# Transparent or opaque – Charges in DC pension plans

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Charging methods may in some jurisdictions be constrained by legislation and by the form of pension plan permitted. In other jurisdictions it is a matter for the markets and for competition between providers. However, such competition may be constrained by the absence of adequate transparency and the difficulty faced by affiliates in understanding the impact of charges and choosing between alternative options. Industry spokespersons will usually point out that charges are only one part of the picture. Investment returns should be regarded as even more significant than charges. A higher charging level may repay itself to the member if the result is a significantly enhanced investment performance. However, high charges are in practice not necessarily correlated with superior investment performance.

## Alternative charging mechanisms

Charging mechanisms can be broadly classified into the following families:

1) Up-front charges
2) Regular charges based on contributions
3) Regular charges based on funds under management
4) Switching and inter-fund investment charges
5) Exit charges
6) Unit pricing charges
7) Annuitisation charges

Although the list of possible charging mechanisms is long, in practice only certain ones will apply in any particular case. However, the variety of possible mechanisms utilised by pension providers competing in a single market will make it all the more difficult for members to compare alternative offerings and to decide which might provide best value for money.

## Up-front charges

A charge may be made when first signing up to a new pension plan. This can be regarded as an entrance fee. The rationale is that there are significant administrative costs involved in admitting a new affiliate to a plan and that such costs are most appropriately covered by charging a fee, which would normally be a flat amount, as at that stage it may not be known at what level the individual will be contributing.

Regular charges based on contributions

This is a very common charging mechanism. However, it may take a number of different forms. There could be a fixed charge per month or each year to cover administrative costs of processing contributions. The charge may be expressed as a percentage of the contributions made to the plan or as a percentage of the salary subject to contributions – these two are broadly equivalent in their effect, depending of course on the percentages applied. It is relatively easy to see the impact of a charge assessed in this way, as it is clear that a fixed proportion of all the contributions is being taken as an expense charge and is not therefore available for investment. Equivalently the amount available at retirement can be expected to be reduced by a similar proportion. Charges may vary by duration of membership or according to salary level.

However, such charges may be expressed in less transparent ways by defining, for example, that only a specified percentage of contributions is to be invested in units, with that percentage varying by period (for example starting high and getting lower). A changing percentage deduction is less easy to understand than a fixed one. A presentation which implies that there is no charge deducted from contributions, but nevertheless the purchase of units in the investment fund is limited to a percentage of the contributions, may not be fully appreciated by the member.

A particularly opaque approach to the issue of allocation of units has been used by some insurance companies, whereby quite a low percentage of contributions is initially allocated to certain specific types of units in the fund (so-called capital or funded units), but additional units are allocated over time. This helps the insurance company to cover high initial expenditure and rewards affiliates who remain invested in the funds for a longer time. However, there was public and regulatory dissatisfaction with the lack of transparency of this and the practice has ceased in many markets.

There is also often a bid/offer spread on unit pricing, i.e. a different unit price is utilised for buying units as compared to selling units (i.e. in the allocation of contributions as compared to the determination of benefits). This will be discussed further under the heading of exit charges.

Regular charges based on funds under management

Another very typical charging structure is for the pension provider to be entitled to deduct each year (or at a correspondingly lower level on a monthly basis) a fixed percentage of the funds under management. The rationale for this is that it is a charge for the management of the investments. Normally the charge is fixed, although it could in principle be related to the investment performance. In just a few jurisdictions there are pension plans which have a charge defined in terms of the achieved investment return, or in some cases the real investment return (over and above price inflation). This type of charging structure could provide a real incentive for pension plan providers to improve investment performance, as otherwise their fee deductions will be highly constrained.

A charge of a percentage of funds under management corresponds to typical charging structures in mutual funds (unit trusts, UCITS, etc) and to charging mechanisms used for managing the investments of defined benefit pension plans, charitable endowments, etc.

This type of charge is in principle understandable to the pension plan member. However, what is not usually so well appreciated is what the overall impact of such a charge might be over the lifetime of investment in a plan. For example, a charge of 1% a year on the funds under management does not sound very much, but would reduce the accumulated amount over 40 years by almost a quarter. A 2% charge would reduce the accumulated amount by almost 40%. So for a charging structure of this type to give good value for money, the percentage charge needs to be quite small, e.g. 0.5% or less.

Switching and inter-fund charges

An obscure area of charging relates to what happens when an affiliate changes their investment allocation, as switching between funds may incur additional charges (either specifically as switching charges or through the impact of withdrawal charges (for which see a later section)). Some pension plans allow a modest level of free switching but charge for frequent switching, partly to discourage it and partly because there is obviously some administrative cost involved in putting into effect frequent instructions to move funds around.

Another problem area is the possibility of double-charging, since some funds into which the affiliate can choose to invest their funds may have a certain direct charging structure but may themselves be invested into other funds, which may also have charges. In such cases it is often quite difficult to establish the overall impact of charges throughout the aggregate structure.

