

Making Pension Charges Clearer

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Introduction

1. The NAPF announced, at its Annual Conference in October, that it would be calling an industry Summit to promote transparency in pensions costs and charges. This was in response to concerns raised by both the Workplace Retirement Income Commission and the Pensions Regulator that people did not understand the costs of their pensions. This initiative has been welcomed by Pensions Minister, Steve Webb MP.
2. To inform initial discussions at the Summit and initiate the development of a Code of Practice, this paper:
 - Sets out proposed aims for a Code of Practice to make pension charges more transparent.
 - Summarises current regulation and practice regarding disclosure of pension charges.
 - Summarises recent relevant customer research undertaken by Ipsos Mori.
 - Identifies for discussion potential issues and problems with the current situation.
 - Lists some ideas for improvement and issues for further exploration.
 - Proposes next steps for taking the work forward.

The paper reflects an initial assessment of the issues. Comments, factual corrections and further evidence are welcome. In particular, **examples of good and bad practice would be welcome by the end of December 2011, with any wider comments by 1 February 2012.**

Proposed aims for a Code of Practice

3. The proposed aims of the Code of Practice are to:
 - provide information about charges to pension scheme members in a form they can understand, as part of good transparent practice;
 - allow more ready comparison so that employers, trustees and advisers are able to act as well-informed customers; and
 - provide a basis on which charges across the industry can be monitored and compared in the public interest.

Current regulation

4. Regulation of charges disclosure in DC pensions varies according to the situation:
 - Pensions sold to **individuals in a retail environment (including Group Personal Pensions)** are **covered by FSA regulation**. This specifies in some detail (see para 5 below) how the effect of charges should be illustrated to the customer pre-sale.

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- Where an employee joins (or is auto-enrolled into) a pension scheme chosen by the employer the rules about charges disclosure vary by type of scheme. **Contract-based** schemes (eg GPPs) are required by FSA regulation to provide an illustration that shows the effect of charges. In the case of **trust-based** schemes there is normally no requirement to disclose charges. However, recent guidance from DWP regarding default funds suggests that 'the charging structure' should be communicated to scheme members.
 - Whether and how charges must be disclosed to an employer when they are choosing a pension scheme for their staff depends on the exact circumstances.
 - Regulations prescribe that holders of money-purchase pensions should receive annual statements ('**Statutory Money Purchase Pension Illustrations**'). However, there is no requirement for them to show information about charges.
 - Providers of **stakeholder pensions** are required to disclose deductions for charges made from an individual's pot.
5. The question of **what counts as a charge** and **how it should be disclosed** is addressed in the FSA handbook (which applies FSA regulated activities ie in general to contract-based, but not usually to trust-based schemes):
- The handbook (at COBS 13, annex 3) prescribes the following tabular illustration to be used at the point of sale. For a pension this table would go up to the intended retirement date:

2.2 The effect of charges table: (1) for a life policy, personal pension scheme or stakeholder pension scheme must be in the following form:

R					
Note 1A	Note 2	Note 3	Note 4	Note 5	Note 6
At end of year	Total paid in to date	With-drawals	Total actual deductions to date	Effect of deductions to date	What you might get back
	£	£	£	£	£
1					
...					
5					
10					
...					

- The same annex (at R3) also requires that the Reduction in Yield (RIY) should be illustrated to show the extent to which charges are reducing the annual rate of return.

- Illustrations must usually be personalised to the individual (re age, contribution level, fund choice, intended retirement age). In some circumstances (including auto-enrolment) an example illustration is allowed instead if the charging structure is simple enough.
- COBS 13 annex 2 (R2.6) prescribes that charges shown 'must not include the firm's dealing costs incurred on the underlying portfolio'.
- FSA have recently published the rules (in Policy Statement 11/14) for showing charges attributable to advice separately from product charges. FSA also intend to consult on showing the effect of inflation in illustrations.

