PENSIONS POLICY INSTITUTE

PPI

PRESS RELEASE
FOR IMMEDIATE RELEASE
Tuesday 29th January, 2008

"The PPI welcomes the personal accounts delivery authority's consultation on the charging structure for personal accounts"

The Government established the personal accounts delivery authority to advise it on the design and implementation of a new national low-cost national pension savings scheme, personal accounts. The delivery authority has today opened a consultation on the appropriate charging structure for personal accounts.

The Pensions Policy Institute (PPI) analysed in research published last year how five alternative charging structures for personal accounts measure up against the Government's five original criteria: fairness, reducing financing costs, simplicity, incentivising members to keep costs down and incentivising providers to maximise fund value. The Government's original criteria are similar to those proposed by the personal accounts delivery authority today.

Niki Cleal, PPI Director, said:

"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 criteria originally proposed by the Government. These criteria are similar to those proposed today by the personal accounts delivery authority."

"Each charging structure has advantages and disadvantages and there are trade-offs that have to be made. The PPI welcomes a wider debate and consultation on the most appropriate charging structure."

ENDS

The PPI's research, ***Charging Structures for Personal Accounts,*** was published March 2007. The PPI will feed findings from the research into the consultation exercise. A summary of conclusions from the report follows. The full report is available on the PPI's website www.pensionspolicyinstitute.org.uk

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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 report 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.