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Pension costs in the accumulation phase: policy options to improve outcomes in funded private pensions

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This document is submitted for discussion under the agenda of the WPPP.

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Introduction

1. Funded pensions pay members' benefits out of assets generated during the accumulation phase. The higher the value of those assets, the more secure the benefit stream of a defined benefit (DB) pension and the higher the potential pay-out from a defined contribution (DC) pension.

2. The asset pool is made up of contributions from members, employers and sponsors and the returns earned through investing those contributions. Pension providers carry out administration and investment activities in order to collect and grow pension assets. The costs of these activities are paid for out of contributions and investment gains. Therefore, all other things being equal, the higher the cost of providing the pension, the lower the amount of assets available to pay benefits and the worse the outcome for members and sponsors.

3. The cost of funded private pensions has come under increasing scrutiny with the growth in defined contribution arrangements. In defined benefit schemes, the scheme sponsor is responsible for making up any shortfall in assets, so members do not directly bear the consequences of excessive costs. In DC funds, any fees that are levied on contributions to pay for administration services and any charges that are deducted from investment portfolios to cover investment expenses ultimately come out of members' retirement pots. Therefore, excessive fees and charges have a direct impact on individuals' future benefits. The impact on smaller pots – such as those of lower-income workers brought into the pension system through automatic enrolment – can be particularly high.

4. To maximise outcomes for members of DC schemes and to limit calls for extra funding on sponsors of DB schemes, it is therefore important that the administration and investment costs incurred by pension providers are as low as possible for the service provided. In addition, providers should pass these costs on to members, employers and sponsors through appropriate charging structures.

5. In an efficient market, both the costs incurred by providers and the charges they apply to members, employers and sponsors should be contained by competitive pressures. Pension providers would monitor and control their payments to external investment managers and other suppliers. Employers and employees would reward providers for keeping costs and charges low.

6. However, there appears to be a lack of such competitive pressures in both mature and more recently established pension markets across OECD and IOPS member jurisdictions. The primary policy response has been to bolster market forces by creating greater transparency around costs and charges but this has not been sufficient by itself to improve outcomes. Policymakers have therefore introduced additional measures to control costs and charges, including pricing regulation (e.g. charge caps in Costa Rica, Turkey and the UK) and structural solutions (e.g. auction mechanisms in Chile, India and New Zealand).

7. It is important that such measures do not encourage a "race to the bottom" among pension providers. Higher cost services can represent good value for money: communication campaigns that encourage members of DC schemes to save more into their pension scheme will increase administration costs but can result in bigger individual pension pots; diversifying the investment strategy of DB schemes to include more expensive asset classes such as infrastructure can lead to better risk-adjusted returns.

8. Policy should therefore consider outcomes as well as costs and charges. Costs and charges are an important driver of outcomes, but administration efficiency and investment strategy and implementation also influence how much both DB and DC pension portfolios grow. Administration cost and service levels and investment cost and performance can each be monitored against a relevant reference point, such as the pension provider's own policy statements, peer groups or a default fund. Such benchmarking exercises can highlight where there is scope for providers to improve outcomes, either by cutting costs or by modifying their administration or investment activity.

9. This paper analyses the reasons why market mechanisms have been insufficient to control costs and charges in funded private pensions and analyses the effectiveness of different policies to strengthen or supplement market forces. It finds that measures to improve transparency are essential but are not enough by themselves to contain costs and charges. It also considers the relationship between costs and outcomes and examines ways in which regulators might use benchmarking to improve overall outcomes in DB and DC pensions. Finally, it considers ways to tie investment expenses more closely to portfolio performance.

10. This paper reflects the findings of two documents presented to the Working Party on Private Pensions: "Analysis of policy measures to contain costs of running funded private pension plans" (discussed at the WPPP meeting held on 19-20 June 2017) and "Cost of running private pensions: focus on 'Value for Money'" (discussed at the WPPP meeting held on 4-5 December 2017). It contains further examples of policy measures introduced in OECD and IOPS member countries and includes a discussion of performance fees in investment management that have not been previously submitted to the WPPP.

11. Delegates are invited to give their comments on the new material put forward in this paper. Delegates are informed that this document, including comments, will be published in the 2018 edition of the OECD Pensions Outlook to be launch at the time of the next WPPP meetings scheduled for 3-4 December 2018

Overview of costs and charges

12. Pension providers carry out administration and investment activities in order to collect and invest contributions and provide other services (such as valuations and account statements) to members, employers and sponsors during the accumulation phase. Members and employers pay for the costs of these activities through visible charges – the fees levied by the provider – and hidden charges – deductions from contributions or from the investment portfolio.

13. To understand the total charges paid by members and sponsors, three pieces of information are needed: what are the total costs incurred by the pension provider; which of these costs are included in the fees; and which result in additional deductions.¹ However costs may be difficult to observe and measure, and fee structures differ across jurisdictions.

14. The costs incurred by pension providers can be direct or indirect. Most administration costs are direct – the provider will either incur operating expenses itself or receive an invoice from an external service provider. Some investment costs are direct, for example compliance and regulatory costs, which are levied at the level of the pension fund. However a number of the costs within the pension plan, especially investment costs, are indirect. An example of indirect costs is transaction costs, i.e. the costs of trading underlying securities in an investment portfolio such as commissions to brokers, clearing and settlement fees to custodians, and applicable taxes. These different costs are usually covered through a reduction in the returns to the portfolio as the transaction takes place, rather than through a separate billing procedure.

15. Getting a full picture of investment costs is further complicated by the fact that some indirect costs are "implicit", as illustrated in Figure 1. Transaction costs for equities are "explicit": brokers' commissions are contractually agreed, stamp duty rates are known and so on. Transaction costs for fixed income are "implicit": commissions and other costs are embedded in the bid-ask spread.

Figure 1. Explicit and implicit costs



16. High indirect costs are not necessarily bad for outcomes. Investment managers undertake transactions in order to make investment gains and the impact of indirect costs will ultimately be revealed in the net returns of the portfolio. However providers arguably have less incentive to control implicit costs and members and sponsors may be unable to identify all of the charges that they face, let alone determine whether or not these charges are reasonable.

17. Table 1 gives an overview of the various different costs that could be incurred by private pension providers. Whether these costs are recouped through fees or through hidden charges, they constitute a reduction in the assets in the portfolio. Different institutional arrangements will incur different types and levels of costs, depending on factors such as the number of intermediaries, the services offered and the investment

¹ We assume that the provider's costs include its profit margin, where applicable.

strategy, so not all cost items are applicable or material to all providers. However Table 1 illustrates how a focus on fees alone may obscure the full extent of fund charges.

