Building personal accounts: choosing a charging structure

A summary of responses following public consultation

July 2008

personal accounts delivery authority

Advisory body to the Department for Work and Pensions

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FOREWORD
by Tim Jones, Chief Executive

Personal accounts will improve the retirement of millions of people—people who would otherwise lack the income to live the retirement they want and deserve.

Getting the scheme's design right is fundamental to its success.

To help us give the Government the best possible advice on the scheme's design, it is important we consider all of the options. This is why we have decided to run a series of structured consultations on key elements of scheme design: the charging structure, investment, decumulation, and scheme order and rules. This gives our stakeholders the opportunity to directly influence the design of the scheme.

The first of these consultations began with the January 2008 release of our publication, *Building personal accounts: choosing a charging structure, a discussion paper to support consultation.*

We received written submissions from 47 organisations, encompassing the financial services industry, existing pension scheme providers, consumer groups, employer groups and individual employers.

This publication summarises the key findings. It also includes some of the delivery authority's initial analysis of the views captured.

While there is no consensus on the details, there is agreement about the qualities the charging structure will need to help personal accounts succeed in its ultimate goal—that of getting more people saving for retirement.

Stakeholders agree that the charging structure will need to be fair, to be easy for scheme members to understand, and to help members to secure good retirement outcomes. The charging structure must also help to ensure that the scheme will be sustainable.

On behalf of the delivery authority, I would like to thank each of the organisations and individuals who responded to this consultation. It is only by considering their different perspectives that we will be able to balance relevant concerns, and to design a robust scheme.

I thank you and hope you will continue to engage with us as we work to design the framework that will support personal accounts.

Tim Jones

EXECUTIVE SUMMARY

Purpose of this publication

1. The Pensions Act 2007 established the personal accounts delivery authority as a non-departmental public body. The delivery authority's initial remit is to advise the Government about personal accounts, so that policy takes full account of operational and commercial considerations.
2. In line with this remit, the delivery authority will be making a recommendation to the Secretary of State for Work and Pensions on the charging structure.
3. The charging structure will be a key design decision for the scheme. The choice of charging structure will have a direct effect on member outcomes. It will affect the viability and sustainability of the scheme. It may have an impact on participation in the scheme.
4. This publication outlines the key findings from the consultation. It includes a summary of the responses received. It sets out how these responses will help the delivery authority to shape a recommendation on the charging structure.
5. It is not the purpose of this publication to set out a recommendation for the charging structure.
6. The delivery authority anticipates that this recommendation will be made prior to procurement, as part of its wider advice to the Secretary of State for Work and Pensions on funding the personal accounts scheme.

The consultation process

7. The delivery authority ran a public consultation on the choice of charging structure for personal accounts. The aim was to canvass views and gather relevant evidence to help make the best possible recommendation.
8. The consultation ran from 29 January to 22 April 2008. 47 responses were received from a wide range of organisations. The delivery authority also met with key stakeholders, and held a seminar event for its stakeholders to debate the different options.
9. To support the consultation, the delivery authority published a discussion paper, *Building personal accounts: choosing a charging structure*[1]. This set out 13 specific questions the delivery authority wanted answers to. These questions were focused on two broad areas: evaluating the options, and building an evidence base.

Options for charging structures

10. The delivery authority wanted to know about the different charging structures currently used by the financial services industry (both for pensions and for other financial products), what the rationale were for these charging structures, and whether these rationale were relevant to personal accounts.
11. Respondents identified two broad approaches to charging in the financial services industry:
    - **Combination charging structures:** a combination of different charges levied as a way of recovering the cost of different service elements; used as a way of meeting the needs of the business by aligning costs and revenues.

1 Personal accounts delivery authority, January 2008, *Building personal accounts: choosing a charging structure, a discussion paper to support consultation.*

- **An annual management charge:** a single charge levied as a percentage of an individual's pension pot; has been adopted more widely in recent years as a result of changes in the regulatory environment governing personal pensions.

12. The discussion paper explored four options for a charging structure for personal accounts. During the consultation, respondents proposed three additional charging structures for consideration. **Figure 1** summarises respondents' views on all of these charging structures.

Figure 1: Views on different charging structures

Option	What respondents said
Options proposed in the delivery authority's discussion paper	
Annual management charge (AMC)	The simplicity and transparency of this option could encourage participation, although it would be slower to build scheme revenues than other options.
Contribution charge	This option could be easily explained to members but could potentially be unsustainable in the long term, particularly in the event of disruption to contributions or an increase in the cost base.
Joining fee with an AMC	This option would be quicker to build scheme revenues than other options but would be problematic in the context of auto-enrolment: it could be poorly perceived by members, risking increased opt-out.
Contribution charge with an AMC	This would be the most sustainable option, with the flexibility to deal with a range of business risks; however, members could perceive it as complex.
Options proposed during the consultation	
Flat fee with an AMC	This option would help align revenues with costs in the operating phase, but would produce a significant variation in member outcomes.
Contribution charge with an AMC; cap on total amount member pays	This option would help align revenues with costs in the operating phase, but might produce a significant variation in member outcomes.
Contribution charge for active accounts/AMC for dormant accounts[2]	This option would enable business risks to be mitigated, and might reduce perceptions of double-charging relative to a contribution charge with an AMC. However, this option could be more administratively complex.

2 An active account is one where members are making contributions. A dormant account is one where members are no longer contributing to the account.

13. Although the discussion paper did not directly ask for a preference, most respondents did specify what they felt to be the most appropriate charging structure. There was no consensus view. For the most part, responses were broadly split in favour of one of the following two options proposed in the discussion paper:
    - an AMC-only structure; and
    - a contribution charge with an AMC.
14. In general, respondents who supported one of these options tended to oppose the other: those who supported an AMC-only structure disliked a contribution charge with an AMC, and vice versa. A minority of respondents said they would be supportive of either approach.
15. There was only very limited support for either a contribution charge on its own or a joining fee with an AMC, but significant opposition to both of these options.
16. Most respondents supported additional charges for particular activities as a way of ensuring that the headline charge was kept low. Respondents suggested drawing up a core set of services, and levying an additional charge for any other services offered. This would keep the scheme simple while allowing for additional charges.
17. Whether in favour of additional charging or not, all respondents highlighted the importance of keeping the product proposition for personal accounts simple. This was considered important as a way to reduce the number of services potentially requiring additional charges, and to reduce administration costs.
18. In designing the personal accounts scheme, the delivery authority will aim to keep the product proposition for personal accounts simple, as a way of keeping scheme costs down. Building simplicity into the scheme will include designing a set of core services that will be covered by the headline charging structure, and seeking to limit those areas where additional charges may be required.

Principles

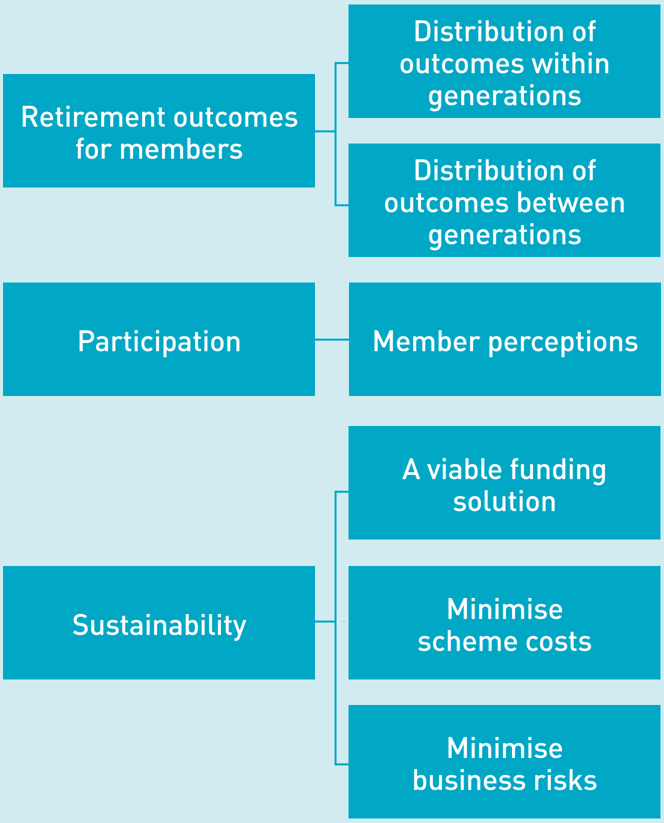
19. In discharging its functions, the delivery authority will have regard to a set of principles[3]: these are set out in chapter three (paragraph 3.4) of this publication.
20. In its discussion paper the delivery authority wanted to know how these principles should best be applied to the question of charging.
21. Most respondents agreed that, where relevant, the delivery authority's principles should be taken into account. Two principles in particular were discussed.
22. Several respondents emphasised the importance of the principle that *any adverse effects on qualifying pension schemes, and members and prospective members of those schemes, should be minimised*. Respondents suggested that it was important for the delivery authority to consider any negative effects that the charging structure might have on other qualifying schemes.
23. Respondents also emphasised the principle that *the burdens imposed on employers should be minimised*. Employer groups indicated they would not support charges being levied on employers.
24. The delivery authority will have regard to all of its principles where they are relevant to its recommendation, in line with its duty set out in the Pensions Bill 2007.

3 These principles are outlined in the Pensions Bill introduced into Parliament in December 2007 and subject to Parliamentary approval.

Evaluation criteria

25. The discussion paper proposed a set of evaluation criteria by which different charging structures could be evaluated. The delivery authority wanted to know whether respondents thought these evaluation criteria were appropriate, which criteria were most important, and whether any other criteria should be included.

Figure 2: Proposed criteria for evaluating charging structures



26. Most respondents were supportive of the proposed evaluation criteria. Many felt that the criteria were inter-related and therefore had difficultly ranking or weighting them.

27. A number of respondents suggested two additional evaluation criteria:

- impact on the market; and
- flexibility to deal with future policy change.

28. **Impact on the market:** this would assess the impact of the charging structure on charging behaviour in the financial services industry, and the potential for the scheme to be unfairly advantaged.

29. In relation to the potential impact on charging behaviour, the delivery authority will take this into consideration. It will do so when it makes balanced judgements in relation to the principle that *any adverse effects on qualifying schemes, and members and prospective members of those schemes, should be minimised.*

30. No decisions on the source and structure of funding for personal accounts have been made: these will not be known until later in the design and commercial process. If there is any Government support, it will be compatible with European legislation on competition and State aid.

31. **Flexibility to deal with future policy change:** this would assess the charging structure's responsiveness to change, particularly in the context of the 2017[4] review of personal accounts.

32. The delivery authority will assess flexibility when evaluating the different charging structures against the criteria of *sustainability* and *minimising business risks* (**Figure 2**).

33. The delivery authority does not intend to change the evaluation criteria from those set out in the discussion paper.

4 There will be a review of the personal accounts scheme in 2017. This review will primarily cover the annual contribution limit and the policy on transfers, but may also include other issues which are relevant at the time.

Member outcomes

34. The delivery authority wanted to know how respondents thought the impact of different charging structures on members' outcomes should be assessed.

35. The discussion paper put forward two ways to assess members' outcomes:

    - **reduction in yield**, which measures the difference in the rate of fund growth with and without the charges being levied; and
    - **reduction in fund value due to charges**, which measures the proportion of a member's final pension pot lost to charges.

36. Respondents suggested that both measures had merit. Respondents felt that both measures should in practice probably be used, albeit in different circumstances. For example, *reduction in fund value due to charges* might be a clearer way of explaining the impact of charging to members; *reduction in yield* might be more useful in ensuring that the scheme offered good value by allowing comparisons with other pension schemes.

37. The delivery authority will assess outcomes using both measures as a part of its work to inform its charging structure recommendation.