Current practice

6. It is common practice for pension providers/schemes to provide information to both employees and employers about charges. However, while there is a degree of prescriptive legislation, practice varies quite widely. For example:
 - Some quote an AMC as a percentage; others illustrate the effect in cash terms.
 - Some present information in a personalised form, others with a generic example.
 - The time periods over which charges are illustrated vary.
 - In some cases the information is prominent, in others it is hard to find.
 - Some use simple language; others are technical.
 - In some cases charges for different parts of the process (eg fund management) are shown separately.
 - The requirement to disclose deductions from stakeholder pensions is usually met by a statement on the level of the AMC.
 - It is rare for providers/schemes to show the actual cash amount of charges on an individual's statement.

We looked at a small sample of cases and summarise the main points from them at Annex A.

7. The actual level of charges also varies considerably. Research for DWP (Research report 630) found 45% of GPPs/SHPs charging over 1% AMC and 33% of occupational schemes over this level. Of the occupational schemes seven percent had AMC charges of 3% or more. The comparable figure for GPPs was not available. Both types of scheme can have extra charges (eg for switching funds); in contract-based schemes these ranged from 0.06% to 1% of the fund.

Customer research

8. Recent focus group research conducted for NAPF by Ipsos Mori found:
 - Low levels of knowledge about management fees and what they pay for. Those who had heard of an AMC were confused as to whether it was levied on contributions in the last year, all contributions to date or the value of the pot.

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- When participants learned of the cash difference over a lifetime between AMCs of 0.3% and 2% they were shocked. They felt the long term cash effect should be clearly explained to customers.
- Annual pension statements were rarely read as customers found them too hard to understand. There was a call for clearer, more easily understandable information on charges as they applied to an individual's own pension.
- Some were sceptical about shopping around for low charges, believing providers would find hidden ways of making a profit from them. Others thought that higher charges could be justified by investment performance.

Discussion of potential issues and problems with the current system

9. A number of issues and problems are evident from the above:

- There is **no clear universal requirement for charges to be disclosed to the employer at the point they are choosing a pension scheme for the workforce**. While charges are commonly disclosed, the lack of any requirement, or specification as to how they are shown, leaves room for employers to make poor choices. This issue is particularly acute given that, following the introduction of auto-enrolment, tens of thousands of employers will be choosing a pension for their staff (many for the first time).
- The FSA **requirement to disclose charges to individuals** at the point of joining **applies only to FSA regulated activities**. Trust based schemes are covered in very general terms in the guidance for default funds issued by DWP; the guidance is silent for example on the need to show the cash effect of charges or the effect over a lifetime.
- Once an individual is in a scheme, the information they receive about charges can be scant or negligible. It is **very rare for charges actually taken to be shown in pounds and pence**, yet that is the language most people understand. The absence of such information may mean there is little demand-side pressure for schemes to maximise value for money.
- It is **hard for individuals and employers to compare charges, and value for money, across the market**. Those with Independent Financial Advisers or Employee Benefit Consultants may get good advice, but this may not be available to many smaller employers. And the lack of regulation of advice to employers may leave some concerns about whether advice is always unbiased.
- The lack of up-to-date comprehensive information about charge levels across the DC pensions sector **prevents effective monitoring in the public interest** eg by consumer groups and the Pensions Regulator/DWP. It also feeds suspicion (often unjustified) about value for money of pensions and makes it **hard to counter false stories**.
- There is a **variety of definitions of charges**. And some formulae designed to enable comparisons do not cover the full range of charges (eg Total Expense Ratios exclude initial and exit charges – see Annex B for more detail). One major issue is whether **dealing costs** associated with the investment portfolio should be disclosed and if so how. Many in the industry (and the FSA definitions) see these as a 'drag on performance' rather than a charge.

Others argue that these costs should be disclosed so that customers can decide for themselves whether they are justified by improved performance.

