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Charging structures for Personal Accounts

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Pensions Policy Institute

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www.pensionspolicyinstitute.org.uk

DWP Department for Work and Pensions

AEGON

STANDARD LIFE

Charging structures for Personal Accounts

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- Evaluated different charging structures against the Government’s criteria
- Concluded that no single no single charging structure, or combination of charging structures, has all of the desirable attributes
- So there are trade-offs that have to be made

Five charging structures were analysed

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Annual Management Charge (AMC)	A proportion of an individual's funds under management (0.5%)
Joining charge + AMC	A one-off payment made on entry (3 months of contributions) + AMC (0.45%)
Annual flat fee	A flat amount for all individuals, made annually (£70)
Contribution charge	A proportion of each contribution made (10% of all contributions)
Contribution charge + AMC	A contribution charge (5%) + AMC (0.25%)

The Government's five criteria

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1. Fair to all members
2. Reducing financing costs
3. Simple and easy to understand
4. Incentivises members to help keep costs down
5. Incentivises the scheme operator to maximise the fund value

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1) Fair to all members, taking into account an individual's ability to pay

What is 'fair'?

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There are different definitions of fairness, e.g.

- Everybody pays the costs of running their fund
- Everybody pays the same proportion of their fund value

An annual flat fee has a consistent impact on the £ amount lost

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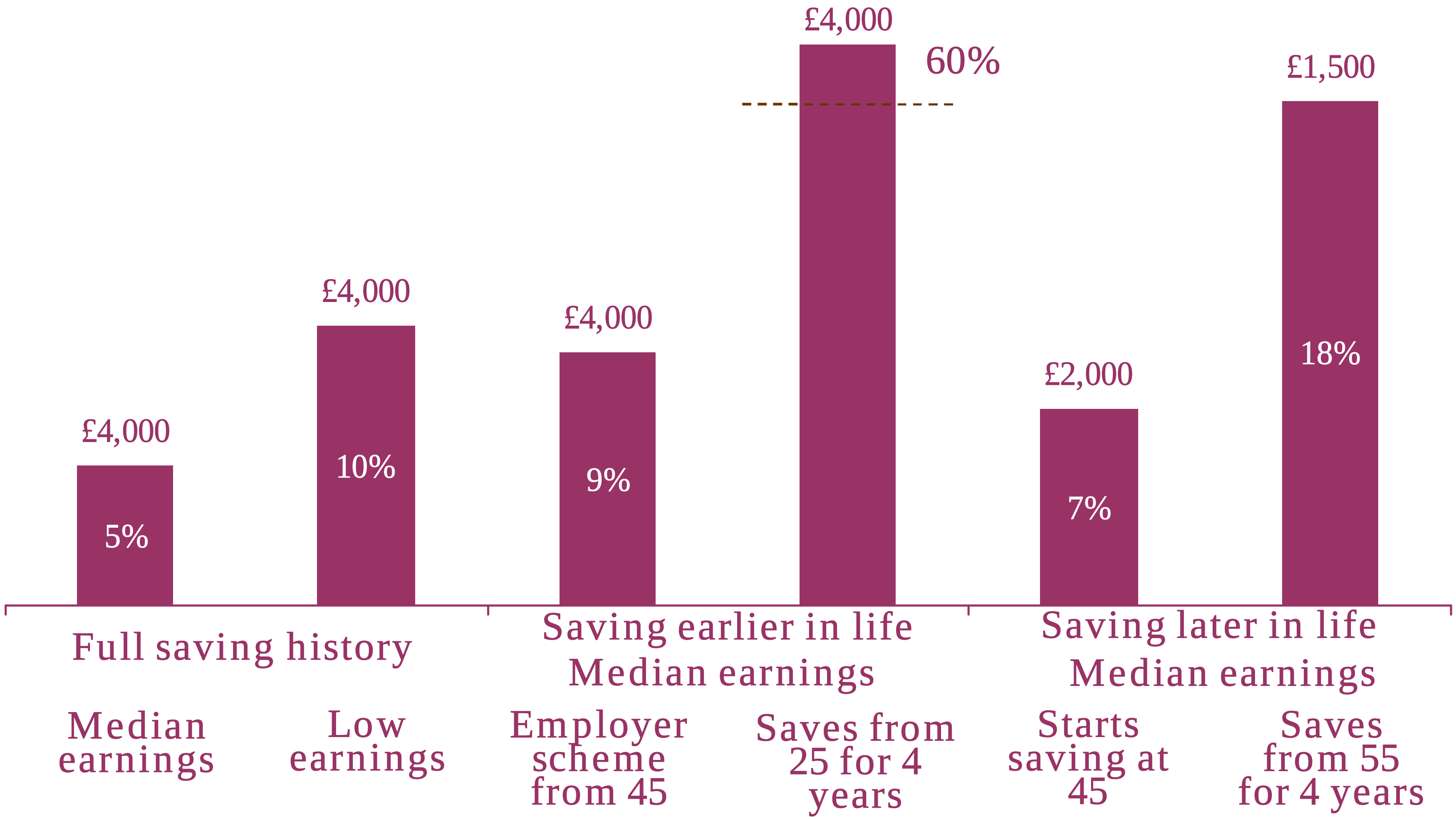

