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Long-term value creation in US retirement

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Retirement is and will continue to be one of the largest growth opportunities for wealth managers, insurers, and asset managers. Recent estimates by the McKinsey Global Institute show retiring and elderly individuals in the developed world will contribute more to global consumption growth through 2030 than will Chinese consumers aged 15 to 59. Not surprisingly, leading firms from across the financial services industries are seeking to tap into this long-term growth opportunity.

The largest retirement market is the United States, which contains $26 trillion[1] in assets held in retirement-related accounts, including public and private defined contribution (DC) and defined benefit (DB) plans, IRAs, and annuities. These accounts collectively support more than $430 billion in revenue for retirement recordkeepers, asset managers, wealth managers, annuity writers, and life insurers, according to McKinsey Performance Lens data.

Contrary to popular belief, this asset pool will not diminish as baby boomers complete their retirement journey. This is a long-term trend that will continue to play out. By 2026, three-quarters of household financial assets will be held by individuals aged 55 and over, up from two-thirds today.[2]

How the economics unfold in retirement markets will continue to have a disproportionate impact on leading financial services firms over the next two decades.

This article shares perspectives on potential industry trajectories and options for incumbents to improve competitiveness in a changing environment.

The evolving market for defined contribution recordkeeping

In many respects, the DC market is the keystone of the US retirement market:

— With over 110 million participant accounts, the DC system is the primary means by which millions of consumers access wealth and asset management services (Exhibit 1)

— At nearly $8 trillion in assets under administration, the US DC market accounts for just under 30 percent of managed retirement assets in the country (including annuities)

— These assets support almost $30 billion of revenue for asset managers and recordkeepers (not including revenue from annuities) (Exhibit 2)

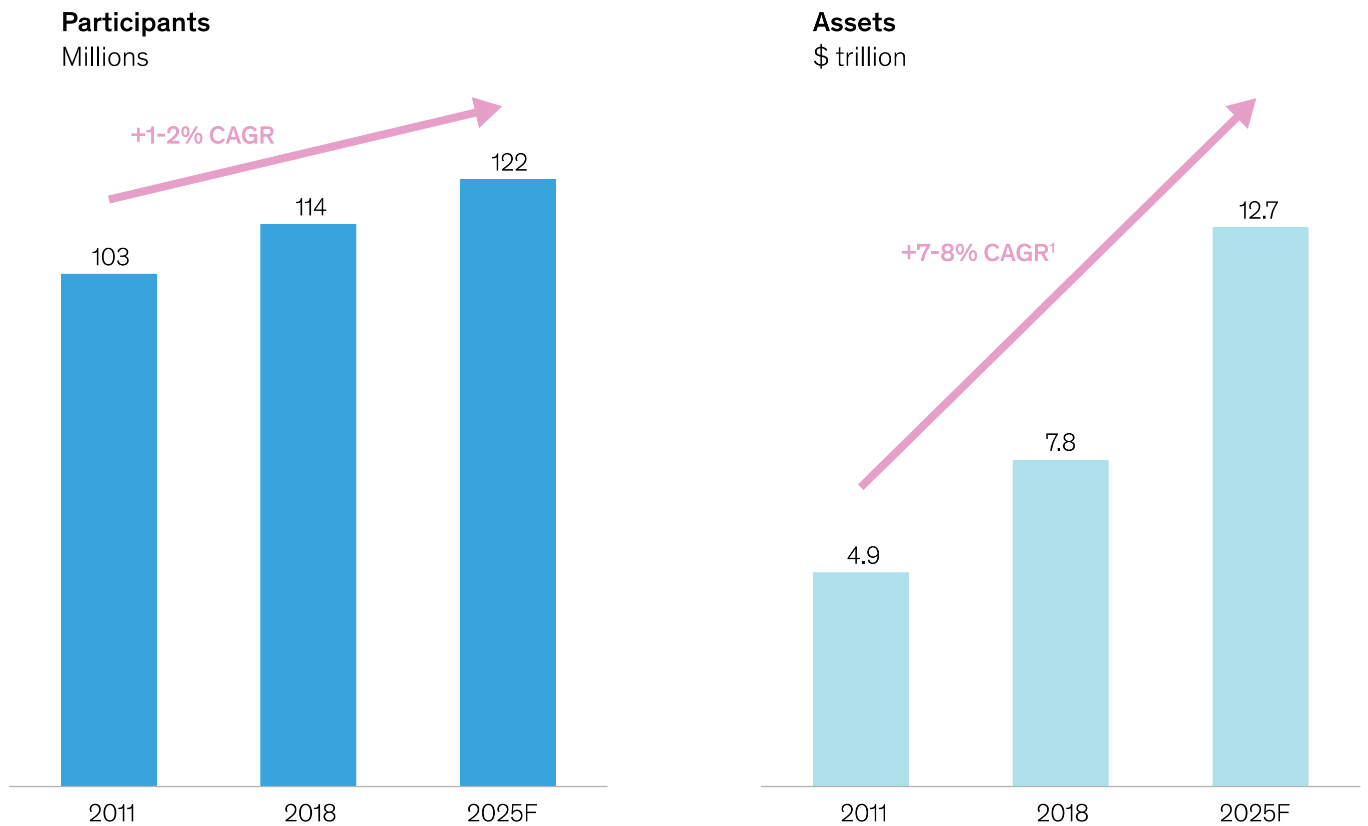
— The DC system is a major money-in-motion opportunity. In 2018, almost $600 billion in gross assets left DC plans, according to McKinsey Performance Lens.

