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Cost of running private pensions: focus on "Value for Money"

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Cost of running private pensions: focus on value for money

1. Introduction

1. The OECD Working Party on Private Pensions (WPPP) approved a project on the costs and charges in private pensions, "Analysis of Policy Measures to Contain Costs of Running Funded Private Pension Plans" (DAF/AS/PEN/WD(2016)2), at its meeting of December 2016. The first paper to be produced for this project, (DAF/AS/PEN/WD(2017)5) was discussed at the WPPP of June 2017. One of the conclusions of this paper was that "To ensure better outcomes for plan participants, policy measures must address value for money rather than costs alone."

2. Following this discussion, several delegates asked the Secretariat to analyse the issue of value for money more deeply and in particular to suggest ways in which value for money might be measured in defined benefit (DB) and defined contribution (DC) arrangements. Initially, we are confining ourselves to the accumulation phase.

3. "Value for money" is commonly taken to involve a combination of economy, efficiency and effectiveness. "Economy" refers to spending as little as possible on inputs to the system (the right quantity at the lowest cost), "efficiency" refers to the way those inputs transformed into outputs (getting the maximum output per unit of input) and "effectiveness" refers to whether this activity achieves its intended outcomes (the policy objective).[1]

4. In order to assess value for money, we therefore need firstly to understand the objectives of the pension arrangement and secondly to establish criteria to determine how well those objectives are being met. The objective of pension arrangements is to build pension assets. To do this, pension providers undertake administration and investment activities: they collect and invest pension contributions from employers and/or members. This report considers how the cost and quality of these activities might be evaluated in DB and DC arrangements.

5. Measuring the quality of DB pension activities is relatively straightforward. DB providers run single investment portfolios whose performance can be compared to an explicit target: to match long-term liabilities. Their administration services can also be benchmarked against quantitative criteria (e.g. accuracy, speed, number of complaints). Measuring the cost is more complex: investment costs in particular may not be treated consistently by different providers, or reported at all. Cost comparisons are only possible in jurisdictions where transparency requirements address indirect costs.[2]

6. Both quality and cost are harder to measure in DC pension arrangements. DC providers may offer a range of pension plans using different investment portfolios, resulting in different investment outcomes and costs. They may have additional goals such as providing financial education or encouraging members to engage with their pension plan that require qualitative as well as quantitative assessment. They have different

[1] See, for example, Glendinning (1998) or National Audit Office.

[2] As defined in [DAF/AS/PEN/WD(2017)5], "indirect costs" are subtracted directly from pension assets, rather than being invoiced to the plan or provider.

operating structures and charge fees to members that may or may not reflect underlying costs.

7. The value for money of individual pension arrangements, whether DB or DC, is influenced by the structure of the pension system in which they operate, for example how competitive the system is or whether there are regulatory constraints on their operating models. A number of delegates expressed interest in examining whether cost metrics or other measures of efficiency used in other regulated sectors might provide useful guidance for private pensions. This report provides an overview of different methods used for assessing and controlling "system" value for money in pensions and in other sectors.

8. The report does not attempt to quantify "good" value but it does aim to identify characteristics that indicate that systems and providers are delivering reasonable value for money and characteristics that are warning signs of poor value.

9. In general, good value is indicated by growth rates in pension assets that meet expectations, a high degree of transparency about administration and investment costs, benchmarking of the performance of pension providers in terms of their administration and investment activities, and incentives to improve performance. Poor value is more likely to occur when the bulk of fees paid by the plan to its suppliers or by the member to the plan are asset based, when fee levels do not decline as assets grow, and when there are many points at which fees can be extracted.

10. The structure of this report is as follows: Section 2 considers different methodologies for assessing and controlling value for money at the level of the system and outlines the approaches taken by Australia and New Zealand in evaluating efficiency in their pensions systems; Section 3 examines the drivers of value for money at the level of the pension provider, for DB and DC arrangements respectively; Section 4 looks at value for money within investment portfolios and the role of cost transparency in improving value for money; Section 5 concludes and makes a number of (tentative) policy recommendations.

11. Delegates are invited to consider different proposals for continuing this project "Analysis of Policy Measures to Contain Costs of Running Funded Private Pension Plans" (DAF/AS/PEN/WD(2016)2). Next steps could include several of the following lines of work:

- Extend the current analysis the drawdown phase to examine overall costs.
- Examine the different approaches to pricing regulation (e.g. tackling cumulative fees) that are proposed in this report.
- Agree on the more important cost items and/or other indicators of value for money to report across OECD countries and propose guidelines.
- Exercise following the outcome of an equivalent or standardised contribution in different jurisdictions or pension plans.
- Develop work on benchmarking and peer groups covering investment design and costs.
- Consider alternative reward structures for investment performance.

12. The Secretariat would like to thank delegates for the information about costs and disclosure that they have already provided and request further assistance in gathering data for the next steps of the project following the analysis contained in document DAF/AS/PEN/WD(2017)10.

2. System-level value for money

13. DAF/AS/PEN/WD(2017)5 highlighted the difficulty of assessing value for money in private pensions. Pension systems are likely to have multiple objectives that are a combination of quantitative – e.g. replacement ratios of retirement income to pre-retirement income – and qualitative – e.g. how well-equipped members are to make informed decisions. In addition, charging structures in pensions such as asset-based fees can make policies designed to control prices less effective.

Qualitative and quantitative indicators of value for money

14. Different jurisdictions have taken different approaches to assessing value for money and the efficiency of their pension systems, reflecting their varying objectives and structural characteristics. The examples of New Zealand, Australia and the UK are discussed below. In each case, low costs in themselves are not an objective of the system, but the relationship between contributions and assets is taken as an indicator of value for money, thus cost control is a measure of system efficiency.

15. New Zealand undertook a value-for-money evaluation of its KiwiSaver system in 2015, covering the period 2007-2014.[3] Australia has launched a similar investigation of its Superannuation system, focusing on competitiveness and efficiency.[4] Both are funded DC systems, however they have different objectives and this is reflected in the assessment criteria established in each case.

