Choosing a charging structure for personal accounts

Introduction

The personal accounts delivery authority (PADA) is consulting on the most appropriate charging structure for personal accounts when they are introduced in 2012[1].

The consultation paper sets out suggested criteria for judging alternative charging structures, and asks for views as to whether any other criteria should be used, and which criteria are the most important.

This Briefing Note highlights the types of charges being considered and the criteria used to evaluate them, and highlights the findings of previous PPI research that are relevant to the consultation[2]. The research concluded that there is no single charging structure that meets all of the proposed criteria and that trade-offs will have to be made.

Chart 1 :Alternative charging structures

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Annual Management Charge (AMC)	A proportion of an individual's funds under management (e.g. 0.5%)
Joining charge + AMC	A one-off payment made on entry + an AMC
Contribution charge	A proportion of each contribution made (e.g. x% of all contributions)
Contribution charge + AMC	A contribution charge + an AMC
Annual flat fee	A flat amount for all individuals, made annually

Alternative charging structures

In March 2007 PPI (co-funded by DWP, Standard Life and AEGON) published research that evaluated 5 different charging structures against the DWP evaluation criteria (Chart 1):

- An Annual Management Charge (AMC): This is a charge made annually as a proportion of an individual's funds under management.
- A joining charge: A one-off payment made by a member on entry to the scheme. A joining charge is likely to be insufficient by itself to finance personal accounts, so in the consultation paper it is combined with an AMC.
- A contribution charge: A proportion of each contribution made. In this paper, this is taken to include contributions made by the individual, the employer and by the state through tax relief.
- A combination of a contribution charge and an AMC: With both elements of the charge lower than if they were used alone.
- An annual flat fee: A flat amount that is the same for all individuals, made annually for as long as the individual is a member of the scheme,

The PADA consultation document considers four different charging structures— it does not consider an annual flat fee on the basis that it could produce large variation in outcomes and completely erode the whole of small pension funds[3].

PADA criteria

PADA have proposed three main criteria for evaluating the possible charging structures:

- Retirement outcomes for members: judged in terms of fairness within generations and across generations
- Participation: based on how members will perceive the charging structures; and
- Sustainability: in terms of providing a viable funding solution that minimises scheme costs and business risks.

These criteria are similar, but not exactly the same, as those initially proposed by the Department for Work and Pensions (Chart 2)[4]. Although the criteria cover most of the same main areas, there are some differences.

The PADA consultation does not

consider incentives for the scheme operator to maximise fund value, as performance management for fund managers need not be related to member charges[5].

Evaluation against the criteria
PPI analysis can be re-cast to the evaluation criteria proposed by PADA.

Participation
The key considerations for this criteria are member perceptions, and simplicity.

PPI research highlighted that an AMC would be readily comparable to existing pension products. However, it may be difficult for individuals to understand the impact of AMCs on final pension funds.

A contribution charge has the most consistent and transparent impact on the proportion of fund value lost to charges, while an annual flat fee may be the easiest to understand in terms of how much is being paid each year.

Recent PADA research for the consultation tested consumer attitudes to different charging structures[6]. Overall the research suggests that the consumers questioned did not feel that the charging structure would be an important consideration for them in determining whether they opted-out from personal accounts or remained in the scheme

However, those questioned did express a preference for a single type of charge rather than a

Chart 2: PADA vs Government evaluation criteria

combination charge, for simplicity and transparency, and the idea of a joining charge had the most negative response, suggesting it could lead to lower participation.

Sustainability
A pure AMC would raise very little revenue in the short term, until the size of funds under management has built up. This could mean that the organisations financing personal accounts may have to borrow between £1.7 and £4.5 billion to finance the costs of setting up and administering personal accounts (Chart 3)[7]. In the central scenario used in this paper, the total amount of interest paid on this debt could amount to between £1 billion and £12 billion, which may ultimately be passed on to members.

The most effective way to reduce borrowing requirements could be to introduce a joining charge, so that members pay an upfront fee for taking out a personal account. However, a contribution charge and an annual flat fee could also eliminate the need for borrowing after 2015.

The financing analysis illustrates how the final decision on the structure of the charge for personal accounts could also affect the level of the charge. For example, the total cost of providing personal accounts would initially be much higher with a pure AMC charge than with the other types of charge due to the cost of debt. If the only way to meet these costs is through the charges, then the charge would need to be higher under an AMC system.

The financing analysis (and summary in Chart 5) does not cover all sustainability risks.

- A contribution charge may be susceptible to business risk, for example if many accounts are dormant (and so not receiving contributions) revenue from charges could fall.

Chart 3: Different charging structures require different amounts of borrowing

	Peak amount of borrowing (£ billion)	Payback period	Cost of debt (£ billion)
AMC	£1.7 to £4.5	15 to 28 years	£0.9 to £11.8
Joining charge + AMC	No borrowing required from 2012		
Annual flat fee	£0.7 to £0.8	2 to 3 years	£0.1 to £0.2
Contribution charge	£0.6	2 years	£0 to £0.1
Contribution charge + AMC	£0.9 to £1.0	5 to 6 years	£0.1 to £0.5

- An AMC may be susceptible to market risk. If investment returns are bad, revenue from charges could be reduced.

Combination charges tend to overcome these issues by balancing one risk against another.

