



Chapter 4: Charges and financing

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High charges reduce people's pension incomes. Personal accounts will be designed to be a low-cost, good-value way to save.

The Pensions Commission suggested that an annual management charge of 0.3 per cent was achievable. The Government believes that this is possible in the long term, and that in the short term, charges will be comparable with the Commission's estimate when this is adjusted to take account of the likely need to finance the scheme over a shorter timescale, and the need to operate a light-touch but effective compliance regime.

The Government is, therefore, confident that personal accounts can achieve a radical reduction in pension charges, even in the short term, making a real difference to people's pension outcomes. The personal accounts board will be tasked with delivering low costs to its members.

"The Government and Pensions Commission have rightly emphasised that the costs of administering and investing contributions in personal accounts should be kept as low as possible, to enhance the returns achieved by consumers on their savings."
(Association of British Insurers)

- 4.1 Through personal accounts the Government aims to provide people with a simple low-cost way of pension saving. This means that the charges for personal accounts will need to be kept as low as possible. The Pensions Commission suggested that an annual management charge of 0.3 per cent would be achievable in the long run. The level of charges will depend on a number of factors which include the financing regime and the charging structure. These are explored further in this chapter.

Importance of low charges

- 4.2 Low charges mean that, for a given rate of pension contribution and fund growth, more money is accumulated in an individual's pension fund each year. Consequently, more growth is accrued and compounded each year, ultimately resulting in a larger pension fund and a larger pension income on retirement.
- 4.3 For example, using an annual management charge (AMC) structure¹, an apparently small decrease in the charge has a disproportionate impact on the level of the final fund. For example, a decrease in the AMC from 1.5 per cent to 0.5 per cent over an individual's working life can mean a 25 per cent increase in fund size.

¹ An AMC is a charge made on the proportion of an individual's fund size.

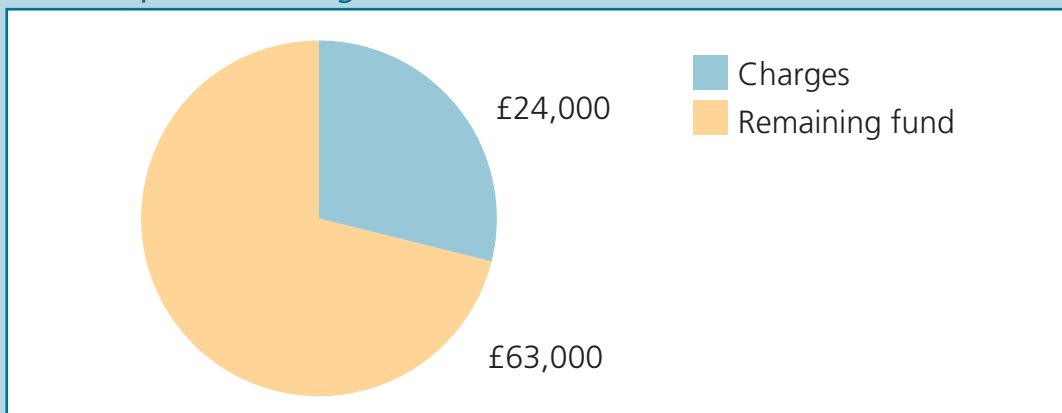
- 4.4 Low charges will make a significant difference to the majority of the target group for personal accounts who, up until now, have not had access to a pension scheme with low charges.

Box 4a: Impact of charges

For a male median earner (£23,000 a year) aged 25 in 2012 who saves in a pension for 43 years², under a 1.5 per cent AMC, his pension fund at retirement is worth £63,000³, meaning that £24,000 of his fund has been lost in charges.⁴ Under a 0.5 per cent AMC, his pension fund is worth £78,000 and £9,000 is lost in charges. This individual's pension fund is, therefore, approximately 25 per cent larger purely as a result of the lower charge. This pattern of variation across charges is similar for all earnings levels, although the absolute size of pension funds vary proportionately according to different income levels.

