SEEING THROUGH BRITISH PENSIONS

HOW TO INCREASE COST TRANSPARENCY IN UK PENSION SCHEMES

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Tomorrow's Investor: introducing fit-for-purpose pensions to the UK

Three years ago, the RSA began investigating the efficacy of the UK investment system. After in-depth research, including the use of 'citizen juries', we concluded that it was not fit for purpose. Private pension saving in particular was found to be patchy, costly and poorly structured.

However, we suggested that, with some modest changes, the private pension system in Britain could be radically improved. This requires two things: first, a system of low-cost, auto-enrolled pension provision; second, a recreation of collective pension structures which share risks and can offer superior benefits.

In line with these initial recommendations, we welcomed the government's decision to adopt auto-enrolment, but noted the need to remove artificial restrictions it had placed on NEST, the default provider established to ensure the policy could work. Further, it should encourage other providers who would offer similar and transparent terms to NEST. We are therefore happy that the Parliamentary Work and Pensions Committee is investigating the restrictions on NEST, and that when giving evidence to the committee, the minister agreed that, without such restrictions, NEST would be more effective and less costly.[1] We are also pleased that two alternative low-cost providers have been established in the UK, one of them a former sponsor of the RSA's work.

With regard to the second suggested change, the creation of collective pensions, we are also pleased that the pensions minister has indicated he would "like to facilitate risk sharing" in pensions[2] – a central element of our proposals. He has announced a consultation later this year to help achieve this. So, while we await action, the debate is moving in the right direction.

Throughout our work, we have noted the need for 'stakeholders' to reach consensus on how best we provide pensions. So we are delighted that the National Association of Pension Funds (NAPF) and the TUC have endorsed our proposals, and that we have also received help from the CBI. We are encouraged that they are now working together to protect collective

1. See evidence at www.parliamentlive.tv/Main/Player.aspx?meetingId=9968
2. See report of speech at http://ipe.com/news/webb-pledges-to-facilitate-pension-guarantees-risk-sharing-in-dc_42567.php [requires free registration to access]

pensions in the UK from the unintended consequences of ill-judged regulations.[3] We would also like to thank the financial press for the exposure they have given to these issues of cost; not just the reports of the RSA but others' work as well. The tide of opinion is changing.

In this paper, we return to the question of pension charges. In particular, how it is possible to inform savers of precisely what charge is being levied on their pension savings.

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3. See www.ft.com/cms/s/0/397de0a2-5574-11e1-9d95-00144feabdc0.html#axzz1mTbjxzFF [requires free registration to access]

Introduction

Our financial system manages the savings of millions of people's pension funds and savings. Four years ago, the RSA began investigating the needs of these 'citizen investors'. Under the project umbrella 'Tomorrow's Investor', the work used citizen juries to probe areas where people felt improvement was merited. Jury members concluded that they were unaware of pension charging structures and the amount of their investment that was swallowed up in charges. It was this area they felt needed greatest reform.

Since then, there has been a lively debate about pension charges, with front page stories in national newspapers, and investigations commissioned by parliamentary committees. But a conundrum remains. If this is such an important issue, why have market forces not brought about a reform of the system? One reason is simply a lack of transparency about what the costs of pension savings are. Do we know the level of charges on our pensions pots?

If this is such an important issue, why have market forces not brought about reform of the system? One reason is simply a lack of transparency about what the costs of pension savings are

In this paper, as part of the 2012 series of outputs from the Tomorrow's Investor programme, we investigate the debate around costs and transparency in UK pension schemes. We discuss pension charges and cost transparency in the UK. The findings show that individual consumers do not have a clear understanding of the charges being levied. Nor do small companies who, in good faith, are trying to offer decent pensions to their employees. Even more worrying, our research suggests pension providers are not freely giving the information needed on costs and charges, or noting its significance for pension outcomes.

We ask why the market has failed to deliver, and draw on behavioural economics to offer some explanations as to why people do not shop around to seek transparency and lower costs. We also examine and review the most recent government investigations into costs and note these have failed to discover the level of pension charges, revealing instead widespread confusion about cost levels.

In the second part of the paper, we discuss a way forward for bringing trust and transparency back to the British pension system. A case study of the Danish system provides an example of transparency and disclosure in practice and we give an outline of its key features and principles. A similar system is to be introduced in Holland.

Finally, we issue a call for action to bring together a change in the UK pension system on transparency and set out the steps needed to revive trust in the system. In this context we welcome the recent consultation from an NAPF-led working group about how pension charges can be made clear and comparable for employers, and we look ahead to how transparency might also be achieved for individuals.

