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Position paper of the EIOPA Occupational Pensions Stakeholder Groups (OPSG) on Cost and Charges

OPSG Position Paper

It should be recognised that costs and charges are only part of the value for money proposition. Performance of funds and levels of contribution will have significant impact on consumer benefits. However reporting all costs and charges are a way to drive competition and good value.

For the issue of consumer protection OPSG has concentrated on the cost categories as identified by EIOPA. Specifically and most importantly:

- Pension scheme/IORP costs – costs related to administration of the pension scheme and/or IORP

- Investment costs – costs related to asset management

The above costs represent the operating costs for scheme members. In the OECD report, 'Pension fund operating costs and fees', in Pensions at a glance 2013 there is an analysis of costs country by country. The conclusion is that structure of charges across countries is fairly complex. What is fixed or variable differs, some costs may be charged to the fund before member borne costs are levied, others do it differently. As a result comparisons are difficult to make.

Recommendation – Standardisation of methodologies for calculating and presenting these two operating costs should be agreed. Standardized definitions of these two operating costs should be provided

- Transaction costs – fees paid for the execution of transactions related to the selling and buying of financial instruments. There are two types of transaction costs: Explicit transaction costs and implicit transaction costs. Using the Novarca conclusion (see background page 6) we can embrace as a principle the approach,

- identify the various transaction-related costs

- determine which transaction costs are relevant

- recommend practical methods for measuring these transaction costs;

- propose standards for disclosing cost information

Recommendation – a common methodology should be determined for transaction costs as above.

Reporting – The stakeholder group has already considered matters of reporting of costs and charges.

Recommendation – costs and charges should be reported to members in a manner which is understandable and allows meaningful comparison with alternative schemes. Relevant data should be produced with the objective that allows a member to understand whether an alternative fund would be a more suitable investment.

Governance – good governance is crucial for effective protection and the OPSG has already received a position paper on this at the October meeting.

Recommendation – EIOPA accepts that without effective governance in place based on fit and proper procedures and personnel the consumer will not be adequately protected from inappropriate costs and charging structures. Governance should always ensure that the consumer need is adequately protected against inherent conflicts of interest.

Comparability – It is important that the individual consumer can understand different mechanisms for disclosure used in financial services. The PRIIPs regime for certain investment products has very specific disclosure rules for costs and charges in a standardised format.

Recommendation – Wherever possible the calculation and presentation of costs and charges should be similar in all products that consumers may need to be familiar with.

The IORP 2 proposals on the pension benefits statement were aimed at standardisation of disclosure on costs and charges but were not agreed during EC consideration.

The EC within the CMU Action plan has asked ESAs to analyse performance of pension products and we would recommend that this is only possible with proper consideration of the benefits of standardisation. Standardisation must take into consideration all elements of product design and purpose. In doing this there will need to be careful consideration of the different nature of products in different Member States.

Background to costs and charges

The OPSG has not agreed the details of the arguments and analysis in the following, but used it as a background for the debate.

The experience in the Netherlands is often held up as being the most transparent and effective with regard to costs and charges. In February 2016, the Federation of the Dutch pension funds received the Transparency Trophy to support the Dutch initiative to increase cost transparency. This trophy was awarded by the Transparency Task Force. This is an UK-initiative of financial professionals who believe that the financial sector would benefit from increased transparency.

Dutch pension funds report the following figures on administrative costs:

- pension management costs (euro per participant)
- asset management costs (% average assets under management)
- transaction costs (% average assets under management)

In 2011, Dutch pension funds started a project to become fully transparent on administrative costs. To reach this goal, the Federation of Dutch Pension Funds published its recommendations on administrative costs. After a short period of time, an overwhelming part of the Dutch pension sector was compliant with the recommendations. The Dutch government adopted the recommendations and as of 2015, pension funds are obliged by law to publish their pension management costs, as well as asset management costs and transaction costs. These costs have to be published both on the website an in the annual report of the pension fund.

Recently the Federation of Dutch Pension Funds published a new, revised version of these recommendations. In comparison to the first version a significant change is the recommendation to adopt a look through approach regarding transaction costs in investment funds.

Undoubtedly the issue of costs and charges is significant for all those with an interest in quality, value for money and confidence in pensions.

1. There is a considerable body of work on the impact of costs and charges on investments, including pensions. Although we are concentrating on occupational pensions, where trustee relationships exist to exercise a fiduciary duty or a duty of care, the reality is that the exercise of costs and charges in private pensions has a similar effect. That is the final pot of money for the retired person is lower with higher costs and charges in a defined contribution scheme or in a defined benefit scheme the sponsor will be faced with a lower surplus or larger deficit.
2. The UK Financial Conduct Authority Consumer Panel commissioned in 2014 a literature review on costs and charges undertaken by Pitt Watson el al. www.fs-cp.org.uk/file/publication/research-paper.
3. This desk research concluded that;

3.1. Costs make a very significant difference to investment outcomes, as illustrated above (OFT 2013, RSA 20092).

3.2. It is not possible from the literature to know with any accuracy, the costs borne by the saver (See discussion in Section 3).

3.3. This is because many costs are not declared to the saver; implicitly and explicitly they are deducted from the savings account without the customer's knowledge. Indeed, implicit costs (such as trading spreads) may not even be known by the fund manager (Frontier Investment Management 2007, Lane Clark Peacock 2013).