16. The primary legislative objectives of KiwiSaver are to

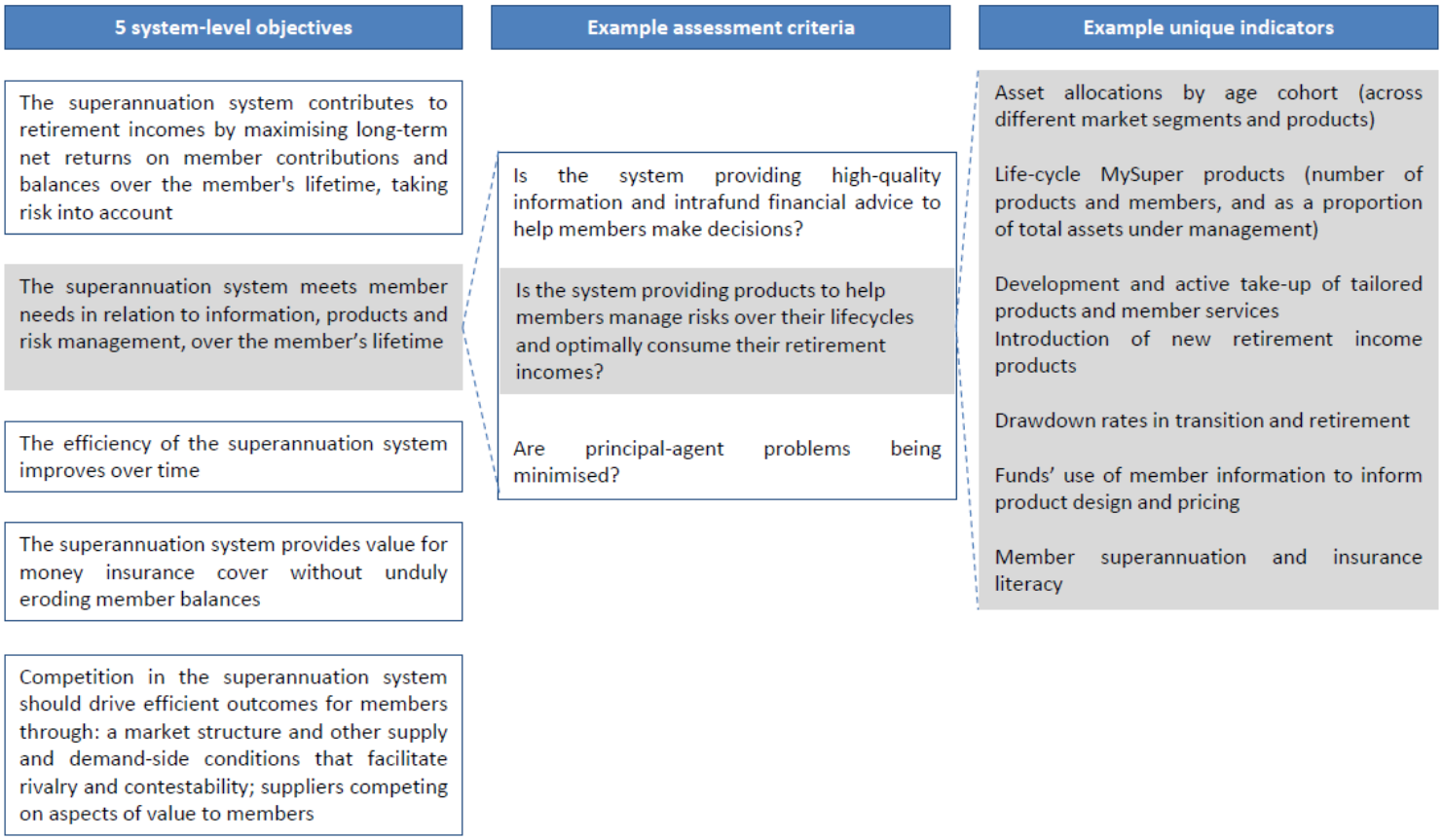
- "encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of retirement similar to those in pre-retirement
- increase individuals' wellbeing and financial independence, particularly in retirement, and to provide retirement benefits"[5]

17. The KiwiSaver review took a quantitative approach to assess whether the system had achieved its objectives,. It considered the proportion of the target population that was enrolled in KiwiSaver, the cost of the scheme per member of the target population and the additionality and leakage from the system (respectively, the extra savings made by the target population for every dollar of government cost, and the extent to which KiwiSaver benefits accrue to non-target populations). It found that KiwiSaver did not offer good value for money: for each dollar spent by the government on KiwSaver incentives, the target population saved only an additional 38 cents.

18. The Australian Government Productivity Commission developed a three-tier analytical framework for assessing competitiveness and efficiency in Superannuation. This was: defining system-level objectives; formulating high-level assessment criteria; and identifying more granular indicators of performance for each of the criteria. In all, 5 system-level objectives, 22 assessment criteria and 89 unique indicators were established. Figure 1 provides a sample. The unique indicators contain a wide range of qualitative and quantitative factors, however the Productivity Commission believes that only 17% of the data it needs is not already available.

[3] Inland Revenue (2015)
[4] Productivity Commission (2016)
[5] Inland Revenue, *op cit.*

Figure 1. Sample elements of Superannuation assessment framework



Source: Productivity Commission (2016)

19. DC trustees and boards in the UK have been required to report on value for money since 2016 although no common metrics have been established by the regulators there. The UK Pension Policy Institute (PPI) proposes three outcomes that together signify value for money in DC systems: the value of the pension pot, the security of the pension pot, and trust in the pension scheme.[6] The drivers of these positive outcomes are

- Contributions (pension pot value)
- Investment default approaches (pension pot value and security)
- Charges (pension pot value and trust in the pension scheme)
- Governance (security and trust)
- Administration (security and trust)

20. The PPI concludes that the level of contributions has the biggest impact on the value of the pension pot. The PPI also notes that while high charges erode returns, members may prefer a higher priced, lower volatility investment strategy to either a lower cost strategy or a higher risk strategy, depending on their risk tolerance and other sources of retirement income.

21. In each of these examples low costs are a primary driver of the efficiency with which contributions are transformed into pension assets. For a given investment strategy and administrative service, the lower the costs the better the outcome for members and sponsors. As noted by the Australian Government Productivity Commission, "The Commission acknowledges that fees need to be considered in tandem with other features that members value (such as returns and service quality). Nonetheless, examining trends in costs, fees and margins is an obvious and objective indicator of competitiveness."[7]

Charging structures and price regulation

22. Most regulatory effort to improve value for money has concentrated on reducing the operating costs of DB and DC pension providers and the fees charged to members of DC arrangements. Disclosure has been the primary regulatory focus in most jurisdictions. However cost transparency has been more effective in encouraging DB providers than DC providers to monitor and control their costs. Some form of pricing regulation for DC arrangements has therefore been introduced in a number of countries, for example low-cost plans in Australia, Canada, Estonia and Hong Kong (China) and charge caps in Chile, Sweden (Premium Pension System), Turkey and the UK.

