

How do charges affect DC pension outcomes?

Introduction

Following the introduction of automatic enrolment, the majority of employees are expected to be saving into a Defined Contribution (DC) pension scheme. This is because over 80% of Defined Benefit (DB) schemes in the private sector are closed to new accruals or new members.¹ Unlike members of DB schemes, members of DC schemes typically pay explicit charges to cover some or all of the costs of administering and running their pension.

The Government published a paper on 30 October 2013 to consult on the issue of charges.² The paper proposes three options to cap pension charges for all members of default funds in qualifying DC schemes for automatic enrolment:

- A cap of 1% of the funds under management;
- a cap of 0.75%;
- a two-tier 'comply and explain' cap with a standard cap of 0.75%. A higher cap of 1% would be available to employers that explain to the regulator the need for a higher cap and why this is delivering a benefit to members.

The DWP paper did not set out how a charge cap would be applied in practice or how schemes using combination charging structures would demonstrate that their charges are below the cap.

This briefing note explains the different factors that may affect

total savings in a DC scheme and how the impact of charges can be modelled into the future. It illustrates how the total pension savings of hypothetical individuals compare under different levels of charges. Finally, the note analyses how the different charging structures currently adopted by DC schemes will impact on those hypothetical individuals, and how combination charging structures compare against a scheme with a 0.75% charge on funds under management.

This note does not cover the impact that a cap on charges could have on providers or on the broader pensions market.

The different factors affecting total DC savings

In a typical DC scheme, a fund is built up on behalf of the members with contributions from the member and/or the employer and pensions tax relief from the government. A range of factors will affect the total pension savings available to provide an income in retirement, including:

- The level of contributions, which in turn depends on earnings;
- the persistency of contributions;
- the investment returns achieved by the funds in which contributions are invested; and
- the charges levied against the fund.

The level and persistency of

contributions is likely to be the most important factor affecting total savings in a DC scheme.³ Following the introduction of automatic enrolment into workplace pensions from 2012, whether employees and employers decide to contribute at the legal minimum of 8% of band earnings or at higher rates will have a substantial impact on total pension savings. For example, contributing 10% of band earnings will increase total pension savings by 25%.⁴

Given the importance of contributions, whether an individual has a long or short history of contributions, when they start to save, and whether they take career breaks, will also affect total pension savings in a DC scheme.

The charges paid by DC scheme members will also affect total pension savings. DC scheme members often pay an Annual Management Charge (AMC) that is levied against the total value of the fund each year. However, some schemes being used for automatic enrolment have more complex charging structures in place, sometimes known as 'combination charging structures'.

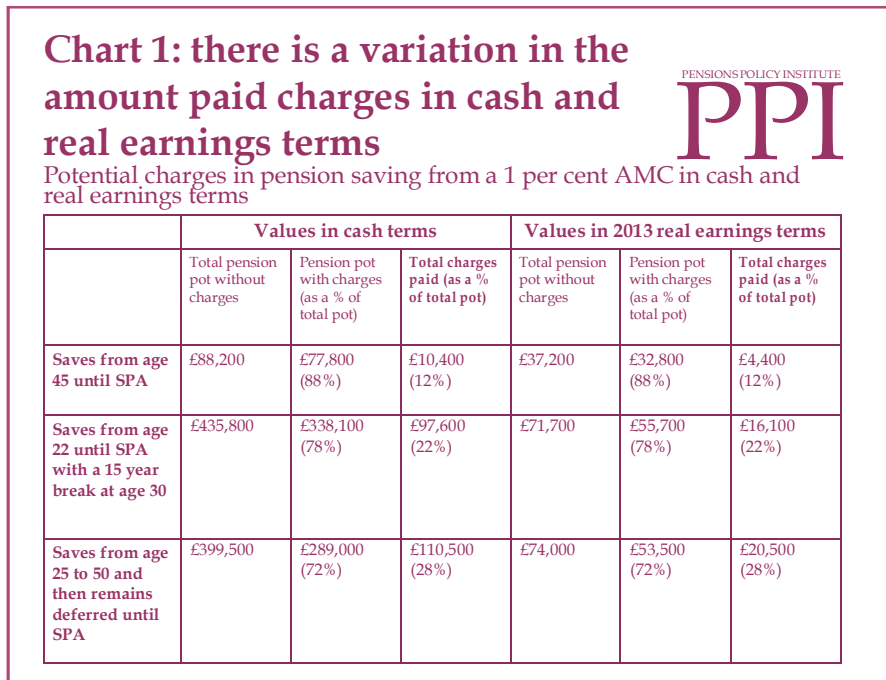
The charges paid by DC scheme members cover some or all of the costs associated with the running of the scheme. These charges are not simply lost, but include the costs of fund management, administration and communications.

