financial advisors and competing, unbundled TPAs are amazed when potential clients insist that they are being charged nothing or close to nothing for their plan when these plan providers know full well that these plan sponsors are taken to the cleaners. While fee disclosure regulations will be implemented in April 2012, that is still quite some time before these plan sponsors are going to be in for the shock of their life. So hopefully this article will try to lessen that sticker shock when plan sponsors get disclosure from their plan providers.

The TPAs who have helped perpetuate the myth of free 401(k) administration tend to be either bundled providers (where one single vendor provides all investment, recordkeeping, administration, and education services and that vendor is either an insurance company or mutual fund company) or those using an insurance company based platform.

Since the 401(k) industry is dominated by mutual funds, it should come as no shock that many mutual fund companies offer services as a bundled provider because it's an effective means of distributing their mutual funds. Mutual fund distribution is extremely important for mutual fund companies because their bread and butter are the funds' asset management fees and more assets under management equal more revenue for the mutual fund company. While many mutual fund companies only offer TPA services for larger plans, they are a few mutual funds companies that have been rather aggressive in offering TPA services to small and medium size plans. While mutual fund companies do offer an attractive alternative as part of a one stop shop, plan sponsors are under misimpression that the mutual fund companies' TPA services are free. Mutual fund companies make their money as a bundled provider through those very same mutual fund management fees that I had discussed earlier. Many of the same companies that offer TPA services are the very same mutual funds companies that offer revenue sharing or sub TA fees to unbundled TPAs for plans that use their funds. So by keeping plans under their roof, these mutual funds companies can keep their revenue sharing/ sub-TA fees to themselves. These mutual fund companies also guarantee the fees they make, by suggesting that a percentage of a plan's assets (up to 100%) be invested into their own proprietary mutual funds. Having a mutual fund lineup dominated by one mutual fund company can be considered a liability risk.

The myth of free 401(k) administration is mostly associated with insurance company providers whether it is through an unbundled or bundled arrangement. While insurance companies do offer different types of programs that cater to plans of all sizes, the myth is associated with insurance based platforms devoted to 401(k) plans that are small (size dictated by plan asset size). Insurance company providers offer a" low" cost 401(k) program that is attractive to small companies or new 401(k) plans that have very few assets. While most independent TPAs may have minimum annual recordkeeping fees that may be between $2,500 and $7,500, an insurance company can offer their platform for $1,500 or less in administrative expenses (whether bundled or unbundled, using an independent TPA), or even "free."

How can an insurance company offer recordkeeping services for free? Well, the recordkeeping services aren't free; they're "free." The mutual funds that an insurance company offers on platform include the mutual fund (with their underlying management fee) and a wrap fee. While the local department store offers free wrapping, the insurance companies' wrap fee isn't free. The wrap fee is an additional asset based fee that a Plan sponsor rarely sees or never sees if they swear they get their administration for free. So while participants think the mutual fund on their 401(k) plan's "shelf" is the brand named mutual fund they have known to love, it's really that same mutual fund with some added fat (a wrap fee of added expenses).

There is nothing wrong with a wrap fee because an insurance company needs to make money and the fact is without this wrap fee, most small 401(k) plans would probably never be implemented because of the high administrative cost for Plans that don't use the insurance company based platforms. While there is nothing wrong with a wrap fee, the point is that Plan sponsors should understand that it does exist and that there is a cost involved with the administration of their plan. Plan sponsors need to understand that retirement plan administration is like any other business with such huge fixed costs such as computer systems, software, and staff that is so cost prohibitive than many unbundled TPAs do not handle daily valued 401(k) plans on their own. So it is impossible for any TPA to charge nothing for administration.

While 401(k) plans with little assets may be wise to stick to using an insurance company based platform, plans that have increased to a size of critical mass (anywhere from $2 million and up) should consider whether this wrap fee arrangement is still attractive or whether going with a fully unbundled TPA is less expensive. While the unbundled TPA may have a higher recordkeeping fee (the $2,500 to $7,500 fee discussed earlier), they may now be less expensive than the wrap fee since the Plan has more assets (which increase the amount of the fees generated by the asset based wrap fee). It should be noted that insurance companies that have 401(k) based platforms have numerous platforms, catering to plans of all sizes. So just having an insurance company platform for your 401(k) plan is not proof you are paying too much in fees, only a review and comparison with other providers will determine that.

Much of the myth of free 401(k) administration will be debunked when the Department of Labor 408(b)(2) fee disclosure regulations are finally implemented in 2012 (April 1, 2012 as of press time). All plan providers including insurance companies and mutual fund companies will have to disclose to plan sponsors and fiduciaries all direct and indirect compensation they receive in providing service to the plan. So if plan sponsors actually read the disclosures (as they should, to avoid increased liability), they will notice that the "free" administration that they have been receiving for the plan came at a price far greater than they ever imagined. In order to avoid having their transaction with their insurance company provider or Mutual Fund Company TPA to be considered a prohibited transaction (with financial penalties attached), plan sponsors and fiduciaries

must determine whether the fees they are paying are reasonable. The only way to do that is shop around the plan to other providers and utilizing independent retirement plan consultants and ERISA attorneys to help with a plan fee review.

There are far too many 401(k) plans that pay too much in fees because they grew in size and the plan sponsor didn't bother to check whether the wrap fees they are paying are reasonable and whether an unbundled provider would actually be less expensive. A perfect example is in 2008, I was working with a TPA in reviewing the retirement plan of a well known retailer. The Plan had $4 million in assets with a well known insurance company. Their contract with the insurer for the 401(k) plan was from 1995 and expired in 2001, which called for annual fees of more than 2.50% annually. What may have been reasonable in 1995 was obscenely expensive in 2008; they were paying more than $85,000 in fees when they could have paid a fraction of that. The retailer didn't bother to keep an eye on their fees to see if they were still reasonable in the marketplace and whether the same insurance provider had a new 401(k) platform with lower fees (they did). The retailer also didn't keep an eye on their business as they folded in 2009.

I have seen too many 401(k) plans with millions in assets that pay too much in administration fees because they are under the mistaken belief that they pay nothing for administration. While their financial advisor may have a nefarious reason as to not letting the Plan sponsor know about the high wrap fees, I have run into many 401(k) financial advisors who don't even know that a wrap fee exists. There is still too much ignorance in the 401(k) marketplace and ignorance costs money.

I would also advise plan sponsors that are about to implement a 401(k) plan with an insurance company to retain a retirement plan/ ERISA attorney to review contract terms with the provider to determine the wrap fee as well as the length of the contract and any surrender charges for early termination. This will ensure that there is no sticker shock when the fee disclosure regulations are finally implemented and to advise a Plan sponsor when changing to an unbundled TPA may make economic sense.

Again, an insurance company provided 401(k) plan may make sense when a Plan is smaller and even when a Plan is larger, depending on their program. Insurance companies offer Plans with different pricing structures, but Plan sponsors are breaching their fiduciary duty by not knowing their cost structure. There is no such thing as a free lunch or free 401(k) administration.

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