

Fee Questions and Economy Drive 401(k) Plan Sponsors to Search for New Providers

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Main article

The first seven months of 2004 marked a period of booming opportunity for 401(k) providers, even as the number of vendors serving defined contribution plans diminished.

The rate of plan sponsors seeking to switch service providers has escalated dramatically this year, for all size plans with up to at least \$1 billion in total assets (see Figure 1). That means the business environment is ripe for those providers seeking to grow their business in the industry.

One factor fueling the decision by almost 10% of plan sponsors to look for new providers is the growing realization that many plans are paying an excessive amount in management fees. For years, companies such as Charles Schwab and McHenry Consulting have been calling for greater transparency in providers' fee structures. That transparency is finally arriving, whether providers are happy about it or not.

"Eighty percent of every provider's book of business is overpriced," says Fred Barstein, president of 401kExchange. The Exchange surveys sponsors on whether they are seeking new provider relationships and then puts out an Opportunity Index indicating how much potential business awaits service providers who might be attempting to increase their client base.

Seeking lower fee structure

Barstein says that sponsors, even those with small-market plans, finally are recognizing that their service providers are charging management fees that often are not only hidden but also excessive. They therefore are going to their providers and asking for a reduction in fees. Sponsors hold the leverage when making such requests. If their providers are unwilling to bend on the fees they charge, the sponsor can threaten to begin searches for new providers.

This turn of events puts pressure on providers to renegotiate the fee structure. But it also poses a dilemma for them.

"What do they do?" asks Barstein. "Reprice all plans? But if they do, their profits drop."

What many vendors are doing, therefore, is being selective in deciding with which sponsors they will renegotiate the existing fee structure.

"What we're hearing anecdotally is that they're going to their very best clients—those that are most profitable for them—and offering them better deals," says Barstein. "They're being pre-emptive with those. For the others, they're taking a wait-and-see attitude."

Pricing the market

Defined contribution providers, like all business ventures, are quick to raise their fees when their own costs go up. But when costs go down, as they have with many 401(k) services thanks to technological innovation and economies of scale, providers have not been so quick to offer price breaks to sponsors.

So sponsors, irked by the mutual fund scandal and the poor market performance of 2000-2002, are taking it upon themselves now to seek better deals with vendors. This is even beginning to hold true with the smallest of plans, which previously were unaware that they could bargain for more economical management fees.

"I think what all of this means is that you're going to see a lot of sales activity," says Barstein.

The surveys of plan sponsors by 410kExchange certainly point in that direction.

In 2003, from January through July, 6.4% of plans with assets of less than \$1 million said they were interested in searching for a new provider. In the first seven months of this year, according to 401kExchange's survey, that percentage has shot up to 9.4%, an increase of 47% (see Figure 2).

Similar increases are seen across the board in all plan sizes. Among plans with assets of between \$1 million and \$10 million, the share of those looking for new management relationships rose from 7.2% during the first seven months of 2003 to 9.5%. That's a jump of 32% over last year.

In the first seven months of 2003, 7.3% of plans with from \$10 million to \$100 million in assets said they were looking for new providers. That percentage also went up by 32%, to 9.6% for January through July of this year.

For those large plans with between \$100 million and \$1 billion in assets, the increase in the percentage of sponsors looking to forge new vendor relationships rose 51% over the past year, from 6.5% during the first seven months of 2003 to 9.8% over the same time span this year.

Barstein expects the high level of churn to continue throughout the remainder of the year, based on what he has seen and heard.

"It's really robust coming into the fourth quarter," he observes.

Making up for lost time

Part of the reason for the vigorous activity in the industry, as *DC Plan Investing* has reported previously, is that there were relatively few provider searches during the economic slump at the outset of this decade.

Companies were so engrossed in trying to make ends meet, avoid layoffs, and figure out how to resolve the dilemma of escalating health care costs for their employees that defined contribution plans were put on the back burner. They also were reluctant to change fund managers during a period when virtually all equity investments were sputtering.

Now that the economy seems to have bounced back, health care issues have been dealt with (if not fully resolved), and the market staged a comeback in 2003, sponsors—particularly their human resource departments—are again focusing on ways to enhance their retirement plans. At

the same time, largely because of the mutual-fund scandal and greater government scrutiny regarding the way defined contribution plans are managed and paid for, sponsors are trying to make their plans more cost-effective. That effort involves not only seeking a more advantageous fee scale, but also new vendors, if necessary.

The playing field shrinks

Meanwhile, however, the number of providers still serving employer-based retirement plans is declining.

That's not necessarily a bad thing, even though it does reduce the number of choices open to sponsors searching for a new vendor.

Many providers, however, probably shouldn't have been in the market to begin with. They've recognized that they are better off abandoning the retirement business or selling off their area of expertise to another company.

A new, stronger environment has emerged as nonprofitable businesses drop out or merge with other providers, while more established players outsource some of their functions to former competitors who have expertise in a particular area of the business.

"We're into a new area of consolidation," says Barstein. "There's less of saying, 'Why did I ever get into this business, it doesn't make sense,' and more, 'I need to be bigger and combine with other providers or sell my services or products.'"

401kExchange has compiled a list (see Figure 3) of companies that have altered their status in the retirement savings industry by either merging or being bought out, outsourcing certain functions, or abandoning the field altogether.

The list is very liquid, however, as consolidations continue almost daily. On the very day that 401kExchange shared its list of consolidations and dropouts with *DC Plan Investing*, for instance, Firserv announced the consolidation of three retirement plan providers—Lincoln Trust, Resources Trust, and First Trust Corp. and Retirement Accounts—all under the Firserv umbrella.

"By consolidating the trust entities, we can strengthen our position and our identity in the marketplace," says Skip Schweiss, executive vice president of Firserv. "Between the four companies, there are 110 years of experience in providing quality trust, custodial, and back offices to the financial services industry. We believe that's important to our clients."

"You're thinking consolidation," adds Barstein, "because it's still a very attractive market, especially with all the rollover dollars involved."

That's why a company such as Merrill Lynch, whose retirement services business was on the ropes a couple of years ago, decided to restructure itself rather than pull out of the defined contribution industry. Now, with some trimming and outsourcing of parts of its retirement plan business, Merrill Lynch has become a healthier and competitive recordkeeper once again.