	Description	Cost type	Fund type
Administration	Oversight/governance of fund	Direct	DB, DC
	Regulatory costs	Direct	DB, DC
	Legal, accounting, actuarial	Direct	DB, DC
	Operations, IT	Direct	DB, DC
	General business expenses	Direct	DB, DC
	Communication	Direct	DB, DC
	Sales & marketing activities, commissions	Direct or indirect (explicit)	DC
	Investment platform	Direct or indirect (explicit)	DC
	Initial charge	Direct or indirect (explicit)	DC
	Additional features/benefits	Direct or indirect (explicit)	DB, DC
Investment	Oversight/governance of fund	Direct	DB, DC
	Regulatory costs	Direct	DB, DC
	Legal and accounting	Direct	DB, DC
	Consultants and advisors	Direct	DB, DC
	General business expenses	Direct	DB, DC
	Custodian, depositor	Indirect (explicit)	DB, DC
	Internal asset management	Direct	DB, DC
	External asset management	Indirect (explicit)	DB, DC
	Look-through costs	Indirect (implicit)	DB, DC
	Performance fees	Indirect (explicit)	DB, DC
	Additional costs of alternative assets	Indirect (implicit)	DB, DC
	Transaction costs	Indirect (implicit)	DB, DC
	Entry/exit costs of underlying funds	Indirect (implicit)	DC
	Platform fees	Indirect (implicit)	DC
	Switching between underlying funds	Indirect (explicit)	DC
	Non-cash costs e.g. opportunity cost, market impact ¹	Indirect (implicit)	DB, DC

Table 1. Overview of pension fund costs

Note 1: Costs related to how well a trade is executed, such as the speed of passing the order and whether the trade itself affects the market price

18. There is a wide range of estimates of the magnitude of indirect costs, but evidence suggests that they can be substantial. Blake (2014) finds that estimates of the implicit costs of investment funds range from 51% to 82% of explicit costs. Transaction costs and look-through costs are estimated to add 19 basis points (bp) to the investment costs of Australian Superannuation funds.² In the Chilean mandatory occupational DC system, estimated explicit indirect costs are 40% again on top of direct costs, although this figure may not include all implicit costs.³

19. The extent to which direct and indirect costs are included in fees varies by country. For example, in Ireland, voluntary occupational DC plans are required to include only administration costs and the costs of investing in primary funds in the fees levied on members. Portugal, by contrast, stipulates that fees cover more categories of direct cost

² Chant West survey 2017

³ Source: Superintendence of Pensions, 07/03/2018

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and some indirect costs: administration costs, investment in primary funds, custodian fees and investment transaction costs.⁴

Costs and charges in DB and DC funds

20. There may be additional costs incurred in running DC funds that do not affect DB plans, as Table 1 highlights. These are related to the elements of choice and liquidity within some DC arrangements. If either employers or employees are able to choose their DC fund, the provider is likely to spend money on commercial activity. Where DC investment strategies have to accommodate inflows and outflows, there may be layers of cost such as platform or entry and exit costs that are charged to members' portfolios.

21. Sales and marketing activity that does not include education or information for members does little to improve outcomes, but the costs are borne 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 2 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.

	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

Table 2.	Costs of	client	acquisition	and	marketing	of Polish	PTE
	00000		acquisition	*****		01 1 011011	

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.

22. Members may pay entry or exit fees to underlying vehicles when DC pension plans execute their investment strategy through investments in underlying vehicles such as mutual funds. 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. DB plans may also invest via underlying funds, but they are typically able to buy share classes that do not carry entry/exit fees and they do not have to manage such frequent portfolio adjustments. 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.⁵

23. When plan members can decide on the design of the investment strategy, then in addition to any entry or exit fees, the member may also pay fees to the provider for the

⁴ Source: IOPS (2017)

⁵ DWP (2017)

ability to make changes to the selection of underlying funds and for using the provider's "platform". 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.

24. As well as having additional layers of cost compared to DB funds, DC arrangements may have higher costs than DB funds for equivalent activities. 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.

25. 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 more effective and lower cost would be to make auto-escalation compulsory, so that individuals' contributions increased automatically in line with their earnings).

Weak market mechanisms to control costs and charges

26. Market mechanisms have failed to contain the costs and charges of funded private pensions at competitive levels. Studies in a number of jurisdictions point to a lack of competitive pressures in both DB and DC systems. Johnson (2017) estimated that the direct costs of the UK's Local Government Pension Scheme doubled as a percentage of assets over the period 2006-2016 and that indirect costs were as much again as direct costs. Schwartz (2008) concluded that "noise" in the Mexican pension fund market prevented workers from accurately interpreting market signals – instead of responding to price incentives, they were prompted to switch providers by intensive sales efforts. Australia's 2014 Financial System Inquiry found that "the superannuation system is not operationally efficient due to a lack of strong price-based competition".⁶

27. There are a number of reason why private pension markets might be uncompetitive. They include (1) lack of engagement by plan participants; (2) complex and opaque charging structures; (3) weak governance; (4) barriers to entry/switching; and (5) failure to exploit potential economies of scale.

Lack of engagement by plan participants

28. Members do not respond to high charges by switching plans or pressuring their provider to reduce fees and charges, or pressing their employer to do so on their behalf. The problems that individuals have in engaging with and understanding financial products are well documented.⁷ The problems are particularly acute with pension products, as neither the benefits themselves nor the reduction in benefits caused by excessive charges will be felt immediately. Consequently, members may be irresponsive to high charges.

29. Employees, employers and sponsors may all be ill-equipped to select and monitor their pension fund. Figure 2 shows the quality of account transfers in Mexico over the period 2011-2015: over half of transfers were made into providers offering a lower net

⁶ Financial System Inquiry (Murray) final report

⁷ See for example <u>OECD/INFE International Survey of Adult Financial Literacy</u>

return than the current provider. OFT (2013) described the buyer side of the UK DC workplace pensions market as "one of the weakest that the OFT has analysed in recent years." Their comment referred not only to plan members, but also to employers that were involved in selecting plan providers; they were concerned that smaller employers might lack the knowledge to select the most suitable provider for their employees and the resources to buy in expertise.





Notes: A negative transfer is one to an AFORE offering a lower net return. A neutral transfer is one to an AFORE offering the same net return or a net return less than 5% higher than the one offered by the previous AFORE. A positive transfer is one to an AFORE offering a net return at least 5% higher than the one offered by the previous AFORE.

Source: OECD (2015).

Complex and opaque charging structures

30. Charging structures are not standardised, making it difficult for employers and employees to compare what different providers charge in total for DC funds. Fees may cover different costs and be expressed in different ways. Deloitte (2014) sampled 525 plans in the USA and found a variety of fee arrangements for similar services. For example, administration costs could be charged directly to the employer, to the participant, or at the level of the plan itself. These fees could be charged on a per-participant basis, per plan, or as a percentage of assets.

31. Complex charging structures may lead to wide variations in charges within a single jurisdiction. The Deloitte study found that the "all-in" fee (total charge) for the sample universe ranged from 0.28% to 1.38% of assets on a participant-weighted basis. Clearer communication of fees, such as expressing them in cash terms rather than as a percentage of assets, could help employers and members compare plans more easily although this would not capture hidden charges. Taking fees paid by employees directly out of their wages rather than deducting them from member contributions members – as is done in Chile – could encourage awareness of fee levels as their impact on disposable income would be felt immediately.

32. In DB funds, there may be information asymmetries between sponsors and boards and their suppliers. RailPen, which manages pension assets of over GBP 20 billion, calculated that the actual costs of external investment management were up to four times the GBP 70 billion that they were paying annually in direct fees, and in response started

to bring more investment management in house.⁸ Investment managers might charge different fees for segregated accounts to different clients and impose non-disclosure agreements so that pension providers cannot compare the fees they are paying to those being paid by their peers. This has led to a wide range in the fees paid by institutional investors for similar services (Table 3).

