CSIRO-Monash Superannuation Research Cluster

WORKING PAPER SERIES

REVIEWING GOVERNANCE OF FUNDED PERSONAL PENSIONS IN AUSTRALIA AND THE UK

NOEL WHITESIDE

UNIVERSITY OF WARWICK, UK

28 February 2016

CSIRO-Monash Working Paper 2016-03

[*] The author would like to thank Bernard Casey who generously sent on recent documentation relating to issues raised in this report. The analytical framework, however, remains her own

ACKNOWLEDGEMENTS: THIS RESEARCH WAS SUPPORTED BY THE CSIRO-MONASH SUPERANNUATION RESEARCH CLUSTER, A COLLABORATION BETWEEN CSIRO, MONASH UNIVERSITY, GRIFFITH UNIVERSITY, THE UNIVERSITY OF WESTERN AUSTRALIA, THE UNIVERSITY OF WARWICK, AND STAKEHOLDERS OF THE RETIREMENT SYSTEM IN THE INTEREST OF BETTER OUTCOMES FOR ALL.

Abstract

This report reviews issues in the governance of personal funded pensions with a specific focus on costs incurred in Australia and the UK. This is a comparison between increasingly similar market-based systems following the advent of auto-enrolment in the UK in 2012.The principal factors that exacerbate costs due to the time between the purchase of a complex product and its receipt are explained: the tendency of providers / employers to change hands; worker mobility and fund transfer issues; problems of legacy and zombie funds. This also covers: perverse incentives caused by purchaser-beneficiary splits; marketing strategies used by providers to gain business; fund management and associated agency issues; short-termism and investment strategies. The advantages of economies of scale (partially realised in Australia) are noted as are the problems of measuring overall costs that, according to official measurements, are higher in Australia than in the UK.

The report then reviews the main policy initiatives adopted in each country to correct these issues, noting how Commonwealth governments, past and present, have retained greater faith in the merits of market competition than have their UK counterparts. In the UK, new regulations will prove far more invasive of pension fund management and investment practices – and possibly more expensive – than before. The report concludes that, as reform is still a work in progress, definitive evaluations are difficult to reach, but notes how compliance costs consequent on regulatory changes, which have tended to increase over time, are liable to raise overall management expenses, thereby exacerbating the very problem policy seeks to address.

Introduction: Anglo-Australian comparisons

This report focuses on problems of governance that characterise funded personal pension systems with a specific focus on their cost. It looks first at the issues that arise when such pensions are offered by private (often commercial) agencies under market competition, then examines policy responses and assesses their effects. The account focuses on recent developments in the UK and Australia. Although the extension of quasi-mandatory personal pension saving, under auto-enrolment, is far more recent in the UK than in Australia, issues of governance and its costs have commanded official attention over a longer period in the former country. This is arguably because UK pension funds have been operating in a difficult climate for many years. Low returns have damaged rates of accrual and have made UK governments give ever increasing attention to charges and fees imposed on scheme members.

According to prevailing economic theory, competition and choice between pension providers enables customers to select the pension product best suited to their personal circumstances at an optimal price. To undercut their rivals, the argument runs, pension providers and their fund managers will seek to contain costs. Fund investments in equities will improve business performance over the longer term, raising general economic prosperity while offering good returns for fund members. However, as a number of commentators have noted, market-based schemes that rely on competitive pressures do not appear to function in this manner in the world of funded superannuation / pensions[*]. There is little sign in either Australia or the UK that competition, of itself, has exerted much pressure on costs. Further, fund investment practices have tended to foster short-term investment ('churning') that is not conducive to the strategic development of the firms involved, prioritising immediate share profile over potential long-term performance. In both countries, governments have become more interested in initiatives to foster transparency, reduce charges through the promotion of low-cost providers and improve investment practices. The next section of this report will provide evidence of market problems found in both countries. The third will outline steps recently taken by both governments, in the UK in particular, to improve pension governance and promote efficiency. The final section comments on recent developments and draws some tentative conclusions.

As this report is written primarily for an Australian audience, an account of recent developments in UK pensions that have created similarities with Australia may be welcome. In the UK, following the reports of the Pensions Commission (2004-5), legislation has abolished the old two-tier state pension (one basic flat-rate, the second (S2P) earnings-related) and, with this, the right of private firms to 'contract out' of part of the state scheme and pay lower national insurance contributions (NICs). From April 2016, a new, single, flat-rate old age pension, set at a standard above Pension Credit (the means-tested supplement available to all retirees with insufficient income) is introduced. More importantly for this report, auto-enrolment into private funded pensions is being rolled out for all workers on salaries above £10,000 p.a. This provision is overwhelmingly DC or group DC. Thanks to its scale (c. 10 million new savers should be covered by 2018) the project is being implemented in tranches. The first, involving large companies of 50+ employees started in 2012. By March 2015, 5.2

[*] The different vocabulary employed in each country is potentially confusing. In this account, with its focus on Defined Contribution (DC) personal savings, the term 'pension' is used generically to refer to both Australian Super and UK pensions (unless Australia alone is under discussion).

million new pension contributors have been auto-enrolled by c. 60,000 employers. The second stage is more daunting, involving some 1.8 million employers, 35 percent of whom have no employees falling within the scheme's remit (at present) and 50 percent of whom only employ one or two people (including domestic servants and nannies - Westminster Briefing 2015). To offer a facility to small employers, the National Employment Savings Trust (NEST) was set up in 2009 as a master trust and low cost provider. It has since been joined by a mutual (People's Pension) and a subsidiary of the Danish ATP (NOW) among others. In addition, from April 2015 all pension savers have been entitled to access their savings from the age of 55 (called Pension Freedom) and the obligation to annuitize has been abolished.

