Transparent or opaque – Charges in DC pension plans

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Summary

This note discusses charging structures within defined contribution (DC) pension plans. The concept of a DC plan appears fairly straightforward and transparent, but the practice can be quite complex and opaque. There is scope for a wide range of charging practices and these may be more or less transparent and comprehensible to the plan member. Moreover, even where the charging mechanism is clear and transparent, the overall impact on pension accumulation is often not well understood – and, even if understood, the member may have little or no idea of the overall impact on his or her pension savings.

Charges may be levied on initiation of the contract, with each contribution, as a percentage of funds under management, or on exit. Less obvious charges may arise on switching investments, from the unit pricing methods employed and during the annuitisation process.

Concerns about the lack of transparency of charges 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.

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 and the second method is to derive what is known as a ‘reduction in yield’. This results in the effect of charges being disclosed in the same ‘currency’ as investment returns – of course as a negative item. 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.

The paper concludes with a brief resume of recent experience in the UK on charges for DC pension plans.