While the DC market remains large and attractive, it is also experiencing a series of disruptions. Asset managers are facing multiple disruptions at once: the rotation to passive driven by fiduciary considerations; relentless pricing pressure

1 McKinsey Performance Lens; ICI.
2 McKinsey Wealth Management Practice; US Federal Reserve Survey of Consumer Finance.

Exhibit 1

Assets in the US defined contribution market are expected to grow 7 to 8% through 2025.



[1] Forecast to 2025 assumes over 6% asset appreciation and 2% organic growth that incorporates a regulatory tailwind that curbs distribution (i.e., similar effect as an implemented DOL rule).
Source: McKinsey Retirement Growth Model

across active and passive, also driven by fiduciary concerns; and the rise of target date funds as the Qualified Default Investment Alternative, which is consolidating flows in five managers who accounted for over 100 percent of net flows into the target-date funds from 2015 to 2018, according to Morningstar. Continued unbundling of asset management and recordkeeping will intensify concerns about the business models of more integrated players. For the myriad of managers on the outside looking in, developing a viable DC strategy is essential to sustainable growth in the space.

The disruptions faced by recordkeepers, however, have been more profound. While the 10-year bull market has propelled DC asset levels, recordkeepers have had to navigate a series of structural shifts in the market that have pressured their economics:

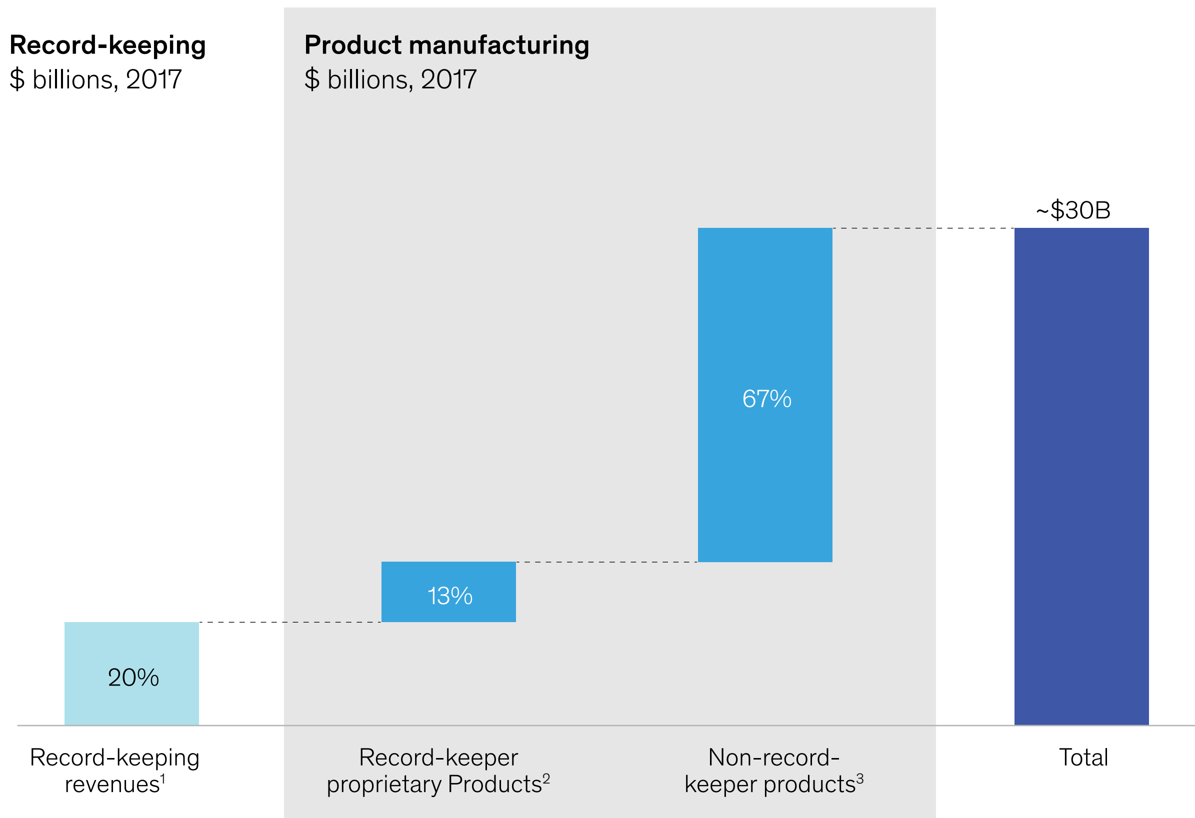
— While margins are already razor thin in the large and jumbo market space, increasing transparency coupled with growing intermediary sophistication in the small and mid-sized plan markets is leading to further downward pressure on pricing

— The continued bifurcation of plan servicing and investments; rotation to passive investment options; and increasing use of institutional share classes and collective investment trusts have further pressured revenues, particularly for recordkeepers who are owned by insurers, asset managers, and wealth managers and who have historically treated recordkeeping like a distribution channel

— Core DC spend risks fragmentation with the rise of competing benefit offers, including Health Savings Accounts, student loan forgiveness, and emergency cash accounts. For recordkeepers who offer these products, this evolution presents much needed alternative revenue streams. For those that do not, these products represent

Exhibit 2

Approximately 20% of the $30 billion revenue in DC markets is generated by record-keeping.



[1] Includes participant fees and revenue sharing.
[2] Management fees from investment products that are manufactured by record-keepers and distributed through a plan.
[3] Management fees from investment products only (excludes group annuity) that are not manufactured by record-keepers.
Source: McKinsey Retirement Growth Model; McKinsey Asset Management Benchmarking Survey; McKinsey Wealth Management Survey; NEPC survey; Ignites research; Pensions & Investments

