



# Branded choice in personal accounts

The Right Decision Matters



INTERNATIONAL

CRA International provides expert advice on regulation, competition policy and business strategy within the financial services sector. Combining an in-depth understanding of how markets work with high-level analytical skills and practical modelling ability, CRA has assisted Government departments, regulators and the industry in designing and assessing the impact of significant regulatory changes in pensions, saving and investment products, banking and financial advice.

Founded in 1965, CRA International is an economics, finance and business consulting firm that works with businesses, law firms, accounting firms and governments in providing a wide range of services. CRA combines economic and financial analysis with expertise in litigation and regulatory support, business strategy and planning, market and demand forecasting, policy analysis, and engineering and technology management. The firm is distinguished by a corporate philosophy of providing responsive, top-quality consulting; an interdisciplinary team approach; unsurpassed economic, financial, and other analytic skills; and pragmatic business insights. The firm has over 700 professional staff at its offices in Europe and the Middle East, North America and Asia Pacific. Detailed information about CRA can be found at [www.crai.com](http://www.crai.com).

#### **Authors**

Kyla Malcolm  
Principal  
Tel: +44 (0)20 7664 3706  
[kmalcolm@crai.com](mailto:kmalcolm@crai.com)

Tim Wilsdon  
Principal  
Tel: +44 (0)20 7664 3707  
[twilsdon@crai.com](mailto:twilsdon@crai.com)

CRA International  
1 Undershaft  
London EC3A 8EE

[www.crai.com](http://www.crai.com)

The views expressed in this paper are those of the authors, not CRA International. The views expressed in this paper are not those of the Department for Work and Pensions or any other Government Department.

November 2006

Material from this discussion paper may be freely reproduced, subject to full acknowledgement of source.

## TABLE OF CONTENTS

EXECUTIVE SUMMARY .....	2
STATIC EFFICIENCY GAINS RESULTING FROM BRANDED CHOICE .....	2
DYNAMIC EFFICIENCY GAINS RESULTING FROM BRANDED CHOICE .....	4
COST OF BRANDED CHOICE .....	5
CONCLUSIONS .....	6
1. INTRODUCTION.....	9
1.1. COLLECTING THE EVIDENCE .....	9
1.2. THE ROLE OF BRANDS IN THE PERSONAL ACCOUNT MARKET: TWO MODELS .....	10
1.3. STRUCTURE OF THE REPORT.....	14
2. STATIC EFFICIENCY GAINS RESULTING FROM BRANDED CHOICE .....	15
2.1. THE ROLE OF CHOICE .....	15
2.2. THE ROLE OF BRANDS.....	20
2.3. PROVISION OF INFORMATION ON THE UNDERLYING PRODUCT ITSELF .....	22
2.4. INFORMATION REGARDING THE DIFFERENTIAL CHARACTERISTICS OF COMPETITORS .....	23
2.5. QUALITY CERTIFICATION .....	36
2.6. CONCLUSIONS .....	42
3. DYNAMIC EFFICIENCY GAINS RESULTING FROM BRANDED CHOICE .....	44
3.1. THE ROLE OF BRANDED CHOICE IN DYNAMIC COMPETITION.....	44
3.2. VALUE OF BRANDS IN CONSUMER EDUCATION.....	47
3.3. CONCLUSIONS .....	52
4. THE COST OF BRANDED CHOICE .....	54
4.1. THE LIKELY LEVEL OF MARKETING TO SUPPORT RIVAL BRANDS .....	54
4.2. COST ASSOCIATED WITH CONSUMERS MAKING ILL-INFORMED DECISIONS.....	57
4.3. COST ASSOCIATED WITH PROCESSING ADDITIONAL INFORMATION AND HIGHER SEARCH COSTS .....	59
4.4. CONCLUSIONS .....	59

## EXECUTIVE SUMMARY

CRA International was asked by DWP to assess the potential value from having competing brands in the personal account market. The visibility of private sector brands is one of the most significant differences between the alternative models of delivering personal accounts but there was considerable uncertainty about whether these would improve the way the personal account market would work or simply be an unnecessary expense pushing up the cost of provision.

In order to investigate these issues we have undertaken interviews with brand managers at the leading insurance companies, fund providers and public sector agencies; reviewed the academic evidence regarding the value of advertising, brands and choice; analysed evidence from research regarding how consumers purchase financial services products and their decision making process; and developed evidence from analogous markets that share some of the same characteristics as personal accounts.

Where possible, we have also disentangled the value of choice from the value of brands. It is clear that it is possible to have choice over some characteristics with, and without, brands. For example, the NPSS could offer consumers different funds based on asset allocation (low risk, medium risk etc). Under the direction of DWP we have considered only two of the possible models for the personal accounts market: the “industry” model and the NPSS which are described in the table below.

**Table 1: Comparison of models**

	NPSS	Industry model
Administrator / provider of customer services	One provider branded as NPSS	A number of different branded providers
Fund choice	A number of different funds covering different asset types branded as provided by the NPSS	A number of different funds covering different asset types from the (private sector) branded provider

Source: CRA International

Where choice is offered we assume that there is a relatively small number of choices offered rather than a proliferation of hundreds of choices (so for example, we consider relatively few fund choices in the NPSS and relatively few competitors in the industry model). We have compared the two models according to whether they bring benefits in both static efficiency (concerned with whether at a point in time consumers get the best value product available) and dynamic efficiency (regarding the incentive to provide the best value product over time), as well as the cost of branded choice.

### STATIC EFFICIENCY GAINS RESULTING FROM BRANDED CHOICE

In order to consider whether branded choice in the industry model allows consumers to make better decisions resulting in providers having incentives to offer better value

products (static efficiency) we have looked at: the relationship between branded choice and the size of the market; whether the industry model with branded choice in providing administration or fund management is valuable; and whether brands offers quality certification in a way that the NPSS would not.

Different evidence on the particular issue of choice and take-up reaches different conclusions, although it seems clear that *too much* choice may lead to increased opt out. Having a limited choice of providers is viewed more positively than choosing from the whole market in qualitative research, and quantitative research from the industry finds that no choice of provider may lead to an increase in opt out supporting a marginal benefit regarding participation from offering a (limited) choice of providers and therefore from the industry model.

When fund choice is considered (which arises in both the industry model and the NPSS), having a large choice of funds is found to make it likely that opt out rates would increase, although the possibility of a shortlist of funds is suggested as a way to make it easier for people to choose.

We find that neither model will, in itself, result in an optimal amount of advertising to grow the market (or in this case prevent opting out), but decisions as to how much public service advertising is required in the industry model is similar to the decision faced by the NPSS regarding the amount of advertising to undertake and hence the models are equivalent on this basis.

In comparing the value of branded choice in the NPSS and the industry model we distinguish between the value of brands for customer administration and for fund management. In administration we find that information is not readily available today to distinguish between the quality of different administrators prior to purchase, nor do pension providers currently compete on this basis to gain customers. However, this is not surprising since today's market focuses on financial intermediaries. Even so, the proportion of consumers lapsing due to customer service is not dissimilar to a number of other markets suggesting it is important for retaining customers.

Different research evidence reaches different conclusions but broadly finds that offering consumers a limited choice of provider of these services would be valued by some people. Since this is stated preference information, this is not as robust as revealed preference data (which does not exist for the personal accounts market), but it does support a marginal benefit from having a choice of provider and hence for the industry model.

Examining funds we find that different pensions do have different funds available although the level of differentiation appears to vary between individual products rather than between providers for all products (providers are not clearly differentiating themselves as those who offer a small choice of funds on all products versus those who offer a wide choice on all products). There is little direct evidence that consumers value this in choosing providers and the ex post data on consumers using the freedom offered by multiple fund offerings is weak. However, Sweden's compulsory pension system, the PPM, could be taken as evidence that some consumers are willing to make branded

choices and that a market that directly communicates with consumers could prompt part of the market to make active choices.

Again, looking at hypothetical information, different research reaches different conclusions on the value of fund choice although some consumers (such as younger consumers seeking ethical funds) clearly value choice. In addition, there appear to be differences between the amount of choice that different consumers want – meeting these different preferences can only be done through competing branded offerings rather than the NPSS.

Finally, we have looked at whether brands provide consumers with reassurance regarding the long-term performance of the provider. This would seem consistent with the role of brands in today's intermediary-dominated market. Prompted awareness of pension brands is high for some companies, although pension brands are less well-known in the target market than in the existing market. Information on whether consumers would trust private brands or a public sector brand more is inconclusive. It is also the case that tighter product regulation reduces the value of brands.

#### **DYNAMIC EFFICIENCY GAINS RESULTING FROM BRANDED CHOICE**

Looking at dynamic efficiency we have considered whether providers have appropriate incentives to provide better value over time (dynamic competition) and whether the role of consumers might change (through increased capability) resulting from the model chosen.

There are a number of reasons to be sceptical regarding the impact of supply side dynamic competition. There is limited evidence suggesting that consumers are sufficiently able to clearly differentiate between different branded pension providers if there are major concerns with pensions such as seen with the Equitable Life. In addition, there has been little evidence of new entrants in the existing pensions market. Moreover, any innovation in the pensions market generally is likely to arise outside the personal accounts market where returns to innovation are potentially greater, and the example of the Thrift Savings Plan in the US demonstrates that such innovations can be brought into personal accounts regardless of the model.

The existing market is an intermediated market and it is an open question as to whether a movement to a "direct-to-consumer" market could radically change the competitive nature of personal accounts through providers communicating directly with the end-consumer. This is an option that is most likely to occur in the industry model where competing brands undertake differentiated marketing strategies.

Nonetheless, there is good evidence of financial services markets developing over time and becoming more competitive, suggesting that it is important to be cautious in assuming that markets currently lacking vigorous competition from active consumers will remain the same in the future. Ten years ago, the presumption would have been that once a consumer chose a mortgage provider and a current account, they were likely to stay with those providers until provoked by an external event such as buying a new house. However, both of these markets have undergone significant change.

In both banking and mortgages, there has been considerable marketing activity to encourage consumers to re-mortgage or compare current account offerings resulting in competition on prices and also service – in terms of the availability of branch networks or being able to talk to a customer service representative rather than an automated service. In addition, the actions of a proportion of active customers have resulted in better terms for all customers.

Furthermore, consumers who purchase financial products do appear to become more capable of making later choices (although decisions regarding pensions may continue to be fairly intermittent and hence have relatively small learning by doing opportunities). However, in the target market, this is likely to be a relatively slow process.

The industry model and the associated branded choice therefore has an option value attached to it since even if initially consumers do not make informed choice regarding branded provision, this value may emerge over time.

### **COST OF BRANDED CHOICE**

Given that the industry model would include a number of different branded providers and would therefore require advertising, it is important to consider whether this imposes significant additional costs compared to the NPSS. In fact we find the risk that the industry model will result in excessive advertising appears relatively small.

First, much of advertising is at the brand rather than the product level, so adding a new product is unlikely to result in large incremental expenditure. Second, the existing market for personal pensions has relatively limited advertising. Indeed, the experience of stakeholder pensions does not suggest that such advertising as arose there could be considered excessive. This reflects both that the market is largely intermediated and that there is a price cap. Therefore, if, as is reasonable to assume, there is a constraint on pricing in the personal account market it is unlikely that there will be excessive advertising.

Costs may also arise due to the impact on consumer behaviour. It appears that the cost of making poor decisions regarding the branded administrator seems likely to be small. The detriment from poor decisions is a much greater risk regarding fund choice (and will therefore be present in both the industry model and the NPSS). The role of the default fund can be used to mitigate the risk of this as well as to limit the search costs for those consumers who do not value choice.

However, there is evidence that fund choices are influenced by framing effects i.e. the decisions made depend on the options presented. There is also evidence of “excessive conservatism” where consumers invest in low risk instruments for long term products. These issues impact both the industry model and the NPSS.

Furthermore, concerns remain regarding the role of advertising in encouraging consumers to select funds with higher risk and higher fees (although this could potentially overcome the excessive conservatism that some consumers would otherwise exhibit).

This needs to be taken into account when considering any price cap, assuming that one is used.

The most significant issue for the industry model is the potential for personal accounts to focus on direct to consumer advertising. While this could bring dynamic benefits to the market as discussed in the previous chapter, it may also lead to additional costs being incurred. Whether this represents a problem depends on the degree of product differentiation allowed in the market and the degree to which charges are constrained by some form of price cap. If limited differentiation is allowed then there will be limited costs although the benefits from this differentiation would also be small.

## CONCLUSIONS

Overall we find that the arguments regarding the value of branded choice in the personal accounts market are reasonably finely balanced. There is a clear trade-off since branded choice is of value where products are differentiated, but differentiation introduces a greater potential for costs to be incurred. If there is little differentiation between the products offered from different providers (because of extremely prescribed product terms) then there is little to be gained from branded provider choice in the industry model (although limited disadvantage from it either).

There does not appear to be any single issue which, on its own, provides evidence favouring models allowing branded choice. Instead we have identified a number of areas, where based on a reasonable expectation regarding how the personal account market would work, brands may bring some relatively modest, but nonetheless positive, advantage to consumers.

It is clear that too much choice may lead to increased opt out, however, having a limited choice of providers is viewed more positively than choosing from the whole market. In addition, the industry model provides the possibility of escaping to a different branded provider in the light of poor customer service and we do find evidence that a small number of consumers already take up this option to switch for this reason. Further, while too much fund choice is also seen as confusing, the industry model provides the opportunity for different branded providers to offer different fund management options which may attract different consumers some of whom value more choice than others.

Over time, the industry model also brings the potential for consumers who learn about personal accounts to become more active in making their choices in the future even if they are not very active at the start of the process. Both the industry model and the NPSS have this potential regarding fund choice, but the option value that the personal accounts market could develop in the future in respect of provider choice (as has been seen gradually in mortgages and current accounts) seems potentially important.

By contrast, the costs associated with branded choice seem reasonably modest since excessive advertising has not been observed in stakeholder pensions (where price was constrained) and search costs can be minimised through the use of the default fund (and there being relatively few competitors). There appears little downside in making poor



choices on the administrator of personal accounts although fund choices are more problematic (and arise in both models).

However, concerns remain regarding the role of advertising in encouraging consumers to select funds with higher risk and higher fees and this needs to be taken into account when considering any price cap, assuming that one is used. Costs would also be incurred if there is a change in the paradigm of personal accounts with a significant focus on direct to consumer advertising, although this would be expected to be associated with a more active customer base.

Overall, the total of all of these different benefits marginally supports branded choice in the industry model as compared to a single NPSS model for personal accounts. The arguments are summarised briefly in the table below.

**Table 2: Summary of the value of branded choice**

<b>The value of branded choice in Industry model relative to NPSS</b>		
<b>Static benefits</b>		
Choice and take-up		✓
Optimal informative advertising		-
	<b>Administration</b>	<b>Fund</b>
Information available on different options	-	✓
Competitors differentiating in today's market	-	-
Consumers switching	✓	✓
Hypothetical value of choice	✓	✓
Quality certification		-
<b>Dynamic benefits</b>		
New entry of branded competitors		-
Innovation in product terms		-
New channels for informing consumers		✓ (gain, unclear probability)
Learning by doing		✓
Potential market evolution towards "competitive" outcome		✓✓ (potentially large gain, option value rather than certainty)
<b>Costs</b>		
Expenditure on advertising		X (could be XX if consumer paradigm develops but mitigated by regulation)
Ill-informed decisions on administrator		-
Ill-informed decisions on funds		X
Search costs		X

Source: CRA International

✓ marginal benefit, ✓✓ significant benefit, X marginal cost, XX significant cost, - no difference between models

## 1. INTRODUCTION

CRA International was asked by DWP to assess the potential value from having competing brands in the personal account market. The visibility of private sector brands is one of the most significant differences between the alternative models of delivering personal accounts but there was considerable uncertainty about whether these would improve the way the personal account market would work or simply be an unnecessary expense pushing up the cost of provision.

