# COST OF PROVIDING PENSIONS AND VALUE FOR MONEY

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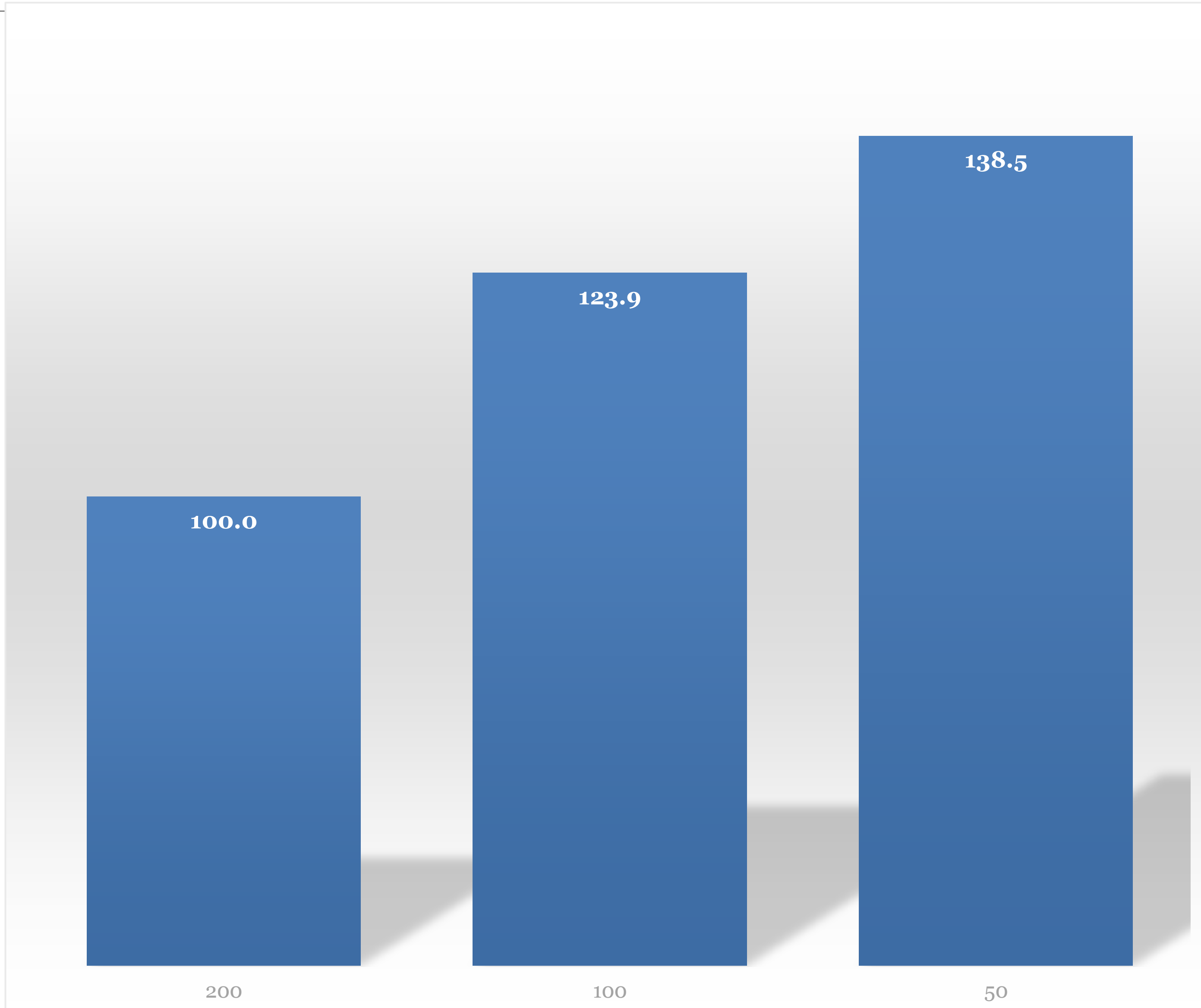
BETTER POLICIES FOR BETTER LIVES

# Structure

- Cost of providing pensions
- Reasons: weak competitive pressures
- Value for money and costs
- Policy responses