British pension provision is thus becoming increasingly Australian (albeit UK politicians claim New Zealand's KiwiSaver as their model). Both countries understand personal savings as central to a comfortable income in old age. Both offer a basic state pension (the Australian version is means-tested) while promoting this funded supplement. In both cases Defined Benefit (DB) schemes based on final salary are dwindling in importance: DC pensions and Super, the replacements, are basically personal, funded savings schemes with strong tax advantages. In Australia, Super has been mandatory since 1992. The introduction of auto-enrolment in Britain in 2012 invites comparison but – as UK auto-enrolment is still being rolled out and the Australian scheme is mature by comparison – comparative statistics to illustrate coverage or average rates of accrual are not very informative. Further, UK employees can opt out (while Australians cannot) although currently fewer are doing so than initially expected (8-14 percent: UK House of Commons 2016) and these are largely older workers with little chance of accumulating a decent sum before retirement. Both countries offer tax concessions on personal pension contributions: both have taken steps to reduce the privileges this traditionally offered high earners. Pension Freedom in the UK allows access to savings from age 55, while in Australia this is 60, currently rising to 65. Neither country imposes obligations to annuitize: both allow savings to be accessed as a lump sum (although only in Australia is this totally tax-free). Finally, both countries allow personal pension funds to be owned and managed by the contributor: Self-Managed Pensions Funds (SMIFs) in Australia and Self Invested Pension Plans (SIPPs) in the UK – although these play a minor part in the analysis offered below, which focuses on group schemes, mostly default funds.

Similarities aside, basic contributory rates are less equal. In the UK, auto-enrolled contributions currently stand at 3 percent of salary and aim to rise to 8 percent by 2017. In Australia the current contributory rate is 9.5 percent, rising to 12 percent over the next two years. Both, but particularly the British version, are widely considered to be inadequate in terms of savings needed as longevity rises. Tax treatment and state pension rights also differ, and this has encouraged policy trajectories to move in opposite directions. As already noted, the Australian Age Pension is means tested while the UK state pension is not. Further, again unlike the UK, Australian Super savings can be accessed tax free. This makes the Australian Commonwealth government very interested in taking steps to prevent retirees withdrawing all their cash for immediate expenditure on holidays or (the more common choice) on their domicile, which can be used as an endowment for the children (the primary residence of retiring citizens is exempt from the Age Pension means test). In contrast, while the UK basic state pension is not means-tested[†], cash drawn down from pension savings is only 25

[†] Low paid private sector workers, previously 'contracted in' to the UK state second pension (S2P), will lose the right to the earnings-related supplement when the new, higher, flat-rate pension is introduced. In

percent tax free. Marginal tax rates are imposed on the balance. From the point of view of the public accounts, therefore, it pays the Commonwealth government to persuade Super savers to convert their funds into an income stream for their old age while a UK Treasury, in the short term at least, stands to gain from 55 year-olds accessing all their savings at once. Thus the Australian government is seriously considering imposing a minimum income stream as a prerequisite for Super savers wishing to access their funds (ASFA 2014). In contrast, as noted, the UK government has firmly rejected this option and has removed all constraints on how accumulated pension savings are spent. In both countries, policy debate on decumulation is commanding more attention. In both cases, the retiree who has spent a sheltered existence in the backwaters of an employer's default fund is asked to make a major financial decision for the very first time about a substantial sum on which future living standards will largely depend. Should governments offer advice / guidance to help (a very expensive option)? Or mandate a (minimum) income stream? Or should they simply stand by, let market forces work, let retirees make bad decisions, allow scammers and fraudsters to deceive the unwary to rob them of their savings - and let the taxpayer pick up the pieces?

Such dilemmas illustrate why governments have intervened in market operations to protect the vulnerable and secure optimal outcomes for all. In this regard, the public good can only be promoted by establishing a legal remit within which the market must operate – and both governments have recently become enmeshed in debates on this topic in recent years. There are specific issues with pension markets that need to be addressed and a few of the major ones are identified below

Market Failures: a brief review

Over the past quarter century, the Australian economy has been buoyant and returns to Super accounts have been impressive. In such a climate, the costs and charges imposed on members' funds were easily absorbed without damaging rising balances to any noticeable effect. The same is not true for the UK. Recent research has established that the average UK pension saver would have lost 0.7 percent p.a. in real terms over the period 2000-12 (European Federation of Financial Service Users 2014), taking management charges and changes in tax, inflation and exchange rates into account. The global financial crisis (GFC) of 2007-8 did not help, either in the UK or Australia, where its immediate impact caused asset management costs (and, thereby, overall charges) to rise (Rice Warner 2014).

- *Time and Complexity.*

Funded pensions are highly complex products that are not easily understood – so judgement reached by the client concerning best value often requires expert advice, which may be expensive, biased, unavailable, or ignored. Decades elapse between the purchase of the product and its receipt. During this period, insurer, provider and/or employer may disappear or be taken over by another concern. 'Consolidation and outsourcing within the insurance industry means that policies taken out 10, 15, 20 years ago are unlikely to be managed by the same brand and by people in the same building as they were at the outset' comments a senior UK pensions consultant 'We want to make sure that customers who were 'sold on' are treated fairly. Some terms and conditions that

---

consequence, many (some say 20 million) low-earners will get a lower state pension than they might have anticipated. The Treasury insisted that the reform had to be fiscally neutral – this explains the development were common 20 years ago are not what we would want to see now' (John Ralfe cited in UK-FCA 2014).

This quote relates to the persistent issue of legacy schemes and policies, set up when circumstances were different (not least in terms of returns), that still retain their original high charges. So-called zombie funds are the closed equivalent: members are often unable to access savings prior to a pre-specified age without penalty, commonly exercised in the form of exit fees. Even when the scheme is effectively closed, charges can be imposed on remaining balances to the detriment of the member who no longer contributes to the fund. An influential report published by the UK Office of Fair Trading (UK-OFT 2014) found £40 billion in pension schemes that represented poor value for money and identified 30 million insurance policies sold between 1970 and 2000 that are still extant and whose charges on average remain 26 percent higher than those available for an equivalent product today. Of course, not all the policy-owners have reached the age of 55 to be able to access their money. Although the Association of British Insurers (ABI) has agreed to review these schemes, many in the industry dispute the right to renegotiate contracts on the grounds that circumstances have changed. The terms are legally binding and policies were set for a pre-specified number of years. The arrangement was freely accepted by both sides at the time. In Australia, policy has addressed legacy default funds to a greater extent (see following section) but earlier high charges cannot be removed retrospectively and their impact on Super savings will remain for years into the future.

While employers and insurers change or move, scheme members do so as well (see also *Changing labour markets* below). They may change jobs and be put into another plan, and/or move address, become self-employed or (especially if female) withdraw from the labour market to raise a family. The result is a proliferation of personal savings 'pots': in Australia now rising towards 30 million in a workforce of just under 10 million over the past 30 years. In the UK, most working people have – or will have – several pension pots by the time they retire. To avoid paying multiple fees, consolidation of savings has become an important policy issue.

