SCHEME MANAGEMENT

Slicing off the fat

Cutting the running costs of a pension scheme is not just a way for companies and providers to save a bit of money. It can also deliver better value and returns for members

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Just how important is cost saving for pension funds? Well, it depends on who you talk to.

As CEM Benchmarking's principal John Simmons says, if you're a large corporate with a huge defined benefit scheme that is dragging your balance sheet down, then your number one priority is to reduce your liabilities. The cost of operating your pension fund and investing its assets is, by comparison, miniscule, leading to some DB pension managers to not sweat too much over how much they are paying for their administration or actuarial consultant.

In the DC world however, cost is hugely important across all schemes as they directly eat into members' savings pots. And at present, says Better Finance policy officer Alex Rodriguez Toscano, costs are taking a significant chunk out of those pots.

A 2017 report produced by Brussels-based Better Finance, which works to improve outcomes for financial services users, found that consumers continue to receive low returns from their pension products.

Better Finance analysed returns from an imaginary portfolio made up of 50 per cent European bonds and 50 per cent European equities from 2000 to 2017. It calculated that this asset mix would have given savers an annual average real return of 2.6 per cent. Worryingly, its research also showed that most long-term and pension savings products did not, on average, return anything close to those of capital markets. In many cases the products even destroyed real value for European pension savers.

"We identified that the fees and commissions are the main culprits and that they are too high compared to what they could be, especially for packaged personal pension products," says Rodriguez Toscano.

Poorly-controlled DC costs also discourage wider take up of private pensions. And with the long-term sustainability of a generous first pillar system in many European countries being called into question, Europe needs to tackle expensive and opaque fees, particularly as the European Commission plans to launch the pan-European personal pension product (PEPP) in the near future. If PEPP cannot guarantee reasonable costs, then it may never get off the ground.

Where to save

Any cost saving discussion has to start with investment fees. These can absorb as much as 90 per cent of the total cost of running a pension fund, according to Simmons, and are very sensitive to a scheme's asset mix.

CEM Benchmarking measures and compares the performances of some 500 funds globally, with combined assets of $7 trillion, in order to help funds manage their costs more effectively. It has found some DB funds that invest 5-10 per cent of their assets into private equity and hedge funds, while paying active managers 50-60 per cent of their total costs to do so.

He says that that some DC pension funds are now considering moving into the asset classes as well.

"It's difficult to see how they could justify it given the scale of the fees," says Simmons.

CEM Benchmarking's research has echoed other studies in the general debate around the merits of active investment. Over a 25-year horizon, it has found that active management decisions have added value compared to passive funds. However, three quarters of that value has been consumed by cost, leaving the net value at about 15 to 20 basis points over the time period.

"Those funds that are paying for active management ought to have regard for whether they're actually generating additional returns over and above the benchmark commensurate with what they're paying," says Simmons.

"Because if you're going to pay for active management then why do it if you can't outperform the benchmark?"

Amundi global head of retirement solutions Christian Lemaire says that many of the European companies that he speaks to are increasingly turning to passive index funds for their DC funds.

"They want to propose limited choice and make it as simple and as easily understandable as possible," he says.

"So in that case they will go to passive index funds in order to decrease the management fees that they have to pay, or the members will have to pay. It's a very big trend. They want to give maximum return to members."

Another way to save on active management fees – apart from getting into some hard negotiation with investment houses – is to build an internal team.

Simmons say that internal management tends to be hugely cheaper than external management and that funds that have assets over £1 billion can realistically look at building external teams – although there are risks in taking that approach, such as having a small team.

"For funds that are scalable enough, the only way to materially move the needle is to implement your strategy in a different way," he says.

"And there is plenty of evidence around the world to show the merits of internal management."

All eyes on the default?

In the DC world, pension trustees are usually heavily focused on the default fund, where the vast majority of members end up channelling their contributions. Although savings can probably be found there, Simmons warns that trustee boards need to scan the whole horizon of their membership to properly judge cost effectiveness.

"The issues in DC of low performance and high cost investment funds tend to be found at the margins," he explains. "Some of the more exotic investment options on the fringes that the members select themselves don't get the scrutiny that they should."

Dealing with the high cost of alternative investments in DC could be taken out of the hands of pension managers. However, Rodriguez Toscano says they could be reduced by the introduction of widespread caps on fees.

"The different pension systems differ quite a lot in member states, so it's really hard to determine the exact cap that we would propose for products. But we're positive about the idea, especially in relation to PEPP."

Administration

In administration, saving through negotiating costs with third-party providers can be tricky, not least because a sizeable number of them have had to do more for suppressed fees for some years.

Instead, says Lemaire, the solution is to offer a fully digital platform that is accessible on all smart devices to members. These need to be user friendly and contain elements such as educational tools, videos and chat facilities in order to engage members.

"If you get it right, then you can add additional savings. Plus most funds have the capacity to do it as it only costs a few euros per month per member. It is very low cost."

IORP II and consolidation

Some of the large multi-national companies who have tried to cut excess expenditure within their various pension schemes by implementing ideas such as digital platforms have still struggled to make inroads.

These conglomerates have been handed a lifeline by the EU's IORP II Directive, which came into force in January.

The directive, which allows different pension schemes from different countries to be hosted in the same vehicle, has been jumped on by a number of providers, such as Amundi, which runs a multi-employer scheme out of Luxembourg. As Lemaire outlines, the vehicle allows companies to benefit from a hub where costs can be better monitored and economy of scale can be used.

"The vehicle is like a big cupboard with one single entry point," says Lemaire.

"If a large corporation wants to put a Spanish pension into the cross-border vehicle, then you create a new drawer in order to add pension rules specific to the company and its staff."

"We have been able to save 30 per cent in costs on average. That means you can speak of additional net accrued capital for the pension members in tens of thousands of euros, so it's not a small impact.

"It translates into a lot of money when you retire." ■