Reinventing the Pension Administrator Business

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The American occupational pension landscape has been transformed over the past decade by defined contribution plans. Heightened awareness about retirement savings, growing popularity of Internet trading, a wealth of investment information, and a rising sense of ownership of occupational defined contribution savings accounts, have all placed new service demands on American pension administrators. The growing pains and experiences by American pension administrators can benefit Scandinavian pension professionals as this region is also venturing full-speed into the defined contribution environment.

The American occupational pension landscape has been transformed over the past decade by defined contribution (DC) plans, also known as 401(k) plans. The number of employees participating in such plans has grown 260% since 1988 and 520% since 1984[1]. These plans allow employees to invest up to $10.500 (year 2000 limit) from their salary. The employer may also contribute to the plan, but the total contribution to an employee's account cannot exceed 25% of his or her annual pay and must be limited to $30.000 (year 2000 limit). The unique feature about American DC plans is the extent to which they rely on employee directed investments. The employer will offer several mutual funds and sometimes, individual stocks, but the employee is generally responsible for the asset allocation of the contributions.

The administration of employer sponsored DC plans generally includes the employer, a third-party administrator (TPA), a trust or other investment institution and a financial consultant who all serve as the entire retirement savings team.

This article will focus on the TPA and how the rapidly changing American pension landscape is forcing these administrators to innovate in order to stay alive in a fiercely compet-

[1] U.S. Department of Labor, Pension and Welfare Benefits Administration, 1999

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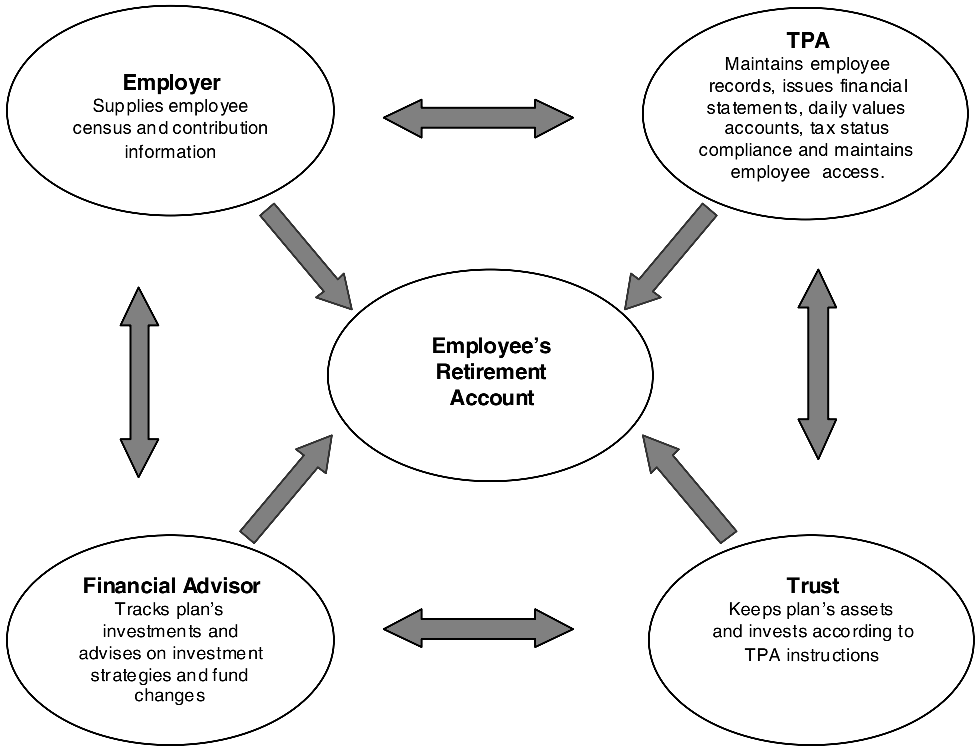


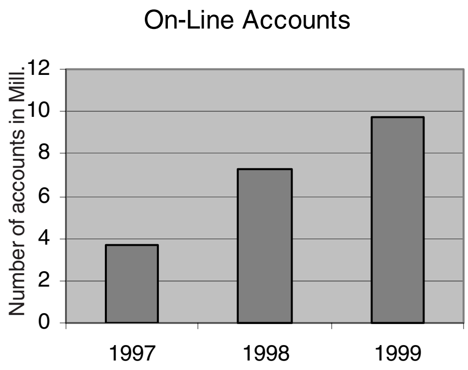
itive atmosphere. The growing pains and experiences by American pension administrators can benefit Scandinavian pension professionals as this region is also venturing full-speed into the DC environment. Sweden's introduction of "premiepension" only adds to the relevance of cross-Atlantic knowledge sharing.

Challenges To The Traditional TPA Role

The traditional TPA/client relationship was one where the administrator was virtually invisible to employees while performing the day-to-day management of the pension plan. DC plans were generally valued quarterly, semi-annually or even annually. Employee statements detailing the performance and activity of the accounts were often prepared six to eight weeks after the valuation date. Deadlines were relaxed and administration processes could normally be batched. Direct contact between the TPA and the employees were unheard of. Macro-management (focus on the plan as a whole) rather than micro-management (focus on individual accounts as part of the plan) was the dominant plan administration approach. Things have drastically changed just over the last five years.