What we know about costs

In previous reports,[4,5] we have discussed the issue of why costs matter. This has often been overlooked because pension costs are expressed as an annual charge on the balance saved. However, the 'average time' during which money is held in pension savings might be 25 years. On that basis, a 1.5% charge per annum translates into 37.5% over the lifetime of the pension. When this was explained to our citizen jurors, they were aghast. They had not understood the mathematics of charges, nor had it been explained to them. This, more than anything, made them feel the system was not trustworthy. So it is perhaps worth taking an example of how charges affect returns.

Imagine that a 25-year-old decides to save for a pension, so they can retire at 65 and enjoy a pension for the next 20 years. They set aside £1,000 each year, and raise that sum to cover inflation, which is 3%. They receive a 6% return on their money. That means that, by the age of 65 if they have no fees to pay, they will have a pension pot of £248,170. This in turn will create an inflation protected pension of £16,080 for the next 20 years. Now imagine that, each year, they need to pay 1.5% on the money they have saved. How much will that reduce the value of the pension? The answer is that it will be reduced to £9,900 each year. In this case, someone who pays no fees gets a 60% higher pension than someone who pays 1.5%.

What initially seems like a modest charge actually equates to a very large difference in pension payment. Compounding of charges is one reason why citizen investors have such difficulty in distinguishing between one pension and another. It is simply not made clear to them that a pension provider with a charge of 0.5% will, all else being equal, provide a pension which is a third higher than one which charges 1.5%.

What we don't know about costs

But even if the calculation we have just described were made clear, consumers need to know about all charges. Right now they do not.

Savers are frequently quoted the *AMC, or annual management charge*. This is what the fund manager takes for their service every year, and is generally accepted as the key indicator of what a pension will cost. However, the fund manager is not the only one who adds charges to the fund. Audit, custodial and other costs are often charged separately. Further, some funds place savers' money with others. So the 'top' fund in which a saver invests may charge 0.5%, which will be disclosed as the AMC, but then subcontracts some of the investment activity to another one which charges 1%, creating a total charge of 1.5%. In order to aggregate all these charges, pension providers are now being asked to provide a *total expense ratio (TER)*; that is, how much in total they charge annually as a percentage of the funds they manage.

But there are still further, hidden costs in managing a pension fund. These costs include taxes, broker commissions and the differential between bid and offer prices. They also include elements such as stock lending fees, and a list of other costs that are associated with different

4. *Tomorrow's Investor: Building the consensus for a People's Pension in Britain*, RSA, 2010

5. *Tomorrow's Investor: Pensions for the people: addressing the savings and investment crisis in Britain*, RSA, 2010

asset types and investment strategies. These costs are not declared, and we have not been able to find a pension provider willing to give us a full breakdown of them. As a result, no one can tell the full costs associated with pension fund investment.

In October 2011, the NAPF warned of the "eye-watering complexity" related to pension fund charges.[6] But it does not have to be like this. Across the North Sea, in Denmark, pensioners are provided with a clear understanding of the costs attributed to the fund. The Danes go further in their disclosure on a variety of topics affecting a fund's performance and ask pension providers to give a clear account of their position. This transparency on both the investment and operational side of the pension means the charging structure and potential value of the future pension pot are clearly understood. Consumers can choose which pension provider is likely to give them the better return and so allows market forces to work effectively.

These examples show that the problem can be addressed in the UK, but only if we see much greater transparency in our pension system.

6. *Daily Telegraph*, 19 October 2011, www.telegraph.co.uk/finance/personalfinance/pensions/8837642/Prudent-savers-hit-by-excessive-hidden-fees-on-pensions.html

Levels of transparency

Retail pensions

In February 2012, we conducted a short survey of the information given to individual, or 'retail' consumers when purchasing, or planning to purchase, a pension. We contacted a sample of 23 pension providers in the UK and asked the following questions:

- What charges would be levied to the pension investment?
- What other charges would be levied apart from the AMC and administration charges?
- Are you able to confirm that no other further charges are levied to the account?
- Is it possible to get a breakdown of any charges?

This followed our 2011 research[7] when we asked Fellows of the RSA to ascertain from pension providers what they were being charged for their pension in relation to costs. In both cases, we wanted to understand whether the information given on costs accurately reflected the true position of the scheme.

Our findings

Of the 23 pension providers questioned, 21 responded by saying that the annual management charge and the administration costs were the only charges. Of the two that did say there might be other possible charges accrued, they were unable at the time of publication to give a list of readily available charges. Yet we know that there are bound to be charges beyond these: for example, for trading or for stock lending.

