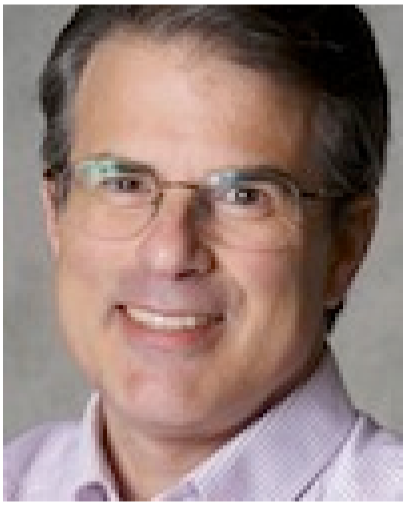
Let’s Concentrate on Recordkeeping

By Kerry Pechter *Thu, Jan 15, 2015*

What's driving the flurry of consolidation in the defined contributon plan recordkeeping industry? RIJ asks the experts: Fred Reish, Mark Fortier, Peter Littlejohn, James Holland, Jeff Feld, Tom Clark and Nevin Adams.



Two days before last Christmas, New York Life became the latest big service provider to quit the world of defined contribution recordkeeping, when it sold its 401(k) plan services business (1,400 plans, $42 billion in assets in 2013) to ManuLife’s John Hancock division for an undisclosed sum.

The pace of consolidation in the DC business, which tends to run in cycles, has accelerated lately. In April 2014, mega-bank JP Morgan decided to sell its retirement plan services business (856 plans, $171 billion in assets) to Great-West Financial. Overall, there were 13 major industry moves last year, according to Fred Barstein of NAPA.Net.

Declining profits drive some companies to sell, while a quest for scale drives others to buy. But observers cite other factors, some familiar and some new: Litigation and regulation, technology expenses, the rise of indexing and target date funds, the “commoditization” of recordkeeping and the undertow of Boomer savings from 401(k) s to IRAs.

“Recordkeeping seems to go through these waves of consolidation every 10 to 12 years,” said long-time retirement industry watcher Nevin Adams of NAPA.Net. “Each time, everybody says, ‘This is it; one more wave and we’ll be down to a handful of large, national providers.’ Then things quiet down, time passes and we repeat the process.”

The immediate impact is that a concentrated industry—a mere 20 providers administer almost 90% of America’s DC savings—is likely to get more concentrated. In the long run, some predict—and hope—that we’re headed toward a new, more transparent era of paying for plan administration directly with flat fees rather than indirectly through asset-based fees, but it’s still too early to tell.

A game of concentration

The DC recordkeeping business, like the banking, insurance and mutual fund businesses to which it is a handmaid, consists of a few superstars and thousands of role players. That was true even before the 2013-2014 round of consolidation got started.

The chart at the right (data from *PlanSponsor* magazine, June 2014) shows the top ten providers. In terms of overall assets ($1.3 trillion) and numbers of participants (16.6 million), Fidelity Investments has a commanding lead. Its pursuers included one giant rival fund complex (Vanguard), five big insurance companies, two mega-banks and a global HR consulting firm (Aon Hewitt).

Top 10 Recordkeepers	Recordkeeping assets ($billions)
Fidelity	$1,335.8
TIAA-CREF	408.5
Aon Hewitt	361.1
Vanguard	358.1
Voya (formerly ING US. Retirement)	340.0
Prudential Retirement	234.5
Great-West Financial	219.4
Wells Fargo	199.3
JP Morgan Retirement Plan Services*	171.3
Principal Financial	162.3

*Now part of Great-West Financial.
Source: *PlanSponsor* magazine, June 2014.

Even before two top-ten players merged last spring, when Great-West bought JP Morgan’s retirement plan business, this business was concentrated. Fidelity alone controlled about a third of the assets. The top 10 accounted for 68% of the assets ($5.6 trillion), 58% of the participants and virtually all of the large plans. The top 20 control over 80% of the assets, 80% of the participants and half the 740,000 plans.