23. Arguably, these efforts do not fully reflect the nature of pension charging structures, especially the impact of asset-based fees and cumulative charging. In every OECD country, total member reductions in DC pension plans contain an ad valorem component. That means that a percentage charge is applied to the assets under management. In some jurisdictions, such as Spain, an asset-based fee is the only charge that is permitted. In other countries, such as Denmark and Poland, a mixed fee structure is permitted with charges levied on both contributions and on assets under management. In Chile, fees paid by members are linked to contributions but external investment managers are rewarded on an ad valorem basis; these charges are deducted directly from the value of members' pension pots.

[6] PPI (2016)

[7] Productivity Commission (2016)

24. Asset-based fees provide few incentives for the supplier of a service to become more efficient or to share efficiency gains with his clients. They can reward poor performance and penalise good performance: a portfolio manager who generates returns of only 8% when the market rises by 10% will earn more in absolute terms, while a manager who returns -10% when the market falls by 50% will earn less in absolute terms, even though he has provided a much better service to his clients by limiting their losses.

25. Mexico's experience shows the limitations of price caps in the face of ad valorem fees. The average net profit margins of Mexican Pension Fund Providers (AFORES) rose from 33.5% in 2013 to 37.4% in 2017, despite pressure from the regulator, CONSAR, that pushed average fees down from 1.29% to 1.03% of assets under management over the same period. Assets under management grew rapidly, implying that the AFORES were reaping economies of scale, and the cost of acquiring new contributions fell (Table 1). CONSAR will therefore start implementing many elements of rate of return regulation, including taking into consideration factors such as net profit, return on equity and return on assets when considering fee proposals from the AFORES.

Table 1. Fees and margins in Mexican AFORES

(million Peso)	2013	2014	2015	2016	2017	CAGR
Assets under management	2,546,915	2,877,673	3,027,296	3,244,518	4,358,958	14.4%
Revenues (inflows)	18,102	18,744	20,123	20,876	22,345	5.4%
Affiliation and transfer costs	5,252	5,723	5,195	5,008	5,115	-0.7%
Total operating costs	7,612	8,247	7,963	8,165	8,756	3.6%
Net earnings	6,057	6,693	6,810	8,094	8,366	8.4%
Net margin (earnings/revenues)	33.5%	35.7%	33.8%	38.8%	37.4%	
Average fee (as % of assets under management)	1.29%	1.20%	1.11%	1.06%	1.03%	

Source: CONSAR

26. CONSAR also intends to introduce aspects of performance-based regulation, by taking into account historical investment performance, investment performance relative to a benchmark portfolio and how much AFORES are spending on activities that do not improve member outcomes, such as commercial expenses. As can be seen in Table 1, "Affiliation and transfer costs", which consist largely of sales commissions, make up around 60% of total operating costs.

27. Another feature of charging structures in pension systems – and one that is linked to ad valorem fees – is that consumers pay the same charge several times over. If an individual joins a pension scheme and pays in his first contribution at the age of 25, and withdraws his entire pension pot at the age of 65, fees will be paid on that first contribution 40 times. Fees will also be paid each year on the prior years' investment returns.

28. As shown in Table 2, just as early contributions to investment pots benefit from compounding returns, they can be penalised by compounding fees. According to our calculations, a 75 bp fee becomes an effective 26% charge on the initial contribution, as it reduces by 26% the overall pot that would otherwise result from a contribution of EUR 1 200 earning returns of 3% per annum over 40 years. There are of course costs associated with the ongoing safeguarding and investing of previously gathered assets, but it is likely that these costs will be lower than the costs of acquiring, administering and investing new contributions.

Table 2. Impact of charges on initial contribution

Assumptions: annual returns 3%, 40-year investment period

EUR	Fees 0%	Fees 0.075%	Fees 1.5%
Initial contribution	1 200	1 200	1 200
Cumulative charges on contribution	0	360	720
Cumulative investment return	2 714	2 268	1 906
Cumulative charges on investment return	0	211	248
Final value of contribution + returns – charges	3 914	2 897	2 139
% of initial contribution taken in fees		30%	60%
% of potential investment returns taken in fees		7.8%	9.1%
% of potential total pension pot taken in fees		26%	45%

Source: OECD calculations

29. In addition to existing measures designed to increase transparency and restrict fee levels, regulators might therefore consider policies that directly address the charging structure in pension products and the impact of cumulative fees. These could include asset-related declines in the charge cap or loyalty bonuses for long-term contributions, or introducing an element of fixed fees on a cost+ basis. If such measures were applied to pension providers, then they would have to impose similar discipline on their suppliers, especially external investment managers, who usually charge on an ad valorem basis.

30. Other types of price regulation could also be considered, borrowing from other regulated sectors where it is considered that competitive pressures are not strong enough to contain costs to consumers. Morris and Nicholls (2017) consider whether forms of price regulation that are used in the utilities sector are applicable to pensions: price cap regulation; rate of return regulation; performance-based regulation; franchise regulation; and benchmark regulation.

31. In the utility sector, ***price caps*** are designed to decline over time in order to share any efficiency gains with consumers. For example, the price that can be charged might decline by RPI-x where x takes into account the proportion of costs that is variable. As discussed in [DAF/AS/PEN/WD(2017)5], there is considerable evidence of economies of scale in private pensions. If the price cap does not reflect these economies, then members will not benefit from them and providers will not be forced to exploit opportunities to become more efficient. Costa Rica has introduced a declining fee cap that will drop from 1.1% to 0.35% of assets under management between 2011 and 2020. In Estonia, fees must be reduced by 10% for each EUR100 million increase in assets.

32. In other jurisdictions, caps are static. The maximum charge for default funds in the UK was set at 75 basis points (bp) in 2015 and will not be changed before 2018 at the earliest, by which time assets under management will have increased significantly – the government expects saving into workplace pensions to increase by over £14 billion annually by the 2019 tax year.[8] This jump in assets may well bring with it higher administration costs, as it will be driven in part by 1.8 million small employers joining the auto-enrolment system, but there are potential economies of scale in investment that could justify a reduction in the cap.

33. ***Rate of return*** regulation follows a "cost+" approach. Pricing is based on a reasonable cost of providing the service and a fair margin for providers. Both metrics can

[8] NAO (2015)

be difficult to establish for pensions. DB and DC pension offerings might be part of a larger financial services business, making it difficult to isolate costs, and service requirements vary considerably across private pensions. However there are some indicators that prices in pension systems exceed reasonable costs by quite some distance: operating margins in investment businesses are high relative to other sectors at around 24%,[9] and there is a long chain of intermediaries involved in pension provision that can both add cost and dilute responsibility for keeping costs under control.

