financial & private sector development

Fee structure: does it matter?

Heinz P. Rudolph, World Bank
V Contractual Savings Conference
Washington DC,
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THE WORLD BANK IFC

What do pension fund management companies do?

	Activity	Production Function	Cost Driver
Account Management	Collection of contributions	Scale Economies	Transaction
	Account settlement	Scale Economies	Transaction
	Account management / Record keeping	Scale Economies	Transaction
Asset Management	Portfolio Management	Scale up to USD 100-500 million	Asset volume
	Depository services	Scale Economies	Asset volume
	Custody Services	..	Asset volume
	Research/Strategy	..	Asset Classes
	Paying benefits (PW)	..	Transaction

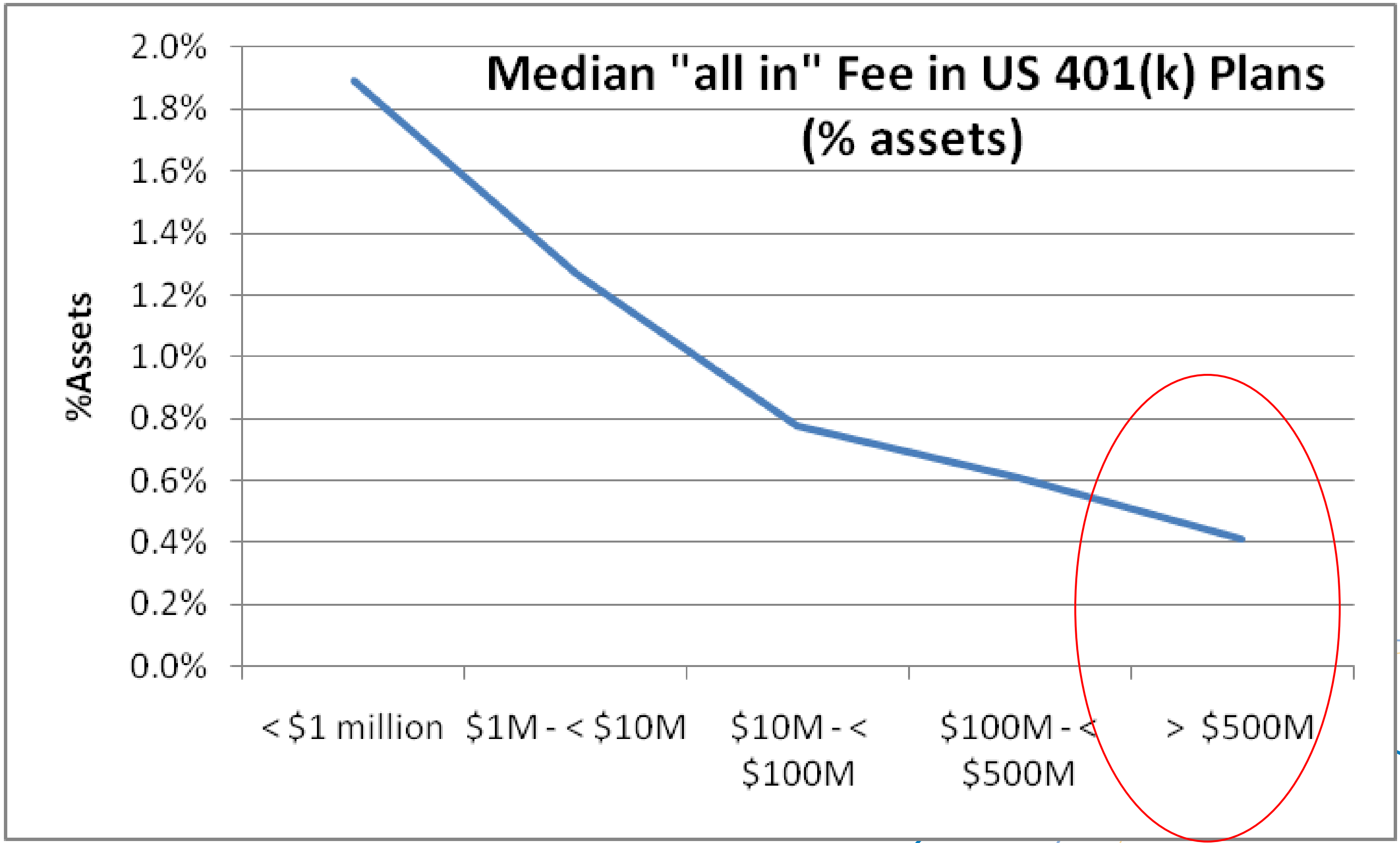
How much do these services cost in global markets?

Activity	Description	Cost Structure	Benchmarks
Pre Trading	Soft infrastructure for trading (IT and research)	Related to the assets (e.g. research)	Varies by asset manager
Trading	Buying, selling, holding, and lending securities	Active trading > passive strategies	**Trade execution**: 8 bps of the value of the transaction **Book trading fee**: € 37 per transaction (it may include research and CCP services)
		Pension funds typically hire asset managers that charge asset management fees	**Median "all in fee" for large 401k funds:** 35 bps. **60+ % of the funds that track the S&P500 index** charge less than 10 bps
			Asset based fees on investments represents 74% of "all in fee"
Post Trading	Central counterparties, clearing and settlement, custody and depository services, valuation, and auditing	The bulk of the costs depend on asset management fees	**Account provision cost**: 0.17 basis points, **Clearing and settlement cost:** €0.46 per transaction, **Central counterparty cost** per transaction: 0.1 basis points

Source: Oxera (2011), ICI (2011)