It is possible that brands could affect outcomes in a number of positive ways including:

- Encouraging participation by reducing the numbers of people who opt out because they are able to change provider in the event of low levels of service;
- Encouraging active choices and even additional savings resulting in a greater degree of personal responsibility;
- Encouraging “higher quality” provision by competing for new consumers and keeping existing consumers; and
- Connecting the target group to providers of other important financial products, e.g. rainy day saving or life insurance and thereby using the benefit of well-established brands from other (mainly financial) markets or reassuring consumers of the longevity of their personal account because of the longevity of the provider.

Alternatively, brands could affect outcomes in a negative way including:

- Resulting in excessive advertising by providers seeking market share whilst pushing up the costs of provision;
- Encouraging individuals to make costly decisions which may be of limited value (or even negative value in the case of individuals being encouraged to make wrong choices) and therefore lowering the returns to their pension saving;
- Taking-up additional products that are inappropriate; and
- Reducing participation through introducing brands that are not trusted by consumers or because of presenting consumers with confusing choices.

The purpose of this project is to gather the evidence that exists to distinguish between these two outcomes.

### 1.1. COLLECTING THE EVIDENCE

The aim of this project has been to develop an evidence based assessment of the value of branded choice in the personal account market. However, collecting evidence regarding the behaviour of a new market such as this is not straightforward and therefore we have had to be imaginative about the types of evidence that are useful. In this case, this is particularly difficult since the new market involves both different types of customers

to that served by the existing market and also exploiting different business models to those currently used in the market. In particular, the existing pensions market in the UK is mostly intermediated by financial advisers whereas the presumption is that there will be no intermediation in personal accounts. We therefore need to use information regarding the way the market works today with care. In order to investigate these issues we have:

- Undertaken interviews with marketing directors and brand managers at the leading insurance companies, fund providers and public sector agencies to understand motivations of those who would be responsible for developing the strategy for personal accounts under particular models;
- Reviewed the academic evidence regarding the value of advertising, brands and choice examining what economic theory suggests about the value of brands under different market conditions;
- Analysed evidence from surveys regarding how consumers purchase financial services products and their decision making process; and
- Developed evidence from analogous markets that share some of the same characteristics as personal accounts.

Given the short time available for undertaking this project, DWP did not wish CRA International to conduct additional consumer research for the purpose of informing the report. However, we note that there are some areas where only limited evidence is available and therefore DWP may wish to conduct further quantitative research in order to inform policy decisions.

## **1.2. THE ROLE OF BRANDS IN THE PERSONAL ACCOUNT MARKET: TWO MODELS**

The objective of the project is to examine the value of branded choice in the personal account market. However, the degree of choice and the role of brands varies significantly depending upon the different models under consideration.

Where possible, we have disentangled the value of choice from the value of brands as it is possible to have choice over some characteristics with, and without, brands. For example, the NPSS could offer consumers different funds based on asset allocation (low risk, medium risk etc) or alternatively they could offer these as funds branded by the fund provider. It is also possible to have branded choice for different activities, for example, we could have branded choice of:

- Administration;
- Fund management; or
- A brand combining both activities.

Under the direction of DWP we have considered only two of the possible models for the personal accounts market: the “industry” model and the NPSS. The key differences between the models are set out in Table 3 below and in the figures overleaf.<sup>1</sup>

**Table 3: Comparison of models**

	NPSS	Industry model
Administrator / provider of customer services	One provider branded as NPSS	A number of different branded providers
Fund choice	A number of different funds covering different asset types branded as provided by the NPSS	A number of different funds covering different asset types from the (private sector) branded provider

Source: CRA International

We have therefore not focused on models where:

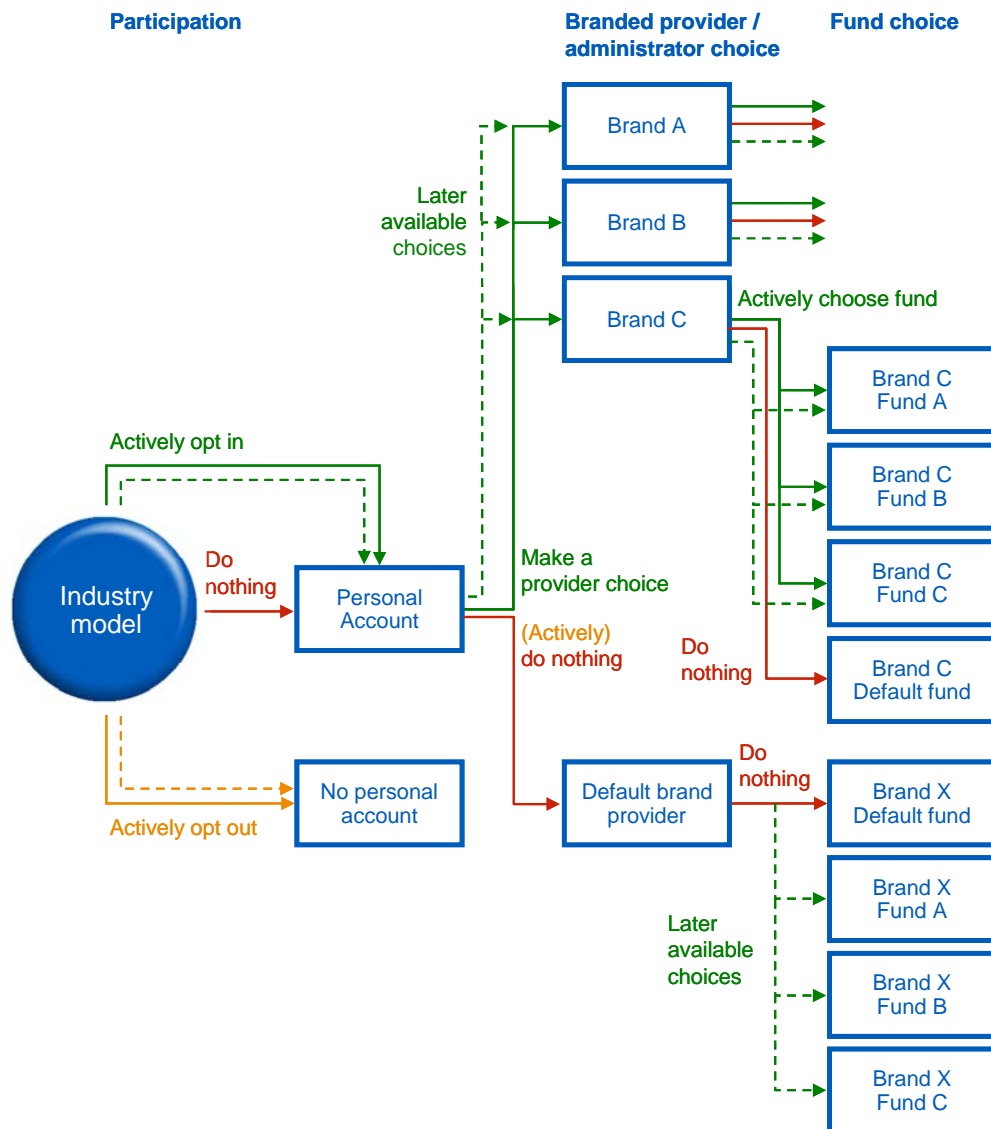
- there are multiple branded central administrators, i.e. competing NPSS's which consumers can choose for administration, but that then offer access to identical fund choices;<sup>2</sup> or
- an NPSS which allows access to branded fund managers.

The figures below attempt to capture both the initial choices that consumers may (or may not) make as well as the choices that would be available to them at a later date in the two models we are focusing on.

<sup>1</sup> These two models reflect the two main options set out in the White Paper, Security in retirement: towards a new pensions system, DWP, May 2006.

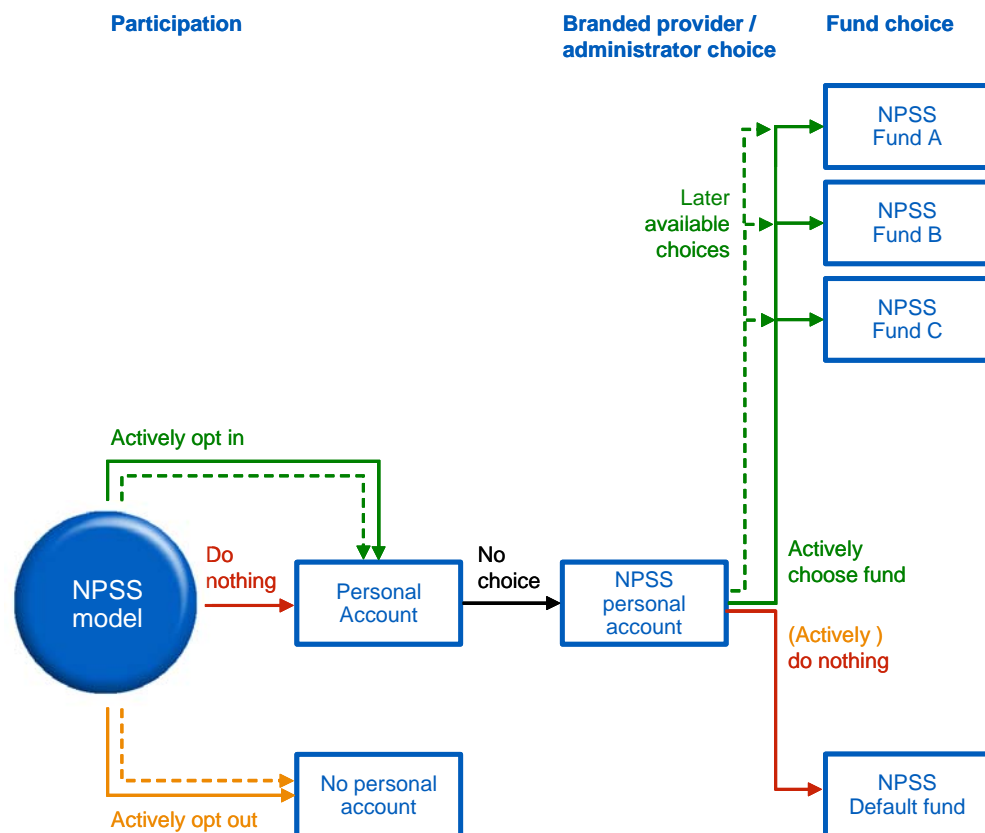
<sup>2</sup> This paper focuses on the value of choice and the resulting marketing costs. We have not considered other potential cost differences between the models, for example, economies of scale in service provision and fund management. These could clearly be a significant issues for models of this kind.

Figure 1: Industry model



Source: CRA International

Figure 2: NPSS model



Source: CRA International

It is important when comparing these models to make a fair comparison between the role of choice and brands in these rival models. For example, although there is a concern that the presence of competing providers in the industry model may result in significant advertising, the NPSS itself will also need to undertake some marketing activity. This is because of the need to establish its own brand, both to inform consumers of its existence and also if there is a desire to encourage active asset choice. It is therefore important to consider what would ensure that the NPSS undertook an optimal level of marketing as well as considering this issue in the industry model.

As will be explained in Chapter 2, if consumers are faced with too much choice, they may not be able to make decisions or they may not participate in making decisions. For this reason throughout the report, unless otherwise specified, when we discuss offering choice of either providers or funds we are referring to a small or limited number of choices.

"Competition in personal accounts" by CRA International, which is published alongside this, should also be read in connection with this report.

### 1.3. STRUCTURE OF THE REPORT

To evaluate the importance of brands and choice we have structured the remainder of this report into three chapters.

In Chapter 2 we consider whether branded choice allows consumers to make better decisions and whether this would result in providers having an incentive to offer better value products (static efficiency).

In Chapter 3 we look at whether including branded choice in the personal account market encourages better provision over time (dynamic efficiency). This could take two forms: the impact on the behaviour of suppliers, e.g. through innovation, which we refer to as dynamic competition, or the development of more active consumers e.g. increased financial capability resulting in consumers being better able to make decisions regarding their long-term savings.

Chapter 4 looks at the evidence regarding the cost of brands in the personal account market. This includes the direct cost associated with advertising but also hidden costs connected to the incentive to artificially differentiate products, the costs associated with unnecessary search activity and whether branded choice could result in consumers making sub-optimal decisions they would not otherwise make. The issue of costs is therefore not considered in either Chapter 2 or Chapter 3.



## 2. STATIC EFFICIENCY GAINS RESULTING FROM BRANDED CHOICE

In this chapter we consider whether branded choice allows consumers to make better decisions resulting in providers having incentives to offer better value products (we refer to this as static efficiency). Static efficiency is concerned with whether, at a point in time, consumers get the best value product available.<sup>3</sup>

Choice and branding are not exactly the same issue and we first consider the arguments for allowing choice and then whether brands have a particular role to play in ensuring that consumers make the decisions that best meet their needs.

### 2.1. THE ROLE OF CHOICE

The role of choice in most markets is to ensure that consumers or purchasers of goods can signal their preferences to providers or suppliers of goods and in so doing impose a competitive restraint on the market. Consumers impose this discipline by searching the market and choosing to purchase from providers who offer the best value products (taking into account both the quality and the price of the products).

However, for consumers to impose this discipline, it is important that they have enough information about the products, their characteristics and their prices. In reality, in many markets, especially financial services markets, this is not the case. Providers have far more information about the products than do consumers. Hence there is a problem of asymmetric information.

A further concern in financial services that is particularly relevant in the personal accounts market is whether consumers are able to make active decisions on a range of (potentially complex) choices. In particular, consumers do not have an infinite ability to process information. Information is costly to process and to find and hence individuals are unable to either gather or understand all available information regarding purchases. Although they may act rationally within the limits of the information they do have, they either may not have all information or they may be unable to process all information. Hence consumers may not appear to act rationally (compared to a situation where they were able to use full information).<sup>4</sup>

---

<sup>3</sup> There are two main forms of static efficiency: allocative efficiency looks at whether products are consumed by the consumer who values the products the most and it is allocatively efficient when the value that consumers place on the product equals the amount of resources required to produce the product; productive efficiency looks at whether the product is produced at the minimum cost.

<sup>4</sup> This issue is known as bounded rationality. When constrained by bounded rationality, disclosure of more information to a consumer may make the problem *more* difficult rather than less, resulting in consumers being even *less* able to discriminate between appropriate and inappropriate products. This suggests that the solution to bounded rationality is not found simply in the provision of information but may be in limiting the choice available to consumers.

An additional factor of importance is that consumer decisions are often highly dependent on the choices they are offered.<sup>5</sup> For example the Pensions Commission highlighted evidence that:

- the asset allocation chosen by an individual depended on whether they were offered a number of equity funds and one bond fund or vice versa;
- people invested in familiar investments, even if this imposed significant additional risk on them (for example, investing in the company they work for);
- consumers put too much weight on the recent past when making a decision but then become resistant to recognising a mistake; and
- more complex choices became overwhelming, leading to a lower level of participation.

The last point refers to work by Iyengar et al.<sup>6</sup> After investigating consumer behaviour vis-à-vis 401(k) plans in the US, they found that,

*“Other things equal, every ten funds added was associated with 1.5 percent to 2 percent drop in participation rate. [...] If there were only two funds offered, participation rates peaked at 75 percent, but when there were 59 funds offered, participation rates dipped to a low of approximately 60 percent.”*

Although the results from this are not directly applicable to participation in personal accounts (since there will be auto-enrolment into personal accounts), it does support a view that being offered *too much* choice leads to less participation.

In addition, in Sweden, where the compulsory PPM system started with around 450 fund choices and increased to over 700 fund choices, consideration is being given to significantly reducing the number of funds.<sup>7</sup>

Apart from information difficulties, whether the provision of choice is valuable or not is partly related to whether the needs of consumers differ and whether the choices offered are differentiated (considered in more detail later in the chapter). The target market for personal accounts are those individuals who are employed in the private sector and earn over £5,000 per year but are either not in an occupational pension scheme or are in a scheme that offers an employer contribution of less than 3%.

