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How COVID-19 is reshaping US defined-contribution recordkeeping

Three emergent trends arising from the impact of the pandemic will jointly increase pressure on the challenged profitability of US recordkeepers.

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The US market for retirement recordkeeping is facing strengthened headwinds attributable to the COVID-19 pandemic. The pandemic, which most significantly has shaken lives and livelihoods around the globe, also has accelerated the challenges already facing recordkeepers. Building on principles of long-term value creation in US retirement,¹ which we discussed in 2019 from the perspective of defined-contribution (DC) recordkeeping, the players in this market need to reflect on factors shaping the market, their long-term market position, and the need to pivot their business model to achieve profitable growth.

Factors shaping the DC market

COVID-19's long-term impacts on the US retirement sector remain uncertain. However, when we look at the months ahead, three implications are coming into focus: a modest reduction in net flows, changes to participant engagement, and shifting investor appetite for fixed-income products.

Resilient flows but gaps in usage. Despite broader market uncertainty, flows have been resilient. However, existing gaps in access and usage by lower-income employees and employees at smaller businesses widened in 2020.

- **Plan participants have stayed on track with contributions, particularly compared with the 2008–09 financial crisis, and CARES Act withdrawals have been limited.** In total, only 2 percent of participants stopped contributing to their DC plans in first half 2020—a moderate uptick from a year earlier.² Further, only 2.8 percent of participants made any type of withdrawal in first half 2020, marginally higher than a year earlier.³ Early data on second half 2020 withdrawals showed a continuation of this trend, with penalty-free withdrawals and

hardship withdrawals slightly higher than in past years. In total, 6 percent of participants made penalty-free withdrawals in 2020, of which 2 percent were hardship withdrawals. The main reason why the withdrawal rates were lower than expected was that the pandemic-related unemployment crisis largely affected lower-income workers from the service and hospitality sectors, most of whom lack access to traditional retirement-savings vehicles.

- **Employer contributions have been affected, but less than originally feared.** Eleven percent of employers suspended their 401(k) company match in Q2 2020,⁴ but micro and small plans were two to three times more likely than larger plans to do so. Early data suggest that the majority of plans have already reinstated or will reinstate their matching—a quicker reversal than occurred in 2008–10.⁵

Greater participant engagement. Participant engagement also has increased, with expected near-term surges during periods of market volatility and longer-term, steadier demand reported for holistic wealth advice.

- **During the market volatility of early spring 2020, recordkeepers reported that daily call volumes increased by 20 to 60 percent, as expected.** In response, one leading firm announced it was hiring 2,000 employees to support increased activity. Others reported offering more automated options (e.g., COVID-19 online resource centers) to give participants rapid self-serve answers and guidance.
- **Beyond transactional demand, recordkeepers saw a sustained increase in demand for holistic wealth advice.** Many firms have responded by offering financial-

¹Alex D'Amico, Jonathan Godsall, and Jimmy Zhao, "Long-term value creation in US retirement," McKinsey.com, August 8, 2019.

²Sarah Holden, Daniel Schrass, and Elena Barone Chism, *Defined contribution plan participants' activities, first half 2020*, Investment Company Institute, August 2020, ici.org.

³Ibid.

⁴Fidelity Q2 2020 retirement analysis, Fidelity, August 2020, fidelity.com.

⁵Anne Tergesen, "Many companies turn 401(k) retirement contributions back on," *Wall Street Journal*, December 3, 2020, wsj.com.

wellness programs or hiring dedicated advice teams with specialized knowledge to help participants navigate challenging financial decisions.

Shift to fixed-income products. In reaction to the significant market volatility in the first three quarters of 2020, investors shifted toward bond and stable-value products, moving away from traditional large-cap equities and target-date funds. In fact, according to Alight Solutions, allocations to fixed-income products—bonds, stable-value, and money market funds—dominated trading for the majority of 2020 (at 74 percent of days in the third quarter, for example). Stable-value accounts were particularly popular, ranking behind only bond funds.⁶

This shift raises two questions:

1. **Are participants maintaining this more defensive posture?** Early evidence from December 2020 flows shows bonds leading inflows (58 percent), with target-date funds and large US equity funds as the second and third leading inflow asset classes. Stable-value, money market, and company stock dominated the outflow asset classes.⁷ These trends suggest the asset allocation pendulum is swinging back but not yet at prior levels.
2. **Did those who rotated out of equities during the spring bear market miss out on the market rebound?** Given behavior patterns during previous market downturns, it is possible that many participants “sold low” and missed out on the second-half run-up in equity markets.

