

Vanguard's total cost of ownership approach to recordkeeping fees



Under the Employee Retirement Income Security Act of 1974 (ERISA), retirement plan fiduciaries have a duty to ensure that any fees paid from plan assets are reasonable for the services received. To assist fiduciaries in determining the reasonableness of fees, U.S. Department of Labor (DOL) regulations under Section 408(b)(2) require covered service providers, such as recordkeepers, to identify all services provided and disclose to plan fiduciaries all direct and indirect compensation received for such services. While the DOL regulations help to provide more clarity and transparency of services and fees, it's still not always clear to plan fiduciaries what the total fees generated are or will be for a given period.

This commentary will review the duties of a fiduciary with regard to plan fees and explain our total cost of ownership (TCO) approach and the impact of participant investment advice. It will also provide a case study that demonstrates the TCO approach and how it can be used to determine the reasonableness of plan fees when comparing different service providers.

Background

While innovative product and service offerings like managed accounts and other investment advice are designed to benefit participants on their road to financial success and well-being, the pricing practices that accompany these services have introduced a layer of complexity that has clouded their true cost. This is primarily because certain services only generate fees from those participants who enroll in the program. The most significant of these “participant-adopted” services is investment advice. Additionally, while fees for advice services are required to be reported on the annual fee disclosure notice to plan fiduciaries, those fees are typically expressed at a participant level, not plan level, often making it difficult for a fiduciary to determine the total fees being generated by the service.

Litigation related to plan fees has continued at a significant pace in recent years.¹ While historically much of the focus has been on investment and recordkeeping fees, as new products and services (like investment advice) are introduced, fees for advice services may be under additional scrutiny.



Unexpected expenses can expose a plan to increased litigation risk.

In evaluating fees, plan sponsors should determine whether all of the plan’s necessary and anticipated services are covered or whether additional charges will be incurred on an à la carte basis. Exclusion of services may have a substantial impact on the plan sponsor’s determination of fee reasonableness.

Moreover, failure to understand which services are excluded from a quoted fee may cause the plan to incur additional, unexpected expenses and expose the plan to increased litigation risk.

Fiduciary basics

The selection of a plan service provider and the payment of provider fees from plan assets are both fiduciary acts. ERISA requires (a) that plan fiduciaries act prudently and in the best interest of plan participants and beneficiaries, and (b) that fees for plan services be reasonable.

To demonstrate prudence, plan fiduciaries must consider all relevant information and make a reasonableness determination that is supported by that information. Whether a plan’s fees are reasonable is dependent upon all relevant facts and circumstances, including the value of the services to be obtained for those fees. Additionally, the DOL has generally required that any revenue-sharing payments be considered in assessing recordkeeping fees. It is important to note that plan fiduciaries are not required to select the provider with the lowest fees. Instead, the DOL and courts generally look for plan fiduciaries to demonstrate that they have followed a prudent process and that there is sufficient rationale to support their decisions. Thus, it is imperative that plan fiduciaries clearly document their decision-making process and not just the decision itself.

¹ “Fiduciary Fundamentals: 401(k) Plan Excessive Fee Suits – A Call to Evaluate Your Plan Governance.” Heather Heath Ryan and Elizabeth C. Smith, Robinson Bradshaw Publication. July 17, 2023.

Total cost of ownership

Historically, as plan sponsors and consultants have evaluated recordkeeper fees, they have often used a base recordkeeping fee expressed as an annual dollar amount per participant. Competition has continued to drive base recordkeeping fees downward as providers look to stay competitive and win new or retain existing business. However, while the base recordkeeping fee is easily obtainable and can seemingly make it simple to compare service providers, plan sponsors should understand that it may not provide a true apples-to-apples comparison, and it may, therefore, be more beneficial to focus on a total cost of ownership (TCO) approach. Plan sponsors have a fiduciary duty to understand all that is included in the fees being charged and whether other charges for à la carte services will be incurred at a later date.

What is TCO?

TCO is a framework that factors in not only base recordkeeping fees but other sources of revenue as well. These additional revenue sources have made it difficult to fully understand pricing. For example, some service providers have opted to leverage additional revenue sources—primarily advice services—to monetize participants and effectively subsidize recordkeeping fees in a way that can be unclear to plan fiduciaries. Per-participant fees appear more attractive because providers are able to use revenue from higher-priced advice offerings to subsidize low recordkeeping costs. And because a provider's advice offerings are typically not able to be adopted without also adopting the provider's recordkeeping services, participants who seek or need advice have but one choice—often a higher-priced offering in which enrollees are actually subsidizing the recordkeeping fees for their fellow participants or for the plan sponsor (if the sponsor is paying the base recordkeeping fee). The result is that while it may appear that a provider offers a low base recordkeeping fee, in actuality, the TCO is much higher. Plan sponsors and consultants who focus solely on a base recordkeeping fee may be overlooking costs for advice services that can significantly impact the total costs incurred by participants.