How much should PFMCs charge? (1)

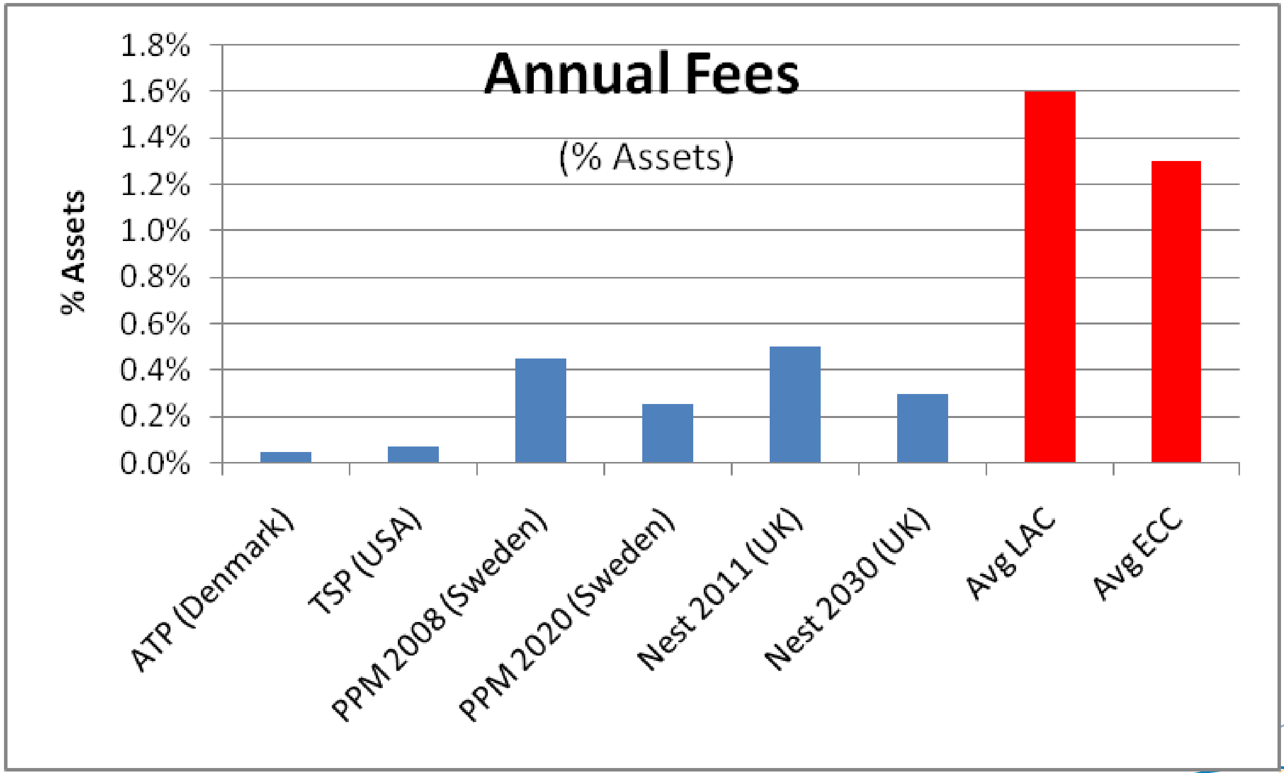
Benchmarking against 401(k)s...



How much should pension funds charge? (2)

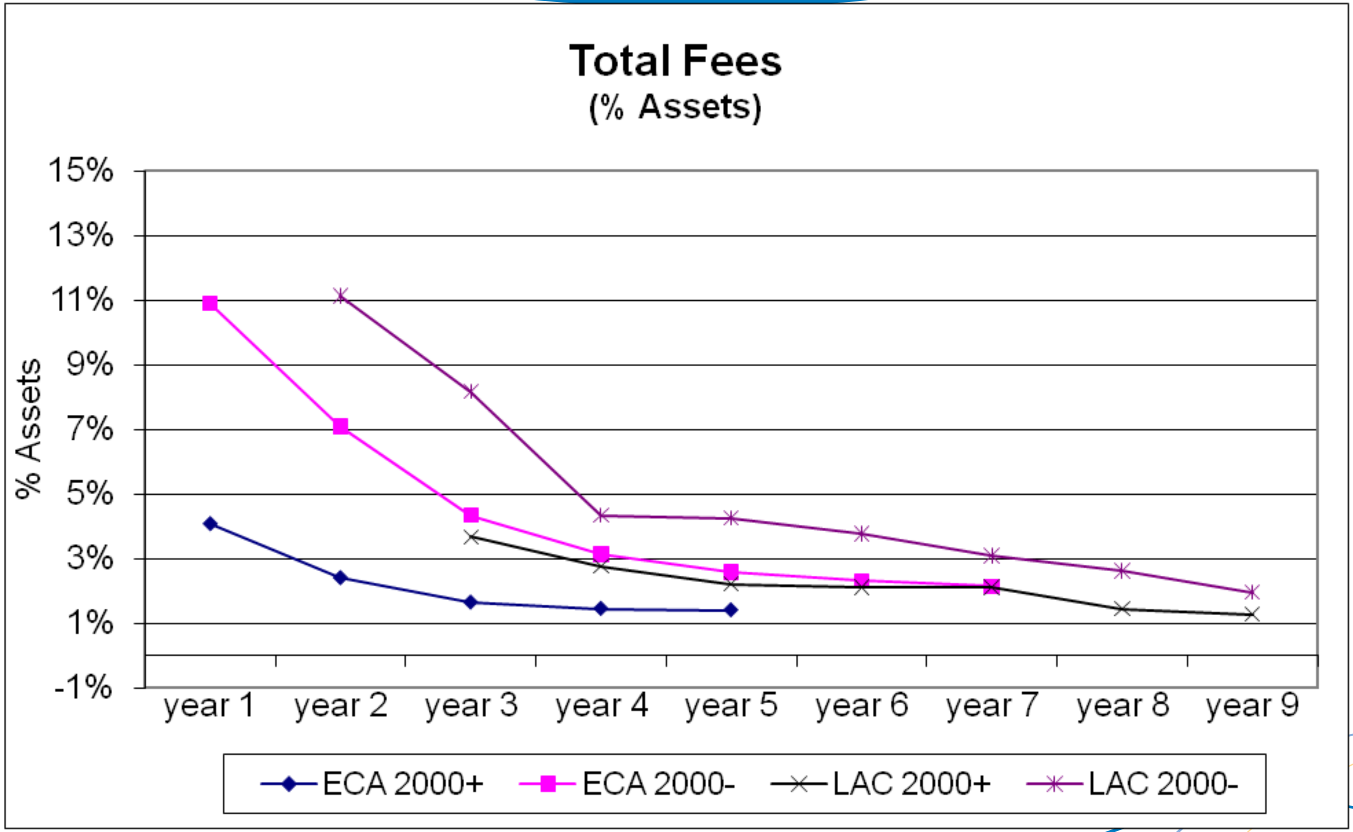
"Frankenstein" Cost Scenarios for Pension Fund Management				
(as a percentage of total assets)				
	Upper Bound		Lower Bound	
Account Management	0.05%	Estonia (Nasdaq OMX)	0.01%	Chile (Sonda)
Collection of Contributions	0.09%	Poland (!)	0.00%	Estonian Treasury
Customer Service	0.05%	Chile large fund (est)	0.05%	Chile large fund(est)
Custodian, Central Depository	0.03%	Oxera (2011)	0.03%	Oxera (2011)
Trade execution (broker fees)	0.08%	Oxera (2011)	0.02%	Oxera (2011)
Portfolio Management	0.40%	US large equity fund	0.05%	US index fund
Total	0.70%		0.16%	

