Consumer and Competition Challenges in investing for Retirement – the Case of ARFs

Notes of an address to the IAPF Annual Benefits Conference
by Jim Murray, Chairman, Pensions Council

Dublin, 6th October 2016

Thank you for your invitation.

As you probably know, the former Pensions Board had both a regulatory and advisory function. These functions were separated in effect. Regulatory functions were taken over by the Pensions Authority and a new Pensions Council was established with advisory functions[1]. Our first meeting was in March last year.

As part of our information gathering, we decided to look at insurers' charges for Approved Retirement Funds or ARFs sold through intermediaries. Together with Buy Out Bonds, there is a big market here – some 1.85 billion Euros of investments for retirement in 2015.

Slide 2

Broadly, insurers tend to sell most of their pensions through intermediaries.

Slide 3

Six insurance companies account for the bulk of ARF sales and we asked each company for details about their ARF products, and their charges for each product <u>when sold through intermediaries.</u> All six companies responded and we are grateful for their cooperation.

We chose examples of 75,000 and 150,000 euro invested over ten years. For each ARF product we asked for the corresponding Reduction in Yield for each of the charge options. (In many cases there were different charge structures for the same product sold by the same insurer – a point to which I will return.)

[1] The Authority will, of course, provide advice from its own perspective.

The RIY is an indication of how charges reduce the yield on an investment as compared to the notional outcome in the case of zero charges.

You can see the results from the following slides:

Slides 4 and 5 (Explain briefly)

A wide variation in charges:

Insurers' ARF charges vary widely and consumers could save up to 7 to 8% of their initial investment by choosing the fund with the cheapest charges – assuming they know about this. Comparing the lowest as against the highest charge, consumers might save as much as 5,440 euro over ten years on an investment of 75,000, and some 11,720 euro on an initial sum of 150,000 – just by choosing the product with the lowest as against the highest RIY.

Variations in charges for the same product:

We found that the 6 insurers had 23 different ARF products, each with a different charging structure. From the consumer's perspective the difference between the lower rather than the higher charge for the same product could save up to nearly 3% of the initial sum invested.

Intermediary Charges are significant

The study focussed on insurer charges for products sold through intermediaries and we tried to look also at the added effect of intermediaries' commission. The next ***slide (6)*** shows the relative weight of insurer charges and intermediary commission – assuming initial commission of 3% and trail commission of 0.5% per annum. As you can see, the intermediary's commission is likely to have the heavier impact – ranging in our examples from 52 to 70% of the total charges borne by the consumer.

Of necessity I have summarised the results of the study but you can download the entire report from our website (www.pensionscouncil.ie). While there you can learn other (interesting) information about the Council.

Summary and Discussion

1. Significant amounts of consumers' savings are invested in ARFs.

2. Little has been known to date about the charges consumers pay in ARF contracts. Our study throws some light on the subject but there is a lot more that is still unknown.

3. Insurers' ARF charges vary widely and consumers could save up to 7 to 8% of their initial investment by choosing the fund with the cheapest charges – assuming they know about this.

4. All insurers have more than one charge for the same product. Choosing the higher rather than the lower charge may typically reduce the yield for the consumer by about 3% of the initial sum invested. In such cases, consumers may never know that there was a cheaper version of the exact same product. (Codes on the application form can allow intermediaries to choose the charging version without the knowledge of the consumer.)

5. Intermediary commission can reduce the yield for the consumer by as much and more than the insurers' charges. In such cases, which seem to be typical, the intermediary makes more from the product than the insurer.

6. Insurer and intermediary charges together have a significant impact on the final returns on an ARF. During the current period of low returns on investments these combined charges may even lead to negative returns, particularly in relation to cash funds, over a full ten-year period. (In the case of early encashment the loss to the consumer may be even higher in effect.)

What does all this tell us about the market for ARFs? The first question is "who are the clients?" It should be the consumer of course but given the structure of the market, the variety of charges, commissions, and incentives and the inherent complexity of products, there is ample reason to suspect that insurers see the intermediary as the client, and not the consumer. Products seem designed to appeal to intermediaries, and to provide a wide menu of commission options for the intermediary, without alerting the consumer to this fact. The use of codes on the application

form and the placing of information on charges and commission options on the 'broker only' part of the insurer's website, not accessible to the consumer, does not facilitate transparency or consumer choice.

In a fully competitive and transparent market we would not expect to find such wide differences in insurers' charges, including different charges for the exact same product – so why do these wide differences exist? Why do intermediaries not work to drive down these differences? Personally, I can think of three possible explanations. It may be that many intermediaries are simply not aware of these wide differences in charges. Secondly, the incentives may not be there or may not be sufficient for intermediaries to chase the lowest charges. Thirdly, the dealings between insurer and intermediary may be based more on a relationship that suits both sides, than on the strict principles of economics and competition. It is certainly the view of a number of Council members that this third explanation may be particularly significant.

The reaction among intermediaries and their representatives to the ARF Report was relatively muted, giving rise to the suspicion that the information in the Report was not seen as immediately relevant to their day-to-day work, and yet surely it should be. It would be interesting, to say the least, to repeat this survey at a later time, to look more closely at the conditions for competition in this market, at the range of relationships between intermediaries and insurers, together with policies on commission, and at the relationship, if any, between insurer charges and commission.

Above all, the case for more and better transparency in this market is overwhelming. Consumers and intermediaries must have better and more useable information about insurer charges, in absolute and comparative terms. The kind of comparative pricing information in our Report is not normally available to consumers or intermediaries and it would be useful if it were publicly available and updated regularly.

Information about <u>intermediaries' commission</u> is no less relevant. Even if more data on charges were publicly available, as I hope will happen, consumers may still tend to rely on the intermediary for the bulk or all of the information they need to make rational choices. Despite the numbers involved it may be possible to publish and keep updated some general information about the range of such commissions, combined with closer attention to how exactly, when and in what form individual intermediaries disclose their own charges to prospective clients. (To take just one example, nonsense such as "103% allocation" likely to be

understood as a bonus or ‘free’ money may serve only to disguise the true charges of insurer and intermediary.)

In many schemes, administrators may help or guide members in converting pension savings to retirement benefits, but this approach can have pitfalls and one that trustees should watch very carefully. Administrators may seem a convenient and known choice but they may also have their own charges. These charges should be no less transparent than any other, and members need to know and understand that they are free to go elsewhere to establish their benefits if they choose. Trustees should try to ensure transparency and freedom of choice for members at this critical stage.

Of course, consumers should shop around between intermediaries, but it is not easy for them to do that, partly because of the lack of any standard and understandable basis for comparison between different offers. They may also be inhibited from shopping around if they know or have some social links with the first intermediary they meet.

Consumers are also reluctant to bypass the intermediary/commission system by paying upfront for independent advice, even though it may be overwhelmingly in their long-term interest to do so. They may have to pay much in commission than they would for financial advice.

Thank you.

END