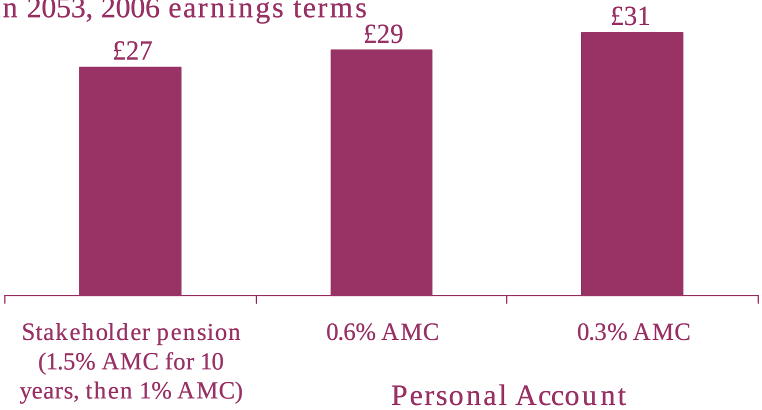
How important are low charges in Personal Accounts?

Chart 1: Lower charges increase pension incomes

Weekly private pension income for a median–earning woman making the minimum personal account contributions for 23 years and reaching state pension age (68) in 2053, 2006 earnings terms



Introduction

The Government ***believes that it is critical that charges for personal accounts are maintained at as low a level as possible*[1].** A low charge is seen as necessary to allow auto-enrolled members to get as high a pension income as possible[2].

But there are many other factors that will affect the final amount of income that Personal Accounts will deliver, and some may have a more significant impact than the level of charges.

Low cost of Personal Accounts

The Government believes that the Pensions Commission's target annual management charge (AMC) level of 0.3% of assets under management for Personal Accounts may be acheivable[3]. This level of charges is similar to that seen in large Defined Benefit occupational pension schemes, but low compared to the charge cap for stakeholder pensions (1.5% AMC for the first 10 years, then 1% AMC).

What affects pension values?

Charges reduce final pension values (Chart 1)[4]. An illustrative woman with median earnings[5] contributing the minimum to a Personal Account could expect to see a better pension, by £4 a week (17%), compared to investing the same amount in a stakeholder pension with the same employer contribution and investment return. Even a charge of 0.6% would see a better pension by £2 a week[6] (10%).

Lower charges do produce a better pension than higher charges. But because the minimum contributions to a Personal Account produce a low final pension income, the difference looks small in terms of weekly pension income.

The impact in Chart 1 of reducing charges from stakeholder pension levels to 0.3% is similar to, but slightly lower than, the impact of charges illustrated in the White Paper for reducing charges to a 0.5% AMC[7]. This is because the assumptions are different: the White paper assumed a 1.5% AMC throughout the savings period, rather than reducing to 1% after 10 years. The White Paper also assumed that Personal Account contributions are made for 40 consecutive years. This example, with a realistic pattern of working and caring, assumes 23 years.

Arguably, the impact of charges will be most important for this type of individual, where contributions and final pension amounts are small.

A low charge in itself does not guarantee a high pension. Compared contributing 4% to a stakeholder pension, other factors that affect the final level of pension received in a Personal Account include:

- The level of investment return.
- The employer contribution.
- Eligibility for Pension Credit. Although this does not change the amount received from a Personal Account, state pension income could be reduced.

Investment returns

The level of investment return for Personal Accounts is likely to have more impact on final pension income than charges. A more cautious investment strategy delivering real returns of 2% a year in a Personal Account for the median-earning woman rather than the 3% from the mixed asset portfolio assumed in Chart 1, would reduce private pension income to £25 a week, more than offsetting the impact of a very low charge.

So the policy decision on the mix of assets available in Personal Accounts, and in particular in any 'default' fund, could have more impact on final pension incomes than very low, as opposed to low, charges.

The employer contribution

The 3% employer contribution proposed for Personal Accounts makes a significant difference to final pension income. The additional 1% Government contribution[8] is available to current stakeholder pensions through the current system of tax relief. The employer contribution to a Personal Account adds an extra £10 to weekly pension income for the median earning woman (Chart 2)[9]. This is more than the £4 from a reduction in charges.

Chart 2: Charges are not the most important factor for Personal Account income

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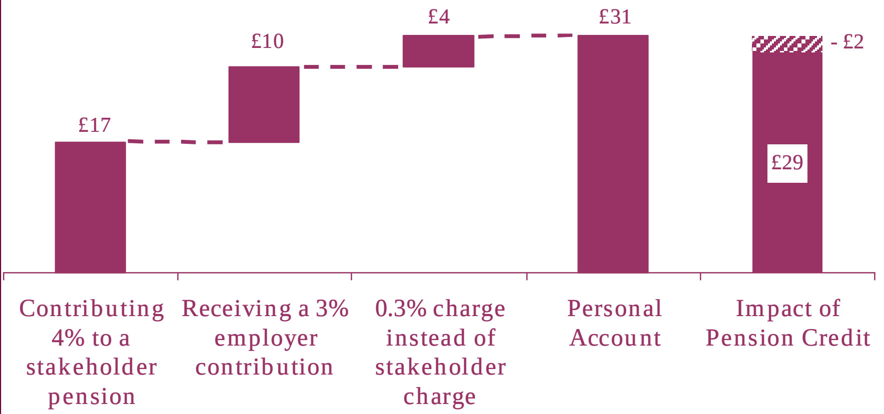
Weekly additional pension income from saving in a Personal Account rather than a stakeholder pension for 23 years for a median-earning woman reaching state pension age (68) in 2053, 2006 earnings terms



Pension Credit

Eligibility for Pension Credit (PC) can have a significant impact on the amount of additional income received from saving in a Personal Account. Although PC projections are uncertain, PPI estimates suggest that the proportion of households eligible for PC could remain at around 45% between now and 2050[10].

The median earning woman could receive £2 a week less Pension Credit as a result of saving in a Personal Account, reducing the 'value' of her saving by 7% (Chart 2). For individuals with less state pension, up to 40% of income from a Personal Account could replace PC income, and in extreme cases even more. A reduction of 40% would offset the value of the employer's contribution.

Charges are not the most important factor for Personal Accounts

While having a low charge would, all other things being equal, undoubtedly give a better pension income than a high charge, the difference between a charge of 0.3% and, say 0.6% is not so large that it should be the critical factor in the final design for Personal Accounts.

The impacts of investment returns and the employer contribution, and the potential impact of Pension Credit, could be more significant for pension income from a Personal Account than the impact of a very low, rather than low, charge.

For more information on this topic, please contact
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[1] DWP (2006) ***Security in retirement: towards a new pensions system*** page 59
[2] DWP (2006) Box 1.g page 60
[3] DWP (2006) page 61
[4] PPI estimates using the Individual Model, assuming a real rate of return of 3% per year
[5] Spending some time caring and in part-time work consistent with previous PPI work
[6] The AMC in Personal Account option 2 DWP (2006) page 52
[7] DWP (2006) page 61
[8] As this will be delivered through tax relief, higher rate taxpayers would receive a larger Government contribution
[9] See footnote 4
[10] PPI (2006) ***An evaluation of the White Paper state pension reforms***