How much are pension fund management companies charging?



(Houston, we've got a problem)

While we thought it as an issue of convergence…



…it seems we are converging to 100-150 basis points

Why are management cost so high?

Fees and PFMC profits in Selected Latin American Countries		
(as a percentage of Assets)		
	Fee Income	PFMC Profits
Chile	0.89%	0.35%
Colombia	1.66%	1.11%
Costa Rica	2.23%	1.47%
El Salvador	1.12%	0.68%
México	1.45%	0.98%
Perú	1.14%	0.68%
Dominican Republic	3.52%	0.93%
Uruguay	0.94%	0.82%
Source AIOS, SP		

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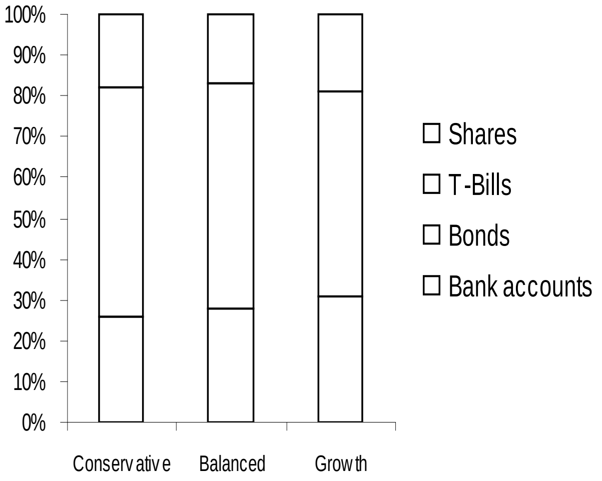
Poland: Fees charged by PFMCs		
(% Total Assets)		
	Total Fees	Operational Profits
2005	1.44%	0.53%
2006	1.29%	0.55%
2007	1.24%	0.56%
2008	1.37%	0.61%
2009	1.13%	0.46%
2010	0.82%	0.26%
Source: KNF		

