

Administrative charges

Options and arguments for controlling fees for funded pensions

The adequacy of retirement incomes is a central goal of all types of pension system. In defined contribution pension plans, the benefit depends on the amount of money paid in, the investment returns earned and the amount fund managers charge for administering accounts and investing the assets. Government policy affects all three factors directly and indirectly.

This briefing focuses on the third: administrative charges. It looks at the policies on charges and compares the fees levied in practice in fourteen, very diverse countries.

Measuring charges

Measuring the price of financial services is more difficult than comparing the cost of other goods or services. Providers can levy many different kinds of fees. Among the fourteen countries surveyed, we find examples of one-off and ongoing charges. Some fees are proportional and some fixed rate. Some are levied on contributions, some on the value of assets in the fund, some on investment returns.

These different kinds of charge accumulate and interact in complicated ways over the lifetime of membership of a pension plan. This leads to the second problem: how to summarize these charges in a single number to compare charge levels both between different providers in a single country and across countries.

The most familiar measure to investors and policy-makers alike is the 'reduction in yield'. This adds together all the charges over the lifetime of an example pension policy and expresses them all as a percentage of assets. An alternative approach is to measure charges as a proportion of contributions. This is the same as calculating the charges over the lifetime of the fund as a proportion of the balance accumulated at retirement. This second measure is known as the 'reduction in premium' or the charge ratio.

Different approaches to charges

Figure 1 summarizes different countries' policies on charges. At the top are the most liberal regimes. Countries lower down impose direct regulations on the structure or level of charges or regulate industry structure with important indirect effects on charges paid.

Australia

Australia introduced its superannuation guarantee system in 1992. From 2002, employers will have to contribute 9 per cent of their employees' pay into a defined contribution account. Only low-income workers, earning less than A\$5,400 a year, are excluded.

The superannuation mandate allows for a variety of different funds, but workers are members of:

- industry funds, which are collective plans covering a number of different companies; or

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master trusts, which are individual accounts offered mainly by traditional financial services firms.

Managers are required to disclose their charges in a 'key features' statement before purchase and in annual benefits statements to their members.

Industry funds typically levy a flat-rate administrative fee of around A\$45 a year plus a fund management charge of around 0.4-0.5 per cent of assets. The retail funds are more expensive. Flat-rate fees average A\$70 a year, while fund management can cost as much as 1.9 per cent of assets. There is also a charge of around 4.5 per cent of contributions.

Adding these different fees together, charges take up around 9 per cent of contributions in industry funds and nearly 30 per cent in master trusts. These are equivalent to 0.5 and 1.9 per cent of funds assets respectively.

The most intriguing question is why the charges are three times higher for retail funds. Australian experts have proposed: 'a difference in governance, historical ethos, institutional practices and industry structure.' Industry funds, with a captive

membership, have no need for marketing or a sales network. And information, services and investment choice tend to be more limited in the industry funds than they are in the retail sector.

United Kingdom

The option of leaving the public pension scheme and taking out a personal pension instead has been available since 1988. Around a quarter of employees have a personal pension. Employer-based schemes, which are predominantly defined benefit, cover another 45 per cent.

Personal pension providers use six different types of fees. Average charges for diversified funds are:

- £12 a year flat-rate
- 6 per cent of contributions
- 0.9 per cent of assets

But these averages disguise a huge range of different approaches. Two in five providers levy no fixed management fee, while one in ten asks for more than £30 a year. Half of funds charge 5 per cent of contributions, but some levy 12 per cent while others have no charge on contributions. Charges on assets range from under 0.5 per cent to 1.5 per cent.

Strategies on pension charges

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No restrictions	Australia Hong Kong United Kingdom (personal pensions) United States (401k)
Cross-subsidies to low-paid workers	Mexico
Limits on charge structure	Argentina Chile Hungary
Partial ceiling on charges	Poland
Variable ceiling on charges	Sweden
Competitive bidding, multiple portfolios	United States (thrift savings plan)
Fixed ceiling on charges	El Salvador Kazakhstan United Kingdom (stakeholder pensions)
Competitive bidding, single portfolio	Bolivia

more restrictive

Adding these different levies together, the average charge is 1.2 per cent of assets or, equivalently, 23 per cent of contributions.