A contribution charge has a consistent impact on the % of fund lost

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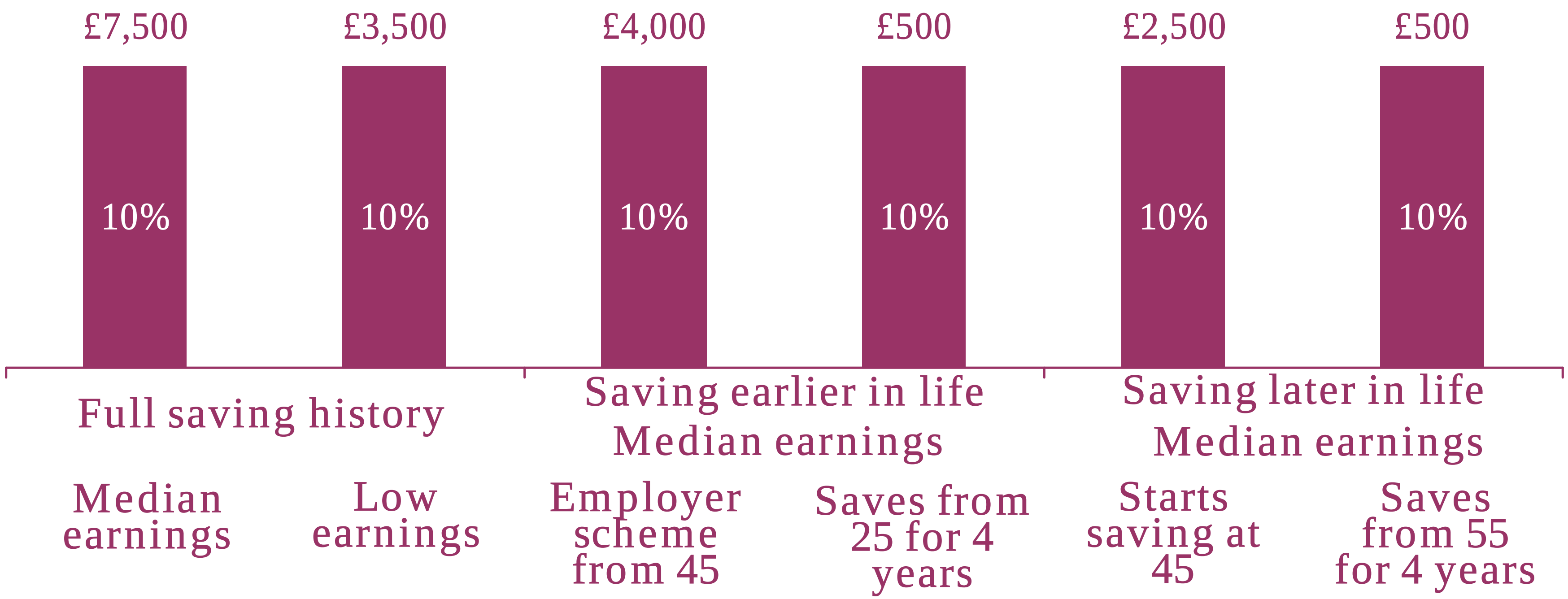