38. Several respondents were also interested in the differences in outcomes between different members, and suggested alternative ways of defining whether these differences were 'fair'. Fairness was discussed in terms of the degree of cross-subsidy between members, which would vary under different charging structures.

39. The discussion paper proposed defining fairness as making the proportion of fund value lost, due to charges, constant across members. This received support from several respondents.

40. Other respondents suggested other definitions, such as a constant annual reduction in yield across all members, and a standard charge level for individual accounts in line with the costs they incurred.

41. The delivery authority is aware that there are different definitions of fairness from that proposed in the discussion paper, and recognises that these definitions may also be valid. The delivery authority will outline the degree of cross-subsidy between members for each option when it makes a recommendation on the charging structure to the Secretary of State as part of the wider advice on the funding strategy for the scheme.

Participation

42. Participation in the personal accounts scheme will be critical if it is to succeed. Potentially people's perceptions of the charging structure for personal accounts could affect participation. The delivery authority wanted evidence about the effects of different charging structures on the perceptions of consumers. It also wanted evidence about how consumers' perceptions had affected participation in pension schemes and other financial products.

43. Respondents felt that the charging structure would be unlikely to have a significant effect on participation. Some respondents felt that people were not always sensitive to pricing structures or levels when thinking about pensions. However, the charging structure could have an impact on the views of opinion formers: this could have an effect on participation, particularly when the scheme is launched.

44. The level of the charge was felt to be a more important factor—although still secondary to wider issues such as the affordability to members of their contributions, and their trust in the scheme.

45. The perceived simplicity of the charging structure was seen as significant, as was clarity in the way it is communicated to members. Some respondents suggested that participation could be affected if the charging structure was seen as confusing and difficult to understand. The way in which the charging structure was communicated was therefore seen, by several respondents, as potentially more important than the nature of the structure itself.

46. The delivery authority recognises the importance of building trust and confidence in the scheme, including through clarity and transparency of communication about the charging structure. The delivery authority will use the sources of evidence identified by respondents (see chapter five) to help inform its understanding and approach in this area.

Minimising scheme costs

47. The delivery authority wanted to know what evidence existed about the way in which administrative complexity or member behaviour had affected costs in the case of other financial products.

48. Most respondents were clear that product complexity and member behaviour could both increase scheme costs. Respondents felt that more complex products tended to need more complex administration, which resulted in higher costs. Pension schemes in general were seen as relatively costly to administer as they were more likely to experience member-driven change — for example, a scheme member receives a pay rise or switches employer.

49. However, respondents also suggested that achieving low costs should not be to the detriment of high quality when designing the scheme.

50. One of the key principles the delivery authority will adhere to in designing personal accounts will be to keep the scheme simple, in part to ensure that costs are minimised.

51. In designing personal accounts the delivery authority will also seek to ensure that the scheme meets the Government's policy intention to provide not only a low-cost savings vehicle, for low-to-moderate earners, but also a high-quality scheme.

CHAPTER ONE

Purpose of the consultation

1.1 On 29 January 2008, the personal accounts delivery authority launched a public consultation about the most appropriate charging structure for the personal accounts scheme.

1.2 The charging structure will be a key design decision for the scheme: it will have a direct effect on member outcomes, will affect the short-term viability and long-term sustainability of the scheme, and may have an impact on participation in the scheme.

1.3 As part of its wider advice on funding for personal accounts, the delivery authority will make a recommendation to the Secretary of State for Work and Pensions regarding the most appropriate charging structure. This consultation will inform that advice.

1.4 To support the consultation process, the delivery authority launched the discussion paper, *Building personal accounts: choosing a charging structure*[5], which broadly asked for input on two themes.

- How should we **evaluate the options** and what weight should we apply to different factors?
- What is the **evidence base** that will support our recommendation?

1.5 The discussion paper also set out a range of charging structure options, a proposed set of evaluation criteria, and an analysis of each of the options against the criteria.

Purpose of this publication

1.6 The purpose of this response document is to outline the key findings from the consultation, including a summary of the responses received. The response document also:

- outlines how the delivery authority proposes to take account of what respondents have said; and
- highlights useful evidence suggested by respondents.

1.7 It is not the purpose of this publication to set out a recommendation for the charging structure. The delivery authority anticipates that this recommendation will be made prior to procurement, as part of its wider advice to the Secretary of State for Work and Pensions on funding the personal accounts scheme.

1.8 Inevitably, it was not possible to include every point raised in the consultation—nor could this publication include quotes from every organisation that sent in comments. However, the delivery authority has read and considered every response and is satisfied that this document contains a fair representation of all comments received.

5 Personal accounts delivery authority, January 2008, *Building personal accounts: choosing a charging structure, a discussion paper to support consultation.*

Questions for consultation

The consultation was framed in terms of a specific series of questions to which the delivery authority wanted answers.

In relation to charging and the delivery authority's principles:

1. How should the principles of the personal accounts delivery authority relate to the charging structure recommendation, and in what way should the principles best be applied in this context?

In relation to charging in the financial services industry:

2. What are the different charging structures currently used by the financial services industry, both for pensions and other financial products?
3. What are the rationale for these charging structures, and which of these rationale are relevant to personal accounts?

In relation to the charging structure options:

4. Are there any other charging structure options that might be suitable for personal accounts that are not included in the discussion paper?
5. Should additional charges be made for particular scheme activities?
6. What activities could members reasonably expect to pay more for, what activities could administrators reasonably expect to charge for, and why?

In relation to the evaluation criteria:

7. Are the evaluation criteria set out in the discussion paper appropriate?
8. Which evaluation criteria do you think are most important for personal accounts, and why?
9. Are we missing any criteria that might be relevant?

In relation to member outcomes:

10. How should we assess the impact of different charging structures on member outcomes, and why?

In relation to participation in the personal accounts scheme:

11. What is your experience of the effects of different charging structures on the perceptions of consumers?
12. What evidence is there about how consumers' perceptions affect participation in pension schemes or other financial products?

In relation to minimising scheme costs:

13. What evidence is there about the way in which administrative complexity or member behaviour have affected costs in existing financial products?

The consultation process

1.19 The consultation period ran from 29 January to 22 April 2008. The delivery authority received 47 responses to its discussion paper.

1.10 The discussion paper was made available on the delivery authority's website and was also distributed to interested organisations, key stakeholders and individuals.

1.11 During the consultation period, members of the delivery authority staff met with representatives from the financial services industry, pension scheme providers, interested employers and consumer groups. This was to ensure that the delivery authority heard a balance of views about the issues.

1.12 The delivery authority held a half-day seminar on Friday 28 March. The purpose was to bring experts and interested parties together, to discuss the charging structure options, to debate the options and to provide evidence that could be used to inform the recommendation. Attendees included:

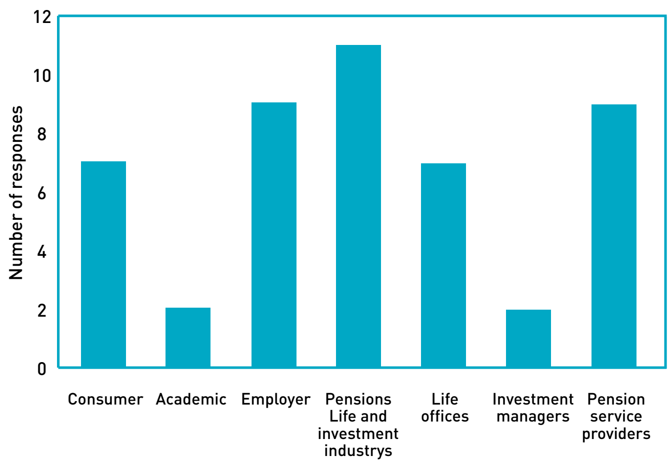
- consumer groups, including members of the delivery authority's consumer representative committee;
- employer groups, including members of the delivery authority's employers representative committee; and
- financial and pensions industry groups.

1.13 A summary of the day is included at the end of this chapter.

Analysis of responses

1.14 A total of 47 organisations submitted comments. Respondents can be broadly divided between the financial services industry, pensions industry, and consumer and employer representative groups. Two academic bodies also responded. The breakdown of responses by organisation type is shown in **Figure 1.1**.

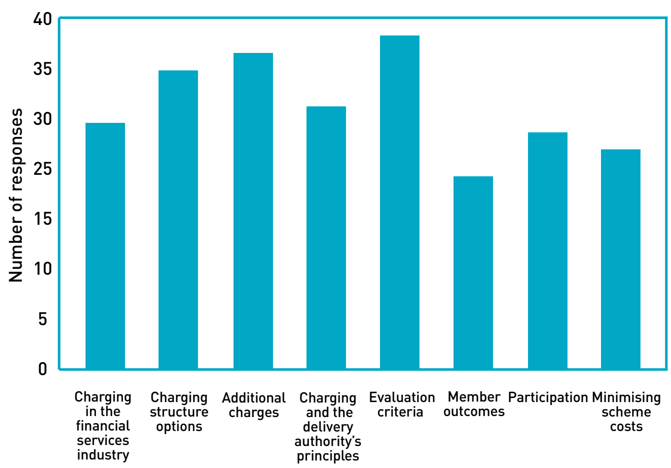
Figure 1.1: Responses by type of organisation



Note: The categories shown here correspond with the categories by which the organisations that responded are listed in **Annex C**.

1.15 The delivery authority received responses to all of the questions it posed in the discussion paper. A breakdown of responses by topic is shown in **Figure 1.2**.

Figure 1.2: Responses by topic



Summary of the stakeholder seminar

Paul Myners, chair of the personal accounts delivery authority, opened and closed the event. He reminded delegates of the need for pension reform and emphasised the delivery authority's commitment to being an open and consultative organisation.

The event was designed to ensure free-flowing discussion between the different organisations present. To this end, the event was divided into a session of introductory presentations followed by two breakout group discussions.

Session one: views on the charging structure options

The first session focused on different views of the charging structure options, as seen from academic, industry and consumer representative viewpoints. This session was intended to kick off the day by getting delegates thinking about the complex issues involved in choosing a charging structure.

Personal accounts delivery authority

The Chief Executive, Tim Jones, reiterated the themes from the discussion paper, *Building personal accounts: choosing a charging structure*, and asked delegates to provide inspiration. He set out the two main areas for consultation.

- How should we evaluate the options and what weight should we apply to different factors?
- What is the evidence base that will support our recommendation?

Pensions Policy Institute (PPI)

Research Director Chris Curry discussed the PPI's work evaluating the different charging structure options. The PPI does not advocate any one option[6]; rather, their research has found positives and negatives in relation to all options. Depending on how the different criteria are weighted, different structures emerge as more suitable— therefore trade-offs will inevitably have to be made.

Association of British Insurers (ABI)

Helen White, Assistant Director of Retirement Policy at the ABI, argued in favour of a combined annual management charge (AMC) and contribution charge. The ABI sees this option as offering a fair balance for all members, while also ensuring long- and short-term financial viability by reducing borrowing costs. The ABI acknowledges that a combined charge is more difficult for consumers to understand: in the ABI's opinion, clear communication would be the key to success under this opinion. However, the ABI believe the charging structure is not a key motivator of pension saving behaviour, and that simplicity is less important than delivering the best outcomes for scheme members.

Which?

Principal Policy Advisor Dominic Lindley outlined Which?'s preference for an AMC. In Which?'s view this structure is simple to understand, is unlikely to discourage participation, and offers a good outcome to all savers. Which? suggests that consumers find the pensions market complex and have difficulty understanding whether a particular product offers a 'good deal'. Which? argues that charging structures within the pensions market are much simpler than they were 10 years ago: for Which? a return to this complexity could lead to high charges and consumer confusion. Which? feels that a mixture of upfront and annual charges would make it more difficult to communicate to consumers that personal accounts was a good value scheme.

