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A Note on Pension Fund Charges in Ireland

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Introduction

The issue of costs in relation to pension provision was ignored for many years but is now recognized as a central aspect of pension systems. It attracts considerable media coverage and political comment (see for example, Cohen and Stacey, 2012), but relatively little research. In October 2011 the Minister for Social Protection announced a study into pension charges in Ireland. The preparation of the subsequent Report (Department of Social Protection, 2012) involved the Department of Social Protection, the Pensions Board, the Central Bank and PricewaterhouseCoopers. The Report purports to be a comprehensive investigation of pension costs in Ireland, and shows the effects of pension charges for various types of scheme in terms of reduction in yield and on the accumulated pension fund².

In previous research (Stewart, 2005) costs were identified as a significant issue in pension provision for Ireland. The Green Paper on Pensions (2007), assumed a “typical charge level of 1.5% per annum” (Green Paper, p. 190). Charges on individual pensions are much higher (Stewart and Hughes, Table 10.5). More recent estimates of costs for DB schemes in Ireland estimate costs in terms of Reduction in Yield of 2.2%. These consist of trading costs of 0.65%, administrative costs of 1.5% and once off expenses relating to annuity purchase of 0.05%. McNally and Stewart, (2012) found annual annuity costs to be low because they represent an assumed average of costs across all pension schemes and most current pensions in Ireland are not annuitized.

In this note we argue that the recent Report (Department of Social Protection, 2012) suffers from a number of problems in terms of understanding the current Irish pension system, and the magnitude of charges. This may be partly explained by data inadequacies. In particular the necessary reliance on self reporting, low survey compliance and consequent bias in survey results. We argue that the Report understates costs of pension provision. The Report suffers from confusion in places, for example who bears the cost in DB type pension schemes. Solutions to inefficiency in pension provision, low coverage and inadequate incomes in retirement are unlikely to be found in the Reports Recommendations in relation to increased transparency.

UK Evidence for Pension schemes and Costs.

Even though there has been limited research on costs associated with pension provision in Ireland, this topic has attracted considerable interest in the UK. Costs associated with pension provision were given considerable prominence in the report of the Pensions Commission in the UK (Pensions Commission, 2004, p. 206-222). Implicit costs were cited in this report for small occupational schemes at 0.5% and explicit costs at a maximum of 1.5%. Implicit costs in relation to a balanced portfolio were estimated to amount to between 0.4 and 0.5% (Pensions Commission, p. 219).

These estimates of costs may be too low. Sier and Norman (2011) produced estimates of costs for an equity based fund of 3.2% (1.5% of disclosed costs, additional costs of 0.3% and trading costs of 1.4%). They report that charges had increased by 9% over the last 10 years (Guardian newspaper, 17th December 2011). The effects of these costs over a 25 year period would halve the value of a

¹ The authors would like to thank Gerry Hughes for extensive comments on earlier drafts.

² The Report states (p. 204) “This is the first comprehensive report of pension charges in Ireland and the work involved in delivering this report has proven to be both complex and difficult”.

pension fund. Yet a survey by Pitt-Watson and Mann, (2012) found that of 23 providers, 21 of the 23 were unable to give a breakdown of TER charges³.

TER charges include an annual management charge (AMC) plus subcontractor charges but may omit some charges such as the difference between the bid and the ask price in purchasing securities. No provider was “willing to give a full breakdown of these charges (p. 8). Of 23 providers contacted 21 indicated that there were no further charges (p. 9).

Similarly other survey evidence of 800 pension scheme administrators in the UK, indicates that employers are unaware of total pension charges (Croll, A. , Vargeson, E. and Lewis. A. p. 12)⁴. A further issue is that returns from lending stocks are retained by the investment institution, rather than reported as part of the cost structure, thus understating profits from share ownership and increasing the gap between returns and costs⁵. Given the complexity of cost structures associated with different assets classes, full costs may indeed be unknowable.