- *Asymmetric information and perverse incentives*

In both countries, default schemes are purchased by employers (or contracted by trustees) who have proved indifferent to finding low cost products as provider charges are commonly paid out of funds – i.e. member accounts (Australia – FSI Murray, 2014b). Neither purchaser nor provider has a vested interest in (or capacity to guarantee) the security of long-term outcomes: one dimension of the 'You'll be gone, I'll be gone' inference identified by Kay (2015) that afflicts the marketing and sale of all long-term financial products. Changing ownership of both insurer and / or employer over time exacerbates the problem. In both countries, employers, trustees and consultants tend to respond more to shiny brochures and good marketing than to competitive charges and sophisticated providers use active member discounts to gain new business.

This insertion of an intermediary between beneficiary and provider thus has unfortunate consequences that have historically been detrimental to low-cost pensions. According to Grattan (2014) Australian fees are three times the OECD average and cost a 30 year old member c A$ 250,000 over a working lifetime. In the UK, the Financial Services Consumer Panel calculated in 2013 that 40 years of saving at a 1 percent annual charge resulted in a 21 percent loss to the eventual pension pot (UK – OFT, 2014). There is no evidence in either country that high cost products outperform tracker or other cheap funds over the long run. In Australia, moreover, high charges hurt the taxpayer more as less Super translates into higher Age Pension payments.

Even as marketing pays dividends, so employer inducements – notably the active member discounts noted above – are found in both countries. These effectively penalise members who leave their original scheme for whatever reason and play a central role in shaping an employer's choice of provider in a manner that penalises the more mobile worker's savings. Mothers who quit work to raise a family are specifically at risk as a dormant Super or pension fund may be eaten up by higher charges (Whiteside, 2014). In addition to the higher fees extracted from accounts of inactive members we can note, in passing, how in Australia, auto-enrolled disability insurance and life premiums also continue to paid from such accounts. Thus the Australian worker who, by changing jobs, accumulates multiple accounts and neglects to consolidate them, pays not only higher fees for membership of past schemes but also may hold multiple life policies, raising overall costs to little purpose.

Other agency issues raise associated problems. At the level of portfolio management, investment decisions should arguably be taken with long-term horizons in mind, but are frequently driven more by quarterly or annual performance results (and the accompanying bonus). It is hard to know whether a fund manager is serving the interests of the investors – i.e. prioritising the short-term to avoid a long-term problem – or not (Grene, 2016). The asset management industry operates largely on trust and legacy issues also emerge here as a result. Inattention by pension providers who do not demand full accounting of all fees and expenses paid to fund managers, consultants and trading communities can translate into high charges for scheme members. In Australia, research has revealed that external investment management charges, used largely by retail funds, have generally proved unresponsive to pressures to reduce costs (Rice Warner, 2014). Mandates between fund and asset manager are notoriously stable and operating expenses in this area are rarely reviewed. As John Kay has noted, the high cost problem is exacerbated by the sheer length of the food chain sustained by funded pensions

> '… the chain of intermediation has become too long and that length adds to costs. Between the company and the saver are registrars, custodians, nominees, asset managers, fund-of-fund managers, investment consultants, pension fund trustees, insurance companies, platforms, independent financial advisers. And when a trade occurs, a high frequency trader, an exchange and an investment bank will all take a cut' (Kay, 2015: 206-7)

In Australia, recent consolidations of pension providers, found notably in the corporate sector, have mediated these effects because larger funds can, in a competitive environment, negotiate lower investment management fees (Rice Warner 2014). However, while this may be possible for domestic investment companies, it is more difficult to exert pressure on large international asset management firms, who are commanding a rising proportion of Australian business. In the UK, larger pension funds are currently bringing investment in-house in order to reduce (or eliminate) dependence on expensive external asset managers (Marriage, 2016).

Then there are problems of investment strategies that also raise costs. The Kay Review of UK equity markets (2012) pointed up the short-termism endemic in equity investment and trading that prioritises immediate returns over any engagement with corporate management. In theory at least, pension funds, as major shareholders of the corporations in which they invest, are well placed to uphold good corporate governance and accountability. In practice, the principal-agent relationship does not function that way. As noted above, the focus remains strongly fixed on short-term investment performance alone (Tilba and McNulty 2013). A culture of investment 'churning' unnecessarily raises costs (through spreads and other transaction charges) without any real benefit to either investors or the firms involved, the latter being pushed into sustaining a share profile not necessarily conducive to its long-term future development. Shareholder engagement as a solution to problems of corporate governance is thus more a hope than a reality. Although describing the situation in the UK, Kay's findings relate to Australia as well. Investment consultants and financial advisers in particular are either self-regulated (thus arguably under-regulated) or escape any official scrutiny. More significantly, perhaps, the translation of fiduciary duty solely in terms of securing short-term profits neglects ethical, social and environmental issues that relate to the wider public good as well.

Annual management charges (AMCs) are notoriously hard to calculate with any accuracy as different administrative processes are covered in different approaches (Casey and Whiteside, 2011). Some UK experts claim full costs cannot be calculated (Pitt-Watson et al. 2014): others argue that total expenses can be estimated, measured and steps taken to reduce them (Blake 2014), others still that the calculation can be done in part, enough to serve the 'fair play' purpose (Novarca 2014). In Australia, APRA standardises fee disclosure to cover operational and investment expenses (including external asset management and consulting fees) together with margins of 'fees over costs' and their sub-components. This measure excludes tax and investment premiums and personal financial advice (Rice Warner 2014). There is also no mention of one-off transactions, including entry fees and exit fees.

- *Changing labour markets*

Precarious employment, broken contribution records and changing employment practices are proliferating in Europe, as standard lifelong employment with a single employer, characteristic of much of the twentieth century, is corroded. Younger generations in the EU experience long periods on temporary job contracts or in part-time work, employment contracts commonly excluded from any pension protection (Hinrichs and Jessoula, 2012). In Australia, the proportion of the working population that is self-employed approaches 10 percent. Around 29 percent of these have no Super at all and over 70 percent are on low or no income (Clare, 2012). As the Australian economy emerges from a long period of prosperity and low unemployment, so the possibility of more insecure employment practices is likely to spread and, with this, a rising number of low-waged self-employed – who are often casual workers in all but name. In the UK, the rising incidence of self-employment now embraces nearly 5 million people. We must recall that this category is far from stable: it embraces not only young entrepreneurs, but those discharged from a secure job, eking out a living on short-term contracts, women who organise their own working lives to accommodate caring responsibilities and disabled people whose condition is unstable and therefore need control over their work hours. In many cases, should circumstances change, so does employment status: the transition to a part-time job or even into full employment (and, possibly, out again).