6 Pensions Policy Institute, Steventon A and Sanchez C, 2007, *Charging structures for personal accounts*. The research was co-sponsored by the Department for Work and Pensions, AEGON and Standard Life.

Session two: how should we evaluate the options and what weight should we apply to different factors?

In this session, delegates were divided into breakout groups. Each group was asked to rank the delivery authority's proposed evaluation criteria (**Figure 3.2**) in order of importance, and also to propose any alternatives they felt had been missed. A number of common themes emerged from each of the groups.

Interconnected nature of the evaluation criteria

All groups concluded that the criteria could not simply be ranked in order of importance, as the criteria were felt to be heavily bound up together. The scheme's sustainability, for example, could be affected by participation levels, which could in turn affect individual member outcomes.

Impact on the wider pensions market

One criterion felt to be missing was the impact of any given charging structure on the wider pensions market. The choice of charging structure could affect the pensions market, as the market might move to either mirror the personal accounts scheme or differentiate itself from it.

Future policy changes

Several groups felt that the delivery authority should take into account how the different charging structures would be affected by any changes in policy following the 2017 review[7]: for example, the potential impact if transfers were allowed to and from personal accounts and other schemes.

Definition of fairness

There was some debate about the definition of fairness that the delivery authority should apply when taking into consideration outcomes for different members. Suggested definitions of fairness included:

- all members pay the same amount in charges;
- all members lose the same proportion of their funds to charges;
- members able to make larger contributions pay proportionately more than those only able to make smaller contributions; and
- all members cover the cost of their individual pot only.

Communicating charging structures

Several groups argued that the manner in which the charging structure is communicated is equally or more important than the actual structure itself. If the charging structure was perceived to be complex, unfair or unsustainable, this could significantly affect participation rates. Simplicity and clarity of communication was therefore seen to be key. A complex charging structure communicated in a simple manner would be perceived as simple by consumers; conversely, a simple charging structure badly communicated could appear complex.

Groups suggested that charges could be expressed in monetary value rather than as percentages, as consumers appeared to find this easier to understand. Another suggestion was to have a document setting out the charges and providing a clear rationale for what they are and how they are levied.

7 There will be a review of the personal accounts scheme in 2017. This review will primarily cover the annual contribution limit and the policy on transfers, but may also include other issues which are relevant at the time.

Session three: what is the evidence base that will support our recommendation?

In the second breakout session, the groups were asked to provide possible sources of evidence and areas of research that could help to inform the delivery authority's thinking about the charging structure.

Other financial services and products

International comparisons with other schemes such as the New Zealand KiwiSaver, the Swedish pension system or the American Thrift Saver were suggested. However, participants warned that international evidence should be approached with some caution due to cultural, practical and operational differences. All groups also felt that comparisons with commercial pension schemes—both defined contribution schemes and group personal pensions—would be useful, as would other UK financial products such as individual savings accounts (ISAs). One group suggested that research into the possible administrative complexity and business risk of different charging structures would be important.

Participation (perceptions)

In relation to the behaviour and perceptions of consumers, all groups argued that the key issue was to fully understand the target market for personal accounts, which might be quite different from the market for existing financial products.

Using focus groups and consumer research to understand the target market was seen to be crucial, together with work on the best way of communicating the charging structure to both consumers and the media. Groups suggested looking at consumer products outside the financial services sector, as these are more likely to be in the daily experience of and accepted by the target market. Research on complex mobile phone fee structures was suggested, as were the complex charging structures for low-budget air travel. Several groups suggested looking at the effects of financial costs and benefits in everyday life on consumer behaviour, such as the Irish Republic's introduction of a plastic bag tax.

CHAPTER TWO
Options for charging structures

2.1 Personal accounts will need to charge its members. As with any pension scheme, it will provide a service to its members. Members will pay charges to cover the cost of setting up and running personal accounts, and the cost of managing funds in the scheme.

Options in focus

2.2 The discussion paper, *Building personal accounts: choosing a charging structure*[8], outlined several ways in which members could be charged.

Annual management charge

2.3 An annual management charge (AMC) would be levied as a percentage of each individual's overall pension pot. Under this charging structure, members would pay charges in every year until they retired. This would include years where no active contributions were made.

Contribution charge

2.4 Under a contribution charge, charges would be levied as a percentage of each contribution paid into an individual's pension pot: by the individual, their employer and the Government (in the form of tax relief). Unlike an AMC, once the contribution, net of the charge, had reached the member's pension pot, no further charges would be levied on it. This means any growth in members' pension pots, as a result of investment returns, would not attract charges.

Joining fee

2.5 Under this option, each member would pay a one-off upfront fee. The joining fee could take the form of a flat fee. Or it could be made as a proportion of members' first-year contributions—for example, equivalent to two months of a member's first year of contributions.

2.6 A joining fee could be levied on its own or in combination with another type of charge such as an AMC or a contribution charge. However, if levied on its own, a joining fee would be unlikely to provide enough revenue to cover all the costs incurred by the personal accounts scheme.

2.7 As part of the initial evaluation of charging structures for personal accounts, the delivery authority assessed a joining fee in combination with an AMC.

Contribution charge with an AMC

2.8 This option would combine an AMC and a contribution charge, which would each be set at a lower level than they would if levied individually. Under this option, part of the charge would be taken from contributions, while the remainder would be taken from individuals' overall pension pots.

8 Personal accounts delivers authority, January 2008, *Building personal accounts: choosing a charging structure, a discussion paper to support consultation.*

Charging in the financial services industry

2.9 It is inevitable that people will compare the charging structure for personal accounts with the charging structures for other financial products. The discussion paper outlined the fact that the delivery authority had little information regarding charging structures in the current pensions market, and their appropriateness or otherwise for personal accounts.

What the discussion paper, *Choosing a charging structure*, asked

- What are the different charging structures currently used by the financial services industry, both for pensions and other financial products?
- What are the rationale for these charging structures, and which of these rationale are relevant to personal accounts?

What you said

2.10 Financial services companies and financial administration providers described a wide range of different charging structures for pensions products and other savings vehicles such as ISAs. Some of these structures are still used by the financial services industry; others have fallen out of use.

Charging in the financial services industry as described by respondents

Figure 2.1 outlines both the charging structures and types of charge used within the financial services industry, as described by respondents.

Figure 2.1: Charging in the financial services industry

Charging structures		
	Definition	**Rationale**
Annual management charge (AMC) only	A proportion of the overall account value, deducted from the account each year. Such a charging structure is most commonly found in simple, mass-market products such as Stakeholder Pensions.	Prevalent because of the combined effect of the introduction of Stakeholder Pensions[9] and the FSA's 'RU64' regulation[10].
Combination charging structures	A combination of multiple types of charge: for example, 'factory gate pricing', which levies a menu of task-specific administration charges relating to the cost of each activity. Most commonly found in products such as self-invested personal pensions (SIPPs).	Enables a close alignment of costs and revenues. Reduces the degree of cross-subsidy between members.
Types of charge		
Bid/offer spread	The difference between the price at which investment funds are sold to customers, and the price at which they are repurchased when a benefit is claimed (typically 5%).	Covers the typical dealing costs associated with purchasing shares and unitised investments.
Allocation rates	Dictates how much of each contribution made by a member will be used to purchase units in the associated investment funds. The figure may be higher or lower than 100 per cent. Typically a lower percentage would apply to a short-term arrangement, reflecting a shorter time in which associated costs could be recouped.	Enables providers to increase the charge on initial contributions, particularly to recover front-end-loaded commission payments to intermediaries.

9 A Stakeholder Pension AMC is fixed at between 1 and 1.5 per cent of total account value.
10 RU64 regulations require a financial advisor to explain to a customer why a personal pension product would be at least as suitable for them as a Stakeholder Pension.

Types of charge		
	Definition	**Rationale**
Performance-related fee	The level of the fee paid to a service provider, typically a fund manager, increases once a minimum standard or performance is achieved for the fund.	Aligns the interests of fund managers and investors.
Policy fee, or flat fee	A set fee deducted from the policy annually or from each contribution.	Closely aligns costs and revenues.
Time/cost fees	Time spent to complete a project is multiplied by the cost, to the individual, of undertaking the task.	Recipient pays for the work involved in relation to a particular request—not designed for a mass market product.
Termination, early surrender, exit fee	A fee charged on terminating a policy or leaving a scheme.	Ensures that front-end-loaded commission payments to intermediaries are recovered if policies are terminated early. Often exit charges reduce over time as upfront costs are recouped.
Active member discounts	The level of charges are reduced over time for scheme members who actively contribute to their pension for sustained periods.	Reduces cross-subsidy. Incentivises members to save.
Fund-size discounts	A reduction in the overall charge level, once the fund reaches a particular size.	Reduces cross-subsidy. Incentivises members to save.
Transfer fees	A deduction made from the fund when money is transferred out of a scheme.	Covers the costs of transferring money out of the scheme.
Drawdown charges	A charge made on retirement for drawing down the fund or purchasing an annuity.	Covers the costs of decumulating the account.
Advice fees	Charges relating to initial or ongoing advice, either as a flat rate or percentage of contributions.	Covers the costs of providing advice about products.
Minimum premiums	Providers may specify a minimum amount to be contributed for each single or regular contribution paid by a member.	Ensures that the provider is protected from meeting the costs of administering small amounts.

2.11 Respondents identified two broad approaches to charging in the financial services industry—these relate to the need to align charges with the needs of the business, or the regulatory environment, respectively. These approaches are:

- combination charging structures (business needs); and
- an AMC-only structure (regulatory environment).

2.12 The rationale provided for combination charging structures were generally concerned with meeting the needs of the business, in particular by ensuring a close alignment of costs and revenues. This was cited as providing financial stability, with combination charges better able to deal with variations in scheme costs.

2.13 In particular, respondents indicated that, historically, providers have used a combination of different charges as a way of recovering the cost of different service elements, such as account set-up, account administration and fund management. For example, the following structure might be used: a joining fee to cover the costs of marketing and account set up; a flat fee to cover account administration; an AMC to cover fund management. Respondents felt that these multiple charging structures were less common than in the 1990s.

2.14 In those products where combination structures with multiple charges are still in use, the suggested rationale was the greater financial literacy of the target market. One example highlighted by respondents was the 'factory gate' style charging structure, often used in self-invested personal pensions (SIPPs), where a menu of task-specific administration charges is levied to cover the actual cost of each service. Respondents argued that this more task-specific approach appealed to more financially sophisticated consumers, who only wanted to pay for the services they actually used.

2.15 Respondents felt that products designed for less financially sophisticated markets, such as group personal pension schemes, tend to have simpler charging structures such as an AMC-only structure, which are easier to understand.

2.16 Respondents felt that an AMC-only structure tended to be a fairly recent development in the pensions industry. Many respondents argued that the move towards an AMC-only structure was the result of changes in the regulatory environment—specifically, the combined effect of the introduction of Stakeholder Pensions and the Financial Services Authority's 'RU64' regulation.

2.17 The 'RU64' regulation places a requirement on advisors to demonstrate that an alternative pension product is 'at least as suitable' as a Stakeholder Pension. Because Stakeholder Pensions are legally required to use an AMC-only structure, many other pension providers have adopted the same structure to ensure comparability between their products and Stakeholder Pension schemes.

2.18 Respondents were divided about the effect of the move to an AMC-only structure in the industry. Some respondents from the financial services industry felt that it had affected the viability of some schemes, by driving the collection of charges further away from the incidence of related costs.

Consumer groups, by contrast, felt that the shift to an AMC-only structure had increased consumers' ability to compare products, which in turn had created pressure for better-value products.

2.19 A minority of respondents discussed defined-contribution occupational pension schemes. Often in these schemes, all or a significant proportion of the costs are subsidised by the employer, so members pay no or relatively low charges.

