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Assessing Fee Fairness: Characteristics of an Effective Plan Fee Structure

Charging all participants the same dollar amount for administrative services may seem fair, but it can benefit some more than others.

Plan sponsors typically incur fees for recordkeeping, customer service, participant communications and other administrative support. Because these costs are ultimately paid by participants, plan sponsors are obligated to allocate administrative fees in a fair and appropriate manner.

The study summarized here, Assessing Fee Fairness: Characteristics of an Effective Plan Fee Structure by Benjamin Goodman and Edward Moslander of TIAA and David P. Richardson of the TIAA Institute, offers four criteria for gauging the effectiveness of fee structures and examines the extent to which two common approaches satisfy desired conditions. To read the full report, click the study link above or go to www.tiaainstitute.org > Research > Retirement Plan Design.

From one service provider to many

Retirement plan designs have transformed significantly over the past two decades. In a traditional plan design, all administrative components are bundled under a single service provider. In recent years, however, regulatory and fiduciary concerns have led many plan sponsors to spread administrative services across several providers and to adopt open architecture investment menus that may include dozens of fund managers.

While these alternative frameworks help distribute fiduciary risks, they make it harder for plan sponsors to levy fees that are reasonable and applied fairly, which can result in an allocation of costs that is neither efficient for the plan sponsor nor equitable for participants.

Characteristics of an effective fee structure

An effective fee structure needs to meet four basic conditions: adequacy, administrative ease, transparency and fairness.

Satisfying the first three conditions makes the fee structure efficient; ensuring horizontal and vertical equity makes it fair. These conditions are defined below.

- *Adequacy* – total fees collected cover the cost of features and services offered to plan participants.
- *Administrative ease* – the fee structure is not too complicated or costly for either plan sponsors or vendors.
- *Transparency* – stakeholders can readily gauge how fees are used to cover the cost of plan features and services.
- *Fairness* – all participants pay a fair share of the fees required to maintain a plan.

Within the fairness criteria, two standards must be satisfied:

- *Horizontal equity* – participants in a similar financial condition pay similar amounts in fees.
- *Vertical equity* – participants who are better off pay at least the same proportion of fees as those who are less well off.

Per capita vs. pro rata fees

In general, there are two types of plan fees: *per capita* and *pro rata*. Per capita fees are fixed dollar amounts charged to participants; pro rata fees are usually expressed as a percentage of assets. If structured properly, both types of fees can meet the efficiency criteria of adequacy, administrative ease and transparency. But only pro rata fees can satisfy the fairness criterion. In contrast, per capita fees are highly regressive, because low-asset participants pay a significantly higher proportion of fees than wealthier participants.

> Pro rata fees are the fairest approach, because they prevent a regressive fee structure in which those with the fewest assets pay the highest proportion of fees.

A real world example

Evaluating pro rata and per capita fee structures with real plan data illustrates the fairness of each approach. The chart below compares the two fee structures in a plan with more than $500 million in assets and over 4,700 participants, whose average balance is about $107,000. Plan costs are roughly $400,000. Covering these costs requires a per capita fee of at least $85 or a pro rata fee of at least 8 basis points (0.08%).

Comparing pro rata and per capita fee structures*

Percentile rank	Asset balance	Pro rata fee = 8 bps (cost in dollars)	Per capita fee = $85 (cost in basis points)
10th	$3,554	$3	239
25th	$9,840	$8	86
50th	$31,820	$25	27
75th	$98,698	$79	9
90th	$259,551	$208	3

* To facilitate comparison, pro rata fees are expressed as the actual dollar cost and per capita fees as the percentage cost. Each fee structure raises the same total revenue.

Both fee structures described above provide horizontal equity because participants with similar asset balances pay similar amounts in fees. The pro rata fee also satisfies vertical equity – because wealthier participants pay at least the same proportion of fees as those with lower asset balances. Conversely, the per capita fee does not satisfy vertical equity and is highly regressive. Participants in the 10th percentile according to asset balance pay the equivalent of a pro rata fee that is about 73 times larger than those at the 90th percentile. And the situation worsens at the end-points of the distribution, with the lowest percentile-ranked participant paying an equivalent pro rata fee *36,000 times* larger than the highest-ranked participant.

Satisfying nondiscrimination rules

While no fee structure is perfect, plan sponsors need to strive for horizontal equity, so that similar plan participants are treated equally. Likewise, they must strive for vertical equity to prevent plan participation from becoming an unfair burden on less-wealthy participants—who also tend to be younger, have shorter tenure, and earn less income. Plans that violate vertical equity may discriminate in favor of highly compensated or key employees, which can put a plan's tax-qualified status at risk.

Using the four conditions to assess the effectiveness of administrative fee structures can help plan sponsors charge fees that are reasonable and fairly distributed among all participants.

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