The government will introduce stakeholder pensions next year. These plans share many of the features of personal pensions, but an important aim is to control costs and charges relative to personal pensions. Employers will have to pick a stakeholder plan for their workforce and facilitate access to it. The aim is to reduce marketing expenses and, with collective provision, of supplying information and advice. Secondly, some tax and regulatory rules will be simplified to reduce compliance costs. Thirdly, regulations on charge structure will only allow levies on assets. Finally, charges will be limited to 1 per cent of assets, equivalent to a charge ratio of just under 20 per cent.

At first sight, this is only marginally below the charges for personal pensions. But stakeholder plans must offer greater flexibility for people to stop and start contributions and change the amount they pay in. The charges on personal pensions could be a much larger burden than the figures quoted above because of their lack of flexibility.

Poland

Pension funds can levy proportional charges on both contributions and assets, but the asset-based charge will be limited to 0.6 per cent a year. Almost all funds levy the maximum. Charges on contributions are uncapped, but funds cannot adjust the charge with fund size or the value of contributions. They can, however, offer loyalty discounts. The typical fee is between 7 and 9 per cent of contributions initially, declining to 5 per cent after two years' membership. This is designed to prevent the excessive churning of members, and the associated marketing and administrative costs, that are characteristic of many of the Latin American systems.

Sweden

At just 2½ per cent of pay, Sweden has the lowest contribution rate to mandatory funded pensions. The government took great care to avoid charges eating up this modest contribution.

The new pension system builds on existing mutual funds. Fees are set by the public pension agency, using a complex formula based on the price charged for voluntary savings in the mutual fund, the value of pension assets attracted and the total assets under management. The result is that total charges for a large fund must not exceed around 0.75 per cent, about half the charges levied in the mutual fund market.

The ceilings were set low to avoid excessive marketing spending and to ensure that mutual funds could recover their marginal costs of managing pension assets but not subsidize their fixed costs. The government did not, however, want to rule out portfolios that are more expensive to manage, such as emerging markets or smaller companies. These funds have a higher charge limit (based on their fees in the voluntary sector) without giving leeway to cheaper funds (investing, say, in large-capitalization domestic stocks) to charge excessive prices.

The scheme has drawbacks. It is very complicated, with 12 different parameters determining the charge ceiling. It also redistributes the gains from the charge ceilings to investors in cheaper pension funds.

Kazakhstan

The Kazakh reform shifted all new pension rights to individual retirement savings accounts. Fees cannot exceed 1 per cent of contributions plus 10 per cent of the fund's investment return. These levies are very low: equivalent to an 11½ per cent charge ratio or just 0.55 per cent of assets. The result is that most funds are loss making. Managers have indicated that they need 100,000 or more members to break even, and only one has reached that target. This implies that substantial consolidation will be necessary or that some managers will have to withdraw from the market.

Bolivia

The Bolivian government auctioned the rights to manage its pension funds internationally. The government picked two managers from a short list of nine, based mainly on the size of their proposed fee. The successful bidders have a five-year guarantee of their duopoly. The government will

initially assign people to one of the funds. People will only be able to switch between them three years after the new scheme began.

