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Agenda

Advancing economics in business

Delivering effective pensions reform: a competition perspective

Around ten million people in the UK are not saving enough to receive an adequate pension in retirement, according to the Pensions Commission. The government is now proposing low-cost Personal Accounts into which millions of workers will be automatically enrolled, spreading personal pension provision throughout the workforce. Oxera's independent research for the Association of British Insurers evaluates how these new low-cost pensions should be delivered: should the government create a single new organisation, the National Pensions Savings Scheme, or build on existing pension provision with a number of private providers?

People are not saving enough and the taxpayers of the future should not be expected to pick up the bill. That is the simple motivation behind proposals for Personal Account pensions, which promise low-cost pensions to encourage those without access to good occupational pension schemes—usually lower earners—to save for retirement. The government's intention is that, from 2012, these workers will be automatically enrolled, but not compelled, to pay 4% of their salary into a personal account. Employers must contribute a further 3%, and the government will pay 1% in the form of tax relief. The scheme will be similar to personal account schemes in other EU countries, such as the Danish Arbejdsmarkedets Tillægspension, the Polish Open Pension Funds and the Swedish Premium Pension System. Described by pensions reform minister James Purnell as 'one of the most important institutions created since the Second World War',[1] it is estimated that Personal Accounts will over time become by far the largest private pension scheme in the UK, with assets worth around 19% of GDP by 2050.[2]

The outline of Personal Accounts was proposed in the Pensions Commission's 2006 report and the government's subsequent White Paper,[3] and the details of how the scheme will be delivered are expected in a further White Paper later this year, followed by legislation in 2007/08. Agreement has already been reached on many aspects of the scheme, which has been designed in light of lessons learned from stakeholder pensions (the previous pensions scheme rolled out for low and middle earners in 2001). The benefits are that:

- existing low participation rates among lower earners will be increased by auto-enrolment;
- high costs will be reduced by direct sales rather than independent financial adviser (IFA)-intermediated sales;
- complications relating to pension portability will be addressed by a single transferable pension account within the scheme;
- confusion over complex financial choices will be addressed by a simplified pension product, likely to involve a default fund into which most savers will be enrolled plus three alternative funds for those who want choice.

Yet the question remains: how should the new market for Personal Accounts be designed? In advance of the publication of the government's White Paper, Oxera has conducted independent research for the Association of British Insurers (ABI) on two alternative systems to deliver Personal Accounts: the Pensions Commission's National Pensions Savings Scheme (NPSS) model for a centralised scheme, and the Industry-led branded provider model. These models were highlighted in the first White Paper as the two possible ways of delivering the low-cost administration system needed to provide Personal Accounts to millions of new pension savers.

Oxera's analysis, the first in a series of ABI research papers, examines the cost efficiency and competition aspects of pension system design. This article is based on that research, and focuses on the question: how can market design help ensure good Personal Account provision now and in the long term?

This article is based on the Oxera report 'How to Evaluate Alternative Proposals for Personal Account Pensions: An Economic Framework to Compare the NPSS and Industry Models', ABI Research Paper 1, October 2006.
Available at www.oxera.com and www.abi.org.uk/Bookshop/default.asp#Research.

How will competition work in Personal Account pensions?

The differences in market structure lie in the organisation of pension administration and fund management. The first model, the NPSS centralised scheme, proposes that the government should let the contract for the day-to-day running of the Personal Account system to a private contractor, or a small number of private contractors. The central system would also let the contract for fund management in a separate competitive tender. Competition in this model would function as a 'bidding market' (ie, one characterised by auctions for a large contract, in which the winner gains a temporary monopoly position). This is similar to the competition between Camelot and its rivals to run the National Lottery in the UK, or the competition between IT contractors to win an outsourcing contract for a government administrative system. In this way, the central system would make the choice of provider on a long-term contract, and consumers would be automatically enrolled with that provider.[4]

The alternative 'branded provider' model proposes that existing pension providers would each launch a Personal Account product, and compete directly for customers on the basis of price and customer service. Each provider would deliver fund management in-house or in some cases would outsource it. Those individuals not actively choosing a provider would be assigned to one of the participating firms through a 'carousel' mechanism. The allocation mechanism has not yet been specified—individuals could for example be allocated randomly or on the basis of providers' market share or a measure of their 'capability'. In either model, once an individual has a Personal Account, it follows them from employer to employer, meaning that the individual contributes without interruption to one scheme throughout their career.