Retirement outcomes

This criteria is linked strongly to fairness—both across different groups of people (for example by gender, earnings level), and across different generations (for examples those in their 50s in 2012, and those in their 20s).

One definition of 'fairness' is that everybody pays the cost of running their fund, with no cross-subsidy between members. None of the charging structures analysed fully meets this criteria. An annual flat fee may be the closest to satisfying this definition of 'fairness'.

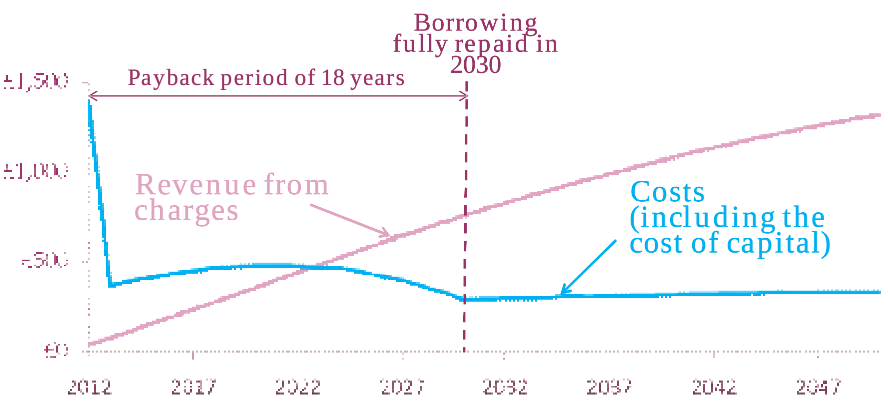
However, an annual flat fee could have a severe impact on people with low earnings who contribute for a short period of time. If no additional protection were introduced alongside a flat fee, this could mean that some people lose the whole of their saving to charges, although this could be overcome[8].

Another definition of 'fairness' is that everybody loses the same proportion of their fund value to charges, so that the amount paid is lower for lower earners and for people with short saving histories. Only a pure contribution charge would meet this test.

An AMC would mean that high and low earners pay the same proportion of the fund value to charges, providing that they have the same saving histories. However, an AMC could affect people differently depending on when in life they save. People who start saving in a personal account early in life but then stop saving, for example because they change job and are auto-enrolled into an occupational pension scheme, could pay proportionately more under an AMC than people who begin to save late in life.

Chart 4: An AMC for personal accounts would require substantial borrowing in the early years

Projected cash flow for Personal Accounts, £ m, 2006 earnings



Fairness across different generations is closely linked to sustainability, and the different funding requirements of different charging structure. Some structures would raise significant amounts of money straight away, while others would take time to raise money and so would need to rely on large amounts of borrowing.

PADA have suggested that structures that repay borrowing quickly allow the levels of charges to fall more quickly, and so reduce the burden on earlier generations[9]. On this basis, as an AMC would take between 15 and 28 years to repay (Chart 4), it would not be seen as fair. The most fair would be the joining fee, which requires no borrowing.

Across all criteria

No single charging structure performs well against all of the criteria, with most scoring well on some but poorly on others (Chart 5). Under some criteria, such as participation, the differences between the structures may be minor. Some criteria can be interpreted in a number of ways.

The criteria used are also interdependent, so it is not easy to say which criteria is the most important. For example, if a structure is to be sustainable, it should encourage participation, and participation is likely to be encouraged by a structure that gives good retirement outcomes.

Chart 5: No charging structure meets all of the criteria

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	Retirement outcomes				
	Within generations		Between generations		
	Same absolute amount lost to charges	Same proportion lost to charges	Set-up costs repaid quickly	Sustainability in the years immediately after set-up	Participation
AMC	O	O	OO	O	P
Joining charge + AMC	O	O	P	PP	O
Annual flat fee	PP	O	O	P	P
Contribution charge	O	PP	O	P	P
Contribution charge + AMC	O	P	O	P	O

Conclusions

The criteria proposed by PADA in the consultation paper - participation, sustainability and retirement outcomes— are similar to those proposed by DWP.

While participation in personal accounts may not, to a significant extent, be directly affected by the final choice of charging structure, simple and transparent single structures were preferred by consumers.

But it may not be possible to separate the decision taken on the charging structure completely from the resulting charging level, due to the different amounts of borrowing needed under different structures.

There are many possible definitions of fairness in retirement outcomes, and no specific charging structure can meet all of them. Some structures may lead to lower charges in future, but higher charges in the short term.

Overall, there is no single charging structure that performs well against all of the criteria. The proposed criteria are interdependent, and hard to rank.

For more information on this topic, please contact
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1 ***Building personal accounts: choosing a charging structure*** (2008) Personal accounts delivery authority (PADA)
2 ***Charging structures for personal accounts*** (2007) Steventon A and Sanchez C: PPI
3 PADA (2008) page 17
4 Chart from PADA (2008) page 47
5 PADA (2008) page 48
6 ***Personal accounts: Attitudes and reactions to possible charging structures*** (2008) Rowe B, Hunt J and Phillips J: BMRB and Henley Centre HeadlightVision on behalf of the personal accounts delivery authority
7 PPI analysis from PPI (2007), see page 31 for more detail on the assumptions used.
8 For example, in Australia, see PPI (2007) page 27
9 PADA (2008) page 32. However, this analysis only considers those aged 25. Results may be different for those at different ages, and there may be other definitions of intergenerational fairness