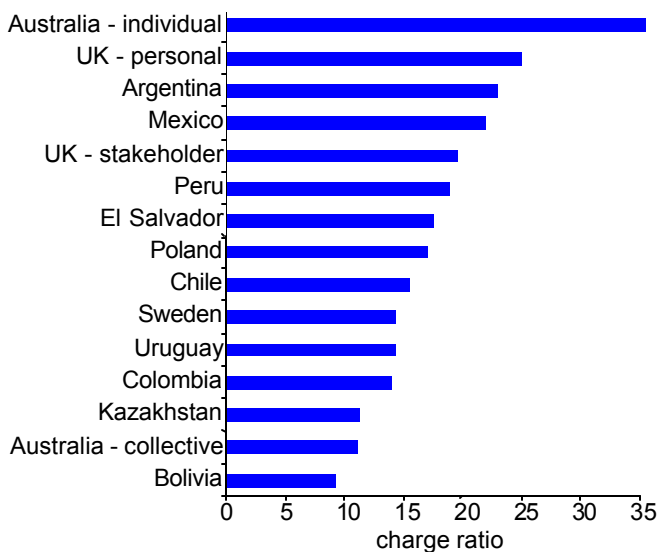
This process has kept charges low, equivalent to less than 0.5 per cent of assets or a charge ratio of under 10 per cent. But Bolivia's experience is in large part unique. The two pension funds also manage \$1.7 billion of privatization proceeds, equivalent to 15 or so years of mandatory pension contributions. There is a substantial cross-subsidy from the fees for managing these assets to the charges on pension accounts.

International comparisons

Figure 2 summarizes data on charges for thirteen countries with mandatory funded pension systems. Even very similar pension systems with similar approaches to charges deliver very different levels of fees in practice. Among Latin American countries with individual accounts systems, the average charge ratio varies from under 15 per cent in Colombia to nearly 25 per cent in Argentina.

International comparisons

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Looking at all the systems, charges range from under 10 per cent in Bolivia to 35 per cent in Australia's retail superannuation funds. As noted above, the three cheapest systems offer very limited choice of provider and/or investments.

Different providers' charges

Most studies of administrative fees for pensions look only at the average. But the average disguises a huge range of different charge levels between different providers.

Different providers' charges

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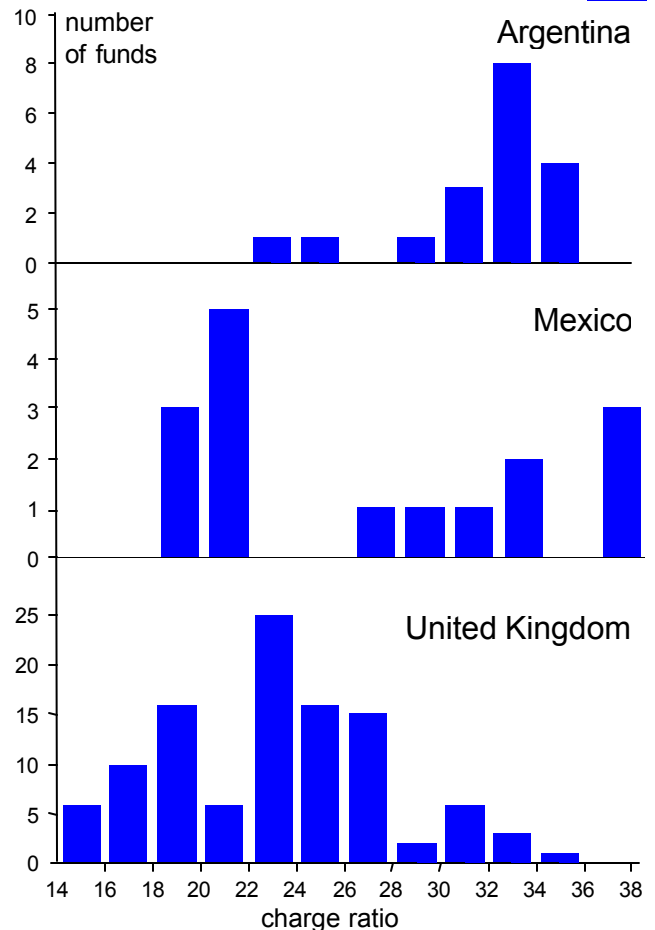