Path through 2021: Rising risks to recordkeeper margins

While these near-term impacts of the COVID-19 crisis on US retirement funds are modest if taken separately, together they will put further pressure on the challenged profitability of recordkeepers. Lower flows reduce revenues tied to plans’ asset balances. Increased participant demand

for guidance boosts operational expenses for firms with weak interactive voice-recognition capabilities or digital and self-serve channels. And any flows into stable-value funds (traditionally offered by insurance carriers to retirement participants) are offset by low interest rates and lower profitability for these proprietary funds.

Recordkeepers should use this opportunity to reconsider their long-term position in the record-keeping market. For firms that have not done so already, now is the time to explore branching out into adjacent revenue streams—for example, by offering HR-adjacent services or acquiring another firm to achieve greater economies of scale. More challenged firms may need to rethink their role in recordkeeping and look to exit, particularly in light of the robust valuations in the market.

How recordkeepers should react

Recordkeepers that decide to persist and grow should consider the following steps:

1. **Reconsider the value proposition to sponsors.** Distinctive firms will step up to increased demand for holistic advice. One path is to offer sponsors a unique, consultative experience and benefit design. Another is to offer participants an advice-led model that expands the traditional record-keeping role into that of a trusted retirement thought partner. Winners will take a page from leading B2B technology firms by incorporating best practices in customer success and focusing on experience and outcomes.
2. **Get ready for a rebound in sales activity.** Not surprisingly, many recordkeepers reported a decline in sales due to lower request for proposal volumes in 2020. The upside of this slowdown was a spike in retention. But in the second half of 2021 or whenever the economy stabilizes, a resurgence in RFP volumes could cause recordkeepers to gain or lose share based on their sales and retention capabilities.

⁶ “Alight Solutions 401(k) Index™: Third quarter 2020 observations,” Alight, alight.com.

⁷ Ibid.

3. ***Boost core profitability through advanced analytics, sponsor and participant segmentation, and a “participant as a client” strategy.***

With current employee accounts, recordkeepers can support margins by using advanced analytics to improve sponsor and employee segmentation and by repositioning resources to serve these segments' unique needs. Recordkeepers can also adopt a “participant as client” approach, developing strategies to support the lifetime value of relationships through job changes and retirement needs.

4. ***Make ruthless and radical choices about where to compete in the value chain and where to partner for an “ecosystem” approach.***

Record-keeping leaders will embrace partnerships and reconsider the noncore portions of their value proposition, all while embracing next-generation cost transformation. Some will partner to shift entirely away from parts of the record-keeping stack; others will accelerate digital programs to drive down cost to serve with chatbots, self-service portals, and internal process automation. To align with this ambition, recordkeepers should hire talent aligned with their strategy, whether it be managing recordkeeping processes or focusing on distinctive, front-end digital experience and servicing.

5. ***Reimagine the role of the workplace.*** As employees begin returning to offices, leading firms will reconsider the future role of the workplace. Potential new approaches include offering greater location flexibility, encouraging certain roles to work full- or part-time from

home, and downsizing offices to match reduced demand. Firms that get the right balance can emerge from the pandemic with a lower long-term cost structure and more flexible talent management.

End state for the US DC recordkeeping market

It appears likely that, as we described in our 2019 article, record keeping will continue to consolidate, squeezing out or rolling up marginal firms, which will leave the remaining competitors with greater scale and profitability and the ability to invest in improved participant and sponsor experiences. In fact, this scenario may take shape more quickly than we had expected.

Successful firms will offer sponsors a unique value proposition and take a “lifetime value” view of sponsor and participant relationships. They'll make tough but thoughtful decisions about where they fit best in the value chain and where they can partner. Further, as recordkeepers outsource portions of their operations to manage near-term cost pressures, middle- and back-office utilities will accelerate their consolidation of the recordkeeping profit pool.

Finally, most recordkeepers will need to choose between being an acquirer or being acquired. If the former, they must maximize deal value through industry best practices.⁸ Ultimately, the winners in DC recordkeeping will be the firms that reduce the costs of record-keeping basics through technology and scale and that innovate and broaden the value they offer plan participants and sponsors.

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⁸Alex D'Amico, Jonathan Godsall, Aditi Jain, and Nadiya Konstantynova, “From diligence to delivery: Capturing value from retirement record-keeping M&A,” McKinsey.com, April 10, 2019.