The New Retirement Saver

The future financing challenge of the American national pension scheme, Social Security, has been well covered in the media. Americans are painfully aware of the need to save for their retirement. The savings method of choice in the U.S. is the stock market. As a result, brokerage firms and other investment institutions have a vested interest in pursuing the idea that Social Security will at best only provide a small supplementary retirement income. In addition to a well-performing stock market, instant information through the Internet has created an informed investor who is used to rapid trading and speedy results – two characteristics not easily compatible with the traditional TPA.



The above chart[2] shows the dramatic increase in the number of investment accounts traded via the Internet. These numbers do not include employer sponsored defined contribution plans, but do show the direction that American saving is taking. Most of the online investors are young and represent the new generation of retirement savers. In fact, 65% of Americans in their 20s and 30s are investing for their retirement while 19% of this age group have DC balances in excess of $50.000[3]. These are savers who feel comfortable with the ownership and individualism inherent in the American occupational DC plans, and these are the savers TPAs have to satisfy.

In this atmosphere of heightened awareness employees are paying much more attention to their quarterly (if not more frequent) pension statements. The bottom line is no longer the most important piece of information. Employees want to see fund and account performance, detailed and often itemized fee and dividend information and alternate investment strategies. If they have questions or concerns they want to be able to talk a knowledgeable pension representative – before and after regular working hours – who can take action. TPAs have to be able to deliver in order to stay in business. They have to move away from the traditionally passive, behind-the-scenes role and become dynamic organizations that answer to each individual plan participant.

John and Jill – Two Scenarios

Let's peek in on some retirement savings experiences by John Smith and Jill Jones, two informed investors who work for ABC Company. John holds assets in a bond fund, a U.S. stock fund as well as an international fund investing primarily in Europe. He has been pleased with his account's performance so far, but is concerned about the overvalued U.S. stock market. One weekend he decides to move half of his U.S. stock fund holdings into the bond fund. He reviews the literature he received from the TPA when he signed up for the plan and finds out that a transfer from one fund to another will be initiated the first business day after his request. On Sunday John logs on to his DC account and enters his request. He makes a note that he holds 1.500 shares in the U.S. stock fund. Monday night he logs on to one of the many websites that lists prices for mutual funds and individual stocks. Great! The price for the U.S. stock fund went up while the price for the bond fund went down. He picked a good day to transfer. Tuesday night he checks the prices again. This time the stock fund is down while the bond fund is up. Good thing he transferred on Monday! When John reviews his account later that Tuesday, however, he

[2] On-Line Brokerage: Keeping Apace of Cyperspace, *SEC*, 1999

[3] Retirement Confidence Survey, *Employee Benefits Research Institute*, October 16, 1999.

realizes that his transfer actually traded on Tuesday as opposed to Monday and that the one-day delay cost him $3.500. He calls the TPA to find out what happened. The customer service representative informs him that his transfer was held up because their transfer processor was out sick on Monday. John demands a detailed statement to be faxed to him so he can review his account. Already upset about the transfer delay, John is not happy to find out that the contribution that was taken from his paycheck two weeks ago has not been posted to his account yet. He decides to talk this over with his company human resource representative the very next day.

Meanwhile Jill decides to review her latest quarterly statement. Everything appears to be in order, but she is curious about the rate of return listed for the international fund she is investing in. She logs on to the fund manager's website to check its reported rate of return. It's 12.5%. She checks her statement again. Her actual return is only 10.2%. What could possibly account for such a difference? She makes a note in her day-planner to see her company human resource representative the very next day.

The ABC Company human resource staff is going to have a busy day, and the TPA will need to research the employees' questions and come up with satisfactory answers.

TPA Solutions

Internal Structure – Fordism Revisited

Traditionally TPAs often divided clients among teams of pension administrators. This allowed for a personal touch and a team that controlled all facets of a client's pension needs. Things have changed. Clients still want that personal touch, but in order to keep up with strict deadlines and maintain a high level of efficiency, other structural solutions had to be found. *Functionalization* has become the buzzword in the industry. A functionalized approach to processing is where one or a team of processors is responsible for one task, such as processing pension withdrawals or transfers. This does create a more monotonous work environment, but allows for a short training period, expertise building as well as efficient batch processing. A client manager is usually maintained to oversee the process as well as building the client relationship.

Functionalization also eases the burden of maintaining strict department procedures. In a team environment, each unit can easily become autonomous where exceptions to procedures are made. Strong procedures are essential in the current TPA environment. They help define service standards and set levels of expectations. Without such procedures a TPA runs the risk of high exposure and liability claims. Employees or employers may feel that deposits should be invested in the market the day the deposits are made. This may not be administratively possible for the TPA, but if this service standard is not communicated to the client, costly misunderstandings are bound to happen. In the example above, the TPA had communicated to John Smith that transfers would be started the very first business day after the request. The TPA did not meet their own service standard in John's case, and the administrator will most likely have to deposit $3.500 into John's account. Certainly, a TPA cannot afford a lot of mistakes like that.

