

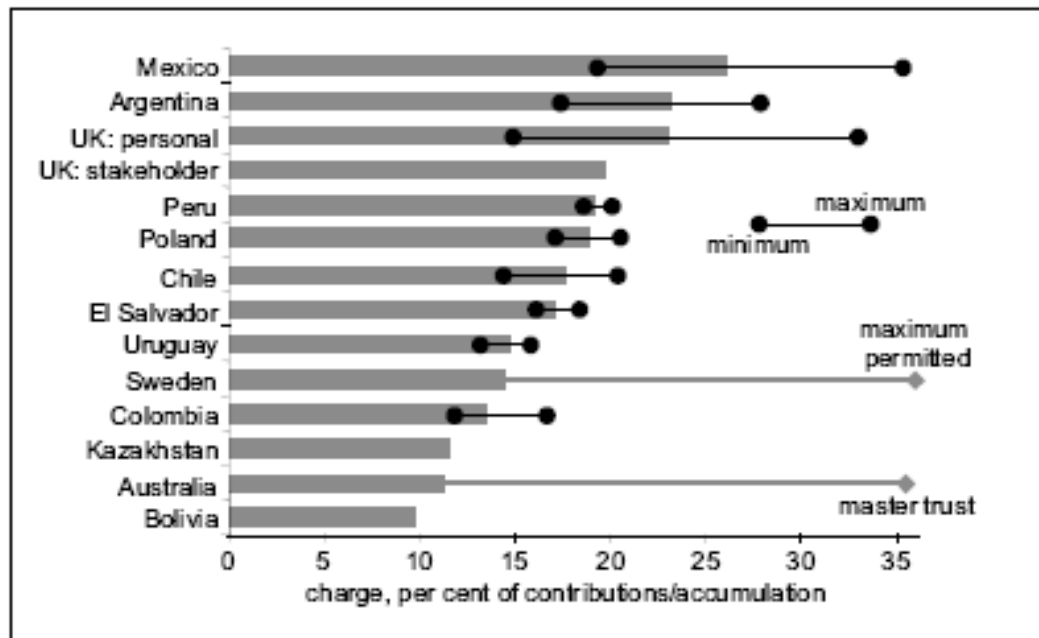


Private Pension Costs and Efficiency

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May 2006

Pension Costs

Figure 6. Charge ratio in funded pension schemes in thirteen countries



Source: see discussion in previous sections

- Edward Whitehouse, *Paying for Pensions: An International Comparison of Administrative Charges in Funded Retirement Systems*, FSA Occasional Paper, 2000

If it were just about costs, why DC and why Privatize?

- Public DB is probably cheaper to administer than a complex DC system
- And if it were private, Private DB is probably cheaper than Private DC



A Low Cost Product

- James et. Al. – cost of retirement annuities around the world (using annuitant mortality tables) is quite reasonable (low markups)
- Industry commissions on retirement annuities typically quite low
- Standardised product
- ... But no one wants to voluntarily buy it.



Another Low Cost Product...

- UK stakeholder pensions – maximum charge level fixed by government
- Problem: ate into insurance company capital, drove firms from market
- Problem: capital costs and profitability provided lack of incentive to distribute -> low take-up



Outline

- Pitfalls with cost comparisons
- Broader issues: efficiency goals
- Approaches to achieving more efficient outcomes