In both models a 'clearing house' for Personal Accounts will collect and reconcile pension contributions, allocate default providers and collate information. The relationship between the clearing house and pension provider, as shown in Figure 1, would be similar to that between a network payments system (eg, BACS) and its client banks, or between a securities clearing and settlement system (eg, DTCC) and brokers/investors.

The centralised scheme and branded provider model represent different ways of organising competition: one as a bidding market (competition for the market, with no consumer choice of provider), and the other a model of product market competition (direct-to-consumer sales, relying on consumer choice to discipline providers).

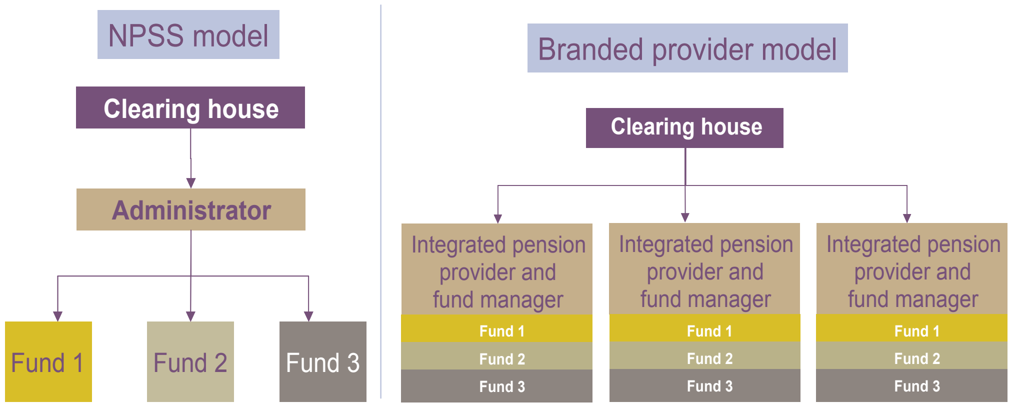
Challenges of direct-to-consumer competition?

In principle, choice by consumers is usually regarded as preferable to a centralised system that selects a provider on their behalf. Indeed, a survey undertaken by the ABI suggests that consumers prefer to have a choice of pension provider. 80% of respondents stated that they want some 'choice over who administers my Personal Account, including the ability to transfer my account to a different company if I am unhappy with the service'.[5]

However, the Pensions Commission identified direct-to-consumer competition as a key risk to cost levels in Personal Accounts:

> there would be a danger that competition to influence employer (or individual) choice would take the form of high expenditure on brand advertising … In a market where the power of choice exercised by individuals or small employers to drive competitive cost reduction may be limited, a model in which an economy of scale agent (the central system) chooses

Figure 1 **Market structure in the NPSS and Industry models**

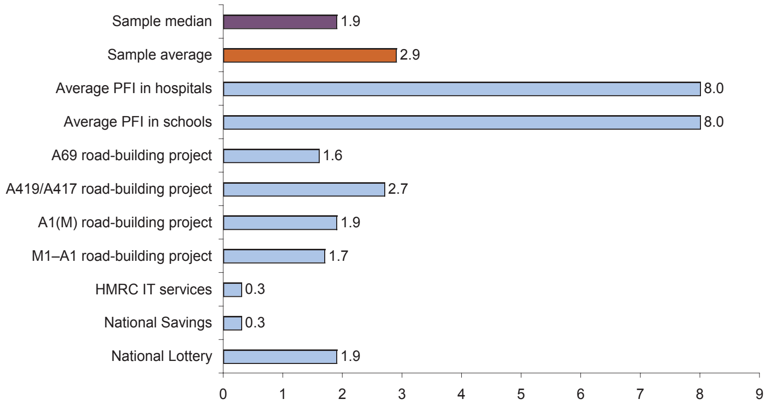


Note: Fund 1, 2, 3, etc represent the simplified asset allocation choice available to consumers. In each case, fund 1 represents the default fund to which most savers will be allocated.
Source: Oxera (2006), op. cit.