Marginalised groups of workers with broken career trajectories create broken and incomplete contributory pension records. They are also a source of considerable administrative expense. This raises questions about responsibility for guaranteeing how contributions made in the early years of employment (that, thanks to compound interest, gain most for the contributor, but are also more likely to be lost) may be safeguarded. Policy has thus addressed how previous accounts may be consolidated (in the UK only if very small) and has imposed demands on providers to be more pro-active in tracing the owners of 'lost' accounts. However, the costs of maintaining and transferring (or policing the maintenance and transfer) of savings are considerable and necessarily entail higher management charges.

*   *   *

This section has reviewed some of the principal factors underpinning market inefficiencies that generate cost problems. It is not comprehensive. A plethora of associated problems (e.g. financial education of trustees: scams afflicting the unwary on decumulation: lack of independent scheme governance and so on) also have cost implications but are less central to the structural issues that affect administrative costs directly. Information has been largely drawn from published documents and official enquiries. In other words, governments have not been inured to these issues and have recently taken steps to mediate their worst consequences. What these steps have been and how far they might be understood to solve the situation is examined in the following section.

State policies to contain costs and improve governance

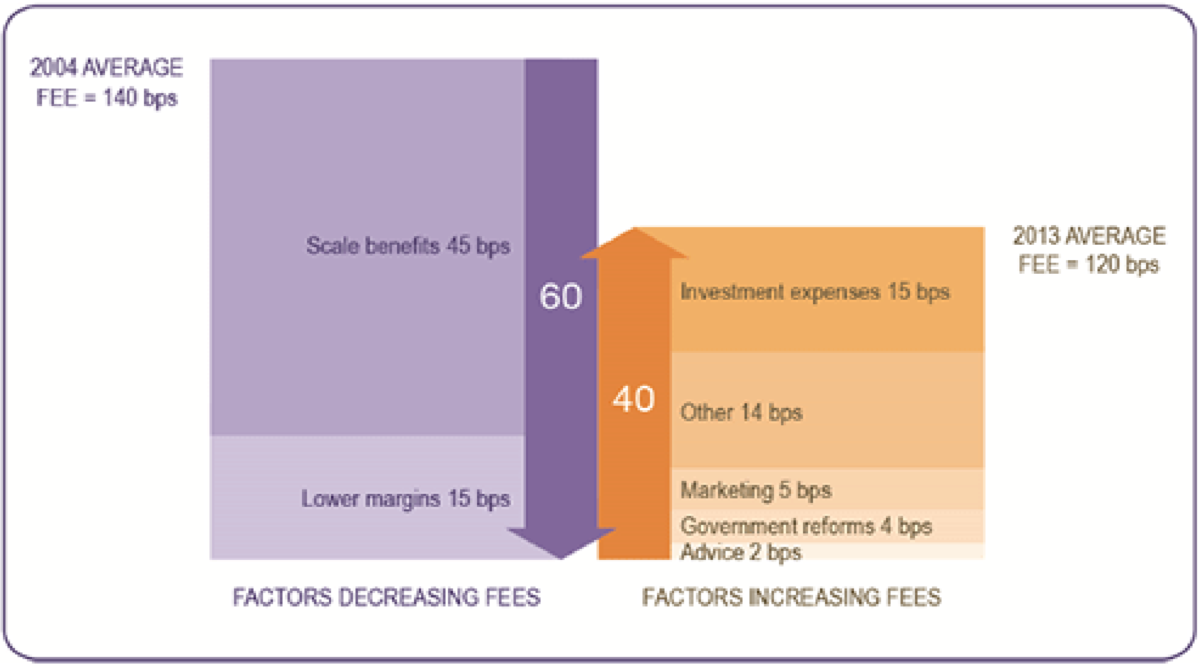
In recent years, both Australia and the UK, have taken steps to regulate their respective markets to improve performance and reduce expenses. The introduction of state-sponsored default products (MySuper, NEST) with lower charges was designed to reduce all costs through market competition (although the jury is still out on whether this can actually succeed). From the perspective of established members of older schemes, however, there is no inherent logic as to why they should pay higher charges than more recent recruits. Conversely, from an industry perspective, an established contractual agreement is precisely that: a legally binding document stipulating charge schedules that contains no provision for revisions. In the UK, as large firms became subject to auto-enrolment, many employers simply extended their established occupational scheme to all workers, whether such schemes were suitable (i.e. transparent and cheaper) or not. Employers who do take the trouble to seek value for money encounter problems: comparison of AMCs does not help as different providers cover different administrative processes in constructing such charges and the non-disclosure of transaction costs and / or fund management charges is common. Several authorities who have researched the issue conclude that loopholes remain (Grattan, 2014; OFT, 2013) that even the regulator cannot address comprehensively – particularly in the UK which still boasts over 43,000 pension funds all with separate rules and governance.

As indicated above, the problems consequent on the failure of pension markets to perform as their apologists suggest that they should have attracted official attention. In Australia, the findings of the Financial Systems Inquiry (2014) demonstrated that recent reforms had failed to reduce fees to any appreciable extent and advocated more state intervention in the form of a formal competitive process to allocate new default fund members to MySuper products, thereby sharpening market competition as a means to secure greater transparency and lower costs (Australia – FSI Murray, 2014b). In the UK, the advent of auto-enrolment (recruiting millions of low earners into pension saving for the first time) coupled with tighter post-GFC public expenditure constraints, has renewed policy initiatives to secure value of money, improve transparency and offer better guidance while also starting to police asset investment practices, thereby drawing into question the meaning of 'fiduciary duty' in a manner that contrasts with Australian practices.

Accumulation

The most prominent policy initiatives have focused on charges at the accumulation stage. In Australia, the Stronger Super reforms addressed the problems of costs raised by the general failure of competitive pressures and the high costs generated by antiquated administrative practices. A MySuper product, based on a single default investment strategy, standardised fees with no commissions to advisors and auto-enrolment into disability and life insurance, has to be offered by every Australian employer. All Australian default funds must be rolled over into a MySuper scheme by 2017. SuperStream, introducing e-commerce into data collection and fund administration, will eventually, once the costs imposed by technology are absorbed, reduce backroom running costs. Both reforms have fostered a consolidation of providers, notably the emergence of multi-employers funds, and – with this – more rationalised administration. However, doubts are emerging as to the efficacy of this strategy. MySuper fees still range from 0.6 – 1.4 percent according to Grattan (2014) and 0.48 – 1.84 percent according to Murray (Australia, FSI-Murray, 2014b). Super charges are falling, albeit slowly – although this is probably due more to the consolidation of providers than reduced margins consequent on lower charges (which have been counteracted by rising investment expenses – see Chart 1 below).

