

Building personal accounts

Choosing a charging structure

Pensions Reform 5

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Introduction

The Personal Accounts Delivery Authority (PADA) will be responsible for overseeing the establishment of personal accounts. It's also advising the government on aspects of scheme design and plans to issue a number of consultation papers. The first of these, published in January, is on the vitally important topic of choosing the charging structure for personal accounts. The chosen charging structure will affect retirement outcomes for members, how the scheme is funded and its ability to cope with business risks.

The main points

- The consultation is about the structure, not the level, of charges.
- The level(s) will be decided later, once PADA has chosen who'll provide administration and investment services within the scheme.
- Government has already concluded that no single structure is ideal, and that trade-offs are inevitable.
- Four structures are considered – an annual management charge (AMC), a contribution charge, a joining fee, and a contribution charge with an AMC.
- For each structure, PADA considers the retirement outcomes for members, what it might mean for participation rates, and how sustainable it is in terms of funding and coping with business risks.

Pensions reform

Personal accounts are one element of a package of state and private pension reforms which are due to go live by 2012. They're being designed to help low to medium-earning employees, who don't have access to a good quality employer-sponsored pension, save for their retirement.

The overall aim is to get more people saving more for retirement, whether through good existing schemes or personal accounts. Come 2012, all employees aged between 22 and state pension age, earning above £5,035 and who aren't already members of a good quality scheme, will be automatically enrolled into either an existing workplace scheme or into personal accounts. Individuals will be able to 'opt out' again.

Specific considerations for personal accounts charges

While personal accounts will be similar to other forms of defined contribution pension schemes, they're also different in a number of ways, which impacts on the design of the charging structure. First, there'll be no advice to members. Compared with other forms of pension, this means overall costs will be lower and, in particular, there are lower upfront costs.



The default contribution will be 8% of total earnings between £5,035 and £33,500, which is likely to be lower than the average contribution into other forms of workplace pension. While individuals (or employers) can choose to pay more, there'll be a limit of £3,600 each year. All these limits will be revalued in line with earnings inflation.

How long members remain contributing within a pension can have a big impact on whether the provider can cover its costs. It's difficult to assess how personal accounts' 'persistency' will compare with other forms of pension. An individual can remain in the personal accounts scheme on changing employers, or be auto-enrolled every three years, which should help. On the other hand, many won't make an active choice to join but will be auto-enrolled. We may find such individuals are less convinced of the benefits of continuing to save and might suspend or stop contributions whenever they suffer a temporary drop in disposable income (for example Christmas).

The evaluation criteria

The government wants personal accounts to be self-financing, without requiring any tax subsidy. As a result, PADA needs to think carefully not just about the outcomes for members, but also about funding issues in both the short and long term, and how to minimise all the business risks to which it will be exposed. Each charging structure is assessed against three sets of criteria.

Retirement outcomes for members

Here, PADA considers both the distribution of outcomes within generations and also between generations. PADA assumes that the fairest distribution between members is that the deduction from each member's retirement pot to cover all charges is the same percentage. This is open to challenge. It could be argued that the fairest outcome is one where the deduction any member attracts is broadly in line with the costs they incur while a member.

Participation

The big concern here is member perceptions. In particular, might certain charging structures discourage potential members from joining? Clearly, this needs to be considered, just as it is within any other form of product. A large joining fee is likely to put some individuals off. But we need to keep this in perspective. Most individuals will join through auto-enrolment and may give very little consideration to the finer details of charges. They're more likely to consider the 'cost' of their pension as the 5% of pay being deducted from their gross salary, not the small contribution and/or fund management charge.

PADA carried out some consumer research which showed a preference for a single charging structure. This may look inherently simpler, but consumers are more than accepting of dual charging structures in many other fields, from utilities to mobile phone packages.

Sustainability

Here, PADA is testing each structure against three sub-criteria – how well does it perform in terms of offering a viable funding solution, does it help minimise scheme costs (primarily in terms of administration costs to collect charges) and what does it do in terms of minimising business risks?