Technology

With the introduction of Internet trading and a wealth of information available on the worldwide web, pension administrators face new technology demands. Employees want web access to their pension accounts 24 hours a day. They demand daily valued balances shown both in dollars and in shares. Employees may also conclude that they would be better off creating their own investment portfolio as opposed to investing in the mutual funds available in the plan. Some companies do allow their employees to direct their retirement savings to a portfolio created by the employee or by a broker independent of the plan's investment options. The TPA has to be able to handle such an investment strategy generally referred to as an *individually directed portfolio* (IDP). The TPA now has to keep track of not only the mutual funds selected by the plan, but literally hundreds of individual stocks and bonds. This might be too much for a traditional pension administration system structurally designed to handle only a limited number of funds. You may also be asked to daily value all assets held in an IDP. Suddenly you have a great data-gathering task on your hands. Even if the TPA can handle such an investment strategy, the trust may not. The four players in the American DC pension field listed above have to work together, and their relationship is only as strong as the weakest party.

Same-day trading is another recent phenomenon in the American defined contribution field. Daily valued plans are still a relatively recent development, and the process is improving rapidly. Internet trading has helped push the envelope. In a same-day trading environment employees are guaranteed the price listed at the current day's market close. If John Smith called in on Monday before the close of the stock market, his trade request would settle at Monday's price. Since mutual funds are valued only at the end of the day, John's trades have to be communicated to the trust sometime before the market opens Tuesday morning so the trades can be settled at the correct price. To accommodate such a process, firm pricing and trading agreements have to be developed between the TPA, the trust and the mutual fund. The TPA will have to build electronic links to the trusts and perhaps the mutual funds directly to accommodate the same-day trading process.

Being responsible for their own asset allocation is something many Americans are not comfortable with. Especially if they are dealing with savings that will in large part determine their retirement income level. That's where the plan's investment advisor comes in. They may be asked to define investment models or portfolios based on the plan's available funds. The idea is that the employee will only need to define the type of investor he or she is – ranging from conservative to aggressive. A conservative investor enjoys safer investments with lower yields while an aggressive investor is comfortable with more risk and looks to invest in stocks. The TPA takes this information and invests the employees' contributions according to the financial advisor's models. Most plans also allow employees to by-pass the models and invest in the available mutual funds as they see fit. The investment modeling idea is a concept that more and more employers are adopting. The TPA has to be ready. The pension administration software must be able to keep track of who is in what model and who has elected to invest on their own. In addition the TPA will be asked to rebalance employees' accounts on a regular schedule. The system must be able to handle the whole model process.

Personnel

As TPAs are changing from passive administrators to active members of the benefit provider system, their personnel mix also has to change. Plan participants want to be able to direct questions or concerns about their pension benefits to the people who work on their plan. Often a company human resource person is not equipped to handle such questions. For instance, the ABC Company human resource representative would not have the necessary records to answer John or Jill's questions. This is where a customer service call center comes in – a concept unheard of just a few years ago when TPAs shied away from all plan participant contact. Call center personnel must be able to answer questions ranging from web access problems to complex investment or taxation issues. A strong set of departmental procedures is once again crucial. Since many TPAs may not have a qualified investment advisor on staff, liability issues can easily come up should a call center representative attempt to give counsel on the various available mutual funds.

As mentioned above, a strong technology foundation is essential in the new TPA environment. With a sophisticated system comes the need for support. Just a few years ago, the company's general IT staff may have been sufficient to provide the necessary support. As web access is introduced, voice response systems are enhanced and more complex features are added to the administration software, a full-time support person will be needed to maintain the system. In addition, special programming may be needed to accommodate electronic trading links or automatic data transfers between payroll vendors, employers and TPAs. In John's example above, contributions may be invested much quicker if an electronic data transfer is built between the TPA and ABC Company's payroll vendor. Again, the liability exposure is reduced. Clients may also request an estimate of system down-times. If the actual down-time exceeds the estimate, the TPA will be asked to reduce their bill. A dedicated system support staff is well worth the investment.

TPAs may also find themselves manning their stations to well into the night and early morning. If the administrator has agreed to same-day trading, a night staff has to be available to generate, settle and send trades after the close of market. Even in a non-same-day trading environment, an early shift has to come in to receive trades that settled the previous day in order to update employees' accounts on a timely basis.

Conclusion

Heightened awareness about retirement savings, growing popularity of Internet trading, a wealth of investment information, and a rising sense of ownership of occupational DC savings accounts have all placed new service demands on American pension administrators. No longer can these TPAs take a passive role where the employer serves as the main client and plans are macro-managed. They have to cater to a new generation of sophisticated savers. Even though great information gaps about retirement savings exist in the U.S., the small, but growing percentage of employees who feel comfortable with the current DC pension style is forcing change among TPAs. In order to remain competitive in an industry where low price combined with a high service level reign, pension administrators must become active service providers who can micro-manage occupational defined contribution plans. This generally means investing heavily in new technology, changing the personnel mix and modifying business goals.