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Exit Signs

What advisers should do during a wave of recordkeeping consolidation

Judy Ward – 08/26/2008

The top four recordkeeping providers have about 51% of the defined contribution plan market share, says Charlie Nelson, President of Great-West Retirement Services. However, more than 50 providers have at least 50,000 participants. "We have a highly fragmented defined contribution market," he comments.

Fragmented markets often consolidate, and the recordkeeping business is seeing a new wave of acquisitions. In May, ING Group announced its plan to buy CitiStreet LLC from Citigroup, Inc., and State Street Corp. It joins a number of recent notable deals to purchase defined contribution recordkeeping operations, including: Great-West Life & Annuity Insurance Co.'s acquisition from Franklin Templeton Investments; Prudential Retirement's deal with Union Bank of California, N.A.; and Hartford Financial Services Group Inc.'s late 2007 acquisitions of Sun Life Retirement Services Inc.'s 401(k) business, as well as the defined contribution recordkeeping alliance business of Atlanta-based Princeton Retirement Group.

What's New Now

The recordkeeping consolidation trend has been going on for awhile, driven by factors such as the high investment required and the frequently low profit margins, but its intensity has picked up lately. Sales jumped from eight in 2006 to 15 in 2007, according to research by Sterling Resources Inc. For 2008, CEO Peter Demmer says, "I would be amazed if we have fewer transactions than last year." He anticipates as many as 20 deals—the biggest number since Sterling started tracking these acquisitions in 1996.
What is different now? A bear market slashes near-term profitability while intense scrutiny of 401(k) fees seems likely to lead to lower fees in the longer term.

Among recordkeepers, the market's value drives an average of 70% of total revenue, Demmer says. These providers' fees can come from three main sources, he says: investment management, revenue-sharing, and wrap fees. "All three move in exact tandem to the market's value," he adds. During the last big bear market, average profit margins came in at only 2% in 2001 and 1% in 2002, Sterling found. In 2002, more than 60% of providers had negative margins. With the ensuing bull market, margins jumped to 15% in 2005 and 17% in 2006.

Then came the start of another volatile period in 2007—and, by now, recordkeepers know what that means. "We are looking at some preliminary [margin] forecasts for 2008 that are going to be pretty ugly," Demmer says.

For long-term players, market volatility should not be a factor, says Marty Swanson, Chief Marketing Officer of The Hartford's Retirement Plans Group. "However, so much of this is asset-based, and the revenues and earnings are driven off of it," he says. "It may cause people to review their business and make a decision."

The market slump comes as fees already have fallen in recent years, amid intense competition. "The price per dollar of assets has been going down steadily, so, in effect, the industry today is nowhere near as well prepared for a sharp correction as it was in 2001 and 2002," Demmer says.

Moreover, potentially big fee-disclosure changes by Congress seem destined to pressure fees further downward. Some recordkeepers probably think that Congress' scrutiny "cannot have an impact other than a future reduction in fees," Demmer says. **"With fee disclosure increasing, that is going to be another reason why recordkeepers consolidate," agrees adviser David Boucher, Vice President of Retirement Services at Longfellow Benefits in Boston. Given that a large number of providers are at break-even or less already, Nelson says, "People are not going to go on, on an unprofitable basis, for the long term."**

So, recordkeeping has tough realities, especially these days. "It is survival of the fittest," says Tom Muldoon, a Rockville, Maryland-based investment analyst at adviser Independent Benefit Services. "If they can make it work, they are an acquirer. If not, they look to be acquired."

One word comes up frequently when talking about what recordkeepers need to make it work: scale. "More and more, the retirement services industry is becoming a game of scale," says Rick Mason, President of the Retirement Services Market Segment at ING US Wealth Management. Scale allows a recordkeeper to spread fixed costs among as many participants as possible. Scale also helps in developing new services, such as participant education or adviser tools, that attract and retain clients, he says.