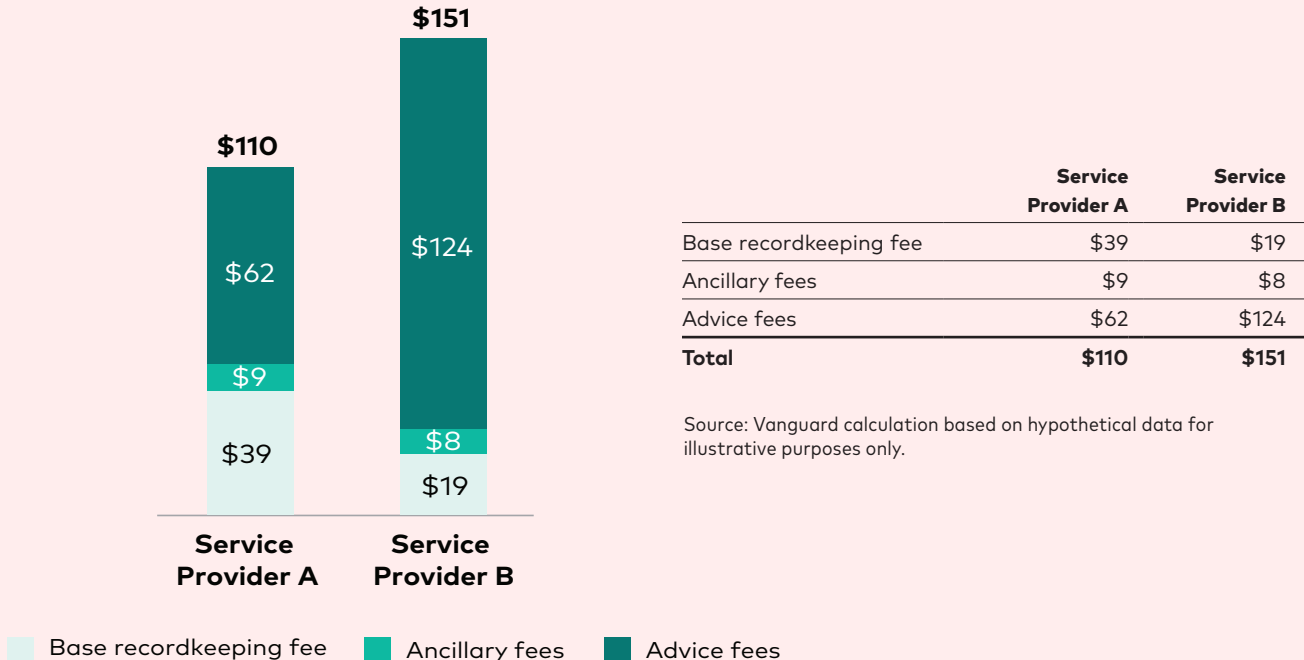
Why include advice fees?

Plan recordkeeping charges generally apply uniformly to all plan participants, which allows for apples-to-apples comparisons of total recordkeeping fees across providers. The addition of investment advice to retirement plans changes that comparison. Investment advice total fees are derived based on participant adoption. If a calculation of total investment advice fees isn't performed and included in the total fees for all plan services, a fiduciary may unknowingly select a provider with considerably higher total plan fees than other providers, even though the selected provider quoted lower per-participant base recordkeeping fees. Providers may quote a below-market recordkeeping fee while having investment advice fees that generate significantly more revenue. When the advice fees are substantially higher than the recordkeeping fees, this could result in a situation where participants who adopt advice effectively subsidize the recordkeeping fees for those who do not adopt advice. In some cases, total advice revenues may far exceed direct recordkeeping fee revenues, so it is critical that these fees are understood and properly evaluated by plan fiduciaries. *By taking a TCO approach, plan sponsors can get a more accurate picture of the total fees that will be paid by the plan and therefore be better equipped to evaluate fees between different service providers.*

Case study

To more clearly demonstrate the importance of TCO, let us consider the following hypothetical example:

This bar chart compares two fee quotes that a plan fiduciary might receive when conducting a fee benchmarking exercise to aid in the determination of fee reasonableness for their plan. The fees were initially presented as an annual per-participant base recordkeeping fee and ancillary fees (that is, fees for distributions, loans, the maintenance of self-directed brokerage accounts, etc.). Fees that were quoted by Service Provider B (shown in the stacked bar on the right of the chart) appeared to be substantially lower than those quoted by Service Provider A (that is, \$27 per participant versus \$48 per participant, respectively).



However, when advice fees are considered, the picture changes dramatically. Service Provider B's total aggregate fees translate to \$151 per participant versus \$110 per participant with Service Provider A. Thus, under the arrangement with Service Provider B, plan participants will pay more than 6.5 times the fees for advice compared with the base recordkeeping fee. This means that participants enrolled in advice may be unwittingly subsidizing the recordkeeping fees for their fellow participants. Such an arrangement could expose the plan and its fiduciaries to increased risk of litigation.

Conclusion

As litigation related to plan fees continues to trend upward, it's more important than ever for plan fiduciaries to be fully aware of total plan fees and not just focus on the difference in base recordkeeping fees across providers when making decisions. While investment advice fees will vary, the magnitude of the difference in advice fees relative to recordkeeping fees may suggest the subsidization of recordkeeping costs by the revenue generated by the higher investment advice fees. Assuming the investment advice programs and services are generally comparable among providers, it may be very difficult to defend against potential excessive fee and subsidization claims.

Plan fiduciaries should include a TCO framework when evaluating fees across providers. As advice adoption continues to increase, we believe it's important to understand the total cost of what's being paid across recordkeeping, advice, and ancillary services. By doing an apples-to-apples comparison across service providers, you will ensure fee reasonableness for both the plan sponsor and participant. Applying a TCO approach to fees offers several benefits: It increases fee transparency, reduces fiduciary risk, and documents that you have the fee information you need to make the right decisions for plan participants.

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