---

5 Pensions: Challenges and Choices: The first report of the Pensions Commission (Box in Chapter 6).

6 How Much Choice is Too Much? Contributions to 401(k) Retirement Plans, Pension Research Council Working Paper, SS Iyengar, W Jiang and G Huberman, 2003-10.

7 PPM Difficult Waters, Extended Summary in English. The report is unclear as to the number of funds that should be included in the PPM and although the range 100-200 is mentioned it is described as not being an absolute objective and there is a recognition that this range could change over time.

DWP has estimated that the number of individuals who are potentially eligible for personal accounts is around 10.8 million, or 60% of the private sector labour force.<sup>8</sup> With such a substantial number of people eligible for personal accounts market, it is difficult to believe that all of their needs regarding pension provision will be identical. For example, some customers may have experience of using different providers (including in other markets such as insurance or investments) and hence have different preferences regarding them. Similarly, some customers may prefer particular fund choices such as ethical funds or those with a corporate and social responsibility.<sup>9</sup>

In addition, although the proposals set out by the Pensions Commission regarding auto-enrolment to personal accounts limit the 3% employer contributions to earnings of between £5,000 and £33,000 per year, large numbers of those earning above £33,000 will only be able to access these employer contributions through personal accounts (although this may be a relatively small proportion of the personal accounts market). Differences in the composition of the target market therefore suggest that choice could be valuable.

### 2.1.1. The relationship between choice and take-up

We first consider whether there is a value in offering choice where there is no significant product differentiation. In particular, we examine whether the provision of choice could result in a lower level of consumers choosing to opt-out or whether consumers get utility from the perception of choice.

Where the product is not differentiated, the consumer will, by assumption, end up with the same outcome. For example, if we consider a situation where a consumer is offered one red marble or a situation where they are offered one of a choice of five identical red marbles, in both cases the consumer ends up with one red marble and hence the additional choice does not in fact change the outcome.

Typically we would not put significant value on choice of this kind since whether the consumer makes a choice or not, they have the same outcome. Hence if making a choice imposes a cost on the consumer and results in costs falling on providers (considered in more detail in the chapter 4), offering choice of this kind is unlikely to raise social welfare.

However, this discussion assumes that the consumer is able to recognise that there is no real choice (that all the marbles are the same). If the consumer irrationally believes that the choices are different, then the consumer may value the fact that there is a choice

---

<sup>8</sup> See the DWP White Paper, *Security in retirement: towards a new pensions system*, DWP, May 2006. The private sector labour force was estimated as 18.6 million by DWP.

<sup>9</sup> Public attitudes to personal accounts: Report of a qualitative study Research report 370 for DWP, Ipsos MORI Social Research Institute, 2006 based on a sample of 160 participants. Younger participants (aged 20-34) were found to value the ability to invest their money ethically and the research finds that corporate and social responsibility is an issue they are keen to support.

because then the consumer is able to select according to their preferences and participate in the personal accounts market (ultimately to their own benefit). This results in a difficult public policy decision as to whether to exploit the mistaken belief of consumers that they have meaningful choice in order that take-up might be increased.

It is also possible that choice could be seen as an end in itself rather than as a means to an end. That is, consumer may value the fact that they can make a choice as a good in itself, rather than value choice because the product chosen may better meet their needs. This may reflect a preference for consumers to be involved in the process.

In the sections below regarding the impact of choice, we report various results from different consumer surveys. As with any research, stated preference or hypothetical questions asked of consumers have drawbacks and should be given less weight to relevant actual behaviour (or data exhibiting revealed preference). Consumers often respond to survey questions without fully taking into account the costs of their actions (biasing the result) and are often asked to focus on particular choices, without being confused by the multitude of information that would actually be provided at the point of purchase. Hence care must be taken when interpreting these results. However, when addressing a new market (facing choices that have not previously been possible) aimed at new consumers this information is often the only available source of data.

#### *Provider choice and take-up*

That there can be too much choice is also supported by qualitative research conducted for DWP which finds that the majority of participants – particularly the non-savers - felt that they were not equipped with the necessary financial expertise to make a choice of provider and that it would require a great deal of their time researching the best option which was also seen as unappealing.<sup>10</sup>

However, those earning over £30,000 per annum stated that they would like a choice of provider. In addition, the possibility of choosing a provider from a shortlist was “more warmly received” than having to choose from all of those on the market.<sup>11</sup> From the existing research, it is not possible to ascertain why they favour choice, i.e. whether they value choice per se or value the ability to choose between the underlying differentiated products.

Similar results have been found in evidence provided by the industry that some less financially aware consumers expressed concerns over having to make a choice of provider, which they considered daunting, and might put them off participating. By contrast, more financially aware consumers expressed doubt over whether they would

---

10 Public attitudes to personal accounts: Report of a qualitative study Research report 370 for DWP, Ipsos MORI Social Research Institute, 2006 based on a sample of 160 participants.

11 Participants did query who would devise the shortlist and on what basis. Public attitudes to personal accounts: Report of a qualitative study Research report 370 for DWP, Ipsos MORI Social Research Institute, 2006 based on a sample of 160 participants.

participate if there was no choice of provider, though a limited choice would be an acceptable compromise for them.<sup>12</sup>

Research for the ABI found that 26% of consumers would be more likely to opt out of personal accounts if it was run by Government rather than private pension providers; although exactly the same proportion said they would be more likely to opt out if it was run by private pension providers rather than Government. (This research is based on a survey that may not be representative of the target group of consumers for personal accounts. In addition, it is unclear whether a different result would have occurred if the individuals had been offered the choice of an independent or non-profit organisation as opposed to "Government".)<sup>13</sup>

Further quantitative research has also been conducted into this issue. A sample of 1,260 consumers who are not in a pension scheme into which their employer was making contributions were asked, hypothetically, "If you were not given a choice of which company manages your account, and the Government simply allocated a company to manage your account, how would it affect your decision about opting out?" The research found that 49% of consumers said that if they were offered no choice of company to manage their personal account, they would be more likely to opt out. This compares to 13% who said they were more likely to stay in if there was no choice and 18% who said it made no difference.<sup>14</sup> Respondents were only offered a choice between these two options in their response and, as above, it is unclear whether a different result would have occurred if the individuals had been offered the choice of an independent or non-profit organisation as opposed to "Government".

#### *Fund choice and take-up*

There is evidence that *too much* choice of funds leads to a fall in participation. As noted above, Iyengar et al find that as the number of fund choices increases, the participation in 401(k) retirement plans falls.<sup>15</sup> Interestingly, the participation rate falls mainly between 2 and 12 funds and then is constant between around 12 and 30 funds before falling steadily towards 60% beyond 30 funds. This suggests that there is value in a small number of funds, i.e. less than 12 but after this there is little impact up to 30.

---

12 Consumer research into personal accounts based on a sample of 15 qualitative consumer interviews. Provided by a leading financial services company.

13 Personal Accounts: What consumers want, Occasional Paper No 5, ABI, July 2006, based on a survey conducted by YouGov with a sample of 2247 adults all of whom were in work for a minimum of 8 hours per week.

14 Consumer research based on 1,260 consumers who do not have employer contributions to a pension scheme in an omnibus survey conducted during the week of 23<sup>rd</sup> August 2006. Data provided by a leading financial services company. We understand that the answer "I would be more likely to opt out" was always read first. It would be useful to have results in the future based on surveys that rotated the answers.

15 How Much Choice is Too Much? Contributions to 401(k) Retirement Plans, Iyengar, Jiang and Huberman, Pension Research Council Working Paper 2003-10.

Similarly, qualitative research regarding personal accounts finds that having a choice of funds was seen as making the scheme more complicated and confusing than it needs to be and participants in the research thought it likely that opt out rates would increase. The research also finds in connection with fund choice that many participants stated that in order to encourage highest rates of participation the most obvious means by which to do this is to limit choice. However, there were some groups that did want to have a choice here and the idea was mooted by these people that a shortlist of funds could be drawn up so as to make it easier for people to choose. Other research on fund choice does not link fund choice with participation – other aspects of the research are considered later where more general preferences regarding fund choice are examined.

### *Conclusion on choice and take-up*

Different evidence on the particular issue of choice and take-up reaches different conclusions. It seems clear that *too much* choice may lead to increased opt out with academic research on fund choice providing evidence on this.

Having a limited choice of providers was “more warmly received than having to choose from all of those on the market” or seen as an “acceptable compromise” in qualitative research for the DWP and industry respectively. Quantitative research from the industry is mixed although one survey finds that no choice of provider is likely to lead to an increase in opt out. This supports a marginal benefit regarding participation from offering a (limited) choice of providers.

When fund choice is considered, research that links fund choice with take-up finds that having a large choice of funds would make it likely that opt out rates would increase, although the possibility of a shortlist of funds was also raised as a way to make it easier for people to choose. This suggests that a large number of fund choices should be avoided.

Overall therefore there is a marginal benefit regarding participation from offering a (limited) choice of providers which gives a slight benefit to the industry model. Fund choice arises in both the industry model and the NPSS, but it is clear that a large degree of fund choice would be expected to be detrimental in either model. It is less clear whether a limited choice or no choice of funds would be preferred from the perspective of take-up. However, in both cases, additional consumer research may need to be conducted into this issue before finalising policy decisions. We note that neither the industry model nor the NPSS model under consideration in this report is based on there being no choice in funds. As we discuss choice in the rest of the report we are therefore referring to a small or limited choice of both providers and funds.

## **2.2. THE ROLE OF BRANDS**

To help consumers to be able to impose competitive discipline in pension markets and to ensure that their different preferences are met, the market has come up with different mechanisms including the use of advisers, employer sponsorship and competition through brands. In this report we consider whether competition through branded choice would improve the personal account market.

There is an extensive academic literature on the question of advertising and branding as well as a literature regarding strategic decisions related to branding from a managerial perspective. Both of these areas have been reviewed during the course of this project.<sup>16</sup> The literature suggests that there are a number of roles performed by brands and the associated advertising including:

- Provision of information on the underlying product itself;
- Information regarding the differential characteristics of competitors; and
- Quality certification including signalling and a reduction of search costs and the assignment of responsibility for the product.

Below (starting in section 2.3) we consider each of these factors, how they relate to the personal accounts market and the evidence available regarding these different elements. As we do so we also examine the issue of advertising expenditure that is required to create and sustain brands. One of the concerns that is expressed is that such advertising may simply be wasteful or excessive advertising. As we note below, in fact, advertising can be overprovided or underprovided, and this depends on the characteristics of the market. The costs associated to advertising are considered in Chapter 4; whereas the current chapter considers the benefits.

Advertising can enhance economic welfare, especially because it can cause a market to expand on an overall basis, as opposed to simply leading to the stealing of competitors' business, or because it can help consumers find a product that is most suitable for their needs. Furthermore, advertising can be considered to be a part of the product itself, as opposed to simply being a "taste shifter" and hence consumers may attribute value to the advertising such that excluding this value would underestimate the utility to consumers. We are therefore testing whether the roles of advertising and branding listed above would be expected to be valuable in the personal accounts market.<sup>17</sup>

These issues are considered in more detail alongside each of the three roles listed above that branding plays.

---

16 This includes the economic literature such as GS Becker and KM Murphy, *A simple theory of advertising as a good or bad*, Quarterly Journal of Economics, Vol. 108(4), 1993; P Nelson, *Advertising as information*, Journal of Political Economy, Vol. 82(4), 1974; GM Grossman and C Shapiro, *Informative advertising with differentiated products*, The Review of Economic Studies, Vol. 51(1), 1984; A Kirmani, *The effect of perceived advertising costs on brand perceptions*, Journal of Consumer Research, Vol. 17(2), 1990; SF Hamilton, *Informative advertising in concentrated, differentiated markets*, Food System Research Group Working Paper Series 2004-01, 2004. and the brand strategy literature such as *Strategic Brand Management* Keller (2003) and M Hinshaw, *A survey of key success factors in financial services marketing and brand management*, Journal of Financial Services Marketing, Vol. 10(1), 2005.

17 This is similar to the objectives of Cronqvist (2006) who looks at the value of advertising in the Swedish PPM. Cronqvist concludes that in Sweden marketing does not fulfil the traditional model in economics focused on advertising's information role. Nor does he find them consistent with theories arguing that advertising is a complement to the advertised product.

### 2.3. PROVISION OF INFORMATION ON THE UNDERLYING PRODUCT ITSELF

The first role of brand marketing that we consider is that of providing information regarding the characteristics of the underlying product and to indicate the product's availability for purchase.<sup>18</sup> In a market with multiple brands, the advertising of each provider will inform consumers in the market about the availability of the product itself (as well as the provider's specific product which is considered in 2.4).

The provision of this information will arise in both of the two models under consideration:

- In the industry model each provider's advertising informs consumers generally about the availability of the personal account. Assuming advertising is related to market participation this will affect the market size i.e. more advertising about personal accounts will lead to more people with personal accounts (less opting out) and more money being invested. However, since this element of advertising relates to the underlying product, advertising will have a bigger effect on the whole market than on the individual provider's market share (i.e. there is a free-rider problem associated with the advertising by any individual provider). Hence in a market with multiple brands, a competitive outcome would result in too little advertising regarding the availability of the product itself since the private benefit gained would be less than the private cost incurred. Thus there is too little incentive to increase the size of the overall market.
- In the NPSS, since the NPSS is a monopoly provider, advertising of the underlying product itself has the same effect on the NPSS's market size as the whole market size by definition.<sup>19</sup> Hence the NPSS has the appropriate incentives to grow the market through this sort of advertising regarding the availability of personal accounts.

Having multiple branded providers therefore does not necessarily result in the "optimal" level of information regarding the underlying product. However, in the same way that the launch of stakeholder pensions saw a combination of private sector advertising and a government sponsored campaign, even in the industry model a decision will need to be taken regarding the appropriate amount of public service information about the product that is necessary. Therefore unless private providers inadvertently invest too much in this form of advertising (discussed further below), this does not differentiate between the models since any government sponsored campaign can always make up the difference between what would otherwise arise between the models. Thus the value from

---

<sup>18</sup> Here it is useful to distinguish between advertising informing consumers about the existence of product in general and what is conventionally regarded as informational advertising informing consumer about the characteristics of a particular product. Cronqvist (2006) shows that even where brands are allowed, as in Sweden, informational advertising regarding the individual characteristics of the product may be small.

<sup>19</sup> Although a monopoly does have an incentive to advertise where advertising increases the overall market, if the monopolist was to maximise profit it would produce at a lower quantity and higher price than more competitive markets and hence may have too little incentive to advertise in comparison to competitive markets. We assume a publicly run NPSS would not be incentivised to maximise profit.



advertising the availability of the product is the same in both the industry model and in the NPSS.

## **2.4. INFORMATION REGARDING THE DIFFERENTIAL CHARACTERISTICS OF COMPETITORS**

The second role of a brand is to inform consumers regarding the different characteristics of rival products. If consumers place a different value on rival products and brands can communicate these differences effectively to consumers, then brands will result in consumers obtaining products that best meet their preferences and firms providing the products that consumers most value.

When comparing between the two models, it is therefore important to consider whether the industry model will lead to providers offering differentiated products to consumers that can form a basis of choice for consumers. That is, we first need to address whether there is valuable differentiation, second whether branded providers can effectively communicate this to consumers and third whether consumers make active choices regarding this differentiation. We also examine whether consumers value this differentiation in the personal accounts market. This latter issue is based on “stated” preferences of what people say they value and hence is not as robust as information based on “revealed” preferences of what people actually do. However, since the personal accounts market does not yet exist, this is the best available evidence on this particular issue.

We consider these issues first for the provision of administration services and then for the provision of fund management services.