An AMC is better for people who save later in life

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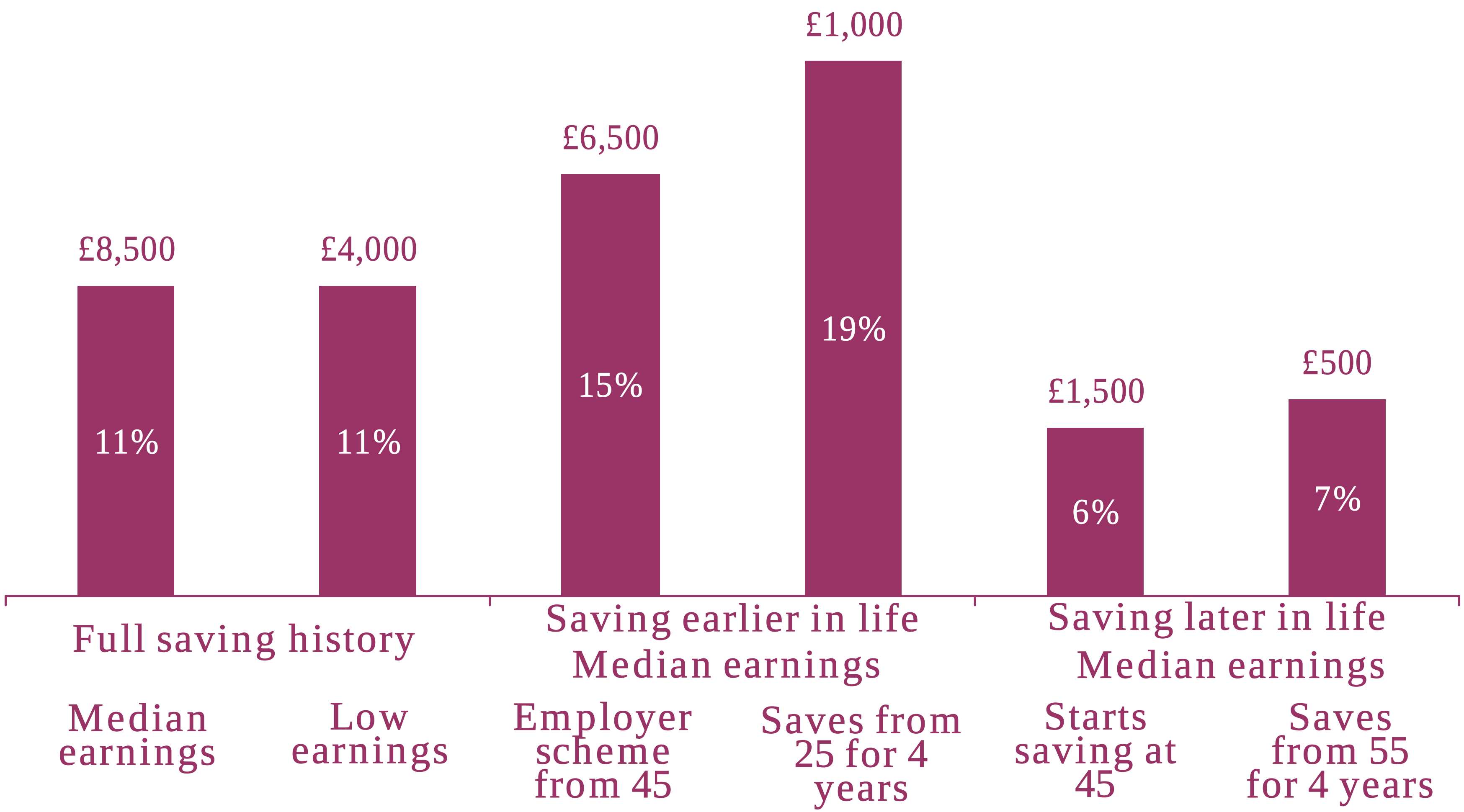

1) Fair to all members

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	Fair to all members	
	Same absolute amount lost to charges	Same proportion lost to charges
AMC	O	O
Joining charge + AMC	O	O
Annual flat fee	PP	O
Contribution charge	O	PP
Contribution charge + AMC	O	P

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

Financing analysis

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- Made projections of future annual costs (set-up, administration, fund management)
- Compared them to annual revenue from charges
- Any deficit is assumed to be made up by borrowing
- Calculated:
  - Amount of borrowing needed (initial and peak)
  - Duration until borrowing is paid off (‘payback period’)
  - The cost of capital