If that sounds like oligopoly, it merely reflects the concentration of employment in the U.S., where Fortune 500 companies traditionally employ about half of American workers and countless mid-sized and small companies employ the rest. The smaller DC recordkeeping companies focus on those smaller companies; Paychex, the payroll administration firm, administers the most plans, with 64,000.

This small world got even smaller in 2014, which ended with Toronto-based ManuLife’s John Hancock unit buying New York Life’s recordkeeping business ($42 billion in assets, 1.03 million participants, at the end of 2013). John Hancock now has $135 billion in plan assets, 2.5 million participants and 55,000 plans (second highest in U.S.). That deal followed the JP

Morgan/Great-West deal, and two 2012 moves that saw Hartford sell to MassMutual and Aegon to fold its Diversified Retirement business into its Transamerica Retirement Solutions.

High costs and low margins drive firms out

There were micro and macro reasons behind all this activity. At the micro level, it made sense for New York Life to stop pouring money into new proprietary technology for its fussy large-plan clients, especially when it wasn’t capturing a lot of rollovers from its 401(k) plans. By reinsuring John Hancock’s in-force life insurance business, New York Life also expanded its capacity to issue more deferred income annuities, a fast-growing product niche that it dominates.

It also made sense for John Hancock to broaden its business by adding New York Life’s bundled (asset management and recordkeeping) large plans (1,600 plans averaging 640 participants and $26 million in assets per plan) to its mass of unbundled (using third-party administrators) smaller plans (55,000 plans averaging only 37 participants and $1.84 million per plan). The deal also helped broaden ManuLife’s business internationally.

But what macro trends are driving consolidation in DC administration? *RIJ* talked to a number of people in the business and got a variety of answers. The short answer was “shrinking profit margins” on the one hand and a reach for economies of scale on the other. The longer answer included a lot of specific reasons why some players are cashing in their chips while others are doubling down.

“Recordkeeping costs a lot, it’s complicated and, done properly, it’s relatively low-margin,” NAPA.Net’s Adams, a former editor of PLANSPONSOR magazine and executive at the Employee Benefit Research Institute, told *RIJ*. “Eventually it gets to a point where asset managers who were hoping for an expanded asset management opportunity aren’t getting as much of that opportunity as they thought they would and get tired of trying to keep up with the required investments in technology and people.”

A company’s ability to control the costs of recordkeeping, which means holding down the costs of technology, is apparently critical to its survival. Some companies build their own proprietary information systems, others buy systems and others outsource the heavy data lifting.

For those who build or buy, years of customization and piece-meal updates can result in an inefficient, expensive and ultimately unsustainable “Frankenstein’s monster” of a system, according to Peter Littlejohn, direct of strategic partnerships at InspiraFS, a Pittsburgh-based recordkeeper.

“Very few people make money in recordkeeping,” he said in a recent interview. “You make money on the investments. But when unit costs are going up because of customization, and regulation adds new compliance costs on the banks, and revenue from asset-based fees goes away, and you can’t control a larger percentage of the client’s wallet,” it doesn’t make much sense to stay in the business.

Revenue from asset-based fees is currently under pressure. Observers agree that new Department of Labor regulation on fee disclosure, the “excessive fee” litigation by the Schlichter law firm and others, perhaps coupled with rising competition from index funds and ETFs, has hurt margins by raising costs for some recordkeepers and making participants and plan sponsors much more conscious of fees.

“The 408(b)(2) plan disclosure regulation and the 404a-5 participant disclosure regulation were costly for recordkeepers—particularly initially, but also on an ongoing basis,” said Fred Reish, the well-known ERISA attorney at Drinker, Biddle & Reath. “In addition, 408(b)(2) regulation heightened awareness of recordkeeping fees and the revenue sharing they received and, as a result, probably negatively impacted their ability to price plans.

“Also, the DOL regulatory agenda includes the possibility of a ‘guide’ for 408(b)(2) disclosure, which would be expensive. Another example is the anticipated proposed regulation on projecting retirement income on participant statements. While that would likely be very helpful to the 401(k) industry, it will be expensive for the recordkeepers.”