Pitfalls with Cost Comparisons



Problem 1: Structure of Charges

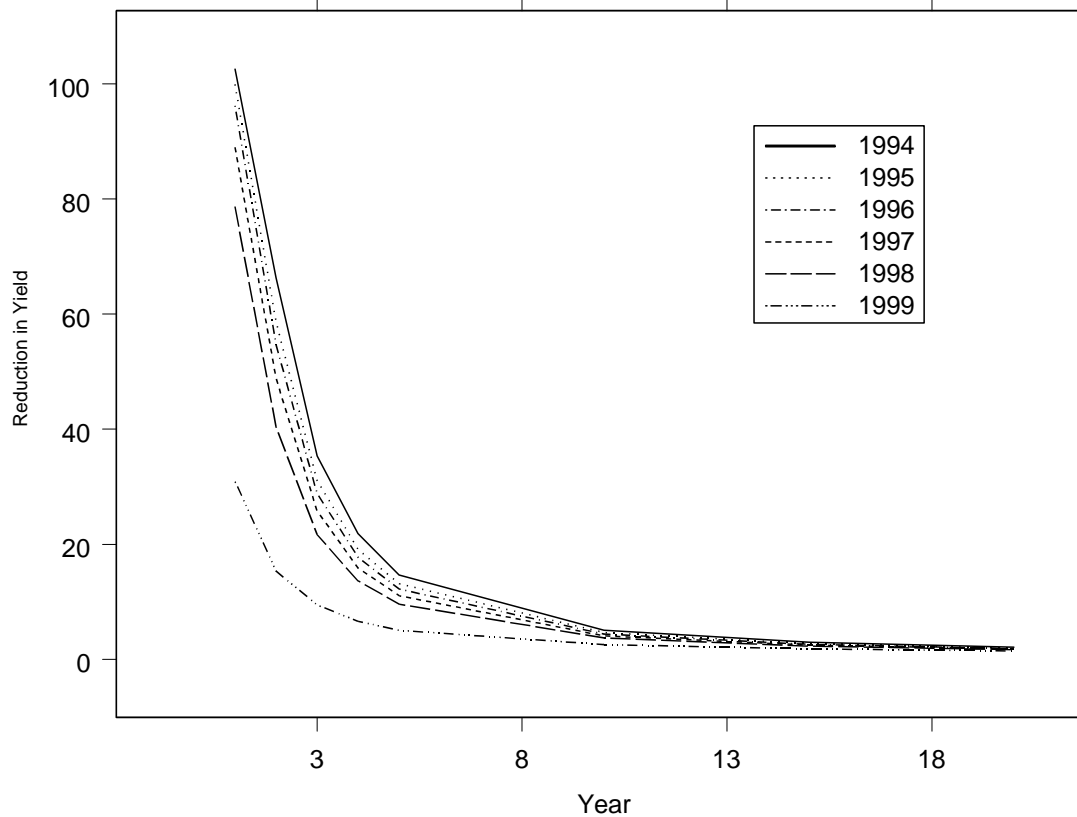
Reduction in Yield = Benchmark Yield - Yield with Charges

**Prospective Data from UK Regulator (PIA Survey):
Effect of Charges on Personal Pensions (1998)**

	£60pm	£200 pm
RIY after 5 years	14.4%	11.5%
RIY at maturity	1.9%	1.4%

Average personal pension was about £100 p.m., PIA: 60% in force after 4 years from company reps, 70% IFAs.