An AMC would not cover costs in the short term

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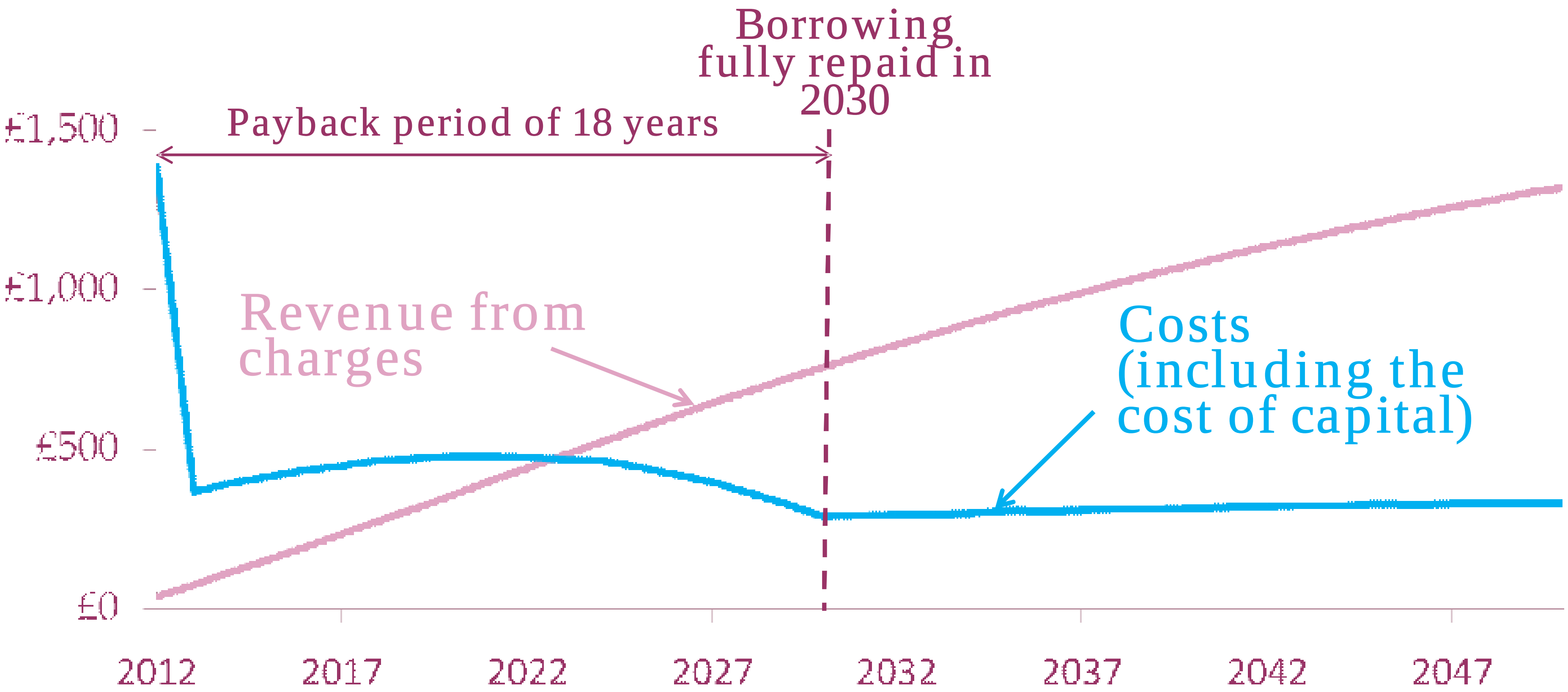
Projected cash flow for Personal Accounts, £ m, 2006 earnings



