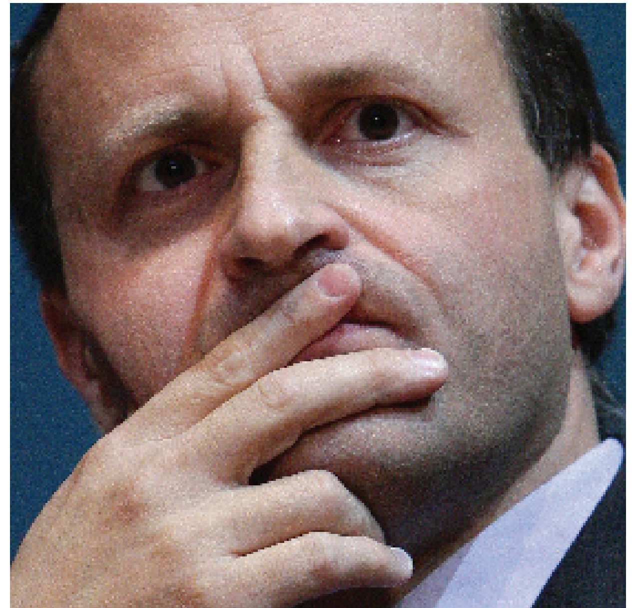
Untangling the pensions web we've woven



Bernard Casey & Noel Whiteside

A discussion on private pension costs is unlikely to pull in the crowds. Faced with the question 'do you think pension charges are too high?' most of us lose the will to live. Yet such charges are highly topical and have claimed much media attention recently.

Faced with a vast hole in the public finances, the Coalition is readdressing the financial issues incurred by the UK's ageing population. Higher pensionable age, already on the books, is to come on stream earlier, compulsory retirement is abolished. As long planned, auto-enrolment into a funded pension will be introduced next year. The basic message remains the same: the state cannot pay more. We must work longer and make private provision for old age.

Private provision, however, is not a free ride. A few weeks ago the *Financial Times' Money* supplement blazed the headline 'Pensions fail to justify charges', citing examples where charges ate up over 40 per cent of what a saver put away. Last December the *Daily Telegraph* carried an article 'Charges and fees cutting 50 per cent from British savers' pension pots'. The BBC's *Panorama* programme recently presented a particularly egregious example showing how a particular plan might 'take up to 80 per cent of contributions in fees'.

These are hardly headlines likely to encourage pension saving.

This problem is not new. The Pensions Commission's first report (2004) calculated that commercial charges could reduce the amount saved by the average contributor by between 20 and 30 per cent. If those on medium or low incomes are to be persuaded to save for their old age (and currently far too few do) they have to be offered a better deal than this.

So what causes the problem — why are charges so high?

The answer to this question is complex. Charges are, as the Pension Commission noted, firmly and negatively related to the size of a pension scheme. Even the state pension costs something to run. However, the state scheme is large and pension rights are standardised. Economies of scale kick in and running costs are comparatively low. For similar reasons, large occupational pension systems entail lower costs than small company schemes. Personal pension plans are the most expensive — so let us look at them first.

The Annual Management Charge (AMC), usually quoted as a percentage of assets under management, forms a central (but opaque) component of these costs. This covers expenses incurred by investments, company administration and so on. As the amount saved in a pension pot grows, so (in absolute terms) does the amount collected under the AMC (irrespective of fund performance). This form of charging hurts those who contribute in early life but who cease saving — as the annual levy is still extracted from their pension fund. A percentage charge on contributions is commonly made in addition to the AMC.

However, a quoted AMC may only be the tip of the iceberg. The Total Expense Ratio (TER) is the important bit, less frequently quoted than the AMC and even less transparent. Additional charges can be levied on early premiums to pay the seller's commission and more imposed if a client switches preferences between different portfolios offered by the insurance company. The personal pension that offers more choice over investments, over when to contribute (and how much) tends to incur higher charges.