- There is a concern that even where there is full disclosure of charges the **material may be too long or complex for many people to understand**.
- Finally, since the core issue is value for money there is a question about whether schemes explain clearly to members **what services/value they are getting in exchange** for their charges. The examples we have looked at suggest there is scope for improvement here.

10. A number of arguments have traditionally been made that while the current situation may not be perfect it is best left alone:

- It is argued that **charges in the workplace pensions sector are generally low** compared to the retail sector. However while this should be mostly true the lack of transparency makes it hard to fully substantiate. And the true comparison is not with the retail sector but between competitors in the workplace sector, where there is clearly significant variation and where the arrival of auto-enrolment changes the consumer protection arguments.
- It is argued that most **customers are not interested in charges**. But the focus group research shows they become interested when they realise the effects. And if customers are unable/unwilling to act to look after their own interests in a key area of public policy the alternative is likely to be state regulation.
- It is argued that when customers see the cash amount of charges **they might stop saving**. But if the product is good value for money and the communication is good this seems unlikely.
- It is argued that **AMC charging structures, which cross-subsidise from the better-off to the worse-off, may come under threat** once their effects are transparent. However, it is hard to see whether great demand-side pressure for different structures will arise.

Ideas for improvement and issues for further exploration

11. Possible ideas for improvement (which are not mutually exclusive) include:

- Ensuring all charges are always disclosed in a standard format to employers when choosing a scheme and to employees when they are enrolled.
- Providing annual information to scheme members about the cash amount they have paid in charges.
- Ensuring, for all scheme types that illustrations of the effect of charges cover a working lifetime.
- Ensuring transaction costs are stated/illustrated. Options range from stating the actual level of each charge through to calculating an expected/actual 'portfolio drag' figure.
- Ensuring public disclosure of charges perhaps linked to the creation of a comparison website.
- Adopting a standardised method of comparing charges (eg through the use of RIY figures or through cash figures for standard illustrative individuals).

12. A number of issues will need to be addressed if these ideas are to be pursued. These include:

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- The balance between standardised illustrations (best for generalised comparison) and those tailored to an individual company or person (may be most meaningful to individuals).
- The balance between using prescribed formats and allowing discretion.
- How to align a new approach with regulatory requirements and to minimise implementation costs.
- How a voluntary Code of Practice would operate and be policed and whether a 'kitemark' should be required for schemes used for auto-enrolment.
- How to ensure the value of the service provided is communicated clearly.

Proposed next steps

13. We would welcome views on the issues raised in this paper and the priorities for further action. A working group will be set up to explore the issue in more depth and develop an industry Code of Practice. We suggest the working group be asked to report back by February with its recommendations for a Code of Practice and any other actions. This would enable the Code to be launched in the Spring, well ahead of the start of auto-enrolment.

ANNEX A: Summary of sample cases examined

Case 1: Trust-based scheme with 300 members

- Charges shown at page 25/6 of document handed to staff.
- Text: *The manager's charges differ according to the type of fund. The charges are made within the fund and are reflected in the price of fund units. With some funds, two unit prices are shown - the "bid" price, at which units are sold, and the "offer" price, at which units are bought; the difference - the "bid/offer spread" - reflects the manager's dealing costs. The bid/offer spread on these funds vary.*
- This is followed by a table which lists 6 funds, showing for each "%Annual Charge on Fund" and "% Bid/Offer Spread".