### **2.4.1. The extent and value of differentiation in administration**

One of the key differences between the industry model and the NPSS is that in the former there are multiple branded providers of administration services whereas in the latter there is only the NPSS performing this role. It is therefore important to consider whether the provision of administration is an area in which we would expect to see differentiation between providers such that consumers can make choices on this basis. We therefore consider four issues:

- Whether there are observable differences in the services of different administrators today;
- Whether brands attempt to communicate differences in administration;
- Whether consumers make active choices regarding administration; and
- Whether consumers hypothetically value a choice of administrators in the personal accounts market.

### *Differences in administration*

First we consider whether there are any differences in administration services that are observable to consumers in the existing pensions market. Here we note, that in terms of information being provided to consumers, there is *no* objective and comparative data source that consumers can examine in order to compare existing providers at present. For example, unlike other characteristics of pensions such as price, fund choice and performance, the FSA comparative tables do not provide information on quality of administrative services or of customer information. Similarly, we are not aware of any private sector information sources providing information to consumers on issues such as internet access, provision of helpdesks, or ease of updating personal information.

However, we do need to be slightly cautious when drawing the conclusion that service levels are unimportant. Currently the pensions market is primarily intermediated and hence service levels may be obvious to intermediaries who deal with providers on a daily basis. Indeed, interviews with brand managers did indicate that service levels were important, although service levels provided to the intermediaries were seen as more important rather than service to the end consumer. For example, one pension company indicated that a number of years ago they had a period of poor service levels leading to processing backlogs on their defined contribution schemes. They noted that while it took a whole year to fully resolve the service quality, in fact it took two years to recover the confidence of advisers that this had happened. The poor service levels were seen to have impacted market share and hence pension companies do have the incentive to maintain service levels to intermediaries.

The question for personal accounts is whether, in a consumer facing environment, the same incentives would remain, but be focused on customer rather than intermediary services. It seems as though such incentives would be smaller. Intermediaries are repeat purchasers of administrative services since this is part of their job. By contrast, interviews with pension providers stated that consumers very rarely contact them about pensions and even in a consumer facing personal accounts world, the frequency of contact by any single consumer would be substantially lower than the frequency of contact by intermediaries. Even at annuitisation (when consumers will start to receive an income) providers have to reach out to consumers to get them to consider their options.

### *Brands communicating differences in administration to consumers*

The second issue is whether branded providers attempt to communicate any differentiation to consumers. The overwhelming response to this issue during the interviews with providers was that communicating differences in pension administration was not something that they attempted to do. It is however possible that if the potential for other forms of competition (such as price competition) were reduced this might play a larger role.

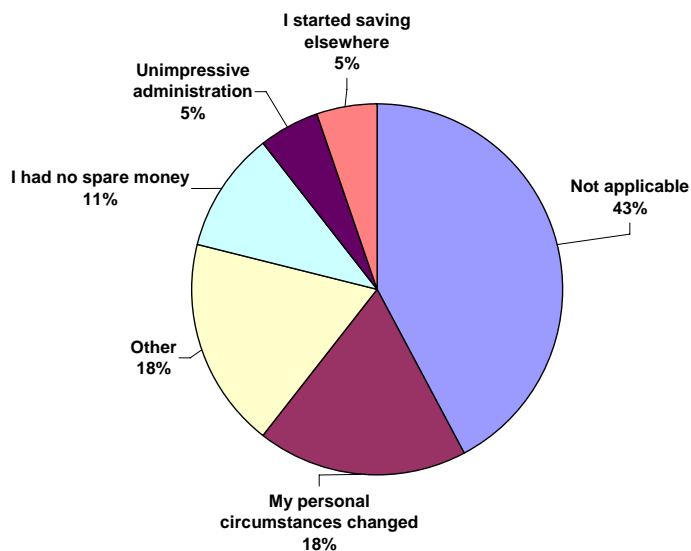
### *Consumers making active choices regarding administration*

The third issue is whether consumers are actually observed to switch pension providers because of poor customer service i.e. having a choice of administrator offers consumers an alternative if they receive poor service. Even where differentiation is not apparent ex

ante, if consumers can subsequently identify characteristics of the product, and they can “vote with their feet”, then choice may still be valuable. Arguably, customer service is an important characteristic of many products but is rarely seen as important when consumers initially purchase a product. However, if customer service affects the retention of consumers, then the ability to choose an alternative supplier can still motivate providers to offer good service. This effect is illustrated by markets such as internet service providers or utility providers, where competition for new consumers focuses on price, but retention may depend on good customer services. This motivates providers to maintain customer service levels in a way that they would not otherwise do.

We start by considering evidence regarding the extent to which consumers switch in the existing pension market which is presented in Figure 3 below.

**Figure 3: Main reason for ending contributions into first private pension scheme (excluding job change)**



Source: Serious about Saving: Reducing proliferation and increasing persistency in long-term saving, Occasional Paper No 3, ABI, August 2005.

It is clear from Figure 3 above that administration is a very small reason for consumers ending their contributions to pensions (even after removing job change which is the most significant reason). In the personal accounts market, job change may be less relevant since personal accounts will be accessible even where consumers change job (although consumers may also change jobs to a company with an “exempt” scheme). Instead, we have therefore examined evidence from a leading pension provider that had conducted a survey of the main reason for surrendering a personal pension scheme. This found that

service was the main motivation for around 8% of individuals which is somewhat higher than the ABI's figures, although still a reasonably small number.<sup>20</sup>

We have also assessed whether this is similar to other markets and have examined two markets that have relatively recently liberalised and in the course of doing so introduced multiple branded offerings into a market that previously had a single brand, namely gas and electricity provision. The main reason for switching providers is shown in Table 4 below.

**Table 4: Top five reasons for switching gas and electricity providers**

	2001	2002	2003
<b>Gas</b>			
Price/cost	64%	62%	65%
Persuaded by salesman	7%	7%	8%
Convenience of having gas/electricity with one supplier	5%	6%	6%
Better customer service	4%	8%	6%
Moved to a new area	2%	2%	4%
<b>Electricity</b>			
Price/cost	72%	70%	65%
Convenience of having gas/electricity with one supplier	6%	7%	9%
Persuaded by salesman	7%	6%	6%
Better customer service	4%	4%	6%
Moved to a new area	2%	2%	4%

Source: J.D. Power and Associates Survey, as reported in Ofgem, "Domestic Competitive Market Review 2004 – A review document," April 2004, pp. 42 and 45. Respondents were allowed to give multiple reasons for switching, and were not prompted by the interviewer.

In both markets the most commonly stated reason for switching was price, although better customer service was cited by around 6% of consumers with some (weak) evidence that this has increased over time. It is also the case that the level of switching has also

<sup>20</sup>

Data provided to CRA by a leading pension provider. Interestingly, consolidation of funds was the main factor for 23% of people. If this relates to having a single provider, this could suggest that consumers may prefer to be able to access the same providers in the personal accounts market as outside the personal accounts market if rules on transfers mean that such consolidation is possible. Other answers given included 27% IFA advised to transfer and 17% fund performance. The results are based on a survey of 150 consumers.

increased over time. For example, in the electricity market the proportion of consumers switching increased from 20% to 22% between 2001 and 2003.<sup>21</sup>

Thus switching because of customer service in the pension market (where there is only occasional interaction) is found to be broadly similar to the level of switching because of customer service in the gas and electricity markets. We note that gas and electricity markets do allow multiple branded providers to compete in the market and although competition is largely seen to focus on price, service levels are not argued to be irrelevant in these industries (indeed, the response of incumbents has been to focus on customer service to retain market share). Thus it would not appear appropriate to see service levels as irrelevant in pensions where switching due to customer service levels is at a broadly similar level.

### *Consumers hypothetically valuing administrator choice in personal accounts*

The fourth and final issue is whether consumers who are asked about personal accounts value having a choice over their administrator. As noted above, it is important to remember that stated preference or hypothetical questions asked of consumers have drawbacks and should be given less weight to relevant actual behaviour (or data exhibiting revealed preference).

Evidence from the ABI finds that 8 out of 10 consumers would prefer to have choice over who administers their personal account and the ability to transfer if they receive poor service.<sup>22</sup> This preference for choice over the pension administrator favours the industry model (where choice is available) rather than the NPSS (where choice is not available).

Additional information is also available from consumer research conducted by a leading financial services company. When asked, "If the money is looked after by pension providers, who should choose the pension provider",

- 41% wanted to make an unrestricted choice themselves;
- 33% wanted to chose from an approved Government shortlist; and
- 14% wanted employers to chose for them.

Results were almost identical among those who currently have no pension. It is important to note that the question presupposes that the industry model is being used and does not

---

21 Interestingly when switching rates for different demographic groups were examined, they found no significant relationship between social class or tenure and a decision to switch. This contrasts with a more recent study by Accent (2005) who found that electricity and gas switching levels were below-average for respondents in the E social class (gas and electricity) and for unemployed households (electricity only).

22 Personal Accounts: What consumers want, Occasional Paper No 5, ABI, July 2006, based on a survey conducted by YouGov with a sample of 2247 adults all of whom were in work for a minimum of 8 hours per week. This research is based on a survey that may not be representative of the target group of consumers for personal accounts.

include an option for the money to be looked after by someone other than a pension provider e.g. there is no option to choose a non-profit organisation. Nonetheless, it does provide evidence that some consumers value choice, although the same research finds that some 69% of consumers do not feel confident to make this choice.<sup>23</sup>

Qualitative research conducted for DWP finds that the majority of participants did not want to have a choice of provider. This was because they were not equipped with the necessary financial expertise to make a choice of provider and that it would require a great deal of their time researching the best option which was also seen as unappealing.<sup>24</sup>

However, those earning over £30,000 per annum stated that they would like a choice of provider. In addition, the possibility of choosing a provider from a shortlist was "more warmly received" than having to choose from all of those on the market.<sup>25</sup>

It seems clear from the research that the value of choice and the extent of choice preferred varies by customer. There is a group of customers who do value choice who will be part of the personal account target market and there is a group of customers who find choice in this market confusing.

Overall, therefore we find that there is little information for consumers to assess the quality of administration prior to purchase. In addition, differences in the quality of pension administration services are not an important differentiator of today's providers. There is, however, some support for the argument that branded choice will support customer service levels for retention purposes which the NPSS would need to achieve through targets and monitoring. When asked whether they would like choice of providers in the personal accounts market, different research reaches different conclusions, although the option of having a limited number of choices as opposed to choosing from all those on the market seems to be supported in research conducted for both DWP and the industry.

#### 2.4.2. The extent and value of differentiation in fund management

As well as choice over administration, the industry model brings different choices over funds compared to the NPSS. For example, in the industry model different providers can offer a different number of fund choices and different fund providers whereas the NPSS will only offer NPSS branded funds and only offer one particular number of funds i.e. the NPSS can not simultaneously offer four funds and seven funds whereas different

---

23 Consumer research into personal accounts based on a sample of 769 consumer interviews. Provided by a leading financial services company.

24 Public attitudes to personal accounts: Report of a qualitative study Research report 370 for DWP, Ipsos MORI Social Research Institute, 2006 based on a sample of 160 participants. We note that this research does not state that having provider choice would increase opt out (unlike where fund choice is discussed, which participants do state could lead to opt out).

25 Participants did query who would devise the shortlist and on what basis.

providers in the industry model can do this. As before it is therefore important to consider whether this choice is valuable and again we examine four different issues:

- Whether there are observable differences in fund choice;
- Whether brands attempt to communicate differences in fund choice;
- Whether consumers make active choices regarding funds; and
- Whether consumers hypothetically value a choice of funds in the personal accounts market.

### *Differences in fund choice*

First we consider whether there are differences in fund choice available to consumers in the existing pensions market. In order to do this we have examined the FSA comparative tables to identify differences between the offerings of providers. The table below shows the variation faced by a 25 year old wishing to buy direct and planning to invest £100 a month with the aim of retiring at 65.

**Table 5: Branded choice in the stakeholder pension market**

Differentiating factor	Amount of differentiation
Number of branded providers	14
Fund choice	1-42
Number of free switches	Unlimited except 2 providers limiting the consumer to 1 and 6 switches respectively
Charges	+/- 10%

Source: CRA International based on FSA comparative tables for stakeholder pensions

What is clear from Table 5 above is that there is differentiation between providers and it is observable by consumers (by virtue of there being information on the FSA's comparative tables). This suggests that providers believe they can differentiate themselves by offering more or less choice or offering different charges, both of which could vary within the personal accounts market.<sup>26</sup> It is also interesting to note that the variation in choice is more constrained in the stakeholder pension market than in personal pensions more generally, suggesting that a more tightly regulated product would be expected to have less differentiation (hence the variation seen in stakeholder pensions could be seen as an upper bound for the likely variation in personal accounts).

<sup>26</sup> Interestingly, there is a positive correlation between charges and funds offered (although it is not statistically significant). This could be taken as evidence that consumers are offered more flexible products at a higher cost or simpler products at lower cost.

Looking beyond the FSA comparative tables, private providers of information also compare stakeholder products offering information on additional characteristics, such as external fund links, and investment performance.

Both pieces of evidence support the view that providers differentiate their products by offering different degrees of fund choice and that the market is responding to these different preferences. Within the fund management sector, the growing popularity of fund supermarkets could be seen as the extreme version of this since these administrative platforms offer access to a wide range of fund providers. Indeed according to interviews, the characteristic of primary importance in fund supermarkets is the number of funds to which access is provided (rather than the administrative aspects of consolidated statements etc). It should be noted that while these fund supermarkets are likely to be targeted at financially sophisticated consumers who will not make up the bulk of the personal accounts market, they do indicate that some consumers value a very large choice.

Furthermore, within the existing market, a number of pension providers also offer access to external funds that are provided, and branded, by someone else (typically by using both the pension provider and the fund manager brand in the name of the fund). We assume that providers will only offer such external links if they are valuable to customers (since the provider loses some revenue from the fund management activity). Again, this also supports a view that at least some consumers value the choice of funds. However, the extent of external fund links is somewhat smaller within the stakeholder market than in the rest of the private pensions market (either because they are of lower value in this part of the market or because they are not economic to provide within the stakeholder price cap). This also suggests that external fund links will be less common in the personal accounts market than in the stakeholder market.

### *Brands communicating differences in fund choice to consumers*

The second issue is whether there is evidence of differences in fund choice being communicated to consumers. There was little evidence from interviews that existing *pension* brands attempted to communicate the different ranges of fund choices to consumers as a method of differentiation from their competitors. Indeed, all interviewees agreed that very few customers would have a perception of different providers offering different fund types. For example, the view that L&G was associated to trackers or Fidelity associated to more actively managed funds was considered to be a view that only the most sophisticated of consumers would have, if at all.

It is, however, possible that brands do not need to focus on communicating this difference to consumers because of the evidence presented above that objective and factual information is accessible in order to identify the fund choices available from different providers. More likely, however, given that most pensions are intermediated, this information is already provided to intermediaries through information packages. It may also be the case that communication of different fund choices is considered in the future and this issue is examined in the next chapter.



*Consumers making active choices regarding funds*

There does not appear to be any information available on whether consumers choose a particular brand on the basis of the range of fund choices underlying the pension other than the fact that providers are taking different strategies in their decision in this regard.

However, another way to consider the value to consumers is whether they exploit this choice when it is made available to them. We therefore turn to consider whether consumers make active choices between the funds that they are offered from a pension provider.

In the UK, the proportion of consumers who are in the default fund of their stakeholder pension scheme is over 70%.<sup>27</sup> The NAPF reports that where the default fund is a lifestyle fund (which is assumed to be the requirement in personal accounts) 83% of members have allowed their money to remain invested in this way.<sup>28</sup> Furthermore, once consumers have chosen their fund (or ended up in the default fund) there appears to be very limited amounts of switching between funds with one pension provider indicating that this was only around 1-2% of consumers each year. This evidence suggests that only a small proportion of consumers would make active choices in the personal accounts market. Yet, based on the NAPF figures we would expect that around 17% of consumers or up to 1.8 million individuals would not be in the default fund.<sup>29</sup>

However, the evidence from Sweden regarding the ability and willingness of consumers to make active choices is much more optimistic (whether this also introduces costs both in terms of the cost of providing these choices and also the cost of making bad choices is discussed in Chapter 4). Sweden's PPM system is a compulsory pension contribution system in which consumers have a choice of the branded fund in which their money is invested (although no choice over administrator). Therefore consumers are offered choice regarding the fund providers and the choice of different fund types.

