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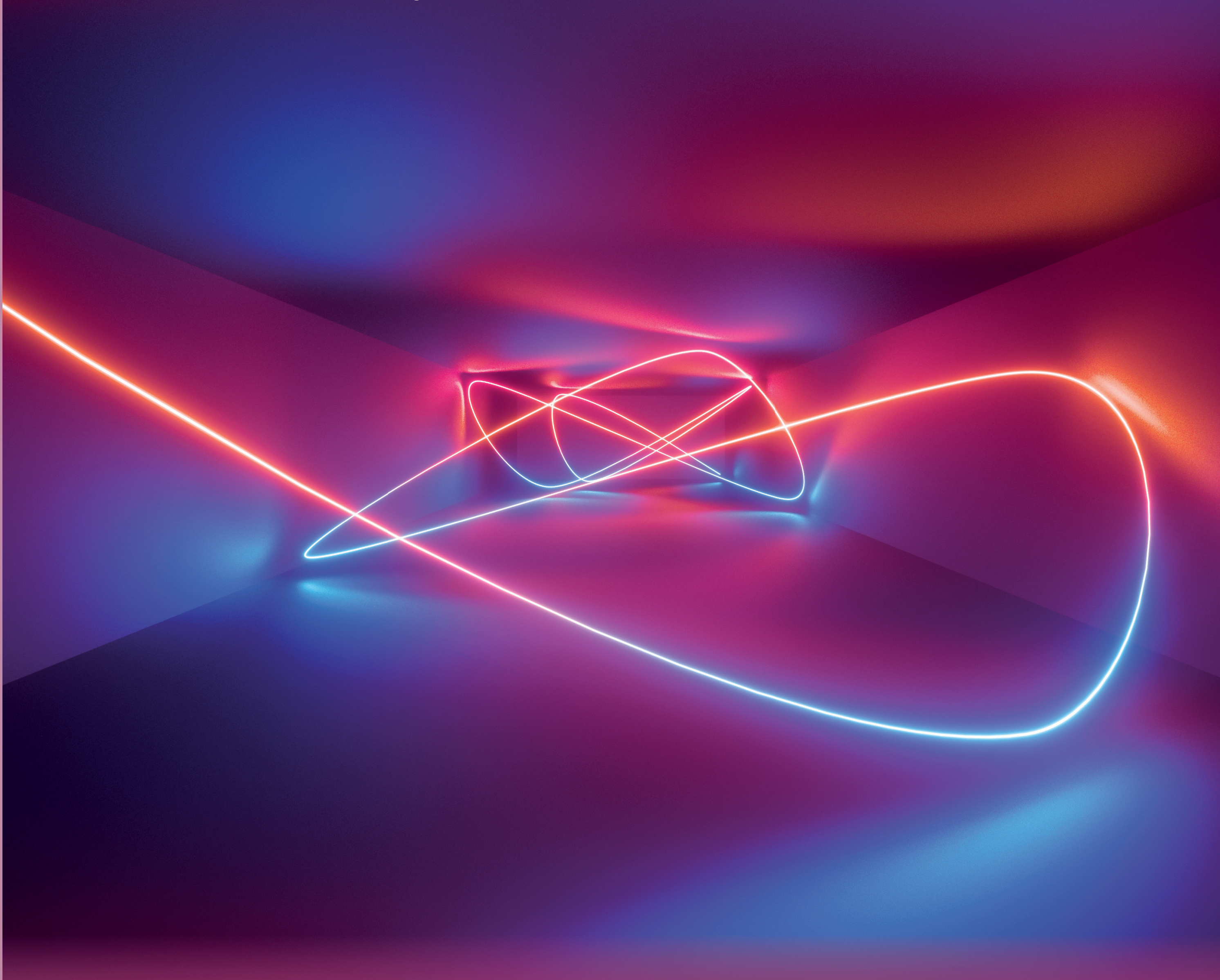
PENSIONS POLICY INSTITUTE

PPI

Pension charging structures and beyond; an outcomes-focused analysis

Executive Summary



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Mark Baker joined Mark joined the PPI in November 2018, as the Senior Policy Researcher. Prior to joining PPI, Mark earned a PhD in Sociology from the University of Exeter before working for RNIB and RNID in senior research and policy roles, authoring a number of influential research reports as well as chairing the Disability Benefits Consortium and ACEVO's welfare to work special interest group.