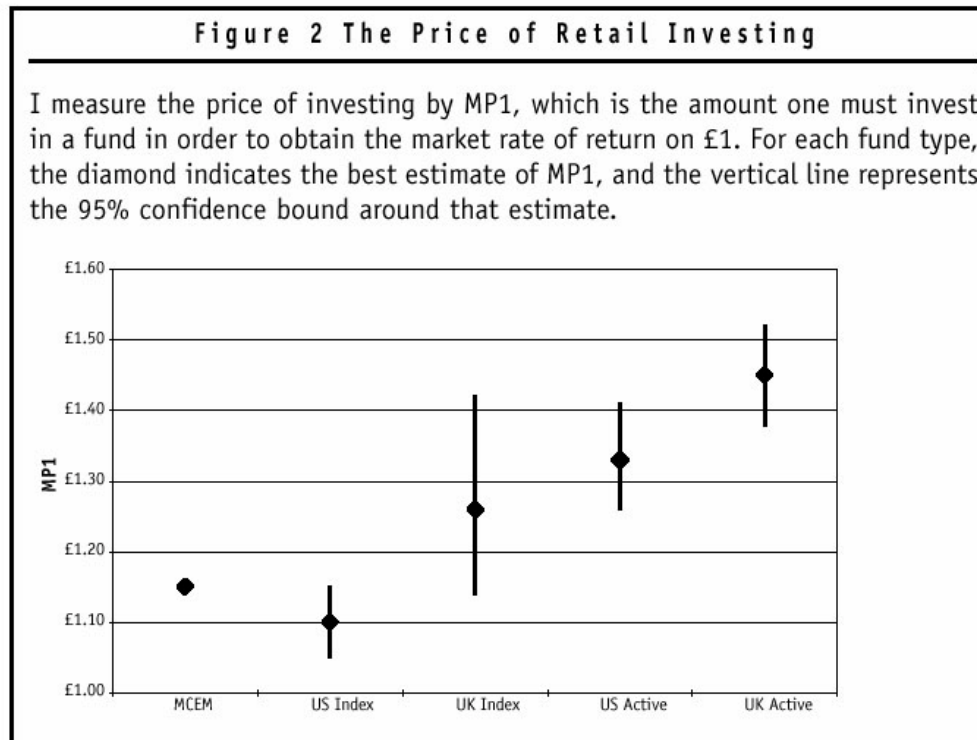
Problem 1: Structure of Charges



Problem 2: Investment Efficiency

Kevin James, Price of Retail Investing in UK, FSA, Feb. 2000

MP1 = Benchmark Yield/Yield with Charges



**Life
offices:**

benchmark
9.56%

fund 5.95%

MP1 = 1.6

Other Issues

- Treatment of dealing costs
- Differences in fundamental costs: fund management, labour costs, etc.
- Differences in system design
- Differences in regulatory requirements



Costs



3As of Consumer Costs

Accumulation - charges during accumulation stage, no change in plan

Alteration - charges for alteration of plan

- varying premium
- changing provider - transfers vs. paid-up

Annuitisation

In UK, alteration costs have been important. Relevant whenever there are front-loaded insurance contracts.

Provider Costs

3As of Provider Costs

Acquisition - commissions, advertising, etc.

Administration - policy maintenance costs, IT, etc.

Asset Management - costs of fund management

In the UK, acquisition costs were traditionally about 60% of total costs. Asset management costs are only 10-15%.

Efficiency Goals



Costs and Efficiency

- **Criteria of efficiency for pension system:** people save what they need for retirement at adequate cost and at a level of risk they understand
- **Measuring efficiency**
- **Ensuring efficiency:** What preconditions are there in terms of financial regulation for efficient DC pension systems?



Efficiency Criteria

- Understanding of benefits they will receive
- Understanding of risks
- Adequacy of saving – coverage and contributions
- Cost efficiency of provision for given level of understanding/adequacy