long-term revenue leakage

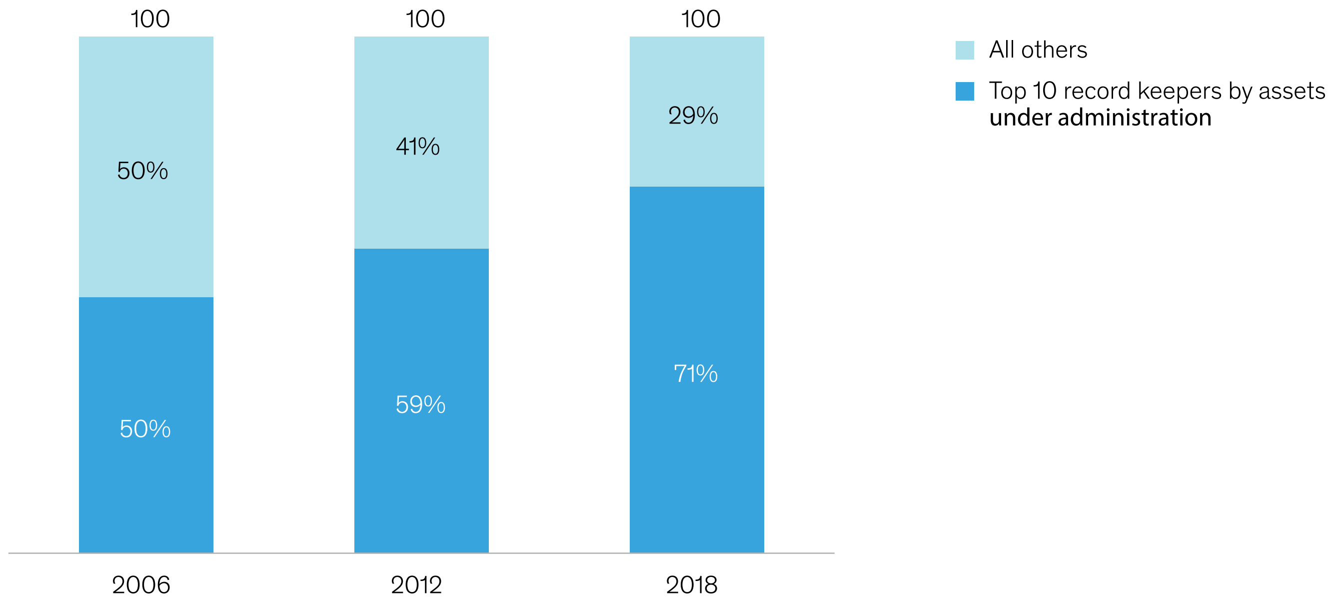
- Stable value and group annuity economics have yet to fully recover as interest rates remain 250 to 300 bps below their pre-crisis highs.
- Operating leverage and returns to scale remain elusive due to outdated technology with extensive “deferred maintenance” and a prevalence of manually intensive processes
- Rapidly evolving expectations around sponsor, participant, and intermediary experience have driven heightened investment in digital capabilities
- Perhaps most challengingly, there is structural excess capacity in the market driven by business models that view recordkeeping as a distribution channel for proprietary products and services, thereby enabling competitors to run their platforms on a break-even basis

These headwinds have led to several critical “from-to” shifts for recordkeepers:

- From recordkeeping fees sufficient to cover the cost of service delivery on a stand-alone basis to fees that are often insufficient to cover the cost of delivery
- From differentiation based on investment product offering to differentiation based on sponsor, participant, and intermediary experience
- From high levels of proprietary share to low levels of proprietary share on both new business and retention
- From recordkeeping as a cost-effective distribution channel for proprietary products and services (e.g., proprietary target dates funds, individual wealth management) to record keeping as a stand-alone, technologically-

Exhibit 3

Asset concentration has increased due to M&A and stronger organic growth for the top 10 firms.



Note: AUM data for top 10 record-keeping firms as of Jun 2006, Sep 2012, and Sep 2018 (2018 results include Principal and Wells Fargo AUA combined).
[1] Does not consider outsourcing of books of business (which is trend we expect to continue).
[2] Includes mergers and acquisitions only; excludes IPOs, capital raising, and rebranding transactions; includes the impact of consolidation after acquisitions.
Source: McKinsey analysis

intensive custody and servicing business with thin margins

These shifts raise critical questions for participants in the market that have historically looked at recordkeeping as a high-margin distribution channel, but now find themselves operating stand-alone, technology- and data-intensive businesses that sit outside their core competencies:

- Will the industry experience rapid consolidation?
- What are the likely end-state scenarios?
- What viable strategic options are available given likely scenarios?