34. Under ***franchise regulation***, a single regulated entity is awarded a monopoly for a given period. There are examples of this in parts of the pension market, for example in Sweden's funded public DC system AP7 is the monopoly provider of annuities although it competes with other providers during the accumulation phase; members reap scale and governance benefits from the collective nature of annuity provision. The winning bidder in Chile's auction system signs up all new affiliates for a period of two years. This should accelerate scale economies, encourage price competition and reduce "unproductive" spending on commercial activity.

35. ***Performance-based regulation*** establishes a required outcome and gives the regulated entities freedom in terms of delivering and charging for it. As discussed above, pension system objectives vary between jurisdictions and may be largely qualitative. However at the level of the individual provider, objectives are similar and the services provided are largely the same, so this type of regulation may be considered for private pension arrangements. The same is true for ***benchmark regulation***: in the case of natural monopolies this typically involves taking the cost of provision in another country as a reference, but internal benchmarks may be found for DB and DC pension providers within a national system.

3. Provider-level value for money in DB and DC private pensions

36. DB and DC pension providers have the same objective: to build pension assets. They carry out the same basic activities, administration and investment, in order to achieve this objective. Pension providers that are offering good value for money will be delivering high quality administration and investment services at a low cost to members and sponsors.

37. To determine whether a pension arrangement is good value, therefore, it is necessary to measure the cost and quality of the different activities and compare them to a relevant reference point or benchmark. The benchmark must reflect the differences between pension plans in terms of membership structure and investment strategy, since these have a significant impact on costs.

38. Both gathering the information on cost and quality and determining a suitable benchmark is easier to do for DB providers than for DC. DB arrangements are usually standalone structures with an identifiable peer group. DC pensions are likely to be operationally more complex than DB and to offer a more varied range of activities, so comparisons are more difficult. However, default funds or a proxy default portfolio could provide an appropriate reference.

39. For both DB and DC pensions, getting a full picture of investment costs is challenging. Net portfolio returns (i.e. including all direct and indirect costs) provide a reasonable assessment of the quality of a provider's investment activities. However,

[9] Source : McKinsey, June 2015

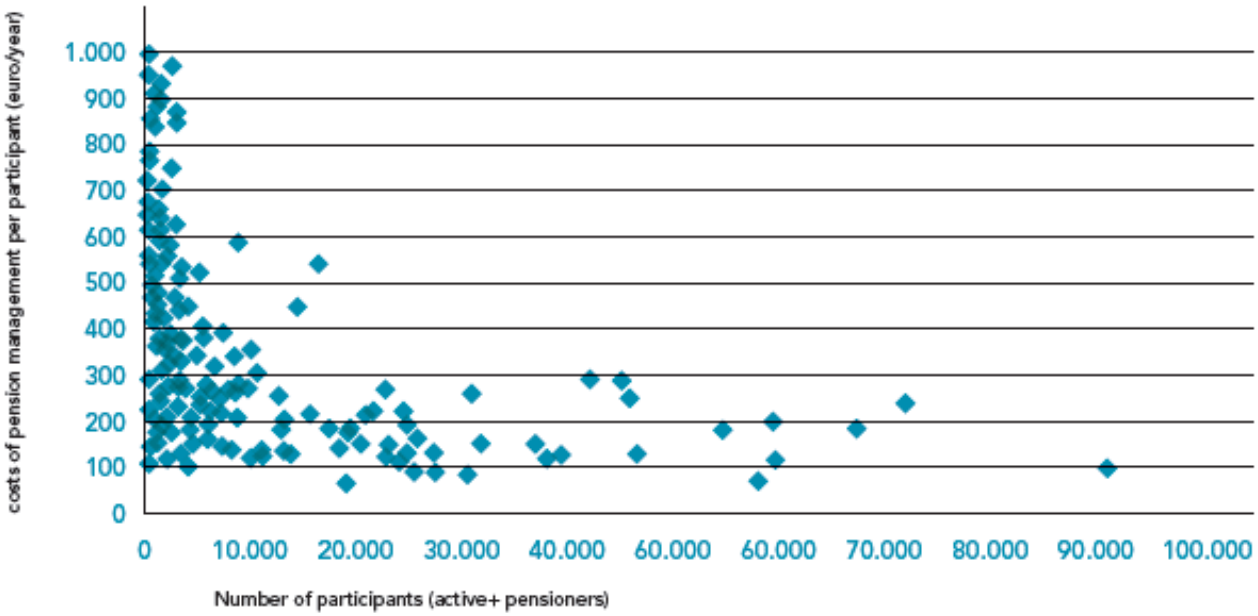
without more detail on what caused the difference between gross and net returns, it is impossible to know whether the provider could have achieved the same investment outcome at a lower cost or a better investment outcome for a marginally higher cost.

Defined benefit

40. Value for money is relatively straightforward to assess in DB arrangements. DB providers have a clear target: to grow assets so that they meet future liabilities. Administration costs can be identified and the quality of administration services can be judged using largely quantitative criteria. Net portfolio returns give an indication of the quality and cost of the investment strategy and can be compared to market returns for equivalent asset classes. Absolute levels of cost and quality will vary across plans, but comparisons can be made across providers with similar activities.

41. Administration costs are largely driven by the size of the plan, as shown in Figure 2; larger plans are likely to deliver better value for money in terms of IT, oversight, communication, collections and payments. Administration service levels can be measured through metrics such as response time and error rates. Administration costs also depend on the service requirements of the plan members, e.g. whether the plan is still open to accruals, the volume and complexity of members' queries, or the types of communication needed.

Figure 2. Administrative costs of pension management per participant relative to total participant numbers in the Netherlands



Note: Excludes pension funds with > 100 000 participants, all such funds had administrative costs below EUR120 per participant per year.
Source: PF (2016)

42. Investment costs are driven by the investment strategy – the choice of asset classes in the portfolio, which may itself depend on the solvency requirements of the fund – and the implementation style – passive or active management and the use of external or

internal managers. Table 3 shows the fees charged by external managers to different types of US institutional investor in a range of asset classes. It can be seen that bigger investors pay less than smaller investors in every case, however as discussed in [DAF/AS/PEN/WD(2017)5], larger pension funds tend to have higher allocations to more expensive asset classes such as hedge funds and private equity. Bigger funds may therefore have higher investment costs than smaller funds, in expectation of superior risk-adjusted returns – investment costs should not be considered in isolation from investment performance.