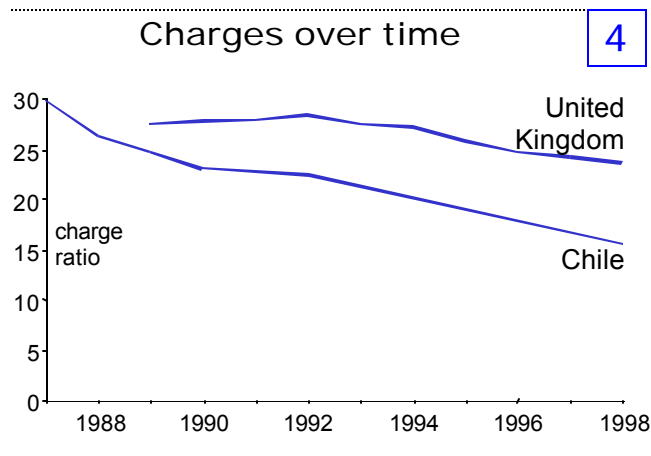
Figure 3 shows the distribution of charges in three countries. The United Kingdom has the broadest range, with the cheapest funds levying 15 per cent of contributions and the most expensive, well over 30 per cent. The range in Mexico is 17 to 37 per cent. Even in Argentina, with the narrowest range, charges vary between 23 and 36 per cent, meaning that the most expensive fund costs over 50 per cent more than the cheapest.

These large ranges raise a difficult question: why do consumers choose expensive funds? Improved levels of service, for example, are unlikely to explain such a large differential. There is evidence in

the United Kingdom that funds with higher charges perform better, but the out-performance is insufficient to offset the higher charge burden on typical pension policies. Perhaps some consumers fail to take proper account of the burden of charges. Whatever the reason, it is surprising that this distribution has attracted little research attention.

Charges over time

An important assumption of the calculations above is that charges remain constant until pensions are withdrawn. But pension providers' revenues, especially from charges on fund assets, are back-loaded while expenses are front-loaded because of set-up costs. Also 'learning by doing' and the consolidation of the pension fund industry in most reforming countries might put downward pressure on costs over time.



Most mandatory funded pension systems were introduced within the last five years or so. But reforms in Chile and the United Kingdom have been in place for longer. Average charges have declined in both countries (Figure 4): by almost one half in Chile (from 30 to 15½ per cent) and a sixth in the United Kingdom (from 27½ to 23½ per cent).

If other countries follow this pattern of declining charges over time, then the charge ratio measures above, which assume constant charges, are overstated.

Keeping charges low

Measuring the impact of charges on pension fund returns is very complicated. The minimum government policy should therefore be a requirement for funds to disclose charges in a standard format. This will help consumers make informed comparisons between different funds. Regulators can make the task easier by producing 'league tables' of charges. The supervisory authorities in Latin America regularly provide comparative information on different pension fund managers, and the new Financial Services Authority in the United Kingdom will soon issue data on the charges for a wide range of financial products.

A second step to bring charges to consumers' attention is to levy charges on top of (rather than out of) mandatory contributions. This encourages shopping around because charges reduce current net income rather than future pension benefits. Four Latin American countries have adopted this approach.

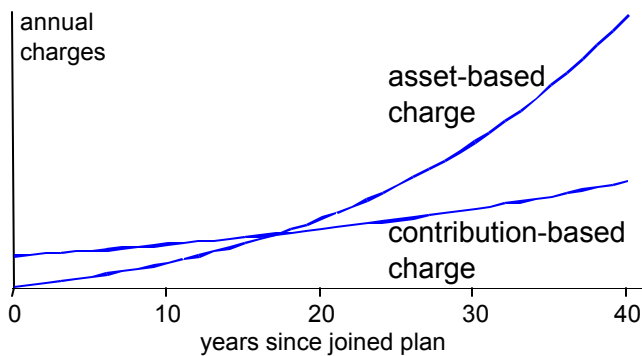
The next stage is to make comparisons simpler still, by ensuring all providers stick to a common structure. We have seen how complex liberal charging regimes can be. A regulated fee structure, in contrast, can mean there is a single 'price' that consumers can compare across providers. And a single proportional charge, on assets or contributions, means that the relative cost of choosing a different provider does not vary with earnings or contributions.