Will the recordkeeping industry experience rapid consolidation?

Given its relatively fragmented structure (there are over 50 firms with at least $1 billion of recordkeeping assets, according to Plansponsor), pricing pressure, and technological intensity, it would be rational to expect the industry to consolidate around a handful of "at scale" competitors, eventually leading to pricing equilibrium.

In fact, the industry has been consolidating when measured by assets under administration. The top 10 competitors have increased their share over time—from 50 percent in 2006 to 71 percent in 2018[3] (Exhibit 3). Much of this consolidation has been organic as stronger competitors have leveraged brand, pricing, and superior intermediary, sponsor, and participant capabilities to take share. M&A has also played an important role. J.P. Morgan, Mercer, The Hartford, and Wells Fargo (announced but not closed at the time of writing) all sold their recordkeeping businesses to strategic buyers.

Looking forward, we expect organic share gains will continue as leading firms look to reinforce their positions. The question, however, is whether the pace of recordkeeping M&A will accelerate or maintain its current pace. On balance, we believe inorganic consolidation will likely see a modest acceleration. However,

[3] *Pensions & Investments;* ICI.

a true M&A brushfire sweeping through the industry over the next three years is less likely for several reasons:

— *Variance in market conduct and structure across segments* (e.g., large segment 401(k) vs. small segment; higher education 403(b) vs. K-12) limits what synergies can be realized through an acquisition.

— *Strategic buyers have found it difficult to realize the synergies promised from acquisitions.* Too many providers continue to operate multiple legacy recordkeeping platforms (even within the same segment), having found consolidation to be a costly and operationally challenging exercise.

— *Second order effects of an exit are unclear* – for instance, asset-management owned recordkeepers may be unclear on how much of highly profitable defined contribution investment only business benefits from the recordkeeping platform.

— *Exiting is financially unattractive for many incumbents.* When competitors with models that have viewed recordkeeping as a distribution channel for asset management and stable value products evaluate the financial implications of an exit, they can find selling is not attractive. The present values of cash flows generated by the installed base of proprietary assets typically exceeds the value that could be realized through the sale of the recordkeeping business, even with reasonably generous assumptions around what they would receive for the business and how much of the installed proprietary asset base they would retain.

This final point also highlights a thorny issue for the industry: firms with high embedded proprietary share (for example, 40 percent of more of assets) have a strong incentive to aggressively discount when their plans go out to bid to protect their installed book of business. The higher the proprietary share in a plan, the greater the incentive to discount. This dynamic leads to structural excess recordkeeping capacity and continued downward pressure on pricing.

Evolution vs. disruption: Likely end-state scenarios

There is a more fundamental question regarding how the industry will evolve over the next 10 years. We see three potential scenarios. The first presumes little disruption while the second and third scenarios see disruption from outside the DC market. The common implication across all three is that recordkeepers need to act boldly to secure their futures through a combination of aggressive restructuring to prepare for continued revenue pressures while investing in next-generation client, participant and sponsor experience capabilities to meet rising customer expectations (Exhibit 4).

Exhibit 4

Three end-state scenarios for the US DC market.

Scenario 1: Continuing consolidation	Scenario 2: Disruption from digital attackers in retirement	Scenario 3: Disruption from another market
Consolidation and pricing pressure continue, as incumbents battle for share and offer concessions to retain proprietary share	Digital attackers such as Betterment, Human Interest, and Guideline penetrate the under-$5 million market before incumbents can react	Human resources information systems providers (eg, Workday, Peoplesoft) substantially upgrade their offerings and disintermediate record keepers
Marginal firms gradually exit as they reach their inflection points	Integrated benefits enrollment platforms (eg, Business Solver, PlanSource, Aetna's bSwift) eventually extend to integrate retirement enrollment and servicing, creating a one-stop shop for employees. Recordkeepers are fully disintermediated and consolidation follows	The effect is similar to the potential disruption of integrated enrollments platforms; record-keeping becomes highly commoditized and consolidated
The end state features clusters of at-scale providers per segment as well as at-scale middle- and back-office utilities		

