

TRANSPARENT OR OPAQUE? CHARGES IN DEFINED CONTRIBUTION PENSION PLANS

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ALTERNATIVE CHARGING MECHANISMS

Charging mechanisms can be categorised broadly into:

- up-front charges
- regular charges based on contributions
- regular charges based on funds under management
- switching and inter-fund investment charges
- exit charges
- unit-pricing charges
- annuitisation charges

ALTERNATIVE CHARGING MECHANISMS

Up-front charges:

- > signing-up charges
- > covering setting up administration
- > and possibly expenses of marketing
- > generally a flat cash amount

ALTERNATIVE CHARGING MECHANISMS

Regular charges based on contributions:

- > fixed charge per month (or year)
- > percentage of contributions to the plan
- > percentage of salary subject to contributions
- > may vary by length of contributing service or by salary
- > percentage of contributions not invested in units
- > ...with percentage perhaps varying with duration
- > capital units

ALTERNATIVE CHARGING MECHANISMS

Regular charges based on funds under management:

- fixed percentage of funds under management (FUM)
- payable monthly or annually
- charge which increases with better investment performance
- for example on real return over price increases
- note the onerous cumulative effect of such charges
- 1% a year on FUM could reduce pot by 25% over 40 years
- 2% could reduce it by almost 40%

ALTERNATIVE CHARGING MECHANISMS

Switching and inter-fund charges:

- > charges on switching investments between funds
- > charges on funds in which funds of funds are invested

ALTERNATIVE CHARGING MECHANISMS

Exit charges:

- > bid/offer spread
- > may be needed when funds are relatively illiquid
- > but in many cases a further source of income for manager
- > bid/offer spread may be waived on switching funds

ALTERNATIVE CHARGING MECHANISMS

Unit-pricing charges:

- > infrequent dealing
- > valuation issues for unit pricing
- > especially where there is no deep and liquid market

ALTERNATIVE CHARGING MECHANISMS

Annuitisation charges:

- > charges embedded in conversion to annuity
- > may be high when there is no open market option

TRANSPARENCY

Disclosure of charges:

- > full disclosure of all charges
- > composite measures of effect of charges on accumulation
- > percentage reduction in amount available at retirement
- > reduction in yield

Rise of defined contribution pension schemes

- many employers have replaced DB with DC schemes
 - ...many using same trust vehicle with new section
 - ...some using group personal pensions with insurance companies
- traditionally no regulation of charges
- stakeholder pensions changed this
- limit is 1½% of FUM each year for first ten years
- and thereafter up to 1%, with no other charges allowed
- although not successful as stakeholder pensions
- ...drove down charges in the market

TRANSPARENCY

NAPF initiative

- > industry-wide code of conduct proposed for UK
- > supported by Pensions Management Institute
- > emphasis on clear and transparent charges
- > hidden charges could do irreparable damage to industry

Auto-enrolment (workplace pensions)

- > auto-enrolment into individual accounts
- > being phased in over 4 years from October 2012
- > contributions on \$9,000 to \$68,000 p.a. earnings:
 - > 4% from employees
 - > 3% from employers
 - > 1% from tax relief
- > applies to all employed persons over 22 up to pension age
- > contribution requirement phased in over several years
- > employers collect contributions
- > auto-enrolment as soon as eligible

Auto-enrolment (workplace pensions)

- > individual can choose to opt out
- > re-autoenrolment after three years or on changing jobs
- > growing market place for autoenrolment options
 - > ...National Employment Savings Trust (NEST)
 - > ...various master trusts, including NOW: Pensions
 - > ...insurance companies
 - > ...eligible DB schemes

Auto-enrolment (workplace pensions)

- > NEST: 0.3% a year on FUM + 1.8% of each contribution
- > NOW: Pensions: 0.3% pa on FUM + £1.50 per month
- > Insurance companies: 1% a year on FUM + charge on contributions
- > ...possibility of negotiating lower charges on FUM
- > competition is not only on charges but also on
 - > investment performance
 - > choice of investment funds and life-styling options
 - > administrative support for auto-enrolment
 - > brand and reputation of providers

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