Figure 4.1: How higher charges reduce the pension fund size of a median earner (£23,000) who saves for 43 years

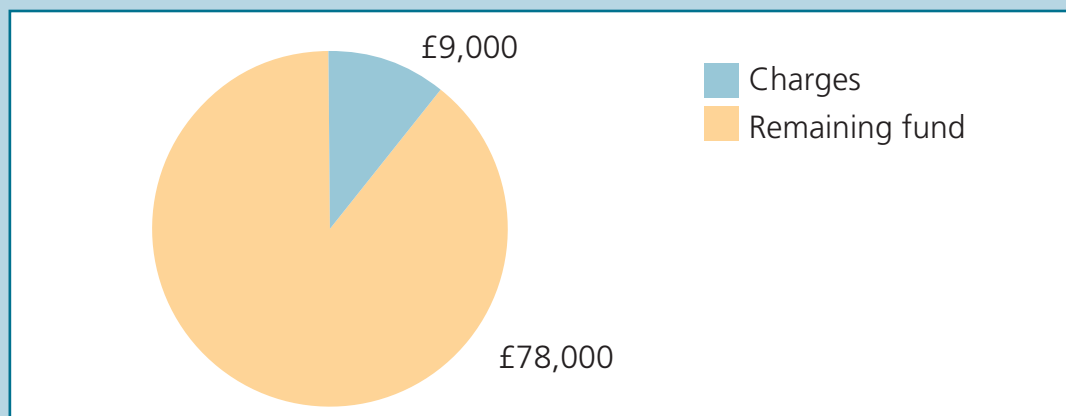
For a 1.5 per cent charge



² In this analysis we assume that there is no relationship between the AMC and the returns achieved by fund managers for investors. 'Active' fund managers usually charge much higher fees compared with 'passive' fund managers, but evidence to date suggests that both types of fund manager achieve a similar rate of return. Research in this area continues.

³ The figures provided are in 2006/07 earnings terms.

⁴ The amount lost in charges was calculated as the difference between the fund size under the relevant charge compared to what the size of the fund would be under a zero charge.

For a 0.5 per cent charge

Source: DWP modelling

Notes: The amount lost through charges was calculated as the difference between the pension fund size under the relevant charge compared with what the fund size would be under a zero charge.

Assumes a total contribution rate of 8 per cent, and nominal pension fund growth of 6.47 per cent a year (3.5 per cent real).

Figures have been rounded to the nearest £1,000.

The figures provided are in 2006/07 earnings terms.

It should be recognised that the actual funds, and the charges paid by members, will be influenced by many factors including fund growth, the source and terms of finance, participation, contributions, choice of funds, the charge structure and operational costs of the scheme, all of which are difficult to predict at this point. They do not represent actual outcomes for members.

This figure is for illustrative purposes only. It should not be used as the basis for individual decisions as specific circumstances or variation from the underlying assumptions will lead to different results.

Would an annual management charge of 0.3 per cent be achievable?

- 4.5 The Pensions Commission report concluded that its proposed National Pension Savings Scheme (NPSS) could be run at an AMC of 0.3 per cent in the long term. Our analysis indicates that in the long term it would be possible to run personal accounts at a charge of, or possibly even below, the 0.3 per cent level. In the short term, charges will be comparable with the Commission's estimate when this is adjusted to take account of the likely need to finance the scheme over a shorter timescale, and the need for a compliance regime.

4.6 The key differences between this analysis and that of the Pensions Commission are that the Commission:

- did not include in the charge, the costs of monitoring the requirement for employers to automatically enrol their employees into personal accounts and make the required contributions; and
- assessed the viability of personal accounts over the average working life of an individual. This meant that costs could be spread over a very long period of time. In reality, organisations financing the scheme are unlikely to accept losses for long periods on the understanding that they may only receive money decades later.

4.7 The work the Government has done indicates that, in comparison with existing pension products, personal accounts would achieve a substantial reduction in charge levels for our target group. The Government believes that personal accounts could deliver an AMC possibly as low as 0.5 per cent in the short term and below 0.3 per cent in the long term. This contrasts with a stakeholder charge cap of 1.5 per cent in the first ten years, falling to 1 per cent thereafter.

4.8 **The Government is confident that charges in the scheme can be radically lower than those currently offered to our target group.** However, the exact charge cannot be estimated with certainty. The charges faced by individuals in personal accounts will be determined by factors that, at this stage, cannot be predicted with great certainty, including:

- financing of up-front costs and early operating losses;
- participation and contribution levels of individuals; and
- administration and fund management costs, which will be revealed by the commercial process.

Box 4b: International evidence for charges reducing over time

International evidence shows that it is possible to achieve both substantial reductions in charges compared to the current charges in UK stakeholder pension schemes and substantial reductions in administration costs over time.