It can be argued that trading and other costs add value to the saver's portfolio, and are therefore worth incurring; indeed, that a good fund manager will wish to incur them if it is in the saver's interest. But regardless of the merit, it does not mean the cost has disappeared. In a recent study for the Treasury, Christopher Sier and former hedge fund manager David Norman sought to disentangle the full costs of investing in company shares.[8] They found the TER using data from a professional fund ratings agency.[9] They then looked at the average cost and frequency

7. RSA Comment, David Pitt-Watson http://comment.rsablogs.org.uk/2011/01/05/tomorrows-investor/

8. Sier and Norman, *Compexity and overintermediation in UK equity fund management*, Nov 2011

9. Lipper, a Thomson Reuters company, which describes itself on its website (www.lipperweb.com) as "a global leader in supplying mutual fund information and fund ratings, fund analytical tools and fund commentary".

of trading shares. They reckoned the TER was 1.7%, and had been rising over previous years, and that trading costs were 1.4%, making a total charge of 3.1%. This was for an equity fund but if such a charge was applied over the 25-year life of a pension fund, more than half the potential pension benefit would disappear.

In Table 1 we illustrate our survey results. As mentioned, even when we probed, only two out of 23 respondents admitted there might be trading and other costs. Fees for similar services varied hugely: from 0.1% to 1.5%, a 15-fold difference. And all the fees are lower than the TER in the survey used by Sier and Norman.

For this reason we re-contacted some of the providers, to probe more deeply into the costs they had quoted. We asked them whether the AMC included all charges which would be declared in the TER. Only seven funds were able to answer the question on the phone. Of these, all said the TER was not included in the AMC. Failure to declare the TER is particularly perplexing given that from June 2012, all funds covered by the European UCITS Directive will be required to show their TER. Since most pension providers are also providers of UCITS products, it is disappointing that they seem not to wish to give a full cost breakdown when selling pensions.

So, right now we would conclude that pension savers are not being provided with adequate information. This means customers are ill-informed about the impact that costs have on the return on their pension pots. This explains why our citizen juries were so shocked at pension charges. It is small wonder then that many people opt out of pensions altogether, while others end up with a pension pot that will not provide an adequate retirement income.

Pension savers are not provided with clear information about costs and without this information, markets cannot work well.

Table 1: Declared charges from selected providers

	What charges would be levied to the pension investment?	What other charges would be levied apart from the AMC and administration charges?	Are they able to confirm that no other further charges are levied to the account?	Is it possible to get a breakdown of any charges?
Pension provider 1	0.35 to 0.75 dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 2	0.85 to 1.15 dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 3	0.50 dependant on fund	Possible	In writing	Pending
Pension provider 4	Dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 5	Dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 6	Dependant on fund	None	Yes – only amc and admin charge	No

Pension provider 7	0.75 to 1% dependant on fund	Possible	In writing	Pending
Pension provider 8	1 to 1.5% dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 9	0.55% dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 10	0.5% to 0.75 dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 11	Dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 12	Dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 13	0.25% dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 14	0.75 to 1.3 dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 15	0.10 to 06 dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 16	0.25 to 0.75 dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 17	Dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 18	1% dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 19	1.5% dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 20	0.555 to 1% dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 21	Approx 1.5 dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 22	Approx 1.5% dependant on fund	None	Yes – only amc and admin charge	No
Pension provider 23	1.45% but may rise in the future	None	Yes – only amc and admin charge	No

Administration and investment costs both matter, and if suppliers give under-estimated figures, surely this will only erode trust in the system. Even if many of the pensions sold are good ones, trust will break down for the entire industry if there is a lack of transparency and providers are unable or unwilling to disclose key figures.

In a world where each individual saves for their own pension, costs are critical to pension outcomes

We do not want to single out individual pension providers, and indeed we recognise there are many in the industry who have sought to address some of these issues. Unfortunately, collectively, the industry seems to maintain a fog around what goes on. Perhaps it feels this has been good for business over the past 30 years so there is little incentive to change.

However, 30 years ago defined benefit pensions were the norm, and costs did not matter to the pensioner because they had a promise on the level of pension they received, irrespective of charges. But in a world where each individual saves for their own pension, costs are critical to pension outcomes. It should be possible for market forces to allow savers to choose the best pension. But they need to know what they are buying. More transparency would empower the consumer and give them a fairer chance of understanding and navigating their way around the complexity of pension funds.