Chart 1: Factors contributing to Australian Super Fees



Source: Australia: Financial System Inquiry – Murray, 2014b

The UK has a longer history of trying to reduce charges, albeit with mixed results. Stakeholder pensions, introduced in 2002 with capped charges, were designed to compete with more expensive products. In the event they failed to achieve very much as marketing budgets were squeezed and providers had little incentive to promote a cheaper alternative to established schemes. Instead, Stakeholder became renowned for enabling wealthy families to avoid inheritance taxes by allowing grandparents to invest wealth tax-free for younger generations. Even so, increasing official pressure has led to average AMCs falling from 0.95 to 0.71 percent between 2001 and 2013[‡].

The advent of auto-enrolment in the UK pushed the question of charges back into the policy spotlight. In 2014, management fees charged under employer auto-enrolled default funds were capped (at 0.75% - to include entry and exit charges, but excluding annuity brokerage and disability cover) and consultancy charges outlawed. A review of transaction charges is promised for 2017. This reinforces the Pensions Regulator (tPR) previous ruling that prevented employers from automatically extending established pension schemes to all workers, as most carry legacies of high charges that do not represent value for money for the low paid. Auto-enrolment has, to date, caused the number of UK schemes to explode to over 210,000 as a result. 94 percent of employers have opted to join master trusts to ensure compliance with tPR regulations. Although a voluntary Master Trust Assurance Framework has been drawn up by the Institute of Chartered Accountants, not all master trusts have complied with its terms and fears are growing about the long-term financial viability of new entrants in this sector (Williams, 2016). Whereas NEST (which remains the largest with 2 million members) can turn to the state for loans (which it is required to repay), People's Pension has introduced a £500 enrolment fee on top of the 0.5 percent AMC to cover rising expenses and NOW has created an extra flat-rate 'administrative fee' of £1.50. Capping management fees either forces creative accounting practices, or places the long-term future of new master trusts at risk.

There is worse to come. Of the 1.8 million employers due to enter auto-enrolment over the next two years, 850,000 will have to set up a funded pension scheme for the first time, raising issues of due diligence for the small employer who will be attracted to any provider offering to take on more of the paperwork. More master trusts are springing into existence. However, inexperience abounds and enforcing compliance is an onerous process. As a recent commentator concluded, 'this is an inherently unprofitable marketplace' (Westminster Briefing 2015). As their annual charges are capped, NEST, NOW and PP struggle to meet the challenges posed by very small employers unfamiliar with administrative processes and due diligence requirements. This creates data quality issues. It may be argued that consolidation under viable master trusts will emerge in time, but the sheer size and complexity of the UK market does not auger well for the near future.

The consolidation of multiple accounts has also attracted political attention. In Australia, the means for members to consolidate their Super funds with their provider of choice was established in 2014. The member is identified by his/her tax code and the operation is performed on an official internet site, without charges. The future proliferation of Super accounts should thereby be contained. However, this operation cannot be undertaken retrospectively, so old multiple Super holdings remain a problem – particularly for women members who have left the labour market (to raise children for example), who have mislaid their tax code (or never had one), who ignore warnings and lose track of their Super (changing names and addresses). The Australian response to the multiple fund issue assumes a pro-active member. The lax and forgetful are currently penalised as higher charges for inactive members will only end when all default funds are rolled over into MySuper products in 2017. However, this does not include disability and life insurance, meaning that

[‡] The UK Annual Management Charge is widely acknowledged to be less than comprehensive than its Australian equivalent as its excludes investment charges (such as bid/offer spreads) and consultants' fees as well as one-off charges such as transfer fees and exit or entry payments.

members who fail to consolidate can still be hit by multiple premiums for the same insurance cover. Although there is no data to suggest it, this risk is probably heavily gender-biased.

This policy response is superior than the one found in the UK, where – thanks to opposition from the industry – little progress has been made. A (much discussed) automatic transfer of pension savings is confined to ludicrously small amounts (maximum £10,000) from 2014 (UK-DWP, 2013). Active member privileges (essentially higher charges on dormant funds) are to be outlawed from 2016. There has been talk of a 'pensions dashboard' – an official site which would allow working people to view all current and previous pension savings 'pots' – but no action to date. The government's Pension Advisory Service (PAS) offers help to contributors seeking to locate earlier savings, but inquirers need dates of employment and, preferably, some record of contributions made and the pension provider involved. As these might date back over 30 or 40 years, this is a tall order. Moreover, both legacy and current schemes can specify exit/ transfer charges that, in some cases, discourage consolidation of pension pots by the mobile worker. Auto-enrolment does not solve the problem: charges remain in place and, as the sphere of self-employment continues to grow (arguably fostered by auto-enrolment itself) and the entry point to auto-enrolment remains high (earnings of £10,000 p.a.), so people will move in and out of pension cover. Further, the extension of pension cover to lower paid workers who are more mobile, more likely to be female and more liable to leave the labour market for family reasons, will raise the incidence of multiple pension savings pots and, in consequence, multiple pension charges.

Finally we should note how both governments are reviewing the advantages given by tax relief on contributions to the better-off. Those in higher tax brackets have, over past years, gained a larger public subsidy to their pension savings than the lower paid. In the UK this has changed in recent years: the maximum tax-free lifetime personal fund has shrunk steadily from £1.5 million to £1.25 million (2013) to £1 million (2016). This last sum buys an annuity of £35,000 p.a. at current interest rates – hardly a vast income. At the time of writing there is speculation that, in future, UK tax relief on pension contributions will be set at a flat rate, said to be 20 percent. We might also note that, with auto-enrolment and the extension of contributory rates from 3 to 8 percent of salary (and, in future, even higher - in order to create a viable pension), income tax revenues are being squeezed – and this has contributed to the UK Treasury decision to review tax-free contributions. Here, the UK is following in the footsteps of Australia as the Commonwealth government has recently introduced annual contribution caps on concessional contributions (taxed at 15 percent) and added financial penalties on post-tax Super contributions that break predefined ceilings (that vary with salary and age). Such initiatives on both sides of the globe meet previous criticisms about the undue advantages tax-free contributions have, in the past, offered the wealthy.