US Thrift Savings Plan

The Thrift Savings Plan is a scheme for government employees with typically high earnings and infrequent job moves, and deals with a small number of employers who operate a common payroll structure. Whilst not directly comparable with personal accounts, the scheme has significantly reduced its charges since its creation in 1988.

Charges in the Thrift Savings Plan started at around 0.35 per cent in 1988 and reduced to 0.07 per cent by 2003. Thereafter, the charges have reduced by 0.01 per cent every year.

Sweden

The Swedish Premium Pension Scheme (PPM) currently has a total charge of about 0.37 per cent for those in the default fund. The average charge for those in non-default funds is 0.64 per cent.

Looking forward, it is anticipated that the total charge for actively managed funds will be reduced to 0.33 per cent by 2020, and the total costs of investing via the default fund will be less than 0.2 per cent.

Australia

Twenty years ago charges under the Australian superannuation guarantee pension schemes were as high as 1–2 per cent. Following the introduction of compulsory superannuation, charges have fallen, especially for large industry and public sector funds, where typical charges are now 0.5–1 per cent.

Conclusion

While these schemes are not directly comparable with personal accounts, they do show that costs in large-scale pension schemes can be driven down over time. International evidence suggests that a long-term target of 0.3 per cent is realistic.

Financing personal accounts

- 4.9 In the short term, until revenue from scheme members' contributions comes through to cover operational costs, there will be a need to provide finance for the set up of personal accounts. There are a number of sources from which finance can be obtained. These could include the Government, suppliers such as pension providers or administrators, third parties such as banks, and members through charges. In assessing the best source of finance for the set up and operation costs, the following criteria will be considered:
- low charges for members;
 - value for money for taxpayers;
 - European Union public procurement rules and legislation on competition; and
 - commercial viability.

Membership charge structures

- 4.10 Regardless of the source of funding, the majority of the costs of personal accounts will be recovered via charges on the members of the scheme. There are a number of ways in which charges can be levied on personal accounts and we have received suggestions for alternatives to the AMC structure described in the Pensions Commission report and the May 2006 White Paper.
- 4.11 Ideally, an appropriate charge structure for personal accounts would have the following attributes:
- simple and easy to understand (for example, easily comparable to other pension products in the market);
 - fair to all members, taking into account an individual's ability to pay;
 - incentivises the scheme operator to maximise the fund value;
 - incentivises members to help keep costs down; and
 - provides significant revenue in the early years of operation, thus reducing the amount and length of operating losses, and reducing financing costs.

- 4.12 Initial analysis suggests that no one charge structure, or a combination of charge structures, has all of the above attributes. Each charge structure has advantages and disadvantages and there are trade-offs that have to be made. Some potential charge structures are outlined below:
- **Annual management charge:** A charge made annually as a proportion of an individual's funds under management.
 - **Contribution charge:** A proportion of each contribution made by the member.
 - **Joining charge:** A one-off payment made by a member on entry to the scheme. One approach could be to make a charge equivalent to a month's premium, spread over an initial period (for example, the first year).
 - **Flat fee:** Charged on a regular basis and continues as long as an individual is a member of the scheme. It is not based on the size of the member's contributions.
- 4.13 The Government is determined that charges will be fair, especially for lower earners. Within that framework the **Government is interested in views on the appropriate method of charging members for personal accounts, taking into account the ideal attributes set out in paragraph 4.11:**
- Which overall charge structure is most appropriate?
 - How much flexibility should the personal accounts delivery authority or the personal accounts board have in deciding the charging structure?
 - Are there particular circumstances or activities for which it is appropriate to make an additional charge?

Conclusion

- 4.14 The work the Government has done indicates that, despite significant uncertainties, it may be possible to achieve an AMC at a rate as low as 0.5 per cent of funds invested in the short term, and below 0.3 per cent in the long term. The Government will give the personal accounts board a duty to deliver low costs to its members. The Government is confident that charges in the scheme can be radically lower than those currently offered to the majority of our target group.

Questions for consultation

The Government is interested in views on the appropriate method of charging members for personal accounts, taking into account the ideal attributes set out in paragraph 4.11:

- Which overall charge structure is most appropriate?
- How much flexibility should the delivery authority or the personal accounts board have in deciding the charging structure?
- Are there particular circumstances or activities for which it is appropriate to make an additional charge?