The scheme was set up in 2000 at which point only 33% were in the default fund i.e. 67% of individuals made an active choice of fund provider that was not the default fund (although subsequently the proportion in the default has increased so that only 8% of first time choosers were not in the default 2005).<sup>30</sup> Furthermore, while the majority of

---

27 Based on interviews conducted for Competition in personal accounts, CRA International, November 2006. All interviewees agreed that the proportion of consumers in default funds was over 70%.

28 Annual Survey 2005, National Association of Pension Funds, Part 3.

29 DWP has estimated (in Security in retirement: towards a new pensions system, DWP, May 2006) that the number of individuals who are potentially eligible for personal accounts is around 10.8 million. 60% of the private sector labour force, and 17% of 10.8 million is 1.8 million. This is based on 100% take-up of personal accounts.

30 It is important to note that these figures relate to first time choosers. When the scheme was first set up this group would have included almost all of the working population. However, in later years, the first time choosers are those who are new to the labour force and are therefore overwhelmingly likely to be young and therefore on lower than average earnings.

consumers have not changed their fund choice, the proportion of individuals that had switched their fund at least once has increased to 12% by the end of April 2005 and 6% switched their fund during 2004 which was described as showing “a tendency for greater activity”.<sup>31</sup>

There is therefore a clear discrepancy between the evidence from the UK (which is largely focused on asset choice) and that from Sweden regarding the active nature of choices (where both brand and asset choices are possible) and it is important to consider the possible explanations for this. There are three areas that may be of most importance:

- In the UK, the figures regarding the proportion of people in the default fund relate to a primarily intermediated market. Having intermediaries recommend pensions or employers offer pensions may lead consumers to abdicate responsibility for making active decisions (with intermediaries not giving ongoing advice to many consumers about switching funds within a pension scheme). By contrast, in Sweden the decision is left to the consumer regarding the choice of the fund (although it is a compulsory scheme so consumers do not need to decide on participation). If the role of the intermediary is the underlying reason for the passive role of the consumer in stakeholder pensions, it suggests that it is possible that within personal accounts consumers may make more active decisions than currently because they feel more responsible for doing so.
- In Sweden, the level of non-default fund choice relates to the figure at the start of the development of the PPM, at which stage considerable national debate was held and hence consumers may have been somewhat more aware of the possibility of making a decision regarding their contributions. In the UK, such a radical change to pension provision and the associated debate has not arisen regarding the ability to invest pension contributions (although this might arise once personal accounts are implemented). If this is the underlying reason it also suggests that within personal accounts consumers may make more active decisions at the start of the personal account system because of increased awareness of the ability to do so.<sup>32</sup> It is also likely that this was connected to the role of branded providers since there was a large amount of marketing by providers when the PPM system was introduced. When the marketing activity reduced so did the consumers making active choices.<sup>33</sup>
- In Sweden, once a year consumers receive “the orange envelope” which provides information regarding the value of their pension fund. This has also been found to generate national debate and may explain why there is higher switching of funds in

---

31 PPM Difficult Waters, Extended Summary in English.

32 Indeed, this could also be supported by the lower proportion of first time choosers that are not in the default fund in the PPM over time because the PPM is no longer “new”.

33 It is also the case that the default fund saw strong performance over the period and the population who were making first time choices was dramatically smaller in later years since it represented only those who were new to the labour force whereas when the scheme was first set up almost all of the working population would have needed to make a choice about where to invest their money.

Sweden because of a raised awareness of the opportunity to do so on an ongoing basis. By contrast in the UK, consumers receive information on existing pensions at different times of the year and there is no such regular ongoing debate. Again this suggests that there is an opportunity to increase switching in personal accounts compared to today.

Evidence is also available from the US on switching of funds in the context of auto-enrolment and a default fund. Where the default fund is either a money market fund or a stable value fund, there is evidence that a large proportion of consumers switch out of this. After six months the proportion of those in the default fund was between 55% and 73%, whereas after 24 months this had fallen to between 40% and 51% showing that around half of the participants had switched their fund after two years.<sup>34</sup>

On balance the evidence suggests that it is possible that there could be more active choice and switching in the personal accounts market compared to today's stakeholder pension market. If this is the case it could arise in both the industry model and the NPSS. However, the industry model brings the additional benefit of different providers offering and marketing different degrees of choice which may prompt debate as well as meeting the needs of consumers who value a range of choice to a greater or smaller degree.

It is also worth bearing in mind the basis on which consumers make their choices. Evidence from the fund management industry suggests that past performance is one of the key factors that consumers consider when deciding on their fund choice. Indeed in the Swedish PPM, the strong performance of the default fund in comparison to other funds may partly explain the increased use of the default fund by first time choosers since the PPM was set up.<sup>35</sup> There is also evidence that the type of fund invested in is influenced by the marketing activity. Whether making choices on the basis of past performance or marketing activity imposes a cost on the consumer is considered in Chapter 4.

#### *Consumers hypothetically valuing branded fund choice in personal accounts*

The fourth and final issue is whether consumers who are asked about personal accounts value having a choice over their funds. As noted above, it is important to remember that stated preference or hypothetical questions asked of consumers have drawbacks and should be given less weight to relevant actual behaviour (or data exhibiting revealed preference).

Evidence is available from the ABI who find that 72% of consumers when asked about personal accounts responded that they would like a wide choice over how their pension contributions are invested (although this does not provide evidence on how many would

---

<sup>34</sup> Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance, Choi, Laibson, Madrian, and Metrick, November 2001. We note that in the personal accounts market the default fund is expected to be a lifestyle fund and therefore it is less clear whether consumers would be expected to gain from switching out of such a fund compared to switching out of a money market fund.

<sup>35</sup> PPM Difficult Waters, Extended Summary in English.

exercise this choice or on the extent of the choice they would like), although only around 25% of consumers strongly agree with this as opposed to “tend to agree”.<sup>36</sup>

Additional information is also available from consumer research conducted by a leading financial services company. When asked, “If a worker doesn’t choose a fund, their pension provider would allocate one. This would be the same fund for all workers. Would you prefer to choose your own pension fund, or would you prefer to be allocated the one your pension provider has chosen?”

- 68% would prefer to choose; and
- 29% would prefer their provider to allocate the fund.<sup>37</sup>

However, when this is considered further we find that even though these consumers state that they would prefer to make a choice of fund, many of them (38%) would prefer to have a shortlist of options and, as seen in Table 6 below, the number of choices they would like is small.

Qualitative research conducted for the DWP found that fund choice was seen as confusing and the majority of participants in the research did not think that they had the necessary financial knowledge to make the right decisions with regard to where to invest their money. The exception to this was those consumers who were currently saving for a pension and, as such, have made these kinds of choices before. Similarly, those not currently saving but earning over £30,000 per year as well as those at the upper end of the £15,000-30,000 range stated that flexibility here would appeal. The idea of a shortlist of funds was mooted to make it easier for people to choose.<sup>38</sup>

Although there appears to be concern about facing too much choice, it is also notable that some younger participants in the qualitative research stated that it was important to be able to invest their money ethically and that corporate and social responsibility is an issue they would be keen to support.

Broadly the research therefore suggests that too much choice would not be valuable but that a small amount of choice would be valued by different groups. However, there are some consumers for whom any choice will be confusing and for whom a single fund would be preferred. We note that both models would have a default fund available for such consumers.

---

36 Personal Accounts: What consumers want, Occasional Paper No 5, ABI, July 2006, based on a survey conducted by YouGov with a sample of 2247 adults all of whom were in work for a minimum of 8 hours per week. This research is based on a survey that may not be representative of the target group of consumers for personal accounts.

37 Consumer research into personal accounts based on a sample of 769 consumer interviews. Provided by a leading financial services company. These options were the only alternatives given and results may be affected by consumer not knowing the basis on which providers would allocate the fund.

38 Public attitudes to personal accounts: Report of a qualitative study Research report 370 for DWP, Ipsos MORI Social Research Institute, 2006, based on 160 participants.

Those who wanted a shortlist were asked how much fund choice they would like. There was a range in the responses given suggesting different underlying preferences for choice as highlighted in Table 6 below.

**Table 6: Number of fund choices preferred by those who want a shortlist**

Number of fund choices	2-4	5-7	8-10	10+
Proportion of sample	24%	41%	23%	6%

Source: Consumer research into personal accounts based on a sample of 769 consumer interviews. Provided by a leading financial services company. Based on those that said they would prefer to choose their own fund (68%) and would prefer a shortlist of funds (38% of the 68% which is approximately 200 consumers). In addition, 5% had no preference and 1% said they did not know. Since the question was only asked to those who wanted a shortlist, the option of only one fund was not offered.

The results in Table 6 appear to be important, since this suggests not only is there a group of consumers that value choice, but within this group the amount of choice that consumers want varies. The NPSS can also offer choice but cannot offer different amounts of choice to different consumers – if the NPSS is the chosen model, then assuming some fund choice is offered, these results would suggest that a fund choice of 5-7 funds would be appropriate since this is the most popular option (mode) as well as being the average (mean) of the sample.

However, different branded providers can offer different degrees of choice with some providers only offering 2-4 funds for the 24% of consumers who prefer very little choice, and other providers offering 8-10 funds for the 23% of consumers who prefer more choice. The possibility for different providers to offer different degrees of choice provides an argument in favour of the industry model.

It is also important to note that despite evidence supporting a limited choice of funds, most consumers nonetheless believe that they are not confident to make this choice. For example, quantitative evidence finds that 65% of consumers are not confident about choosing a fund without formal advice.<sup>39</sup> As noted above, this is supported by the qualitative evidence as well as evidence on financial capability which finds that there are some consumers who have low levels of financial capability.<sup>40</sup>

Overall therefore we find that in terms of fund choice, there are observable differences in branded fund choice in the existing pensions market. Although pension providers are not actively attempting to communicate this to consumers, they are nonetheless following different strategies which meet the needs of consumers that value fund choice to a

39 Consumer research into personal accounts based on a sample of 769 consumer interviews. Provided by a leading financial services company.

40 Financial capability was found to be particularly poor in connection with choosing products, although it is unclear how this translates for personal accounts with auto-enrolment. Levels of Financial Capability in the UK: Results of a baseline survey, prepared for the Financial Services Authority by Personal Finance Research Centre, University of Bristol, March 2006.

greater or lesser extent. Evidence from the UK suggests that there is limited active choice being made regarding funds although evidence from a more consumer-focused approach in Sweden suggests that there is potential for considerably more. Different research reaches different conclusions on whether consumers would like to have fund choice in the personal accounts market, though there are some groups who do want choice. The possibility for a small or limited number of choices as opposed to choice from the whole market appears reasonably well received. However, it is also important to note that many consumers do not feel confident enough to exercise choice over funds.

Given that the NPSS would have a given (although as yet unspecified) number of fund choices, it is also clear that it can not meet the different needs of different consumers who have different preferences regarding the number of choices that they would like to see. By contrast, the industry model with competition between branded providers can offer different options regarding the fund choices such that those who value additional choice can choose a provider with more fund choices available. However, we note that if the number of fund choices is regulated in the personal accounts market even under an industry model then this no longer becomes a differentiating factor and the value of choice is much reduced.

## 2.5. QUALITY CERTIFICATION

The third and final role of brands is that of quality certification which is closely related to the issue of trust. The academic literature distinguishes between search goods (tangible products such as clothes where quality can be assessed in advance) and experience goods (less tangible products which have to be experienced in order to assess quality). With experience goods the role of brands is important as a signal of quality for something that can not be assessed in advance.

Personal accounts would have some elements of search goods (pricing and the number of fund choices could be disclosed in advance) and some elements of experience goods (the quality of administration will only be observed over time). Other elements have credence characteristics where the quality is difficult to ascertain even in the longer-term.

There are three elements of quality certification that are important:

- Badge of ownership – identifying the source of the product and assigning responsibility for it;
- Reduction of search costs - both internally (not having to think) and externally (not having to look around) as the reputation of the provider certifies quality; and
- Signalling – particularly important for experience goods this involves reassuring the consumer that the overall product will perform to expectations and will be worth the price paid.

Discussions with brand managers supported these views as brands were described as a “guarantee of certainty”, a “badge of origin”, a way of providing “reassurance and safety” and a “means of making the product familiar”.

Broadly speaking, all of these factors imply that consumers are able to learn which brands meet their needs and which do not. Hence based on what consumers already know about the brand, they can make assumptions and form reasonable expectations about what they may not know about the brand. In the case of personal accounts for consumers who do not have a pension and therefore have not experienced the brand, this is most likely to come from other markets in which they have observed the brand to be active such as their experience in general insurance market or in investments (potentially it could also go much wider than this to include banking and non-specifically financial services providers). Although this may not be an “ideal” way to learn about providers, according to interviews for this project this is an important factor in today’s pension market (even though intermediaries are the main source of information).

That consumers behave in this way is also supported by the experience of the Child Trust Fund where research found that half of parents who had chosen their Child Trust Fund said they made their selection based on the fact that they already had an account with them.<sup>41</sup>

In each of these cases it is important that if the product is not found to be of high quality or to live up to the expectation created by the brand, the consumer is able to observe this and then, by leaving the product, to punish the provider, thereby leading to any investment in the brand through advertising being wasted. This requires that information is revealed over time and consumers are sufficiently active to actually penalise providers.

It is important to consider what it is about the brand that provides the quality certification to consumers in pension markets and how this is linked to the brand values that pension companies have. During the course of our interviews, it was obvious that different companies had different brand values that they saw as important and that lay at the heart of their marketing strategy. For example, one firm stated that its customer research revealed that consumers found it to be “British, conservative, trustworthy, big, and good value”. Another spoke of “heritage and history, trust and stability, and good guidance”. For another firm it was “secure future, honest dialogue, simplicity, and demystify.”

Overall, however, there were a number of striking features observed including that nearly all pension firms attempt to convey safety, honesty, and expertise. Although they use slightly different language, the different firms strike quite similar themes in their brand values and hence there is little differentiation between the existing pension providers in the values they are trying to convey (especially those linked to long-term reassurance or longevity). What was also clear was that the brand values make little attempt to describe detailed product features but rather advertising and branding would be focused at the generic level of brand awareness in order to reassure customers of the existence and *continual existence* of the brand. Indeed, many of the companies make considerable use of the longevity of the company in order to convey the impression that this will continue (which is particularly important for long-term savings). However, it is important again to be cautious about assuming that personal accounts will operate in the same way as the

---

41

Saving for Children: A baseline survey at the inception of the Child Trust Fund, Personal Finance Research Centre, September 2006, HM Revenue and Customs Research Report 18.

existing pension market. The role of the intermediary means that information for consumers regarding the product is less necessary since intermediaries can examine this; instead brands today can focus on their role in reassuring the customer.

Indeed, the longevity of branding itself was also seen as surprisingly long in some cases with examples including very high proportions of individuals stating that they had seen particular advertising campaigns or sponsorship in the last month despite the fact that the advertisements had not been shown for years! This is in contrast to the evidence presented in Sweden where the impact on recognition was seen to decay quickly.<sup>42</sup>

By way of contrast, it was argued that an unknown provider would struggle to be acceptable to individuals, because of the lack of this reassurance. In addition, brand managers indicated that, even though unsophisticated consumers may be less likely to make a choice, they attach more value to the role of brands than sophisticated ones and hence that the role of brands in certifying quality was likely to be more important in the personal accounts market than in other parts of the market.