The costs of these activities can vary across schemes. For example, more active investment approaches that aim to reduce volatility through greater diversification and strategic management of the asset allocation may involve higher charges than passive investment strategies. Some employers may prefer to offer their employees a scheme with a higher charge in the belief that this offers greater value for money, whether through higher expected returns, less volatile returns or better engagement and communications.

Estimating the impact of charges on future pension savings

Presenting the value of future pension contributions, fund values and charges in today's money requires making some assumptions. Specifically, when estimating the impact of charges on the pension savings accumulated by an individual up until retirement it is important to take into account the effect of future price or wage inflation. To present the value of estimated future pension savings in real prices or earnings terms they should be discounted for the impact of future earnings or prices growth in the relevant period.

Real prices is most relevant when the focus is to measure purchasing power over time, while real earnings is most relevant when the focus is to measure relative incomes over time. Real earnings are typically used to present the value of pensions over time as the focus is to compare the living standards of pensioners to those of working age individuals. Therefore, real earnings allow us to compare the value of future



savings, which in turn will be turned into a retirement income, to today's earnings.

The DWP consultation paper uses nominal cash terms to illustrate the impact of charges over a 22 to 46 years period.

Chart 1 replicates the DWP consultation paper analysis and shows the results for the value of the total pension pot and the amount paid in charges for a set of individuals. An initial annual pension contribution of £1,200 is assumed, with a 1% AMC. The chart compares the results presented in the DWP paper in nominal cash terms with their equivalent value in real earnings terms. Similar assumptions to the DWP paper are made for investment growth (7% per year) and contribution growth (4% per year). The values that are expressed in real earnings terms are calculated assuming

future earnings growth of 4% per year, consistent with the assumption of 4% annual contribution growth. Individuals are assumed to start saving in 2013 at the starting age set out in each example.

Under a 1% AMC, an individual that saves from age 45 until reaching their State Pension Age (SPA) could pay around 12% of the total pot in charges. The amount paid in charges represents £10,400 in cash terms, but this is worth £4,400 when considered in real earnings terms.

Similarly, an individual that saves from age 22 until SPA but that has a 15 year career break from age 30 could pay around 22% of their pot in charges. The amount paid in charges represents £97,600 in cash terms, but it is worth £16,100 in real earnings terms.

An individual that saves from age 25 to 50 but then stops saving and remains a deferred member until SPA could pay around 28% of their total pot in charges with an AMC of 1%. The amount paid in charges represents £110,500 in cash terms, but it is worth £20,500 in real earnings terms.

The analysis highlights the importance of presenting results in way that is comparable and meaningful in today's terms, particularly when considering the value of pension savings and charges far into the future. For example, for the latter individual paying £110,500 in charges can represent many times their annual income if considered in current cash terms, compared to paying £20,500, if using real earnings terms.

Nonetheless, the results for the three different individuals illustrate the significant impact that charges can have on an individual's pension pot. Under an AMC approach, the impact of charges can be more amplified for individuals that start saving early in life but that have career breaks or who remain deferred members until reaching their SPA. This is because the AMC is levied against the fund accumulated and continues to reduce the value of the fund each year even when the individual is a deferred member and is not making any pension contributions.