The Pensions Policy Institute (PPI)

The PPI is an educational, independent research organisation with a charitable objective to inform the policy debate on pensions and retirement income provision. The PPI's aim is to improve information and understanding about pensions and retirement provision through research and analysis, discussion and publication. It does not lobby for any particular issue or reform solution but works to make the pensions and retirement policy debate better informed.

Pensions affect everyone. But too few people understand them and what is needed for the provision of an adequate retirement income. The PPI wants to change that. We believe that better information and understanding will lead to a better policy framework and a better provision of retirement income for all. The PPI aims to be an authoritative voice on policy on pensions and the provision of retirement income in the UK.

The PPI has specific objectives to:

- Provide relevant and accessible information on the extent and nature of retirement provision
- Contribute fact-based analysis and commentary to the policy-making process
- Extend and encourage research and debate on policy on pensions and retirement provision
- Be a helpful sounding board for providers, policy makers and opinion formers
- Inform the public debate on policy on pensions and retirement provision.

We believe that the PPI is unique in the study of pensions and retirement provision, as it is:

- Independent, with no political bias or vested interest
- Led by experts focused on pensions and retirement provision
- Considering the whole pension framework: state, private, and the interaction between them
- Pursuing both academically rigorous analysis and practical policy commentary
- Taking a long-term perspective on policy outcomes on pensions and retirement income
- Encouraging dialogue and debate with multiple constituencies

A Pensions Policy Institute report

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Executive Summary

The type and level of charges levied on workplace pensions has recently been the focus of attention for policymakers and the wider industry. The introduction of the charge cap brought significant attention to cost, and much work has been done to improve transparency in how pension charges are calculated and levied.

However, low charges don't necessarily guarantee good value. And different charging levels and structures can impact on individuals' potential outcomes. The key questions that this research addresses are:

To what extent do charging structures and levels matter?

What more can be done to aid people to have a retirement income that meets their needs?

Key conclusion:

Charging structures and levels impact on member outcomes in retirement, but they are not necessarily the most important factor

Charging levels and structures have an important role to play in determining member outcomes. However, in order to secure improved outcomes, charges need to be considered alongside other factors such as contribution levels, investment strategies, member communications and experience, the strength of governance oversight and the impact of having multiple pots.

The main findings of this report are:

A low charge does not guarantee good value

People approaching retirement with multiple pension pots are more likely to lose out compared to people who either have a single pot throughout their working lives or who consolidate their pension whenever they change employer. The amount they lose will depend on the nature of the charges they face across their different pension schemes.

Charges do not necessarily reflect costs

The costs incurred in running a pension scheme are many and complex, and not all fall within the remit of the cap. Key among those that are exempt are transaction costs, which may be volatile and can be difficult to predict. This means that the composition and nature of charges is not always obvious, creating a transparency deficit.

Value for money can be hard to define

Value for money will have different meanings for different participants at different times in pension schemes, with a range of factors having a direct impact on stakeholders.[1] While employers may be looking for a scheme that provides them with low administration costs, members (who do not choose their scheme provider themselves) will be looking for a scheme that provides them with their desired retirement outcomes.

Transparency is important, but not necessarily a solution

Greater transparency in terms of default strategies and their costs and charges will allow for greater understanding of the charges levied by providers, but may not always produce data that members or employers can understand or use effectively.

Cross-subsidies exist within pension schemes, but can be difficult to identify

Cross subsidies within automatic enrolment pension schemes are often associated with specific strategies. People who continue to pay ongoing Annual Management Charges (AMC) even when not contributing to their pension effectively subsidise current members, and smaller pots can be loss-making for providers meaning that it can be difficult to reflect underlying cost. Also, where a scheme makes no administrative charge to the employer, the members (employees) could be seen to be subsidising that employer. However, any such cross–subsidies are likely to be very small as far as the majority of individual members are concerned.

