A consultation on charging – DWP consultation on Better workplace pensions

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I am responding in a personal capacity as an independent policy adviser, and a pensions industry and consumer expert.

Highlights of this response – top ten issues

1. *Reform of annuity charges and value for money is even more important than capping charges during accumulation – 0.5% lower annual charge could mean 11% larger pension fund after a lifetime of saving, but poor annuitisation risks losing far more than this in one go at retirement*
2. *It is vital to have charge controls to ensure charges don't drift up as small firms start auto-enrolment*
3. *Not necessary to mandate reform of both past and future scheme charges simultaneously – but charge controls on new schemes are urgent and easier to implement*
4. *Changing charge structures for existing schemes is more complex and could be delayed till after 2018*
5. *Auto-enrolment requires economies of scale to operate most efficiently and charge controls should help consolidation*
6. *Government intervention is required to protect workers from principal-agent problems especially as small firms stage*
7. *All charges should be disclosed in a mandatory format, covering all the fees paid, but transaction costs should be disclosed separately*
8. *NEST's charge structure undermines the principle of clear, simple, comparable charges and should be simplified*
9. *Active and deferred members of a scheme should face the same charge levels, with no more Active Member Discounts or Deferred Member premiums*
10. *It's impossible to say what a 'fair fee' is and there is no one right answer. However 0.75% excluding transaction costs may be a suitable compromise figure.*

Introduction:

I am delighted that the DWP is consulting on the issue of charges for workplace pension schemes, especially as auto-enrolment is starting to reach smaller sized employers. It is important to note that charges on pension funds have fallen significantly in recent years, with many schemes offering good value, in the context of a market of relatively small scale in relation to countries such as the US. Although charges have fallen, upcoming capacity constraints which will result from so many smaller size employers starting auto-enrolment in coming months, could cause fees to rise. The DWP and OFT should be congratulated on the excellent work to identify important areas that need to be addressed to ensure protection of workers' pension savings and to try to maximise the value of future pension funds over the longer-term. However, it is even more urgent that the Government addresses the shortcomings of the annuity market, where losses from buying poor value annuities can be far higher than those resulting from paying somewhat higher fees while accumulating the pension fund in the first place.

Detailed Response:

1. **It is even more important for the DWP to reform charges and value for money on annuitisation, than for the accumulation stage:** While the Government is right to focus on ensuring that future auto-enrolment pension costs are reasonable and fair value, it has missed the big elephant in the room with respect to pension charging and value. Even if the Government manages to ensure that all auto-enrolment schemes have charges that are 0.5% a year lower than they otherwise would have been, over the course of a whole retirement the DWPs figure suggest that the average fund at retirement would be 11% higher. However, the costs and values of annuitisation can wipe out far more than 11% of people's pension. Therefore, the failure to address egregious charges and poor value annuities will ultimately cause far more damage to pensions than the charges in the accumulation phase. Workers who buy the wrong annuity can end up losing well over a quarter of their pension fund and they will often pay at least 3.5% of their entire fund value to an insurer, pension company or annuity broker when they buy an annuity. This is without receiving any advice to ensure they buy the right product at the best rate. The issue of annuity charges is far more important than pension charging. Indeed, the urgency is much greater too. A worker will only lose the 11% of their fund value from the 0.5% higher charges over the course of a full working lifetime, whereas those reaching retirement soon are at risk of losing far more than that all at once. Given that charges on fund accumulation have already fallen significantly since the days of excessive unfair fees, reforming annual charges is perhaps less urgent than the need for attention to value for money and full charges disclosure on decumulation.
2. **It is important to ensure charges do not drift upwards as small firms start auto-enrolment:** The DWP is right to be concerned in particular about smaller employers and the consultation suggests that the Government is already aware of the dangers that small firms may be offered far less attractive terms than larger companies that have auto-enrolled so far. SMEs are bound to have less buying power than larger employers. Small firms will be unable to negotiate such good terms and as demand exceeds supply, members need protection to ensure fair value and economies of scale if possible. The evidence clearly shows how much better value large schemes are than those run at smaller scale – for example the DWP Survey results showing schemes with 12-99 members have average AMCs of 0.82%, while those with over 1000 members have average AMC of 0.5%. In addition, there is a looming

capacity issue in the pensions industry, as more and more small firms try to set up schemes in time for their staging date but do not understand all the complexities of pensions. Capacity constraints are already emerging, with some pension providers already turning away business. If there is too much demand in any industry, charges are bound to rise. Therefore, it is certainly important to consider capping the charges for future auto-enrolment schemes as soon as possible. In situations where demand exceeds supply, and where consumers do not understand the way a product works, coupled with the principal agent problem, it is vital that workers' interests are protected at the earliest possible opportunity. Just forcing disclosure of charges would not require employers to act, but setting an upper limit will mitigate the risks of pension companies taking advantage of the lack of buying power of small firms. All trust based schemes should be required to disclose the charges to members in their annual statement in future.