Decumulation

On the face of things, the freedom of Australians to use their Super savings as they see fit appears as a model that has recently been transferred to the UK. Since the advent of Pension Freedom (2014), UK citizens from the age of 55 can access their pension savings in any form they wish – subject to conversion[§] or early exit fees that may be required by their provider and tax imposed at the marginal

[§] As Pension Freedom allows employees covered by a DB pension scheme to access their funds, DB insurers have to convert a final salary-based pension entitlement into a lump sum, entailing a conversion to a different financial product.

rate on 75 percent of any money drawn out[**]. This contrasts with Super liquidation which remains tax-free as long as the recipient has reached preservation age (60 for those born before 1960, rising in annual stages to 65 for those born after 1964). Pension Freedom leaves the British retiree with a similar range of choices as his/her Australian counterpart when it comes to deciding what to do with the money. In the first three months of Pension Freedom (April- June 2015), of the 205,000 policies accessed, over 71,000 were lodged in drawdown options. The number of annuities issued in those three months fell from nearly 90,000 in 2014 to 12,500 in 2015 (UK-FCA, 2015b): proof, if any were needed, of the unpopularity of annuities, long criticised as over-priced. Neither country currently requires the conversion of pension/ Super savings into an old age income, even though this exerts pressure on the public finances. In Australia, the requirement that retirees secure a minimum income from their Super is under review. The UK government has abandoned this idea (arguably unnecessary, given the Prime Minister's commitment to keep the state pension 'triple locked'[††]). The Treasury is reviewing transfer and exit charges as potentially damaging to the long-term interests of the low paid.

However, matters have not rested there. Allowing working people in the UK to access their savings up to ten years prior to their state pension age has raised the prospect of these savings being misappropriated, not simply on luxury cruises or Lamborghinis[‡‡], but being siphoned off by criminal interests promising tax and investment advantages that they could not possibly deliver. The media has feasted on stories of pension fraud and its victims (e.g. Macadam, 2015; Rickard-Strauss, 2015). The result was Pension Wise, a state-sponsored service funded by the industry that offers free basic guidance on the options available to those accessing their pension savings, available by telephone or on-line. Here, 'guidance' is carefully delimited from 'advice'. The government does not recommend any specific financial products. Formal financial advice is a requirement for all with pension pots over £30,000, but this has to be paid for by the fund owner. As Pension Wise has been in existence for less than a year (at the time of writing), any evaluation of its impact is premature, but numbers availing themselves of this service have been very low, leading the PAS to recommend mandatory independent financial guidance for all (Westminster Briefing, 2015). Prior to the advent of Pension Freedom, 45 percent of retirees took the annuity offered by their provider and failed to shop around – which, in 80 percent of these cases, would have secured better value for money (UK-FCA, 2015a).

Governance, due diligence and fiduciary duty

Governance issues haunt the world of funded personal pensions, raising opacity, fostering oligarchy and feeding into the problem of high costs in both countries.

Steps towards the more professional management (in the form of independent members and chairpersons on governing bodies) are currently promoted in both countries. In Australia, the Australian Pension Regulatory Authority (APRA) recently reinforced the messages coming from the

[**] The withdrawal of a large lump sum in one year would be 25% tax free and the rest at the appropriate income tax rate for earnings of the balance in a single financial year. Frequently this raises the average taxpayer (who pays 20 percent) into the higher (40 per cent) tax bracket.
[††] State pensions currently rise annually by the CPI, the inflation rate or 2.5 percent, whichever is the highest.
[‡‡] Pension Minister Webb stated, when challenged about the problems liable to follow Pension Freedom, that he was quite happy for savers to lash out on this car if they so wished.

Financial Systems Inquiry (Australia, FSI - Murray, 2014b) that improving (professional) pension fund governance would sharpen competition and improve investment outcomes for members. 'Vested interests' (namely employer and union representatives) in Super fund management distort investment strategies, thereby failing to secure the best returns (see, e.g. Sloan, 2014). Following consultations, draft legislation was prepared for all Super fund boards to include an independent chairperson and at least one-third independent members (Brown, 2014; APRA 2015). This was challenged by the Super trustees themselves (AIST, 2015). Industry funds, governed by representatives of employers and unions, had not under-performed, but rather out-performed professional management found in the retail sector, not least on charges (possibly because of the latter's more extensive use of independent asset managers). This legislation was rejected by Senate by the narrowest of margins in December 2015. Throughout, the emphasis of reform focused on increasing market expertise in management as the route to better returns at lower cost. This financial strategy appealed to a conservative administration eager to reduce future public liability for the Age Pension and an industry eager to help them achieve this goal by raising the average income replacement rate for retiring Australians (see also ASFA 2014). The debate was highly politicised as the collectivism embedded in Australian industry funds confronted the professional financial sector in a discussion over the promotion of the public good.

In the UK, a similar debate (on the merits of independent governance) has taken a similar turn. However, while structural features are shared by the two sets of reforms, they differ in motive and objective. Both advocate the inclusion of independent members and chairs in the management of multi-employer funds. However, whereas Australian reforms aimed to improve market-based outcomes, UK policy focuses on accountability and transparency issues. The report of the Office of Fair Trading on pension markets (2013) extensively criticised the costs associated with funded pensions. In 2014 the Department of Work and Pensions (DWP) issued a command paper that set out future requirements for default funds following auto-enrolment to secure quality and transparency in governance structures. This requires multi-employer providers to create Independent Governance Committees to include a minimum of three non-affiliated members (independent of any firm in the financial sector) and an independent chair. IGCs must produce annual reports disclosing total investments and sales, audited accounts and enforce a Stewardship Code designed to secure the long-term profitability of the businesses they invest in[§§]. This involves public disclosure of 31 quality features: the selection, monitoring, retention and realisation of all investments; information on corporate investments; the stewardship of these investments (how voting rights are employed); the selection, appointment and monitoring of investment managers (their agents and their costs); fund performance; investment policies (types, balances, risk assessment procedures, returns); the names of advisors, banks and custodians employed by the fund and their charges; how social, environmental and ethical factors contribute to investment strategy[***]. The eventual objective is to bring the governance of contract-based schemes and ex-public sector schemes into line with trustee schemes: the extensive demands on governing bodies will, it is hoped, accelerate the creation of viable and solvent master trusts, thereby fostering consolidation and eliminating less competent elements from pension governance. The scope of due diligence and fiduciary duty is extended and redefined.