	Externally-managed passive global fixed income	Internally-managed active real estate	Externally-managed active global equity
90 th percentile	8.5	60.2	83.3
75th percentile	7.8	41.2	62.7
Median	7.1	27.3	49.2
25th percentile	4.0	15.8	38.8
10 percentile	1.6	7.1	24.0

Table 3.	Cost ran	ge in basi	s points for	r selected	asset classes
Table 5.	Cost I an	ige in Dasi	s pomus to	sciecteu	asset classes

Note: The CEM global universe covers around 360 DB funds, SWF, buffer funds and DC platforms with almost USD 7 trillion of assets.

Source: CEM Benchmarking presentation to World Bank Global Pension and Savings Conference, April 2014.

Weak governance

33. Weak governance can result in a failure to identify and contain costs and charges. Smaller schemes in particular may lack the resources for effective oversight of costs and be in a weak position to negotiate with their suppliers.

34. Conflicts of interest may weaken governance: external trustees of small plans might vote against scheme consolidation if it would put their jobs at risk, while the boards of providers that are part of a larger financial institution might be reluctant to reduce costs that are a source of revenue for their parent company.

35. Governance failings could also arise from agency problems, or from a dilution of fiduciary responsibilities as the intermediary chain gets longer. Employers may not focus on the costs borne by employees. Fund platforms might not use their bargaining power on behalf of members. Investment consultants could be tempted to increase their billings by proposing complex investment strategies or frequent changes to asset allocation. Advisors who benefit from built-in commissions (an implicit cost) are less likely to recommend switching providers. Investment managers who are not required to report indirect costs might not try to control them.

Barriers to entry/switching

36. Competition between plan providers should be strongest when a new plan is being set up or when participants are thinking of switching plan. Barriers may exist at the level of the provider or at the level of the plan participant.

37. Providers may face barriers to entry due to the high proportion of up-front costs in setting up a new plan - fixed costs such as IT are incurred before significant pools of assets are collected. This may make it especially difficult to attract new providers for automatic enrolment schemes targeting smaller employers and lower paid workers. New plan providers and external asset managers might be at a competitive disadvantage from

⁸ Source: Financial Times, 24 August 2014

lower brand recognition or a shorter track record. Vertically-integrated providers might limit access to their platforms by external asset managers or benefit from lower internal management costs through crossing trades within their platforms (if a plan participant decides to change from one underlying investment product to another, the provider might be able to match that trade with an equivalent trade by another participant). On the other hand, if it is too easy for new providers to enter the market there is a risk that they will not achieve sufficient scale and be forced to increase charges or reduce the quality of the plan, or withdraw from the market completely.

38. When plan participants consider changing plan provider, they may be put off from doing so by regulatory barriers, such as taxes, or by commercial barriers such as explicit charges. They may also be unwilling to spend the time and effort researching a new plan, resulting in inertia and the failure to switch out of poorly performing plans. However, excessive churning of investment portfolios can create additional administration expenses for providers and unnecessary trading costs for members.

Failure to exploit potential economies of scale

39. As noted in OECD (2016), there has been a significant decline in the number of private pension funds and plans since 2005 in several OECD member jurisdictions. A number of countries with mature pension systems, such as Canada, the Netherlands and Australia, are actively encouraging further consolidation of funds. Pension plan size varies considerably across OECD and IOPS members and it is not clear that there is an "optimal" plan size, but the existence of high fixed costs in pension plan administration implies that larger plans will be more efficient. They could also benefit from better governance: the decrease in the number of pension funds in the Netherlands since 2005 from 800 to less than 400 has been accompanied by tougher qualification requirements for trustees.

40. Administration costs are largely driven by the size of the plan, as shown in Figure 3. Cost items such as IT, oversight, communications and collections have a substantial fixed element and there is evidence that scale economies can be captured relatively quickly. Di Gialleonardo and Marè (2015) found that the administrative costs per participant of supplementary closed pension funds in Italy fell from EUR31.43 for funds with 10 000 - 50 000 members to EUR19.63 for funds with over 50 000 members. Furthermore, there were no diseconomies of scale for bigger funds. Bikker (2013) reached similar conclusions for Dutch pension funds and found also that the size at which funds could continue to reap scale economies was increasing over time, suggesting that "average administrative costs per participant now decline without limit", in part because of more expensive technology and more complex regulation.





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

41. Both studies found that the evidence for economies of scale in investment costs was less conclusive. Sources of economies of scale in investment costs include negotiating power with asset managers and other suppliers such as custodians, spreading semi-fixed costs such as research on external managers, and bringing investment management in house, especially for complex asset classes. Table 4 shows the fees charged by external managers to different types of US institutional investor in a range of asset classes – bigger investors pay less than smaller investors in every case.

%	Small endowment	State pension fund	Quality foundation
US TIPS	0.27	0.15	0.16
US high yield bonds	0.50	0.34	0.42
EM government bonds	0.60	0.45	0.49
US small cap equity	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 funds	1.70	1.41	0.95

Table 4. Fees	by a	asset	class	and	US	investor	type
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Note: EM = emerging markets; REIT = real estate investment trust. Source: Jennings & Payne (2016).

42. Di Gialleonardo and Marè suggest that the relatively low level of management fees for closed funds in the Italian market might leave fewer opportunities for further cost reduction and that larger funds implement more complex and so more costly investment strategies. Bikker found that larger funds used more expensive asset classes and that scale economies were exhausted at an asset size of EUR690 million. However, Broeders et al. (2015) found significant and sustained economies of scale for all pension funds with assets over EUR20 million. Dyck and Pomorski (2011) found that investment economies of scale worth between 43-50 bp per year for the largest DB funds, driven by insourcing asset management and increasing allocations to alternative asset classes.

43. However, there may be diseconomies of scale arising from concentration risk (investors may have limits on the proportion of an underlying asset that they can own, or of the share of an individual manager's business that they can represent), from market impact (market delays or adverse price movements from passing large trades) or from the temptation to go into riskier asset classes. Larger DB plans may find it difficult to implement LDI strategies because there are fewer counterparties for large derivatives trades. Reducing the number of plan providers too far could stifle innovation by both providers and external investment managers, although this is unlikely to be a problem in countries such as Australia, the USA or the UK where there are multiple providers.⁹

Policy responses

44. Policymakers have introduced different measures to bolster or replace weak market mechanisms. As shown in Figure 4, cost reductions have been reported in DB and DC markets. The range of measures includes disclosure-based initiatives, price regulations, and structural solutions.

⁹ Axa (2013)



Figure 4. Total costs of running funded/private pension plans in selected markets, 2001-2016

% of total assets, index 2001 = 100

Note: Includes administration costs and investment expenses. Note that Mexico's costs as a % of AUM were more than 3 times higher than Australia's at the beginning of the period under review and slightly below Australia's at the end of the period. *Source*: OECD Global Pension Statistics.

Disclosure-based initiatives

45. Disclosure-based initiatives have been the principal focus of regulatory efforts to strengthen competitive pressures on providers. Making costs and fees more transparent has been a key objective of policy in all jurisdictions, with measures to improve reporting, communication and benchmarking of investment costs and plan charges. Such measures target market failures arising from lack of engagement by plan participants, complex and opaque charging structures, and weak governance.

46. Cost transparency has been successful in encouraging providers to monitor and control their costs in both DB and DC occupational pension markets. In the Netherlands, pension funds are required to provide granular information on administration and investment costs and this has led to greater cost awareness among sponsors and fund boards, resulting in better outcomes (see Box 1). Funds must report on their costs to a level of detail similar to that in Table 1, and the Dutch National Bank benchmarks the costs and investment performance of plans against their peer group and calls "expensive" plans to account.

