COVER STORY
Passing the fairness test: The case against per capita fees in defined contribution plans
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Reprinted with Permission from The SPARK Journal – Second Quarter 2016
PASSING THE FAIRNESS TEST
The case against per capita fees in defined contribution plans

Greater transparency has helped plan sponsors better determine the reasonableness of fees, but their fiduciary obligation doesn't end there. Plan sponsors are also responsible for the fair and appropriate allocation of fees paid by participants. Many in the retirement industry have argued that a flat-dollar per participant fee (per capita fee) is the fairest approach for sponsors to cover plan administrative costs. While we agree that this approach may be simple and transparent, we believe it fails the test of fairness. When all factors are considered, we believe a pro rata fee – a percentage fee based on a participant's account balance – may generally be considered fairer for participants and just as efficient.
Defining “fair”

Simply speaking, fee fairness means that everyone should pay a fair share of the fees required to maintain a plan. But like many concepts that seem simple at first glance, choosing the fairest way to assess participant fees is more involved. Achieving fee fairness depends on how a plan sponsor applies fees. One method that seems like a fair approach for all may benefit some participants more than others.

More than a quick assessment

Beyond investment-related expenses, plan sponsors typically incur fees for administrative services such as recordkeeping, accounting, legal and trustee services, customer service and participant communications. In general, plan sponsors pass along these administrative fees to participants in one of three ways: per capita, pro rata or a hybrid of the two.

- Per capita fees charge participants a fixed-dollar amount.
- Pro rata fees charge a percentage of employees’ assets.
- Hybrid fees are a newer trend that uses both per capita and pro rata components.

In the absence of ERISA provisions specifically addressing how plan expenses may be allocated among all participants and beneficiaries, the U.S. Department of Labor (DOL) leaves plan sponsors with flexibility on which approach to follow.¹ That’s why it’s so important for plan sponsors to understand the implications of the different fee structures available to them.

A quick assessment may suggest that allocating the same flat-dollar fee (per capita fee) to all participants is the fairest approach. But if plan sponsors take the analysis further, they may see very little that is fair about this approach. Once plan sponsors dig deeper, they’ll find that participant demographics play a role too critical to overlook.

Consider fairness criteria

To be fair and equitable, a fee structure must satisfy one or more fairness criteria. Two important fee fairness concepts to consider are horizontal equity and vertical equity.

Horizontal equity means that participants in a similar financial condition should pay similar amounts in fees. It is possible to define this goal across a number of categories: assets, salary, tenure, or perhaps some combination of these measures. From a plan fee perspective, using assets as the preferred option for assessing horizontal equity is simple and transparent. Under this metric, participants with similar levels of assets should pay similar amounts in fees.

Vertical equity means that participants who are better off should pay at least the same proportion of fees as those who are less well off. Plan sponsors can use asset levels as an appropriate measure for “well-off” or ability to pay. By looking across asset levels—a simple and transparent metric—it’s possible to see if wealthier participants (from a plan asset perspective) are paying at least the same proportion of fees as those with lower levels of assets.

The Social Security analogy

It can be helpful to look at how fees are treated in other settings. Social Security provides an especially strong public sector parallel to retirement plans. Both Social Security and institutional retirement plans offer services available to everyone (citizens in the case of a government public good like Social Security, and participants in the case of retirement plans). These services are available without consideration to who pays for them or who uses plan services more than others.

With Social Security, administrative fees are necessary for the system to function and pay for services, regardless of whether any particular citizen calls or visits Social Security in any given year. Currently, these administrative costs are paid by revenue collected from the pro rata payroll tax on workers’ earnings. The government could, however, pay for these services by charging a flat per capita tax on the roughly 320 million people currently alive in their database. While this type of fee levelization is transparent and simple, few would argue that it’s fair for the

¹United States Department of Labor, Employee Benefits Security Administration, Field Assistance Bulletin 2003-3
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unemployed (including children, elderly, and disabled) and low income workers to pay the same fee as those with greater ability to pay.

Compounding the issue
Yet, that is precisely what a per capita fee in a retirement plan does: those with low levels of assets pay significantly higher fee rates in their early career years than the higher accumulators. And it has more than just a short-term impact. Due to the lifetime compounding effect (the ability to generate growth by reinvesting existing earnings), the participant never makes up for those excess fees and pays the price over his or her entire career.

