Fee Compression: Five Ways Providers Monetize Recordkeeping

Author: Erik Daley, CFA
Managing Principal

Each year, our firm completes our review of retirement plan costs, benchmarking them against our peer ranges. In 2018, we continued to see prices decline and participants benefiting from the compression. For clients, we now routinely see their fees at $100 per participant or less for more attractive engagements. That means for recordkeeping, custody, call center, web trading, employee education, and frequently legal and technical support, large financial service organizations are getting $100 a year for each account holder they serve.

While some of the compression can be attributed to vendor consolidation and scale, why would billion-dollar financial services organizations continue to invest in recordkeeping capabilities where profits have traditionally been so thin? The answer is: they believe there is an opportunity to generate additional revenue beyond the recordkeeping fees for servicing retirement plans. Generally, we believe there are five areas where recordkeeping vendors have tried to monetize their relationship with retirement plans:

- **Proprietary investment management**
- **Managed accounts**
- **IRA rollovers**
- **Cross-selling retail financial products**
- **Annuitization**

All five of the solutions carry the possibility for the recordkeeper to earn additional higher-margin revenue not part of a standard recordkeeping engagement. In this paper, we take a closer look at each of these five approaches.

Proprietary Investment Management

Once upon a time, asset custodians and recordkeepers were selected based on the quality of the investment products they managed and made available to consumers. For retirement plans, that dynamic has been gradually changing for years. Even to the point where virtually any retirement plan of any size should be selecting retirement plan custodians and recordkeepers based on their ability to meet the needs of participants and with full knowledge that the plan can use the best investment options in the marketplace in nearly any custodial environment.

> ***"…any retirement plan of any size should be selecting retirement plan custodians and recordkeepers based on their ability to meet the needs of participants…"***

Unlike providing recordkeeping services to retirement plan sponsors, investment management is a highly profitable and scalable revenue opportunity. While financial service firms may receive asset based or per capita fees scaled by the complexity of the work they provide, investment managers collect asset-based fees that grow along with the performance of the market. As recordkeeping firms grow, they are pressed for significant investments in technology and to add staff to service plan sponsors and participants alike.

Investment managers have virtually no marginal costs as their investment mandates grow. Funds become more "profitable" as the fixed legal, accounting, and research costs are spread across a larger and larger asset base.

Our annual fee benchmarking for recordkeeping services to our clients also details investment management costs at the same time. For larger plan sponsors, investment management costs may be as much as four-times the cost of recordkeeping services. Given the scale of revenue available in investment management and the profitability of that revenue, it should be no surprise the degree to which recordkeepers may have interest in seeing their investment products in the investment menus of their retirement plan clients.

In addition to using captive recordkeeping clients to promote the marquee investment products from the recordkeeper, financial service firms regularly steer plan sponsors to use proprietary investments in three core areas:

1. Cash alternatives – whether its insurance companies selling annuity and stable value accounts, or mutual fund companies with money market funds, these mandates which are largely commoditized are promoted heavily by retirement plan providers

2. Indexes – index funds continue to take significant cash flows in retirement plans. As mutual fund companies compete for the lowest-cost index, retirement plan providers are encouraging sponsors to use proprietary indexes in their menus

3. Target dates – whether active or passive, retirement plan providers are using their trusted role with committees to communicate the merits of their proprietary target date investment products

The success of those initiatives is clear. According to a study conducted jointly by AllianceBernstein and BrightScope in 2017[1], 43% of sponsors were using proprietary target date funds in their plan. While this is down from 59% back in 2009, it's clear that the link between retirement plan providers and target date funds utilized remains strong. According to the same study, 31.7% of billion-dollar and greater plans used proprietary target date funds.

IN 2017

43%

of sponsors were using proprietary target date funds in their plan.

*2017 AllianceBernstein and BrightScope survey.

Even if the correlation between proprietary investment mandates and recordkeepers is mild the opportunity is huge. As of Dec. 31, 218, 62% or our clients' retirement plan assets were in target date funds, cash, or index products.

The Department of Labor (DOL) has been aware of these correlations for some time. In 2013, the DOL published tips for plan fiduciaries that included the tip, "Inquire about whether a custom or non-proprietary target date fund would be a better fit for your plan."