NAPA Net’s Defined Contribution Industry Consolidation Report (Deals in 2014)

Provider	Action	Successor
New York Life Recordkeeping	Sold	John Hancock Retirement (ManuLife)
Newport Group	Sold	Verisight and Stone Point
Financial Telesis	Sold	LPL
Great-West/ Putnam/JP Morgan	Rebranded	Empower Retirement
City National	Sold	OneAmerica
Frank Russell	Sold	LSE
Cetera	Sold	RCAP
JP Morgan Recordkeeping	Sold	Great-West
Putnam Recordkeeping	Merged	Great-West
Nuveen	Sold	TIAA-CREF
Daily Access	Sold	Verisight and Stone Point
Munder	Sold	Victory
CPI	Rebranded	CUNA Mutual
Ridgeworth	Sold	Lightyear & Management

Source: NAPA Net, November 2014. Used by permission.

James Holland, an independent fiduciary at MillenniuM Investment and Retirement Advisors in Charlotte, NC, thinks that fee disclosure requirements are having a gradual but persistent effect in driving down fees.

“The disclosure document traditionally provided minimal information, so nobody read them,” he told *RIJ*. “But now, you can see on the statement that you paid $2,000 in fees last year. So, after maybe the eighth time you’ve seen it, you mention to your colleague Jane that you paid $2,000 and she says, I only paid $200. Everyone was expecting an earthquake from fee disclosure, but I see the industry building toward a Malcolm Gladwell-type ‘tipping point.’”

Holland believes that the business model that involves covering the cost of administration by charging high asset-based fees on the investments is doomed. If so, firms that relied on it will leave the recordkeeping business. “Revenue-sharing is about to become a thing of the past, so some are shedding the administrative parts of their business to focus on other areas where they can make more money,” he said

Small company owners, whose core business is plan design and administration, like rural folk who see the summer crowd come and go, say they are accustomed to turnover among big companies who enter the recordkeeping business as a path to large asset pools without considering the risks or the complexities. Since these same big companies often underprice them to capture plan administration business, the small company owners aren’t very surprised when the venture fails.

“Insurance companies and brokerages tend to go in and out of the business over the years,” said Lawrence Starr, president of Qualified Plan Consultants Inc. in West Springfield, Mass. “When they *aren’t* in it, they think it’s an easy business and see all those dollars that they can capture. When they *are* in the business, somebody in the actuarial department figures out that their internal return on investment is not high enough and decides the company would be more profitable if it invested that money in, say, Greek reinsurance. So they get out.

“Five or ten years later, somebody in the company says, ‘Why aren’t we in that business? We ought to be; look how much money we can make.’ By that time, everyone previously involved in that business is gone, along with all the institutional memory as to why they got out in the first place. So, they decide to get back in somehow. And the cycle starts all over again. When two companies at different points in the above cycle get together… Whoosh! You get consolidation. I’ve watched this cycle now for over 30 years. It is as predictable as the sun rising in the morning.”

“Every insurance company has said, ‘There’s gold in them thar hills—let’s throw up a tent and bring in a lot of money,’” said Jeff Feld, a CPA and principal at Alliance Pension Consultants in Chicago. “The approaches they all took were different. Some retrofitted their annuity or life insurance people and tried to adapt them to retirement plans. Making money was easy because there was so much fat in the system. But, as in any maturing space, people eventually start to scrutinize the costs. The inability to make easy money is driving out those with less than ideal models and sending business to those with more ideal models.”

“Fee disclosure was the straw on the camel’s back, as it removed the ability to bundle services,” said Mark Fortier, who has held senior retirement plan positions at AllianceBerstein and State Street Global Advisors. “But on the service side of the 401(k) business, the [consolidation] trend had been ongoing for decades. Thin margins and the need for ongoing and large investment in technology and people has been the long-term driver.”

“Asset retention has been the elusive ‘Holy Grail’ for years as well, since it can turn thin to negative margins into positive. Another factor is risk. Insurers in particular have liked the service business because it is lower risk and requires less capital than, say, the variable annuity business. However, class action lawsuits that sweep in service providers remind them that it is not riskless.”

