The Myth Of Free 401(k) Administration

By Ary Rosenbaum, Esq.

People believe in crazy things like conspiracy theories and urban legends. When it comes to 401(k) plans, the biggest myth out there is that some plan sponsors believe that they pay nothing for administration. Just because you don't see the fees, doesn't mean it's not there.

While fee disclosure regulations that the Department of Labor will implement in July 2011 will give Plan sponsors a dose of reality, that will still give them almost a year before they get sticker shock.

The myth of free administration tends to be a creature of insurance companies. Insurance companies 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 third party administration firms (TPAs) may have minimum annual recordkeeping fees that may be between $2,500 and $7,500, an insurance company can offer their services for $1,500 or less, 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 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.

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 annuity arrangement offered by insurance companies. 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.

While 401(k) plans with little assets may be wise to stick to this arrangement, Plans that have increased to a size of critical mass ($1 million to $2 million) should consider whether this wrap fee arrangement is still attractive or whether going with an 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). In order to properly exercise their role as plan fiduciaries and to limit their liability, Plan sponsors should annually review their administration fees including a wrap fee to determine whether the fees they pay are reasonable for the services they see.

There are far too many 401(k) plans that pay too much in fees because they grew in size and didn't bother to check whether the wrap fees are reasonable and whether an unbundled pro-

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vider 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 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) 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.

The Rosenbaum Law Firm P.C.

The Rosenbaum Law Firm P.C.
734 Franklin Avenue, Suite 302
Garden City, New York 11530
(516) 594-1557

http://www.rosenbaumlawfirm.com

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