Table 3. Fees by asset class and US investor type

%	Small Endowment	State Pension Fund	Quality Foundation
US TIPS	0.27	0.15	0.16
US high yield	0.50	0.34	0.42
EM government bonds	0.60	0.45	0.49
US small cap	0.84	0.30	0.35
EM equity	0.95	0.28	0.42
Private equity	1.00	0.89	0.56
Real estate	0.76	0.50	0.41
REITs	0.75	0.43	0.51
Diversified hedge fund	1.63	1.33	0.89
Event-driven hedge fund	1.67	1.35	0.89
Macro hedge fund	1.70	1.41	0.95

Note: EM = emerging markets; REIT = real estate investment trust.
Source: Jennings & Payne (2016)

43. To determine whether a higher cost plan nevertheless represents good value for money, it should be compared to an appropriate benchmark or reference point. The most useful benchmark is the peer group: administration costs can be compared on a per capita or per transaction basis to pension plans with a similar membership profile; investment costs and returns can be compared to plans with a similar investment strategy. A provider who achieves a similar outcome at a lower cost than the peer group is delivering better value for money.

44. "Better" value for money does not, however, necessarily mean "good" value for money, especially when considering investment costs. Net investment returns reflect total costs, so comparing investment performance indirectly also measures costs – the lower the cost, the higher the net return. However, without granular data on direct and indirect investment costs, it is impossible to know the total cost paid by each provider. Providers may be paying external managers different rates for similar investment mandates, or be receiving different service levels from other intermediaries such as brokers. Ultimately, net portfolio returns are the critical determinant of whether a DB plan will achieve its investment objective, but they do not by themselves indicate value for money.

45. Although many DB providers issue annual financial statements and other reports that include data about their cost structures and investment portfolios, few countries require them to provide detailed cost breakdowns. Table 4 shows the information revealed in the financial statements of four large occupational DB plans and one public fund. There is a wide range in both the level of costs and in the degree of detail provided, making comparisons difficult even between plans with relatively similar portfolios.

Table 4. Cost comparisons in DB plans

	BT Pension Scheme (UK)	RBS Group Pension Funds (UK)	ABP (NLD)	PMT (NLD)	New Zealand Superannuation Fund (NZ)
Assets under management (AuM)	GBP 46.1 bn	GBP 45.3 bn	EUR 381.8 bn	EUR 68.2 bn	NZD 30.1 bn
Asset allocation:[1]					
Equity	25.6%	19.3%	31.7%	19.3%	39.3%
Bills and bonds	39.5%	52.9%	35.6%	45.9%	20.2%
Cash and deposits	5.6%	3.6%	-	3.6%	7.1%
Alternative investments	16.0%	19.6%	11.6%	19.6%	29.2%
Property	11.3%	3.8%	11.5%	3.8%	0.0%
Other	2.1%	0.9%	9.5%	0.9%	4.2%
Administration expenses as % of AuM	10 bp	4 bp	4 bp	10 bp	12 bp
Investment management expenses as % of AuM:					
Direct only	19 bp	15 bp	10 bp	16.5 bp	29 bp
Total	Not available	Not available	60.9 bp	47.8 bp	35.6 bp
Direct transaction costs as % of AuM	2 bp	2 bp	5 bp	8 bp	Not available
Equity transaction costs as % of AuM[2]	0.6 bp	2.2 bp	1.4 bp	Not available	Not available

Note: 1: reconciled to GPS classifications except ABP where no breakdown available for collective investment schemes; 2: for BT and RBS, mid-range of current and previous year's AuM
Source: Annual reports

46. It follows that an indicator that DB providers are more likely to be delivering good value for money is that they are transparent about their costs and that they are able (or required) to benchmark the cost and performance of their administration and investment activities against relevant peers. If there is an incentive to improve relative performance – or a sanction for being at the bottom of the range – then it is even more likely that pension providers will deliver good and improving value.

47. In the Netherlands, both transparency and benchmarking are enforced by the supervisor. Pension plans are required to explain deviations from the cost structure of the peer group. The average investment costs for all pension funds in the Netherlands in 2015 were 58.5bp; administration services for members (i.e. excluding the costs of governance and oversight of the plan) cost a further 7.5 bp; total costs across all funds ranged from 15 bp to 200bp.[10]

48. In Switzerland, pension funds have been required to report their Total Expense Ratio (TER) in their annual reports since 2013;[11] in that year they were also obliged to collect TER data from underlying vehicles in which they were invested and publish a blacklist of those who did not comply. The Swiss supervisor, OAK, is expected to publish comparative data on more than 2 000 pension funds in the near future.

49. Members of DB schemes do not bear scheme costs directly, but indirectly through the parameters of the fund. It is nevertheless important for the sustainability of DB schemes to control costs. In 2011 the Netherlands Authority for Financial Markets calculated that a 25 bp reduction in costs would lead to a 7.5% increase in the assets in the collective pension system over 40 years. Members of DC schemes bear all of the costs of running and administering the schemes (except for employer charges where relevant).

Defined contribution

50. In principle, value for money in DC pensions can be evaluated in the same way as value for money in DB pensions: members receive a satisfactory level of service and their assets grow at the rate they expect. However the element of choice within DC arrangements (that does not exist in mandatory DB plans) makes it is more difficult to assess and benchmark DC providers. Members may choose between different investment strategies and require different levels of administrative support. This means that a wide range of DC outcomes is possible, making it complicated to construct peer groups. Implementing DC arrangements is also likely to involve intermediaries between the provider and the member.

51. Administration activity is likely to be more expensive within workplace DC plans than in DB plans. DC administrators handle large volumes of small inflows; they may also incur additional costs such as the need to provide middleware (connecting their IT systems to employers' payrolls) or to offer transfer services to members when they change employers.

52. DC providers may also have to invest more in communications designed to build member engagement, to help members make choices about their pension arrangements or to encourage them to contribute more. (An alternative to such expenditure that would be

[10] Source: CEM Benchmarking

[11] The TER includes explicit investment costs that are deducted directly from members' assets and some administration costs

more effective and lower cost would be to make auto-escalation compulsory, so that individuals' contributions increased automatically in line with their earnings). Measuring the quality of DC administration may therefore involve more qualitative assessments.

53. Investment costs within DC, as in DB, will depend to a large extent on the underlying investment strategy. In order to assess value for money in DC investment, it is therefore important to analyse the design of the investment strategy and its suitability for the membership of the scheme, as well as the cost of implementing the strategy. In contrast to DB schemes, where a single investment strategy is developed to meet a specific goal (matching liabilities), "good" design in DC depends on the risk tolerances, income requirements and other characteristics of individual members.

54. DC providers may offer more than one investment strategy to fit different investor profiles (e.g. from risk-averse to risk-taking) or they may construct a single portfolio to cover all members. Where members are allowed to choose between different strategies offered by their provider or to build their own asset allocation from a range of underlying investment options, they could have widely differing investment outcomes in terms of returns, risks and costs (Table 5).