Source: McKinsey analysis

Scenario 1: Continuing consolidation

Under this scenario, industry sees continued consolidation and further pricing pressure as incumbents battle for share and offer pricing concessions to retain business with high proprietary share. Over time, marginal players gradually exit as they reach their specific inflection points where the value of a sale exceeds the perceived value of staying. The end state features clusters of four to five at-scale providers at a segment level (e.g., large/jumbo 401(k), small plan 401(k), K-12 403(b)). While the pace of consolidation will likely remain steady, it could be accelerated by:

— One or two large transactions that force the hand of potential buyers (or sellers)

— Acceleration in the growth of substitute products (e.g., health savings accounts, student loan forgiveness) that drive economics out of the DC market

— Pronounced shifts in the regulatory landscape

It is important to note that consolidation could occur in a more subtle form. Specifically, the market could see the rise of middle- and back-office utilities (similar to the role played by leading third-party recordkeeping platforms as well as what AWS does for Amazon). In this scenario, the number of "recordkeepers" remains steady, but their economics shift to those who own industry utilities, including, potentially, competitors. This form of consolidation could occur concurrently with M&A.

Scenario 2: Disruption from digital attackers in retirement

The second scenario entails external disruption. While it is common practice to ask what would happen if a Silicon Valley giant were to attack the DC industry, low margins and regulatory scrutiny are likely to ward off a large technology company from competing directly with recordkeepers. They are likely more than content to syphon economics from the industry as service providers (as is already the case through cloud services).

There are, however, two groups in the broader employee benefits markets who could meaningfully disrupt the industry.

The first are attackers such as Betterment, Human Interest, FourUsAll, and Guideline. These digital natives are attacking the under-$5-million space with simple, fee-based models leveraging ETFs, distributed on a direct basis. While their long-term viability remains uncertain, they are well-funded and one—HonestDollar—has already been acquired by a strategic buyer.

Whether they capture meaningful share might be irrelevant in the long-term. In the individual wealth management space, robo-advisors such as Wealthfront and Betterment have driven the introduction of similar models from leading incumbents. We can expect a similar response from incumbent recordkeepers.

The second group would be the emerging integrated benefits enrollment platforms that optimize enrollment decisions—including participation and deferral decisions—across the full spectrum of benefits (that is, health insurance, ancillary insurance lines such as dental and disability, and retirement). Enrollment platforms that already integrate health insurance and ancillary insurance enrollment with decision support tools for employees exist today (e.g., Business Solver, PlanSource, Aetna's bSwift) and have been the beneficiaries of considerable investment from venture firms and strategic buyers.

These platforms could eventually be extended to integrate retirement enrollment and servicing, creating a one-stop shop for employees and disintermediating recordkeepers from the enrollment process, which is a critical point for establishing lifetime relationships with participants as well as differentiating through the deployment of guidance tools. Should such a model gain broad appeal with intermediaries and sponsors, recordkeeping would be relegated to a fully commoditized transaction-processing function. Under this scenario, rapid market share consolidation would likely follow.

Scenario 3: Disruption from another market

Finally, disruption could come from another market—the human resources information systems (HRIS) industry (e.g., Workday, Peoplesoft). This industry is a long-term threat given the privileged access it has to employee payroll and census data fees. While many HRIS providers have modules that accommodate defined contribution enrollment today, the modules often lack high-quality decision support tools provided by leading plan providers. Should they choose to do so, however, HRIS providers could substantially upgrade their offerings and disintermediate recordkeepers. The net effect would be similar to the disruption caused

by integrated enrollments platforms: recordkeeping would become a highly commoditized transaction processing and custody business, and consolidation would likely follow.