Exit charges

The most common charge on exit is the bid/offer spread, already referred to in the section on charges related to contributions into the fund. It can be looked at from either perspective since it is a charge which results from paying money in and subsequently taking it out. However, a pension plan inevitably involves these two aspects!. The concept is simple, in that the price used to allocate units for a given amount of contributions (contributions divided by bid price equals number of units allocated) is higher than the price used to determine the value of units held at the time of exit (value of member's pension pot equals number of units multiplied by the offer price).

The rationale is that there are costs involved in buying and selling investments and that too small a bid/offer spread will result in the pension provider losing on every transaction. The argument is ratcheted up when the investments in the fund are less liquid than, for example, quoted equities (stocks) or highly liquid bonds, or when markets are changing rapidly. In such circumstances a predominance of sales can adversely affect the sale price and a predominance of purchases can force the price up. For less liquid asset classes the bid/offer spread may therefore be much higher and may depend on the market conditions and on whether there is buoyant allocation of contributions to the fund or a 'run

on the bank'. Where the bid/offer spread can vary significantly in this way, the impact on the member is likely to be unpredictable and potentially surprising. Where a fixed percentage bid/offer spread is used throughout (often 5% for equity funds) the impact is the same as a direct charge of that percentage on the contributions allocated to investment funds.

There might appear to be some possibility of overcharging in having a fixed percentage bid/offer spread in all circumstances, since, whilst the fund is growing, units sold by one member reaching retirement age, can usually be reallocated to another member who is making contributions, and the fund manager does not in practice have to sell any investments, just pocketing the bid/offer spread as a bonus contribution to profits.

Some funds apply bid/offer spreads even on switches between funds, which can penalise those who manage their investments actively. Others may allow inter-fund switches with a lower or with no bid/offer spread.

Unit pricing charges

Another area of possible obfuscation is in the pricing of units in funds. Apart from cash funds or deposits, where the investor may be allocated an absolute amount in the fund, collective investments typically operate by regarding the fund as divided into a number of units, with the price of the unit determined on a regular basis as the value of the investments held by the fund divided by the number of units that have been created. This sounds simple, but there is plenty of room for different practices. Many funds do not have daily dealing and so prices are only reset every few days (and in some cases as infrequently as once a month).

Values of the investments held may not be unambiguously defined, as the underlying investments can be valued on a variety of different bases (e.g. closing prices for the day, mid-market prices, bid prices, offer prices) and some investments do not have a market price available with the necessary frequency, so values on a particular date may need to be estimated. This is particularly problematic for funds of property investments, private equity investments, infrastructure and other investments which do not have a deep and liquid market with instantaneously determined prices.

Although unit pricing policies may be disclosed by a pension provider, it is a technical area and in practice there is often room for the unit pricing to be operated in a way designed to protect the pension provider – and consequently to have an undisclosed cost for the member.

Annuitisation charges

In principle the investment (accumulation or build-up) phase of a DC pension plan can be seen as quite distinct from the decumulation (or draw-down) phase, with the two phases often handled by entirely different entities. However, even where the entities are different, it is often not precluded that the companies could be related and form part of a group

ownership structure, in which case there is scope for using the annuitisation process to extract further value (i.e. impose additional charges) from the member.

Clearly there is a cost in setting up and administering a life-time annuity – and indeed there are considerable risks for the insurance company or annuity provider because of the danger of systemic mortality improvement resulting in pensions having to be paid out for longer and longer. Such costs do need to be priced into the annuity rates offered, but a properly competitive situation, where the member has the right to make a choice at retirement across the whole market of potential annuity providers, would act in such a way as to keep such charges at an economic level. What happens in many markets is that a true open market option does not exist – or is not encouraged – and members saving with a particular pension provider are channelled to convert their pension savings into an annuity with the related insurer or pension annuity company. This gives rise to the possibility of overcharging relative to a fully competitive open market option.

Transparency of charges and disclosure requirements

In practice only certain of the charges discussed above will apply in any particular case. However, unless a market is regulated in such a way as to insist on the same charging structure being used by all firms competing for pension savings, there is a risk, even a strong likelihood, that affiliates will find it difficult, or even impossible, to compare the charges imposed by competing providers. They will also find it difficult to get any real understanding of the overall impact of the charges on their ultimate pension.

These concerns can to some extent be alleviated, even in a market where pension providers are allowed to use different charging mechanisms, if regulators insist on full disclosure of charges in a transparent and comprehensible way. Particularly helpful is if the regulator insists on each pension provider illustrating the overall impact of all the charges by combining them into a single measure, although usually it will be necessary to have a matrix of measures in order to illustrate the impact in different situations. For example, the impact of certain types of charge (such as the percentage of funds under management) will be much greater on longer durations of membership and hence for affiliates who join at a relatively young age, than for shorter durations of membership (older joiners). Charges which are fixed in nominal terms rather than as percentages, or where is a ceiling – or threshold – in monetary terms, will have different impacts according to the level of remuneration on which pension contributions are being assessed.