One effect of the new private pension scheme in the UK (National Employment Savings Trusts) by making enrollment automatic thus increasing numbers – is to make charges a more political issue.

The Report on Pension Charges in Ireland (Department of Social Protection,2012)

Research on pension charges suffers from the difficulty of obtaining accurate and comprehensive data. The Report on pension costs in Ireland (Department of Social Welfare, 2012), however, is based on detailed survey data collected by the Central Bank which surveyed life insurance companies, investment managers and pensions advisors and the regulator (the Pensions Board) which surveyed trustees (Report, p. 3). However even with these resources parts of this report suffer from a relatively low response rate from trustees (33% of the overall sample, Report, p. 224). Even where trustees did respond the Report states in some cases replies were “excluded from the analysis” as some trustees appear “to have misinterpreted the question regarding fees” (footnote 18 p. 63)

The Report shows charges for a variety of pension arrangements. These are summarized on p. 6 and in Table 13.1 of the Report. This table, and subsequent tables shows a range of “identified disclosed charges” reported from the survey. From these ranges an average is calculated and these averages are then used to calculate a reduction in yield (RIY), for different pension arrangements, such as individual pensions. However how these averages are calculated is not disclosed, nor are calculations performed for RIY for the ranges found. This would have been particularly useful for calculations using the highest charges reported. Hence the average RIY may not indicate the experience of a majority of pension scheme members.

³ The total expense ratio (TER) is defined as total fund costs divided by fund assets. This can be calculated on an annual basis or on over the lifetime of a fund that is prior to annuitisation. The expense ratio that is more normally cited, the annual management charge (AMC) will always be lower than the TER.

⁴ These authors state (p. 31) “These results should be treated with caution. A high level (17% of respondents) estimated that no more than one percent of the charge goes toward commission” suggesting that respondents misinterpreted the question. A further 51% did not know the level of payments to intermediaries from overall charges (Table 4.8).

⁵Stock lending or securities lending, involves the owner of a security lending the security to another party for a period of time in exchange for a fee. Rubicom Investment consultants comment :- “Securities lending offers pension funds the prospect of a small additional return for some small additional risk and administrative inconvenience”. Available at <http://www.rubiconic.ie/>

The report is mostly concerned with DC schemes. The report considers that “DB arrangements are somewhat different in construction from DC, given that in practically all cases all pension costs and charges are borne by the employer rather than the individual pension saver” (p. 2) and hence “DB schemes are not included as the costs are generally borne by the employer (p. 6). Elsewhere the Report states (p. 120) “Under a DB scheme, implicit costs are borne by the pension fund and it is ultimately the employer who bears such additional costs”. However empirical research on DB schemes (McNally and Stewart, 2012) shows that of 58 schemes examined, trading and investment costs were in all cases borne by the scheme, but only 12 (20%) indicated that fees and expenses were borne by the sponsoring company.

Indeed the Report itself produces contradictory evidence to these statements, for example Table 7.8, (p. 124) shows that of the trustees of DB schemes who responded, 76% of schemes claim to have no employer support⁶. It is likely that some costs are borne by the employer in all employer based schemes (DB and DC) for example certain administrative services for example, collecting and remitting contributions.

Most DB schemes are in deficit. The greater the charges the lower the returns. Because investment and other costs are borne by the scheme itself any actions that reduce these costs, improves returns net of costs to the benefit of the scheme. While employers may agree to meet any deficit in full a more likely response is to require increased employee contributions, reduced benefits and/or closure of the scheme to new entrants and to existing members. Table (1) below shows some of the trends in employer responses to rising costs, poor returns and resulting deficits amongst DB schemes. An increasing number of DB schemes have either been wound up, or are in the process. Table 7.2 of the Report reports similar results but does not detail other employer responses such as placing a cap on benefits, changed pensionable salaries, increased employee contributions, and increased retirement age. It is interesting to note that increased employer contributions are not noted in any of the IAPF surveys examined.

