PENSION REVIEW COMMITTEE
RECOMMENDATION
ADOPT FEE LEVELING WITH A FLAT FEE PER PARTICIPANT
December 19, 2019

INTRODUCTION

Lancaster County has contracted with the Prudential Retirement Insurance and Annuity Company (Prudential) to provide record keeping services for the County's 401(a) Employees Retirement Plan and 457(b) Deferred Compensation Program, together referred to as the Plan for purposes of this report. Prudential's fee for these services is paid by Plan participants through revenue sharing fees, which are embedded in the expense ratios of the mutual funds offered in the Plan's investment array. The amount of revenue sharing varies from fund to fund, and according to share class. Some funds in the array generate 35 basis points (bps) of revenue sharing; while all Vanguard funds in the array pay zero revenue sharing. In fact, 39% of the assets held by Plan participants generate zero revenue sharing, and therefore contribute nothing toward the administrative costs of the Plan. Also, 14% of participants pay nothing toward the administrative expenses of the 401(a) plan; and 10% of participants pay nothing toward the administrative expenses of the 457(b) program. Consequently, the administrative costs of the Plan are not being shared fairly by all Plan participants. A more equitable approach to paying administrative costs is clearly needed.

At its September of 2018 meeting the Pension Review Committee (Committee) was presented with an alternative method for managing administrative costs known as fee leveling. At that time Prudential had offered to reduce its annual revenue requirement from 10 bps to 7.5 bps in exchange for a continuation of its Administrative Services Agreement with the County. Subsequently, the County and Prudential agreed to a two-year extension of the agreement at 7.5 bps, effective January 1, 2019. Frank Picarelli of Segal Marco Advisors advised the Committee that the reduction of Prudential's revenue requirement presented the County with an opportunity to reduce fees paid by Plan participants by moving to share classes with less revenue sharing. He also suggested the Committee should consider moving away from the traditional approach of using revenue sharing to pay administrative costs by adopting fee leveling. Under fee leveling all participants pay the same administrative fee, regardless of the expense ratios for their individual investment holdings.

The Committee followed up with several meetings to gather additional information on fee leveling and to discuss how the amount of revenue sharing paid by participants could be reduced. In June of 2019, the Committee received a presentation on fee leveling programs offered by Prudential. The Committee met in August of 2019 to consider fund share class changes to reduce the amount of excess administrative revenue. Finally, the Committee met in October of 2019 to formulate a recommendation to the County Board on fee leveling.

DISCUSSION

In addition to the Prudential contract, the County's primary expense for administering the Plan is the consulting contract with Segal Marco Advisors, which carries an annual fee of $28,500.00. Other expenses include travel costs to Prudential client conferences and membership dues in the National

Association of Government Defined Contribution Administrators (NAGDCA). These additional expenses average less than $2,000.00 annually, bringing the total to approximately $30,000.00 per year.

As of June 30, 2019, Plan assets totaled $180,782,878. With 13 bps of revenue sharing, this balance generates approximately $235,000.00 annually for administration of the Plan. Prudential's reduced revenue requirement of 7.5 bps for its record keeping agreement totals $135,000, leaving more than $100,000.00 available for County administrative purposes, which far exceeds the County's annual expenses of $30,000.00. These funds are placed in an expense account maintained by Prudential; and must be spent for the benefit of Plan participants. The balance of the expense account is projected to be approximately $149,000 as of December 31, 2019. While it is possible to return the excess to Plan participants, there is no equitable way for determining how the funds should be distributed. The better approach is to not collect the excess revenue in the first place.

The Committee was presented with two options to reduce the excess administrative revenue being collected from Plan participants. The first option involves the selection of lower-cost share classes for funds within the Plan's existing investment array. Under this approach administrative costs are still covered by revenue sharing, so inequities still exist on how administrative costs are paid. However, reducing the amount of revenue sharing fees is still beneficial to the Plan participants paying the fees. Share class changes can be implemented immediately by Prudential; and can be changed as often as necessary without creating an administrative burden on Prudential.

For these reasons the Committee decided to move ahead with a recommendation to reduce revenue sharing fees. Following the Committee meeting held in August of 2019, the Committee recommended six fund-share changes to reduce administrative revenue. The Committee's recommendation was accepted by the County Board and became effective November 20, 2019. The changes will reduce the amount of County administrative revenue collected annually from $102,000.00 to $13,000.00. This will allow the County to spend down the existing expense account balance on administration of the Plan.

The second option for reducing excess administrative revenue is fee leveling. Also referred to as fee equity, this approach does not rely on revenue sharing to pay administrative expenses. Prudential offers the following two approaches to fee leveling: (1) zero-revenue sharing; and (2) most efficient share class. Both approaches to fee leveling can be implemented through the existing investment array for the Plan.

