

# THE FUTURE OF THE RECORDKEEPING INDUSTRY


## WHITE PAPER

Arnerich Massena, Inc.

September 2015

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In 2014, thirteen merger/acquisition deals were made among retirement plan recordkeepers, a record number of consolidations and ownership changes. Looking ahead, we predict continuing changes in the recordkeeping industry as it evolves. How can plan sponsors plan and prepare for these industry shifts, safeguarding the services that are important to their plans? In this paper, we examine the future of the recordkeeping industry and how plan sponsors can use that knowledge to be prepared.



## TABLE OF CONTENTS

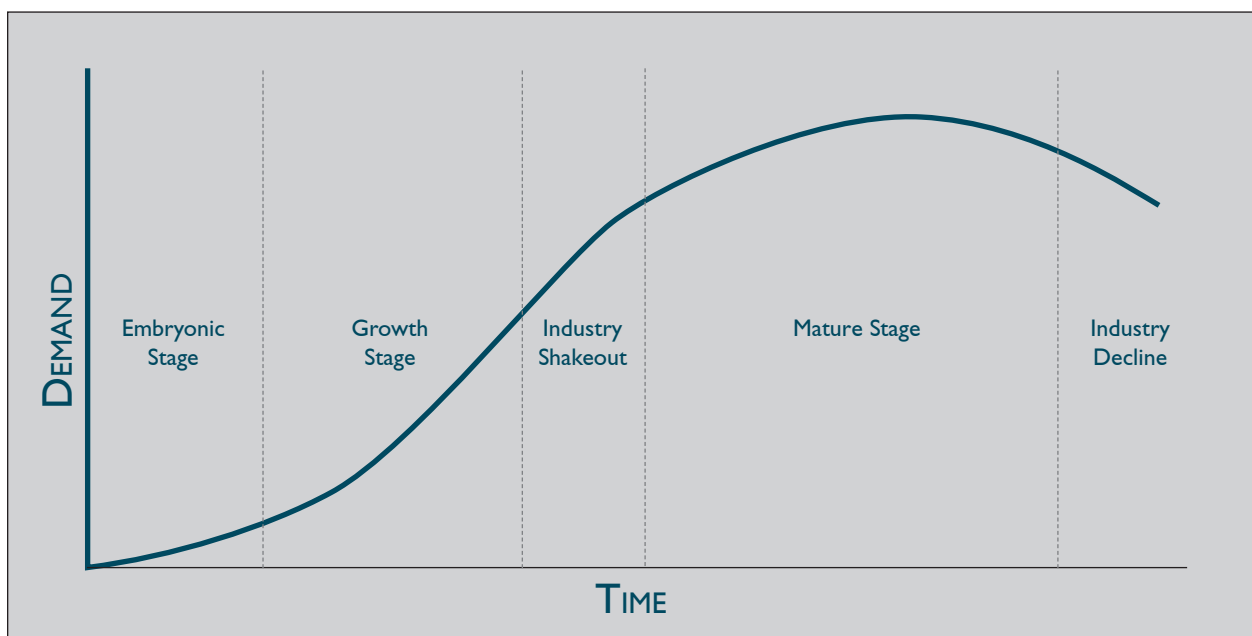
Consolidation of the recordkeeping industry . . . . .	page 2
The nature of the recordkeeping business . . . . .	page 3
How will recordkeeping changes affect plan sponsors? . . . . .	page 4
How can plan sponsors plan for the future of the recordkeeping industry . . . . .	page 5
Conclusion . . . . .	page 6
Endnotes . . . . .	page 8

## THE FUTURE OF THE RECORDKEEPING INDUSTRY

It's 1920-something, and the nascent automobile industry is just about to bust out of its seams. Everyone wants an automobile, and entrepreneurs are jumping on the bandwagon to start manufacturing them. Hundreds of automobile manufacturers launched into the industry, aiming to capture some of that massive demand. But by the end of the 20s, only three companies — GM, Chrysler, and Ford — dominated the industry. There's a natural evolution in the lifecycle of an industry. As you can see in Figure 1, the initial growth stage is followed by an "industry shakeout" that culminates in the mature stage of the industry. The auto industry's shakeout period happened in the 1920s, when the necessity for economies of scale resulted in a consolidation in the industry to those companies with the greatest efficiency. This cycle is common, particularly in industries with high fixed costs such as auto manufacturing...and defined contribution plan recordkeeping.