Case 2: Contract-based scheme with 100 members

- Charges are mentioned on page 19 of the 24 page 'toolkit' given to members (and at slide 26 of a 34 slide staff presentation).
- First block of text headed Investment Funds: *The annual management charge depends on the funds you invest in and ranges from 1%-2%. This is based on the funds available to you as at 3 Feb 2011. There is a rebate of 0.42% each year achieved by monthly creation of units.*
- Second block of text is headed Additional Expenses: *Additional expenses such as trustees', registrars', auditors' and regulators' fees may be deducted from some investment-linked funds. In addition where the [name of insurer] investment-linked fund links to a Fund of Funds (a fund that holds other underlying funds as its investments) the additional expenses may also include the cost of managing the underlying funds. Where these expenses arise within the fund they have been taken into account in the calculation of the unit price. Details of the Annual Management Charge and any Additional Expenses can be obtained from your [insurance company] Pension Pack.*

Case 3: Contract-based scheme with 4000 members

- Charges are mentioned on page 4 of 5 of the invitation to join letter (and on slide 10 of 42 in employee presentation).
- Text under heading 'What are the charges?': *[The employer] has negotiated a discounted Annual Management Charge (AMC) on your behalf. The AMC is 0.5% on both your own and [the employer's] contributions. If you leave the company your AMC will increase to 0.7%.*

Case 4: Trust-based scheme with 1500 members

- Here we looked only at a sample Annual Benefit Statement.
- Its only mention of charges was in the footnotes explaining the assumptions made in calculating the future pension forecast.
- Text: *It has been assumed that...future investment returns will be 7% per annum, however a deduction of 0.5% per annum has been made in respect of expenses.*

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Case 5: Contract-based scheme with 100 members

- We looked at a Key Features document and a personalised illustration.
- Charges were mentioned on page 3 of 6 of the key features document which refers the reader to the illustration for details.
- Information about charges is given on pages 5, 6 and 7 of the 10 page illustration. It begins by explaining there is a charge of 0.29% of the fund per year. Two tables follow.
- The first table shows the 'effect of deductions to date' as a cash figure at the end of a given number of years. In total 16 sample years are shown (between 1 and 40).
- The second table shows the RIY and explains: *[The charges] would have the effect of reducing...growth from 7.0% down to 6.7% a year.*

Case 6: NEST

- Pages 4 and 5 of the 14 page 'Welcome to NEST' booklet are devoted to charges.
- The booklet uses simple language and using an example of £50 a month going into a pot worth £5000, shows that the charge for the year would be £23.80.

Commentary

This small sample illustrates a number of issues:

- Language varies from the simple (eg case 6) to the technical (cases 1 and 2).
- Transaction related charges are rarely mentioned (case 2 is the exception).
- The cash effect of charges is illustrated in cases 5 and 6 but not in the documentation we saw for the other cases.
- The long term effect of charges is shown only in case 5.
- In most cases charges are mentioned after many pages of other material.

ANNEX B: Summary of existing ways of capturing the total effect of charges

Total Expense Ratios (TERs)

These are defined in FSA regulation for collective investment schemes, based on the EU Directive on UCITS. They do not apply directly to pensions but may be given when a pension invests in unit trust/OEICs. Strong points:

- They include a wide range of operating expenses such as Annual management charge, Legal fees, Administrative fees, Audit fees, Marketing fees, Directors' fees, Regulatory fees, 'other' expenses.
- As they are expressed as a single percentage they can be easily compared.

Less strong points:

- They are measured retrospectively at the end of each year and not guaranteed for the year(s) to come.
- They don't include Initial charges and exit fees, Brokerage fees, Bid-offer spreads, Market impact costs, Taxes (eg stamp duty), Interest on borrowing, Soft commissions may also be omitted.

The FSA definition can be found at Annex 1 of COLL4.

Reduction in Yield (RIY)

This is a single percentage figure that shows how much the investment return will be reduced by charges. For example, if an investment yielding 6% a year is reduced to 4% for the customer by the effect of charges, the RIY is 2%. Strong points:

- It captures initial and exit charges as well as ongoing annual charges.
- It is expressed as a single percentage allowing easy comparison.
- Current FSA rules already require these for contract-based pensions.

Less strong points:

- They are projected based on assumed investment growth and over an assumed period so may prove different in reality.
- Some costs are excluded such as transaction costs associated with the investment portfolio .

The FSA definition can be found in COBS 13 annex 3.



Securing the future of pensions

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