Combining an AMC with a joining charge could reduce the duration of borrowing…

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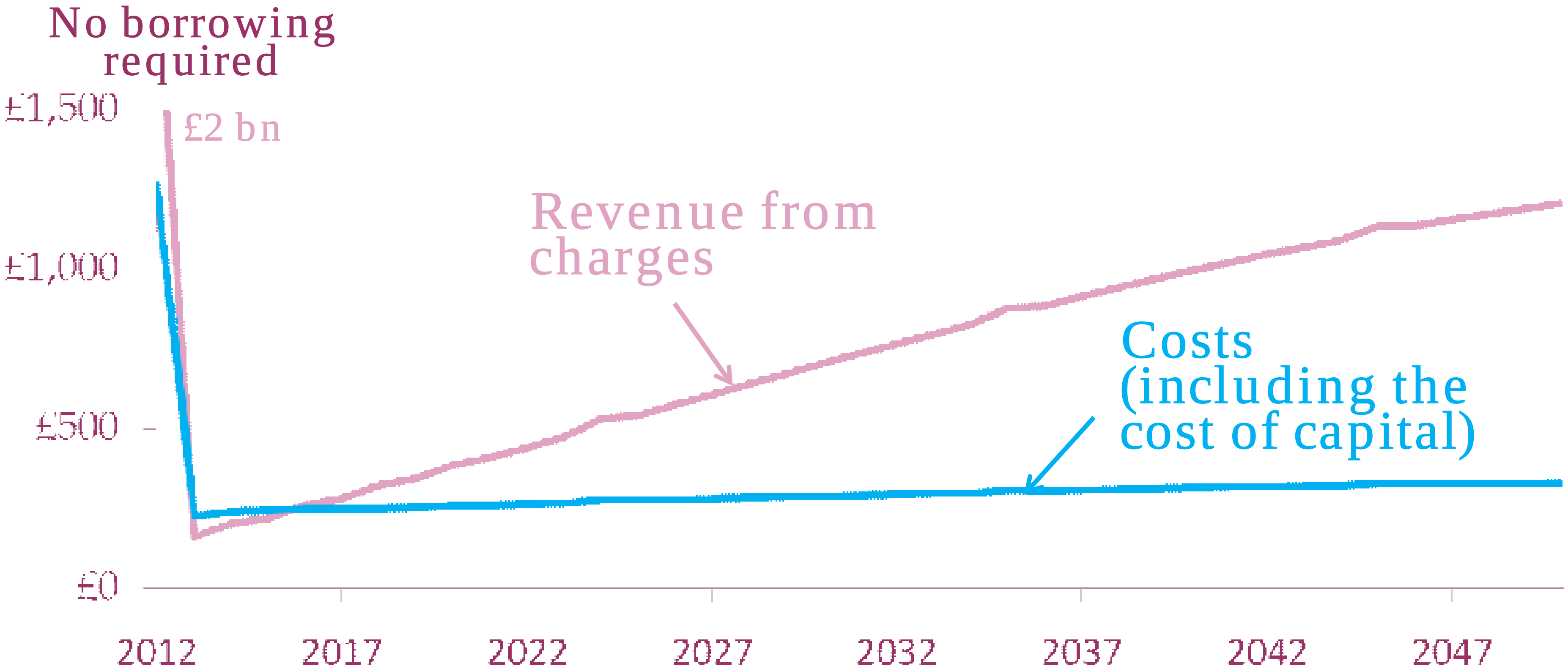
Projected cash flow for Personal Accounts, £ m, 2006 earnings