Charging in the financial services industry: some comments from respondents

"The types of charging structure mentioned in the document [Building personal accounts: choosing a charging structure] are common in the insurance sector, as are transaction based fees; in the occupational sector, time cost or fixed fee arrangements are also common." (Mercer)

"For most financial services products, investment fund administration and management is normally charged for on a funds-under-management basis through an AMC (annual management charge). For example in Stakeholder Pensions, the total charges are normally expressed as, and collected through, an AMC [...] For most other pensions products there are a range of methods for recovering the costs associated with setting up the policy and subsequent administration." (Vertex)

"An alternative view of charging is to focus on the customer service content rather than the charging mechanism and then to determine how this content is to be charged for without compromising the scheme principles." (Siemens)

"The purpose underlying any commercially-driven pensions charging structure is the recovery of production, sales and advice costs, ongoing administration expenses and the provider's margin—ideally as close in time as possible to those costs arising." (Legal & General)

"While a variety of charging structures is possible, in recent years, pension providers have moved towards two main bases: a single annual management charge, which is required for stakeholder pensions but is also common for personal pensions; and charges differentiated by the service they pay for—principally administration, investment management and advice." (Scottish Widows)

"[T]he impact of stakeholder pensions, and the accompanying regulatory requirements under RU64, has had an impact on pensions charging, leading to some providers relying solely on an AMC model." (Association of British Insurers)

"Before the introduction of stakeholder pensions, many personal pension schemes levied a variety of upfront and annual management charges, flat administration fees (initial and monthly) and termination charges or transfer penalties. These charging structures were typically driven by the need to recoup initial sales incentives (such as commission to financial advisers) and other acquisition costs." (Which?)

How the delivery authority will take this forward

2.20 The delivery authority is grateful for the evidence provided by respondents around charging structures in the financial services industry. This information has increased the delivery authority's understanding of the different charging structures used. Although personal accounts will be an occupational trust-based scheme, where the trustee will act in members' best interest, these considerations could be potentially relevant to the scheme, and will be taken into account when the different charging structure are considered.

Charging structure options for personal accounts

2.21 The delivery authority was also interested in obtaining respondents' suggestions for structures that could be particularly suitable for the personal accounts scheme.

What the discussion paper, *Choosing a charging structure*, asked

- Are there any other charging structure options that might be suitable for personal accounts that are not included in this document?

What you said

2.22 A number of respondents proposed alternative charging structures to those outlined in the discussion paper.

2.23 **AMC combined with a flat fee:** under this option members would pay a percentage of their total funds under management each year combined with a fixed charge of £X a month or year. The rationale for this option was to enable a closer alignment of the costs and revenues associated with each individual member's account, thereby reducing cross-subsidies between members. As such, the flat fee element of this charge would reflect the costs of administration, while the AMC component would cover fund management costs. Respondents also suggested this structure would be transparent and simple to understand.

2.24 **Contribution charge and AMC, where the total amount paid per month or year is capped:** under this option, the charge would be taken as a percentage of both the total contribution paid into each individual's pension pot and the total funds under management in each pot. However, the overall amount paid in charges would be capped each month or year, meaning above a set threshold members pay a flat fee. The rationale provided for this option was again to enable a closer alignment of the costs and revenues associated with operating an individual's account, while shielding those making smaller contributions or taking breaks from losing a significant proportion of their pot to charges (as they would do under a flat fee).

2.25 **Contribution charge for active accounts combined with an AMC for dormant accounts:** if members were making contributions into their account, a percentage of the total contribution paid into their pension pot would be taken as a charge; if members were not contributing to their account, a percentage of their total funds under management would be taken as a charge. The rationale for this option was to obtain the benefit of a contribution charge with an AMC—namely minimising business risks—while helping to overcome the perception of double-charging associated with a contribution charge with an AMC[11].

2.26 **Employer charges:** a very small minority of respondents also suggested charging employers an administration fee, in addition to the contributions employers would make on behalf of their employees. The cost of collecting and reconciling contributions was felt to be one of the largest administrative costs for a pension scheme: levying a charge on employers would cover this cost in a simple fashion. Respondents also saw an employer charge as a way of modifying employer behaviour—employers could be charged more for paying contributions through inefficient and expensive methods such as cheques.

Charging structure options: some comments from respondents

"It is our view that a combination of a contribution charge and an AMC with an element of capped charge is the best mechanism for ensuring that each member pays the lowest possible charge." (Xafinity Paymaster)

"Rather than applying a contribution fee and an AMC for all members, the charges could be operated dependent on the status of the member, which would make the overall charging structure more competitive. Thus, all the time an individual is actively contributing, a contribution charge is payable, this would produce the initial revenues that PADA is looking for and an ongoing income stream for all contributing members. Once an individual stops paying contributions, the contribution fee would fall away and an AMC would instead be levied against the value of the member's fund. This would provide the ongoing revenue to meet the ongoing costs of administration." (Gissings)

"One possible option is the levying of a sterling contribution charge (say £1 or less per member contribution) on the employer, payable in addition to the eventual 3 per cent of banded earnings. Experience of running group pension schemes has shown that one of the largest expenses is that generated by collecting and reconciling contributions. So a sterling contribution charge, payable alongside the collection of each contribution, would match this expense." (Legal & General)

11 BMRB and Henley Centre HeadlightVision for the personal accounts delivery authority, Rowe B, Hunt J and Phillips J, January 2008, *Personal accounts: attitudes and reactions to possible charging structures, a qualitative research study.*

How the delivery authority will take this forward

2.27 The delivery authority has carried out a preliminary assessment of the three additional charging structures proposed by respondents: this assessment and any further analysis required, will be used to inform the recommendation to the Secretary of State as part of the wider advice on funding the scheme.

2.28 **AMC combined with a flat fee:** the flat fee element would bring in significant revenue in the early years of the scheme, thereby helping to reduce the scheme's overall funding requirement. As both elements of the charge (the flat fee and the AMC) would be levied regardless of whether contributions were being made, this option would minimise the business risks associated with both a decline in the value of assets and a high number of dormant pots.

2.29 The flat fee element could potentially be transparent and easy to explain to members, although the overall effect on member perceptions, and potentially participation, is unclear.

2.30 This option would be likely to produce a closer alignment of costs and revenues for individual accounts, limiting the degree of cross-subsidy between members. However, the delivery authority's view is that the flat fee element would produce an unacceptably large variation in retirement outcomes between different types of member, with those on low incomes and those saving for very short periods faring worst. Potentially, the flat fee element could erode the whole of some members' pension savings.

2.31 **Contribution charge and AMC, where the total amount paid per month or year is capped:** like the contribution charge with an AMC structure outlined in the delivery authority's discussion paper, this option would better align the scheme's overall costs and revenues—by bringing in more revenue during the early years of the scheme than an AMC on its own, although less than a contribution charge on its own. It would also help to mitigate business risks.

2.32 It is unclear what the effect of this option might be on member perceptions and participation.

2.33 This option provides a reasonable alignment of individual account costs and revenues, limiting the degree of cross-subsidy between members. In particular, the cap element would limit the amount paid in charges by members with larger accounts, or whose contributions were above the level of the cap. This is because it would create a flat-fee structure for these members. However, members with smaller accounts, or whose contributions fell below the cap, would be protected from the distributional effects of the flat fee.

2.34 Potentially, this option could produce a significant variation in member outcomes. For example, members contributing at or immediately above the level at which the cap started would pay proportionately more than those contributing a higher amount.

2.35 **Contribution charge for active accounts combined with an AMC for dormant accounts:** the contribution charge element of this option would mean significant revenue would be brought into the scheme early on, better aligning overall scheme costs and revenues and reducing the funding requirement. This option would mitigate against business risks. The contribution charge on active accounts would help to minimise the risk of a fluctuation in the value of assets; the AMC on dormant accounts would protect against an increase in the number of non-contributing members.

2.36 However, the structure could potentially be more complex to administer, which might lead to higher costs.

2.37 Switching between the two charges could reduce the potential for negative perceptions of double-charging, which research[12] has suggested could be associated with levying both types of charge simultaneously. However switching between the two types of charge could generate confusion among members.

2.38 **Employer charges:** it is anticipated that the costs of setting up and running the personal accounts scheme will be met through charges paid by the scheme members.

2.39 The delivery authority is likely to advise that, for any standard service, no charges to employers should be made. In line with the Government's overall policy for pension reform, employers will be expected to pay contributions on behalf of their employees to the personal accounts scheme.

Other issues raised

2.40 Although the discussion paper did not directly ask for a preferred charging structure, most respondents used this section to specify what they felt was the most appropriate charging structure for personal accounts.

What you said

2.41 There was no consensus view on this particular issue, with most respondents broadly split in favour of one of the following two options proposed in the discussion paper:

- an AMC-only structure; and
- a contribution charge with an AMC.

2.42 In general, respondents in support of one or other of these two options tended to oppose the other: those who supported an AMC only structure generally disliked the contribution charge with an AMC option, and vice versa. A minority of respondents said that they would support either approach.

2.43 Those who were in favour of an AMC-only structure felt that this option would be clear and transparent to members, and would be easy to compare with other financial products as many of them also charge an AMC. The shift to an AMC-only structure in the pensions industry, resulting from the introduction of Stakeholder Pensions and the Financial Services Authority's RU64 regulation, was seen as a positive outcome for consumers by a number of respondents. In particular, consumer groups felt this shift had resulted in transparent, good-value charges.

12 BMRB and Henley Centre HeadlightVision for the personal accounts delivery authority, Rowe B, Hunt J and Phillips J, January 2008, *Personal accounts: attitudes and reactions to possible charging structures, a qualitative research study.*

2.44 Several respondents also pointed out that an AMC would be likely to be viewed positively by members because the headline charge level looks small: for example, a 0.5 per cent AMC looks much smaller than a 5 per cent contribution charge. Further, respondents pointed out that an AMC does not deplete the contributions members make to their accounts each month, meaning that an AMC is 'invisible'.

2.45 Other respondents argued that an AMC-only structure would not be sustainable. An AMC would bring in only a small amount of revenue in the early years of the scheme, meaning that overall scheme costs and revenue would not be aligned. This would mean the overall funding requirement would be higher.

2.46 Some respondents highlighted presentational challenges associated with this structure. Because the amount charged each year through an AMC would increase each year in line with fund growth, an AMC-only structure would be hard for members to understand.

2.47 Those in favour of a contribution charge with an AMC argued that this dual structure would be more sustainable. A contribution charge and AMC would align individual account costs with account revenues better than an AMC-only structure, reducing the amount of cross-subsidy between members. A contribution charge and AMC would also bring in more revenue during the early years of the scheme than an AMC alone, meaning that the scheme's overall costs and revenues would be more closely aligned, reducing the scheme's funding requirement.

2.48 Respondents also felt that a contribution charge and AMC would reduce business and financial risks to the scheme, as the scheme would have two different sources of revenue to draw on.

2.49 Other respondents were concerned that a combined contribution charge and AMC would be more complex for members to understand than either option on its own, and could even dissuade people from engaging with the scheme. A combined structure was seen as less transparent and less easy to compare with other products. Respondents also argued that a combined structure could be more complex and expensive to administer than a single structure.

2.50 A contribution-charge-only structure had some support. Those who supported this option highlighted the fact that it would match revenue to account running costs well, reducing cross-subsidy, and would be simple to administer. Presentationally, respondents in favour of this option argued that the fact that a contribution charge would never reduce an individual's fund below the amount paid into it would make the charge simple and acceptable to members.

2.51 However, other respondents argued that, in terms of business risks, a contribution charge alone would be less sustainable in the long term than an AMC-only structure.