We believe using pro rata fees is the fairest approach. It avoids a regressive fee structure in which the proportion of fees paid by participants decline as their asset levels increase. A simple flat per capita fee may satisfy horizontal equity, but violates vertical equity because low-asset-level participants pay a much higher proportion in fees than those with a high level of assets. This makes per capita fees regressive. It may also result in the plan discriminating in favor of highly compensated or key employees by providing them with a fee advantage over other participants. Hybrid fees are less regressive than per capita fees, but also fail the fairness test.

We believe pro rata fees are the fairest approach and avoid a regressive fee structure where the financial burden is greater for those with lower asset levels.

Putting it to the test
Comparing pro rata and per capita fee structures

Evaluating participant pro rata and per capita fees with real plan data illustrates the effects of each fee structure on plan participants and makes it easier to understand what is fair. With this goal in mind, we analyzed a plan with more than $500 million in assets and over 4,700 participants. In this example, two fee structures are compared: one with a pro rata fee and the other with a per capita fee. To make the comparison easier, we express the pro rata fee (8 basis points or .08 percent) in terms of actual dollar cost and the per capita fee ($85) as a percentage cost. It’s important to note that each fee structure raises the same level of revenue to cover plan costs.

The chart below compares per capita and pro rata fees allocated to plan participants according to their ranking by assets. For example, participants in the 10th percentile rank in the lowest 10 percent of all participants according to their account balance. Conversely, participants in the 90th percentile rank in the top 10 percent of participants.

<table>
<thead>
<tr>
<th>Percentage rank</th>
<th>Average asset balance</th>
<th>Participant per capita fee = $85: Cost as a % of assets</th>
<th>Participant pro rata fee = 8 Basis points/.08% Cost in $s</th>
</tr>
</thead>
<tbody>
<tr>
<td>10th</td>
<td>$3,554</td>
<td>2.39%</td>
<td>$3</td>
</tr>
<tr>
<td>25th</td>
<td>$9,840</td>
<td>.86%</td>
<td>$8</td>
</tr>
<tr>
<td>50th</td>
<td>$31,820</td>
<td>.27%</td>
<td>$25</td>
</tr>
<tr>
<td>75th</td>
<td>$98,698</td>
<td>.09%</td>
<td>$79</td>
</tr>
<tr>
<td>90th</td>
<td>$259,551</td>
<td>.03%</td>
<td>$208</td>
</tr>
</tbody>
</table>

Source: TIAA Institute

Even these basic statistics reveal that a per capita administrative services fee would be highly regressive. They show that participants who are starting to build their retirement savings accounts are shouldering a greater proportion of the costs than those with substantially higher account balances. Simply stated, the many participants with small account balances are subsidizing those few participants with high account balances.

In both fee structures, participants with similar levels of assets pay similar amounts in fees and meet the horizontal equity measure. The pro rata fee also satisfies vertical equity—participants with larger balances pay at least the same proportion of fees as those with smaller asset balances.

By contrast, the per capita fee approach does not meet the definition of vertical equity and wealthier participants pay a much smaller proportion of fees than those with lower account balances. Note that with a pro rata fee, participants with the highest account balances pay substantially more in fees (73 times more in fact) than those with the lowest account balances.
Per capita fails the fairness test

Selecting a fair fee system requires more than a passing glance by plan sponsors; it deserves careful analysis based on participant demographics and how equitable they are for participants with varying account balances. While at first blush per capita fees may appear fair, it’s worth remembering that features such as simplicity and transparency do not make them equitable.

While no system is perfect, plan sponsors should consider how a pro rata approach can help them meet their fiduciary responsibilities by ensuring their fees are reasonable and fairly distributed among participants. Most plan sponsors understand that participant contributions and investment performance are factors that greatly impact long-term retirement outcomes for their employees. With better outcomes in mind, the fair application of fees is another critical test that plan sponsors should make every effort to pass.

For a more in-depth analysis of fee fairness, please see our paper on this topic: Assessing fee fairness: Characteristics of an effective plan fee structure.

The views expressed in this article are solely those of the authors. TIAA cannot provide legal advice. Plan fiduciaries should always consult their own counsel about these matters.

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