Table 5. Conoco Phillips Savings Plan Investment Options, Performance and Expenses

Sample of funds available within 401k plan

Fund name	Expenses	Average annual total return		Beta	Benchmark
	% of assets	1 year	5 years		
Short-term reserves					
Stable Value Fund	0.32 %	2.28 %	2.16 %	n.a.	Bloomberg Barclays US 3-month Treasury Bellwether Index
Vanguard Prime Money Market Adm	0.1	0.98	0.33	n.a.	Money Market Funds Average
Bond funds					
PIMCO Total Return Institutional	0.51	2.8	2.31	0.98	Bloomberg Barclays US Agg Bond TR USD
Vanguard Inflation-Protected Securities Institutional	0.07	-0.18	-0.1	1.04	Bloomberg Barclays US TIPS Index
Balanced Funds (stocks and bonds)					
Target Retire Income Tr P	0.06	7.36	4.97	0.99	Target Retirement Income Composite Index
Vanguard Balanced Index Fund Inst	0.06	14.18	9.8	1	Balanced Composite Index
Domestic Stock Funds					
Vanguard Extended Mkt Index Inst	0.06	20.55	14.85	1	Spliced Extended Market Index
Vanguard PRIMECAP Fund Admiral	0.33	31.03	19.38	1.04	S&P 500 Index
Vanguard Small-Cap Growth Idx Inst	0.06	26.55	13.84	1	Spliced Small Cap Growth Index
Vanguard Windsor II Fund Adm	0.25	19.68	12.62	1	Russell 1000 Value Index
International Stock Funds					
Vanguard International Growth Adm	0.33	35.41	11.92	1.10	Spliced International Index
Vanguard Total Intl Stock Ix Inst Pl	0.07	23.80	7.82	0.95	Spliced Total International Stock Index

Note: Returns are net of fees. Beta is volatility relative to the associated benchmark, calculated from trailing 36-month returns relative to the benchmark. "Spliced" refers to time-series that have been linked.
Source: Vanguard ConocoPhillips Savings Plan.

55. DC pensions may also have extra layers of cost that are related to the way a plan is structured or sold. It can be difficult to determine whether these layers add value for members.

56. Sales and marketing activity can add cost to a plan that is ultimately paid by members. These costs may be indirect, for example commissions paid to advisors that come out of contributions, or they may be direct as in Mexico and Poland, where they are counted as operating costs of the provider. Table 6 shows the cost of acquiring new business in Poland from 2008 to 2016 and the impact on operating costs of Pension Societies (PTE) when sales activity was banned from 2012. Notably, PTE did not return the savings from reduced sales activity to members; instead they enjoyed an increase in operating margins.

Table 6. Costs of client acquisition and marketing of Polish PTE

	2008	2010	2012	2014	2016	Q2 2017
Acquisition costs (PLN million)	368.0	464.4	121.5	109.8	30.0	14.6
As proportion of operating costs	35.1%	37.6%	16.8%	14.7%	6.9%	5.8%
Operating margin	41.0%	32.3%	51.8%	61.2%	52.1%	49.1%
Number of client transfers	451 677	603 508	107 011	24 759	2 286	258

Note: A ban on acquisitions was introduced in 2011, effective 2012. Operating margins affected by other system reforms from 2016.
Source: OECD calculations based on quarterly bulletin of KNF

57. Where a pension plan includes an investment strategy set by the provider and executed via underlying investment vehicles selected by the provider, members may pay entry or exit fees to the underlying vehicles. This is because the plan has to adjust its holdings in the underlying vehicles when members make contributions or withdraw their assets. Entry and exit costs are implicit – they come out of the value of the member's portfolio – and can be hard to measure.

58. The UK Department for Work and Pensions found that among 14 providers handling 14.4 million pension pots, two were unable to say whether they applied entry costs, six applied entry costs but were unable to say what they amounted to, four did not apply entry costs and two applied entry costs that amounted to a reduction of between 5 bp and 40 bp per contribution. Providers also said that they found it hard to get clear information on entry and exit costs from the managers of the underlying vehicles.[12]

59. Alternatively, a plan may leave the design of the investment strategy to the member and offer a choice of underlying vehicles through its investment platform. In addition to any entry or exit fees, the member may then also pay platform fees to the provider. The platform provides a service (choice, customisation and easier implementation) but it may be hard to understand what members are paying for this service and what it is really worth. Sweden's PPM clearinghouse illustrates the potential for platforms to negotiate lower charges on behalf of members: total investment costs including transaction costs for funds on the platform were 30 bp in 2015, down from 37 bp in 2012; exit costs are not permitted.[13]

60. In general, the more intermediaries there are standing between a member's contributions and the investment return on that contribution, the higher the risk that value for money will be reduced. Each actor in the chain has to be rewarded, through a commission or a mark-up, but the level of the reward may be out of proportion to the

[12] DWP (2017)

[13] Source : PPM Orange Report 2015

service provided, especially where costs are hidden. Furthermore, intermediaries may not be incentivised to keep their charges low, if they are not scrutinised by pension providers or if they do not have any fiduciary obligations towards the ultimate beneficiaries of a plan.

61. In addition to transparency and benchmarking of administration and investment activities, therefore, an indicator of value for money in DC arrangements is that the intermediary chain is short, there is transparency around the cost of intermediary services, and intermediaries have a responsibility towards members that is equivalent to a fiduciary duty.

62. Establishing peer groups for DC providers is therefore complicated: there may be significant differences between the administration and investment costs and outcomes of different DC plans, depending on the characteristics of the membership, the types of service offered and the operating structure. Moreover, once peer groups are established they may lead to herding behaviour among providers, limiting competition, performance dispersion and thus choice of outcomes for members.

63. A potential solution is to use default funds as a reference point for DC plans. Default funds are intended to provide an investment strategy that is suitable for the majority of DC members, which limits the design options. They are usually required to be low cost. Harrison et al. (2014) find that "The key features of a scheme's value for money are the design and cost of the default asset allocation strategy, plus scheme costs, such as administration, marketing" and suggest that 50 bp is a reasonable TER for a default fund operating at scale.

64. Not all pension systems include a single default fund. Countries may have a number of competing default funds offered by different providers, or no default option. Other, similar types of pension plan could serve as reference point, such as the lifecycle funds that are offered by the Thrift Savings Plan in the US. Alternatively, a proxy portfolio that follows the principles of a default option could be constructed as the basis for comparing the investment design and cost of actual DC arrangements (it would not, however, give information about administration activity).