Contribution or asset-based fees?

The important policy option for governments taking this route is the type of charge to be permitted. There are four features of the two charges important in making this choice.

The first is the time profile of charge revenues. Fees on contributions generate more up-front revenues than fees on assets (Figure 5). This allows providers to cover their start-up costs more quickly. This might boost competition by encouraging more entrants to the pension market when the system is established.

Time profile of different charges 5



A second issue is the incidence of the levies across different types of consumer. If there are fixed costs per member—and the evidence suggests that these are sizeable—then levies on assets redistribute from people with large funds to people with fewer assets in their plan. Older workers, with larger funds on average, would cross-subsidize younger workers, for example. Contribution-based charges redistribute from people with high levels of contributions (typically higher earners) to people with low levels of contributions.

Indeed, there would be no revenues from people who do not contribute. This might be because they have lost their job, withdrawn from the labor force or moved into the informal sector of the economy. But pension providers would still have to bear the cost of administering these people's funds. Asset-based fees ensure a continuing flow of revenues from non-contributors, but this means that the fees bear more heavily on people who withdraw from work early.

Finally, a charge on fund value encourages providers to maximize assets, both by attracting funds from other providers and, more importantly, by maximizing investment returns.

The choice between the asset-based and contribution-based approach is finely balanced. Unsurprisingly, different countries have taken different options. Levies on contributions are the norm in Latin America, while the United Kingdom has opted for asset-based fees. The government's main arguments were fund managers' performance

incentives and the continuing revenue stream from members suspending contributions.

Ceilings on charges

Quantitative restrictions on charges are rare. Only El Salvador, Kazakhstan, Poland, Sweden and the United Kingdom, in the new stakeholder plans, have such limits.

The problem with this approach is the risk that governments set the 'wrong' ceiling. Too high a limit would be ineffectual. Too low a ceiling might mean that fund managers could not cover their costs. This will restrict competition and choice. It could even lead to the failure of weaker providers, undermining public confidence in the system. Ceilings all too often become a *de facto* minimum charge as well as the legal maximum. Price competition, beyond meeting the regulatory requirement, would be curtailed.

The availability of data to help setting an appropriate ceiling will vary. If capital markets are well developed, governments can see the costs and charges for similar financial services and make an informed choice of limit. But in emerging economies, there might not be an appropriate domestic yardstick, although international experience can be a guide.

Treatment of low earners

A common reason for any regulation of charges is to protect low-income workers. This is particularly important in mandatory funded pension schemes. It would be manifestly unfair if low earners saw most or even all of their contributions eaten up in charges.

Regulating charge structures can provide a significant degree of protection. Limiting fees to proportional charges (either on assets or contributions) means that there are no fixed charges, which bear disproportionately on the low-paid.

Nevertheless, most countries provide a minimum pension guarantee, a universal flat-rate pension or social assistance incomes in retirement. People with persistently low earnings are unlikely to build up a funded pension above the minimum level.

A sensible solution is to exempt low paid workers from the requirement to contribute to a funded pension or to allow them to opt out. The United Kingdom, for example, will aim the new stakeholder schemes at people earning more than 55 per cent of average earnings. Australia excludes workers on less than 15 per cent of average pay, and has plans to allow people earning between 15 and 30 per cent of the average to opt out.

An alternative approach is to cross-subsidize low-paid workers' accounts directly. The Mexican government ensures a contribution of at least 5½ per cent of the minimum wage. Coupled with a tax-credit system that boosts the incomes of low-paid workers, this encourages Mexicans into the formal sector. Together, these policies promote broader coverage of the pension system. A second advantage of direct subsidies is that they make the redistribution from higher-paid to lower-paid workers transparent.