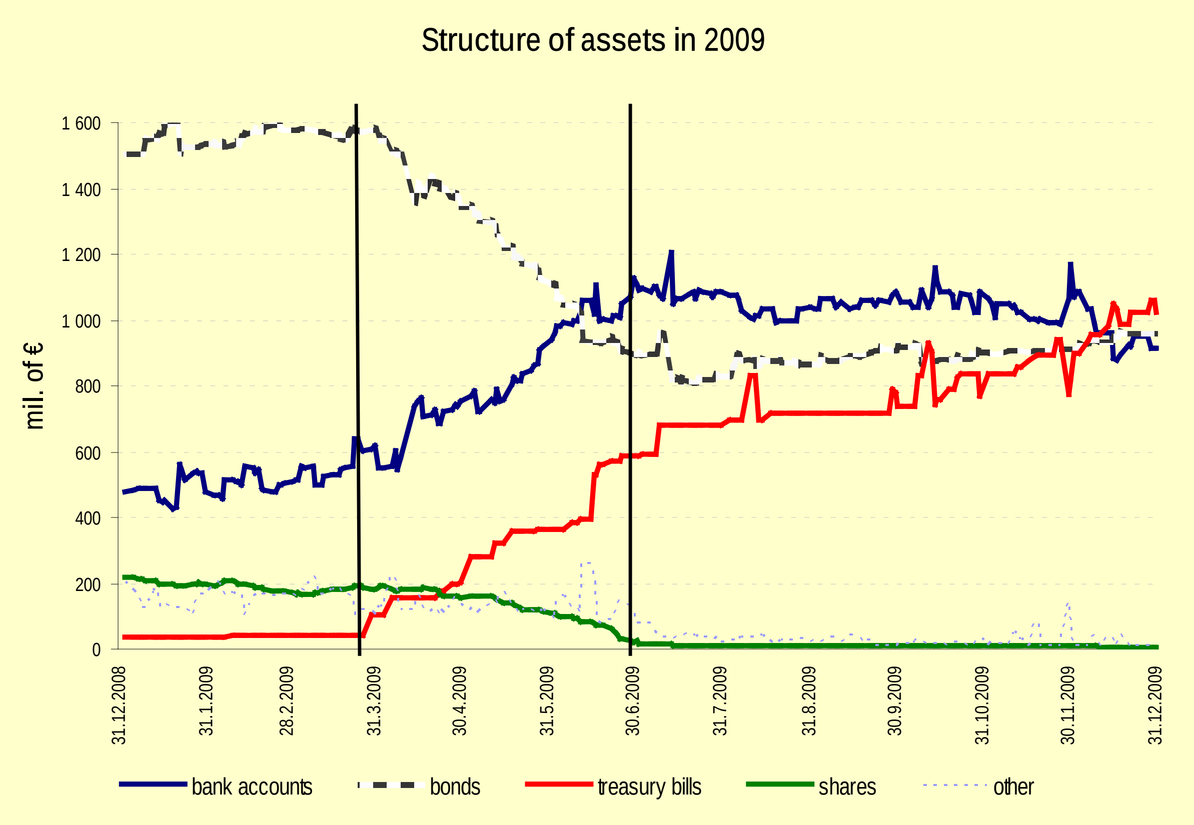
- It looks like a profitable business, at a low risk (no explicit liabilities)
- The risk of triggering the minimum return guarantee is manageable

What have countries done to deal with high fees? (1)

- Pointing out that fees are high
  - Not much progress with this strategy
  - Coordination failure.
  - PFMCs: let’s keep dancing while the music is still playing (some participants have already left)
- Imposing caps on fees
  - Problem with the political cycle
  - We have ended with cases like Slovakia. In 2009, drastic cut in cap on fees from 0.78% to 0.30% of assets.

Caps on fees: the case of Slovakia





Source: National Bank of Slovakia

What have countries done to deal with high fees? (2)

- Bringing more PFMCs
  - Mexico in the early 2000s
  - Misunderstood concept of competition
- Diplomatic persuasion
  - Mexico in the late 2000
- Competition on fees for new entrants
  - Chile in 2010s
  - How many years will it take? Risks?

The problem seems more structural

Cost Structure of Pension Funds
Chile's Pension Fund Management Companies, 2009
(as apercentage of PFMC's fee revenue)

		PFMC1		PFMC2		PFMC3		PFMC4		PFMC5		System	
Fee Revenue (USD million)		334		250		210		177		38		1,010	
Net Operational Revenues[1]		64%		73%		66%		81%		67%		69%	
Operational Expenses		39%		33%		44%		35%		55%		39%	
	Wages Administrative Personnel		13%		13%		14%		12%		16%		13%
	Wages SalesForce		7%		5%		13%		12%		10%		9%
	Marketing Expenses		1%		1%		1%		1%		1%		1%
	IT Services		2%		1%		3%		1%		5%		2%
	Other Administrative Expenses		10%		11%		12%		7%		18%		10%
	Others		6%		2%		2%		1%		5%		3%
Operational Margin		24%		40%		21%		46%		12%		31%	
Assets of the Pension Fund (USD million)		35,810		29,183		26,642		22,869		3,547		118,051	
Fee (% contibutor's wages)[2]		1.5%		1.4%		1.4%		1.5%		2.4%		1.5%	

[1] Includes fee revenues minus premium paid for insurance of disability and survivorship

[2] As of August 2011

It is not the sales force, it is not the administration costs…

It looks more like a problem of a cartel…

- The essence of the high fees problem has not been properly addressed in emerging economies
- The main problem is in the industrial organization of the PFMCs…
- Two part solution (in this order):
  - Redesign the structure of the industry (break down the cartel)
  - Improve the fee structure with efficiency criteria (asset management fees, contribution fees and success fees)

Redesigning the structure of the PFMCs industry (1)

- Necessary to separate the account management and portfolio management functions
  - Why do they have to be together?
- This separation is about building a firewall at the level of the account manager about the identity of the clients (Sweden's blind accounts)
  - Building a centralized account management company is a necessary but insufficient condition for ensuring lower fees
  - With a blind account system, Sweden's pension system is moving to a 25 bps average charge
  - With a centralized account management system that charges only 4.7 basis points of the assets, but with PFMCs accessing the database of clients, total fees charged in Estonia are about 180 basis points
- A centralized account management, without blind accounts, does not solve the market inefficiency.