65. This argument is supported by the characteristics of existing default fund investment strategies. Table 7 shows the investment strategy and fees for selected default funds in different jurisdictions. There is considerable similarity between the investment designs – all include a form of de-risking as the member approaches retirement age – implying that a representative proxy portfolio could be built. Fees vary from a minimum of 6 bp (Sweden) to a maximum of 95 bp (Hong Kong (China)). Return targets and investment performance also differ between the funds.

Table 7. Cost comparison across default funds

	NEST Retirement Date Funds (UK)	LGIM Multi Asset (UK)	Fidelity Freedom Funds (US)	MySuper – Industry level (AUS)	AP 7 Safa (Sweden)	DIS – industry level (HK-China)
AuM	GBP 1.7 bn	GBP 6.3 bn	USD 175 bn	AUD 474 bn	SEK 328 bn	HKD 15.4 bn
Investment strategy	Target date	Multi-asset with option to switch into lifecycle for drawdown	High return-seeking up to retirement date, then de-risking	Lifecycle and single strategy	Lifecycle	Lifecycle
Return target	CPI + 3% Volatility target for each stage of lifecycle	Benchmark mixed asset portfolio	Benchmark Morningstar Target Date	CPI over 10 years	Average return of private sector PPM funds	Market indices for each of bond and equity components
Returns (5-year annualised)	Range 1.9% - 11.4%	9.6%	Range 4.7% -11.3%	6.6%	19.5%	n.a.
Fees						
- asset-based	3 bp	50 bp	62-75 bp	49 bp	11bp in growth phase reducing to 6 bp at age 75	75 bp investment management
- other	180 bp per contribution	-	-	AUD 87 annual administration fee per member*	-	20 bp recurrent operating expenses
Total as % of AuM	50 bp	50 bp	62-75 bp	≅50 bp	6-11 bp	95 bp
Direct transaction costs as % AuM	Range 0-4.9 bp	Range 4-8 bp	n.a.	n.a.	n.a.	n.a.

Note: excludes one-off fees e.g. entry/exit, switching fees
Source: Morningstar 2017, Annual Reports, APRA, Orange Report 2016

66. Some of the funds in Table 7 have a dual charging structure with an asset-based fee to cover investment costs plus a flat or contribution-based fee for administration activities. Dual charging structures increase the effective charge on members who leave the fund after a short period but they can be appropriate for default funds, which are likely to have higher administration costs. Rice Warner (2014) found that the introduction of MySuper products in Australia led to additional compliance, product design and systems costs that were passed on through higher monthly fees; these partly offset the reduction in asset-based fees that resulted from their simpler investment design.

67. The fact that funds with very similar investment designs can achieve such different outcomes and charge such a wide range of fees underlines the difficulty of making value for money assessments in DC arrangements. Just as for DB pensions, comparing DC arrangements on the basis of net returns and direct costs gives some useful information – it tells members by how much each provider has made contributions grow in the past. However it does not tell members how much more growth might have been possible. Requiring providers to make their investment costs more transparent is intended to make comparisons between providers easier and put pressure on higher-cost providers to reduce their costs.

4. Value for money within investment portfolios

68. There are increasing demands for pension providers to disclose the full cost of their investment processes and to make hidden costs transparent. As discussed in DAF/AS/PEN/WD(2017)5, evidence from DB funds in the Netherlands, Switzerland and

the UK that have undertaken transparency exercises indicates that cost awareness can lead to significant cost reductions.

69. Such data does not tell the full story about value for money, however. Pension portfolio outcomes are determined by the combination of investment cost, risk and return. Efforts to benchmark providers should take all three factors into account, and policies designed to reduce costs should not constrain providers' ability to generate returns.

Investment cost transparency

70. Regulatory efforts to increase investment cost transparency are accelerating (Box 1). Australia's revised Regulatory Guidance 97 (RG 97) came into force in 2017. It requires Superannuation providers to calculate transaction costs and look-through costs,[14] resulting in an estimated 19 bp of additional investment cost being revealed.[15] Some commentators have raised concerns that retail savers will view this new information as amounting to a fee increase, rather than simply making explicit costs that were formerly implicit, and so be less willing to contribute.

[14] Look-through costs are the costs of investing in underlying assets through intermediaries such as fund-of-funds structures or special purpose vehicles.

[15] ChantWest survey September 2017

Box 1. Initiatives to improve investment cost disclosure

The Netherlands cost disclosure framework requires pension funds to supply detailed information on their administration and investment costs in their annual reports. Asset management costs must include both direct and indirect costs, down to the level of the underlying investment, and from accounting year 2017 look-through reporting on transaction costs must be provided.

The UK Financial Conduct Authority (FCA) Policy Statement PS17/20 will come into effect at the start of 2018. [16] It requires firms managing money on behalf of DC workplace pension schemes to provide:

- Information about transaction costs calculated according to the *slippage cost* methodology (i.e. the difference between the price at which a transaction was executed and the price when the order to transact was transmitted to a third party)
- Information about administration charges
- Appropriate contextual information

DB providers in the UK are not required to provide or benchmark cost and performance data, however the regulators have tasked the industry to come with proposals to improve transparency.[17]

The Australian Securities and Investment Commission (ASIC) introduced enhanced fee disclosure requirements for most superannuation products and managed investment schemes in 2017.[18] Regulatory Guide 97 requires issuers of superannuation products to disclose indirect costs, defined as any amount that could potentially reduce the return of a product or the ultimate reference asset and that is not charged to the member as a fee. This includes the costs of interposed vehicles, such as fund-of-funds structures.

In the European Union, two new pieces of legislation will come into effect at the start of 2018 that will increase transparency requirements on those providing investment services:

- MiFIID II specifies that firms providing investment services shall provide ex ante and ex post disclosure on total costs and charges that are expected to be incurred by the client
- PRIIPs will require all entities advising on or selling Packages Retail and Insurance-based Investment Products to provide information on all direct and indirect costs to be borne by the retail investor

71. It is important that the new data resulting from these enhanced disclosure initiatives is accurate and useful. The potential list of direct and indirect investment costs is extremely long – the FCA Institutional Disclosure Working Group (IDWG) came up with over 300 discrete cost items – but not all of these costs are easy to capture or are

[16] FCA (2017)

[17] For example, the Institutional Disclosure Working Group set up by the Financial Conduct Authority is expected to prepare templates for pension trustees to gather cost data from their suppliers.

[18] ASIC (2017)

meaningful. Governing bodies, sponsors, regulators and members may be overwhelmed by too much data. In addition, some costs are relatively small, so may not be worth measuring; others are relatively large but cannot easily be compressed even once they are revealed.