Swanson points to three current motivations for The Hartford to acquire other recordkeepers. It might look to increase its scale in an existing line of business, which it did when it bought Sun Life's defined contribution recordkeeping business and got more scale in the small-plan market. It might seek new capabilities, such as in its purchase of Powell, Ohio-based TopNoggin, a defined benefit administrator and consultant with strong proprietary technology. Or it may want to expand into new markets, which it can do with its purchase of Princeton Retirement Group and its private-label recordkeeping business.

Meanwhile, many small and mid-size players are asking themselves questions, Swanson says: Is this a core business for us? Is this something we are in for the long term? "If they say 'Yes,' I think they are also going to say, 'We need to get bigger, quicker.' A lot of people are at that decision point, and it is going to drive consolidation." If the answer is no? Adviser Bill Heestand, President of Portland, Oregon-based The Heestand Co., a member firm of National Retirement Partners, says, "A number of players have grown to a scale where it is time to cash in and focus on their core business—or just plain cash in."

Three Options

Advisers regularly hear speculation in the industry that certain recordkeepers may get acquired, Muldoon says, but the companies involved try to keep it quiet. So, pinning down whether the rumors have any truth proves difficult, he says.

Those advisers with clients whose recordkeeper announces its acquisition have three basic choices on how to react as they see how the deal unfolds.

Complete a new RFP. First, they can encourage the client to do another RFP (request for proposal) process. "From our perspective, any time a recordkeeper is acquired, that causes a fiduciary decision at the plan sponsor level, because that is not a vendor that he has selected," Muldoon says. "The process by which [the sponsor] selected the incumbent has to be redone, whether he did it a year ago or 10 years ago. Otherwise [sponsors] are saying, 'This is prudent,' but did not go through the selection process."

Boucher also advises clients to go through an RFP process, and he knows that they can face a push from the acquirer to do nothing. "There is pressure put on a plan sponsor to 'repaper': You keep everything the

same, and just the name of the entity behind the scenes changes," he says. "[Plan sponsors] are under pressure to do it quickly, and a lot of sponsors just say, 'OK, where do I sign?'"

Benchmark the plan informally. Second, knowing how much time and effort a full-out RFP process requires for employers, some advisers favor taking a more informal look at the marketplace. "If you are the sponsor, nobody asked your permission to move you," Heestand says. "It is prudent to hedge your bets and know what the alternatives are."

When he does that review, Heestand first helps clients understand their plan's current cost structure. Employers frequently have trouble pulling out all that information from complex documents that may spread fee disclosure over dozens of pages. "You have 80 pages of documents that say, 'This is what we charge for trust services' on page six, and 'This is what we charge for custody' on page 18, then refer to appendix B for other fees, etc. It is confusing, and plan sponsors want to know how to make sense of it," he says. Advisers can spare sponsors some of the hassle by going through the documents to uncover details on costs.

With that step done, Heestand uses the NRP database of recordkeeper and mutual fund fees, as well as spreadsheets custom-built for that project, to compare those costs with the fees of other recordkeepers, including the acquirer. "Once we figure out what the account is paying and what the acquirer is proposing to charge, it is pretty easy to get competitive quotes for the plan," he says.

Wait and see. Third, in some cases advisers recommend taking a wait-and-see attitude, until the acquisition's implications become clear. An acquisition does not automatically mean huge disruption to the work with recordkeepers for sponsors or advisers. "We work with so many different vendors—more than 60 of them—that even when one group acquires another, there is a pretty good chance that we work with that new recordkeeper," says adviser Phyllis Klein, Director of Professional Services at Raleigh, North Carolina-based CAPTRUST Financial Advisors. Some advisers do not work with that many recordkeepers, but a deal's announcement could lead them to expand their select recordkeeper group.

Most sponsors decide to go with the new setup unless there have been issues with their recordkeeping service, Klein says. "If there have been no problems up to that point, they generally are not going out to look right away," she adds. "If it occurs, it is usually a little further out: It may be 12 to 18 months, as they see changes occur in the service model."