Redesigning the structure of the PFMCs industry (1)

- Separation between the account management and the portfolio management is essential for a welfare improving competition
  - Salespersons would not be able to claim ownership of the switching
  - Without over-dimensioned sales force and office space occupancy, the main PFMCs' competition deterrence mechanisms disappear
  - Creating artificial competition in quality of service, or cost of the premium of disability and survivorship only confuses the main objective
    - Define the quality of service that you want
    - Common cost of disability and insurance for all participants
- PFMCs' hand waiver argument for high fees disappear
  - Pension fund management turns into a highly standardized business. Investment risk management becomes the main function
    - Pre trading, trading, and post trading
- PFMCs compete against a predetermined and common benchmark

Main inconvenient

- Shareholders of PFMCs would strongly oppose this idea because their share prices will fall.
- PFMCs sales force will protest on the streets because they will lose their jobs
  - Unfortunately, their social value added is probably negative
  - Mexico (30,000), Peru (1200)

- Too late? maybe, but
  - High fees are not endemic to 2nd pillars
  - Fees need to move down to ensure sustainability of 2nd pillars

Improving the fee structure of pension funds

- The time for discussing the optimal fee structure for pension funds (asset management fees, contribution fees, success fees) comes only after dismantling the incentives for creating a cartel.
- Otherwise it is a pure redistribution of wealth between
  - Old and young contributors
  - White and blue collars
  - High density versus low density contributors

How do fee structures looks like in emerging economies?

	Contribution Fee (% contribution)	Asset Management Fee (% assets)	Performance Fee (% return above benchmark)
Chile (2011)	11.4-15.4	..	..
Colombia (2010)	15.9	..	..
Mexico (2011)	..	1.0-1.7	..
Costa Rica (2010)	2.0-4.0	..	6-8%
Costa Rica (2011)	..	1.0-1.1	..
Dominican Republic (2009)	5.7	..	30%
Peru (2011)	17.5-23.0	..	..
Lithuania: Conservative (2011)	10.0	0.5	
Lithuania: Other Funds (2011)	10.0	1.0	..
Estonia (2009)	..	2.0	..
Latvia (2009)	..	0.75-1.90	..
Poland (2010)	3.5	0.5	0.03%
Macedonia (2009)	0.9	0.6	..
Slovak Republic (2011)	1.0	0.3	0.56%
Romania (2011)	2.5	0.6	..
Kazakhstan (2011)	..	0.05	15%

Source World Bank

Fee structures (1)

Portfolio Management					
	Service Provided	Advantages	Disadvantages	Fairness	Perverse Incentives
Asset management fees	Paying for the assets being managed that period	Aligned with the cost structure of the Asset Manager	No revenue at the beginning of the system	..	..
		A common base of comparison	..	..	..
Contribution fees	Paying for the management of that contribution until retirement/death	Generates revenue from the launching of the system	Not aligned with the cost structure of the asset manager	High income individuals subsidize lower income ones	Managers assume a commitment not supported by reserves
	..	..	Difficult to change once implemented	High density contributors subsidize sporadic ones	Cherry picking
	..	..	..	High income individuals subsidize older contributors	..
Performance fees	Paying for the the asset being managed that period	..	Distortion on the long term objectives of pension funds	Not clear	Incentives to short term optimization
			Difficult to outperform the efficient frontier on a systematic basis		PFMCs can take too much or too little risk
					Incentives to set easily achievable targets

Fee structures (2)

Account Management				
	Service Provided	Advantages	Disadvantages	Fairness
Asset management fees (%)	Pays for transactions carried in each specific period	A common base of comparison	Not aligned with the cost structure of the account manager	Older contributors subsidize younger ones
Contribution fees (%)	Pays for transactions carried in specific period	Generate revenue from the launching of the system	..	Higer income contributors subsidize lower income ones
	..	..	..	High density contributors subsidize sporadic ones
Annual flat fees	Pays for transactions carried in each specific period	Aligned with the cost structure of the account manager	..	..
	..	Generates revenue from the launching of the system	..	..
Performance fees	Pays for transactions carried in each specific period	..	Not aligned with the cost structure of the account manager.	Contributors in riskier strategies subsidize the ones in conservative strategies
	..	..	Account managers receive rewards for something outside their performance	Older contributors subsidize younger ones

Optimal fee structure

- Once oligopoly incentives have been addressed, a two part fee structure would fit:
  - Annual flat fee to cover account management costs
    - Preferably on the contribution
  - Asset management fee to cover portfolio management

Policy Recommendations

- High fees charged by pension funds are mostly a consequence of an industrial organization that promotes the creation of a cartel
- Governments should promote a separation of account management and portfolio management functions
- Portfolio managers should only manage assets (blind accounts)
- Once these problems have been addressed, countries should consider improving the fee structure
- Two part fee structure is desirable:
  - Asset management fees to address portfolio management
  - Flat annual fee to address account management

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Reshaping the Future of Funded Pension Systems

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Thanks!

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Mexico is a vivid example in which the structure of fees has mattered in a variety of manners

Facts:

1. Up to 2008 the Law of SAR allowed pension funds to charge fees on the basis of: i) assets under management (AUM) ii) contributions or iii) a combination of the previous. From to 2008 onwards only fees on AUM are allowed.