[§§] The Occupational Pension Schemes (Changes and Governance) Regulations (2015)
[***] The Occupational Pension Schemes (Charges and Governance) (Amendment) Regulations (2016)

At the time of writing, all component parts of the UK financial services industry are struggling to come to terms with extensive changes that, let us recall, are being put in place at the same time as Pension Freedom and auto-enrolment in small and medium-size firms. It is no longer acceptable to explain asset management objectives in terms of strategies to secure the best returns at any price. An ongoing review of legacy schemes (predating 2001) currently undertaken by the ABI is revealing charges running 26 percent above more recent schemes. TPR is undertaking a review of all small trust-based schemes. A rationalisation of the pensions industry is sorely needed and official enquiry and tighter regulation are likely, between them, to bring this about. When transaction costs are reviewed in 2017, this may mean tighter controls over fees from stock lending, foreign exchange dealing and so on (although we might suppose that asset management firms might prove resistant). 'Light touch' regulation is being abandoned. The market is being instructed how it should work.

Whether these changes will succeed in reducing costs and raising transparency is an open question. First, the incorporation of independent members who know what they are doing onto IGCs (whose three year tenure can only be renewed three times) will be difficult. If they are not to be paid, it will be impossible. Second, no-one has mentioned regulatory compliance costs which, as the Australian review of financial services (Australia – FSI Murray 2014b) demonstrated, tend to raise, not lower, overall expenses. Financial lawyers, for example, do not come cheap and their UK business is set to blossom in the immediate future. Third, earlier attempts to cap charges (and encourage clients to 'shop around') have not been markedly successful – in part because of generally low levels of financial literacy but also because of the facility with which the industry 'bundles' charges in order to disguise their origins. These reforms might improve transparency between tPR, DWP and the industry, but are unlikely to enlighten the wider public - will anyone outside government and the industry actually read and understand IGC annual reports? Finally, we might wonder whether all this is designed as elaborate window dressing to reassure a sceptical public that auto-enrolment into a pension offers a secure means to save for retirement. The recent history of HSBC suggests that to introduce new regulation and to actually enforce it involves separate processes[†††].

That said, different principles of pension governance underpin reforms on each side of the globe. In Australia, where a more rational structure of Super funds is now in place, faith in competitive markets as the means to secure cost-effective efficiencies remains dominant. In the UK, the picture is less distinct. Arguably, the drive to contain investment short-termism has an ulterior motive. As public funds dry up under the pressures of austerity, politicians seek alternative sources for long-term investment, most notably in infrastructure (for examples in the EU see Casey, 2014). Pension funds are extremely attractive for such purposes and infrastructure would certainly meet the criteria concerning ethical, social and environmental investment strategies required in recent regulation. But insufficient time has passed to evaluate any results.

[†††] In spring 2015, HSBC – among the world's largest banks - announced that it intended to move its HQ from London - first to Hong Kong, then (in October) to New York – because of excessive regulation and taxation imposed by the UK. Chancellor Osborne reduced the tax levy on international banks and removed the 'presumption of guilt' on bank executives when subordinates are found guilty of misdemeanours. HSBC announced in February 2016 that it would keep its HQ in London. Readers may draw their own conclusions

Comments and conclusions

Any review of personal funded pensions in Australia and the UK has to conclude that, thanks to the different dates at which greater obligation was imposed, we are not comparing like with like. Super was first introduced over thirty years ago. Thanks to a buoyant economy, fund performance has won the system extensive popular support in Australia. In the UK, unstable returns on funded pensions over the last 15 years meant that auto-enrolment was introduced in a context of greater public suspicion. As a result, UK state interventions to secure better market performance have been more extensive and heavy handed (the use of caps to lower fees: interventions to reform investment strategies and so on). Whether Super will sustain its appeal in a colder financial climate remains an open question. And, when markets fail, publics turn to government for more protection, not less.

The evidence presented above therefore reviews the field of pension governance as a work in progress. Behind the strategies to lower costs and improve performance, both governments seek to reinforce the financial service sector as the solution to rising longevity and to foster public confidence and trust that personal saving indeed offers the pathway to financial security in old age. However, this colonisation of private commercial agencies to serve policy purposes is proving to be a messy business, fostering more oligarchic governance that transforms the voting citizen into a customer with a choice of products, but little control over (or understanding of) policy development. The proliferation of regulation entails ever higher compliance costs and, in consequence, government actually exacerbates the very problem it seeks to cure. This is less a matter of a greedy financial sector (as frequently depicted in the UK popular press) than a structural problem and should be understood and addressed as such.

This point can be developed further. Evidence suggests that market competition does reduce charges and fees of pension providers and their acolytes, but the process is very slow. Savings consequent on provider consolidation in Australia have not been passed on to consumers in the form of lower fees (Australia – FSI 2014b). In European countries like Denmark and the Netherlands, where competition between providers plays little part, funded pension schemes operate on much lower fee structures. The annual fee of ATP in Denmark is about 0.2 percent: as this is a monopoly provider, problems of transfers and lost accounts rarely arise. This invites the conclusion that market-based solutions are not an optimal policy choice if the object of the exercise is to run a pension saving scheme at minimal cost to its clients. However, we are where we are. Both countries currently prioritise consumer choice in the provision of savings for old age, but choice is expensive. More pooled risk reduces fees and charges. In Australia, industry funds outperform retail alternatives in this respect. By removing obligations to annuitize, the UK has abandoned the final elements of mandatory risk pooling in the provision of funded pensions.

Yet, with continuing pressure on the public accounts, it seems unlikely that present settlements can be sustained. Decumulation will receive more official attention. There is no equivalent of MySuper or NEST at the point of liquidation of pension savings, to serve the needs of the small saver who still forms the greater part of the retiring population, is more liable to reach poor decisions at key moments – and therefore more likely to end up reliant on the state for income supplementation in later life. In other words, the constant jiggling with regulations designed to convert a financial product to social purposes is unlikely to end any time soon. Longevity risk remains a hot potato, passed back and forth between the industry and government as each seeks to contain future liability. We might argue that both sides offer unduly optimistic prognoses of future developments. Current mandatory savings rates, most evidently in the UK, are plainly inadequate for long term financial security. Yet, to pillage Kay's writing once more (2015), political and financial interests have shorter time horizons: 'you'll be gone: I'll be gone' by the time the consequences of current political and financial strategies become evident.