Many plan recordkeepers have excellent investment products, and sponsors should use those products when they meet the needs of the plan, its participants, and adhere to the investment policy statement. However, any plan using proprietary funds should be cognizant of their requirements to evaluate those products with the same care and rigor they would any other investment product. Using proprietary funds may make sense, but fiduciaries should take extraordinary care in ensuring the independence of the plan provider and investment product decisions.

Managed Accounts

Participants in defined contribution plans continue to be confused with more investment choices than they wish to manage. Many firms are selling managed account solutions, where participants delegate investment management to the recordkeeper or a party offered through the recordkeeping relationship. In exchange, the recordkeeper gets an asset-based fee. Managed accounts are highly profitable as the allocation, and investment rebalancing aspects are entirely automated. Much like recordkeeping, managed accounts are largely a scale business where costs are fixed and revenue variable.[2]

The software that manages participant allocation and executes trades has either been built by the recordkeeping provider or licensed from an external party. Revenue from managed account solutions, however, is variable and tied to assets. While some staff is required to service the managed account participants, those costs are largely integrated into the larger cost of maintaining a call center pool.

To get a good sense of the margins in managed account solutions, you can speak with the technology providers that license their solution to recordkeeping organizations. Frequently, the fee they asses is either fixed at the relationship level or variable based on utilization at less than 0.10%. The retirement plan service providers then take that solution and package it for participant use at fees ranging from 0.325% to 0.60%. The premium compensates them for any participant fiduciary risk they may encounter by running the managed account program as well as for any staff they retain to support participants using the service. As recently as 2014, the U.S. Government Accountability Office (GAO) expressed concerns with the fees being charged and whether the benefits of the service were sufficient to justify the cost.[3]

> ***"Further complicating the issue is how managed accounts are marketed to sponsors."***

Further complicating the issue is how managed accounts are marketed to sponsors. Frequently, the sponsor assumes no cost for adding managed accounts and those costs are paid exclusively by the participants utilizing the service. Those costs incurred by participants are costs that must be monitored by the fiduciary to ensure reasonableness.

With the continued growth of assets in target-date funds, managed accounts are receiving much attention as the "smarter" do-it-for-me solution where differences in risk, income, and accumulated wealth can be incorporated into the asset allocation of every participant.

According to the PSCA 2017 Annual Survey of Profit Sharing and 401(k) Plans,[4] 39% of all plans offered a managed account solution, and in those cases, 76% of plans had the cost paid by the participant.

While Vanguard's 2017 How America Saves survey[5] states that currently only 4% of assets are invested in managed account solutions, we have seen a tremendous variance in the plans we have engaged with including a client where half of the participants had managed account exposure.

> ***"Managed accounts may provide a valuable tool for participants with very specific investment objectives and circumstances…"***

Managed accounts may provide a valuable tool for participants with very specific investment objectives and circumstances, but when deciding to extend those services, the fiduciary should be mindful of managing quality and minimizing conflicts.

In addition to the qualitative aspects, asking questions about how utilization impacts the compensation of those interacting with your participants is prudent and necessary to understand where conflicts may potentially arise.

IRA Rollovers

For many financial service companies, IRA rollovers are the lifeblood of their sales efforts. Recordkeeping firms have become very good at communicating the benefits of rolling over to participants before they arrive at a distributable event and are in the first position to be notified when a participant becomes eligible for a rollover. Once in an IRA account, frequently, the cost for investment products and investment management increase and become more attractive to the financial service company.

Additionally, the ability to sell managed accounts and utilize proprietary investment products in an IRA setting is virtually unconstrained by law and operates outside of ERISA's prudence requirements.

> ***"...as of March 31, 2018, IRA accounts accounted for more than $9.1 trillion in retirement assets."***

According to the Investment Company Institute (ICI), as of March 31, 2018, IRA accounts accounted for more than $9.1 trillion in retirement assets.[6] In fact, IRA assets exceed those in qualified plans by more than $1.4 trillion. While some of the $9.1 trillion was made through individual annual retirement contributions, the majority were sums raised in qualified retirement plans and later rolled out into IRA accounts.

The oldest of the baby-boom generation hit age 65 in 2011 and the growth of the IRA marketplace has been notable as they have begun the retirement process. IRA assets have increased by 82% since the end of 2010, while defined contribution plans have only increased by 61% during that same period.