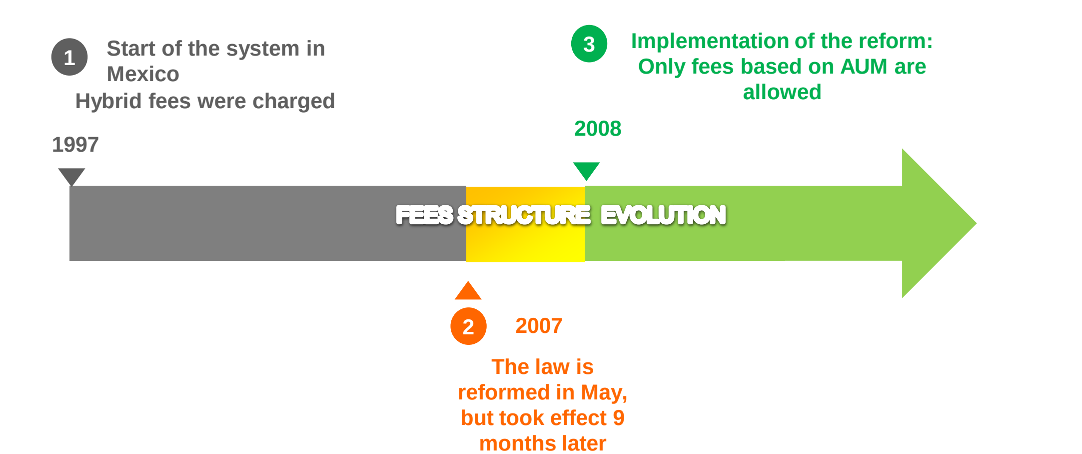
2. In the beginning fees were designed such that allowed pension funds to fund the huge start up costs (even with the existence of a centralized entity focused on collecting and dispersing periodic contributions).
   - Most funds chose fees based on hybrid schemes with an important revenue coming from fees on contributions. There was a case of a fee based on real returns.
   - It was cumbersome to inform the exact fee charged to each affiliate: they lack financial education and comparisons needed assumptions that made them inexact

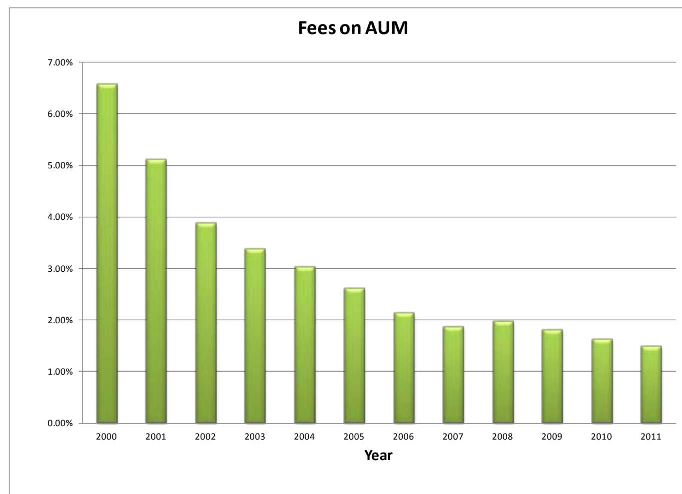
3. The fee structure authorized in 2008 imposes the exploitation of economies of scale
   - It is estimated that the economies of scale level off at around 100 billion pesos (7.5 USD Billions)
   - There has been 9 mergers since 2007 up to now, and one new entrant. The number of fund managers changed from 21 to 13.
   - Fees have been significantly reduced since 2007 and are much simpler.

Facts: Drivers for fee reduction

A notorious reduction in fees have been prompted by a number of factors:

- ✓ Maturing system (start up cost were high, this situation was left behind)
- ✓ Transfer of savings to affiliates derived form an efficient mechanisms for collection and distribution of periodic contributions
- ✓ Fees competition was the driver written down in the Law before the reform of 2008
- ✓ Profitable fund managers are observable. Rapid growth of AUM increases the revenues, unless fees are adjusted
- ✓ Deregulation of operational activities have fostered efficiency and eliminated costs
- ✓ Submission of new fees to the board of CONSAR on yearly basis

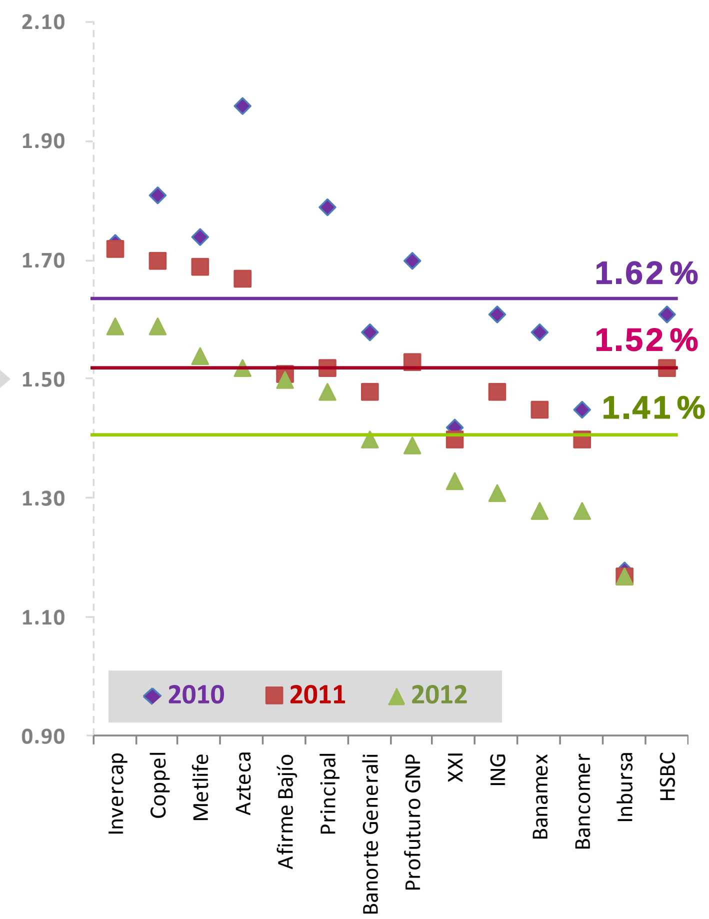




Facts: The dispersion has been reduced reaching just 0.42 % (considering the mergers in late 2011 *).