# Income lost from different costs

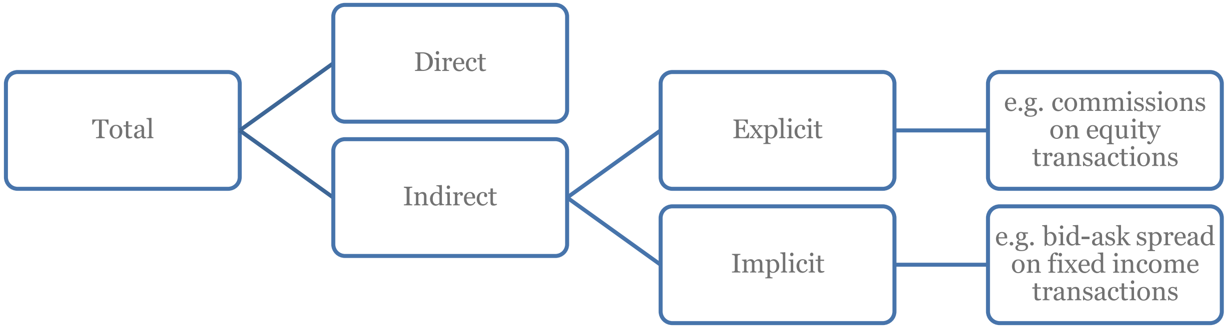


# Total member reductions

- Charges by pension provider ≠ costs to pension fund member
- All “payments out” reduce the potential pension pot
- Whether charged up-front, out of assets or ad hoc

# Difficult to get a full picture of costs

- Different types of cost




- Different types of fee
  - Flat rate, % contribution, % assets, performance-related, loyalty bonus…
- Plan/scheme fees, investment management fees (primary, underlying fund), investment transaction fees, custodian fees, guarantee fees, commercial costs, …

# Weak competitive pressures

- Lack of engagement
- Complex and opaque charging structures (diff. information reporting)
- Weak governance (small schemes, conflict of interest)
  - Regulators and supervisors have a strong role to play here
  - Australia, Netherlands, UK, and USA
- Barriers to entry/switching
- Failure to exploit economies of scale

# Policy responses

- Disclosure
  - Transparency from providers, easier comparisons for members
- Pricing regulations
  - Charge caps, charging bases
- Structural solutions
  - (Semi-) defaults providers (low costs), auctions (tender mechanisms, quality?), centralised institutions (“arm length”), governance

# Preliminary findings

- No single measure is effective in isolation
- Transparency is necessary but not sufficient for containing costs
- Measures to stimulate market mechanisms work best when reinforced by pricing regulation and structural solutions
- Policy needs to evolve over time
- The role of the regulator is critical (reporting)
- Policy makers should address value for money rather than costs alone

# Value for money

- Low cost ≠ good value
  - Members benefit from high service levels; complex investment strategies may deliver higher pension payments…
- But lower cost = better value

# Definition of value for money

“economy, efficiency and effectiveness”

- Economy: right quantity at the lowest cost
- Efficiency: getting max out per unit of cost
- Effectiveness: policy objective

➢ The rate at which contributions are transformed into pension assets*

# Assessing VFM

- System-level value for money
  - General objectives of the pension system
  - Charging structures and price regulation
- Provider-level value for money
  - Defined benefit and defined contribution (investment administration costs)
- Investment portfolio value for money
  - Cost transparency
  - Risk and return versus reward

# System-level indicators of good value

- Transparency
- Fee caps
- Measures that address asset-based fees directly
  - Declining fee caps
  - Loyalty bonuses
  - Fixed fees
- Other approaches
  - Performance-based regulation and benchmarking

# Provider-level value for money

- Objective of DB and DC: build pension assets
- Activities of DB and DC: administration and investment
- ➢ VFM = high quality activities at low cost
- But: different membership profiles, investment strategies, administrative requirements
  - How to set a benchmark/reference
  - How to access relevant data