### 2.5.1. Brand awareness

To perform the role of reassuring consumers, it is only valuable if consumers are familiar with the brands. It is therefore worth considering whether consumers are actually aware of different financial services brands. If they are aware of these brands, then there may be benefits of using existing brands within the personal accounts market, rather than needing to create a totally new brand in the form of the NPSS.<sup>43</sup>

Figure 4 below provides information regarding the awareness of different brands by consumers (based on prompted awareness).<sup>44</sup> It is clear from this that there is very high brand awareness for many of the leading pension providers, although the major banks also feature highly. As expected, those companies that have traditionally focused only on sales through intermediaries such as Scottish Equitable have lower brand awareness than companies which have more direct to consumer strategies. In addition, offering multiple products is also likely to lead to increased consumer awareness e.g. general insurance products for Norwich Union.

---

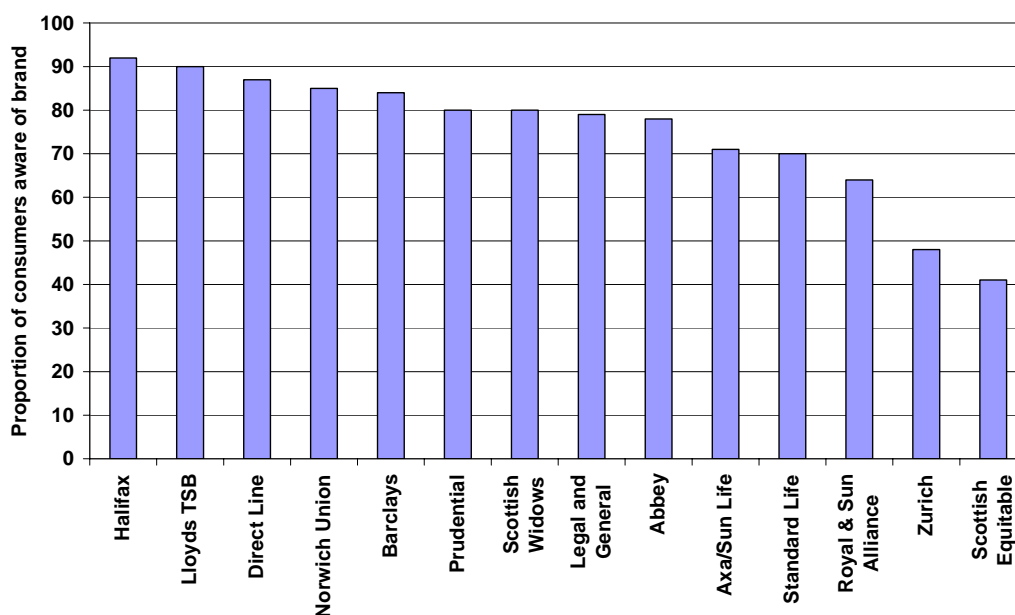
42 Cronqvist (2006). This may reflect the large number of providers competing for the consumer attention in Sweden, compared to the relatively small number of recognised brands in the UK pension market. Alternatively it may reflect the benefits of longevity in the UK pension market since some brands have been in existence for a very long time unlike all of the brands in the PPM.

43 As shown in Cronqvist (2006) the awareness of a brand is an important element in the relationship between advertising and consumer behaviour.

44 Note that this is not an exhaustive list of financial services brands but reflects those that are covered in the particular tracking study provided to CRA.



**Figure 4: Awareness of different financial services brands**

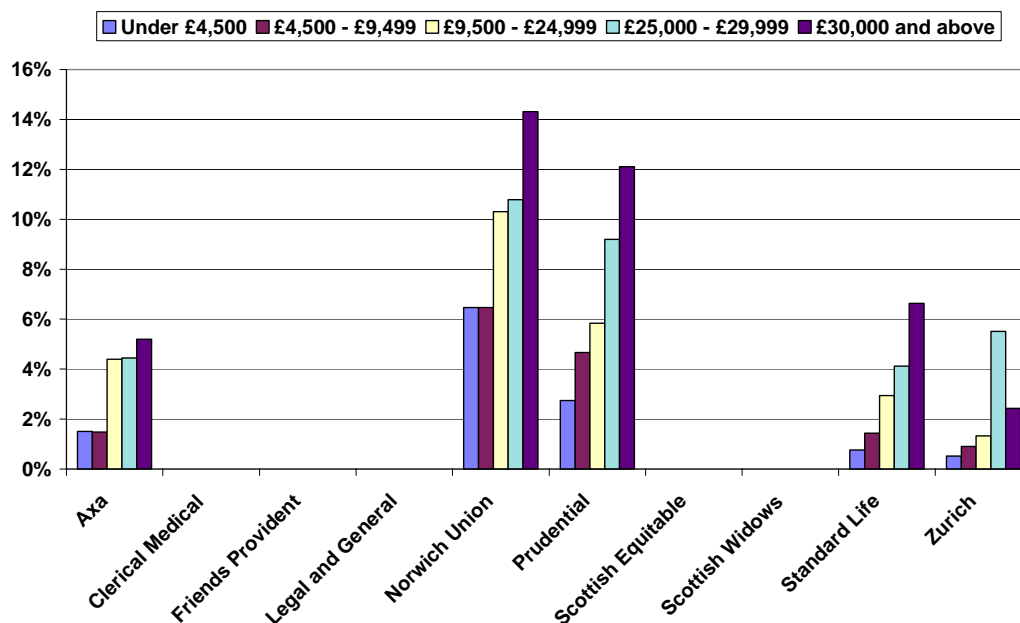


Source: TRBI Brand Tracking Study, Analyst Presentation, “Transforming Life and Driving Value” 8<sup>th</sup> October 2004.

In addition to the figure above, we also consider differences according to socio-economic characteristics of customers. Here we use a different data source and rely on “unprompted” or “spontaneous” awareness in which consumers were asked to name a financial services company rather than being asked whether they have heard of a named company (as in Figure 4 above).

Research on spontaneous awareness shows considerably lower awareness scores than prompted awareness as would be expected. Indeed, only banks and building societies have awareness figures of greater than 10%. Other than the banks or pension companies mentioned below, none of the top ten fund management companies feature at all regarding spontaneous awareness. In Figure 5 below, we provide the awareness figures for the top ten individual pension providers.

**Figure 5: Spontaneous awareness of pension providers**



Source: Ipsos-MORI for six months ending June 2006.

This finding accords with the view that lower income groups are less knowledgeable about pensions and financial services generally than higher income groups. Similar information was also available splitting the sample according to whether or not they had a pension or not. Those without pensions, unsurprisingly, had lower awareness figures.<sup>45</sup>

If the industry model is used for personal accounts and includes the ability of consumers to access a list of brands that are providing personal accounts, then the relevant set of awareness figures would be those for prompted awareness. Using the industry model then benefits from the existing high awareness among consumers of these leading brands, which would enable personal accounts to take advantage of these existing brand franchises.<sup>46</sup> Given that HM Treasury provided a list of Child Trust Fund providers on their website, we assume that at the very least something similar would be done in personal accounts, if not substantially more depending on the role of the clearing house.

However, if consumers are left to their own devices to identify providers of personal accounts, the spontaneous awareness figures suggest they would struggle to identify

<sup>45</sup> Awareness figures for those without pensions were: Axa 2%, Norwich Union 7%, Prudential 4%, Standard Life 2%, Zurich 1%.

<sup>46</sup> Whether this is of more or less benefit to low income consumers is unclear. Low income consumers have a lower unprompted awareness of existing pension providers compared to high income consumers. Although we do not have data on prompted awareness it seems likely that this result would also be the same for prompted awareness. However, it may be the case that the advantage of providing a list of brands to consumers is greater for low income consumers compared to high income consumers since they start from a lower base of unprompted awareness.

existing pension providers. Either this would lead them into the default, or it could offer the opportunity to other more well known brands such as the banks to enter the market. (Indeed since HBOS owns Clerical Medical, and Lloyds TSB owns Scottish Widows this is a very plausible approach.)

### 2.5.2. Trust

Quality certification is also often looked at in terms of trust. One of the problems identified with the financial services industry is a lack of trust with the consumer. This could potentially represent a meaningful difference between the NPSS, with a government sponsored brand and the industry model of branded financial services providers.

In our view it is difficult to draw strong conclusions from headline numbers representing trust for the Government in pensions and for financial services companies. The way the NPSS would be structured is unclear at this point and trust is likely to vary depending on whether it is seen as an agent of the Government e.g. the Child Support Agency, a contracted party e.g. the National Lottery, or backed by Government e.g. National Savings and Investments. The value of the association to Government will also work in different ways: it will provide re-assurance regarding the financial stability of the NPSS, for example no one has questioned the financial security of the Pension Protection Fund; however, private contracts may offer a re-assurance regarding whether the product terms offered today will remain in the future.

Therefore to consider trust, we have examined further the perception of financial services brands. Research has been carried out into the trustworthiness of different financial services providers. The research distinguishes Low Level Trust/Trustworthiness which relates to the extent to which an organisation can be relied upon to act on its promises and Higher Level Trust/Trustworthiness which deals with the extent to which an organisation is concerned about the interests of its customers.<sup>47</sup>

They find that consumers are “moderately trusting” of current financial services providers with the institutions scoring highly compared with non-financial institutions such as the NHS and the BBC. However, while financial institutions receive high ratings in relation to their ability/expertise, they are weakest in relation to shared values.

In addition, one concern regarding the development of personal accounts is that the financial services providers who came out with the lowest levels of trust were the life assurers i.e. those providers who currently participate in the pensions market and who are expected to be those who would participate in an industry model of personal accounts.

The same research found that trust in information received through journalism was more highly rated than that provided directly from financial institutions. In terms of personal

---

47

Research carried out by The Financial Services Research Forum, an independent body affiliated to the Nottingham University Business School which interviewed more than 1,500 people looking at what makes consumers trust financial service providers.

accounts, it is possible that if there is a movement to a new paradigm where providers communicated direct to consumers rather than through intermediaries, and if the media was involved in examining and comparing this information, then consumers may trust this source of information and hence act upon it.

## 2.6. CONCLUSIONS

In order to consider whether branded choice in the industry model allows consumers to make better decisions resulting in providers having incentives to offer better value products (static efficiency) we have looked at: the relationship between branded choice and the size of the market; whether the industry model with branded choice in providing administration or fund management is valuable; and whether brands offers quality certification in a way that the NPSS would not.

Different evidence on the particular issue of choice and take-up reaches different conclusions, although it seems clear that *too much* choice may lead to increased opt out. Having a limited choice of providers is viewed more positively than choosing from the whole market in qualitative research, and quantitative research from the industry finds that no choice of provider may lead to an increase in opt out supporting a marginal benefit regarding participation from offering a (limited) choice of providers and therefore from the industry model.

When fund choice is considered (which arises in both the industry model and the NPSS), having a large choice of funds is found to make it likely that opt out rates would increase, although the possibility of a shortlist of funds is suggested as a way to make it easier for people to choose.

We find that neither model will, in itself, result in an optimal amount of advertising to grow the market (or in this case prevent opting out), but decisions as to how much public service advertising is required in the industry model is similar to the decision faced by the NPSS regarding the amount of advertising to undertake and hence the models are equivalent on this basis.

In comparing the value of branded choice in the NPSS and the industry model we distinguish between the value of brands for customer administration and for fund management. In administration we find that information is not readily available today to distinguish between the quality of different administrators prior to purchase, nor do pension providers currently compete on this basis to gain customers. However, this is not surprising since today's market focuses on financial intermediaries. Even so, the proportion of consumers lapsing due to customer service is not dissimilar to a number of other markets suggesting it is important for retaining customers.

Different research evidence reaches different conclusions but broadly finds that offering consumers a limited choice of provider of these services would be valued by some people. Since this is stated preference information, this is not as robust as revealed preference data (which does not exist for the personal accounts market), but it does support a marginal benefit from having a choice of provider and hence for the industry model.

Examining funds we find that different pensions do have different funds available although the level of differentiation appears to vary between individual products rather than between providers for all products (providers are not clearly differentiating themselves as those who offer a small choice of funds on all products versus those who offer a wide choice on all products). There is little direct evidence that consumers value this in choosing providers and the ex post data on consumers using the freedom offered by multiple fund offerings is weak. However, Sweden's compulsory pension system, the PPM, could be taken as evidence that some consumers are willing to make branded choices and that a market that directly communicates with consumers could prompt part of the market to make active choices.

Again, looking at hypothetical information, different research reaches different conclusions on the value of fund choice although some consumers (such as younger consumers seeking ethical funds) clearly value choice. In addition, there appear to be differences between the amount of choice that different consumers want – meeting these different preferences can only be done through competing branded offerings rather than the NPSS.

Finally, we have looked at whether brands provide consumers with reassurance regarding the long-term performance of the provider. This would seem consistent with the role of brands in today's intermediary-dominated market. Prompted awareness of pension brands is high for some companies, although pension brands are less well-known in the target market than in the existing market. Information on whether consumers would trust private brands or a public sector brand more is inconclusive. It is also the case that tighter product regulation reduces the value of brands.

### 3. DYNAMIC EFFICIENCY GAINS RESULTING FROM BRANDED CHOICE

In this chapter we look at whether including branded choice in the personal account market encourages better provision over time (dynamic competition). This could take two forms: the impact on the behaviour of suppliers e.g. through incentives to innovate, or the development of more active consumers e.g. through increased financial capability resulting in consumers being better able to make decisions regarding their long-term savings.

#### 3.1. THE ROLE OF BRANDED CHOICE IN DYNAMIC COMPETITION

In most markets, the fact that consumers have a choice regarding the provider of a particular service over time brings two benefits. First, existing providers have an incentive to maintain their level of service in order to retain consumers. Second, new providers can enter the market bringing a new product, offering consumers either additional services or the same services at a lower price.

##### *The importance of reputation*

The effectiveness of choice as a mechanism to encourage providers to maintain a high level of service depends on their ability to observe the relative characteristics of the products. Only with products where the quality of the provider can be observed and compared to others over time, will consumers choose to move to rival providers if this service level is not maintained. This discussion is the flip side of whether brands are effective in terms of signalling quality. As argued in section 2.4.1, although very few consumers do lapse because of the quality of the provider, this is not dissimilar to other markets.

Indeed, the interviews undertaken for this project found that the level of customer service was not directly seen as an element of competition between providers (although the service provided to intermediaries might be) but rather service and the need to meet customer expectations reflected a desire to meet the FSA's regulatory requirements to treat customers fairly.

An additional element to consider in this analysis is whether low service standards experienced by one consumer can also be observed by others. Where this is possible the damage to the brand is significantly increased and the incentive to provide good service correspondingly higher. In many markets, the impact on the reputation of the providers is the most important mechanism, for example, the downturn (and subsequent recovery) in the fortunes of Marks and Spencer (M&S) may not have resulted from the experience of individual consumers but rather from the damage to the M&S reputation both for actual and prospective customers.

One concern in the pension market is that consumers may not be able to sufficiently differentiate between brands and that a bad experience caused by any individual provider will damage the reputation of all providers. In this case, even though consumers may still have the choice to go to another provider, they will not value this choice. In other words,

this introduces an externality into the market where consumers may believe that providers are inherently similar and therefore that the actions of any one provider would be representative of them all. For example, there was an industry wide concern regarding the impact of Equitable Life since this was believed to have damaged confidence in all pension brands.

This suggests that there is a significant down-side risk associated with multiple branded choice in the industry model. Whereas typically any poor service by a single provider would lead to a switch to other providers, in the case of personal accounts it could result in a higher level of opting out. However, this will be mitigated either if the product design is tightly regulated (as expected) or if consumers are able to more clearly differentiate between providers (due to providers having to market directly to them rather than through intermediaries).

#### *Entry of new branded competitors*

The incentive for existing providers to continue offering high quality products to retain customers is not the only means by which branded choice leads to dynamic competition. In many markets there are examples where a new branded provider has entered the market and fundamentally changed the basis of competition. Examples of this include the impact of FirstDirect on the current account market by opening up telephone distribution, Dyson in the vacuum cleaner market, and Body Shop in the cosmetic market. By understanding the needs of a part of the target market or by bringing an innovative product to market, they have been able to change the market.