Chart 2 shows the impact of different levels of AMC on the total pot for an individual that saves throughout their working life from age 22 to SPA (46 years), as illustrated in the DWP consulta-

Chart 2: There is a variation in the amount lost at different levels of charges in cash and real earnings terms



Potential loss in pension saving under different AMC levels in cash and real earnings terms for an individual that saves from age 22 to SPA (46 years)

	Values in cash terms			Values in 2013 real earnings terms		
	Total pension pot without charges	Pension pot with charges (and as a % of total pension pot)	Pension pot lost due to charges (and as a % of total pot)	Total pension pot without charges	Pension pot with charges (and as a % of total pension pot)	Pension pot lost due to charges (and as a % of total pot)
AMC 0.5%	£701,800	£610,000 (87%)	£91,800 (13%)	£115,500	£100,400 (87%)	£15,100 (13%)
AMC 1%	£701,800	£532,100 (76%)	£169,700 (24%)	£115,500	£87,600 (76%)	£27,900 (24%)
AMC 1.5%	£701,800	£465,800 (66%)	£236,000 (34%)	£115,500	£76,700 (66%)	£38,800 (34%)

tion paper. Again, an initial annual contribution of £1,200 is assumed.

This demonstrates that what may appear as small percentage point differences in AMCs to employers and scheme members can have a significant impact on the value of the pension pot and the amount paid in charges. Under a 0.5% AMC, the amount taken out in charges is around 13% of the total pension pot. This represents £91,800 in cash terms and £15,100 in real earnings terms.

Under a 1% AMC, the proportion of the total pot taken out in charges is around 24%. This amounts to £169,000 in cash terms and £27,900 in real earnings terms.

Under a 1.5% AMC, the proportion taken out in charges is around 34% of the total pen-

sion pot. This amounts to £236,000 in cash terms but £38,800 in real earnings terms.

While a higher AMC will lead to a higher amount of money paid in charges, it is important to present figures in real earnings or prices terms so they are more meaningful to employers and scheme members considering the impact of charges today.

The different types of charges in DC schemes

The AMC is not the only type of charge that members of DC schemes may pay. The recent Office of Fair Trading (OFT) report found that there are 18 different names and configurations of charges in legacy schemes, most commonly found in those set up before the introduction of stakeholder pensions in 2001.⁵ The report explains that since 2001 the pensions industry started to move towards levying a single

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charge, known as the AMC.

Nonetheless, charges other than the AMC may be used even in schemes that have been set up after 2001. For example, Active Member Discounts (AMDs) reduce charges to active members but increase the charges once the member stops contributing to the scheme and becomes deferred. The OFT report found that there are around 10,000 contract based schemes with AMDs and that, on average, members of these schemes could expect an increase of 0.47% in the AMC that they pay if they stop contributing. The report also found that 94% of the schemes with AMDs are open for automatic enrolment.

To demonstrate the impact of an AMD we can consider the individual in Chart 1 that saves from age 25 to 50 and then remains a deferred member until reaching their SPA. With an AMC of 0.5% they would see around £11,070 taken out in charges in real earnings terms (around 18% of the total pension pot). However, if the AMC increased to 1% when they became a deferred member the amount of the pension pot paid in charges would increase to £16,520 in real earnings terms (around 29% of the total pension pot). If the AMC was increased to 1.5% when they became a deferred member, the amount paid in charges would be around £21,530, or around 41% of the total pension pot.

The variety of charges and charging structures adopted by DC schemes could mean that a cap on charges is difficult to implement in practice. The DWP paper

does not define exactly what costs and charges would be included within the cap and this will also be important for driving transparency. The OFT report has suggested that a more effective approach could be to review whether the different types of charges provide value for money for members and whether certain elements should be listed separately, capped or banned in the future.

For example, AMDs in schemes that qualify for automatic enrolment could be of particular concern if charges are significantly higher once members become deferred and if they are unaware of the impact of the charges and the extent to which they will see their pension savings eroded by those charges over time. However, if AMDs were removed, it is possible that charges for active members in schemes that currently have AMDs could increase.

The Government has consulted on the implementation of a "pot follows member" mechanism through which DC members' pots would be automatically transferred to their new employer's scheme when they switch jobs.⁶ While "pot follows member" could, in theory, mitigate the potential effects of AMDs, the policy is still in development, and would not benefit those taking career breaks who do not have a new employer scheme for their pot to go to.