72. For example, stamp duty is a large part of trading costs, but cannot be avoided. In his analysis of Local Government Pension Scheme costs in 2014, Chris Sier (head of the IDWG) estimated that direct equity trading costs on a portfolio with turnover of 140% per annum were at least 75 bp. Of this, only around 10 bp was commission (which can potentially be squeezed through negotiation with brokers) while 65 bp was stamp duty and taxes.[19] This figure was considerably higher than the direct investment management costs of 25.4 bp and administration costs of 12.6 bp.

73. Custody fees are easy to measure but are very small in percentage terms – usually around 1 bp for an institutional client. Although this can equate to a large number in absolute terms there is probably limited room to reduce such fees. However, custodians generate most of their income through custody services such as foreign exchange and stock lending, where costs are opaque. This is therefore a potential area where savings could be made.

74. The more granular the information required, however, the more challenging and expensive it becomes to collect it. In addition, different providers may use different methodologies, making data less comparable. In the Netherlands, look-through reporting on transaction costs is required from this year, but pension funds can choose their own method for calculating bond spreads. There are several possible approaches, all of which involve making assumptions, for example the actual spread per transaction, the average spread over the past quarter or a standardised proxy spread. The UK FCA has chosen the slippage method for transaction cost reporting. This can generate negative results if an investment manager is selling into a rising market or buying into a falling market.

75. Regulators therefore need to decide which costs are relevant and whether and how they should be made transparent. No regulator requires pension providers to calculate market impact (whereby the investor influences the market price by the act of trading), although this can be a significant cost for an individual trade. Market impact is an area where the cost of capturing and analysing the data may outweigh the potential to make improvements: it cannot be measured until after the event (although it can be estimated) and depends on the size and duration of the order, so is intricately linked to the investment strategy.

76. Complexity should not, however, be an excuse for not requiring pension providers to be more transparent about their costs. Cost reductions can be achieved even before detailed information about indirect costs is available. From 2011 to 2017, pension providers in the Netherlands were able to use standard, proxy spreads to measure transaction costs in fixed income portfolios and to use entry and exit charges as a proxy for look-through transaction costs. Despite this lack of detailed information, cost awareness increased and total costs fell. Similarly in the UK, the 75 bp charge cap was applied to workplace DC default funds helped raise awareness of higher charges in other DC arrangements.

77. Policy makers might therefore find that putting in place a limited disclosure regime and making it more stringent over time is more effective than asking providers to

[19] Sier (2014)

be introduce full cost disclosure in one go. Compliance rates are likely to be higher and the amount of data will be manageable for regulators as well as providers. Getting accurate comparisons on some of the biggest costs – especially investment management fees – could yield material savings and lay the groundwork for tackling other cost categories as more information becomes available.

Investment value for money

78. Costs do not exist in isolation from the investment strategy. Other indicators that take account of investment performance and manager skill are needed in addition to cost information to assess relative value for money within and between investment portfolios.

79. Investment cost, risk and return are interdependent: low cost, low risk strategies will generate lower returns than high risk strategies. It may be possible to reduce the transaction costs of an active emerging equity fund by negotiating with external managers and brokers; it is not possible to reduce them to the same level as the transaction costs of a passive bond fund.

80. Most of the investment cost savings made by Dutch pension funds in the wake of their transparency initiative came from changing their investment strategies and implementation styles, although they also made savings by putting pressure on external managers and other intermediaries to offer them lower prices . In particular, pension funds reduced their allocations to high-cost alternative strategies and brought active management in-house. Morkoetter and Wetzer (2016) found that the introduction of TER reporting may have led Swiss pension funds to avoid higher-performing asset classes because they are focusing on absolute costs rather than costs in the context of returns.

81. Investment costs should be reported alongside information on portfolio risk and return. This enables fair comparisons between providers. It also enables providers to compare the different asset classes within their portfolios and the value for money they are getting from each of their investment managers. Within a portfolio, managers can be compared along several dimensions:

- the share of the total AuM that they manage
- the share of total fees that they earn
- the degree of risk they run relative to their own benchmark
- the share of total return that they contribute
- the amount of total outperformance (alpha) that they generate relative to their own asset class

82. Investment managers can be analysed in terms of the returns they achieve per unit of risk taken, their fees per unit of return and the amount of alpha that they retain in fees. This analysis is robust across different asset classes and investment styles. For example, passive management will score highly in terms of cost versus risk because passive portfolios track the reference benchmark closely and have low management fees and transaction costs. However passive management scores poorly in terms of cost versus alpha because passive funds are not designed to outperform.

83. This type of analysis gives providers insight into the degree of manager skill and what they are paying to access that skill, without penalising higher cost managers who are performing well. Policymakers might need to consider such analysis to avoid the risk that pension providers attempt to reduce costs at the expense of the returns necessary to build pension pots.

5. Conclusions and policy recommendations

84. The role of pension providers is to undertake administration and investment activities in order to build pension assets. In order to determine whether they are offering value for money to their members and sponsors, and to encourage providers to control their costs, they can be compared to each other in terms of the cost and quality of their different activities.

85. There are big differences between the membership profiles and investment strategies of different pension funds, so their costs can vary significantly. It is therefore important to find a relevant reference point against which the performance of different providers can be evaluated. Peer groups are a useful benchmark for DB providers but may be difficult to establish for DC arrangements, where it may be necessary to construct a proxy reference fund.

86. For this benchmarking exercise to give an accurate picture of value for money and to be effective in motivating providers to improve, a greater degree of cost transparency is required than currently exists in most pension systems. Cost awareness and cost reductions can be achieved without imposing an excessive burden on providers or regulators in terms of data collection. Efforts to reduce costs should not lead to overly conservative investment strategies.

87. Policymakers might therefore consider

- *Creating and maintaining benchmarks for comparing DB and DC providers that include information on administration costs and service levels and investment cost, risk and return*
- *Imposing sanctions on providers who perform badly against their benchmark*
- *Requiring transparency of, at a minimum, direct investment costs in the first instance and making transparency requirements more stringent over time*

88. DC providers may have additional operational layers or use intermediaries to collect or invest contributions. Policymakers might want to encourage greater control over the associated costs

- *Intermediary fees and other fees associated with operating structures (e.g. platform fees) should be transparent*
- *Intermediaries should have fiduciary obligations towards members*

89. Asset-based fees and cumulative charging are standard practice in pension systems. They lead to high levels of charges on early contributions and reduce the incentive for providers and their suppliers to pass on efficiency gains to members. Policymakers might therefore consider policies that directly address the charging structure in pension products

- *Asset-related declines in fees, loyalty bonuses for long-term contributions, or introducing an element of fixed fees on a cost+ basis could help to reduce the impact of cumulative fees*

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