3. **DWP has left it late to consider controlling charges and may need to consider a two-stage approach to reform, dealing separately with future schemes and past schemes:** Ensuring fairer charges for the newly established schemes is much easier than changing charging structures for schemes already established. This consultation is particularly important for ensuring that the pension schemes which are being and soon to be set up for auto-enrolment among smaller and medium sized firms, will offer good value for money for workers' pension savings. It is, of course, somewhat late to only be looking at this issue now and would have been far better to address it before auto-enrolment had already reached millions of workers, but the attention to this issue now is welcome nevertheless. The delay in dealing with charges makes a solution more complicated, but as there are still huge numbers of employers yet to set up pension schemes, it is important to proceed as quickly as possible to deal with new schemes, while leaving legacy issues for future reform.
4. **Changing charges for legacy schemes could be delayed while auto-enrolment is still ongoing and then start after 2018 to coincide with pot follows member:** I have concerns about trying to change charges on legacy schemes while auto-enrolment is still ongoing. Currently, only 10% of contract-based schemes and 6% of trust-based schemes charge over 1% and the average charges are 0.71% for trust-based and 0.95% for contract based schemes. Larger schemes have average AMCs of 0.46% and the ABI says that new schemes set up for auto-enrolment have an average charge of 0.52%, compared with previous Group Personal Pensions which averaged 0.77%. The PFT also found that charges for bundled trust based schemes have fallen from an average 0.79% in 2001 to an average 0.51% AMC in 2012. Charge caps on legacy schemes should be considered separately from the issue of capping or controlling charges on newly established schemes. Once auto-enrolment has already started, a charge cap may require the scheme to be changed and this would cause further disruption to the whole auto-enrolment process. As most auto-enrolment schemes already have reasonable charges, it is better to delay the requirement for any charge cap until after 2018, perhaps by 2019, for those schemes already established. It will be much simpler to ensure that schemes not yet set up have fairer charges than to address those already established and the major concern is that smaller firms will not achieve as good outcomes for members as larger ones have been able to. It would be better not to wait until problems arise before introducing controls, as has too often happened in the past with pensions. As auto-enrolment is going to spread to more and more medium or small scale employers, most of whom will never have offered pensions to their workforce before, there is an opportunity to ensure good value for the future. As regards schemes already established, while auto-enrolment is still ongoing, I believe that the Government should signal its intention to ensure charges are fair after 2018 sees auto-enrolment fully matured,

and once the 'pot-follows-member' reform begins, rather than forcing pension providers to change charging on existing schemes as well as on new schemes. The ABI is conducting its audit of pre-2001 schemes and any post 2001 schemes with AMCs above 0.75%. This study should highlight where the real problems lie, but achieving change in schemes that are already running will be more difficult and complex than for those yet to be introduced, which is why I suggest a two-stage approach.

5. **Auto-enrolment pension schemes ideally need economies of scale to offer good value:** Pension funds for auto-enrolment will be much better value if they achieve economies of scales, than if they are run one by one at small scale. The smaller the scale, the higher the costs are likely to be, as pension administration and management is far more cost effective when spread across large numbers of members with large sums of money being contributed. Thus the UK is unlikely to achieve the same scale as countries such as the US. This issue has already emerged as a problem for many of the smaller defined benefit pension schemes, which have much higher costs because they are being run individually, rather than having industry-wide schemes or having many firms joining together to benefit from reduced administration costs. As the DWP consultation shows, smaller schemes have administration costs of around £200 per member per year, whereas those with large numbers of members have administration costs of just £10-£30 a year. It has become far too difficult to change legacy DB schemes and merge smaller schemes together, but before such difficulties are entrenched in auto-enrolment schemes, it would be sensible for the Government to encourage as many larger pools of assets as possible. That will drive down costs. It is also likely to lead to consolidation among providers. If there is a charge cap, it would mean smaller, less efficient providers will be forced to improve or lose out to rivals and consolidation could be beneficial, if it allows the economies of scale to ensure a lower cost base and lower fees. Already, the ABI says that five firms account for two thirds of insurance-administered pension funds and most of those using passive management are able to offer lower fees.
6. **Principal-agent problem requires Government to step in on behalf of workers who actually pay the charges even though employer selects the scheme:** The principal agent problem is an important issue and workers need to be sure that their employer will select a pension scheme that offers them value for their money. Without controls on the charges for workplace pension schemes, workers would be at risk of poor value, because the employer chooses the scheme but does not have to pay the actual fees. Where precisely the level of fees should be set and what is 'reasonable' is almost like asking 'how long is a piece of string'. There is no one right answer. The principal agent problem in auto-enrolment makes it necessary to consider regulatory controls in the customer interest, since it is the employer who chooses the scheme, while the workers pay the charges. Until now, there have been too many examples of employers passing unfair costs onto their workforce – whether via consultancy charges or active member discounts or commission. Employers obviously need to pay to set up pension schemes and the costs should be considered alongside other professional fees such as accountancy or legal fees, rather than being thrust onto the workforce without ensuring the workers are receiving good value for the fees they are paying.
7. **Mandatory disclosure of all charges in a standardised format would help employers and workers compare schemes properly, but transaction costs should be reported separately:** I do not believe that a mere code of conduct is sufficient, since it would not be binding. I believe that mandatory disclosure in a standard format for all default funds in newly established auto-enrolment schemes is required. AMCs are not sufficient, currently TERs do