We warmly welcome the attention PADA is giving to the sustainability criterion. It's very difficult to predict how many people will join personal accounts, how long they'll remain members and what might happen within investment markets. The charging structure has to be able to cope with all these uncertainties, bearing in mind the government doesn't want taxpayers to have to subsidise the scheme if things don't go to plan. In our view, the scheme can't meet the sustainability criterion unless there's some form of upfront or contribution charge.



The charging structure options

In its White Paper in December 2006, the government spent some time considering different charging structures and concluded that no single structure was ideal. Trade-offs are inevitable because what might be fair for one group is less fair for another. Individuals have very different levels and patterns of earnings (and hence contributions to pensions) and different structures can favour some over others.

The Pensions Policy Institute (PPI) carried out detailed analysis into charging structures in its paper *Charging structures for Personal Accounts*, published in March 2007.

PADA is considering four options, but equally wants to hear if there are others it should be considering.

Annual management charge (AMC)

This looks simple, but - as the pensions industry knows only too well - creates huge financing strains in the early years. The scheme continues to deduct charges whether or not a member continues to contribute. The amount available in charges is wholly dependent on the investment performance, but many of the administration costs will not be, creating a huge risk of mismatch between charges and costs.

Contribution charge

Again, deducting a fixed percentage from each contribution looks simple. Compared with an AMC, a larger charge is collected in the early years, reducing the financing strain. However, it's vulnerable to large numbers of members stopping contributing. In addition, investment management costs are typically linked to funds under management, so again, there's a major risk of mismatch.

Joining fee

This structure further reduces the need to borrow to cover initial costs, but produces charges only if new members are joining. It may also be off-putting to potential members. In practice, it would have to be combined with a modest AMC, which makes it more complex for consumers to understand.

Contribution charge with an AMC

While this approach lacks the simplicity of a single charge, it scores well against the other criteria. It reduces the mismatching risk and isn't as vulnerable to either individuals stopping contributing or to investment performance being particularly poor. It also helps reduce the initial financing strain.

PADA tends to favour either the AMC or the contribution charge with AMC structure.

Consumer research

PADA carried out consumer research to assess attitudes to different charging structures. This was relatively small scale – based on 10 discussion groups and 16 interviews, covering 76 people in total.

Because the scheme will be not-for-profit and operated on an opt-out rather than an opt-in basis, respondents had higher than usual expectation of fairness, transparency and value. The research highlights the importance of being clear about how much charges are, what they cover, and what benefits members get for the money they pay as charges.

Single charging structures were preferred over combination charging structures as they were easier to understand. This perhaps isn't surprising – would you opt for one charge or two? - but the research wasn't able to highlight how different structures can be fairer to people with varied savings patterns.



Applying extra charges

As well as consulting on the best structure, PADA also wants views on when it would be reasonable to charge extra. There may be options available to members which, if chosen, add costs to the scheme. If these options are likely to appeal to only a small minority, then perhaps it's fair to deduct an extra charge from the members who select them, to cover the additional costs. One possible area where an extra charge might be seen as fair is if more specialist and costly fund choices are offered.

Timescales

The consultation period runs until 22 April. PADA will publish a response to the consultation within three months of then. This will indicate what recommendation it will make to the Secretary of State for Work and Pensions.

What we believe

- Personal accounts should be subject to similar financial management disciplines as life offices.
- Ideally, the charging structure should mirror the timing of when costs will arise. This minimises the need for the scheme to borrow and so the risk of getting into financial difficulty if the experience is different from assumed.
- But the charging structure still has to be attractive and appear fair to potential members.
- We strongly favour a structure which combines a contribution charge with an annual management charge.
- Inevitably, the charging structure of personal accounts will have an impact on charging structures for other forms of pension.

What this means for you

2012 may seem like a long way off and personal accounts themselves are unlikely to offer opportunities for adviser firms – they are, after all, designed as non-advice vehicles. But how personal accounts fit with the rest of the pensions market will be hugely significant for all of the industry. The chosen charging structure will be part of this – inevitably, shapes used by other types of pension will be compared with personal accounts. It's important that personal accounts achieve what they set out to achieve – and remain focused on their target audience. It's also important that they're set up on a sound financial footing – the last thing we need is a further hit to consumer confidence in pensions.

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