2.52 Some respondents argued that an AMC-only charging structure would be exposed to the business risk of fluctuations in the value of assets: as these respondents pointed out, this risk would reduce over time as the size of the total funds under management grew. In contrast, a contribution-charge-only structure would be exposed to the risk of an increase in the number of non-contributing members. Under this structure, active members would cover the account costs of non-contributing members, potentially through an increase in the charge level. This risk would not reduce over time.

2.53 Several respondents felt that a contribution charge would have a disproportionate impact on people who only saved for a short time.

2.54 A combined joining fee and AMC had very limited support. It would bring in significant revenue in the early years of the scheme, aligning overall scheme costs and revenue and reducing the scheme's financing requirement. These respondents also noted that a joining fee and AMC would match the cost and revenue profile of an individual account quite well, reducing cross-subsidy between members.

2.55 However, several respondents felt that a joining fee could have a negative impact on participation, especially for members who might want to cease working or stop contributing to the scheme at a later date. Respondents also argued that the joining fee element would be unfair to members making small contributions or contributing for a short period of time, as it could have a disproportionate effect on the value of their account.

2.56 A small number of respondents commented on the delivery authority's proposal to rule out a flat fee charging structure in the discussion paper. Of those who did comment, all were supportive of the proposal. Respondents agreed with the rationale outlined by the delivery authority that a flat fee would produce an unacceptably large variation in retirement outcomes between members.

Other issues raised: some comments from respondents

"Which? favours an annual management charge (AMC) as the charging structure for personal accounts. Which? believes that it is most likely to be simple and easy to understand, support a clear message that personal accounts are good value, provide a good outcome for all savers, encourage participation and support recent positive changes in the pensions market away from upfront charges." (Which?)

"[A] charging structure primarily based on an annual management charge is the most appropriate due to: i) its compatibility with existing industry charging structures; ii) more constant revenue without the potential fluctuations and risks associated with a contribution charge structure; and iii) resulting supplier incentivisation." (Capital International)

"[The personal accounts delivery authority] quite rightly acknowledge that the use of an AMC in isolation would be least effective in terms of reducing the requirements to fund the establishment of personal accounts, but would be most resilient to changes in both the numbers and demographics of members. The level of income generated solely from the application of an AMC would potentially be very insignificant, particularly in the first two years, when contributions will be phased in and thus not at the full level." (Gissings)

"The hybrid charge combines the benefits of an AMC (low charges in the early years so encourages members to stay opted in) and that of a contribution charge (provides a steady income stream and avoids eroding the pension pot when the account is dormant)." (National Association of Pension Funds)

"Single charge products are inherently risky for the product provider so we agree that combination charges are by far the best way to manage business risks and create equity between members." (The Actuarial Profession)

"[W]e are concerned that a combination of the charging structures would be too complex and difficult for consumers to understand. We would not like this complexity to dissuade consumers from engaging with personal accounts." (Financial Services Authority Consumer Panel)

"[T]here are two sustainable options for the charging structure of personal accounts—a management charge on individual pots levied annually (AMC) or a lower management charge coupled with a small charge on contributions as they initially enter the scheme (AMC + contribution charge). We do not believe other options are particularly attractive." (Confederation of British Industry)

"It is our observation that the industry has had some difficulty adapting to the absence of such an initial expense availability, now having to recoup expenses over a period of years, sometimes many years, with low persistency (which may also happen in personal accounts) affecting prospective profitability in some cases. Therefore, a joining charge is sensible in seeking to recover initial expenses." (Institute of Directors)

"We agree any joining fee option should be discounted as unacceptable to customers. We are pleased to see [the personal accounts delivery authority] is not considering levying any £-based policy charge or fee on members. For a universal scheme targeted at low to moderate earners, this sort of structure would be particularly inappropriate as it would be disproportionately expensive to those making low contributions who can least afford to pay." (AEGON)

"[W]e have very serious reservations about having a charging structure for personal accounts that includes any form of joining fee as we believe this is likely to act as a deterrent to individuals joining the personal accounts scheme." (Engineering Employers Federation)

"Vertex proposes a contribution charge [...] as it is simple to administer and could not create a negative unit position. It would be perceived as fair and can be easily explained to members." (Vertex)

"The business risks associated with a contributions-based structure appear, on the face of it, to be less certain and less manageable." (Invesco Perpetual)

"[A] contribution charge used as the sole means of generating fee income from savers presents a range of challenges, including serious commercial risk for the Board." (Investment Management Association)

"The EHRC is pleased to see [the personal accounts delivery authority] has already rejected flat rate charges, and is exploring charging structures that are proportionate to member contributions." (Equalities and Human Rights Commission)

How the delivery authority will take this forward

2.57 The responses received indicate that two of the options outlined in the discussion paper perform less well against the criteria (**Figure 3.2**) that the delivery authority proposes to use to evaluate the charging structures. These options received only limited support from respondents.

2.58 **Joining fee:** although this option would result in the smallest variation in outcomes between generations of savers and would reduce the overall funding requirement for the scheme, individuals and stakeholders have indicated it would be problematic in the context of auto-enrolment. It is likely to be poorly perceived and to produce the highest risk of opt-out, potentially resulting in a detrimental effect on participation.

2.59 **Contribution charge only:** although this option could be easy for members to understand it has been highlighted as unsustainable in the long term, particularly in the face of disruption to contributions or an increase in the cost base.

2.60 The responses received indicate that there is significant support for two of the potential charging structure options.

2.61 **Annual management charge:** the simplicity and transparency of this option should encourage participation.

2.62 **Contribution charge with an AMC:** this option has been highlighted as the most sustainable option with the flexibility to deal with a range of business risks.

2.63 In making a recommendation to the Secretary of State, the delivery authority will outline the weight of respondents' views on the four charging structures, together with the arguments respondents put forward in support of these different structures.

Additional charges

2.64 A potential risk to the scheme posed by all of the four proposed options is that they provide little incentive to individual members to keep costs low. The demand for some services provided by the personal accounts scheme will be driven by the preferences of individual members: for example, some members may make numerous requests for pension statements. It is important to take this into account. If even a small proportion of members chose to undertake particular activities frequently, this could increase scheme costs for all members. This in turn would increase the degree of cross-subsidy.

What the discussion paper, *Choosing a charging structure*, asked

- Should additional charges be made for particular scheme activities?
- What activities could members reasonably expect to pay more for, what activities could administrators reasonably expect to charge for, and why?

What you said

2.65 The majority of respondents were supportive of additional charges as a way of ensuring that the headline charge for personal accounts is kept low.

2.66 However, a number of respondents felt that the scheme should be kept as simple as possible, with only a limited number of activities that members would pay an additional charge for. This would reduce complexity and hence overall costs, and would mean that the charges were easier for people to understand.

2.67 Some respondents suggested that additional charges could be divided between at-cost and punitive charges; respondents were divided as to whether punitive charges would be acceptable for personal accounts. At-cost charges would cover the additional administrative cost of carrying out a more complex, non-standard activity. Punitive charges would be higher than true cost, and would be used to discourage members from engaging in certain activities that are administratively expensive, such as requesting excessive statements.

2.68 The majority of the respondents who favoured additional charges suggested that a core set of essential services should be identified; additional charges could be made for non-essential services outside of this core set. As such, several respondents suggested that additional charges could be used to minimise costs for members who behaved in the default manner, with those who wished to manage their account in a more sophisticated manner charged additionally.

2.69 Respondents suggested that the core set of services could include:

- collection of contributions;
- account administration;
- fund management (default fund);
- provision of basic communication material including a joining booklet and annual account statements;
- change of name or address;
- change of employer;
- change in contribution amount; and
- temporary cessation of contributions.

2.70 Services that members could reasonably expect to pay additional charges for were felt to include:

- pension sharing following divorce settlement;
- death allocation;
- additional advice about the appropriateness of investing in the scheme;
- excessive fund switching; and
- non-default funds.

2.71 The question of additional advice was explored by several respondents. Respondents suggested that the extent to which the scheme provided members and potential members with advice and guidance would need to be clearly delineated, as would any sources of more detailed, personal advice. Respondents felt that this advice and guidance should be subject to an additional charge.

2.72 A minority of respondents felt that charges should be made for accessing funds at retirement, or for advice regarding different options.

2.73 Opinion on dealing with excessive statement requests was split. Some respondents were clear that additional statement requests should be a part of the core service, as members should be entitled to information about their accounts. A cap on the number of additional statements would be acceptable to limit excessive requests: requests exceeding this cap would then either be charged for, or disallowed. Other respondents argued that additional charges should be levied for all additional statement requests as a way of keeping these requests to a minimum.

2.74 Further, several respondents drew attention to the possibility of some members having quite complex requirements. Respondents felt that provision of materials in non-English languages or in braille, for example, should not be charged for.

2.75 A minority of respondents felt that no additional charges should be levied, as they could be confusing to members and could discourage them from fully engaging with their personal account. At worst, additional charges were viewed as a potential trigger for increased opt-out, as respondents felt that they might affect members' trust in the scheme.

2.76 Respondents who were opposed to additional charges emphasised that active participation should be encouraged. They argued that levying additional charges would act as a disincentive for people to fully engage with their accounts.

2.77 Several respondents cautioned that levying additional charges could be complex to administer. Handling the additional work required to process requests and additional payments would itself have an administrative cost to the scheme. Respondents felt that this would make additional charges, and potentially headline charges, more expensive.

2.78 The concept of simplicity was also raised by those respondents who did not support additional charges. Respondents argued that another way of creating a simple scheme would be to have no additional charges, but to limit the amount of activities members could engage in. For example, pension statements could only be made available online, or could be capped at a certain number per member per year. This would create a very simple, basic service at a low cost to all members.

2.79 Regardless of their views on the desirability of additional charges, respondents were clear that any additional charges would need to be clearly documented to members. Levying an additional charge without providing information was viewed as unfair: additional charges would need to be communicated clearly and transparently to all members to prevent them from inadvertently incurring additional costs. Respondents argued that members would need to be aware of any extra charges they might face, and be able to calculate them, before engaging in any activity likely to generate those extra charges.

2.80 Respondents stated that if additional charges were not made clear, members incurring these charges could create increased administrative work for the scheme as a result of enquires and complaints. This could potentially increase costs.

Additional charges: some comments from respondents

"Additional charging will inevitably add to the complexity and therefore influence individuals' understanding of their scheme costs, however, there is a case for reserving the right to charge in certain, uncommon circumstances, ie to cover excessive fund switching; to cover the costs of specialist, higher maintenance funds. Both of the above are chargeable events in the pensions industry today." (Association of British Insurers)

"A distinction could be drawn between 'core' activities that are desirable in order for someone to maximise their outcomes and other non-essential activities." (Age Concern)

"Member services outside this core would be charged for on an as-used basis [...] The purpose of these transaction charges is to keep the costs of the core service to a minimum. It is anticipated that this will benefit the majority of members rather than 'padding' the annual charges to compensate for minority administration cases." (Siemens)

"The consultation raises a related issue of how best to cover the cost of day-to-day customer service, for example, providing statements or addressing telephone queries. As a commercial provider we accept that such costs should be met within the overall AMC structure. While this may involve some degree of cross-subsidy benefiting those savers who require higher levels of customer service, we feel that it is important that there are no additional cost barriers facing savers when accessing customer services." (Invesco Perpetual)

"[A]dditional administrative charges should be avoided to maintain clarity and simplicity of charges for a relatively unsophisticated audience." (Tax Incentivised Savings Association)

"As we would like to see default costs kept as low as possible, we are supportive of additional charges for those wishing to manage their personal accounts in a more sophisticated manner. The actions of those who are more financially capable (more likely to be higher earners) members of personal accounts should not be cross subsidised by the default behaviour of those who are less financially capable (more likely to be lower earners)." (Equalities and Human Rights Commission)

"Additional charges can also be a useful deterrent against excessive use of the services by a small number of members." (Pensions Management Institute)

"The consultation also raises the issue of dealing with excessive administrative requests from members. These may be excessive switching of funds, excessive requests for statements or numerous address changes. Whilst excessive switching may be an issue, it does, in part, depend upon the number of funds available for investment within the scheme [...] In terms of statements and address changes, many pension companies provide a web service which would contain valuations and instant statements, including the facility for changes of address. In any event, we would not envisage the changing of address to be either too frequent to be a problem, or politically viable to be charged." (Depositary and Trustee Association)

How the delivery authority will take this forward

2.81 One of the key considerations the delivery authority will take into account in designing the personal accounts scheme will be to keep the scheme simple: to keep costs down, to keep communications clear, and to minimise delivery risk

2.82 Building simplicity into the scheme will include designing a set of core services that will be covered by the headline charging structure, and seeking to limit those areas where additional charges may be required.