Alternative institutional structures

The pension plans discussed above are mainly decentralized: people choose between a range of competing pension fund managers. An alternative approach is some sort of collective mechanism.

Australia's collectively provided industry funds, for example, tend to be cheaper than retail master trusts. (Although there are many potential explanations for this difference: see above). The new stakeholder plans in the United Kingdom will have a similar structure.

A step further is to move to a single, publicly managed fund. However, research in the pension reform primer series shows that public management has typically led to poor returns. Even with good management, the state as a large shareholder raises corporate governance concerns that are very difficult to resolve.

Trade-offs in regulating charges

The main cost of strict regulation of charges is the reduction in pension members' choice. Low-cost regimes, such as the thrift savings plan for federal employees in the United States, offer only a small range of funds, often indexed to avoid the extra

cost of active management. Bolivia offered no choice of fund initially and only a choice between two funds after a few years.

This restriction of choice has a cost. Pension members are unable to choose investments that suit their preferences. For example, older members might want to invest more conservatively than younger people, but both can be constrained by a 'one-size-fits-all' fund.

The counterpart to restricted choice is limits to competition, which might result in poorer service and performance than a deregulated, decentralized market.

How large are economies of scale?

The potential for economies of scale in managing pension funds has important consequences for public policy on charges and industry structure. The evidence, unfortunately, is inconclusive.

Figure 3 showed the very broad distribution of charges across providers in three countries with mandatory funded pension systems. Despite this variability, there is no relationship between fund size and charges.

Various studies have suggested anything from under 100,000 to 500,000 members as the minimum to achieve efficient scale. In mutual fund markets, which share many of the features of pension markets, some studies have suggested that the fall in costs with size comes to a halt once funds reach \$0.5 billion. Others suggest this could be as high as \$40 billion.

Currently available evidence does not demonstrate that highly centralized approaches to managing funded pensions will significantly reduce costs. And the potential gains must be balanced against the cost of stifling competition, which in the medium term should act as a spur to innovation and cost control.

Further reading

James, Estelle, Gary Ferrier, James Smallhout, and Dimitri Vittas (2000), 'Mutual Funds and Institutional Investments: What is the Most Efficient Way to Set Up Individual Accounts in A Social Security System?' Administrative Costs and Social Security Privatization, ed. John Shoven, University of Chicago Press, also available as NBER Working Paper No.7049 and World Bank Policy Research Working paper No. 2099, 1999.

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Whitehouse, E.R. (2000), 'Administrative charges for funded pensions: an international comparison and assessment', Pension Reform Primer series, Social Protection Discussion Paper no. 0016, World Bank.

World Bank (2000), 'Collection: transferring contributions to individual pension accounts', Pension Reform Primer briefing note.

On public management of pension funds:

Iglesias, A. and Palacios, R.J. (2000), 'Managing public pension reserves, part I: evidence from the international experience', Pension Reform Primer series, Social Protection Discussion Paper no. 0003, World Bank.

World Bank (2000), 'Public management: how well do governments invest pension reserves', Pension Reform Primer briefing note.

Conclusions and recommendations

- ✂ ✂ administrative charges are just one variable affecting retirement incomes in funded pension systems
- ✂ ✂ governments must at the least ensure clear and transparent disclosure of charges so people can compare different funds' fees
- ✂ ✂ there is a good case for regulating charge structures to ease comparisons
- ✂ ✂ the choice between restricting charges to assets or contributions is finely balanced, depending on the structure of the labor market, the desire to encourage entry into the pensions market and views on the importance of manager incentives
- ✂ ✂ imposing ceilings on charges has the risk that limits are set at the wrong level, discouraging entry and competition
- ✂ ✂ the evidence on economies of scale is mixed
- ✂ ✂ even if centralized management of pension assets is cheaper because of economies of scale, the restriction of choice and competition imposes a difficult trade-off