Table (1)
Changes in DB Schemes 2009-2011
% of respondents

	2009	2010	2011
Scheme wind up planned or actual	21	22	26
Closure to new members	47	64	70
No future accrual to members	38	43	47

Source IAPF Benefits Survey various years.

Thus several statements in the Report appear to be incorrect. For example:-

p. 6 “There are approximately 197,000 individual members in 993 Defined benefit funded schemes where running cost do not directly impact members”;

p. 44 “Under a DB scheme pension costs are generally borne in their entirety by the employer as opposed to the members of the scheme in question”;

P. 115 “Unlike a DC scheme, where operational costs impact member pension values, the operational costs of a DB scheme have no impact on member pension values”;

p. 120 “Under a DB scheme, implicit costs are borne by the pension fund and it is ultimately the employer who bears such additional costs”;

p. 206 “In DB arrangements the costs are generally borne directly by the employer, in DC

⁶ Table 7.8 in the Report refers to the per cent of schemes “utilizing internal Employer Resources”.

insured and non-insured schemes, there are varying arrangements for the sharing of charges between employers and the member”;

A Critique of Cost Estimates

The overall conclusion of the Report is that there are a range of charges for various kinds of pension schemes. The report in particular focuses on defined contribution schemes as noted above. These explicit charges (annual management charge, etc.) are shown (Chart 13.1 p. 207) in terms of RIY (reduction in yield) as varying from 0.09% to 1.83% for employer based schemes and from 0.89% to 3.64% for individual based schemes. The report states that further implicit charges add from 0.1% to 0.3% to the RIY (p. 8, p. 80)⁷. This data was provided by investment managers.

Identifying implicit costs is difficult. The Report states (p. 80) that these were estimated as follows:-

Implicit costs = TER (Total Expense Ratio) – AMC (Annual Management Charge) + additional costs of brokerage commissions + stamp duty.

This methodology raises a number of issues for example how is TER estimated? The assumed operation of a pension fund in the Report (p. 36) is that pension contributions are first made to a pension fund manager. The Pension fund manager then invests in various asset classes consisting of pooled funds (such as a balanced managed fund, discussed in the Report pp. 67-69).

The various charges that might arise are described as a reduced “allocation rate” meaning somewhat confusingly a proportion of contributions are kept by the pension fund manager to cover costs, profit margin etc. The pension fund manager also charges an annual fee (referred to as an annual management charge).

The report assumes investment charges consist of a bid – offer spread of 5% which applies to the pension fund investment in an investment fund such as a broad based equity fund. This is assumed to be the only bid-offer charge. The report in estimating costs, does not adequately take account of tiering of pension fund charges. For example a pension fund may invest in a broad based equity fund (used by 83% of funds according to Mercers Benefit survey 2012), or a balanced managed fund (used by 63 % of respondents according to the Report (p. 58). This equity fund then purchases equities and pays commission (2nd level bid-ask spread and commission charges). The equity fund may invest some funds in another equity fund (resulting in 3rd level bid-ask spread charges). As the second level equity fund in turn purchases equities and other assets, bid-ask and commission charges will be paid, resulting in 4th level charges. If for example all pension contributions were used to purchase units in a broad based investment fund. The investment fund manager will pay commission on assets purchased. Charges could be a flat commission fee (for example 0.5%) and/or could be reflected in a bid/ask spread. Stamp duty/local taxes must be added to these charges. If the investment manager were to allocate a proportion of funds (assuming 20%) under management to a second fund (for diversification) this would incur a bid/ask spread charge of 5%. This second fund could as in the primary fund, incur additional charges. Thus the assumed costs in the bid/ask spread of 5% increases to 7.2% as follows:-

5% (initial purchase of units) + 1% (equity share purchase costs)⁸ + 1% (allocation of primary fund to a secondary fund) + 0.2% (equity share purchase costs of second fund).