There are two main overall measures which are usually considered for enforcing disclosure of the overall impact of charges. The first is to derive the percentage reduction in the sum available at normal retirement age. This might be more directly understandable as the roughly equivalent concept of the percentage reduction in the annuity resulting from annuitizing the accumulated savings at retirement age. However, it is often not mandatory to annuitise all of the savings, and annuity pricing is now becoming more sophisticated, which means that the annuity rates applied will differ according to the sum available for investment (because there is a correlation between larger sums available for investment

and greater longevity), so it is simpler to focus the pre- and post-charges comparison on the accumulated capital sum before any annuitisation takes place.

The second method is to derive what is known as a 'reduction in yield', If projections of the ultimate outcome of pensions saving throughout the career are made assuming a yield of 6%, say, making those projections without any charges would give a higher outcome than projections made allowing for all the charges. This can be re-expressed as being equivalent to a reduction in the assumed yield in going from the 'no charges' scenario to the 'with charges' scenario. This is a neat technical solution, resulting in the effect of charges being disclosed as a 'reduction in yield' of, let us say two percentage points (e.g. from 6% to 4%). It makes it possible to have consistent comparisons between pension providers with different charging structures and levels, but it is probably not particularly easy for the average affiliate to comprehend what this really means.

Case study – DC plan charges in the UK

Historically in the UK there have been no regulatory constraints on charging structures adopted by insurance companies or other DC pension vehicles. The first direct control over charges came with stakeholder pensions when they were introduced in 2001. Providers of stakeholder pensions can charge fees of up to 1½% of the funds under management each year for the first ten years, and thereafter up to 1%. No other charges are allowed. Employers are required to make a stakeholder pension available to all employees meeting certain criteria, but are not required to contribute to the pension.

Stakeholder pensions have not been a great success, since employers do not have to contribute and pension providers do not find the charging structure sufficiently attractive to make it worth their while marketing the product. However, the cap on charges for stakeholder pensions had a positive impact on charging levels for other pension products and charges generally came down significantly.

From October 2012 employers in the UK will have to auto-enrol eligible employees into a pension plan meeting the auto-enrolment (AE) requirements. Employers will have to contribute a minimum of 3% of relevant salary, employees will contribute a minimum of 4% and there will be tax relief on the employees' contributions, equivalent to adding at least a further 1% contribution. Individuals who are auto-enrolled will be permitted to opt out, but they will automatically be auto-enrolled again after three years, or if they change employers before that.

There are no restrictions on charges but the marketplace is likely to be much more competitive than for stakeholder pensions because of the auto-enrolment feature and the expectation that inertia will ensure that many more people will end up with a pension plan than is currently the case. The benchmark on charges has been set by NEST (National Employment Savings Trust), which is a not for profit corporation established by the government with a public service obligation to accept all potential employers as customers. NEST has said that it will charge 0.3% a year on funds under management and 1.8% of each contribution made.

This is a challenging level compared to insurance companies in this market, who will generally be charging of the order of 1% a year on funds under management as well as some charge on contributions made. However, insurance companies (and other commercial providers) are mostly interested in targeting middle to high earners and in providing a more sophisticated product which will be attractive to their target market. Competition is not only on price but on reputation and image, reliability, expectation of investment performance, administrative capability and support to employers for the auto-enrolment process, as well as track record. Moreover, it is known that insurance companies will negotiate more favourable charging structures with larger employers which have many higher paid employees.

Another competitor in the market is NOW: Pension Trustee Ltd, which is a master trust established by ATP, the social security organisation in Denmark. NOW: Pension charges 0.3% a year on funds under management (the same as NEST) and a contribution of £1.50 a month on contributions, which is reduced for low earners in the first few years whilst their pension pot is starting to build up (£0.30 a month for those earning under £18,000 a year for the first 5 years). There is no bid/offer spread or exit charge and, since there is a single investment fund offered, there are no switching charges.

Auto-enrolment provides a real opportunity for the UK DC pension market to improve on transparency of charging structures and communication to members about charges, as well as about the need to save more to provide an adequate income in retirement.

Conclusions

There is no doubt that charging structures in DC pensions have the potential to be very confusing and lacking in transparency for the typical member. What is regarded as standard practice in the insurance and pensions industries may be perceived by members of pension funds as difficult to understand and the full impact of charges probably does not register for most members.

Regulators can facilitate transparency by limiting the types of charging structures permitted and by publicising comparisons between pension providers using a comparable measure, such as reduction in yield or reduction in accumulated funds available at retirement age. Industry can help by adopting more transparent and understandable charging structures, with charges aligned as closely as possible to costs to reduce perverse incentives, and by making strenuous efforts to disclose the full impact of charges to their customers.

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