# Defined contribution

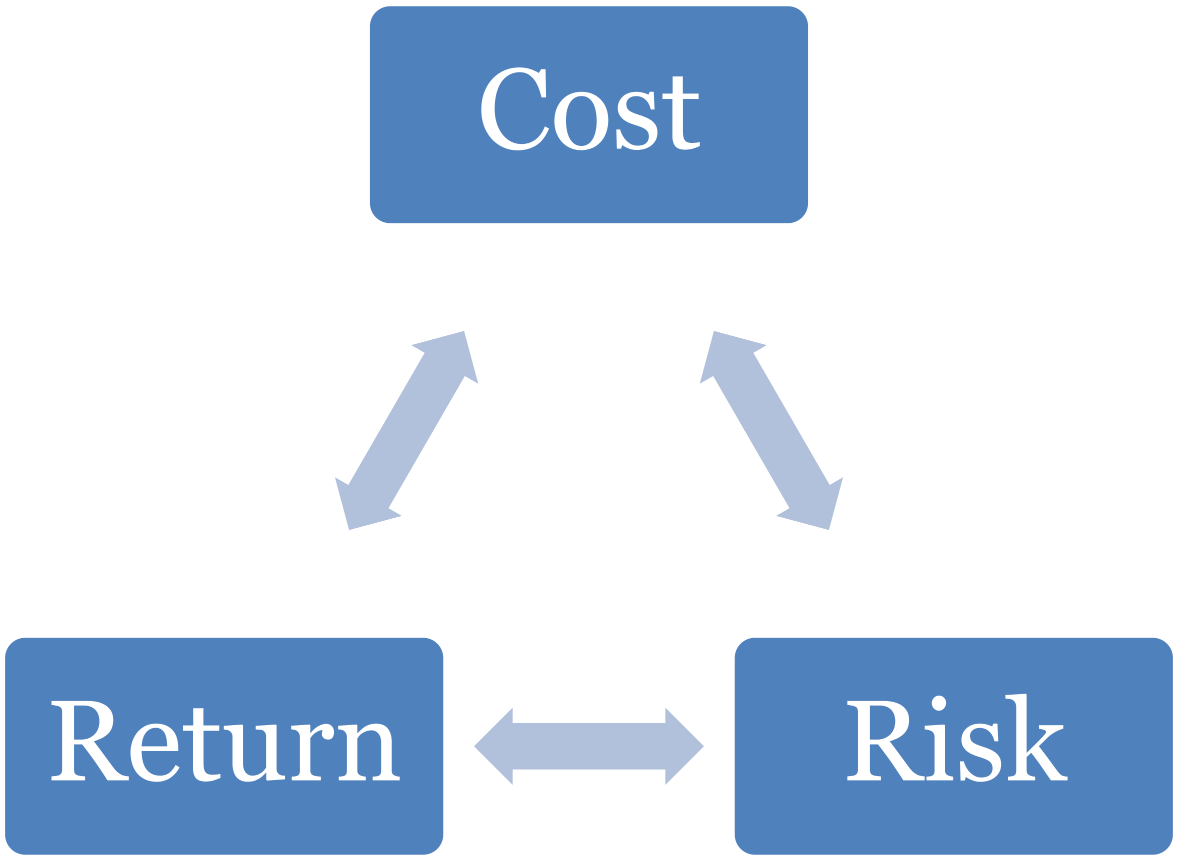
- Both admin and investment activity likely to be more expensive
  - Greater choice, more small contributions, cost of investment design
- Wide range of outcomes possible
  - Harder to establish peer group/benchmark
- Use default or construct proxy
  - Lifecycle with 50 bp investment charge

# “Extra” costs in DC

- Commercial costs
- Entry/exit
- Platforms
- Other intermediaries

# Value for money in investment portfolios

- Investment costs do not exist in isolation



# Manager value for money

- Returns versus risk
  - Passive management does well
- Cost versus outperformance
  - Passive management does badly
- How much outperformance is retained in fees

# Conclusions and policy recommendations

- Cost awareness and cost reductions should not create a big burden on providers
- DC and DB
  - Benchmarks and rewards/penalties, custodian (long-term)
  - Transparency of (at least) direct costs
- DC
  - Transparent and responsible intermediary chain

# Next steps

- Develop work on benchmarking and peer groups covering investment design and costs.
- Consider alternative reward structures for investment performance.

# THANK YOU!
# QUESTIONS?

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