How advisers and sponsors should react when a recordkeeping deal is announced depends on what the buyer plans to do with the business acquired, says John Leeson, Atlanta-based Managing Director at Investment Research & Advisory Group, Inc. "If it will be run as a stand-alone organization and remain on the same platform and so forth, then we would not be as skeptical," he says. "If there is going to be a conversion onto the new parent company's platform, we will probably recommend that the plan sponsor go out and take a look at the marketplace, because the sponsor is going to have to go through a conversion anyway."

Five Questions To Ask

As they evaluate which route works best with a sponsor when a new recordkeeper takes over, advisers can answer these questions to help make a decision:

What impact will platform changes have? Both sponsors and participants will feel some effects during any transition. Blackout periods during a transition generally last two to four weeks, Muldoon finds. As an adviser, he helps smooth the process by having weekly calls with the new vendor throughout the transition period, from the time a deal is announced until the blackout period ends. In those calls, he finds out what specific things the new

recordkeeper wants a sponsor to do that week, such as make a plan design decision or sign documents. Then, he relays that information to the sponsor. “Our job is to keep the two parties on track,” he says.

The bigger issue is how much lasting impact sponsors and participants feel once the conversion happens, as they deal with the new platform. “Moving from one recordkeeping system to another is always a challenge,” Nelson says. **The plan sponsor Web site typically changes, so that alters the way a sponsor interfaces with the recordkeeper, Boucher says, and the participant Web site may be more or less robust with the new provider. Advisers can make the transition much smoother by training employers to adapt as well as participants.**

Are the sponsor and participants likely to get different service? “The hardest aspect to quantify—and the most important aspect, in terms of client satisfaction—is the service model,” Muldoon says. He gleans some of those details from vendor-benchmarking data on fees and services provided to his company as a paid subscriber of 401(k) Producer Services. Advisers recommend looking into service issues such as: What employee education does the new recordkeeper offer? How will participant statements change? What are its call center’s hours for participants, and will the voice response system differ? Will the adviser and sponsor have a single point of contact at the recordkeeper? Is that contact local? “We often like to find an organization that has a local representative,” Muldoon says. “That representative can see the client face-to-face and work on any issues, but there are some clients that do not really need that.”

Will a plan see any investment changes? Find out whether the new recordkeeper requires use of any proprietary funds, Klein recommends, and if any of a plan’s existing investments will be unavailable on a new platform. “I would not find it unusual to see the options narrow,” she says. Advisers want open architecture, she says, and the trend is definitely in that direction. “That being said, we have found in practice that platforms that claim open architecture may have limited access to either funds or share classes often tied directly to the size of the plan,” she adds. “The definition of ‘open architecture’ varies from provider to provider.”

Investment modifications do not happen immediately after an acquisition is announced, because a new recordkeeper generally runs the old platform for some time. “It may be at the time of migration to the new platform that they write letters to plans that have something unusual,” Heestand says, referring to an asset category that is not widely available. “Possibly the new vendor will say, ‘We are not handling those assets,’ or, ‘We are going to charge extra for that asset.’”

Will fees get altered? Prices generally do not shift right away, so advisers need to keep an eye on this issue for awhile after an acquisition’s announcement. “A provider would have to have a lot of guts to go in immediately and raise the fees,” Leeson says. “Usually there is time to let the dust settle.” Boucher agrees: “[The static pricing] is not a good thing, because every year assets increase, and the price should [theoretically] go down. What happens often is that they lock in the prices for two or three years.”

With his clients, Leeson has not seen fee increases after an acquisition, “however, one of the issues that can arise is that recordkeepers have differing profitability formulas,” he explains. “If an acquiring recordkeeper has a higher profitability threshold than the recordkeeper it is acquiring, some of the acquired plans may not be as attractive. Because of this, fund offerings—certain share classes—could be more restrictive or plan services could change. Custom communication pieces, employee meetings, quarterly plan reviews, etcetera, could be cut back.”