2.83 It should be noted that some member activities could have negligible costs to the scheme, depending on the way in which the scheme is designed—for example, members might be able to access their account details electronically.

2.84 In relation to the issue of charging for additional advice (paragraph 2.71), including advice on options for decumulation (paragraph 2.72), financial advice will not be part of the personal accounts service.

2.85 It is probable that the delivery authority will advise that no additional charge should be made for individuals accessing their funds on retirement (paragraph 2.72). Accessing funds at the point of retirement is something that all members of the scheme will have to do. The delivery authority also anticipates that the costs incurred in this area are likely to be broadly similar across all members.

2.86 The possibility of differential charging for different fund management options and additional charges for fund switching (paragraph 2.70) will be considered in the investment consultation that the delivery authority will be holding in autumn 2008.

CHAPTER THREE
Evaluating charging structures

3.1 The discussion paper, *Building personal accounts: choosing a charging structure*[13], proposed a set of criteria by which the charging structure options for personal accounts could be evaluated. These criteria built upon those set out by the Government in the December 2006 White Paper, *Personal Accounts: a new way to save*, and drew on the delivery authority's own internal evidence and the views of stakeholders.

3.2 In addition to these criteria, the delivery authority was mindful of the principles outlined in the Pensions Bill introduced into Parliament in December 2007 (see 3.4).

3.3 The discussion paper sought views on how both the principles and the proposed evaluation criteria should be applied to the choice of a charging structure.

Charging and the delivery authority's principles

3.4 The delivery authority's principles, outlined in the Pensions Bill introduced into Parliament in December 2007, are:

- participation in qualifying schemes should be encouraged and facilitated;
- the burdens imposed on employers should be minimised;
- any adverse effects on qualifying schemes, and members and prospective members of those schemes, should be minimised;
- the cost of membership should be minimised;
- the preferences of prospective members should, so far as practicable, be taken into account in making any provision about investment choice for personal accounts; and
- diversity among members and prospective members of personal accounts should be respected.

What the discussion paper, *Choosing a charging structure*, asked

- How should the principles of the personal accounts delivery authority relate to the charging structure recommendation, and in what way should the principles best be applied in this context?

What you said

3.5 Most respondents commented on the delivery authority's principles. The majority felt that, where relevant, the principles should be taken into account. While all of the principles were seen as important, only two of the principles were raised by a significant number of respondents.

13 Personal accounts delivery authority, January 2008, *Building personal accounts: choosing a charging structure: a discussion paper to support consultation.*

3.6 Several respondents felt that the principle *any adverse effects on qualifying pension schemes, and members and prospective members of those schemes, should be minimised* was important. They argued that the delivery authority should consider any negative effects that the charging structure for personal accounts might have on other qualifying scheme charges.

3.7 Several responses received from financial services industry organisations suggested that the delivery authority should ensure that it does not create a disparity between personal accounts and commercial pension providers through a charging structure that would not be viable without Government funding. Respondents were concerned this could distort the market for pension products, with negative effects for other qualifying schemes and their members.

3.8 Several respondents also emphasised the principle that the *burdens imposed on employers should be minimised*. In particular, employer representative organisations were concerned that employers should not be required to pay an additional charge to cover the costs of the personal accounts scheme on top of their contributions on behalf of employees.

3.9 The Equality and Human Rights Commission (EHRC) highlighted the need for the delivery authority to take account of the public sector duty to proactively address discrimination and inequality in the areas of race, disability and gender. The EHRC pointed out that, as a public sector organisation, the delivery authority is required to draw up an equality impact assessment for any policy or programming change. This will ensure that the policy does not have a negative impact on any of these three equality groups.

Delivery authority's principles: some comments from respondents

"We agree that the personal accounts delivery authority will need to make a balanced judgement in meeting the principles." (Age Concern)

"The two most relevant principles are (a) [participation] and (d) [minimise membership costs]. The effects are interrelated for example because higher participation may be encouraged by accepting higher cost to promote membership. Assessments must be made of the relevance of charging structures on the two principles." (Prudential)

"The principles elaborated by the personal accounts delivery authority seem to strike a good balance between members' needs (participation, cost, preference and diversity) and those of employers (burden and impact on other schemes). The charging structure recommendation should ideally take all of these principles into consideration; however, the interest of the members should be the most relevant. The burden on the employer and the impact on other pension schemes would probably be of a secondary nature." (JPMorgan)

"The personal accounts charging structure could have a positive or negative impact on the charging structures of alternative schemes." (Equality and Human Rights Commission)

"Evidence suggests that none of the charging mechanisms under consideration for personal accounts will directly inhibit participation. Other factors, such as affordability, will have a far greater impact on participation. Nevertheless, it is important that the charges are transparent and seen to be both fairly applied and a fair reflection of the cost of administration, as any negative publicity about the charging is likely to have some impact on participation [...] Whichever charging mechanism is chosen should lead to the lowest possible absolute charges. It should minimise finance costs and any costs associated with collecting the charges. This also means matching the administrator's revenue as closely as possible to costs in order to avoid under or over recovery of costs." (Xafinity Paymaster)

"The personal accounts delivery authority should be mindful that their principles commit them to consider the diverse nature of the target audience for personal accounts ie those on low to moderate earnings who are not currently saving and who do not have access to qualifying employer schemes. This would suggest that minimising cost to employees and minimising the administrative burden on employers should be a major consideration when considering the charge structure." (National Association of Pension Funds)

"The target group for personal accounts is very diverse in terms of working patterns, saving patterns, levels of income, age, etc. In order to ensure that this diversity is reflected, the recommended charging structure must not discriminate against particular groups." (EDS Sungard)

"[W]e note from the Pensions Bill that the principles set out in the Bill are not the only matter that the authority has to consider, and that the principles do not necessarily have to determine the choices the authority makes. Therefore, we do not think that the principles should dictate the decision made on the charging structure." (Friends Provident)

How the delivery authority will take this forward

3.10 The delivery authority will have regard for all of the principles where they are relevant to the charging structure recommendation. The delivery authority will make balanced judgements in meeting these principles.

3.11 As shown in **Figure 3.1**, a number of the principles are implicit in the delivery authority's assessment of different charging structures. For example, the principle that *participation in qualifying schemes should be encouraged and facilitated* relates to the evaluation criteria of *participation* and *member perceptions*.

Figure 3.1: How the delivery authority's principles relate to its assessment of different charging structure

Principle	Commentary
Participation in qualifying schemes should be encouraged and facilitated	The effect of charging structures on *participation* and *member perceptions* is one of the evaluation criteria used for assessing different charging structures.
The burdens imposed on employers should be minimised	In the discussion paper, the delivery authority did not propose employer charges. The delivery authority is likely to advise that, for any standard service, no charges to employers should be made.
Any adverse effects on qualifying pension schemes, and members and prospective members of those schemes, should be minimised	The delivery authority proposes to make balanced judgements in considering this principle.
The cost of membership should be minimised	Minimising membership costs is being factored into the delivery authority's assessment of different charging structures via the evaluation criteria *minimising scheme costs* and *retirement outcomes for members*.
The preferences of prospective members should, as far as practicable, be taken into account in making any provision about investment choice for personal accounts	Differential charging for fund choice will be covered in the delivery authority's consultation about investment.
Diversity among members and prospective members of personal accounts1 should be respected	When making its recommendation about the charging structure, the delivery authority will consider the distribution of outcomes between different types of members. The delivery authority will also undertake an equality impact assessment as a part of the recommendation.

3.12 The delivery authority proposes to make balanced judgements in considering the principle *any adverse effects on qualifying schemes, and members and prospective members of those schemes, should be minimised*. The impact of the charging structure on other pension schemes is also addressed below in paragraphs 3.23 to 3.26, in the context of the proposed evaluation criteria.

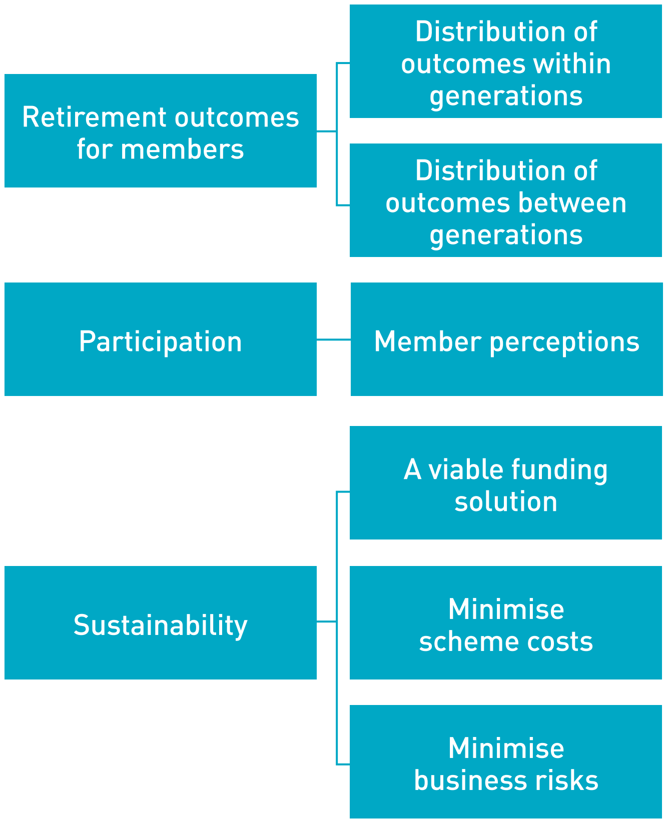
3.13 In relation to the principle that *the burdens imposed on employers should be minimised*, it is anticipated that the costs of setting up and running the personal accounts scheme will be met through charges paid by the scheme members. The delivery authority is likely to advise that, for any standard service, no charge to employers should be made. In line with the Government's overall policy for pension reform, employers will be expected to pay contributions on behalf of their employees to the personal accounts scheme.

3.14 The delivery authority will undertake an equality impact assessment as a part of the recommendation to the Secretary of State for Work and Pensions on the most appropriate charging structure for personal accounts.

Evaluation criteria

3.15 The evaluation criteria proposed by the delivery authority are set out in **Figure 3.2**.

Figure 3.2: Proposed criteria for evaluating possible charging structures for personal accounts



3.16 **Retirement outcomes for members:** the delivery authority is concerned with the average retirement outcome for savers, and with the distribution of outcomes between different kinds of savers and different generations of savers over time. In the discussion paper, the delivery authority proposed that the ideal charging structure would only result in a small degree of variation in the outcomes received by different members.

3.17 **Participation:** participation is important in meeting the Government's overall reform objective—to increase the number of people saving adequately for their retirement. The delivery authority is interested in how members might perceive different charging structures, and what this might mean for overall participation in terms of the number of members saving, the amount they save and the persistency with which they save.