Small employer pensions

If retail pensions are sold unreliably, what about occupational pensions? It is a government policy, and one endorsed by the RSA and other stakeholders, that employers are best positioned to choose pensions for their employees. In the past, of course, when the employer guaranteed the level of pension paid, the employee had little concern about how much the pension cost, since any shortfall would be made good. But in the new era of defined contribution, any charges directly affect the pension paid.

It is a government policy, and one endorsed by the RSA and other stakeholders, that employers are best positioned to 6choose pensions for their employees

It is important that employers choose a good pension. In particular, with the introduction of auto-enrolment, many small employers will be providing pensions for the first time. So what do we know about the pensions which smaller employers are buying. Are they indeed providing good value for money?

Very little evidence is available to answer this question. However, some relevant government research has been done in this area. In Table 2, we set out a review of various papers and a synopsis of comments and the results. What does it tell us?

First, it only tells us about AMC, rather than the total costs of managing a pension. So employers, just like personal pension holders are without a clear understanding of the impact and the breakdown of cost charges.

The most comprehensive study of charges is entitled *Charging Levels and Structures in Money Purchase Pension Schemes*.[10] It had two parts, the first of which involved talking to small trust-based *employers*. The research found charges to be quite high at 1.23% on average and 1.53% for very small schemes. These figures did not include all commissions given to intermediaries, other elements of TER or any hidden costs. But the most striking discovery in this study was the confusion surrounding pension charges. For example, nearly a quarter of scheme owners believed that the charge was only levied on contributions, not on the outstanding balance. Of these, 45% thought the total charge to be only 1% or less on the contribution; in other words, they believed it to be a tiny fraction of the true cost. Some others believed that the charge was 5% per annum on the outstanding balance, a figure which would leave little for the saver, while 8% simply did not know what the charge was.

The second part of this study approached *providers* of contract-based pensions. Of 22 providers, only eight were willing to give figures for their charges. And the information given was somewhat limited. Of the group prepared to reply, they claimed 55% of the pensions they provided charged less than 1%. The providers gave no information of the distribution of charges above 1%.

So what can we conclude? First, that charges are high. The numbers reported for small employers all exclude charges which would be included in a TER, as well as hidden costs. Further, we feel respondents are likely to have under-estimated, rather than over-estimated. Witness the number who believed there was no charge. But second, small employers, just

10. *Charging levels and structures in money – purchase pension schemes: Report of a quantitative survey*, Department for Work and Pensions, 2010

like retail purchasers, do not know what they are being charged. They often do not know the true AMC. They are therefore unlikely to understand the TER, still less the total cost. Essentially the employer, with good intent, is trying to make provision for its workforce. But without transparency in charges and a clear understanding of the significance of those charges, there is a huge danger that it will be sold an expensive and inappropriate product.

Because of the danger of such misselling, one consultant hired by the DWP to research pension provision through small employers suggested it "gives … careful consideration [to the view that] a light-touch, process-based approach to regulation in this area is not appropriate and more heavy-handed, outcomes-based regulation would be better".[11]

In fact, the DWP has done the reverse. It has emerged that as part of the reform to workplace pensions, the DWP has inadvertently allowed the removal of the consumer protections which currently cover workplace pensions. It is now a matter of urgency that these are replaced; otherwise, in the absence of information given openly to sophisticated buyers of pensions, there is a real danger of the otherwise admirable wider reforms to pensions resulting in a misselling scandal.

Table 2: Recent studies on value for money of pension schemes

Title, year (and DWP research paper number)	Sample/approach	Result	Comment
Charging levels and structures in money purchase pension schemes, 2010 (630)	Small trust based DC schemes. Quantitative.	Average charge level for trust-based schemes was 1.23%, for those which had annual fee. Smaller trust-based schemes (with 6–11) members had an average charge of 1.53% [page 28]. This covers intermediary commission in only 50% of cases, so is underestimated. But there was apparently a significant confusion on how charges are levied. Almost a quarter of respondents believed them only to be chargeable on contributions. Others believed there was no charge, and some thought the charge to be as high as 5%.	Like all studies, this only reveals the annual management charge, and not the total cost of running the pension plans. However, this is the only quantitative sample of purchasers which is relevant to auto-enrolment (viz small schemes). It reveals considerable confusion about charges, and some very high charges indeed.
Charging levels and structures in money purchase pension schemes, 2010 (630)	Suppliers of contract-based schemes. AMC charge for eight (out of 22 approached) participating providers covering 3513 schemes sold during the 2008/09 financial year. All members; ie including active member discount.	No average charges provided; 55% charge less than 1% on average for total sample. For schemes with 5–49 members, the average charge was more than 1%.	This study could be relevant but it must be treated with some caution since the information came from a self-selected group of providers who would not have an interest in revealing high charges if these existed. The results were not audited. Respondents did not reveal the distribution of charges over 1%.