To encourage personal savings, governments have subsidised pension plans (through tax relief or NIC rebates — although these are set to change) that meet particular criteria. In the mystical world of Self Invested Self Invested Personal Pensions, Approved Pension Plans and Stakeholder pensions, state subsidy means state regulation. State regulation incurs its own expenses: additional charges to cover legal fees, audit fees and regulatory fees.

The issue of charges is not confined, however, to personal pensions purchased by private individuals. Over the past decade, company schemes have abandoned Defined Benefit pensions based on a percentage of final salary. Outside the public sector, only about ten per cent of companies offer a Defined Benefit pension to new recruits. They are more likely to offer a Defined Contribution plan: each employee saves for what is essentially a personal pension.

As noted above, economies of scale remain significant: larger corporate Defined Contribution plans are cheaper to run than their smaller counterparts. From 2012, all employers, even small ones, are obliged to auto-enrol their employees in a funded pension scheme. Again the knotty problem of charges rears its ugly head.

So is government aware of the problem?

The short answer is 'yes' — and this has been true for years. Personal pensions cannot be officially endorsed while the media reveals how commercial charges eat into savings.

High charges and mis-selling scandals in the 1980s and 1990s created demands for tighter state controls. They also encouraged New Labour to create the Stakeholder pension in 2001, a personal pension whose charges were capped at one per cent AMC (subsequently raised, thanks to the financial services lobby, to 1.5 per cent for the first ten years of

contribution). Employers were instructed to designate a suitable provider for their employees.

The Stakeholder pension has not proved an overwhelming success. Other issues aside, the initial one per cent AMC neither covered the management costs of numerous small pension pots, nor paid for much needed financial advice for customers. Forcing charges down also reduced the number of companies prepared to market the product and, with this, Stakeholder's visibility for its target clientele

The Pensions Commission returned to the issue of charges in its first report in 2004. Noting how US Thrift Funds managed an AMC at 0.1 per cent, the second report (2005) declared it should be possible to run a national pensions savings scheme at 0.3 per cent AMC. Subsequent policy has been based on this principle.

Policy has also been influenced by Swedish experience of compulsory personal pensions, where the state plays a larger role. Compulsory contributions are collected by the Swedish Tax Authority, records are maintained by the Swedish Insurance Agency and contributory income is allocated by the Swedish Premium Pension Authority (PPM) between some

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700-800 different approved funds, according to contributor choice (although most today prefer the state-run default fund).

Charges on assets under management are set by individual fund managers, but PPM savers gain a part rebate. Thanks to competition from the state default fund, overall charges are kept low at about 0.45 per cent, comprising a 0.33 per cent AMC and a 0.12 per cent PPM charge.

Elsewhere (e.g. Germany, Chile various Central and Eastern European countries and Hong Kong), competition between private providers is assumed to reduce charges. As charges are opaque, competition generally proves an ineffective instrument to control costs. There is no single basis on which customers can make comparison. Pensions, particularly personal pensions, are not bought off the shelf, but are actively sold. How a product is marketed shapes what the consumer hears and the choice she makes. Hence the UK now relies more on caps than competition to keep charges in check.

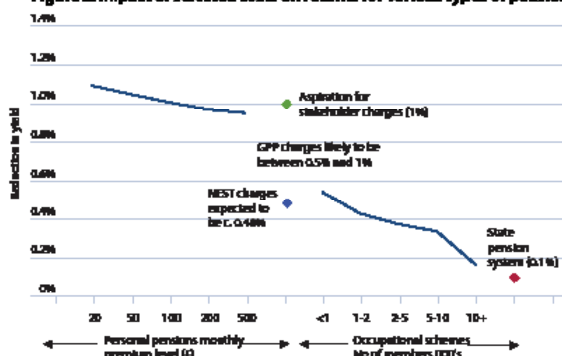
Figure 1 Comparative value of hypothetical funds built up from initial lump sum of £10k (assumes seven per cent nominal growth over 25 years)