Box 1. The Netherlands Recommendation on Administrative Costs

In 2011, the Dutch Authority for Financial Markets (AFM) published a report on pension fund costs that highlighted:

- The influence of costs on retirement incomes
- That costs differed markedly among pension funds of similar size
- The potential for economies of scale
- Under- reporting of costs by pension funds

The report sparked a considerable backlash in the press and prompted the industry to address the issue of transparency. Over time, the Netherlands has introduced a series of legal and voluntary requirements for pension funds to publish more and more detail on their cost structure, service levels and performance. It is now mandatory for pension funds to report their administration costs, investment costs and transaction costs.

The effectiveness of the Netherlands' cost disclosure framework is demonstrated by the evolution of plan providers' costs since the start of the reforms. Cost data for five of the largest DB funds is shown in Table 5.

Costs of asset management (bp)	2010	2011	2012	2013
ABP	39	64	73	76
PFZW	48	55	57	61
PMT	17	62	54	40
BPF Bouw	52	46	50	58
PME	70	53	37	29

Table 5. Reported costs of asset management

Note: ABP restated its 2010 figure to 70 bp. *Source*: PF (2016), Novarca.

The table indicates that pension providers had an incomplete picture of their costs before reporting requirements were introduced: ABP and PMT understated their 2010 costs. The data also shows that pension funds were able to take action on the basis of the new information – PME and PMT both reduced their costs over the period 2011-2013. (It should be noted that the other funds took similar action, but made other changes that mean that overall costs did not decline).

The success of the framework reflects a number of factors:

- Regulatory pressure: although the development of reporting standards was led by the industry, there was a clear message from the DNB that it would intervene if progress was too slow (public pressure also contributed).
- Industry leaders: the biggest funds adopted the voluntary Recommendations on Administrative Costs quickly; the Recommendations are burdensome for smaller funds but compliance is now close to 100%
- A gradualist, pragmatic approach: reporting requirements have become stricter and more detailed over time. For example, look through costs will only have to be reported from 2017. The usefulness of data is set against the cost of collecting it.

- Benchmarking: the data is intended to enable participants to understand the relative performance of their plan on a number of criteria. Standard definitions and calculations are therefore used.
- Explaining cost drivers: pension plans' costs are heavily influenced by the choice of investment strategy, the scale of the fund, the complexity of the membership base, and service quality. Pension plans are benchmarked against plans with similar characteristics and annual reports contain detailed information about investment strategy and about service levels (for example, query handling).

47. Disclosure requirements are accelerating in many jurisdictions (Box 2). However, cost transparency can be cumbersome. The potential list of total direct and indirect investment costs is extremely long – the FCA Institutional Disclosure Working Group (IDWG) came up with over 300 discrete cost items – but many indirect costs are difficult to capture and may not be 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. For example, stamp duty is a large part of trading costs, but cannot be avoided. An analysis of Local Government Pension Scheme costs in 2014 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. This figure was considerably higher than the direct investment management costs of 25.4 bp and administration costs of 12.6 bp.¹⁰

¹⁰ Sier, C. (2014)

Box 2. Accelerating disclosure requirements

Regulatory efforts to increase investment cost transparency are accelerating in several countries.

The Australian Securities and Investment Commission (ASIC) introduced enhanced fee disclosure requirements for most superannuation products and managed investment schemes in 2017.¹¹ 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 came 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.

In the UK, both the Financial Conduct Authority ("FCA", the regulator of contract-based schemes) and the Department for Work and Pensions ("DWP", the regulator of trustbased schemes) have imposed enhanced reporting requirements on providers but they have so far been reluctant to impose a standardised cost disclosure template on providers or asset managers. However, the regulators have tasked the industry to come with proposals to improve transparency.¹²

Since April 2015, all providers of contract-based pension schemes have been required to establish an Independent Governance Committee (IGC). IGCs are required to consider all the costs and charges of the scheme and produce an annual report demonstrating the value for money delivered by the scheme so that members can compare providers across the market.

FCA Policy Statement PS17/20 came into effect at the start of 2018.¹³ 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, in line with MiFIID standards)
- Information about administration charges
- Appropriate contextual information

¹³ FCA (2017)

¹¹ ASIC (2017)

¹² The Institutional Disclosure Working Group set up by the Financial Conduct Authority has prepared voluntary templates for pension trustees to gather cost data from their suppliers.

48. Regulators therefore need to decide which costs are relevant and whether and how they should be made transparent. Transparency does not have to create complexity: meaningful 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 the lack of detailed information about indirect costs, cost awareness increased and total costs fell.

49. A number of jurisdictions have introduced measures to improve transparency about DC costs and performance, in order to raise member engagement. The Danish government-backed site <u>www.pensionsinfo.dk</u> provides members with information on their individual accounts including direct and indirect administration and investment costs and past returns. The 2015 Communications Act in the Netherlands requires schemes to provide standardised information to members.

50. This type of information can enable members to make more straightforward comparisons between funds. In Mexico, individual pension statements include information on net-of-fees returns across AFORES (providers). Both Hong Kong (China) and Italy provide comparison websites and therefore impose a degree of standardisation on the way information about fund charges is collected and displayed.

51. In several countries, including Israel and the Netherlands, transparency initiatives have been spurred by demands from the public or press for better disclosure of costs. However, a clear signal from the regulator has been the decisive factor in ensuring that providers sign up to disclosure standards. The Netherlands reporting framework was developed by the pensions industry in response to demands from the regulator. The UK relies on a combination of regulation and industry co-operation, while binding transparency requirements have been introduced in Australia and the EU. The US approach is different: the law requires fiduciaries to act prudently and in the interests of participants, and implicitly relies on market forces, supervisory activity including disclosure and the right of legal redress by members to contain costs.

52. Disappointingly, most OECD and IOPS member countries have found that disclosure-based initiatives, giving members and sponsors the information they need to apply competitive pressure to pension providers, have not been enough to contain costs and charges. Therefore, they have supplemented these initiatives with measures to regulate fees or influence the structure of the market or of the providers themselves.

Pricing regulations

53. Disclosure will only be effective in bringing down costs and fees if providers, sponsors and members understand and act on the information. Pricing regulation can contribute to disclosure efforts by simplifying fee structures, making it easier for participants to understand what services they are paying for and exactly how much they are paying. Alternatively, pricing regulation can force providers to take action on costs, by imposing limits on what they can charge.

54. DC arrangements are subject to this type of price regulation in several countries. Australia, Estonia and Hong Kong (China) have introduced low-cost plans and Chile, Sweden, Turkey and the UK have imposed charge caps. Mexico simplified fee structures in 2008 by stopping the use of fees on contributions, so that AFORES can only levy a fee calculated on assets under management (which was also capped). Costa Rica replaced its mixed fee structure with a single, asset-based fee in 2011. In Denmark and Poland, fees are levied on both contributions and assets under management, whereas in Spain only asset-based fees are permitted.

55. Different fee structures may be appropriate at different points in the development of the pensions system or the growth of a pension fund. Assets grow over time, so assetbased fees reward established providers who have had time to collect and grow contributions. Contribution-based fees enable new DC schemes to raise revenues more quickly, but may not cover costs as plans mature if members leave or defer. Pricing regulation may therefore need to evolve as pension systems mature.