11. *Default options in Workplace Personal Pensions: report of a qualitative study*, DWP Research Paper 628, Department for Work and Pensions, 2010. See table.

Default options in Workplace Personal Pensions, 2010 (628)	Literature review; 14 interviews with providers (six), consultants (four) and other stakeholders.	N/A	The report concludes with a "cautionary note" that current practice may not be best practice and that "the DWP gives … careful consideration [to the view that] a light-touch, process-based approach to regulation in this area is not appropriate and more heavy-handed, outcomes-based regulation would be better".
Current practice in workplace personal pensions; *Pensions industry responses to the workplace pension reforms*, 2009 (591/592)	Qualitative study of providers (16) and intermediaries (24). Questions about current contract-based schemes.	Typical AMC 0.9% including intermediary fee. Range 0.4–1% but "if member selected relatively unusual fund options", fee could rise above 1% 0.5%, excluding intermediary fee. AMC higher as a function of scale, staff turnover, contribution size etc. Notes the existence of "active member discounting", ie people charged more when they leave employment. Also quotes one respondent: "Before stakeholder, there were a raft of charges – some too high, some much too high, some OK."	A qualitative survey, with a sample of providers and intermediaries (likely to be biased?). Only looks at AMC. Questions are about current large schemes and, as interviews suggest, unlikely to be relevant to small companies.
The use of vesting rules and default options in occupational pension schemes, 2011 (725)	Qualitative study of 24 employers, 10 providers and seven intermediaries. Of employers, six had fewer than 100 members, none had fewer than 12. Existing trust-based schemes.	Most charges between 0.4 and 0.6%; range 0.15–0.9% Employers said: "The AMC was of relatively low importance in comparison to fund performance in choosing a supplier."	The sample chosen includes no pension plans of below 12 members. However, this is a very important report, since it appears to be the one which is relied upon by the government in assessing fee levels. One might note that the aim of the study was not to discover current fee levels, and that employers were asked, in one hour, to answer over 100 questions.
Costs of running pensions schemes: findings of a feasibility study, 2007 (535)	Feasibility study, "essentially qualitative" of 35 DB and DC schemes of more than 12 members.	Trust-based DC (five responses) range 45–133 bps. Contract-based. Two employers didn't know. Two said 0.8–1%.	Shows the effort required to glean data, since employers tend not to be well informed about charges.

Why don't customers demand change?

So far, we have argued that retail customers and small employers are not well-informed about costs, and are likely to be charged at a high level. This prompts the question, why have consumers not shown more interest? Surely, if they had been concerned then there would be mounting pressure by the industry to provide transparency? Further, what has been government's view of the cost-charging structures; why haven't ministers intervened? These questions are now explored in the following section.

Consumers and financial literacy

As we have seen, the effect of costs on pension outcomes is substantial. But we have also seen that individual consumers lack awareness or understanding of pension costs, hidden or otherwise. As a result, they do not generate the necessary pressure for change.

How should we account for this lack of consumer understanding. One possible explanation is consumers' (lack of) financial literacy. Might better financial education solve the problem?

Financial literacy (often known as financial capability in the literature) refers to the "the ability of individuals to make appropriate decisions in managing their personal finances". Research by Lusardi and Mitchell at the Harvard Business School found that consumers struggled with understanding concepts such as stocks and bonds, compound interest and even simple division calculations.[12]

One reason pension charges are difficult to understand is because of the effect of the compounding of charges. A question posed by Lusardi and Mitchell is particularly germane. They asked:

> "Let's say you have $200 in a savings account. The account earns 10% interest per year. How much would you have in the account at the end of two years?"

Only 18% of respondents answered this question correctly. Of those who answered it wrong, 43% made a simple interest calculation, ignoring both principal and interest. Relating this to pension asset management costs, failing to recognise that costs are compounded would mean people

12. Lusardi, Annamaria and Mitchell, Olivia S., *Financial Literacy and Planning: Implications for Retirement Wellbeing*, Working Paper, Pension Research Council, WhartonSchool, University of Pennsylvania, 2006

Pension products are by nature a long-term product and, since people tend to undervalue income in the future and overvalue income in the short term, they may be less attractive

were unable to understand the impact a small increase in costs would have on their pension outcome.