3.18 **Sustainability:** a key challenge will be to select a charging structure that helps to ensure the personal accounts scheme is viable over the short term and sustainable over the long term. There are three main objectives a charging structure should meet to help secure this. The structure should: achieve a viable funding solution for the scheme, minimise scheme costs and minimise business risks to the scheme.

What the discussion paper, *Choosing a charging structure*, asked

- Are these evaluation criteria appropriate?
- Which evaluation criteria do you think are most important for personal accounts, and why?
- Are we missing any criteria that might be relevant?

What you said

3.19 Most responses were supportive of the proposed evaluation criteria outlined in the discussion paper.

3.20 However, many respondents had difficultly ranking or weighting them in terms of importance. The criteria were felt to be inter-related and therefore difficult to look at in isolation. For example, the sustainability of the scheme was felt to relate closely to participation levels, which in turn might be driven by the retirement outcomes members were likely to receive.

3.21 A minority of respondents saw either participation or sustainability as the most important criterion. Participation was felt to be especially significant by these respondents, as it is a measure of the Government's overall aim for pension reform—to get more people saving adequately for their retirement. Respondents who emphasised sustainability often did so in terms of the need for a close alignment of costs and revenues to ensure that the scheme is able to repay any borrowing in a reasonable timeframe and without unfair Government support.

3.22 A number of respondents suggested two additional evaluation criteria:

- impact on the market; and
- flexibility to deal with future policy change.

3.23 **Impact on the market:** a number of respondents suggested that the delivery authority should take account of the impact of the charging structure on the wider pensions market. They were concerned about the potential for the scheme to be unfairly advantaged, and the potential impact on charging behaviour.

3.24 In relation to the potential for the scheme to be unfairly advantaged, several respondents from within the financial services industry expressed concerns that the charging structure—and crucially the level at which it is set—could spread set-up costs over an unrealistic timetable as a result of Government support. These respondents felt that this could leave commercial pension providers at a disadvantage, as it could result in low charges for personal accounts that commercial providers could not match. This could affect take-up and profitability of their pension schemes. These respondents therefore felt that the scheme should not be unfairly advantaged by the Government, and that any borrowing should be repaid in a reasonable time-frame.

3.25 In relation to the potential impact on charging behaviour, responses from consumer groups suggested that other pension providers could change their charging structures and levels as a result of the personal accounts charging structure and level. This could have positive or negative results for consumers, depending on the structure chosen. These responses presented the personal accounts charging structure as a model for the charging structures of other schemes.

3.26 Some respondents were concerned that a charging structure for personal accounts that included up-front charges such as joining fees might act as an encouragement for the financial services industry to reintroduce charges of this type. These respondents felt that this could lead to higher charges and lower value for money for consumers. Other respondents saw the choice of a charging structure for personal accounts as an opportunity to influence the spread of lower, better-value charges across the financial services industry, to the benefit of consumers.

3.27 **Flexibility to deal with future policy change:** some responses highlighted the need for any charging structure to be flexible enough to respond to any future changes in the policy or economic environment affecting personal accounts. This was felt to be particularly important in the context of the 2017 review of personal accounts[14].

3.28 For example, respondents suggested that, if transfers in and out of personal accounts were permitted after 2017, the charging structure would need to be flexible enough to respond to the effects of this change. The possibility of future increases in the minimum contribution level was also raised by respondents, who felt the charging structure would need to be able to adapt to higher contributions without affecting either member outcomes or sustainability.

14 There will be a review of the personal accounts scheme in 2017. The review will primarily cover the annual contribution limit and the policy on transfers, but may also include other issues which are relevant at the time.

Evaluation criteria: some comments from respondents

"The evaluation criteria relate to three themes; ensuring fair outcomes for members, encouraging levels of participation in personal accounts and sustainability. All three of these themes appear key." (Financial Services Authority Consumer Panel)

"All the evaluation criteria are inter-dependent, but a criterion that deserves more attention is how business risk can be minimised without penalising particular groups of members." (Age Concern)

"Our view is that retirement outcome for members and sustainability are the most important criteria for personal accounts. Retirement outcome for members: the charging mechanism must be as fair as possible. Sustainability: the charging structure must support the administration in the early years, but should at the same time provide a stable charging platform which does not discriminate unacceptably between generations." (Xafinity Paymaster)

"[P]articipation is the most important as the long term goal of the scheme is to increase the level of saving among the target audience for personal accounts." (National Association of Pension Funds)

"[T]here is no charging structure that ideally meets all of the criteria against which the personal accounts charging structure should be assessed. We also agree that some of the criteria are of more significance than others. When considering the three categories of criteria, it is important to note that (fairness of) retirement outcomes for members and participation can be met to varying degrees – they are not 'all or nothing' criteria. None of the options under consideration deliver 100 percent 'fairness' and participation will be higher or lower depending on a whole range of considerations. However, sustainability is much more black and white." (AEGON)

"We think that the evaluation criteria that are appropriate to the charging structure are: simplicity – this drives participation and buy-in; does it deliver good value for money? Is it competitive against the market place? For example, does it influence better charging behaviours from the commercial sector?" (The Pension Advisory Service)

"The key to success will be the participation levels. Our understanding is that the retirement outcomes for members will drive the participation level and members perceptions and as such they are of less importance than the participation and sustainability." (Vertex)

"Providing fair outcomes and ensuring personal accounts are sustainable are important evaluation criteria. The personal accounts delivery authority should note that fairness is a relative not absolute concept. It will reflect how the burden of the costs of personal accounts is shared between participants with different characteristics. There is no single definition of what constitutes a fair charge in these circumstances. Sustainability is key, and it is essential that an inadequate charging structure does not leave a future generation of taxpayers with a bill to pay. We suspect that the link between charging structures and membership participation will be tenuous, given that, in the main, inertia selling is being used for personal accounts. The interests of members are protected by the criteria of fair outcomes." (Pensions Management Institute)

"Sustainability is key, because to would be unacceptable to Government and tax payers to get into a position where Government subsidy and/or a significant increase in charges is required. [....] There has been a lot of emphasis on keeping personal account charges very low, but this has not yet been accompanied by robust analysis of whether the charges suggested are sustainable." (Scottish Widows)

"One potential additional criterion to use is the impact on the wider market for pension saving. This could give some weight to the retirement outcomes of those outside of the membership of the personal accounts scheme, which are likely to be affected by the introduction of personal accounts." (Pensions Policy Institute)

"Whilst we appreciate the desire to find a viable funding solution, and minimise borrowing, this should not have a disproportionate impact on the first cohort of people to retire under personal accounts by loading the funding burden on this cohort. This would have a particular impact on women in this cohort." (Equality and Human Rights Commission)

"[S]ome consideration of the wider impacts of personal accounts should be taken into account." (HBOS)

"We believe that the key issues for the authority to consider are: simplicity and transparency for members and commentators; covering the set-up costs of the authority; the effect on the rest of the pensions market; fairness between scheme members, and between scheme members and other stakeholders, including employers." (Confederation of British Industry)

How the delivery authority will take this forward

3.29 The delivery authority recognises respondents' concerns that the scheme's charging structure and level might affect competition. No decisions on the source and structure of funding for personal accounts have been made and these will not be known until later in the design and commercial process. If there is any Government support, it will not unfairly advantage the scheme and will be compatible with European legislation on competition and State aid.

3.30 In relation to charging behaviour within the pensions industry (paragraph 3.25), there are two segments of the market that could potentially be affected by the choice of charging structure for personal accounts. These are occupational pension schemes and the personal pensions market.

3.31 In terms of defined contribution occupational pension schemes, the delivery authority anticipates the charging structure chosen for personal accounts will have little impact on charging behaviour. Evidence[15] provided by the National Association of Pension Funds (NAPF) suggests that often defined contribution occupational pension schemes do not charge their members a fee: in these cases the employer sponsoring the scheme meets most or all of the costs.

15 National Association of Pension Funds member survey.

3.32 In relation to personal pensions, the regulatory environment has to some extent determined the charging structures chosen by providers in recent years, and will most likely continue to do so—even after the introduction of personal accounts.

3.33 However, the delivery authority also recognises the potential for the personal accounts charging structure to be a model for other schemes in the market, and in this way to influence the charging behaviour of other personal pension providers. With the exception of Stakeholder Pensions, these schemes are, and will remain, free to choose whichever charging structure is most appropriate. Therefore, providers of personal pensions may or may not decide to align their charging structures with that of the personal accounts scheme.

3.34 In discharging its functions, the delivery authority will make balanced judgements in considering its principles, including the principle *any adverse effects on qualifying pension schemes, and members and prospective members of those schemes, should be minimised*. In considering the impact of the charging structure for personal accounts on the market, the delivery authority will therefore have regard to this principle in making a recommendation to the Secretary of State.

3.35 In terms of a potential need to respond to any future changes in the policy or economic environment for personal accounts (paragraph 3.27 - 3.28), the delivery authority feels that the criterion *minimising business risks* (**Figure 3.2**) is sufficient to address this issue. As part of its wider advice to the Secretary of State, the delivery authority will extend its evaluation of the options under this criterion to take account of the potential policy changes highlighted by respondents (paragraph 3.28).

3.36 While the delivery authority has taken on board all of the suggestions made by respondents, it does not propose to change the evaluation criteria from those set out in the discussion paper. All of the evaluation criteria in that publication will be taken into consideration when making a recommendation on the charging structure as part of the wider advice on funding the scheme.

CHAPTER FOUR
Member outcomes

4.1 In recommending a charging structure, the delivery authority wants to help members to get the best possible retirement outcomes. At the same time, it must be remembered that each member will have a unique set of characteristics that will also affect their final outcome—such as the age at which they start to save, and the persistency with which they save.

4.2 The discussion paper, *Building personal accounts: choosing a charging structure*[16], highlighted that the preferred charging structure would depend on the level of concern one has about variations in member outcomes relative to other criteria. Further, no one charging structure would be best or worst for all members. In particular, the delivery authority's analysis of a range of illustrative members[17] concluded that:

- a contribution charge would be the best for a member with a full savings history, with some breaks in saving, or who saved earlier in life;
- an annual management charge (AMC) would be best for a member who saved later in life;
- in the case of the illustrative members, a contribution charge would lead to the smallest variation in outcomes and an AMC would lead to the highest variation; and
- a joining charge with an AMC would lead to the smallest variation in outcomes between different generations of savers.

Measuring member outcomes

4.3 The discussion paper also outlined two methods for measuring member outcomes:

- **reduction in yield**, which measures the difference in the rate of fund growth with and without the charges being levied; and
- **reduction in fund value due to charges**, which measures the proportion of a member's final pension pot lost to charges.

4.4 The discussion paper proposed that the *reduction in fund value* due to charges would be the best measure. It would relate directly to the overall objective of maximising retirement outcomes for individuals, and would be simple and easy to understand.

What the discussion paper, *Choosing a charging structure*, asked

- How should we assess the impact of different charging structures on member outcomes, and why?

What you said

4.5 The question of how best to assess the impact of different charging structures on member outcomes is complex. Fewer respondents answered this question directly: several focused on the issue of variations in outcomes, such as the level of cross-subsidy between members, as well as the ways in which member outcomes should be assessed.

16 Personal accounts delivery authority, January 2008, *Building personal accounts: choosing a charging structure, a discussion paper to support consultation.*
17 See annex A, 'Six members in profile'.

4.6 Of those respondents who commented on the best way to measure the impact of different charging structures, several were content with the approach taken in the discussion paper (paragraph 4.4), which they saw as easier for members to understand. However, others preferred the *reduction in yield* measure, because it is currently used across the financial services industry, and is useful as a means of making comparisons between savings products with differing performance.