56. However, unless both asset-based and contribution-based fees cover a significant part of total costs, including indirect and implicit costs, this may not be sufficient to deliver better pension outcomes. Therefore more direct controls over pricing, such as charge caps, may be introduced. The UK introduced a charge cap of 0.75% of assets under management on workplace default funds from April 2015. The cap applies to all direct and indirect administration and investment costs, but does not include transaction costs. As well as putting an upper limit on default fees, the cap also helped to raise awareness of high charges in other DC arrangements.

57. Charge caps set a clear and simple standard for member charges but can have unintended consequences. If the cap is set too high, charges tend to rise to the level of the cap, as was seen earlier in the UK market when stakeholder pensions were introduced with a maximum charge of 1%, which quickly became the market price for all similar retirement savings products. In a similar manner, the German government's estimated total charge for Riester products of 10% has become the de facto standard charge.¹⁴ If the cap is set too low, plan providers might try to cut costs by offering lower-quality plan designs or by reducing the number of transactions they undertake, even when the trades would be in the best interests of members.

58. If the cap does not include all direct and indirect costs, then providers might have an incentive to exaggerate uncapped costs in order to compensate for any lost profits in areas that do fall within the scope of the cap. Turkey reduced its charge cap quite significantly in 2013 and introduced a new charging structure consisting of a capped ad valorem fee that varies by asset class (ranging between 1.09% and 2.28%), a fee on contributions and a small fixed on-boarding fee. The cap takes into account all fees that pension providers can earn from participants and total fees are capped from the sixth year of a contract.

59. Establishing the correct level of the cap is especially complicated in markets where providers have different cost structures. Setting the cap in line with the cost structure of large, vertically-integrated providers might squeeze out smaller providers. A low cap can also discourage new entrants. However a relatively high cap could enable lower-cost providers to generate excessive profits if they chose to price at the level of the cap, unless there was pressure from participants or other stakeholders to reduce charges. In the UK, Legal and General responded to the 0.75% charge cap by capping its default fund charges at 50 basis points.

60. In order to capture economies of scale on behalf of members, charge caps should not be static. Costa Rica's fee was initially capped at 1.1% and this will reduce to 0.35%

¹⁴ Better Finance (2016)

by 2020. In Estonia, fees must be reduced by 10% for each EUR100 million increase in assets.

61. Charge caps focus on fees rather than design, putting the onus on providers to come up with a pension design that is profitable for them within the cap. An alternative form of pricing regulation is to introduce standardised pension designs with regulated fees. MySuper products in Australia have simplified product specifications and a limited range of fees, although the funds' designs are not fully standardised. The Default Investment Strategy introduced by Mandatory Provident Fund (MPF) schemes in Hong Kong (China) in 2017 has a fixed asset allocation and maximum fees. MPF schemes were already required to offer a low-fee fund with no restrictions on design but with maximum management fees of 1% of assets.

62. Another form of price control is to change the basis for charges. Member-borne commissions have been banned in UK DC schemes; similar measures have been introduced in Australia and the Netherlands. Mexico changed the incentive structure of sales agents to limit negative-yielding switches.

Structural solutions

63. Structural solutions entail efforts to overcome market weaknesses by intervening in the structure of the market. These can include measures to strengthen market mechanisms or alternatively to circumvent them by imposing new organisational structures.

64. Mexico and Chile provide examples of policies designed to strengthen market mechanisms. In Mexico, the number of providers (AFOREs) in Mexico increased from 11 to 21 between 2003 and 2008 as the Regulator encouraged new entrants in order to stimulate price competition. However, because of weak member engagement and understanding, this led instead to increased expenditure on commercial activity that did not benefit plan participants.

65. Chile followed a different approach, introducing an auction process in 2008.¹⁵ Providers bid for the right to enrol new members of the mandatory DC system who remain captive for two years. Bids cover administration costs and internal investment costs and must be lower than the minimum fee currently available in the market. This appears to have been effective in reducing fees levied by Chilean providers (AFPs): the first auction in 2010 was won by a new entrant to the market with a bid of 1.14% of salary; by 2016 the lowest fee in the market had fallen to 0.41%. However average fees, weighted by the number of contributors, have shown a smaller decline from 1.50% in January 2010 to 1.20% in June 2017.¹⁶ Furthermore, there were no bidders for the latest auction, most probably because providers could not improve upon the previous winning bid as required by the design of the auction process (see <u>DAF/AS/PEN/WD(2018)2</u> for a fuller discussion).

66. The Australian Productivity Commission notes the potential risks of a fee-based auction system: providers may make an unsustainably low bid, in the hope that they would make enough gains from economies of scale if they won the auction to remain

¹⁵ Chile also introduced other reforms in 2008 to help drive competition, such as the elimination of fixed fees and including comparative fee information on members' account statements.

¹⁶ Source: Superintendence of Pensions, 26/10/2017

profitable; or the quality of investment and administration services might be reduced.¹⁷ A multi-criteria tender, such as that used to select default providers in New Zealand, uses a range of selection criteria in addition to fees (e.g. fund features, past investment performance) so avoids these risks but is more expensive to implement and may introduce more subjective judgements into the tender process.

67. In some pension systems, regulators look to improved governance to create the conditions for market mechanisms to function. Australia and the Netherlands have imposed tougher qualification requirements on members of governing bodies and the UK regulator is asking for more detailed reporting from the Independent Governance Committees of DC schemes. These reforms are in each case part of a much larger package of measures to improve outcomes for DC plan participants. In the US, the fiduciary duties of plan sponsors (backed up by legal sanctions) are viewed as the most effective driver of competition among plan providers.

68. Policymakers may consider measures to influence the operational set-up of pension providers or the organisational set-up of the market in which they operate in order to contain costs. Policymakers in several jurisdictions are encouraging schemes to consolidate to reap economies of scale. Fund mergers can be mandatory, as in Sweden, or a voluntary response to other regulatory pressures such as increased scrutiny of costs, as in the Netherlands and Switzerland. Canada's Pooled Registered Pension Plan system is designed to pool individual accounts in order to benefit from scale economies and participating providers must ensure that charges are no more than they would be for a plan with 500 members.

69. The Australian Prudential Regulation Authority (APRA) found considerable scope for rationalisation and efficiency within the superannuation system, with over 40 000 investment options available across the industry.¹⁸ Although APRA does not stipulate a minimum size for a provider, it suggests that better-resourced supers might be more sustainable as the system matures and cashflows turn negative. APRA applies a scale test to MySuper products to check that returns are not adversely affected by the size of a (smaller) fund.

70. Alternatively, rather than try to change the cost structure of existing pension providers, policymakers may change the structure of the market by establishing new, centralised institutions. These can help to control total member reductions in a number of ways. They can provide additional competition to plan providers – the UK's NEST competes with other providers for auto-enrolment business. They can offer low-cost solutions directly to underserved populations – NEST has an obligation to take on smaller accounts. They can ensure that scale economies are available to all participants – Sweden's PPM clearinghouse offers very low platform fees to plan providers and has negotiated total investment costs including transaction costs for members of only 30bp.