Different charging structures will result in different outcomes for savers

Combination charges (where an AMC is combined with either a flat fee or a contribution fee) generally provide better outcomes over time than an AMC-only approach. This is particularly true when an individual has deferred or multiple pots, where the same AMC continues to be levied even when contributions have ceased. However, fixed flat fees can erode deferred savings over time.

Automatic enrolment is likely to see people reaching retirement with multiple pension pots

There is no doubt that automatic enrolment has been successful in increasing numbers of people saving into workplace pensions. However, the fact that automatic enrolment results in people having multiple smaller pots can work against people achieving better results, as they can lose out by paying multiple charges across the accumulation period. Multiple pots can also mean that people are at risk from losing track of their pensions.

There are three main approaches that can tackle the issue of people accumulating multiple pots, though none of these are without their drawbacks:

- A single pot approach, whereby the saver does not change their scheme throughout their working life, and the employer pays into their existing scheme.
- ‘Pot follows member’ whereby an individual’s existing pot is automatically transferred into their new employer’s pension scheme.
- Member-borne consolidation / reinvestment, whereby the saver makes an active decision to consolidate their existing pension pot into their new employer’s scheme, or asks the new employer to make contributions into their existing scheme.

A single pot approach can provide better retirement outcomes, but this depends on the scheme an individual is first enrolled into

People who are initially enrolled into and remain in a scheme with an AMC-only strategy, or one that maintains a relatively high AMC will still have better outcomes than those who have multiple pots in schemes with a similar charging structure. These people could gain from moving into combination-charge schemes that offer savings for larger pot sizes. Similarly, those enrolled into combination schemes could most likely see their pot size fall if they left it for another scheme with a different approach.

1. Echalier, M. *et al*. PPI (2016).

Pot follows member can provide better retirement outcomes, but this depends upon the nature and order of the schemes an individual is enrolled into

As with the single pot approach, 'pot-follows-member' can see people increase their retirement income, but only if they are fortunate in their automatic enrolment pathway. Again, the advantage is with those people who are enrolled into and remain in combination schemes with a combination charging strategy either throughout their working lives, or as their pension pot increases. Those who remain in schemes without variation are likely to lose out in comparison.

Member-borne consolidation can result in better retirement outcomes, but will require greater engagement

Both previous options mean that individual scheme members have little control over the default schemes they are enrolled into. When an individual changes employer, they can opt to have their current pension pot consolidated into their new scheme, or can opt for a non-default investment strategy from the same provider, but they cannot choose to remain in their previous scheme without losing the employer contribution, something that would be likely to more than offset any potential gains.

However, even this limited ability to control their pension saving can have some positives, and pensions dashboards could allow for more engagement from members, resulting in better informed decisions about their pensions.

Contribution levels tend to have the most significant impact on pension outcomes

A person contributing an extra 2% of salary on top of their statutory minimum contribution into their workplace pension will achieve a 25% increase in retirement income regardless of the charging structure they are in.

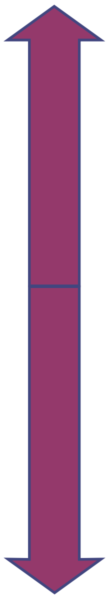
Every automatic enrolment charging structure has advantages and disadvantages for providers, employers and members alike

Table Ex1 provides a summary of how different approaches to charging can affect stakeholders.

Table Ex1. Advantages and disadvantages of charging structure approaches.

Charging structure	Pros	Cons
AMC Only	• Easier to understand for employers and members. • Provides for easier comparison between schemes. • Smaller pots benefit from cross-subsidies.	• Can involve considerable cross-subsidies from those with larger pots. • Difficult to split out administration and investment costs • Requires greater initial capital outlay from providers.
AMC plus contribution charge	• More cost effective at start-up for providers. • Deferred members are not penalised when no longer contributing	• Difficult to understand the split between costs, such as those related to administration and investment • Active members can lose some of the advantage of making additional contributions
AMC plus flat fee	• More cost effective at start-up for providers • Easier to split out administration and investment charges. • More transparent in aligning costs and charges. • Reduces cross-subsidy.	• Active members making lower contributions may lose out. • Deferred members with multiple small pots could face significant erosion of savings.

Higher cross-subsidy



Lower cross-subsidy