Pension products tend to have a number of characteristics that make them more complicated than other financial products. They are by nature a long-term product and, since people tend to undervalue income in the future and overvalue income in the short term, a pension product may be less attractive. This effect is called hyperbolic discounting, meaning that the participant's internal discount factor is too low for the future and too high for the near future from the rational point of view. In other words, the loss incurred now (paying a premium) is overvalued, while the benefit (pension income after retirement) is under-valued. In addition, unlike other products, there is no feedback mechanism when buying a pension as the 'reward' is only received after retirement, making it hard to learn from your mistakes until it is too late. Nor is it easy to compare pensions from the past generation. Comparisons are hard because schemes change and the pension product is dependent on the performance of the financial markets in a specific time period.

Research by the Danish insurance association supports this evidence of consumer behaviour.[13] It found:

- Most consumers do not know or care about their pensions
- Many consumers do not try to understand
- 90% of those questioned felt they were in good control of their finances.

The Danish study went on to look at consumer motivation to engage actively in pensions. It concluded that any system needed to deal with two key issues relating to consumer behaviour:

1. *Level of choice*. Questions arise as to how much choice consumers with low financial literacy needed to have in complex markets.Having many options attracts attention, but also reduced ultimate action to purchase a pension.
2. *The use of norms*. People generally like to fit in and do the 'right thing', so, unless pushed, consumers are unlikely to act or feel motivated to act to change their pensions. As a result, they maintain their current arrangements.

One long-term solution would be to educate consumers to understand their pension products. However, this also has a potential downside. In 2006, the Financial Services Authority launched a seven-point programme, the National Strategy for Financial Capability, to improve people's levels of financial capability. In a review of this work, three behavioural economists concluded:

> "If poor financial capability is mainly a matter of psychology, the information-based approach of the National Strategy for Financial Capability is likely to have only a modest effect in improving outcomes. The best

13. "Pensions, financial literacy and motivation", Danish Insurance Association presentation, 2010

> empirical work finds that financial education is not likely to have major effects on knowledge and especially on behaviour."[14]

So, financial education is not a panacea. And whatever the level of financial understanding, the market for individual pensions cannot be effective without transparency in clear and understandable English. Even the most capable financier cannot make a good choice if they do not know what they are buying.

14. *Financial capability: a behavioural economics perspective*, Consumer Research 69, Financial Services Authority, 2008

What information should be provided?

In the previous sections we have learned that individuals and small pension plans do not consistently know what they are charged for their pensions, and/or they do not know the implications of those charges. As economists will tell us, where customers are unable to discover the characteristics of the product they are buying, it encourages a 'market for lemons', where poor products crowd out, and can eventually destroy, the market for good ones. So, no one can object to pension buyers being given information explaining in clear and simple terms the costs associated with their pension. This information should be:

- *Clear and easy to understand.*
- *Comprehensive.*
- *Capable of reconciliation.* Like a bank statement, the customer should be clear how the provider has arrived at the declarations it has made.
- *Low-cost to produce.* The information should be provided so that it does not place an administrative burden on the industry that would be passed on in higher administration fees to the fund. So, ideally, it should use the same accounting systems that are already in place.

We note that in Denmark, such a system exists. In the following discussion, we have borrowed from Danish experience, and have outlined its characteristics in more detail in Appendix 2.

We believe that customers need information of two types. First, to help them make a decision about what pension to purchase. Second, to monitor the activities of their pension provider during their pension period, to check that it is being managed as expected.

The annual statement

In Appendix 1 we have illustrated a typical statement from someone who has a direct contribution (DC) pension. This statement should tell the policyholder about the charges which have been made to their pension. It does not. Nor does it show the return before charges. Readers may wish to reflect on this. A pension statement typically tells you (a) the amount saved at the end of the previous reporting period and new contributions made, and (b) the amount saved at the end of this reporting period. No information is given about how the provider got from (a) to (b).

It cannot be difficult for pension providers to show how the numbers have been arrived at, because these must have been calculated in order for the pension provider to know the level of pension saving at the end of the period

We consider this practice to be wholly inadequate. Imagine a bank statement that said: "This is what you had last year, and this is what you have now, but we will give you no information about how those two numbers reconcile, in particular how much has been taken in fees." This would clearly be unacceptable.

But it cannot be difficult for pension providers to show how the numbers have been arrived at, because these must have been calculated in order for the pension provider to know the level of pension saving at the end of the period. So, this information can easily be made available to the saver. If this was done online, the cost would be minimal.

That is what happens in Denmark. The saver can discover how the provider has calculated the difference between the money they had at the beginning of the year and the contributions to it, and the money available at the end of the period.

The Danish system is available online. It includes a summary schedule of costs and, for each cost category, the customer can, at a click, find a breakdown of each line item. Here is how we might envisage a statement for a UK pension. We have also suggested some of the breakdowns which would be given for each line item.