71. However, it could be argued that centralised institutions have an unfair marketing advantage and can price in scale economies before they are realised thanks to government support. Furthermore, centralised institutions may add to complexity when employers or members have choices to make. NEST's annual management charge of 0.3% is low relative to the UK market, but it also charges employers a fee on contributions of 1.8% that makes comparisons with other providers more difficult (Now Pensions has a monthly

¹⁸ APRA (2016)

¹⁷ Productivity Commission (2017)

charge of GBP 40 and People's Pension charges a one-off set up fee of GBP 500 or GBP 300 if the employer comes via an intermediary).

72. India's National Pension System (NPS) combines centralised institutions, an auction system and fee caps. Rather than having integrated providers, NPS has unbundled the various administration and investment activities and found a low-cost intermediary for each activity, as shown in Table 6. There are two providers of central record-keeping and clients can choose between them based on quality and cost criteria. The NPS is technology driven, both to enhance interactions with members and to contain costs.

Intermediary	Activity	Price-setting	Fees charged by client type			
			Private sector	Government	"Lite"	
Central Record- keeping Agency	Account opening	Auction (2 suppliers)	Rs 40 / Rs 39.36	Rs 40 / Rs 39.36	Rs 15 / Rs 15	
	Annual account maintenance		Rs 95 / Rs 57.63	Rs 95 / Rs 57.63	Rs 25 / Rs 14.4	
	Charge per transaction		Rs 3.75 / Rs 3.36	Rs 3.75 / Rs 3.36	Free	
Points of Presence	Initial subscriber registration and contribution upload	Regulator	Rs 200	n/a	n/a	
	Any subsequent transactions		0.25% of contribution, min Rs 20, max Rs 25 000. Non-financial Rs 20	n/a	n/a	
	Administration charge per 6 months or Rs 1 000 contribution		Rs 50 per annum	n/a	n/a	
	Contribution through eNPS		0.10% of contribution, min Rs 10, max. Rs 10 000	n/a	n/a	
Trustee Bank	Flows between intermediaries		NIL (potentially ge	ets benefit of sweeping	cash)	
Custodian	Asset servicing	Auction	0.0032% per annum			
Pension funds	Investment management	Auction	0.01% AUM	0.0102% AUM	0.0102% AUM	
NPS Trust	Fiduciary	Expenses only	0.01%	from Trustee Bank		
Retirement advisers	Advice, onboarding	Regulator	Rs 120 for onboarding, Rs 20 for subsequent services, max. Rs 100 per annum			

Table 6. New Pension System in India

Source: PFRDA

Policy responses and outcomes

73. Policy makers in many jurisdictions have been successful in reducing the level of costs and fees in pension funds and this should have a positive impact on outcomes. Australia's Productivity Commission found evidence that "fees *are* a primary determinant of net returns".¹⁹

74. However, policy measures that are successful in containing costs and fees may not be as effective in improving outcomes. Costs are a function of the quality of plan administration and the design and implementation of the investment strategy, and higher costs may result in more sustained growth in pension assets, for example if they result in more engaging communications with members or superior investment performance. APRA (2016) stated that "for any given pattern of contributions, members' retirement outcomes are primarily driven by investment performance".

¹⁹ Productivity Commission (2017)

75. Furthermore, policy intervention may lead to higher regulatory 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. Australia is re-evaluating RG97, which has proven burdensome for providers, and MiFIID 2 is also under scrutiny. Some commentators have raised concerns that retail savers will view new information on costs as amounting to a fee increase, rather than simply making explicit costs that were formerly implicit, and so be less willing to contribute to pensions.

76. There is therefore an argument that to be effective, policy should not look at pension fund costs and fees in isolation but should consider the "value for money" offered by the provider. Regulators in Australia and the UK require pension fund trustees to deliver good value for money, rather than low costs. Pension providers that are offering good value for money will be growing assets through high quality administration and investment services at a competitive cost to members and sponsors.

Value for money in the accumulation phase

77. Both 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.

78. There are quantitative measurements that can be used to assess administration quality and cost, such as the number of calls handled, the turnaround time for member queries and the direct cost of the administration function. Similarly, net investment returns give an objective measure of the quality of investment services, including the impact of direct and indirect costs. The <u>OECD Core Principles of Private Pension</u> <u>Regulation</u> include the recommendation that pension plans have a written investment policy that establishes "clear objectives for the pension fund consistent with its retirement income objectives and specific attributes".

79. However, these metrics do not indicate whether the provider could have done better. Would it have been possible to provide more speedy and accurate administration services at the current cost, or was the provider offering expensive services that members did not value? Could investment costs be reduced to increase the net returns generated by the investment strategy? To determine whether a pension fund offers good value for money, such that outcomes could not be significantly improved, it must be benchmarked against a relevant reference point.

80. Finding a relevant point of comparison for pension funds is not straightforward. Cost and quality can vary widely, depending on the nature of the pension arrangement, the complexity of its administration and investment operations, its membership structure and the design and implementation of its investment strategy. Benchmarking can lead to herding behaviour in investment and less innovation in administration, resulting in weaker competition among providers, and might encourage short-termism in investment. However, peer groups and proxies can be constructed that give regulators, members and employers/sponsors information about the relative cost and quality of their pension fund.

Benchmarking DB funds

81. Value for money should be relatively straightforward to assess in DB arrangements. DB providers have a clear target – to grow assets so that they meet future

liabilities – and often have a strategic asset allocation to guide long-term investment strategy. 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, or to the investment gains made by other DB funds with similar portfolios. Absolute levels of cost and quality will vary across plans, but comparisons can be made across providers with similar activities.

82. Table 7 shows the information revealed in the financial statements of two large occupational DB plans in the Netherlands and two in the UK. Table 7 does not show that one fund offers better value than another, but it highlights areas where there may be scope for funds to reduce costs. Administration costs of the four funds range from 4 bp to 10 bp of assets under management and direct investment costs from 10 bp to 19 bp. The UK does not require funds to report total investment expenses.

	BT Pension	RBS Group	ABP (NLD)	PMT (NLD)
	Scheme (UK)	Pension Fund (UK)		
Assets under management (AuM)	GBP 46.1 bn	GBP 45.3 bn	EUR 381.8 bn	EUR 68.2 bn
Asset allocation:1				
Equity	25.6%	19.3%	31.7%	27.4%
Bills & bonds	39.5%	52.9%	35.6%	45.9%
Cash & deposits	5.6%	3.6%	-	6.1%
Alternatives	16.0%	19.6%	11.6%	9.2%
Property	11.3%	3.8%	11.5%	8.4%
Other	2.1%	0.9%	9.5%	3.0%
Administration expenses % of AuM	10 bp	4 bp	4 bp	10 bp
Investment expenses % of AuM:				
Direct only	19 bp	15 bp	10 bp	16.5 bp
Total	n.a.	n.a.	60.9 bp	47.8 bp
Direct transaction costs % of AuM	2 bp	2 bp	5 bp	8 bp
Equity transaction costs % of AuM ²	0.6 bp	2.2 bp	1.4 bp	n.a.

Table 7. Cost comparisons in DB plans

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

83. If DB providers understand their cost structures and they are able (or required) to benchmark the cost and performance of their administration and investment activities against relevant peers, they will be able to see where there is scope to improve outcomes. 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.

84. 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 were 58.5 bp in 2015; administration services for members (i.e. excluding the costs of governance and oversight of the plan) cost a further 7.5bp; total costs across all funds ranged from 15bp to 200bp.²⁰

²⁰ Source : CEM Benchmarking

85. In Switzerland, pension funds have been required to report their Total Expense Ratio (TER) in their annual reports since 2013;²¹ 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.