While gradual consolidation remains the most likely scenario, recordkeepers (and their owners) should maintain a strong external awareness and explore partnerships with these potential attackers to both learn from their capabilities and stay ahead of potential discontinuities.

What viable options exist for incumbents?

Given these end state scenarios and near-term pricing pressures, what steps should recordkeepers (or their corporate parents) consider to maximize their performance?

Winning in this industry will require bold action and meaningful investments—enterprise commitment is critical. As a result, recordkeepers must first determine whether to stay in the DC business or exit. This requires a dispassionate, fact-based strategic review that weighs the realistic cash flows and related benefits from staying in the market against potential proceeds from a sale (taking into account realistic projections on proprietary asset retention, as applicable for insurers and asset managers). Given the variance across segments, this review should be done at a segment level (e.g., large plan 401k; 457 plans; 403(b) plans for K-12). The process should then overlay any idiosyncratic considerations (e.g., regulatory risk, the degree to which the business is "core" to a broader institutional strategy).

For those committed to the market, it is imperative to have a viable strategy focused on how their firm will differentiate and win in a manner that is firmly rooted in the business's underlying business model (i.e., pure-play service provider, group annuities-led, asset management-led, wealth management-led).

The strategy should be translated into an execution roadmap that delivers long-term revenue growth, transforms the business's cost structure, and leads to competitive differentiation. This is no small task, as a comprehensive strategy and roadmap needs to answer the following questions:

1. How will the business generate sustainable organic growth?

Despite challenging market conditions, competitors can achieve sustained revenue growth above industry averages. Doing so is a two-step process.

The first involves answering the question of where to compete by taking a granular lens to the market. By definition, industry averages are misleading as they mask the fact that some parts of any market are growing faster than others. Granular growth thinking disaggregates markets into discrete cells to identify relatively higher growth, more attractive segments. While building this more granular view is time consuming, advanced analytics and the growth in market data have created unprecedented visibility allowing leaders to reposition resources against the most attractive opportunities and, thereby, increasing the potential to achieve above-market growth.

The second step is implementing next-generation distribution capabilities (Exhibit 5). At the advisor and sponsor level, this includes:

- A tailored home-office engagement strategy to ensure preferred access to the most important distribution networks
- Advisor targeting models to enhance wholesaler productivity
- Churn models to maximize net sales (versus simply focusing on new business) by improving retention rates
- Deployment of digital engagement tools for sponsors and, critically, intermediaries to enhance the reach of wholesalers and account managers

At a participant level, this includes:

- Easing the account consolidation process
- Churn models to target at-risk participants who are likely to move assets out of plan
- Mass-customized engagement models and solutions to deepen and eventually broaden the provider's relationship with the participant, particularly where the provider has retail wealth management capabilities
- Improving participation rates through plan feature modernization (for example, auto-enroll, auto-escalate, periodic reenrollments), particularly on legacy plans, and targeted outreach at critical points in the employee lifecycle

At both the sponsor and participant levels, retention should be given equal weighting to sales. Too often, providers are quick to ignore installed books in pursuit of the next sale.

Exhibit 5

To improve revenues, next generation capabilities are required.

At the advisor and sponsor level:	**Home-office engagement strategy** to ensure preferred access to distribution networks **Advisor targeting models** to enhance wholesaler productivity **Churn models** to maximize net sales by improving retention rates Deployment of **digital engagement tools** for sponsors and, critically, intermediaries to enhance the reach of wholesalers and account managers
At a participant level:	**Churn models to target at-risk participants** likely to move assets out of plan **Mass-customized engagement models** and solutions to deepen and eventually broaden the provider's relationship with the participant, particularly where the provider has retail wealth management capabilities **Plan feature modernization** (e.g., auto-enroll, auto-escalate, periodic reenrollments), particularly on legacy plans, and targeted outreach at critical points in the employee lifecycle