3.4. Even where costs are declared, they are ill understood (DWP 2012, 2014, OFT 2013)

3.5. Costs of at least some products, or ranges of products seem very high (Khorana et al., 2007).

3.6. There do appear to be good products on the market, but that the price of similar products varies very significantly, perhaps by as much as four or five fold, for near identical services. (ABI 2012). Such price differentials are incompatible with the operation of efficient markets where such anomalies would rapidly be competed away

4. In this research a number of costs are listed;

ONE OFF COSTS

- 1 The cost of entry or exit from a fund.
- 2. Commissions: The cost of commissions payable to a sales agent. These, one-off charges are declared to the saver.

RECURRING CHARGES

- 3. Fund Manager Direct Costs: Annual charge made to cover the fund manager's expenses.
- 4. Performance Fees: Further charges made by the fund manager for achieving agreed performance targets.
- 5. Other Ongoing Charges: Further charges commissioned by the fund manager necessary for the ongoing management of the account, such as audit and custodial fees.
- 6. Sub-fund fees: Fees chargeable by another fund manager who has been commissioned to manage part of the saver's fund.
- 7. Direct Trading Costs: Direct charges such as commissions payable as the result of trading shares or other transactions undertaken on the saver's behalf.
- 8. Implicit Cash Costs: Indirect charges, such as the 'spread' between the cost of buying and selling a security, made on the saver's behalf.
- 9. Stock Lending and other Activities: Cost (and income) derived from using the saver's account to facilitate stock lending, or similar activities.
- 10.Non-cash costs: Such as the movement in the price of securities which is caused by trading them (market impact).

5. But data is not easily found and compared. Pitt Watson reports that, 'As regards pensions, there are some studies looking at pension system characteristics and costs such as that done by (Oxera 2013). The study found that information availability restricted the analytical frameworks to assess important data on costs. Therefore the study concluded that for charges and costs,

data was either unavailable or had not been available to a level that allowed consistency to make international comparisons'

6. EIOPA published in January 2015 a report on costs and charges in IORPs. This is a significant report and noted below some of the difficulties faced for an EU approach.

7. 'The wide diversity of regulatory approaches, but especially the fact that there is a lack of detailed information and practical experience in a number of Member States as regards obtaining the details of costs and charges in particular, indicates that, at this moment in time, pension scheme members and a number of National Competent Authorities (NCAs) cannot always accurately assess if pension schemes offer value for money or are affordable. [i] It should be noted however that not all NCAs consider it necessary to have an overview of all costs and charges in order to be able to supervise effectively if pension schemes offer value for money or are affordable. Therefore, the current situation shows that it would not be possible to consider the original goal of this project - considering common definitions and standardised breakdowns of costs and charges.'

8. It goes further to state 'Therefore, the most significant question to consider is: what are the costs and charges of a pension scheme and how do they influence the IORP's overall ability to deliver value for money or overall affordability for scheme sponsors? 'Perhaps it should also have stated that the costs and charges should deliver the best outcome for scheme members as the first priority.

9. Costs could be regulated through legal measures, supervisory tools or practices. This could include capping. However the OPSG in recent consideration of the PEPP decided that a thorough assessment should be carried out before introducing any caps on costs and charges for PEPP default investment options. Consistency would suggest that the same view is held generally.

10. Also important is transparency, both of the quantum of costs and charges and how these are structured and broken down to ensure that the involved parties have all the necessary information for decision making on appropriateness of the costs they have to bear.

11. As outlined above, although not OPSG research, it is important to consider how costs and charges are disclosed. According to the studies that are briefly commented on above, it seems as if there could be a lack of transparency.

12. The EIOPA report helpfully categorises costs and charge as below;

Costs and charges can be broadly divided into three categories:

• Pension scheme/IORP costs – costs related to administration of the pension scheme and/or IORP

• Investment costs – costs related to asset management

• Transaction costs – fees paid for the execution of transactions related to the selling and buying of financial instruments. There are two types of transaction costs: Explicit transaction costs and implicit transaction costs.

Looking back at the Pitt Watson review above there is clearly much overlap.

13. The conclusion of the EIOPA report is that;

'EIOPA considers that it would be beneficial for all parties that bear costs and charges in IORPs if:

All costs and charges within the value chain are disclosed transparent and comprehensively to the parties bearing them, so that:

- The parties bearing costs and charges are able to assess if the costs and charges they are paying represent good value for money, and;
- Disclosure of 'costs and charges' information better enables all parties to exert market pressure on costs.

To avoid overload but not preclude comprehensiveness is the question to be resolved.

NCAs have effective means to assess costs and charges so as to be able to – in a wider perspective – assess how these affect value for money or the affordability of the pension schemes provided.'

Looking to how we therefore progress it is undoubtedly the case that there are differing perspectives on costs and charges and most importantly how to properly determine and calculate them. There is a debate about whether some costs can be calculated or whether they are theoretical rather than practical e.g. opportunity costs.

It is often claimed that the calculation of all investment costs is difficult, and it might be, but research by Novarca is helpful in that context.

http://www.fca.org.uk/yourfca/documents/research/transaction-costs-transparency

- identify the various transaction-related costs that exist within the Group Personal Pensions market;

- determine which transaction costs are relevant to assessing the value for money offered by a workplace personal pension;

- recommend practical methods for measuring these transaction costs;

- propose standards for disclosing cost information

Novarca's analysis and research, commissioned by the UK FCA, focused primarily on workplace personal pensions. Nevertheless, the issues for occupational pension schemes in capturing and disclosing transaction costs, and the role these can play in assessing value for money, appear to be similar.

The UK Department of Work and Pension consultation paper in March 2015; https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/407942/workplace-pensions-transactions-costs-consultation.pdf has an extensive discussion of the types of charges and how they could be treated. A response to submissions received has yet to be published.

[i] EIOPA-BoS-14/266