⁷ These estimates were provided by the largest four funds of 8 investment managers surveyed (Report p. 46 and p. 52)

⁸ Davy stockbrokers quotes a flat brokerage fee for online execution only accounts of 0.5% . See: <http://www.davy.ie/TopLevel?page=commissionsandchargesroi>. In addition the web site states “The above charges are Davy

The greater the turnover within these funds the greater these costs. The Kay Report (2012) noted that the costs of intermediation adds to the costs of the investment chain and furthermore leads to a focus on returns as seen by intermediaries rather than those purchasing equities and other assets such as pension funds (Kay Report p. 30).

The Assumption of Straight Line Growth

In estimating the effects of charges on the Reduction in Yield (RIY), the Report assumes straight line growth rate of 5% (p.50) . If for example the growth rate were zero, front loaded charges and fixed charges will have an even greater effect on terminal values. The interaction of charges together with periodic falls in fund value can have a substantial effect on accumulating lump sums as shown in Table (2) and figure (1). Example (4) shows the accumulated lump sum is approximately 30% lower than in example (1). A greater fall would be shown if charges and periodic falls in assets values were greater.

Table (2)

The Effect of charges and Falls in Asset Values on Accumulated Funds

	Example 1 €700 per month, for 21 years, no charges, 6% return	Example 2 €700 per month for 21 years, 1.5% charges 4.5% net return	Example 3 €700 per month for 21 years, no charges, 6% return, but 12% capital loss every 7 years	Example 4 €700 per month for 21 years, 1.5% charges, 4.5% net return, but 12% capital loss every 7 years
Accumulated lump sum after 21 years	€311,039	€259,980	€264,949	€222,099

Note: Adapted from “How Much do you Need to save for a Pension, Society of Actuaries, May 2006, (reproduced in Green Paper p. 137).

Assumptions: As in Table 9.2 Green Paper, salary €40,000, pension of 50%, current age 44, planned retirement at 65, monthly pension contribution is €700. Returns are assumed to be 6% per annum gross of costs. Cost assumptions are not clear (See, Society of Actuaries GN31A). We assume 1.5% RIY. Gross loss every 7 years is 12% or net of returns 6%.

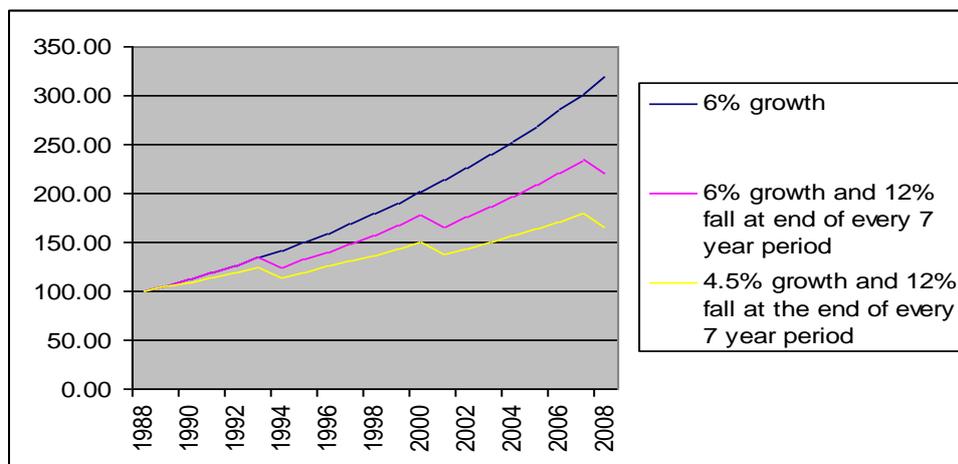
Source Stewart (2011).