not include all costs either. It should be mandatory for all auto-enrolment pension funds to disclose their charges in the same manner, including the same items, so that figures for total management fees can be compared. However, I believe that including transaction costs is not feasible for comparison purposes, nor is it likely to be meaningful, however transaction costs should be clearly and fully disclosed to all parties on at least an annual basis.

8. **NEST's own charging structure adds to the complexity of charges comparisons and it is best to have just one simple charge, not multiple charges:** If the Government seriously wishes to achieve comparability across funds, so that employers and workers can compare the costs of one pension provider's funds against another, then having a simple single-tier charging structure is necessary. The OFT rightly pointed out that the past over-charging has been hidden by multiple layers of fees, with up to eighteen different fees being identified. The most sensible approach is for all schemes to have just one charge, clearly reported and easily compared, so that employers and employees can assess value for money. Unfortunately, by having an initial 1.8% fee and then 0.3% AMC, NEST merely adds to the problem of comparability. The DWP suggests that a charge cap could operate as long as the majority of members achieve low costs in the long-run, but that is not the optimal solution. NEST's charging structure will penalise some members. For example, a 1.8% fee is not fair on older workers who can only be in the scheme for a short time. Trivial commutation rules will not necessarily help here and the DWP's aim of achieving a charge cap to aid comparison of charges is somewhat undermined by NEST's complex charging. This seems rather unhelpful to the reform agenda. NEST should ideally be in the vanguard of best practice for charging, but it is not.
9. **Deferred members should pay the same as actives:** The Government is right to ban Active Member Discounts and I believe that all members in auto-enrolment should face the same charges, whether they are active or deferred members. Banning Active Member Discounts is important, since this practice seems highly unfair to workers who will not realise that their pension savings are subject to higher charges. Costs should be fairly shared between all classes of member and fully disclosed to all. Employers should not be allowed to favour their own workers in terms of fund fees, but obviously only active members will have the employer contributions. The finding that AMCs for deferred members are around 0.47% higher than for actives is clear evidence of the detriment caused by such hidden arrangements. In addition, the practice of moving workers out of the company scheme when they leave and into individual pensions is merely a disguised way of making deferred members pay extra and is unfair on those who change employer. Given that the average worker changes jobs eleven time during their life, there could be significant detriment to such arrangements. If there were an automatic transfer system, this problem would be reduced, but it is necessary to ensure that workers are not just transferred into higher charging schemes if they do not need to be. If employers wish to reward their own workforce with better value, then this can be reflected in the employer contribution, rather than in the charging structure. Deferred members will no longer be getting contributions from their previous employer, but should not be penalised with higher charges.
10. **It is impossible to say what a 'fair' level of fees is – there is no one right answer – but 0.75% does not seem unreasonable, excluding transaction costs:** Of course, firms have to make a profit and companies managing pension funds cannot be expected to perform all the functions required without making a commercial return. It is not possible, however, to determine what a 'fair' level of fees is. There is no one right answer. Nevertheless, it is clear that some firms charged excessive fees in the past, and imposed terms that were unfair on customers, but were not understood at the time. A significant contributory factor to the

problem of high charging was the need to offer commissions to salesmen who would bring customers in. Now that auto-enrolment means employers have to set up pension schemes, rather than being persuaded to do so, the need for high commission structures is reduced and I believe the DWP is right to suggest that schemes used for auto-enrolment should not have built-in commission. All charges should be explicitly and fully disclosed in a comparable manner. The crucial issue is to ensure all charges are declared. If a charge cap covers only the 'AMC' then there will be room for funds to charge other fees that are uncapped. .