…as could combining an AMC with a contribution charge

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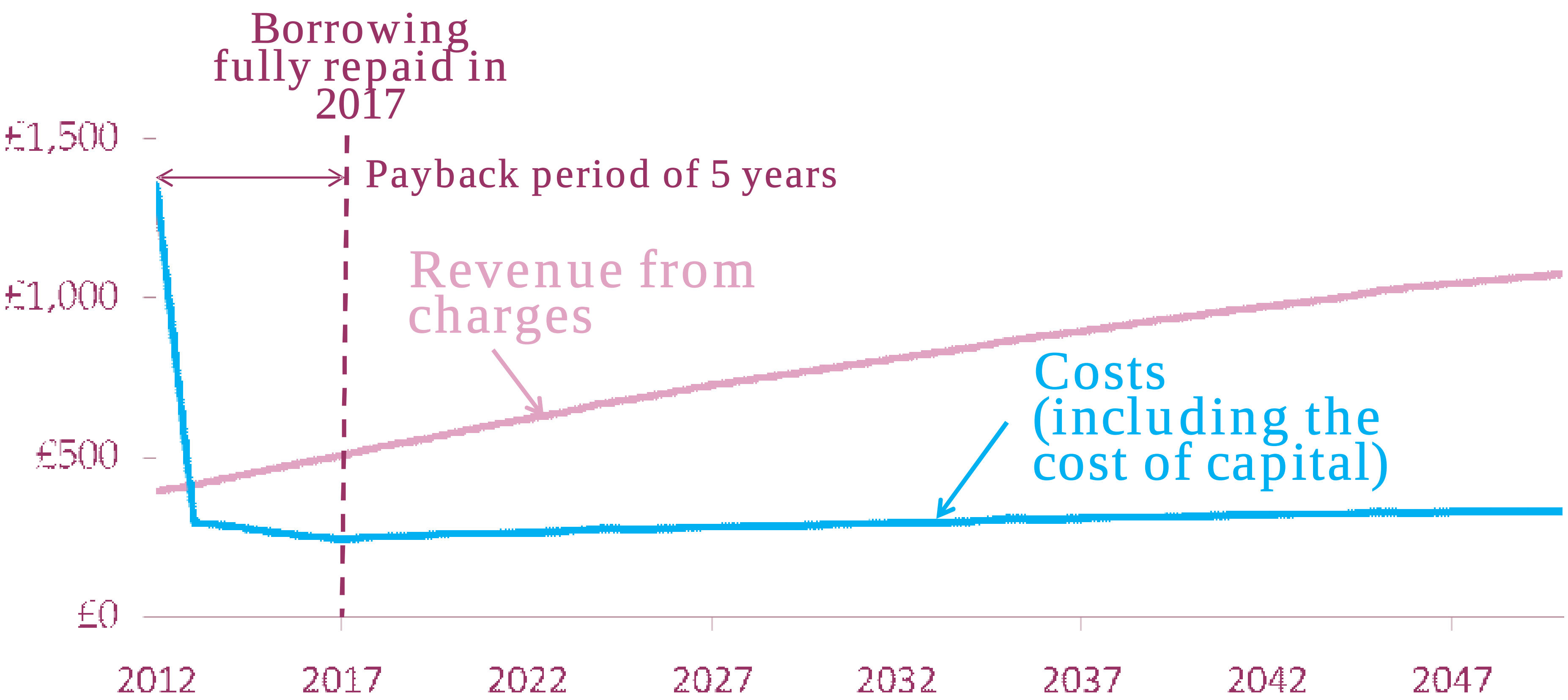
Projected cash flow for Personal Accounts, £ m, 2006 earnings



2) Reducing financing costs

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	Peak amount of borrowing (£ billion)	Payback period	Cost of debt (£ billion)	Reducing financing costs
AMC	£1.7 to £4.5	15 to 28 years	£0.9 to £11.8	O
Joining charge + AMC	No borrowing required from 2012			PP
Annual flat fee	£0.7 to £0.8	2 to 3 years	£0.1 to £0.2	P
Contribution charge	£0.6	2 years	£0 to £0.1	P
Contribution charge + AMC	£0.9 to £1.0	5 to 6 years	£0.1 to £0.5	P