Fees

AFORES	2010	2011	2012
	Year		
Invercap	1.73	1.72	1.59
Coppel	1.81	1.70	1.59
Metlife	1.74	1.69	1.54
Azteca	1.96	1.67	1.52
Afirme Bajío	1.51	1.51	1.50
Principal	1.79	1.52	1.48
Banorte Generali	1.58	1.48	1.40
Profuturo GNP	1.70	1.53	1.39
XXI	1.42	1.40	1.33
ING	1.61	1.48	1.31
Banamex	1.58	1.45	1.28
Bancomer	1.45	1.40	1.28
Inbursa	1.18	1.17	1.17
HSBC	1.61	1.52	
Average	**1.62**	**1.52**	**1.41**
Range (Max - Min)	**0.78**	**0.55**	**0.42**



* \ Considers the fees after the mergers that took place in 2011: ScotiaBank (21/jan/10), Argos (08/jan/10), HSBC (05/sep/11)

Three perspectives from which fee structure matters

- Worker's perspective
- Pension Fund's perspective
- Regulator's perspective

Worker's perspective

In what sense may the fee structure matter to AFFILIATES?

A

Affects the replacement rate

- They are a component of long term returns. Reductions in fees are a permanent increase in returns. Although the size of the reduction is bounded

B

Market discipline exercised by the workers

The simpler the better

- There is limited financial education of affiliates. Complexity hinders rationale decisions

Accuracy

- Many schemes are not comparable directly unless assumptions are made (Equivalent fees in Mexico: Representative agent, balances, returns, etc.). For example brokerage commission, and rebalancing costs are more important for performance fees.

Transparency

- Ensure that total fees are included. Costs of outsourcing investments may not be included (ETF's, mutual funds, structured products).

C

Equality

- Examples are: a) fees on contribution inactive workers do not pay the expenses the pension funds incur (investment costs, account balances, etc.) and b) exit fees inhibit negative externalities on those who stay.

Pension Fund's perspective

In what sense may the fee structure impact the PENSION FUND?

i

Viability of the business

Several types of fees may be non viable depending on a combination of the system's characteristics:

1. **Pure fee on contributions:** They are useful for starting systems but they hinge on the mass of contributors to pay for expenses of the whole.
2. **Performance fee:** In practice it is combined with fees on AUM and returns, otherwise they may result too big.
3. **AUM fees:** Not operative for starting systems

ii

Competition

Too low fees may create entry barriers.

iii

Risk taking and efficient investments

Fees are the main source of revenues, thus their structure introduces different types of incentives. Examples are:

1. **Fees on AUM:** May lead to short sighted investments
2. **Pure Performance Fees:** It can lead to excessive risk taking (when things went wrong for a while and in order to compensate poor results), but for risk averse managers it could incentivize them from the beginning to conservative investments.

Pension Fund perspective

In what sense the fee structure impact the PENSION FUND? (cont.)

iv **Quality and variety of services provided** directly to the affiliates and indirectly on the sophistication of investments and risk management.

v **Selection and economic discrimination of affiliates.** The following are not the unique causes for a bias for or against, but the may affect decisions

- **Fees on contributions:** Prefer people with higher contribution densities (which are correlated with higher salaries)
- **Fixed fees:** As in all other cases, due to cost savings, prefer people with higher balances.
- **Fees on AUM:** Prefer people with higher assets
- **Performance Fees:** May prefer affiliates with greater risk appetite and or younger (that may also enjoy a more flexible investment regime).
  - More assets (Exists a trade off between assets and risk aversion)

Regulator's perspective

In what sense may the fee structure matter for the REGULATOR?

For the regulator, fee structures matter in addition to the following, also because for all of the reasons that matter to affiliates and to pension funds

1

Supervision of mandatory limits (price regulation) and fair play

- **Complexity reduces the effectiveness**

2

Search for efficient outcomes

- **Consolidation of the system may lead to efficient scale.**
- **Appropriate incentives may foster returns and /or avoid gambling.**
- **It may help to reduce the waste of resources in unproductive activities (for instance with a fixed fee the regulator may decide what can be covered)**

3

Political sensitivity

- **Press and Congress may be misled. Congressmen claim that fees must include a sharing mechanism between affiliates and fund managers**

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Fee Structure: Does It Matter?

5th Contractural Savings Conference
Comments by Will Price

Will Price
January, 2012

Key messages on fee structure – and the example of recent reform in the UK

- Supply and demand dynamics matter. Transparency without effective players on the demand side will not achieve sufficient benefits for members.
- Disaggregated voluntary systems relying on 'competitive' markets will face problems of coverage, conduct and effectiveness.
- The UK's introduction of the new National Employment Savings Trust (NEST) and auto-enrolment is a long overdue intervention that will yield profound benefits for members.
- The process and final policy 'consensus' on NEST reveal a reform package that has further to go if the full benefits to members are to be delivered – other countries have been braver in introducing more far reaching reforms.
- Fee structure matters - the overall level, the impact on different kinds of savers and because costs can be hidden.

Disaggregated voluntary systems may face impossible hurdles to ensuring full coverage at costs that make sense for members.

Annual Management Charge required to make provision to different sized firms in the UK profitable.