The institutional retirement plan marketplace has become more transparent and less expensive over the last decade. The DOL has helped plan sponsors better understand expenses, and sponsors have increasingly gone away from using the proprietary investments of their recordkeeping providers. The IRA marketplace hasn't benefited from similar efficiencies or transparencies.

In fact, the DOL's fiduciary rule, which was intended to increase the liability for those encouraging participants to roll out of qualified retirement plans died a quiet death in the federal courts last year.
While the SEC continues to work on increasing scrutiny related to sales practices, IRA accounts and participants continue to end up with investment products that are frequently more expensive, less independent, and less efficient than those that were available in qualified plans.

The recordkeepers that serve plan participants are aware of how effective inertia is in driving behavior. The same behavioral finance biases that make automatic enrollment and auto escalation effective, also work in convincing participants to roll money out of retirement plans. Messaging to participants frequently addresses the individual ownership of IRAs in helping participants decide what to do when they leave employment.

The most successful providers may expect to capture 50% or more of IRA activity out of client plans.

In 2013, the GAO issued a report[7] that recommended the DOL and IRS:

- Issue clarification of the circumstances that will cause a service provider who assists participants with their distribution decisions to be an ERISA fiduciary
- Require service providers to clearly disclose their financial interests in participant decisions
- Require plan sponsors to provide a summary to a separating participant of his or her options and the key factors that the participant may wish to consider in comparing options

With the death of the fiduciary rule, we are unfortunately no closer to addressing the recommendations of the GAO. Monitoring the activity of your providers continues to be wise, and while not required by the DOL, providing participants with information on their options at the separation of service (as recommended by the GAO) may help them make more informed decisions regarding a high impact decision.

Cross-selling Retail Financial Products

For financial service sales people, few things are more valuable than a room full of employed consumers looking to them for help. Some organizations have successfully used employee education, financial wellness, and personal financial counseling as an avenue to discuss other products and financial needs outside the plan, from 529 accounts to life insurance. These solutions carry tremendous margins and the opportunity to capitalize on the value of the participant.

The compression of fees in the retirement plan marketplace has by-in-large been a positive phenomenon for participants, with the costs of maintaining a retirement benefit account contracting at rapid rates. The cost for retirement plan administration is routinely sub-$100 per participant for mid- to large-plans.

At $100 per year, that makes the cost of providing recordkeeping and education services to a participant less expensive than satellite radio, Apple Music, Netflix subscription, and HBO.

> ***"Given the complexity and risk of retirement plan recordkeeping, why would companies grossing billions in revenue elect to play in such a low margin market?"***

Given the complexity and risk of retirement plan recordkeeping, why would companies grossing billions in revenue elect to play in such a low margin market? Perhaps it's not the plan these companies are interested in, but the participants who utilize it.

Retirement plan administrative solutions are rich with data. Plan administrators know where participants live, their income, their savings patterns, and how long they've been with their employer. By serving as the face of the retirement plan data, these financial services companies also maintain much higher interest, and potentially trust, with the employees they serve.

For those of us who work in the industry, the transition from institutional services to retail marketing has been pronounced and notable. Now there is increasing evidence that marketing services to participants may be the next area of focus for litigators.

In the case *Cassell v. Vanderbilt*, the amended complaint states:

> *"…Defendants breached this duty[8] [1] by allowing … the Plan's recordkeeper to obtain access to participants, gaining valuable, private, and sensitive information including participants' contact information, their choices of investments, the asset size of their accounts, their employment status, age, and proximity to retirement, among other things… to sell ... products and wealth management services to the Plan's participants, and failed to even attempt to determine the value of this marketing benefit. This information was particularly valuable … give that it had already been endorsed by Defendants as recordkeeper."*

The value of the list is one of the critical issues of interest in the complaint. For sponsors looking to integrate retirement planning into broader financial health and estate planning, restricting vendors to discuss issues outside of pure retirement may limit the effectiveness of what's being delivered.

While the parties have agreed to settle in the *Vanderbilt* case, there are some steps clients may consider taking to manage their vendor relationships.