Table 3: Performance evaluation table for UK pension

	£
Money saved at the end of the last period	75,000
Contributions made [See Schedule 1] (this period)	5,000
Cash available for Investment	80,000
Returns Achieved [See Schedule 2]	5,000
Fund size before managers' fees	85,000
Direct Costs of Investment (TER) [See Schedule 3]	1,000
Costs of other services provided [See Schedule 4]	–
Money saved at the end of the period (after fees)	84,000
Cost if you were to realise the investment today	–
'Transfer Value' of your pension	**84,000**

Schedule 1, would allow the user to see when payments had been made into his or her account, and by whom.

Schedule 2, would allow the saver to see how well the investment manager had performed and how much had been spent by them on trading. We would envisage it to be shown:

Investment Returns	£
Total Gross Return from Investment	6,000
Cost of trading etc.	1,100
Investment returns before managers' fees (See evaluation below)	4,900
Other returns	100
TOTAL	5,000

Evaluation of Performance	£
Total Gross 'benchmark' return	5,000
'Value added' from investing before managers' fees (100)	(100)
Investment returns before fees	4,900

Schedule 3, would break down the main elements of the TER, including management fees, audit, custodial fees etc.

Schedule 4, would allow the inclusion of the costs of services which were bundled with the pension, for example life insurance policies.

In addition to this performance evaluation table, customers would also be given an indication of how much pension their savings might be expected to provide them with. This is already given by pension providers, assuming costs make no difference to outcomes. Again, this should show how the number has changed from the previous year, and why this has been the case.

Information before purchase

In the section above, we have outlined the information we believe should be provided during the life of the pension. But what should be provided to the customer before purchase? As we have noted, customers frequently fail to understand the implications of costs on pension outcomes. We suggest that these be made more explicit.

As automatic enrolment approaches, employers are in the front line in choosing pension schemes for their employees. We agree with NAPF that it is vital that *employers* receive clear and comparable information about charges before they choose a scheme for their employees. We welcome the approach to this set out in the recent consultation document from the NAPF-led working group.[15] In parallel, we have been considering what information should be given to *individuals* when they are considering joining a scheme.

In a typical sale of a pension, a customer will be given information about what level of saving is required to achieve a given pension. So, for example, they will be told that, on given assumptions about returns, a certain level of saving will give a certain level of pension. Beside this, a projection should be given for the value of the pension *if no fees were charged*, ie if the TER was zero.

We would note that this is a generous assumption for active fund management, since it assumes that the trading of securities is value adding when all participants have been included. Most academics would suggest that costs of trading might be added to TER to illustrate the likely difference in pension outcome.

Such information should be mandatory in any sale.

What other information do consumers need?

We have suggested there are two specific pieces of information which pension savers should receive.

15. www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0254_Telling_people_about_DC_pension_charges.ashx

1. An annual statement which reconciles their investment savings.
2. A statement before purchase which shows the likely effect that fees will have on their pension outcome.

Neither of these seem radical demands. Indeed, without such information, clearly expressed, it is difficult to see how anyone can understand whether their pension is appropriately managed, and represents value for money.

To these requests we would add a further one. The pensions industry in the UK, like that in Denmark, should aim to provide one platform where all the pensions which an individual holds are reported upon in this manner. People hold many pensions from different organisations, and should have the ability to compare and contrast them. In Denmark, such a system is already in operation. In Britain, where we boast one of the most advanced fund-management industries in the world, it should surely be possible to replicate what is already available on the other side of the North Sea.

Summary and recommendations

For markets to work effectively, consumers need to know what they are buying. In the purchase of pensions, it is clear many do not. Indeed we have shown that individual savers are not informed about costs, and that smaller occupational funds also lack an understanding of charges and their potentially profound effect on pension outcomes.

If we are to avoid a 'market for lemons', where good suppliers are crowded out and people stop saving, simple, accurate, high quality information needs to be provided

So, if we are to avoid a 'market for lemons', where good suppliers are crowded out and people stop saving, simple, accurate, high quality information needs to be provided.

There are some short-term fixes which should to be put in place. First, all pensions suppliers must commit, from today, that their sales forces will give full information on total expenses and their implications for pension outcomes. Our market research into the lack of information given to customers suggests there is a huge gap between the policies advocated in the board room and what is happening on the ground. This gap needs to be filled immediately.

This is particularly true for occupational pensions, where the beneficiary does not choose the pension provider. In our view, expressed in previous RSA reports, and endorsed by the Parliamentary Work and Pensions Committee, limits like those applied to stakeholder pensions need to be placed on the charges which can be taken from occupational pension savers. Without such protection, the UK risks a misselling scandal.