What Goes Wrong: More Than Costs

- Product Design
- Distribution
 - Access
 - Education
 - Communication
 - Costs



Visual presentation matters

- Choice between real and level annuity
- Details presented either by table or

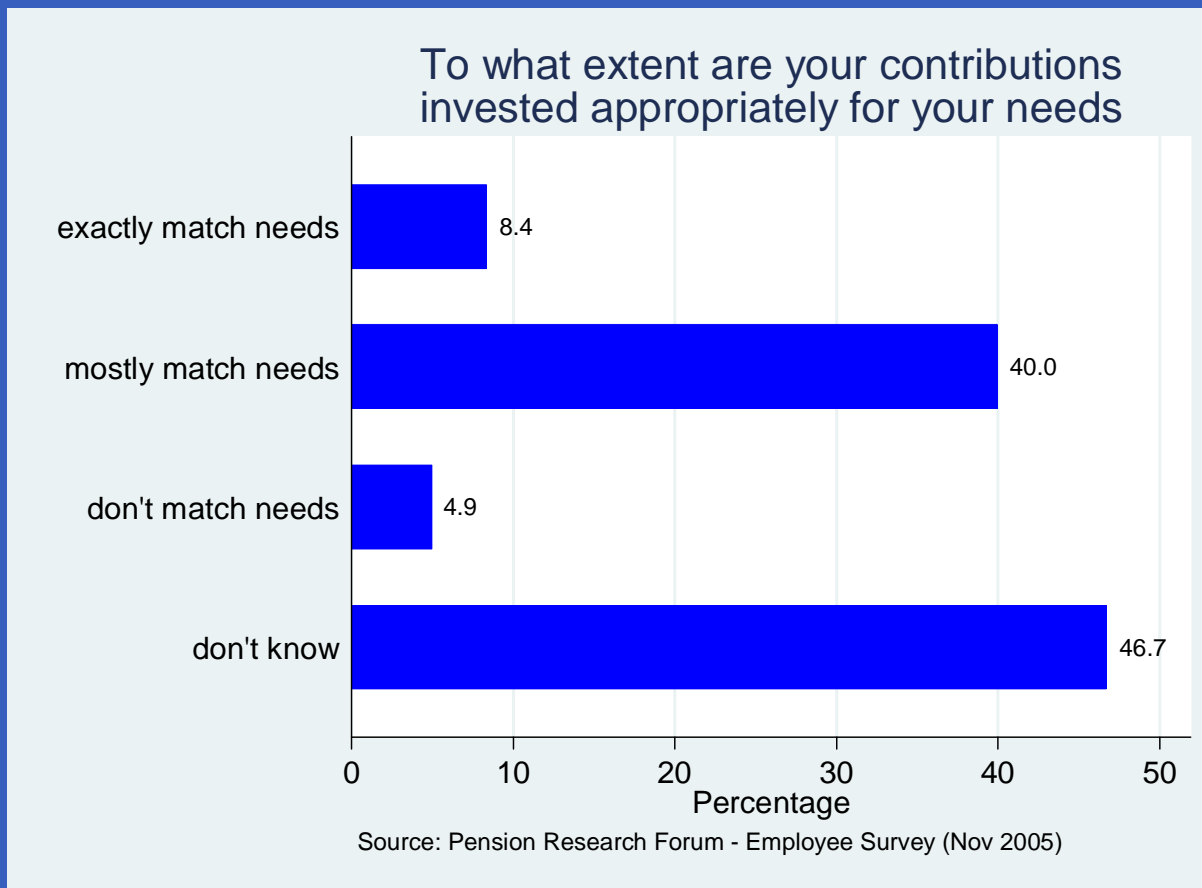
Age	Level Annuity	Inflation-linked Annuity
65	7,000	4,900
70	7,000	5,500
75	7,000	6,300
80	7,000	7,100
85	7,000	8,000
90	7,000	9,000
95	7,000	10,300
100	7,000	11,600



When was the last time the member made a fund change



How appropriate are the investment choices?



Around half of DC members are not sure their investment choices match their needs.

Approaches to More Efficient Outcomes



Conceptual Framework

Profits = (charges – costs)* savings(perceived charges)

Optimal strategy:

Markup = 1/elasticity of demand (simplicity)

Individual providers lose with simple products even though they would gain if products in aggregate were more simple.



The 3Ds of Distribution

- **Design** - product design
- **Delivery** – means of delivery (sales, marketing)
- **Durability** – persistency of relationship

What Goes Wrong:

- Imperfect information among consumers leads to complex “flexible” designs which consumers do not understand. Complex designs = high delivery costs
- High delivery costs = high consumer costs
- High consumer costs/misunderstanding = low durability



Policy Options

	Design	Delivery	Durability
Price Regulation	?	?	?
Product regulation			
Sales process regulation			
Disclosure			
Structural Change (e.g., Clearinghouse)			

Disclosure

- **Advantages: appears simple**
- **Disadvantages:**
 - Individuals do not pay attention to disclosure details
 - Little evidence it influences behaviour



Investment Regulation (a type of product regulation)

- **Advantages: reduces costs**
- **Disadvantages:**
 - Can be too inflexible for individual needs
 - Does not really deal with the core cost/distribution issues (fund management usually not a large component of total costs)
 - Can result in loss of talent in fund management sector



Clearinghouse System

- **Advantages: centralised (eliminates marketing costs)**
- **Disadvantages:**
 - Can be difficult to set up
 - Can be designed with too many choices for individuals
 - May not work well for voluntary contributions (no incentive to market)



Conclusions



International Lessons

- Pension costs are part of a much bigger problem: ensuring adequate efficiency of pension arrangements.
- Pension costs are tricky to measure and compare across countries
- Pension costs are tricky to regulate (there is not one accepted approach)