The elephant-in-the-room might simply be the fact that assets are steadily leaving the 401(k) system and going into retail IRAs, noted Littlejohn. That hurts recordkeepers that don’t have a strong rollover business; and if they don’t have one, they have little reason to build one. “When there’s outflow, you lose both the recordkeeping fee and the asset management fee. If your unit costs were too high on the institutional side, it’s not going to be any cheaper on the retail side,” he told *RIJ*.

Distributors may also be driving consolidation in recordkeeping. In a recent blogpost, NAPA.Net’s Fred Barstein divided the retirement plan providers into direct-sold firms (Vanguard and Fidelity) and advisor-sold firms, and said that as advisors are reducing the number of plans they do business with to “five or six” from “20 or more,” and that those five or six need expertise in serving plans of all sizes.

“The question now is whether the consolidation heats up,” he wrote. “Will those without a secure seat at the advisor sold DC table (defined by the ability to serve multiple markets and plan types) seek to acquire smaller fish?”

“The 401(k) industry is a maturing industry. It’s not uncommon for maturing industries to consolidate and to compete on price,” said Reish. “With the increased competition on price—as well as the ongoing focus that the Department of Labor and court cases have placed on costs—it’s not surprising that the smaller, more marginal recordkeepers are having difficulty competing—particularly when you consider the need for ongoing capital investment to keep up with other providers.”

Who will remain?

So who will stay in the recordkeeping business? According to Littlejohn, we can assume that the leading target date fund companies will stay in the recordkeeping business, because the certification of TDFs as qualified default investment alternatives in DC plans ensured that they will always earn asset-based fees in their plan administration business. A list of the top TDF providers, from a 2014 Morningstar report, overlaps quite a bit with the top DC recordkeeper list. (Voya was ranked twelfth and Great-West fourteenth on the Morningstar list.)

Ten largest DC recordkeepers (By assets, 2013)	**Ten largest TDF providers** (By assets, 2013)
Fidelity	Fidelity
TIAA-CREF	Vanguard
Aon Hewitt	T. Rowe Price
Vanguard	Principal
Voya*	JP Morgan
Prudential	American Funds
Great-West**	TIAA-CREF
Wells Fargo	Wells Fargo
JP Morgan RPS	John Hancock
Principal	American Century
*12th largest target date fund provider. **14th largest target date fund provider. Sources: Morningstar, *PlanSponsor* magazine, 2014.	

Vanguard and Fidelity, which market themselves directly to plan sponsors rather than through advisors or brokers, have, in addition to economies of scale and strong TDF offerings, strong IRA platforms for capturing rollovers. Vanguard has the added advantage of being the low-cost indexing leader at a time when low-costs and indexing are in ever-increasing demand.

Other firms, for one reason or another, dominate specific niches. Aon Hewitt, as a benefits consultant, and Xerox HR Services, a unit of the technology firm, serve the same large firms with the core businesses and their recordkeeping business. Each has an average of over 10,000 participants in their plans. TIAA-CREF has a secure niche in the educational market (part of the non-profit 403(b) plan market). Among the insurance carriers, OneAmerica (through its Paychex unit), Voya, Principal, John Hancock, Nationwide and MassMutual have tens of thousands of small and mid-sized plans.

In the long run, those with the greatest scale will endure, said Larry Kiefer of DST Systems, the IT firm. "I think size will matter in the end," he said. ERISA attorney Tom Clark, who thinks the fee litigation has had a big impact on recordkeeping firms, agrees. "Those who invested in technology to get economies of scale and efficiencies will win," he told *RIJ*. "Those who used revenue sharing to prop up their primary business and even secondary businesses will not win."

"Consolidation will continue," said Littlejohn. "Recordkeepers without fund families will also go out." Reish said, "I suspect that the largest providers will be the consolidators and the smallest, most entrepreneurial recordkeepers will do relatively well. But that leaves the recordkeepers that are in middle in terms of size. They may be the most exposed and, therefore, the most likely to decide to sell.”