between alternative providers is likely to be more efficient.[6]

This conclusion appears to reflect the experience of the introduction of UK stakeholder pensions in 2001, where much of the target market of middle- and low-income savers was missed, and the initial charge cap of 1% had to be revised upwards. Even at a 1.5% charge cap, analysis by the Pensions Commission suggests that, at income levels below £20,000, it is still difficult to sell current pensions profitably.[7] The significantly lower target for the NPSS of charges in the region of 0.5% must therefore require a different cost structure, and a different market design, in order to be sustainable or even feasible in the first place.

Figure 2 Winner's bidding costs as % of total contract value for a selection of public 'bidding market' projects



Source: Oxera (2006), op. cit.

Issues identified by the Pensions Commission and others in achieving a low-cost system include the role of marketing costs, excessive switching (churn), and a lack of informed consumers. The Commission's model is seen as an opportunity to take advantage of greater economies of scale, since in the centralised system there would be fewer administration service providers and funds than in the branded provider model. These considerations led to the conclusion that an 'economy of scale agent' might achieve low costs in a way that competition between branded providers could not.

However, Oxera's research for the ABI has shown that economies of scale in pension administration are limited beyond a certain point, and that the differences in the number of accounts between the two models are unlikely to cause significant variation in administration costs. It also indicates that the average fund in the branded provider model is sufficiently large to avoid significant differences in fund management costs between the two models.

Hence cost differences between the two models are not driven by economies of scale. Yet would a centralised system do better than branded provider competition in keeping costs down in the long term?

Bidding markets are not perfect either

Both models will be cheaper than existing pensions since there will be no role for IFA commissions. The centralised model will also eliminate branded provider marketing, as workers will be automatically signed up to an NPSS provider and will not be able to choose a different provider. In contrast, the branded provider model relies on marketing to inform consumers about the relative merits of different pension providers. Thus the element of marketing may be key to any cost differences between the two models.

In light of this, Oxera's approach was to examine marketing costs using a cross-industry comparison. The long-term expected marketing spend in the branded provider model is around 2% of total costs (a figure estimated by market participants and based on a streamlined distribution mechanism using, for example, the Internet and call centres). This does not appear to be out of line with other industries such as banking, and indeed is significantly lower than expenditure in certain markets such as mobile telephony. The message is that with a streamlined distribution mechanism the expected marketing activity for Personal Accounts is not excessive by the standards of other consumer markets.

A further comparison is possible given that a bidding market has an equivalent to marketing costs in the form of bidding and transition costs, as the focus of firms' marketing efforts is transferred to a single consumer—ie, the public procurement agency. Oxera examined bidding costs in a range of government contracts for large administration systems, including the National Lottery and IT systems for National Savings and HM Revenue & Customs, focusing on the winner's costs, as these are subsequently recovered from consumers. Figure 2 indicates the magnitude of these bidding costs, demonstrating that they are non-negligible, and in some cases of the same order of magnitude as marketing costs in a branded provider model.

The conclusion is that bidding and transition costs are prevalent in similar large-scale public investment projects, and should therefore be taken into account when comparing the two models. These costs do not appear to have been factored into the Pensions Commission's modelling.

