PENSIONS POLICY INSTITUTE

PPI

PRESS RELEASE
FOR IMMEDIATE RELEASE
Monday 19th March, 2007

"The charging structure in Personal Accounts is important but no single structure meets all of the Government's criteria" says Pensions Policy Institute

The PPI will today publish a new report ***Charging structures for Personal Accounts.***

The Government has proposed a new low-cost national pension savings scheme of Personal Accounts and is consulting on the detailed design of the scheme.

The PPI has analysed how five alternative charging structures for Personal Accounts measure up against the Government's five criteria: fairness, reducing financing costs, simplicity, incentivising members to keep costs down and incentivising providers to maximise fund value.

Niki Cleal, PPI Director, said:

"Until now an annual management charge (AMC) has often been used to illustrate the potential level of charges for Personal Accounts. An AMC has the advantage that it would be directly comparable to existing long-term saving and pension products such as stakeholder pensions. "

"However, an AMC would also require a large amount of borrowing by the provider of Personal Accounts. It could be 18 years before all the borrowing is repaid. Other fee structures, which would bring in more revenue from day one, would reduce the need for borrowing and could ultimately mean a lower overall cost to Personal Account members."

"Overall, our analysis shows that the charging structure in Personal Accounts is important but no single charging structure, or combination of charging structures that the PPI analysed, meets all of the Government's criteria. Each structure has advantages and disadvantages and there are trade-offs that have to be made."

"Ultimately, it is important to understand how consumers might respond to the different charging structures. The Government may want to conduct further research to better understand how alternative charging structures may influence participation in the Personal Account scheme."

ENDS

A summary of conclusions from the report follows on the next page. The report's findings will be presented at a PPI seminar on Monday 19th March. The full report will be available on the PPI's website www.pensionspolicyinstitute.org.uk at 08.30am on Monday 19th March.

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Notes for editors

The PPI is an independent research organisation, focused on pension provision. Its aim is to improve information and understanding about pensions (state and private) through research and analysis, discussion and publication. It does not lobby for any particular issue, but works to make the pension policy debate better informed.

Details of the PPI's supporting members' scheme is also available on the website.

The paper is intended as a contribution to the policy debate on Personal Accounts. Nothing in this paper should be used by individuals or their advisors as the basis for saving and investment decisions.

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Summary of conclusions

The Government has proposed a new national pension savings scheme, called Personal Accounts. The Government aims for Personal Accounts to operate at low cost.

All other things being equal, a low charge would lead to higher pension incomes for those who save than a high charge. However, other factors affecting pension incomes may be more significant, including investment returns, employer contributions and the tax and benefit systems.

This paper does not explore the implications of different levels of charges but the implications of different structures for how the charges are levied. A variety of charging structures are possible for Personal Accounts:

- An Annual Management Charge (AMC): This is a charge made annually as a proportion of an individual's funds under management.
- A joining charge and an AMC: A joining charge is a one-off payment made by a member on his or her initial entry to the scheme. Since it is unlikely to raise sufficient revenue by itself to finance Personal Accounts, it could be combined with an AMC.
- 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.
- A contribution charge: A proportion of each contribution made, from the individual, the employer and the state.
- A contribution charge and an AMC: This is an example of a possible hybrid structure and combines a contribution charge with an AMC.

The Government has suggested five criteria for the evaluation of charging structures. This paper uses these criteria to evaluate the five alternative charging structures.

Fair to all members, taking into account an individual's ability to pay
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 test, due to the differences in how providers charge for different services. Of those analysed, the 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.

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 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.

Provides significant revenue in the early years of operation, reducing the amount and length of operating losses, and reducing financing costs
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 in order to finance the costs of setting up and administering Personal Accounts. In the central scenario used in this paper, the total amount of interest paid on this debt could amount to £3 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.

Simple and easy to understand
Further research is needed to determine how well individuals understand charging structures and how charging structures may influence their behaviour. An AMC would be readily comparable to the existing Stakeholder Pensions. However, it may be difficult for individuals to understand the impact of AMCs on final pension funds.