REFERENCES

Allison, I. (2015) ‘Auto-enrolment: Brave new pensions world still leaves savers short by a long chalk’ *International Business Times UK*, 15 July. http://www.ibtimes.co.uk/uk-pension-reforms-brave-new-auto-enrolment-world-leaves-savers-short-by-long-chalk-1508954

Australian Institute of Superannuation Trustees – AIST (2015) ‘Government changes to Super fund boards not supported by evidence’ June 26th: http://www.aist.asn.au/media/14852/2015_06_26_media_aist_government_changes_not_supported_by_evidence_FINAL.pdf

Australian Prudential Regulation Authority – APRA (2015) Draft Prudential Standard SPS 150: Governance. http://www.apra.gov.au/Super/Documents/DRAFT-Prudential-Standard-SPS-510-Governance-August-2015.pdf

Australian Superannuation Funds Association – ASFA (2014) *The future of Australia’s Super: a new framework for a better system*

Australia: Financial System Inquiry: FSI – Murray (2014a) *Interim Report*

Ibid. (2014b) *Final Report*

Blake, D. (2014) ‘On the Disclosure of the Costs of Investment Management.’ Pensions Institute Discussion Paper no. PI-1407. http://www.pensions-institute.org/

Brown, D. (2014) ‘Super Fund Directors and Independents’ Day’ http://cuffelinks.com.au/Super-fund-directors-independents-day/

Casey, B. (2014) ‘From pension funds to piggy banks: (Perverse) consequences of the Stability and Growth Pact since the crisis’ *International Social Security Review*, 67, 1: 27 - 48.

Casey, B. and Whiteside, N. (2011) ‘The pensions web which Mr Webb has to unweave’ *Parliamentary Brief*, 13, 7: 27-8

Cazelet Consulting (2014) *When I’m 64* *https://www.royallondon.com/Documents/PDFs/Research%20and%20Consultation/cazalet-consulting-when-im-sixty-four.pdf*

Clare, R. (2012) *Equity and superannuation: the real issues* ASFA

European Federation of Financial Service Users (2014) *Pension savings: the Real Return* www.betterfinance.eu

European Federation of Financial Service Users (2015) *Pension Savings: the Real Return.* www.betterfinance.eu

First FT (2015) ‘Government delays push for pension transparency’ (19 January) http://www.ft.com/cms/s/0/0b8acffa9d9911e48ea300144feabdc0.html?siteedition=uk#axzz3PHTvzl8h

Grene, S. (2016) ‘The dance of denial about agency problems’ *Financial Times FTfm* 11 January: 8

Hinrichs K. and Jessoula M. (2012), *Labour market flexibility and pension reforms. Flexible today, secure tomorrow?* Basingstoke, Palgrave.

Kay Review of UK Equity Markets and Long Term Decision Making (2012) *Final Report* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

Kay, J. (2015) *Other People’s Money* London, Profile Books

Macadam, D. (2015) ‘Crooks in £1 billion pension swindle’ 27 July: *Daily Express* http://www.express.co.uk/news/uk/593992/Crooks-in-1bn-pension-swindle

Marriage, M. (2016) ‘UK pension funds pile pressure on fund houses’ *Financial Times FTfm* 11 January: 3.

Mather, J. (2015) ‘Super funds face $20m upheaval’ *Australian Financial Review,* 24 July: 9.

Minifie, J. (2014) *Super sting: how to stop Australians paying too much for Superannuation* Grattan Institute

Novarca (2014) *Transaction Costs Transparency* a report prepared for the UK FCA

Oxlade, A. (2015) ‘The ‘refund ISA’ and the beginning of the end for high fees’ *Daily Telegraph*, 21 January: http://www.telegraph.co.uk/finance/personalfinance/investing/isas/11365601/The-refund-Isa-and-the-beginning-of-the-end-for-high-fees.html

Pitt-Watson, D. et al. (2014) *Investment costs, an unknown quantity: a report for the Financial Services Consumer Panel.* Fi-Nexus and BDO LLP

Pitt-Watson, D. (2015) ‘UK fund managers must stand up and be counted on charges’ *Financial Times*, FirstFT, 19 January

Rice Warner, (2014) *Superannuation Fees: financial system enquiry*

Rickard-Strauss, R. (2015) ‘Beware pension fraudsters’ 16 March, *This is Money* http://www.thisismoney.co.uk/money/pensions/article-2997136/Beware-pension-fraudsters-Retirees-told-scam-proof-savings-ag

Ring, P.J.(2010) ‘Governance and governmentality: a discussion in the context of UK private pension provision’ *Economy and Society*, 39, 4: 534-50

Skypaler, P. (2015) ‘Capping fees could be the best way of controlling fund management costs’ *Financial Times*, November 23rd

Sloan, J. (2014) ‘What sort of pathetic joke is this from the regulator?’ *The Australian*, July 12-13: 22

Tilba, A. and McNulty, T. (2013) ‘Engaged versus disengaged ownership: the case of pension funds in the UK’ *Corporate Governance: an International Review*

UK Department for Work and Pensions UK - DWP (2013), *Automatic transfers: consolidating pension savings* Cm 8605.

UK Financial Conduct Authority UK-FCA (2015a) MS 14/3 *Retirement income market study: final report* http://www.fca.org.uk/static/documents/market-studies/ms14-03-3.pdf

UK Financial Conduct Authority UK- FCA (2015b) *FCA Pension Freedom: data collection exercise: analysis and findings.* www.fca.org.uk/

UK House of Commons (2016) Public Accounts Committee *Report*, 27 January.
http://www.publications.parliament.uk/pa/cm201516/cmselect/cmpubacc/581/58102.htm

UK House of Commons (2015) Work and Pensions Committee *Progress with automatic enrolment and pension reforms: fourth report of session 2014-15.* The Stationery Office, London.

UK Nest (2014) *What does NEST cost* http://www.nestpensions.org.uk/schemeweb/NestWeb/public/NESTforSavers/contents/what-does-nest-cost.html

UK Office of Fair Trading – UK-OFT (2014) *Defined contribution workplace pension market study* OFT-1505 www.oft.gov.uk

Westminster Briefing (2015): Employment Forum Keynote Seminar: The future for the pensions and annuities market - priorities for policy, November 5th

Whiteside, N. (2014) ‘Gender issues in European pensions’ CSIRO-Monash Research Cluster working paper

Williams, J. (2016) ‘UK Defined Contribution: mastering the master trusts’ *Investments and Pensions Europe* (26 February)