How committed to recordkeeping is the acquirer? A recordkeeper relatively inexperienced in the business may make a hasty retreat once its many challenges hit home. However, after all this time, some might argue, those buying other recordkeepers seem unlikely to have only a casual commitment to the business. “Certainly, acquiring

other recordkeepers is an indication of a company's commitment to the recordkeeping business," Nelson responds. "There are other indications of commitment as well, such as: Does the recordkeeper have a viable long-term plan? What has the company done in the past 10 to 15 years? Has it capitalized on the acquisitions it has made—is it stronger and more efficient?" To those who think the recordkeeping business is nearly down to its survivors, he responds, "We believe there is still more consolidation to come in the years ahead."

For that matter, Leeson says, the current consolidation wave reminds advisers that it behooves them to get informed about as many recordkeepers as possible. After all, they could be tomorrow's partners in serving clients. "It should reiterate to advisers that they have to go beyond their one or two or three favorite providers, and learn as much as they can about the entire provider field," he says. "You never know what is going to happen."

How Advisers Can Help: Sponsor Training

Recordkeeper changes add stress to sponsors' already-hectic jobs, says adviser David Boucher of Longfellow Benefits. "Right now, HR departments are running lean," he says. "They build up efficiency working with a provider. It takes time to get retrained and get up to speed and figure out the shortcuts, and that all adds to the stress level of the plan sponsor. Down the road, the new system may work even better than the old system, but sponsors initially will run into frustration [after a deal is completed]."
When the platform changes, as it often does in the wake of an acquisition, Boucher says advisers can help by proactively scheduling employer training on the new technology. "We run training right off the bat, before an integration occurs," he says. "Being able to train them out of the gate is the best way to do this. Because we work with 19 providers, we already know the shortcuts."

The initial training often happens in two meetings that last an hour to 90 minutes each. Those sessions look at both the more immediate, basic issues such as how to upload participant data, as well as more detail-oriented questions such as the new recordkeeper's process when participants request loans. Sponsors want to know things like how to adapt the recordkeeper's spreadsheets to their needs, Boucher says, or find out the quickest way to process participant changes of address.

Sponsor training needs to be ongoing for a full year, Boucher says, as annual issues such as Form 5500 or discrimination testing emerge. For instance, he says, "In December, we will send out an e-mail saying, 'Nondiscrimination testing is coming up, and we are running seminars for all our Fidelity clients. Do you want to join us?'" Most of these types of sessions happen via Webinars lasting no more than 90 minutes.

How Advisers Can Help: Employee Education

Although a new recordkeeper does not affect participants as much as sponsors, it makes some employees uneasy about the implications for them. Advisers can play a key role in preventing that.
As soon as a deal is announced, adviser John Leeson and his colleagues at Investment Research & Advisory Group, Inc., talk to sponsors and find out if they want to stay with the new recordkeeper or take a look at the market. "If they decide that they are staying with it, we start crafting a participant communications campaign," he says. "The more stress you can take out of the situation, the better."

Take the lead on scheduling education and communications, advisers recommend, and do not wait for a potential flood of questions from anxious participants. "It requires some proactivity on the part of the adviser," says adviser Bill Heestand of The Heestand Co. "We would hold meetings, just as if we had done a complete due diligence and decided to move."

Participants want to know if they need to take some kind of action. They also wonder about questions including: Are the investment options changing? What will happen to my loan? Am I going to be in a blackout and not have

access to my money for some time? Will I still deal with the same adviser? What hours will the phone center be available? They need answers that explain to the participants—in participant-friendly language—what will happen and why, and how it will affect them, if at all, Leeson says.

Investment Research & Advisory Group typically crafts a letter from a company's senior management, explaining what is happening. "In addition, we put together a question-and-answer piece: We come up with eight to 10 questions that participants may have with regard to the transaction, and we put together answers in layman's terms," he says. "It tends to take all the anxiety out of the situation." Should any anxiety remain, Leeson and his colleagues also list their company's contact information for those with more questions.

*Illustration by Gérard DuBois