A contribution charge has the most consistent 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.

Incentivises members to help keep costs down
None of the charging structures seems to directly incentivise an individual member to reduce costs that providers incur on their behalf.

Higher participation may mean that the fixed costs of Personal Accounts are shared between more individuals, reducing the average cost per member. Some of the charging structures may encourage participation in Personal Accounts more than others. For example, an up-front joining charge may discourage participation.

Incentivises the scheme operator to maximise the fund value
An AMC explicitly relates revenue to fund value and so may provide the greatest incentive to maximise fund value. However, a hybrid charging structure with an AMC element could also achieve the same objective.

Overall, no single charging structure, or combination of charging structures, has all of the desirable attributes. Each charge structure has advantages and disadvantages and there are trade-offs that have to be made.

Depending on what the main priority is, different charging structures might be chosen (see the attached table):

- If fairness was the main priority, then the choice of charging structure would depend on the definition of 'fairness' being used. For example:
    - If it meant that everybody should pay the cost of running their fund, then this might suggest an annual flat fee is the best structure.
    - If it meant that everybody should lose the same proportion of their fund value to charges, then a contribution charge may be appropriate.

- If reducing financing costs was the main priority, then this may lead to a hybrid between a joining charge and an AMC.

- If being simple and easy to understand was the main priority, then there may be different views on which structure is the most appropriate:
    - An AMC may be the easiest to compare to existing Stakeholder Pensions.
    - A contribution charge has the most consistent impact on the proportion of final pension funds lost to charges.
    - An annual flat fee may be the easiest to understand in terms of how much is being paid each year.

- None of the charging structures seem to directly incentivise members to help keep costs down, although some of the charging structures may encourage participation in Personal Accounts more than others.

- If incentivising the scheme operator to maximise the fund value was the main priority, then a charging structure with a substantial AMC component may be appropriate.

	Fairness		Reducing financing costs	Simple and easy to understand	Incentivises members to help keep costs down	Incentivises the scheme operator to maximise the fund value
	Same proportion of fund size lost to charges	Same absolute amount lost to charges				
Annual Management Charge (AMC)	• Members who start saving early in life but then stop contributing pay the highest proportion of their fund value	• High earners pay more in absolute terms than low earners • People with full saving histories pay more in absolute terms than people with broken histories	• £1.7-£4.5bn borrowing • 15-28 year payback • £900-£11,800m cost of debt	• Most comparable to existing Stakeholder Pensions	• Does not seem to directly encourage members to make fewer queries and therefore, to help keep costs down	• Yes, because charging revenue is directly related to fund value
Joining charge plus AMC	• Compared to a pure AMC, outcomes are worse for people with very short saving histories and slightly better for those with full saving histories	• As with the pure AMC, high earners and people with full saving histories pay more in absolute terms	• No borrowing required after 2012	• Two components may seem less easy to understand	• May discourage people from joining Personal Accounts. By decreasing participation, fixed costs per head could be higher as they are shared between fewer members	• Yes, because most of the charging revenue is related to the fund value after the first year
Annual flat fee	• Low earners pay a higher proportion of their fund value than high earners	• Everybody pays the same absolute amount each year	• £700-£800m borrowing • 2-3 year payback • £100 to £200m cost of debt	• Could be easiest to understand the amount lost in charges each year	• Same as AMC	• Charging revenue is not directly related to fund value
Contribution charge	• Everybody pays the same proportion of their fund value	• High earners pay more in absolute terms than low earners	• £600m borrowing • 2 year payback • £0 to £100m cost of debt	• Could be easiest to understand the impact of charges on the final fund value	• Same as AMC	• Charging revenue is not directly related to fund value
Contribution charge plus AMC	• Members who start saving early in life but then stop contributing pay the highest proportion of their fund value (but not as much as under a pure AMC)	• High earners pay more in absolute terms than low earners	• £900m-£1bn borrowing • 5-6 year payback • £100 to £500m cost of debt	• Two components may seem less easy to understand	• Same as AMC	• Partially as some of the charging revenue is related to the fund value in the long term