Other charging structures being used by automatic enrolment schemes include contribution charges and fixed or flat fee

charges. For example NEST charges an AMC of 0.3% on the fund and a 1.8% charge on contributions, while Now: Pensions charges an AMC of 0.3% AMC and an £18 a year administration flat fee. For deferred members, Now: Pensions cap the charge to 0.5% of the fund.⁷

The impact of different charging structures

DWP have not set out the detail of how the charging cap will be calculated or applied in practice. Chart 3 compares the impact of 5 different charging structures on the total pension pot for different individuals. The benchmark is an AMC of 0.75%, the lower of the caps proposed in the DWP paper.

A second alternative option is a lower AMC of 0.5%. A third option is an AMC of 0.7% but where that includes a 0.5% AMD, which the OFT report found was the average value of an AMD in schemes with those charges. Two further alternative options replicate the NEST charging structure, with an AMC of 0.3% of the fund combined with a 1.8% charge on contributions, and the Now: Pensions charging structure, with an AMC of 0.3% of the fund combined with an £18 flat charge.

The modelling for this section assumes that the different individuals start saving in 2018 at the legal minimum of 8% of band earnings, currently between £5,668 and £41,450 per year. The modelling uses assumptions that are consistent with the economic assumptions

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of the July 2013 Office of Budget Responsibility report and the PPI Modelling suite.⁸

With an AMC of 0.5%, all the different individuals will pay a lower or the same proportion of their final pension pot in charges than under the benchmark of an AMC of 0.75%.

In a scheme with an AMC of 0.7% but that includes an AMD of 0.5% (so a total AMC of 1.2% for deferred members), individuals that do not take career breaks or that are not deferred will pay lower or the same level of charges than in a scheme with the benchmark AMC of 0.75%. This is because the AMD applies across their whole working career.

Individuals that do take career breaks or who become deferred members will pay a higher proportion of their final pension pot in charges than under the benchmark AMC of 0.75%. For example, an individual that saves from age 22 to SPA but that takes a 15 year career break from age 30 to 45 will pay 15% of the pot in charge, compared to 14% under the benchmark. Similarly, an individual that saves from age 25 to 50 and then remains deferred will pay 26% of their pot in charges. An individual that only saves for 5 years from age 25 to 30 and then remains deferred will pay around 38% of their pot in charges.

For NEST and Now: Pensions six out of the seven individuals considered all pay a lower or the same proportion of their pot in charges than under the bench-

Chart 3: the charging structure affects the proportion of a DC fund paid in charges

Percentage of a total DC fund paid in charges for men at median and 10th percentile of earnings, under different charging structures

	AMC: 0.75%	AMC: 0.5%	AMC: 0.7% (includes 0.5% Active Member Discount)	AMC: 0.3% and 1.8% charge on contributions	AMC: 0.3% and £18 administration charge
Saves from age 22 until SPA	17%	12%	16%	9%	8%
<i>(At the 10th percentile of earnings)</i>	17%	12%	16%	9%	8%
Saves from age 45 until SPA	9%	6%	9%	5%	4%
Saves from age 60 until SPA	13%	13%	13%	14%	13%
Saves from age 22 until SPA but with a career break from age 30 to 45	14%	10%	15%	8%	7%
Saves from age 25 to 50, deferred until SPA	21%	14%	26%	10%	9%
Saves from age 25 to 30, deferred until SPA	26%	19%	38%	13%	15%
<i>(At the 10th percentile of earnings)</i>	27%	19%	38%	13%	18%
Saves from age 25 until 30	9%	8%	8%	9%	8%

mark of an AMC of 0.75%. However, the individual that saves from age 60 to SPA will pay 14% of their pot in charges under the NEST charging structure, compared to 13% under the benchmark. This is due to the impact of the charge on contributions on a relatively short period of years saving before reaching retirement.

Whether an individual is a median earner or a low earner may affect the proportion of the pot paid in charges under the Now: Pensions charging structure. A median earning man that saves from age 25 to 30 and then becomes deferred will pay 15% of their pot in charges while a low earner at the 10th percentile of the earnings distribution will pay 18% of the pot in charges. This is due to the higher relative impact of the flat fee on contributions.