Outcomes for the AMC depend on the cost of capital

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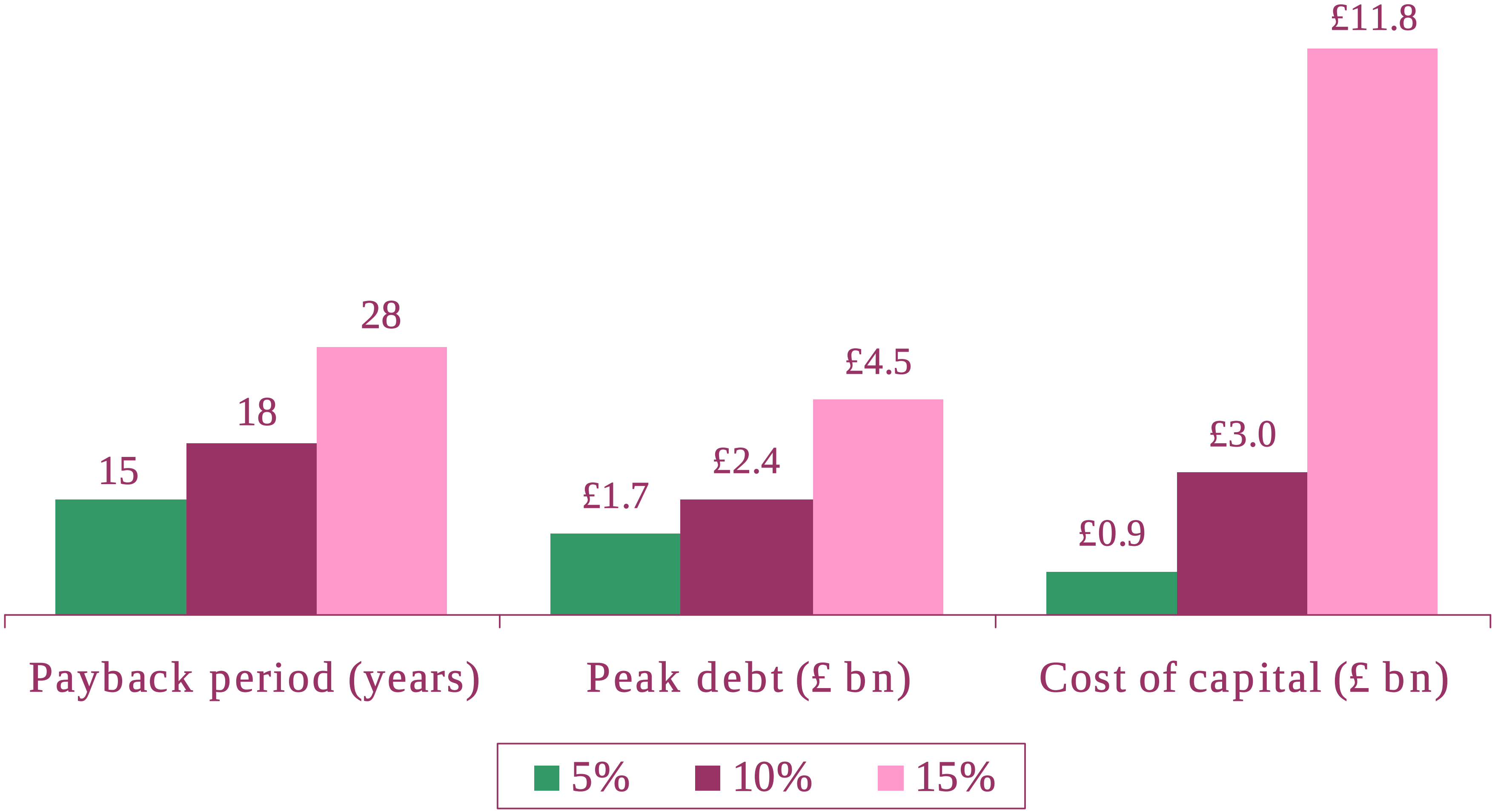

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3) Simple and easy to understand (for example, easily comparable to other pension products in the market)

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	Easy to…	Simple and easy to understand
AMC	Compare with Stakeholder Pensions	P
Joining charge + AMC	Two components seems complicated	O
Annual flat fee	Understand amount paid each year	P
Contribution charge	Understand impact on final pension fund	P
Contribution charge + AMC	Two components seems complicated	O

Research needed into how consumers will respond?

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4) Incentivises members to keep costs down

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- Any of the structures could be adapted to incentivise a member to reduce costs
    - But would this be in members' best interests?
- Some charging structures may affect levels of membership more than others:
    - Would a joining charge discourage participation?
    - What is the impact of the charging structures on persistency?

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5) Incentivises the scheme operator to maximise fund value

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	% of charging revenue from an AMC element	Incentivises the scheme operator to maximise fund value
AMC	100%	PP
Joining charge + AMC	90%	PP
Annual flat fee	-	O
Contribution charge	-	O
Contribution charge + AMC	50%	P

Difference between how consumers are charged vs. how providers are paid?

No charging structure is ideal

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	Fair to all members					
	Same absolute amount lost to charges	Same proportion lost to charges	Reducing financing costs	Simple and easy to understand	Incentivises members to keep costs down	Incentivises the scheme operator to maximise fund value
AMC	O	O	O	P	?	PP
Joining charge + AMC	O	O	PP	O	?	PP
Annual flat fee	PP	O	P	P	?	O
Contribution charge	O	PP	P	P	?	O
Contribution charge + AMC	O	P	P	O	?	P

Questions for discussion

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- Which overall charge structure is most appropriate?
    - Is there anything missing from this analysis?
    - Are the Government's criteria the right ones?
    - Which are the most important criteria?
- How much flexibility should the delivery authority or the personal accounts board have in deciding the charging structure?