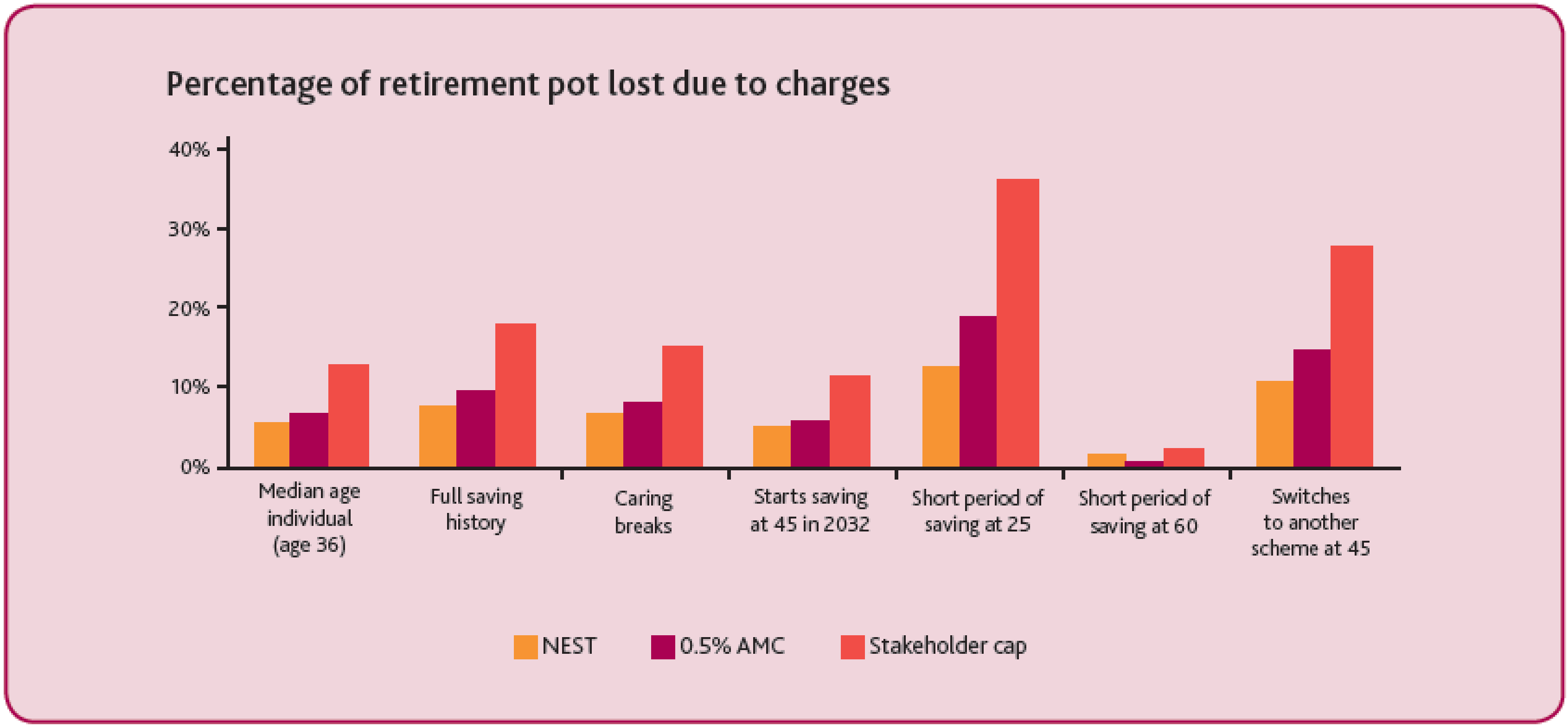
Source: Department for Work and Pensions modelling.

In the UK the National Employment Savings Trust (NEST) was designed to fill this missing market

- The concept of NEST was originally set out by the ‘Turner’ Commission in 2004
- It was originally conceived as the default provider for employer based pensions – but now employers have to chose to join
- It is a key part of enabling auto-enrolment of workers into pension schemes – starting in 2012
- It provides low cost pensions aimed at segments of the market that are not covered by existing supply. But it is open to all – and has to take any customer (public service obligation)
- It is a not-for profit fund, run by trustees with a professional management company reporting to the trustees
- Employees and employers are represented by panels
- There are restrictions on making transfers in or out of NEST – to protect the market of existing players
- There are restrictions on the amount that can be contributed to NEST each year to protect the market of existing players
- The investment approach is innovative, with a ‘foundation phase’ before a more traditional life-styling approach
- NEST will quickly become one of the largest and then <u>the</u> largest pension fund in the UK

The fees in NEST are low by UK standards – but have a more complicated structure in order to speed up payment of a Government loan for set up costs

Comparing charges between the NEST (1.8% contribution + 0.3% AMC), a large workplace scheme in the UK (0.5% AMC) and the UK's 'stakeholder' charge cap (AMC 1.5% then 1%)



Source: Modelling by NEST Corporation.

A central part of NEST's achievement of low fees compared to UK comparators is the use of passive funds procured through a competitive bidding process

Underlying funds

UBS	**UBS Life World Equity Tracker Fund** Provides exposure to global equity markets by tracking the FTSE All-World Developed Index.
BLACKROCK	**Blackrock Aquila Life Market Advantage Fund** Invests in a wide range of asset classes. The fund's objective is to deliver returns similar to a 60 per cent equity/40 per cent bond portfolio over the long run but with 40 per cent lower risk.
STATE STREET GLOBAL ADVISORS.	**SSgA UK Conventional Gilts All Stocks Index Fund** Tracks the performance of the FTSE Actuaries UK Gilts British Government All Stocks Index.
STATE STREET GLOBAL ADVISORS.	**SSgA UK Index Linked Gilts over 5 Years Index Fund** Tracks the performance of the FTSE Actuaries UK Gilts British Government Index-Linked Over 5 Years Index.
BLACKROCK	**Blackrock Aquila Life Cash Fund** A low risk fund which aims to maximise current income, consistent with preservation of principal and liquidity, by the maintenance of a portfolio of high quality short-term sterling money market instruments.

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