Recordkeeping services have evolved based on industry needs, technology, and regulations, and the industry is continuing its evolutionary arc into new territory. In this position paper, we'll examine how recordkeeping is experiencing its industry shakeout and what the implications are for plan sponsors, who will experience the real-world impacts of these shifts. We'll discuss how sponsors can work with their advisors to plan ahead for changes that may affect how they manage their plans and how they select and work with their recordkeeping partners. Better understanding the recordkeeping industry landscape can help you find the right leverage to negotiate the services and prices that will best fit your plan.

FIGURE 1: STAGES IN THE INDUSTRY LIFE CYCLE



## CONSOLIDATION OF THE RECORDKEEPING INDUSTRY

It seems that new announcements of M&A activity among retirement plan service providers are popping up constantly. In fact, 13 deals were made in 2014, an increase from the six mergers in 2013. (Barstein, 2015) There are 42 national DC recordkeepers (according to NAPA's National 401(k) Record Keepers list), but more than 90 percent of all DC assets are held by just the top 21 recordkeepers (in 2014). You may have seen J.P. Morgan's recordkeeping business acquired by Empower, or Citistreet becoming ING becoming Voya Financial, or Hartford Financial becoming MassMutual. This is the industry shakeout.

**“THE** consensus among DC industry consultants, executives and experts is that record keeper consolidation will continue. Driven by rising technology costs, lower fees and increased intellectual capital needed to remain competitive, the prognosis is for fewer providers.”

~ Barstein, 2014

A few decades ago, defined contribution plans were just appearing on the map. While they had been around for a while, they were usually ancillary to pension or other defined benefit plans. But in the 1980s and 1990s, employers began to switch from defined benefit to defined contribution, a sea change that swept the country and changed the face of retirement. Suddenly, defined contribution plans became a core part of employers' retirement benefits. This change required a different and growing set of services from recordkeepers — everything from statements to participant education. Defined contribution recordkeepers sprung up like flowers after a spring rain to meet the growing demand. This was the growth stage.

The growth stage is characterized by massive competition pushing prices down as the variety of providers fight to capture market share. We've seen exactly that happen over the last two decades, with recordkeepers becoming more and more competitive. The list of available services has expanded while prices have been driven down.

So why is the industry consolidating now? What tipped it over into the shakeout stage and what does that mean? Let's take a look back at the auto industry. With a large number of auto manufacturers, the price of a car was pushed down. In order to continue to turn a profit, the manufacturers had to either become very efficient or provide a value that justified a higher price.

The same thing is happening in recordkeeping. Competitive pricing began to force providers to become more efficient or exit the market, resulting in industry consolidation. Those providers that have economies of scale have an advantage, as they are able to stay competitive with pricing while still maintaining a margin. It's not just competitive pricing that is squeezing providers either; they are also faced with growing regulatory requirements and increasing technology costs to provide data security and cutting edge services. Hence, the larger providers with economies of scale and efficient platforms are able to offer services more cost effectively, while smaller providers are having to adjust their service models or tighten their margins, sometimes to the point of exiting the market altogether.

**“HIGH PROFILE** acquisitions and mergers among record keepers will continue as the firms cope with pressure for lower fees and more services in a low-margin business.”

~ Steyer, 2014

## THE FUTURE OF THE RECORDKEEPING INDUSTRY

Industry consolidation is a healthy step on the way to the mature stage of the industry. But it will result in changes that affect plan sponsors. One of the most profound effects is pricing. Plan sponsors are likely to see prices for recordkeeping services begin to rise. The so-called “race for the bottom” is over, and without an oversupply of providers, pricing can normalize, becoming a product of the services provided rather than a product of competitive bidding. Sponsors may find that simply going out to RFP is no longer a guarantee of a price reduction, and that their recordkeeping costs are tied more closely to the services they desire.

The other major impact will be on the services recordkeepers provide and how those services are delivered. Offerings from recordkeepers have expanded enormously since the days when recordkeeping simply meant sending out a periodic statement with a balance to participants. Now, it involves loan administration, daily valuations, instant online access, participant education, summary reports, and fee disclosures. As with the auto manufacturers, recordkeepers are faced with two choices: become more efficient or provide a greater value to justify a higher price. Sponsors will likely see providers moving in both of those directions, which makes the process of selecting and working with the right recordkeeper more crucial and complex than ever.