There are a number of reasons to be sceptical about the value of brands as a vehicle for encouraging such innovation in the market for personal accounts:

- There has not been significant entry into the personal pension market where there are more sophisticated consumers (or sophisticated intermediaries) and more freedom to innovate. Non-traditional brands entering the personal pensions market (such as Virgin) have found only moderate success in comparison to traditional providers (even though they have attempted to market directly to prospective consumers);
- Personal accounts may be highly prescribed by the Government with less freedom than personal pensions (either due to regulation or the economics of a product with a low level of charges) meaning that the rewards to innovation are likely to be small;
- If competition worked well at encouraging and maintaining standards, initiatives such as the ABI's Raising Standards and the FSA's Treating Customers Fairly would not have been necessary. If a regulatory solution is required, this can be equally applied to the NPSS as to a branded provider in the industry model; and
- Where innovation does take place in the personal pension or group market, this can be incorporated into the offering of the NPSS at a later stage. That is, the market outside of personal accounts can be monitored and successful innovation integrated. Indeed, looking at international evidence regarding innovation we find that the US's

Thrift Saving Plan has introduced efforts to monitor the largest private sector pension providers in order to keep up with industry trends.<sup>48</sup>

### *New dynamics of competition*

It is important to be cautious about assuming that the personal account market will work in the same way as today's individual or private pension market. As explained earlier, branding in the existing market is intended to provide a context of familiarity and reassurance for the consumer. The role of the intermediary is central, and the business model is constructed around it. Branding and marketing is therefore usually intended to complement the role of the adviser and to work in conjunction with it. Similarly, regulation has been constructed around the issues of suitability and best advice to ensure that intermediaries make appropriate recommendations to consumers.

The advent of auto-enrolment is expected to eliminate the role of the intermediary in the personal account market. An important question is whether new mechanisms will therefore arise that provide information enabling informed choice (in the absence of intermediaries).

In our interviews with pension providers we asked how branding and marketing would change in the context of the industry model in personal accounts. Most providers were very aware of the challenges that would result from the elimination of the adviser in this new environment, and acknowledged that much would change. A number of themes emerged in these discussions:

- The industry would no longer be selling "through" the intermediary but "directly" to the consumer. This was seen as an opportunity to innovate in a fundamental way that could result in favourable outcomes for both provider and consumer. This could be through direct marketing or innovative uses of retail networks;
- Providers would have an incentive to fill the information gap that arose. This would be achieved through innovative marketing approaches involving direct mail and other targeted marketing vehicles; and
- The role that the press and other media could play in filling the gap was highlighted in a number of discussions. Research into the importance of trust showed that information received through journalism was more highly rated than that provided directly from financial institutions. Of course, the role of the media to fill in the information gap could also be used in the NPSS model and therefore is a positive outcome of both models. However, the competitive incentive to discover the best means of providing information is only found in the industry model.

---

48 Federal Thrift Savings Plan: Customer Service Practices Adopted by Private Sector Plan Managers Should Be Considered, GAO-05-38. As well as illustrating how a public sector body can exploit innovation from a private market, this does illustrate that there will be a delay in bringing innovation to market as successful innovations need to be identified before change can occur. It also shows that without the incentives introduced by competition, external assessment and monitoring will be required to encourage this to happen along with the associated costs.



In the NPSS model, the burden of consumer education would fall upon the government as companies have no incentive to participate in the promotion of personal accounts and indeed pension providers may have greater incentive to promote the importance of advisers. By contrast, in the industry model (with sufficient incentive), the combined power of the marketing departments of pension providers would be aimed at discovering the most effective way to use this new customer-focused approach.<sup>49</sup>

### **3.2. VALUE OF BRANDS IN CONSUMER EDUCATION**

A further issue regarding dynamic competition is the extent to which consumers can learn about a product over the course of time. In particular, it may be the case that going through the process of purchasing a personal account leads to consumers understanding more about the various characteristics of personal accounts over a number of years. This may then cause them to be more active consumers over time even though they may not have been especially active when they first obtained or were defaulted into a personal account. Hence, it is important to assess whether allowing branded choice today will mean that consumers will be in a better position to make choices in the future. In this context, it is particularly important whether this leads to changes in the way consumers purchase personal accounts, but it could also affect the way they purchase other financial services products throughout their lives.

The ability of consumers to make informed choices is an area where there has been significant regulatory attention. It is well recognised that many of today's consumers are not equipped to cope with the complexity of choosing financial services products.<sup>50</sup> This has been one of the prime reasons why consumers need financial advice which in turn has resulted in products that are too expensive to serve the target market (one of the primary justifications for the development of personal accounts in the first place).

#### **3.2.1. Impact of products on financial capability**

We first consider whether there is any evidence that having financial products leads to learning about products. Research for the FSA found that:

- the number of products bought personally in the last five years is particularly important in explaining capability in the “choosing products” domain, suggesting that people may learn from experience;
- people who had recently bought either of the two most complex products they investigated (investments and mortgages) scored considerably higher in the

---

<sup>49</sup> Note that this form of marketing is different to the advertising described in section 2.3 regarding advertising the availability of personal accounts where the industry model and the NPSS were found to be equivalent once public service information was taken into account.

<sup>50</sup> This is clearly the case in the UK, as evidenced by the FSA baseline on financial capability, it is also the case in the US where financial literacy levels are very low, see for example Financial Literacy and Planning: Implications for Retirement Wellbeing, Lusardi and Mitchel, 2006, which presents evidence for the US.

“choosing products” domain than those taking up a relatively simple current account; and

- both the number of products bought in the last five years and the number of products where the consumer had been active in the purchase were independently important in determining the capability of the consumer. This implies that even where consumers were not active in purchasing the product, having a product still increases their ability to choose products in the future. Indeed the report notes that the significance of the number of products bought in determining capability in “choosing products” is evidence that people learn from experience.<sup>51</sup>

However, the causation of results is unclear since it is not known whether having more products cause financial capability or whether financial capability enables consumers to purchase more products.

### 3.2.2. Impact of default arrangements on learning

There is very strong evidence that default arrangements can have a substantial impact on the outcomes for consumers. For example, where default contribution rates were included in US 401k schemes, the proportion of participants choosing these rates increased from between 11% and 20% to between 42% and 71% (the ranges refer to different company schemes examined).<sup>52</sup>

Given this framing effect it is important to consider whether consumers who have been “defaulted in” would exhibit any learning over time or whether they would simply remain with their default arrangements. There is no direct evidence on this that would apply to the industry models in personal accounts since the majority of evidence relates to employer-based pensions and hence consumers do not have a choice over the provider of the pension but only have choices over contribution rates and funds. It would therefore be useful to gather additional information in this area.<sup>53</sup>

---

51 Levels of Financial Capability in the UK: Results of a baseline survey, prepared for the Financial Services Authority by Personal Finance Research Centre, University of Bristol, March 2006.

52 Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance, Choi, Laibson, Madrian, and Metrick, November 2001.

53 We note that identifying evidence of “learning” in existing pension schemes is not straightforward since it is not clear what that evidence would be. It is possible that switching funds could represent evidence of learning since it represents actions by the consumer. However, where there is auto-enrolment the characteristics of the default fund, as well as the risk preferences of the consumer, are likely to influence whether such switching is good or bad. The evidence from Choi et al finds very high switching away from the default funds when the default fund is a money market fund or a stable value fund and that this increases over time which could represent evidence of learning over time by those who do not switch immediately.

### 3.2.3. Examples from other markets

Since looking at a cross-section of consumers is problematic, it is useful to look instead at how markets evolve over time. Indeed, over the last ten years we have seen a number of markets change dramatically. Two useful analogies to consider are the market for mortgages and the market for current accounts. These markets have interesting characteristics for personal account because:

- There is often no question about the need for a mortgage, i.e. suitability is not generally in doubt, the issue is which provider and product type is required; and
- Many consumers will choose the provider of their current account early in their lives potentially with limited search activity (relatively similar to being defaulted into a personal account), however, they are then free to change provider over time.

#### *Mortgages*

In the market for mortgages we see that the market has changed fundamentally over the last decade with many more people reviewing their mortgage provider in order to check whether there is a better product on the market.

Over recent years the scale of re-mortgaging in the UK has risen from 9.2% of the stock of mortgages in 2001 to 16.7% in the twelve months to the end of August 2003.<sup>54</sup> In addition, the form of advertising has changed with many more adverts describing the terms of the product and providers competing to offer consumers products that they understand and that will remain competitive over time.

The degree of competition in the mortgage market and the focus on discounted prices is demonstrated in the analysis by David Miles. There appears little dispute at the moment regarding the intensity of competition in the UK mortgage market, although there are some doubts whether the focus on variable rates results in an optimal outcome for the UK's mortgage consumer.<sup>55</sup>

It is also interesting to compare the proportion of individuals who purchased their mortgage direct from a mortgage company as opposed to an intermediary and how this changes due to experience.

---

54 "The UK Mortgage Market: Taking a Longer-Term View" Interim Report, Information, Incentives and Pricing, David Miles December 2003.

55 'Incentives, Information and Efficiency in the UK Mortgage Market' by David Miles of Morgan Stanley and Imperial College London is published in the March 2005 Economic Journal. In the view of Miles, the UK market focus on discounted variable rate mortgages is inferior to a market which used fixed rates mortgages to mitigate the risk of interest rate changes.

**Table 7: Distribution by type of mortgage**

	First time buyer	Mover
Advice and a recommendation as to which mortgage was most suitable for me	49%	33%
Information on different types of mortgage product, but I made the choice	41%	58%
Information on a single product only	6%	9%
Don't know / not sure	4%	-

Source: Mortgage Code Compliance Board, Consumer Research Report 2003 as cited in The UK Mortgage Market: Taking a Longer-Term View, David Miles March 2004.

Table 7 above compares the proportion of people taking advice depending on whether they are a first time buyer or a mover. It is clear from the figures that the proportion taking advice falls from 49% to 33% for first-time buyers to movers whereas those gaining information on different types of increases from 41% for first time buyers to 58% for movers. Furthermore, there were no movers who didn't know how they got their mortgage, whereas 4% of first time buyers were unsure of how they did so. This evidence is consistent with a view that having a product leads to consumers learning about the product over time and to them being more confident in making the choice over the product type that best suits their needs.

The use of the mortgage market appears a useful analogy for thinking how the personal account market could possibly develop, although it is not perfect:

- Mortgages are generally seen as more "straightforward" than pension products;
- Switching a mortgage provides an immediate short term gain in the form of a lower monthly payment, whereas the gain from switching a pension arises over time and the benefits are only received at retirement;
- Moving occurs relatively frequently which gives an opportunity to learn by doing as mortgages must be re-examined, whereas with a portable personal account there may not be this need to review (although this depends on the process by which the consumer remains with the personal account following a job change); and
- Those exploiting better mortgage deals, may not be the same consumers that will be in the target market for personal accounts.

These issues illustrate the difficulty of providing direct evidence to address the likely development of a market that does not yet exist.

### *Current accounts*

In the market for current accounts (which are used by the great majority of the population) we see that this is a market that has traditionally seen relatively little switching and arguably poor value products offering low returns to consumers. Over the last ten years,

however, we have seen the entry of a variety of new competitors, changes in distribution channels and a significant increase in the level of customer switching. For example, in 1999, only around 460,000 customers switched current accounts whereas this increased to 920,000 in 2003 although this still only corresponds to an increase in the switching rate from around 1% to 2%.<sup>56</sup>

### *Implications for personal accounts*

In the personal accounts market evidence of learning over time would suggest that even if consumers end up in the default path when they first obtain a personal account, they may be more confident in making an active choice at a later date. In the industry model, this could mean making a different choice of administrator or a different fund choice; in the NPSS the choice would only be available over funds (where there is less evidence of learning arising).

Another important issue for personal accounts is the amount of switching that is required in the market. In both the mortgage and the current account market, although the level of switching has risen dramatically, it is not the case that all consumers have become sensitive to terms and prices on offer. Nonetheless, in many markets, consumers that do not switch are protected by those consumers that do switch. That is, for a market to work effectively there needs to be a group of active consumers searching the market, that is sufficiently large that the action of this subgroup brings a competitive constraint on the whole market; it is not necessary that all consumers need to switch.<sup>57</sup>

The mortgage market again provides a useful example here. In the past, a number of providers reacted to the increasing competitive terms of the mortgage market by offering better terms for new customers than they were offering for their existing customers. However, as re-mortgaging increased and because of the danger to their reputation many providers subsequently re-priced their back book effectively bringing existing customers in line with the product terms being offered to new consumers.<sup>58</sup>

This implies that a requirement for the model relying on branded choice is that there is some degree of consumer activity and enough information that it is not possible for providers simply to offer this group of customers a better deal without offering these terms of the rest of the market. For example, it is not possible for Tesco to offer better terms only to the consumers who actively compare Tesco's prices to those of Sainsbury. In the

---

<sup>56</sup> This was partly linked to the development of the Banking Code and figures are cited from the Study of Competition in non-Investment Banking Services in Ireland: Report and Recommendations, November 2004.

<sup>57</sup> It is beyond the scope of this project to estimate the proportion of consumers that need to switch to encourage price competition across the market. This requires an understanding of how the value of a customer is related to their sensitivity to price, the degree to which the market is segmented and the ability of providers to price discriminate.

<sup>58</sup> Retail Investors' Seminar held by HBOS 16 December 2003 [http://www.hbosplc.com/investors/includes/HBOS\\_16-12-03\\_Transcript\\_Retail\\_Seminar.doc](http://www.hbosplc.com/investors/includes/HBOS_16-12-03_Transcript_Retail_Seminar.doc)

personal accounts market, this is likely to arise simply through ensuring that providers offer a single pricing mechanism as opposed to allowing discounts for new customers.

It is also clear that consumers draw evidence from consumption in one market to those in another market. Interview evidence suggests that consumers do consider their experience from general insurance products (such as car insurance and home insurance) when considering who they would accept as a provider of their pension. As already noted, similar behaviour has also been observed in the Child Trust Fund market. Hence they learn from their experience in other product markets when making decisions in new product markets. To the extent that this connection exists it appears to run from short-term experience goods such as motor and home insurance, where consumers have direct evidence regarding claims etc, to long-term experience goods, such as pensions.<sup>59</sup>

### 3.3. CONCLUSIONS

Looking at dynamic efficiency we have considered whether providers have appropriate incentives to provide better value over time (dynamic competition) and whether the role of consumers might change (through increased capability) resulting from the model chosen.

There are a number of reasons to be sceptical regarding the impact of supply side dynamic competition. There is limited evidence suggesting that consumers are sufficiently able to clearly differentiate between different branded pension providers if there are major concerns with pensions such as seen with the Equitable Life. In addition, there has been little evidence of new entrants in the existing pensions market. Moreover, any innovation in the pensions market generally is likely to arise outside the personal accounts market where returns to innovation are potentially greater, and the example of the Thrift Savings Plan in the US demonstrates that such innovations can be brought into personal accounts regardless of the model.

The existing market is an intermediated market and it is an open question as to whether a movement to a "direct-to-consumer" market could radically change the competitive nature of personal accounts through providers communicating directly with the end-consumer. This is an option that is most likely to occur in the industry model where competing brands undertake differentiated marketing strategies.

Nonetheless, there is good evidence of financial services markets developing over time and becoming more competitive, suggesting that it is important to be cautious in assuming that markets currently lacking vigorous competition from active consumers will remain the same in the future. Ten years ago, the presumption would have been that once a consumer chose a mortgage provider and a current account, they were likely to

---

59

Providers also see the cross-sale of products as valuable and have invested significantly in this area. However, the relative difficulty of cross-sale in financial services is demonstrated through the experience of banks having to invest in insurance brands to compete in the pensions market (although this is also likely to reflect intermediary preferences). Given that the branding seems to flow from short-term goods to long-term goods and not vice-versa this suggests that the value of cross-sale from personal accounts is likely to be relatively small.

stay with those providers until provoked by an external event such as buying a new house. However, both of these markets have undergone significant change.

