Charging Structures for Personal Accounts Seminar 19 March 2007

The Pensions Policy Institute is conducting a series of seminars exploring outstanding issues in Personal Accounts. The first seminar was held on 19 March 2007, and focused on options for a Personal Accounts charging structure. This seminar was chaired by David Yeandle, of the Engineering Employers' Foundation, hosted by the Nuffield Foundation, and co sponsored by the Department for Work and Pensions (DWP), AEGON and Standard Life. The PPI is grateful for their support.

The seminar was attended by 47 people representing the range of interest areas across the pensions sector.

Sam Brand (DWP) presented an overview of the context for reform, the Government's proposed reforms outlined in the DWP's White Papers published in May and December 2006, and the DWP's consultation process and questions regarding charging structures.

Chris Curry and Adam Steventon (PPI) presented findings from PPI research, ***Charging Structures for Personal Accounts.***

The PPI research investigated in detail the impact of five alternative charging structures for Personal Accounts against five criteria suggested by the Government.

The research concluded that 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.

Discussants

John Lawson (Standard Life) suggested that a mix of charging structures would be the best option. There may be an argument to not levy charges on small accounts if this would begin to erode the value of the contributions. The Government's aim of a charge equivalent to 0.3% – 0.5% Annual Management Charge (AMC) is unrealistically low. Sweden is often referred to as a low cost scheme, but the costs quoted do not include collection costs. The industry can compete with Personal Accounts but only if it is a fair playing field - it will not be fair if Personal Accounts is subsidised to an unrealistic charging level due to subsidisation.

Dominic Lindley (Which?) stressed that the needs of consumers need to be central to Personal Accounts policy. It was important for the Government to assess the effect that any charging structure might have on participation in the scheme. Which? supports the AMC structure because it is the best structure for encouraging participation, is simple to understand and has a fair reduction in yield for all members. Further analysis could explore the effect on peak debt and the payback period from an AMC if contributions were higher than the default level or if a significant number of people made lump-sum contributions at the start of the scheme.

Steven Cameron (AEGON) commented that if the Government wants Personal Accounts to cross subsidise groups of members through the charging structure it needs to be very clear who is being subsidised and by how much, ideally focussing on the target group. Personal Accounts are very different from stakeholder pension plans because they rely on services from lots of contractors (fund managers, administrators, collection etc) and costs will be incurred in different ways by each of these contractors. The closer the link between the charging structure and the cost structure, the easier it will be to adjust charges fairly over time to reflect actual costs. Participation levels in Personal Accounts may also be sensitive to public sentiment, with 'scandals' in the tabloid press potentially having a disproportionate effect because of centralised nature of scheme

Questions and discussion
The following points were raised by speakers or members of the audience and do not reflect the views of the PPI.

General comments
It is very important that Personal Accounts are targeted on the target group. The design needs to also take into account regulatory costs.

Stakeholder pension schemes operate in a different regulatory context, with regulated advice, so it does not necessarily follow that the AMC approach used in stakeholder pensions can provide many lessons for Personal Accounts.

There is a risk of over-engineering the charging structure while there are still major uncertainties as to how Personal Accounts will operate. The Personal Accounts scheme (Delivery Authority / Personal Accounts Board) needs to have flexible powers to adjust charges as these uncertainties are played out.

The PPI research is based on Pensions Commission assumptions about the persistency of Personal Accounts, which may prove to be optimistic. Further sensitivity analysis in this and other areas would be useful. In particular, assuming rates of return vary form year to year could change the findings relating to the perceived fairness of Personal Accounts, and it may be worth 'stress testing' charging structures by making extreme assumptions about participation rates.

The Governments five evaluation criteria
Simple and easy to understand
There are conflicting views as to how important it is for a charging structure to be simple and easy for consumers to understand. While some view it as essential, others express the view that charges are not a large factor in consumers decision making.

'Simple' should not necessarily mean 'simplistic' – a hybrid charging structure may be able to be understood as well as a single charge, and advice and information have a role to play in communicating charging structures clearly.

Fair to all members
Fairness could be interpreted in different ways. It could mean that all members pay the same proportionate value of their fund in charges. This would mean some members subsidising others.

Another type of fairness could be that Personal Account members pay broadly what it costs to run their account.

Some felt it would be difficult to leave judgements about fairness to the Personal Accounts Delivery Authority.

Current members of existing private pension arrangements have commented that entry charges are unfair, exit charges are unfair, but rarely complain about the fairness of contribution and AMC charges. This suggests that people do not necessarily care about the structure unless they perceive it impacts on them in an unfair way.

A cap on charges levied for small funds may be one way to deal with the perceived unfairness of charges eroding the value of small funds. However, this may be difficult to administer due to the 'unbundled' nature of Personal Accounts: different elements of Personal Accounts (such as collection, administration, fund management) are likely to be operated by different contracted providers.

The PPI analysis suggested that there was scope for charges to fall over time. But this could mean today's older workers paying a higher charge than future generations. It may be 'fairer' to borrow today to keep charges lower today, even if that meant higher charges than might otherwise have been possible in future.

Incentivises the scheme operator to maximise the fund value

This criterion may be less important than others. PPI research noted that the AMC model performs well against this criterion. However, the contracts with Personal Account providers could explicitly provide incentives for fund managers to maximise fund value and administrators to minimise scheme costs and could be different from the charging structure for scheme members. This raises the question of who bears the risk of charge revenue not meeting the costs, or conversely who benefits from any surplus?.

Incentivises members to help keep costs down

None of the structures examined did this directly, although some may do indirectly through encouraging participation. Any of the structures could incorporate specific charges to attempt to affect behaviour.

Provides significant revenue in the early years of operation, thus reducing the amount and length of operating losses and reducing financial costs

The PPI research suggests that some charging structures will require significant upfront borrowing (for example, the AMC) whereas charging structures with upfront fees require less borrowing and reduce the overall costs of financing. There may be a surplus of charges over costs at some point in the future under all of the options.

It would need to be clear who owned the surplus, what would happen to it, and whether the structure be changed over time to manage the surplus.

Other possible criteria

Other relevant evaluation criteria may relate to whether the charge structure incentivises participation and persistency. However, not all persistency is good, as some people who remain in Personal Accounts might be better off not saving.