“PRICE pressure is on 401(k) recordkeepers as a result of commoditized services, the government’s focus on fees, and a slowdown in turnover among plan sponsors. With margins already thin, consolidation is inevitable”

~ Barstein, 2015

### THE NATURE OF THE RECORDKEEPING BUSINESS

Recordkeeping is a high-transaction, low-margin business, where the costs to keep up technologically, combined with tight competition, mean that recordkeeping services frequently earn very little margin. For some providers, recordkeeping may even serve as a “loss leader,” where it is a source of cost rather than profit for the organization, but provides horizontal value by drawing in other business. In other words, recordkeeping services may be subsidized by the organization’s other functions, being valuable insofar as it provides a service that clients expect or desire.

Due to the low-margin nature of recordkeeping, providers have leveraged several options for maintaining a viable business model. Some large recordkeepers bundle services, so that the actual recordkeeping is a small portion of the overall services provided. In this model, recordkeeping is integrated with investment management revenue, with most of the earnings coming from proprietary investment management fees in bundled packages. Other recordkeepers may not bundle investment products, but will arrange incentives to utilize their other services, such as managed accounts or brokerage windows.

Service providers may also use recordkeeping services as a doorway to access potential clients. As a service provider, they are well poised to capture IRA rollovers or other monies from participants. The more access they have to market to participants, the less they may charge for the recordkeeping services themselves. Opportunities to court ancillary business through a recordkeeping relationship is a significant value. If that opportunity is not available, the cost for recordkeeping services may be higher.

There are still a few providers who solely provide recordkeeping services as their core offering, with a straight fee-for-service structure. Because these mostly smaller shops can't compete on cost, they have to focus more on providing a niche value proposition. For example, think of Tesla Motors, which offers a unique product customers don't mind paying a higher price for. Because recordkeeping does have tight margins, however, this type of business model seems likely to become rarer, a victim of the industry shakeout.

“Reasons [for recordkeeper consolidation] include the pressure to reduce fees, the cost of improving record-keeping technology and the skill in deriving sufficient income from selling other products and services to participants.”

~ Steyer, 2014

### HOW WILL RECORDKEEPING CHANGES AFFECT PLAN SPONSORS?

What specifically can employers expect over the next few years as the recordkeeper industry shifts? We spoke with several recordkeeping partners to learn more about what they see as the future of their industry and how those changes will affect plan sponsors.

One of the most significant changes is the consolidation itself. Plan sponsors may experience unexpected changes of recordkeepers as mergers and acquisitions happen.

As the industry matures and prices evolve over time, companies tend to gain pricing power as industry competition recedes. Whereas in the past, recordkeepers may have been compensated in other ways for providing services at little to no profit, that is likely to shift as fees become more transparent and differentiated. Pricing will adjust over time to more accurately reflect the cost of providing services, including a reasonable margin. However, at the same time, plan sponsors may find that service providers become more aggressive — and creative — in seeking out access to gain ancillary business from participants.

Recordkeeping services are also likely to change in several different ways. Providers are beginning to look more at their overall value proposition, taking a bigger-picture view of how they can help participants reach their retirement goals. Rather than building services up as needs arise, recordkeepers are building comprehensive service models that provide personalized “experiences” for sponsors and participants. Being able to differentiate themselves by offering this value will help them keep a competitive edge.

This will likely translate into broader available services for employers, with an accompanying shift in how “customized” services are provided. Plan sponsors may see fewer “one-off” client customizations as organizations focus on economies of scale, efficiencies, and standardization to remain competitive. But when we spoke to them, recordkeepers noted that instead, recordkeepers will begin leveraging solutions across their complete book of business, offering what once were “customized” services as standard offerings on their platforms. This might be thought of as “scalable customization,” where all sponsor clients become the beneficiaries of services designed for individual clients. While smaller shops that provided individualized services may get swallowed up by larger providers, those larger providers will be looking for ways to continue to provide their clients with the services they expect. On the other hand, recordkeepers are also likely to phase out services that don't fit

well with their platform and are less efficient. For sponsors, this may be an opportunity to switch to more effective practices that could lead to lower participant costs.