In both banking and mortgages, there has been considerable marketing activity to encourage consumers to re-mortgage or compare current account offerings resulting in competition on prices and also service – in terms of the availability of branch networks or being able to talk to a customer service representative rather than an automated service. In addition, the actions of a proportion of active customers have resulted in better terms for all customers.

Furthermore, consumers who purchase financial products do appear to become more capable of making later choices (although decisions regarding pensions may continue to be fairly intermittent and hence have relatively small learning by doing opportunities). However, in the target market, this is likely to be a relatively slow process.

The industry model and the associated branded choice therefore has an option value attached to it since even if initially consumers do not make informed choice regarding branded provision, this value may emerge over time.

## 4. THE COST OF BRANDED CHOICE

If there were no benefits associated with branded choice, we would not need to consider the costs associated to providing such choice. However, given the potential for benefits identified in previous chapters we need to consider whether these are likely to be offset by costs. These costs could take a number of forms:

- An inefficient or high level of advertising expenditure arising from multiple brands;
- Costs associated with consumers making ill-informed decisions; and
- Costs associated with processing additional information and higher search costs.

### 4.1. THE LIKELY LEVEL OF MARKETING TO SUPPORT RIVAL BRANDS

Identifying the types of products that see substantial amounts of advertising is an area that has attracted much academic research. Advertising is generally found to be low for “search” goods. These are products whose characteristics can be objectively identified and any advertising focuses on informational advertising i.e. letting consumers know about new features or where the products are available. Equally, advertising is low where the experience of the good provides little information regarding its quality (i.e. credence goods). By contrast, advertising is higher where they are experience goods and the quality of the product is revealed over time.<sup>60</sup> Long-term saving products, where quality is difficult to determine even over the longer term are thought to be closer to credence goods suggesting advertising will be low.

Data on aggregate spending on advertising in the UK shows that none of the top 50 advertisers in the UK were financial services companies (let alone pension providers) in 2004. Instead, the top 50 is predominantly made up of consumer goods companies (healthcare, cars, food items, telecommunications, furniture, supermarkets).<sup>61</sup> This provides some support for the view that we would not expect to see excessive advertising in the personal account market since we do not observe it in the current pension market.

Indeed, this view was supported by interviews with pension providers from whom, we sought information on marketing and branding spend. Although firms were wary about revealing commercial information, they gave some indication of their spending, and this usually did not exceed £1-2 million with most firms not using television advertising (generally a more expensive form of advertising). The ratio of spending on distribution compared to expenditure on advertising for branding purposes was said to be as great as 25:1 (we consider below whether a new model of distribution that excludes intermediaries could lead to this money being spent on advertising).

---

<sup>60</sup> This literature is summarised in the Foundations of Corporate Success, John Kay 1995.

<sup>61</sup> Marketing Pocket Book 2006 based on Nielsen Media Research 2005. Note that this reflects brands rather than consolidated groups.



Evidence from the development of the stakeholder pension market (at which stage some providers saw the stakeholder market as a commercial opportunity) is potentially relevant in order to understand the extent to which firms are likely to spend money on advertising in the early development of the personal accounts market. This again supports the view that advertising would be expected to be reasonably modest:

- Stakeholder pensions were launched in 2001 and the majority of companies interviewed stated that they had spent less than £1 million on advertising during the launch year (although this may not include more general brand based advertising);
- There was one notable exception highlighted by many of the interviewees which was Norwich Union. They were highlighted as having spent considerably more money on stakeholder pension advertising in 2001 than any of the other pension providers. This was also associated with an increase in their market share.
- Advertising covering all types of specific pension products or pensions generally totalled only £3.7 million for the whole industry for the year ending March 2006.<sup>62</sup>

Looking at the amount of advertising undertaken by different companies it is interesting to note that this does not appear to be strongly related to the number of products offered. That is, advertising appears to be similar for marketing a large range of products as for a small range. For example, the advertising of ING focusing only on savings products is similar to Abbey or Lloyds TSB across their portfolio. This suggests there is a minimum level necessary to maintain name recognition and familiarity. Therefore the incremental cost of advertising an additional product such as personal accounts would be expected to be relatively small.

Indeed, the great majority of brand managers that we interviewed agreed that most of the advertising that they undertake relates to generic brand awareness rather than product specific information and hence this overall level of advertising would not be expected to change simply through the addition of the personal accounts product.

However, one caution that needs to be noted is that the market for personal accounts could be substantially different to today's personal pension market in that it may focus on direct to consumer advertising. It is also possible that problems associated to personal pensions (where a lack of price competition was seen to result in unnecessary differentiation between providers as they competed over intermediaries) could also result

---

<sup>62</sup> Nielsen Media Research, 1<sup>st</sup> Quarter 2006, Digest of UK Advertising Expenditure. Note that the aggregate statistics includes all categories under pensions except for annuities, advice and intermediaries. It includes AVC pensions, company pensions, general pensions, SIPPS, and stakeholder pensions. Figures also found that advertising specifically on stakeholder pensions was only £12,000 for the year ending March 2006. However, given the importance of intermediated sales and the current debate regarding the future of pensions, this is not surprising.

in the personal accounts market. Indeed, this was one of the justifications for the subsequent introduction of stakeholder pensions along with a price cap.<sup>63</sup>

In the interviews with pension providers we also examined how they might market their personal accounts. Although their plans were still developing and much depended on the details of the scheme, it is clear that they were looking for innovative and cost effective ways to meet consumers through their employer or direct marketing. There was a universal view that large scale advertising through press and television would not be economic to undertake.

One of the few analogies available to look at is the situation in Sweden. In this case, the new pension system allowed free entry of funds which (amongst other factors) competed through advertising. Recent analysis has looked at the relationship between advertising and consumer behaviour.<sup>64</sup> This found that in the two years leading up to the pension reforms, firms spent \$94 million on advertising with advertisements in print media, such as newspaper ads, and television commercials accounting for about 90% of the advertising expenditures compared to total contributions of approximately \$5.6 billion. The level of expenditure fell significantly after the introduction of the scheme as did the numbers making active choices suggesting that competing brands can lead to consumers making more choices.<sup>65</sup>

It could therefore be argued that providers in the personal account market will also have an incentive to differentiate their products and instead of focusing on competing for intermediaries, they would focus on consumer advertising. In this case, advertising rather than the level of commission paid would be constrained by the price cap (assuming that one is applied to this market). Indeed, the expectation of a price cap for personal accounts is likely to explain the apparent contradiction between the Swedish findings where there was considerable advertising, and the UK findings where, in the case of stakeholder pensions there was limited advertising, and in the case of personal accounts it is expected to be limited.

If differentiation in product terms are such that consumers can and do compare products, and once price becomes a determinant of choice, advertising would be constrained by market forces rather than the need for a price cap. In the interim, however, it is anticipated that the personal account market will have a price cap (since consumers are not expected to be choosing on the basis on price at the start of the market) and therefore

---

63 The concern that a lack of price competition leads to unnecessary product differentiation to the benefit of intermediaries rather than consumers is covered in the Sandler Report. However, we note that this is of less concern in the personal accounts market since auto-enrolment removes the intermediary.

64 Advertising and Portfolio Choice, Cronqvist, July 2006.

65 We note that there are other explanations including that there are a much smaller number of first time choosers now that the PPM has been established and these are predominantly young and on lower incomes.

the level of the price cap itself will be an important determinant of how much firms can afford to spend on marketing.<sup>66</sup>

In summary, historic advertising expenditure on stakeholder and other personal pensions has been seen to be modest, both absolutely and in comparison with other industries. With advertising focused on generic brand awareness rather than products, it seems that considerable additional spend is unlikely for an additional product such as personal accounts. However, the personal account market could represent a paradigm change, with increased focus on consumer advertising. Without price competition, this could result in excessive advertising and hence the level of the price cap will be an important determinant of this. Indeed, it could be argued that decisions regarding the level of the price cap and choosing the level of advertising within the NPSS are similar. However, if competition emerges in the industry model (as discussed in the previous chapter) issues regarding excessive advertising are diminished.

#### 4.2. COST ASSOCIATED WITH CONSUMERS MAKING ILL-INFORMED DECISIONS

One potential problem associated with branded choice is the social cost of consumers making ill-informed or wrong decisions about their personal accounts. In the part of the market that is currently advised today, this risk is mitigated by the intermediary, but this role is not expected to arise with auto-enrolment.

Whether the risk of making bad decisions is significant depends on the degree of differentiation between choices. On the provider or administrator side, if there is no real differentiation in administrative services or in terms of access to fund choices then there is little downside risk. However, if there is little differentiation there is also limited value to choice.

If the belief is that providers' offerings are significantly differentiated, then the problem is more complicated. In this case, the genuine risk of ill-informed decisions must be weighed against consumers' desire for choice, their ability to become more knowledgeable over time, and the ingenuity of the pension industry in filling, at low cost, the "information gap" arising from the absent intermediary. Regulations regarding the default option would also serve as a safety net for consumers who are unable to exercise choice effectively.

On the decision regarding fund choice, it is clear that differentiation exists in both models and will arise as different funds offer different asset allocations. Hence one risk is that consumers choose a fund that does not have the potential for higher returns over the long run because of the high weighting that they place on downside risk. This is sometimes known as "excessive conservatism" and leads to consumers investing in low risk instruments for long term products. There is strong evidence that this does in fact arise.

---

66

If there are a limited number of participants in the market and as competition is repeated over time the level of advertising could reduce over time. However, although this might prevent excessive advertising, without competition over consumers, these savings would not be passed onto consumers.

For example in the US, evidence from 401(k) provision finds that some 28% of individuals in their 20s have no equity funds held in their pension.<sup>67</sup> This is also supported by evidence from Sweden where around 12% of men and 15% of women who are first time choosers (and hence likely to be relatively young) have 0% of their portfolio in shares.<sup>68</sup> Similarly, Thaler and Benartzi find that losses weigh more significantly than gains with estimates of loss aversion suggesting that the cost of losses is around twice the benefit of gains.<sup>69</sup>

Similarly, fund choices, as with other choices, are influenced by framing effects i.e. the decisions made depend on the options presented. For example, research finds that TWA pilots offered five equity funds and one fixed income fund, chose on average to invest 75% in equities. University of California employees offered one equity fund and four fixed income funds chose 34% equity investment.<sup>70</sup> Other examples include dividing investments equally across available funds.

We note that all of these issues described above regarding the potential to make poor fund choices will apply to both the industry model and the NPSS. They therefore demonstrate the importance of how fund choices are described in any model for personal accounts.

In addition, evidence from Sweden finds that advertising is more likely to be undertaken for actively managed equity funds. This shows that advertising is likely to affect the decision regarding the allocation of funds, resulting in consumers investing in riskier funds with higher fees (although this can be partly offset by higher service offerings of these funds) than would otherwise be the case.<sup>71</sup> The problem identified in Sweden, is that providers are incentivised to market to consumers (as this is found to be effective in gaining market share) and focusing on actively managed equity products where fees are greater. Depending on the structure of any price constraint (assuming there is one) used in the personal account market, this incentive may not exist in this market, but if this incentive does arise, it will be of greater concern in the industry model than in the NPSS.

The final issue regarding fund choice is the extent to which there may be an over-reliance on past performance figures which could lead to excessive switching. The issue of consumers making decisions on past performance arises in all investment based markets and personal accounts are no different in this regard. It would therefore seem appropriate

---

67 401 (k) Plan Asset Allocation, Accounts Balances and Loan Activity, Investment Company Institute Perspective, January 1999. Although it is unclear whether these people that have actively chosen or is this the result of very conservative defaults.

68 PPM Difficult Waters, Extended Summary in English.

69 Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving, Thaler and Benartzi, 2001.

70 Naïve Diversification Strategies in Defined Contribution Saving Plans, The American Economic Review, Thaler and Benartzi, March 2001, Vol. 91. No. 1, pp79-98.

71 Advertising and Portfolio Choice. H. Cronqvist, July 2006.

if the restrictions placed on the presentation of past performance figures that are found in other markets were also used in the personal accounts market. An alternative approach that could be used if there was a concern regarding excessive switching could be to limit the number of switches that consumers are able to make. However, since the primary concern in the personal accounts market seems to be insufficiently active consumers rather than excessively active consumers, this would not appear an appropriate strategy. Furthermore any potential costs from allowing switching may be worth incurring in order to build a more active customer base over time.

#### **4.3. COST ASSOCIATED WITH PROCESSING ADDITIONAL INFORMATION AND HIGHER SEARCH COSTS**

Choosing between rival brands increases the amount of information that needs to be collected and makes the resulting decisions more difficult. This may lead to significant search costs falling directly on the consumer. While some consumers will feel this is a worthwhile investment to achieve a superior result, others may feel the cost is too high. Consumer research indicates that both these kinds of consumer are present in the target group. Perhaps the simplest solution for those who choose not to incur search costs is the provision of the default fund. If this is constructed in such a way as to provide a safe and generally suitable product for such customers then they will not need to incur search costs in order to assess this. By contrast, those who truly value choice should not balk at incurring search costs in order that they can exercise this choice.

Therefore concerns regarding the distributional effects of offering a choice may be overstated e.g. the concern that choice imposes a cost on the majority (who will probably be at the lower end of the income distribution) for the benefit of the minority (that will probably be at the higher end of the income distribution) who are likely to use it.

However, there is a danger in encouraging choice without product differentiation. Although the perception of choice could increase consumer confidence (for a group of consumers at least), if consumers realise that their efforts make little difference to the outcome they may be both aggrieved at having invested this effort in the first place and also reluctant to undertake search in the future.

#### **4.4. CONCLUSIONS**

Given that the industry model would include a number of different branded providers and would therefore require advertising, it is important to consider whether this imposes significant additional costs compared to the NPSS. In fact we find the risk that the industry model will result in excessive advertising appears relatively small.

First, much of advertising is at the brand rather than the product level, so adding a new product is unlikely to result in large incremental expenditure. Second, the existing market for personal pensions has relatively limited advertising. Indeed, the experience of stakeholder pensions does not suggest that such advertising as arose there could be considered excessive. This reflects both that the market is largely intermediated and that there is a price cap. Therefore, if, as is reasonable to assume, there is a constraint on

pricing in the personal account market it is unlikely that there will be excessive advertising.

Costs may also arise due to the impact on consumer behaviour. It appears that the cost of making poor decisions regarding the branded administrator seems likely to be small. The detriment from poor decisions is a much greater risk regarding fund choice (and will therefore be present in both the industry model and the NPSS). The role of the default fund can be used to mitigate the risk of this as well as to limit the search costs for those consumers who do not value choice.

However, there is evidence that fund choices are influenced by framing effects i.e. the decisions made depend on the options presented. There is also evidence of “excessive conservatism” where consumers invest in low risk instruments for long term products. These issues impact both the industry model and the NPSS.

Furthermore, concerns remain regarding the role of advertising in encouraging consumers to select funds with higher risk and higher fees (although this could potentially overcome the excessive conservatism that some consumers would otherwise exhibit). This needs to be taken into account when considering any price cap, assuming that one is used.

The most significant issue for the industry model is the potential for personal accounts to focus on direct to consumer advertising. While this could bring dynamic benefits to the market as discussed in the previous chapter, it may also lead to additional costs being incurred. Whether this represents a problem depends on the degree of product differentiation allowed in the market and the degree to which charges are constrained by some form of price cap. If limited differentiation is allowed then there will be limited costs although the benefits from this differentiation would also be small.

# Hard Facts Clear Focus

The Right Decision Matters



INTERNATIONAL

EUROPE & THE MIDDLE EAST NORTH AMERICA ASIA PACIFIC

1 Undershaft  
London  
EC3A 8EE  
UK

T: +44 (0)20 7664 3700  
F: +44 (0)20 7664 3998

[www.crai.com](http://www.crai.com)