Provider	*Protected fund value after 25 years (£)*	*Proportion of fund lost in fees (%)*
HSBC Life	32,172	41
Friends Provident stakeholder	40,209	26
"Low-cost" stakeholder *	42,215	22
"New" stakeholder **	40,131	26
NEST basic ***	48,123	11
Pension fund with no fees at all	54,274	0

* assumes charges of 1.0 per cent of assets under management
** assumes charges of 1.5 per cent of assets under management and 1.0 per cent thereafter
*** assumes charges of circa 0.48 per cent of assets under management

Source: *Financial Times Money Supplement*, 13 Feb 2011, and own calculations
Notes: This table underestimates the impact of charges as it is calculated on the basis of a one-off lump payment that grows over 25 years, not on regular monthly contributions for 25 years, the more normal way of accumulating pensions savings.

Figure 2: Impact of selected costs on returns for various types of pension



Source: First Report of the Pension Commission (Fig. 7.5) and authors' additions.
Personal pension data from FSA comparative tables; the line shown is the unweighted mean
Occupational pension data from GAD survey 1998
GPP estimates based on discussion with the industry

Notes: National Insurance Fund estimate is based on the assumed total value of accrued state pension rights and the estimated administration cost of the National Insurance fund. Reduction in Yield results from the price charged by the provider to cover costs of selling, administration and fund management. They do not include all charges but are the charges that pension plans are required to cite. They are not the same as, and are lower than, an effective charge on assets.

In the UK, following the Pensions Commission's recommendations, a new National Employment Savings Trust (NEST) will enrol all employers without pensions schemes (there are a fair few) into its pensions system from 2012. However, to meet the start-up costs of NEST and its predecessor (PADA), a 1.8 per cent charge on contributions has been added to the Pension Commission's 0.3 per cent charge on assets under management. This produces an AMC of approximately 0.48 per cent. Still, NEST offers a far lower charge premium than anything that has been seen in the UK to date, as *figure 1* shows.

Thanks to the low cap on charges, it initially seemed possible that no pension providers would come forward but the sheer size of the future market proved too tempting. Although some commentators suggested that, after other costs were added, the 'effective' AMC might reach 1.5 per cent, a member of NEST's staff assured one author 'unlike some providers, our quoted AMC and levy on contributions is our TER [Total Expense Ratio]'.

Figure 2 shows how NEST's projected costs compare with estimated charges levied by current state sponsored funded personal pensions and occupational schemes. Note how larger funds incur lower costs.

If the plan holds, then NEST represents a major achievement. It will have established a system half as expensive as Stakeholder and a quarter as expensive as the worst performer in *Money*'s list of high chargers.

That said, the triumph is not unmitigated. A cap of £4,200 contribution p.a. on annual incomes between £5,035 and £33,540 will help lower-income earners but leaves those who want to save more exposed to the risk of punitively high charges. Moreover, even within NEST, only 89p out of every £1 saved ends up in the pension pot. NEST pensions are cheaper than many alternatives, but still not as cheap as the employer-sponsored DB schemes that used to populate the UK pension landscape. Let alone the state pension scheme.

Choice is expensive. Despite what advocates of privatisation argue, it does not automatically offer better returns. Obtaining information is often difficult. Processing it can be even more difficult. As a recent OFGEM report noted, faced with some 340 different gas and electricity tariffs, only between five and ten per cent of customers try to shop around. Here, the regulator advocated 'sweeping away complex and unfair pricing practices'. Providers must pull their socks up or risk reference to the Competition Commission.

So what should government do about personal pensions?

Irons are already in the fire. The present regulator (Financial Services Authority) is being split up. From 2012, a new Financial Conduct Authority will operate with powers to oversee how financial institutions treat their customers.

This process looks unwieldy. Far better to revive one of the Pension Commission's forgotten recommendations; create a permanent body to oversee and report on private pensions, kite-marking good products, offering consumer guidance, monitoring how change in tax and charges affects pension outcomes. But that is a subject for another time.

Bernard Casey and Noel Whiteside work at Warwick University: both currently research on pension reform under the EU FP7 GUSTO programme: http://www.gusto-project.eu.