Source: McKinsey analysis

2. How can providers transform their cost structure while improving advisor, sponsor and participant experience?

Given rising customer expectations and continued pricing pressure, incremental actions to evolve the business will not be sufficient to drive a differentiated experience or support long-term profitability. Some providers might respond to this challenge by white-labeling recordkeeping, which cedes significant control to a third party. Others might pursue a roll-up strategy, which assumes the availability of targets and the ability to extract economies of scale in an industry with relatively few unalloyed success stories. A third approach recognizes that intermediary, sponsor, and participant experience at appropriate price points are critical battlegrounds for the industry. Winning on these battlegrounds requires a fundamental reworking of operating models and culture. It calls for a more significant transformation.

We see four flavors of transformation:

— Cost transformation: Many recordkeepers have launched enterprise cost-cutting programs, focused on reducing anywhere from 10 percent to 30 percent of the cost base. These transformations focus on all levers and often have high initial success rates, though sustaining the lift is often challenging.

— Customer experience transformation: CX transformations focus on redesigning end-to-end customer journeys and are typically aimed at achieving both cost reduction and improved customer experience. Variance in the success of CX transformations is high. We observe a 10-fold difference in CX capabilities between leading and lagging organizations. Successful CX transformations often require a combination of new ways of working, talent and capabilities, in addition to traditional change program excellence.

— Human capital transformation: Some organizations expect 30 to 50 percent of the talent in their organization to look very different in 10 years. We expect that recordkeepers will look more like data companies with close to half the workforce in IT, data, analytics, and digital roles, compared to less than 20 percent today. In order to achieve this kind of enterprise transformation, the CEO, CFO and CHRO often act as a triumvirate focused on human capital requirements to lead change.

— Next-generation operating model: "Next generation" operating model transformation entails the systematic integration of advanced analytics; end-to-end digitization; agile ways of working; robotics and automation; sourcing optimization; and lean management to

transform the business from inwardly-oriented, functionally-aligned operating models to externally-oriented, cross-functional models aligned against key customer journeys for intermediaries, sponsors, and participants, each of which is “owned” by a “product owner” who is responsible and empowered to drive business value. As companies transform, the product owner role emerges as a destination of choice for high-potential talent and an essential proving ground for future leaders.

Increasingly, we believe organizations need to incorporate elements of all four transformation models. Cost and CX transformations are no longer sufficient. In addition, a cultural shift is needed, and a recognition that the “product” that matters in an open-architecture world is not access to a specific fund or vehicle, but rather the experience for intermediaries, sponsors, and participants. For recordkeepers owned by asset managers or insurers, and therefore have historically viewed this market as a distribution channel, this shift can be tectonic.

3. How can recordkeepers acquire the requisite capabilities?

Embarking on this transformation requires firms to build new skills and capabilities and challenge conventions. It's not for the faint of heart. Those firms that are successful, however, will find themselves with a long-term, defensible cost structure and—more importantly—a culture that enables the business to respond more dynamically to changing market conditions and continuously improve to meet customer needs.

Making the journey will require investments in new capabilities ranging from analytical insights to digital marketing to automation. In this context, talent will emerge as the critical gating factor, as most providers lack the right skills in the requisite quantities to successfully transform. This gap is most pronounced in two areas. The first is related to next-generation operating model capabilities: digital, analytics, automation, and agile. Acquiring these skills will require an approach that balances (i) traditional talent acquisition methods, (ii) M&A for discrete capabilities, and (iii) partnerships for specific parts of the value chain (e.g., design firms, digital marketing boutiques). Organizations that pursue this three-pronged approach will be better positioned to more rapidly overcome the talent shortfalls they face today.

The second talent gap is in transformative leadership. The metaphor of changing the tires while speeding down the highway is fully applicable. There difference, however, is that this is a two- to three-year transformation for most providers, and not a one- or two-day road-trip. Given 70 percent of transformations fail to realize their intended outcomes, leadership will play arguably the most important role. Successfully executing transformations of this magnitude requires not only the will to transform, but the technical leadership skill do so.

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