Benchmarking DC funds

86. It is more difficult to assess and compare across DC funds. They have a wide range of administration service levels, investment strategies and liquidity constraints, especially in DC systems where there is an element of choice. Employers or employees may be able to choose their provider, they may select bespoke investment strategies or require different levels of administrative support. There may be intermediaries between the member and the provider. This means that a wide range of DC outcomes is possible, making it complicated to construct peer groups.

87. Unlike DB funds, which have a unique long-term investment objective (meeting liabilities), DC plans can have very different investment strategies. PPI (2016) noted 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 tolerances and other sources of retirement income. 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 8). Absolute investment gains and performance relative to market benchmarks or peers could also vary markedly over different time horizons.

²¹ The TER includes explicit investment costs that are deducted directly from members' assets and some administration costs

Sample of funds available within 401k plan.								
Fund name	Expenses	Average ann	ual 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 PI	0.07	23.80	7.82	0.95	Spliced Total International Stock Index			

Table 8. Conoco Phillips Saving Plan Investment options, Performance and Expenses

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, 2017

88. Given the difficulty of creating DC peer groups of funds with similar administration and investment activities, a simpler method of assessing value for money and member outcomes could be 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) suggest that 50 bp is a reasonable TER for a default fund operating at scale. The <u>OECD Roadmap for the Good Design of Defined Contribution Pension Plans</u> recommends establishing appropriate default investment strategies, in particular lifecycle strategies.

89. Not all pension systems include a unique 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 a benchmark, 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 lifecycle 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.

90. DC plans could be assessed against the fees (to members and employers) and net returns of the default strategy or proxy. Members of other DC plans could reasonably ask

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their provider whether they were on track to achieve equivalent outcomes to the default for a similar cost, and if not, why not.²²

91. Default funds with very similar investment designs can deliver different investment returns and charge a wide range of fees. Table 9 shows the investment strategy and fees for selected default funds or proxies in different jurisdictions. Return targets and investment performance differ between the funds, but the investment designs are similar: all include a form of de-risking as the member approaches retirement age. Fees vary from a minimum of 3.8 bp (US) to a maximum of 95 bp (Hong Kong (China)).

	NEST Retirement Date Funds (UK)	Thrift Savings Plan (US)	MySuper – Industry level (AUS)	AP 7 Safa (Sweden)	DIS – industry level (HK-China)
AuM	GBP 1.7 bn	USD 500 bn	AUD 474 bn	SEK 328 bn	HKD 15.4 bn
Investment strategy	Target date	Lifecycle/building blocks	Lifecycle and single strategy	Lifecycle	Lifecycle
Return target	CPI + 3% Volatility target for each stage	Market indices for each of bond and equity components	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%	Range 1.5% -2.3%	6.6%	19.5%	n.a.
Fees - asset-based	3 bp	3.8 bp administration	49 bp	11bp in growth phase reducing to 6 bp at age 75	75 bp investment management
- other	180 bp per contribution	0-1.2 bp stock lending	AUD 87 annual administration fee per member*	-	20 bp recurrent operating expenses
- total as % of AuM	50 bp	3.8-5 bp	≈50 bp	6-11 bp	95 bp
Direct transaction costs as % AuM	Range 0-4.9 bp	n.a.	n.a.	n.a.	n.a.

Table 9.	Cost	comparison	across	default	funds
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Note: excludes one-off fees e.g. entry/exit, switching fees. *Source*: Annual Reports, APRA, Orange Report 2016.

92. Benchmarking DC plans against a default could help to identify outliers in terms of outcomes, but it would remain complicated to draw conclusions about the value for money offered by individual funds in jurisdictions with a large number of providers and a wide variety of plan designs. Therefore benchmarking should complement and not replace measures to put downward pressure on costs.

Investment expenses and outcomes in the accumulation phase

93. Investment expenses are likely to be a major cost item and potentially one that can be compressed in both DB and DC funds. Ramsey (2002) found that charges to recover the cost of investment management typically were the largest ongoing charges and had the most direct relationship to the performance of retirement funds in Australia.

94. However, investment 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 whether a fund's investment expenses are

²² Short-term investment returns could differ e.g. if a bespoke strategy included more volatile asset classes than the default.

reasonable in absolute and in comparison to the costs incurred by other portfolios. These indicators would also make it possible to tie rewards more directly to outcomes.

The impact of investment strategy

95. Investment cost, risk and return are interdependent. Low cost, low risk strategies 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. 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.

96. Investment costs should therefore be reported alongside risk and return. Focusing only in cost may have unintended consequences. 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. However, Ainsworth et al. (2016) found that while higher fees were associated with returns, they were also associated with higher risk, so that outcomes were not necessarily better.

97. Pension funds can also consider a number of complementary indicators to understand the contribution that different asset classes and different managers within their portfolios are making to overall outcomes. Investment managers and strategies can be analysed in terms of the returns generated per unit of risk taken, fees per unit of return and the amount of alpha that is retained in fees.

98. 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 the market. This type of analysis makes it easier to improve the value for money of investment activities by tying rewards for investment managers to outcomes.

Rewards for investment managers

99. In traditional asset classes, investment manager fees are usually ad valorem, that is they are calculated as a percentage of assets under management. Managers of alternative assets, such as hedge funds or absolute return funds, may charge a combination of an asset-based fee and a performance-based fee. Neither fee structure will necessarily reward managers appropriately. Asset-based fees can reward managers who underperform the market and their peers and penalise those who outperform. Performance-based fees should avoid that problem but need to be carefully designed so that managers do not keep a disproportionate share of the value they create.

100. Ad valorem or asset-based fees provide few incentives for investment managers to become more efficient or to share efficiency gains with 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 one

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.

101. Ad valorem fees also limit the effectiveness of price caps. 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 (Table 10). Assets under management grew rapidly, implying that the AFORES were reaping economies of scale, and the cost of acquiring new contributions fell (Table 10). CONSAR will therefore start considering cost indicators, such as net profit, return on equity and return on assets, when assessing fee proposals from the AFORES. It also intends to introduce performance-based assessments, by taking into account historical investment performance, and investment performance relative to a benchmark portfolio.

(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%	

Table 10. Fees and margins in Mexican AFORES

Source: CONSAR.

102. Performance fees can help to align better the interests of investment managers and pension fund members and sponsors. Hamdani et al. (2017) use evidence from a regulatory experiment in Israel to demonstrate that funds with performance fees exhibit higher risk-adjusted returns than funds with asset-based fees operating in different competitive environments.