An additional concern for a 'bidding market' NPSS is whether competition will function effectively, allowing the NPSS Board an effective choice of providers over time. As Paul Klemperer notes in his Competition Commission paper on bidding markets, these markets 'are often regarded as "different" from ordinary markets', in the sense that the existence of two firms is 'enough to imply perfect competition, or even that just one firm is enough.'[8] Klemperer rejects this as a myth, pointing out that competition problems are still relevant even where a bidding mechanism is used.[9]

Oxera's analysis of how the bidding market NPSS may work in practice indicates that there are a number of risks associated with the implementation of this model. For example, it may be difficult for the NPSS Board to specify and monitor levels of customer service (such as call waiting times) in the contract.

The analysis also suggests that competition between contractors to run the NPSS may be impeded by high switching costs, since the provision of pension administration services at the scale required in the centralised model requires specific investments by the providers, leading to a long payback period of up to 20 years. A long contract and large investments mean that the winner of the first contract is likely to gain an advantage over new entrants, making it more difficult and less attractive for new entrants to bid upon contract renewal.[10]

Thus there is a risk that the NPSS Board becomes locked into one (or more) provider. Without effective competitive pressure, an incumbent supplier has no incentive to perform over and above the incentives created by a payment for performance contract, and gains a degree of market power. Regulatory pressure may ultimately alleviate these concerns, but regulation brings its own costs for suppliers and taxpayers.

Conclusion

It is apparent from Oxera's analysis that opting for a 'bidding market' is not an automatic solution where problems have been identified with direct-to-consumer product competition. Indeed, relying on competition for long-term contracts has its own difficulties.

While economic logic suggests that competition for the NPSS contract would be intense in the first round (since the prospect of rents from future market power would feature in the bids, making the first round highly competitive), the NPSS board could eventually become stuck with an incumbent, which—in the absence of effective competitive pressure—would have little incentive to improve service beyond that built into the contract.

Moreover, the costs of marketing in the branded provider model do not appear unduly high when compared with the costs of bidding and transition in other large public administration systems. These costs are considerable when systems and personnel must be transferred between companies in order to hand over from one provider to another.

In conclusion, the research does not demonstrate a strong case for the effectiveness of competition in the Pensions Commission's NPSS model, and indeed uncovers potential problems in sustaining an effective market in the long term. While the branded provider model also has disadvantages (see the Oxera paper for the ABI), the NPSS model will have to demonstrate significant cost advantages to emerge as the optimal choice. Yet according to the analysis, these efficiencies, which may come from economies of scale and scope in fund management and pension administration, are not decisively superior to those of the branded provider model.

The final choice of market design for the provision of Personal Accounts will therefore be finely balanced, but competition analysis has shown it should not depend on a presumption that a bidding market is a costless remedy for the problems of poor consumer choice and excessive marketing costs.

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[1] Department for Work and Pensions (2006), speech by James Purnell, Minister of State for Pensions Reform to the Cicero/MoneyMarketing Financial Services Summit, October 12th.
[2] Pensions Commission (2006), 'Implementing an Integrated Package of Pension Reforms: The Final Report of the Pensions Commission', Appendix F, p. 256.
[3] Pensions Commission (2006), op. cit., and Department for Work and Pensions (2006), 'Security in Retirement: Towards a New Pensions System', White Paper, May.
[4] An NPSS consumer will be transferred to another provider should the central system change its administrator, but this should not result in a change of service, since the incumbent would transfer all accounts to the new provider.
[5] ABI (2006), 'Personal Accounts: What Consumers Want—Executive Summary', Occasional Paper, No. 5, July.
[6] Pensions Commission (2006), op. cit., p. 32.
[7] Ibid., Appendix F, p. 228.
[8] Klemperer, P. (2005), 'Bidding Markets', Competition Commission Discussion Paper, p. 4.
[9] See also *Agenda* (2006), 'Bidding Farewell? The 'Bidding Market' Defence in Competition Investigations', March. Available at www.oxera.com.
[10] This problem can be mitigated but not eliminated by dividing the contract between a number of suppliers.

If you have any questions regarding the issues raised in this article, please contact the editor, Derek Holt: tel +44 (0) 1865 253 000 or email d_holt@oxera.com

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