1. Ensure the Committee knows how their providers are paid and for what services that payment covers
2. Communicate with employees the role of the education providers at your institution and call out potentials for conflicts
3. Notify participants that approaches from your providers outside those paid for by the plan have not been reviewed or endorsed by the sponsor, and encourage them to shop intelligently from products and services not subject to fiduciary review

Incorporating these steps in to your annual fiduciary work plan can help increase awareness of the risks and opportunities of opening your list up to your provider.

Annuitization

One of the challenges of the defined contribution solution so prevalent in the country today is the lack of certainty related to lifetime income. Insurance firms in the recordkeeping marketplace are continuing to develop insurance solutions for use in defined contribution plans. Whether pure annuitization or guaranteed lifetime income solutions, these insurance driven solutions also carry the possibility of much higher asset-based and general account revenues.

> ***"…annuitization occurs when a participant elects to take a pool of assets today to purchase the promise of income over their lifetime (and perhaps beyond)."***

By way of refresher, annuitization occurs when a participant elects to take a pool of assets today to purchase the promise of income over their lifetime (and perhaps beyond). Annuitization should eliminate longevity risk - the risk of a participant outliving their retirement savings, by transferring that risk to an insurance company. In an annuitization setting, participants pool their mortality risk. While you or I may not know when we will die, an insurance company with a large enough pool of participants should be able to predict with some accuracy the average life expectancy of the pool. Insurance companies invest in their general account with the objective of making the promised monthly annuity payments to purchasers.

While annuities have a bad reputation, the type of income annuities a participant may elect to purchase in retirement may very well enhance their retirement security when purchased by a mindful participant with concerns about outliving their income.

2017: immediate income **annuity sales were only $8.3 billion**, but in a **$7.8 trillion defined contribution marketplace** the potential for growth is great.

Currently, participants electing annuitization is rare. According to a 2017 LIMRA annuity sales survey, immediate income annuity sales were only $8.3 billion[9]. While not as lucrative as some insurance products, income annuities are an attractive income source for many insurance companies. When a participant purchases a lifetime annuity, the assets of the participant are invested in the general account of the insurance company. The life insurance companies earn income by investing those proceeds and achieving a rate or return higher than that required to pay their income obligations by participants.

Unlike property or disability insurance solutions where natural catastrophes or economic slowdowns can lead to unpredictable claim activity, lifetime income annuities rely on highly predictable mortality behavior for large pools making profits predictable and consistent for insurers.

Interest among financial service companies in lifetime income has never been higher. In 2018, a group of financial services companies created the Alliance for Lifetime Income[10] to educate Americans about the value of protecting income, simplifying retirement income planning, and helping consumers better understand annuities.

While retirement income may be appropriate for many participants, it is also unquestionably a product sale opportunity to some recordkeeping service providers. Plan sponsors will need to continually monitor their retirement service provider to ensure the solutions presented to their participants are monitored and are not biased by the profit motives of their providers.

Final Thoughts

None of the five areas are definitively evil, and each may even bring value in the right type of plan. Good investment products should always be used regardless of recordkeeper, and quality managed accounts may improve savings or returns for participants. Assisting participants with assets after termination in an IRA may help them avoid leakage, taxation or penalties. Talking to financial educators about mortgages and college expenses may provide a complete picture of financial health. Annuitizing a portion of a benefit may improve financial security.

The challenge for sponsors is identifying these ancillary areas of revenue, understanding them, and ensuring that they are not done in such a way to victimize already overwhelmed participants.

[1] https://www.alliancebernstein.com/sites/investments/us/resources/pdf/final_dci-7572-0717.pdf

[2] https://blog.multnomahgroup.com/forward-thinking/monitoring-a-managed-account-program

[3] https://www.gao.gov/products/GAO-14-310
[4] https://www.psca.org/PR_2018_60thAS
[5] https://pressroom.vanguard.com/nonindexed/How-America-Saves-2017.pdf
[6] https://www.ici.org/research/stats/retirement/ret_18_q1
[7] https://www.gao.gov/products/GAO-13-30
[8] https://s3.amazonaws.com/si-interactive/prod/plansponsor-com/wp-content/uploads/2018/06/06144029/CassellvVanderbiltSecondComplaint.pdf
[9] https://www.limra.com/Posts/PR/News_Releases/LIMRA_Secure_Retirement_Institute__Total_Annuity_Sales_Continued_to_Decline_in_2017.aspx
[10] https://www.allianceforlifetimeincome.org/