103. Performance fees must be structured in such a way as to give the right incentives to pension funds and their investment managers. Rewards should be paid for delivering high returns per unit of risk taken, and a fair share of returns should stay in the portfolio rather than being paid out in fees. The basic parameters of a performance fee design (there are many more complex structures in operation) are:

- The fee base (e.g. is the fee calculated on investment gains or on AUM) and the fee rate
- The performance reference point, i.e. the minimum return the fund must earn before a performance fee is due
- The measurement period, i.e. the length of time over which performance is calculated
- The high watermark (HWM), if any, which is the last highest value that the fund has reached

104. The performance reference point can be fixed (a "hurdle rate") or variable (e.g. a market index). It is important that the reference point reflect the investment strategy of the fund. An equity manager should not be paid a performance fee for outperforming a cash benchmark, since the bulk of any outperformance is likely to be due to the investment characteristics of equities relative to cash rather than to manager skill. Pension

fund management companies operating in Latvia's mandatory funded scheme are benchmarked against a composite debt and equity index. In Poland, the reference point is competitors' performance. Performance fees are calculated as 0.06% of assets under management multiplied by the "percentage premium ratio", or the relative performance of the fund versus its peers. The ratio is 1 for the best performing fund – which receives a performance fee of 0.06% of AUM – and 0 for the worst performer – which receives no performance fee. Other funds receive an amount below 0.06% of AUM that reflects their relative position.

105. High watermarks (HWM) are intended to ensure that managers are not paid a performance fee for good performance in one period unless they have caught up any underperformance in previous periods. The fund value must always be above the previous HWM for a performance fee to be earned. The Czech Republic and the Slovak Republic both use HWM in the calculation of performance fees; the Czech Republic sets the HWM as the historic maximum value of the fund while the Slovak Republic looks back over a shorter period.

106. High watermarks can be effective in preventing a "double fee". Such double charging is a feature of ad valorem fees, where the fee basis is the full AUM. An individual who joins a DC scheme at the age of 25 and retires at the age of 65 will pay annual fees on his first year's contributions 40 times. Fees will also be paid each year on the prior years' investment gains. Box 3 illustrates the application of a performance fee with a fee base of investment gains, a fee rate of 20%, a hurdle rate of 5%, a measurement period of 1 year and a HWM. Box 3 also shows that a high watermark (HWM) can be effective in preventing a "double fee" (i.e. the fund manager is not rewarded for the Year 1 performance in both Year 1 and in Year 4).²³

²³ Conversely, if an asset class suffers a sharp fall, a manager might take several periods to get back to the HWM even if he outperforms the market consistently. This outperformance would not be rewarded. This can be resolved through the use of "relative high watermarks".

Box 3. Simple performance fee

The chart shows the path of a pension fund portfolio, with a starting value of 80 rising to 100 at the end of Year 1, falling to 70 at the end of Year 2, climbing back to 90 at the end of Year 3 and finishing Year 4 with a value of 110.

The fund manager receives a performance fee of 20% for performance above a hurdle rate of 5%, subject to a high watermark, HWM. The fee is calculated on the absolute increase in the value of the portfolio.



At the end of Year 1, the fund manager has earned a performance fee of 4. This is equal to 5% of AUM and 20% of investment gains. Absolute performance is 20 (100-80), equating to an investment return of 25% (20/80) and the hurdle rate is 5%. The performance fee is therefore calculated as [20 * (25% - 5%)]. The high watermark rises from 80 to 100.

The fund ends Year 2 with a negative performance and fails to meet the hurdle rate, so no performance fee is due. At the end of Year 3, the fund value has risen from 82 to 90, a return of 9.75% which is almost double the hurdle rate. However the value of the fund remains below the HWM so no performance fee is due.

At the end of Year 4, the fund value has risen by 20, or 22%. The fund manager earns a performance fee of [20 * (22% - 5%) = 3.4]. This is equivalent to 3% of AUM and 17% of investment returns. The new HWM is 110.

107. However, this may not be enough to create alignment of interests. The upside potential of a strongly-performing manager is potentially unlimited, while the downside risk is limited – especially since most performance fees are payable on top of an assetbased fee. Fee caps can help to create more symmetrical payouts; so can reserve systems, whereby a portion of any performance fees earned are "banked" in a reserve pool, and used top up the portfolio if the manager subsequently underperforms. This cushions investors against a run of poor returns and leaves the possibility for the manager to earn back lost reserves and fees once performance improves. 108. There are practical difficulties in implementing performance fees. Parameters need to be negotiated and calculating fee accrual can be complex; performance fees may be higher than asset-based fees for strong managers and so increase investment expenses. They may also pose stability risks, as performance fees are more volatile than asset-based fees. Given the importance of investment manager fees and performance to outcomes, they are nonetheless a potentially powerful means of improving the value for money of the investment activities of pension funds.

Conclusions and policy implications

109. The cost of running pension funds – providing administration and investment activities – and the way those costs are passed on to members, employers and sponsors have a significant impact on outcomes. The value of pension assets is directly affected by fees that are levied on contributions before they are invested and by other charges that are deducted from the investment portfolio throughout the accumulation phase.

110. Market mechanisms have failed to keep costs and charges at competitive levels. Disclosure-based initiatives are the principal policy tool for strengthening competitive pressures in private funded pension systems. These policies have been supplemented by regulations to control pricing and/or structural measures to influence the set-up of the pension market or the products offered by pension providers.

111. There are a number of lessons that can be learned from the experience of different jurisdictions in addressing weak market mechanisms in both DB and DC pension provision.

- No single policy response is effective in isolation. Measures aimed at stimulating market mechanisms work best when they are reinforced by pricing regulation and structural solutions.
- Transparency is a pre-requisite for containing costs and charges, but is not sufficient in itself to improve outcomes. Sponsors and trustee bodies must be prepared to act on the information to reduce the costs of DB plans, and employers and members must be able to benefit from greater disclosure to put pressure on DC providers.
- The role of the Regulator is critical neither plan providers nor plan participants will take action on costs and charges independently of regulatory action, or the threat of such action.

112. Regulatory efforts to increase investment cost disclosure are accelerating and reporting requirements are increasingly stringent. However policy makers might find that putting in place a limited disclosure regime and making it more stringent over time is more effective than asking providers to introduce full cost disclosure in one go.

- Aiming for a very high level of investment cost transparency can create delays and generate new expenses.
- Compliance rates for less rigorous disclosure regimes are likely to be higher and the amount of data will be manageable for regulators as well as providers.
- Direct costs especially direct investment costs have a significant impact on outcomes and are relatively easy to identify.

113. Cutting costs leads to immediate gains, which can become significant over time through the effect of compounding. Targeting costs and fees may not, however, improve outcomes.

- It is difficult to get a true picture of total costs, so such policies may miss important indirect or implicit charges.
- Cost-cutting may lead to overly conservative investment strategies or lower quality administration services.
- Policy makers have therefore tried to address the "value for money" offered by pension providers as well as their costs.

114. If a pension fund is offering good value for money, there will be limited scope to improve outcomes.

- Benchmarking DB funds against relevant peer groups, and DC funds against a lowcost lifecycle strategy, can reveal whether administration and investment costs are competitive and investment performance is commensurate with investment expenses.
- For benchmarking to be effective, providers that under-perform need to be held to account by the regulator, sponsor, or members.
- Direct investment costs are likely to be one of the biggest expenses for pension funds so it is important that they do not over-pay for investment performance relative to other funds. Rewards for portfolio managers should reflect their contribution to outcomes, which is a function of performance, risk and costs. Performance-based fees can improve incentives for investment managers and avoid the double-charging inherent in asset-based fees.

115. Policy makers have been successful in reducing the costs and fees of pension funds in several jurisdictions through a combination of different measures to strengthen market mechanisms, restrict fee options and introduce structural changes in the overall system or at the level of the provider. These efforts could be complemented by data on the value for money offered by different funds, which would indicate whether individual funds have the potential to reduce costs further in order to generate better outcomes for their members and sponsors.

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