SPECIFIC RESPONSES:

Question 1: Effectiveness of initiatives so far and extent to which the industry discloses charges upfront, in a consistent manner, to members and employers

I agree with the WPSC that initiatives so far are not sufficient to achieve the desired aim of comparability and transparency of charges. The joint industry code, the ABI initiative and the IMA Enhanced disclosure initiatives are all welcome, but do not cover all funds nor all charges and there are no penalties for non-compliance, therefore those with the best practices are likely to sign up, while those who operate to lower standards will not do so. Currently, there is no uniform disclosure of charges across pension funds and employers are unable to compare like with like even if they want to. We really need charges to be disclosed consistently across all funds, so that they can be compared on a like for like basis. This ideally requires just one charge – a simple charging structure that members and employers can understand, that is fully disclosed with no more hidden fees. NEST currently has a two-tier charging structure which makes it more difficult to compare with other funds. I would urge the Government to consider simplifying NEST's charging structure. The Governments suggestion that any charge cap need only apply to the 'majority of members over the long-run' will obviously mean NEST can comply, however that is not necessarily in members' best interests. Many older or short-staying members will find NEST charges are higher than in other schemes.

Question 2: Is further action required by the Government to improve disclosure and if so which of the options should be introduced? Are there any other options?

I believe disclosure of all charges is important, but that is not the same as requiring a cap on all charges. Capping transaction costs, for example, would not be sensible since some fund managers will add value with more frequent trading, while others trade less but may achieve worse results. The important element for members is the full disclosure, so they can judge whether higher transaction charges are leading to better performance. If transaction costs are hidden, the member will not receive the information they need to make comparisons, should they wish to. I would not be in favour of only disclosing transaction costs to a governance committee, I believe there should be full transparency and disclosure.

Question 3: How might the total cost of scheme membership including transaction costs be captured, what would be reasonable and practical to ask providers and investment managers to report on and to whom (members, employers and governance committees/trustee boards?)

As in Question 2, I think full disclosure to members, employers and governance committees or trustee boards should be made. All parties should be given the relevant information.

Question 5: Which of the three options for a cap is the most appropriate?

If a cap is used, I believe that a 0.75% cap is most appropriate at least initially, but the cap must apply to all charges excluding transaction costs and only on one default fund offered. A 1% cap is too high to ensure good value.

Question 7: How will employers and pension providers respond to a cap on charges and what evidence is there that charges will be levelled up in response to a cap?

There is a danger that charges may drift upwards if a cap as high as 0.75% is introduced, since many schemes currently charge much less than this. However, starting with a 0.75% cap will allow time for some smaller firms to improve their cost structure and then ultimately charges should fall further in future.

Question 12: Should transaction costs be included within a charge cap?

It is not reasonable, in my view, to include transaction costs in a charge cap. But they should be fully disclosed. Transaction costs should be clearly itemised, but the charges on the scheme should relate to the non-transaction costs, since performance may suffer if funds are unable to trade due to needing to keep in line with a cap. In times of market turbulence, trading costs may rise because of beneficial asset allocation changes.

Question 13: Would requiring the disclosure of transaction costs to trustees and the independent governance committees to be set up for contract-based schemes help to manage any potential avoidance risks associated with a charge cap?

I do not believe selective disclosure is appropriate. Members should be given all the information, even if most of them will not use it.

Question 14: Are there any specific services that may need to be excluded from the cap to avoid constraining innovation, for example, in respect of annuity broking services?

I do not believe that annuity broking services are appropriate as the decumulation default option – brokers will not ensure that members get the right product or buy their income at the right time. Advice is really needed. Annuity brokers also charge exceedingly high fees for selling annuities to members and an investigation of value for money and charges is urgently needed.

Question 21: What would be the impact of a ban on commissions in qualifying schemes and does commission present a barrier to switching?

In an ideal world, employers should pay a fee and not commission to anyone helping them set up a pension scheme for their staff. Just like hiring an accountant or a lawyer to help with other requirements, those setting up pension schemes should pay for a professional to help them. Commissions have in the past been responsible for a large part of the problem of over-charging customers and banning commission is the optimal solution. In the real world, however, there are more practical difficulties, but I still believe banning commission would be appropriate.