A median earning individual

with a short service that saves from age 25 and 30 and then leaves the scheme taking the pot with them, will pay 9% of the pot in charges under the NEST charging structure, similar than under the benchmark. Meanwhile he will pay 8% under the other charging structures.

As Chart 3 demonstrates, the impact of different charging levels and structures will vary by individual, depending on their earnings, contributions and working and savings patterns. For example, under the benchmark of an AMC of 0.75% the percentage of the pot paid in charges will range from a minimum of 9% for a median earning individual that saves from age 45 to SPA to 27% for a low earning individual that saves from age 25 to 30 and then becomes deferred.

Any proposal to cap charges will need to set out how a cap

can be applied on a comparable basis across different pension schemes being used for automatic enrolment and across different groups of individuals. It will also need to set out over what timeframe the impact of charges is to be considered—as the impact of charges can look very different over short periods compared to over a working career. In summary, the impact of charges on a member's total pension savings is highly sensitive to the assumptions used to calculate the impact of the charge.

The implementation of a charge cap will also need to be specific on who will be responsible for complying with the cap. If employers will be responsible, as the DWP paper implies, the Government should be clear on how to consider the overall impact of different charging structures and their potential suitability for employees.

Finally, the level of the charges paid should not be the only issue to consider when assessing the value for money of a DC scheme. The charges paid by members should be weighed up against the quality of the administration, member communications, investment performance and other quality features of the scheme, all of which will impact on the members experience and their incomes in retirement. This is

consistent with the approach set out in the joint industry code of conduct.⁹

How many individuals are likely to be affected by a cap?

The Government has estimated that between 5 and 9 million people will be saving for the first time following the roll-out of automatic enrolment.¹⁰ The OFT report has found that the average AMC for new contract based schemes, which would be likely to be used for automatic enrolment, has fallen from 0.79% in 2001 to 0.51% in 2013. A number of multi-employer schemes have entered the market with an AMC of around 0.5%.

Within this context, it could be unlikely that large numbers of new members automatically enrolled into a new DC scheme will benefit from a cap on the AMC of 0.75% or 1%.

By contrast, a number of people in legacy schemes set up before 2001 that are likely to be charging an AMC of more than 1% could benefit from a cap of 1% or 0.75%, as proposed in the consultation document. The OFT report has found that there are around 186,000 pots in schemes charging an AMC above 1%. However, the DWP consultation focuses on automatic enrolment schemes.

Conclusion

While there are many factors affecting total pension savings in a DC scheme, the level of charges paid can have a significant impact. The existence of different charging structures across DC schemes being used by employers for automatic enrolment landscape will mean that any charge cap will need to be calculated and applied on a comparable basis across schemes. Depending on the circumstances of the scheme members, different charging structures can have very different impacts.

The impact of charges on total pension savings should not be considered in isolation, but should be weighed up against other quality features of DC schemes and their impact on value for money for employers and scheme members.

¹ PPF/TPR (2013) *The Purple Book*

² DWP (2013) *Better workplace pensions: a consultation on charging*

³ PPI (2013) *What level of pension contribution is needed to obtain an adequate retirement income?*

⁴ PPI (2012) *Closing the Gap*

⁵ Office of Fair Trading (2013) *Defined contribution workplace pension market study*

⁶ DWP (2013) *Automatic transfers: consolidating pensions savings*

⁷ See NEST (2012) *Low charges for future members of NEST* and Now: Pensions (2013) *Costs and Charges Guide*

⁸ The analysis uses earnings data (by age) from 2010, uprated to 2013. From 2013 to 2018 earnings are assumed to increase following the Office of Budget Responsibility economic assumptions from the July 2013 Fiscal Sustainability Report. The same assumptions are used to increase the lower and upper limit of the band of earnings for automatic enrolment. Long term earnings are assumed to increase by 4.4% per year. Furthermore, the modelling assumes a 6% investment return.

⁹ NAPF (2012) *Pension Charges Made Clear: Joint Industry Code of Conduct, Telling Employers about DC pension charges*

¹⁰ DWP (2013) *Pensions Bill impact assessment*

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