Under the zero-revenue sharing approach, share classes are selected which pay no revenue sharing. Each participant is then charged either a flat fee or an asset-based fee to cover Plan administrative expenses. The fee appears on participant statements as a separate charge for administrative services

Prudential also offers fee leveling through the most efficient share class approach. While this approach is more complicated than the zero-revenue share approach, participants do pay slightly lower net fees. The most efficient share class approach looks for fund share classes which pay the most revenue sharing, but then returns it to the participant who initially paid it. Under this approach the average net manager fee is .2 bps lower than the existing net fee. As with the zero-revenue sharing approach, each participant is then charged a separate administrative fee which appears on their statements. Under either approach to fee leveling, the true cost of the Plan is more transparent to participants. Also, both approaches will also result in lower fees because the excess administrative revenue collected through the traditional revenue sharing approach is eliminated.

However, the most efficient share class approach is more difficult to administer. Constant monitoring is required to guarantee that the most efficient share class is being used. The revenue sharing must first be collected from participants and then returned. Also, participant statements can get very complicated under this approach to fee leveling. Given these problems, the Committee determined the most efficient share class approach is not the best fee leveling model for the Plan.

On the other hand, the zero-revenue sharing approach is easier to administer. Since revenue sharing is eliminated completely, the extra steps of collecting the revenue and returning it to participants are eliminated. Additionally, participant statements are less complicated with zero-revenue sharing. For these reasons the Committee favors the zero-revenue sharing approach.

Having determined the zero-revenue sharing approach should be used, the Committee then addressed the question of whether the administrative charge should be a flat fee, or an asset-based fee determined by the size of a participant's account. After a thorough analysis the Committee determined a flat fee should be established to pay the administrative costs of the Plan.

The Committee believes the flat fee per participant is the most equitable way to cover the administrative costs of the Plan. With a flat fee every participant supports the Plan equally. Since the flat fee will be included separately on participant statements, there is a clear distinction between investment costs and administrative costs, and therefore greater fee transparency.

In making this determination the Committee noted that a flat fee could be viewed as regressive because it would constitute a larger percentage of a small account than a large account. This concern is mitigated by the size of the actual fee. Prudential's revenue requirement of 7.5 bps generates an annual revenue requirement of approximately $135,000 (based on the June 30, 2019 Plan balance). This translates to a yearly flat fee of almost $100 for the 401(a) portion of the Plan, and $36 for participants enrolled in the 457(b) portion of the Plan. Additionally, County administrative expenses are $30,000 per year (1.7 bps), which could add another $22 for the 401(a) portion and $8.25 to the 457(b) portion. The fee is paid in quarterly installments, which reduces the impact on smaller accounts. The Committee believes the size of the flat fee will not be an unreasonable burden on participants with small accounts. Also, with a 16% combined contribution small accounts in the 401(a) plan will grow rapidly, further mitigating the disparate impact on newer participants.

There are times when a large account may generate more activity than a small account, and record keeping mistakes on large accounts may be more costly and difficult to correct. However, the day to day administrative burden of servicing a small account is basically the same as servicing a large account.

In formulating its recommendation, the Committee is mindful of the possibility of litigation based on a breach of the County's fiduciary duty to set fees which are reasonable for Plan participants. The current system of relying entirely on revenue sharing is inherently unreasonable, with some Plan participants paying nothing on administration of the Plan. While those participants will see their overall expenses increase with fee leveling, it is more important that all participants help cover the administrative costs of the Plan. Also, a system which charges an asset-based fee may have a disproportionate impact on larger accounts. For example, an account of $100,000 might generate a fee of $75 for Prudential, while an account of $1,000,000 might pay $750 for essentially the same record keeping services. The committee also noted that the clear trend in the defined contribution pension industry is toward the use of fee leveling with a flat fee per participant.

Fee leveling is a significant change, and the Committee recognizes the critical importance of participant communication and education before it is adopted. An effective communication plan should be developed and presented to participants, explaining why the change is being made and why it is best for the Plan.

Finally, the Committee discussed the need for the County Board to contact all the labor unions representing County employees prior to the implementation of fee leveling. In the case of Scottsbluff Police Officers Association, Inc., F.O.P. Lodge 38 vs. City of Scottsbluff, Nebraska, a City of the First Class, 282 Neb. 676; 805 N.W. 2d 320 (2011), the Nebraska Supreme Court determined that health insurance coverage and related benefits are mandatory subjects of bargaining under Nebraska's Industrial Relations Act. Based on advice from the County Attorney's Office, the County Board should not implement fee leveling until all unions representing County employees have either agreed to it or waived their right to negotiate on its implementation.

RECOMMENDATION

Based upon the foregoing information and analysis the Pension Review Committee hereby tenders the following recommendation:

1. The Lancaster County Board of Commissioners should adopt fee leveling with a flat fee per participant, in an amount to be determined, for both the 401(a) Lancaster County Employees Retirement Plan and the 457(b) Deferred Compensation Program, subject to approval by all labor unions representing Lancaster County employees

Respectfully submitted on behalf of the Pension Review Committee this 19th day of December, 2019.

Kerry P. Eagan
Chief Administrative Officer

F:\Admin\Private\Committees\Pension Review Committee\Reports & Recommendations\fee leveling (flat fee) Nov 2019.docx