Figure (1) shows the hypothetical movement of an index assuming continuous growth of 6% per annum, 6% growth less charges of 1.5% per annum, 6% growth with a fall of 12% at the end of every seven year period, 6% growth less charges of 1.5% per annum and with a fall at the end of every 7 year period of 12%. The figure shows the dramatic difference an assumed fall in the stock market makes to index movements. This is compounded by the introduction of charges. The index at the end of the 21 year period, (assuming growth of 6% and charges of 1.5% and periodic falls in the index of 12%), is less than half the value of the index without these assumptions.

transaction charges, other charges will apply to these trades or to your account generally”. Most major equity markets impose some tax on transactions (Eun and Resnick, 2004, exhibit 8.7). Stamp duty on all share trades is 0.5% for the UK and 1% for Ireland.

Figure (1)

Index movements with various assumptions



Exit Charges/Annuity Charges

The Report identifies three major phases to pension costs over the Life Cycle, set up phase; accumulation phase; and exit phase (transfer penalties or entry costs to post retirement vehicle (p. 33). However there is relatively little discussion of annuity charges in the Report, so that the focus of the Report is on the effect of costs on the value of the accumulating fund. With the growth of DC schemes, annuity purchase will become a more common source of pension retirement income, even with the growth of annuity deferment options, for example Approved Retirement Funds (ARF). The Report states (p. 10) that “commission levels for . . . annuities have shown little variation with time”. This is at variance with other costs examined in the Report which appeared to have declined through time (p. 135). The Report comments that “annuities have no associated direct costs from the policy holders’ perspective with the exception of the entry cost of commission”. However the effect of fixed commissions and falling annuity rates is to increase the size of the commission as a proportion of the annuity rate. Commission costs identified in the Report (p. 181) would reduce income from an annuity by approximately 3% per annum⁹. Because of the level and variability of annuity costs the Financial Services Authority in the UK has recently launched a Review of the UK annuity market (Guardian Newspaper, 31st January, 2013).

Some further Comments

This Report is useful in revealing the extent and nature of pension system charges, and the effect of these charges on yield and the accumulated lump sum. But the level of charges is likely to be higher than that detailed in the Report. The Report does not attempt to justify the level or purpose of the many charges identified. The Report states (p. 139) “Survey responses indicate that reductions in allocation rates and/or increases in annual management charges are the most common methods used by life assurance companies to recoup commission costs”. The Report also states (p. 163)

⁹ Example for Life Assurance company A and pricing assumption A

“Commission structures are a common feature of public sector AVC schemes and to recoup these costs life assurance companies will increase pension charges”. Elsewhere the Report equates commission charges with distribution costs (p. 34). The Report further states (p.224) “The individual charges do not always have an explicit purpose. They have overlapping meanings and many are simply mechanisms to apply charges”. Yet the Report concludes that “The research findings suggest that Irish DC schemes are reasonably competitive from a member’s perspective”. The Report suffer from an absense of analysis or attempts to explain charging structures¹⁰. Evidence for a fall in charges (p. 135) relies on self-reporting.

Conclusion

The Report states (p. 226) that “In principle, it is not good practice to interfere in the price fixing mechanisms of the market particularly where this could result in unintended consequences which may impact on competition”. The Report fails to recognize that existing ‘market mechanisms’ have failed to deliver a pension system which is efficient and which delivers adequate pension income to those in retirement. This is in spite of large subsidies via the tax system. The assertion in the Report that “similar to any service, consumers should be in a position to shop around and compare prices and obtain the best product available” fails to recognize the deep rooted information asymmetries in pension provision and the considerable uncertainty and risk in pension provision. It is unlikely that the recommendations in the Report such as a “communications action plan” (Report, p 229) will adequately solve these difficult issues. Rather the implications are that pension needs can be best met by collective provision, which ensure economies of scale in both cost and information provision. Financial market transactions are subject to considerable agency type issues (moral hazard, asymmetric information and self-interested behaviour). These may be mitigated not by an emphasis on markets and information provision but by careful regulation.

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¹⁰ Even though the subject matter is complex, explanations in the Report in some cases fail to add clarity. This is exacerbated by some instances of poor presentation and minor errors (for example in relation to labeling axes Charts 8.1, 9.1, 9.3, footnote 58 is missing, etc.).

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