### HOW CAN PLAN SPONSORS PLAN FOR THE FUTURE OF THE RECORDKEEPING INDUSTRY?

Looking ahead is the first step toward meeting the challenges posed by a shifting recordkeeping landscape. Knowing what direction the trends are heading and understanding the reasons for the changes puts you in a better position to be able to plan ahead. So what specifically can you do to help ensure that your recordkeeping needs are met into the future?

Partnering with a provider is a little like a marriage — it's a major commitment that requires trust, transparency, and most of all a good fit. Hopefully, when you select a provider, it will be a long-term partnership that serves both parties. While there is no way to know which providers might be acquired or merged, there are some signposts to help you select a recordkeeper that is as committed to you as you are to your plan.

The key question for prospective providers is: "How does recordkeeping fit into your overall business model?" With such variation in how recordkeeping can be structured as a service offering within an organization, understanding how the role of recordkeeping services is defined is a crucial factor. The long-term vision a provider has affects their commitment to and investment in its recordkeeping platform. Consider the significant difference between:

- A company that focuses exclusively on recordkeeping,
- A company for whom recordkeeping makes up a very small and insignificant portion of their business, and
- A company where recordkeeping may be only a small part of their service offerings but key to their value proposition.

Having insight into this question can help you determine:

- Does the company have a long-term commitment to supporting its recordkeeping platform and services?
- Is recordkeeping a core function and service offering for the organization?
- What is the company's mission, and how does recordkeeping support that mission?
- Will the company make the necessary investments to maintain its technological capabilities?
- Is recordkeeping subsidized by other aspects of the business, and how will that figure into an agreement? Is the purchase of ancillary services expected or required?

## THE FUTURE OF THE RECORDKEEPING INDUSTRY

Because recordkeeping is a high-cost, low-margin business, understanding how an organization will manage those costs and also how it is rewarded for providing its services will help you as a plan sponsor find the right fit. Also, understanding where your negotiating leverage is will help you come out ahead in the process. There's probably not much you can do about prices increasing as a whole, but you can certainly work to establish the best deal for your plan.

In seeking a recordkeeping partner, focus on value rather than cost. Ideally, you want to look for a recordkeeper that supports its recordkeeping platform with ongoing investment and attention. Those providers that take a long-term view of their service model and invest for the future will be better partners in a business where technological solutions, data security, and cutting edge services are so crucial.

Because the future is uncertain and the recordkeeping landscape is shifting, one of the best ways to prepare is to know thyself. Focus more on evaluating and understanding what's important to your plan in a recordkeeper than on provider names and brands. The more you understand what makes for a good fit and what services are most meaningful for your plan, the more solid ground you have to stand on when things shift. You'll know what your plan needs and will be able to discern between changes you can weather and changes that will require looking for a new provider. At the same time, maintain a modicum of flexibility; you may be pleasantly surprised at the new approaches that emerge out of the turbulence. Your provider may be able to guide you to take advantage of new ideas and service structures developed to meet new industry needs and trends.

When it comes to negotiating a provider contract, transparency is key. Request both bundled and unbundled pricing. Find out what the expectations are in terms of seeking or accessing ancillary business from your participants, and consider if and how you are willing to provide that access. It may be as minor as allowing ads to appear on the website where participants access account information, or as significant as allowing representatives to visit and solicit business. Be aware that these opportunities have value for the recordkeeper and may serve as a negotiating tool for you.

Because economies of scale are so important, consider how your plan might become more adaptable to a recordkeeping platform. If you have flexibility in terms of fitting into a more standardized service model, you may find opportunities to reduce your costs.

## CONCLUSION

Most importantly, work with your advisor, preferably prior to drastic changes, to consider what your plan's needs are and how a provider can best service them. Your advisor can serve as a guide and advocate as you move into the future of the recordkeeping industry.

Arnerich Massena is looking ahead at how the industry is shifting in order to help our clients navigate the changes and maintain strong provider relationships that serve them and their participants. We are planning now for how to best help our clients prepare for consolidations and mergers that may affect their recordkeeping services.



## THE FUTURE OF THE RECORDKEEPING INDUSTRY

Overall, we see these changes as being beneficial for plan sponsors in the long term. As the industry matures, providers are adding greater value, pricing structures are becoming clearer, and the industry is shedding those players who are only focused on the short term. The auto industry consolidation left us not just with only three manufacturers, but with the three top manufacturers providing the highest quality products. We are optimistic that the recordkeeping shakeout will have a similar outcome, resulting in the highest quality providers and the strongest service models.

### ENDNOTES

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