Other measures go beyond the short term. For example, we have shown that much of the information given to pension customers is provided in a format that is hard to understand.

We need a change to the way annual statements and pre-purchase information are given to customers. The annual statement should be presented like a bank statement. This is simple to do. It already happens in Denmark, and we have shown what the statement might look like.

Pre-purchase information should show what effect charges will have on pension outcomes.

Both of these seem the most basic requests. And, if a national system of this type was established, the market for pensions saving would begin to work better.

These are all simple recommendations. That such information does not already exist must be a contributory factor to the lack of confidence people have in the pension system. These are simple, low-cost, 'nudge' suggestions which will benefit all pension suppliers wanting to succeed on the basis of the value of the products they sell. But, more important, by providing this information, Britons can have greater confidence in the saving system and enjoy better, higher pensions at reduced cost.

Appendices

Appendix 1: An example taken from a typical UK pension statement

These are sent annually by most providers to defined contribution pension holders in the UK. We have put this together from a real client statement to illustrate the simple differences between the information available in the UK and in Denmark (figures and calculations are illustrative). We note that the UK information is summarised from one of the country's most reputable suppliers, and has been taken from a six-page statement. No summary table, such as the one compiled is included in the statement.

Yearly statement

Prepared for Mr Hansen

This pension plan aims to build up money in a tax-efficient way for when you retire. It will then provide a pension for the rest of your life.

The statement shows what your plan is worth now, the payments into your plan and how much pension you might get. It gives you the opportunity to review your financial needs.

Please keep this statement safe for your future reference.

Your plan Summary (from 1 April 2011 to 1 April 2012)	
Plan Values Calculated on 1 April 2012	
Current Value	£30,000
Last year's value	£20,000
The value is the amount you could have transferred to another plan	
Plan Payments for 1 April 2011 to 1 April 2012	
Payments into your plan	£9,000
What you might get back	
If our investments grow at:	7%
This could give you a final plan value of	£50,000
This could give you a taxable pension each year of:	£2,000
Detail given of assumptions for the calculation	
Investment gain for the year	£1,500
Charges (broken down by month, but not by cost category)	0.5%

Appendix 2: The Danish system

In Denmark, consumers are able to log on to a government-backed site that provides them with information of their pension provision (www.pensionsinfo.dk). The site, which is now subscribed to by most pension suppliers, provides comprehensive information to all Danish citizens. It explains how the pension system works, and once logged in, it provides individuals with details of all their pensions. For example, the site provides information such as:

- How the consumer is covered, in which funds they are invested.
- What contributions have been made into the fund.
- What returns have been made.
- What has been paid out in costs and expenses, for each element of the pension (for example, for life insurance).
- How much money they currently hold in the fund and its present value.
- And, as with a UK statement, it illustrates what the pension might be worth in the future.

An example of how this might look for the individual consumer is given below.

The Danish Pension statement

Figure 1: Example of pension statement

Eksempel: Hr. Hansens pensionoversigt

	Ind	Ud	Total
Depot pr. 1/1			230.000 kr.
Indbetaling	40.000 kr.		
Rente	11.000 kr.		
Betaling for administration		2.000 kr.	
Betaling for forsikringsdaekning		8.000 kr.	
Depot pr. 31/12			271.000 kr.

Translation

	Kr
Balance at last statement	230,000
Deposits	40,000
Returns	11,000
Costs for administration	2,000
Costs for insurance coverage	8,000
Balance at year end	271,000

For each of these categories, the account holder can then obtain further information and detail on the funds. This depends on the type of investments that the portfolio has. In terms of transparency, the definitions given for costs and the figures that have to be included are as follows:

- *Direct and indirect administrative costs.* These can include fund trustee and administration expenses, along with general set costs.
- *Direct and indirect investment costs.* These include the actual trades made on the customer's account, such as any money the company receives from investment managers, performance fees charged by fund managers and fees on stock lending. In real-estate funds, these might also include other expenditures related to the properties' current income, such as expenditure for collecting rent, salaries of caretakers, property taxes, maintenance, improvements and any other administration costs.
- *Annuity costs.* The costs associated with buying an annuity in a pension.
- *Risk-free return.* The risk of return is calculated as the excess return over the risk-free rate the capital could obtain on market conditions.

The system provides the account holder with the same level of detail and information that the pension fund itself has on its costs, its performance and its benchmarks. By visiting the website, you will be able to see some demonstratory explanations of the system, highlighting its ease of use and also its level of detail.