4.7 Most respondents who had views in this area felt that in practice both measures should probably be used depending on the circumstances. While measuring the reduction in fund value due to charges might be more applicable for member information, for example, measuring the reduction in yield might be more useful as a comparator to ensure that the scheme offered good value. Many respondents felt that standard industry practice would be to use both measures, to give a more nuanced view of the effect of charges.

4.8 Some respondents also suggested other ways of assessing the impact of different charging structures on member outcomes.

4.9 **Total expense ratio:** this is the ratio of total fund costs in relation to total fund assets.

4.10 **Reduction in contributions:** this is the loss in value to the fund, measured in terms of the difference between the total contribution and the effective contribution. The effective contribution is defined as the contributions that would have to be paid into a hypothetical scheme with no charges, so as to generate the same final pension pot as the scheme in question.

Member outcomes: some comments from respondents

"The reduction in yield is a commonly-accepted benchmark for charge comparisons, and usefully reflects the fact that those who are in the scheme for many years receive the benefit of investment growth management for much longer than those who are only members for a short time. The proposed method of comparing the percentage in final fund for different charging structures also has advantages because those who invest for a short period close to retirement result in relatively high costs to the scheme. In practice, both measures must be kept to an acceptable level." (Association of British Insurers)

"In terms of member information, we agree that an outcomes-based method (reduction in pot) is the most useful. Reduction in yield is useful for people comparing between different savings vehicles, but people in the target market are unlikely to be making that sort of comparison. However, the clearest method is not necessarily the most fair, and just as the personal accounts delivery authority explains that how managers are paid need not be the same as how members are charged, the impact of charging may be illustrated in one way but measured in a variety of ways for governance purposes. "(Age Concern)

"The principal question that needs to be answered here is not "how much of the pension pot have I lost to charges?" but, instead "for every x percent of investment return that my funds earn, how much is removed by the charges?" We firmly believe that a reduction in yield approach would be better than the more simplistic approach of looking at the percentage of the total pot lost to charges." (Fidelity International)

"The impact of charging structures must be easily understood by members or they may conclude (possibly incorrectly) that their pension is being eroded by fees charged." (National Association of Pension Funds)

"For the purposes of internal analysis in order to compare different charging structures and levels, reduction in fund value due to charges is a sensible approach. [...] The advantage of reduction in yield is that there is compatibility with other 'packaged products' (pensions, life policies, ISAs and other savings products). It also provides an approximation of charges if the value of the account grows above or below the quoted amount in the literature (scalability). In contrast the reduction in fund value due to charges cannot be applied if the member expects the fund to grow by a greater or lesser amount than stated in the illustration." (Depository and Trustee Association)

"We believe reduction in yield is the best way of measuring charges as it takes explicit account of the length of time which the product is held [...] Using a reduction in yield measure also allows the scheme to set an absolute benchmark for what is a good or bad outcome for members. For example, the reduction in yield experienced by different members could be compared to that which they would have experienced had they been in a stakeholder pension." (Which?)

"It may be more important to consider how the charging structure would be explained to people than to decide what the best numerical driver might be. Given the multiplicity of outcomes depending on the quality of participation, a single numerical indicator may not be the best solution. That is especially true when other numerical indicators may also be promoted (such as the return that the individual gets on his or her own contributions)." (Prudential)

"[I]t should be noted that under current market structures, the total expense ratio (TER) [....] provides the clearest picture of the total annual costs involved in running an investment fund." (Investment Management Association)

How the delivery authority will take this forward

4.11 There are a variety of ways in which the impact of charges may be measured. While a number of additional measures were suggested during the consultation process, the delivery authority does not propose to widen the assessment of member outcomes beyond the two measures proposed in the discussion paper.

4.12 Charges may have a significant impact on the final retirement outcomes of savers. Therefore, it is important that consumers are able to make meaningful comparisons of the effect of charges across different financial products, such as personal accounts. The discussion paper proposed to measure the *reduction in fund value*—partly because this measure would be easy for the target population to understand.

4.13 The other important aspect of the measure used is that it should be accurate and fit for purpose. Previous research[18] has shown that *reduction in yield* and *reduction in fund value* are both sensitive to changes in assumptions such as investment returns, an individual's earnings profile and the duration of an individual's pension policy.

4.14 In the discussion paper, the delivery authority identified six illustrative members for the purposes of comparison. Analysis assumed the same fund growth and earnings profile for all of these members. Therefore, any sensitivity of the measures to changes was not relevant.

4.15 However, the analysis did assume differences in the duration of members' policies. This makes it important to recognise that the two measures have different levels of sensitivity, depending on whether the charging structure is asset-based (for example an AMC) or contribution-based.

4.16 The implications of this difference in sensitivity are outlined in the analysis in the breakout box below. This compares the analysis of member outcomes highlighted in the discussion paper with the outcomes that would be produced using *reduction in yield*.

Measuring member outcomes: comparative analysis

The aim of this analysis is to assess whether the results described in the discussion paper, which applied the measure of *reduction in fund value*, would remain consistent when applying the measure of *reduction in yield*.

This analysis has used the same illustrative charge levels as the discussion paper:

- an AMC of 0.5 per cent;
- a contribution charge of 5 per cent;
- a joining fee of two months of contributions and an AMC of 0.45 per cent; and
- a contribution charge of 3 per cent and an AMC of 0.25 per cent.

18 Whitehouse E, 2001, *OECD Administrative Charges For Funded Pensions: Comparison and Assessment of 13 Countries.*

Outcomes for one member across the different charging structures

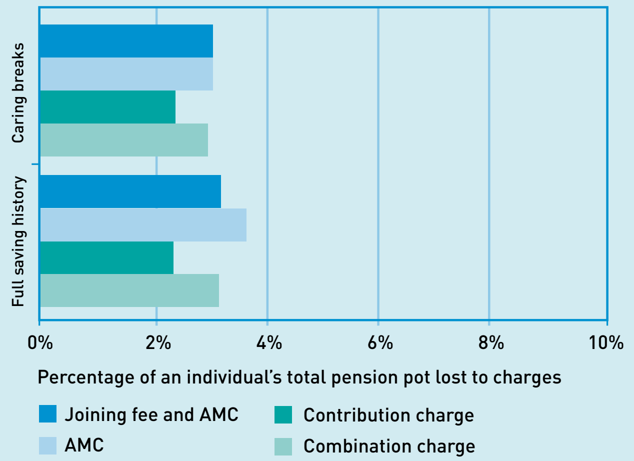
When comparing a particular member's outcome under each of the four charging structures, that member will fare best under the same charging structure and worst under the same charging structure, regardless of which of the two measures is applied.

Outcomes within generations of savers

The delivery authority analysed the outcomes for six illustrative members within a generation of savers (that is, all the people who join the scheme at the same time, regardless of their age or other characteristics).

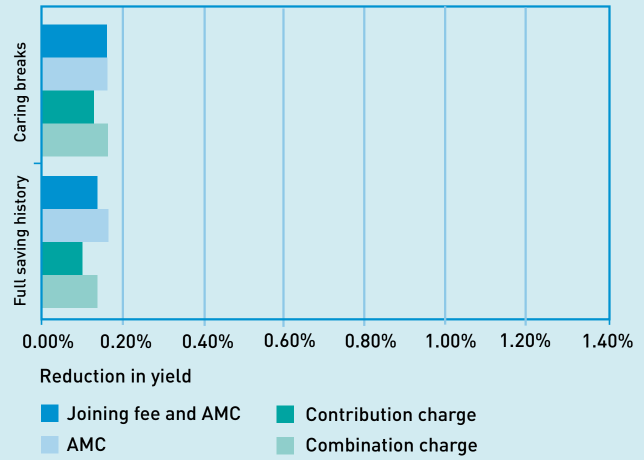
Full savings history compared with caring breaks

Figure 4.1: Reduction in fund value—outcomes for someone with a full saving history compared with someone who takes caring breaks



Source: modelling by personal accounts delivery authority

Figure 4.2: Reduction in yield—outcomes for someone with a full saving history compared with someone who takes caring breaks



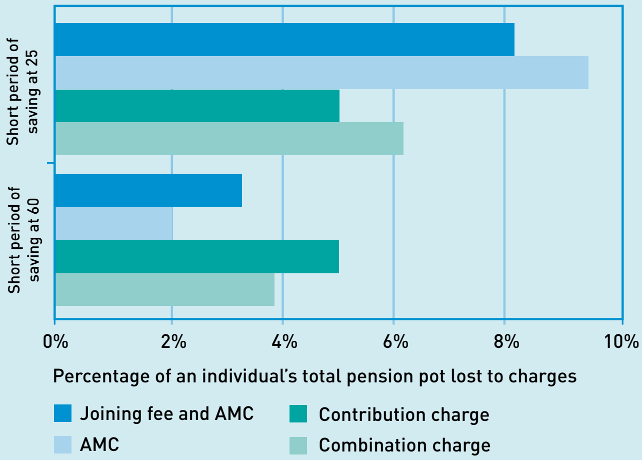
Source: modelling by personal accounts delivery authority

The *reduction in fund value* faced by these two illustrative members does not vary significantly across the four charging structures, as shown in **Figure 4.1**. These findings are replicated for these two members when assessing outcomes using *reduction in yield*, as shown in **Figure 4.2**.

Short-term saver who joins later in life compared with short-term saver who joins early in life

In this scenario, applying *reduction in yield* produces significantly different results from applying *reduction in fund* value.

Figure 4.3: Reduction in fund value—outcomes for a short-term saver who joins later in life compared with a short-term saver who joins early in life

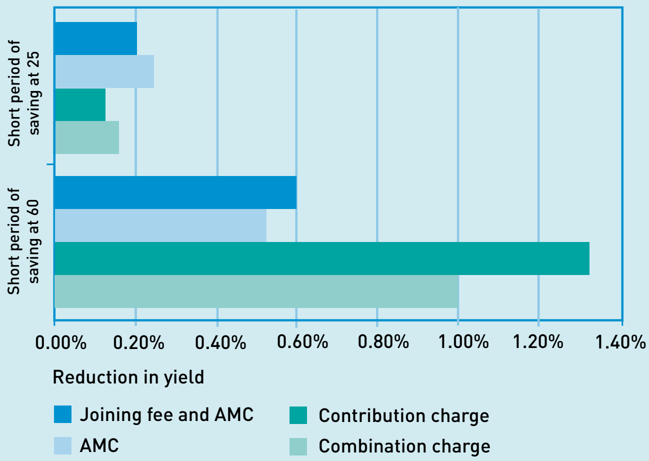


Source: modelling by personal accounts delivery authority

In the case of all four charging structures, when applying *reduction in fund value*, the illustrative member who saves for a short period at age 25 does significantly worse than the member who saves for a short period at 60, as shown in **Figure 4.3**.

This difference in outcomes is explained by differences in the way each charge is levied. Under an AMC, charges are paid each year until retirement, including those years in which no active contributions are made. In terms of *reduction in fund value*, this type of charge would benefit those joining the scheme later in life, because they would only pay charges for a short period of time, on a relatively small pot.

Figure 4.4: Reduction in yield—outcomes for a short-term saver who joins later in life compared with a short-term saver who joins early in life



Source: modelling by personal accounts delivery authority

In terms of *reduction in yield*, under all four of the charging structures, the member who saved for a short period at age 25 would receive significantly better outcomes than the member who saved for a short period at age 60, as shown in **Figure 4.4**.

In this scenario, the individual who saves for a short period aged 25 benefits from the compound investment growth over the life of their membership—while the older saver does not. Consequently, for the 25-year-old saver, the impact of charges on their final retirement outcome is mitigated by the fund growth they receive over the life of their membership. In contrast, the overall outcomes for the member who saves at 60 are more heavily affected by charges, because they do not receive the benefit of fund growth.

Outcomes for a member who starts saving in personal accounts at age 45 compared with one who stops saving in personal accounts at age 45

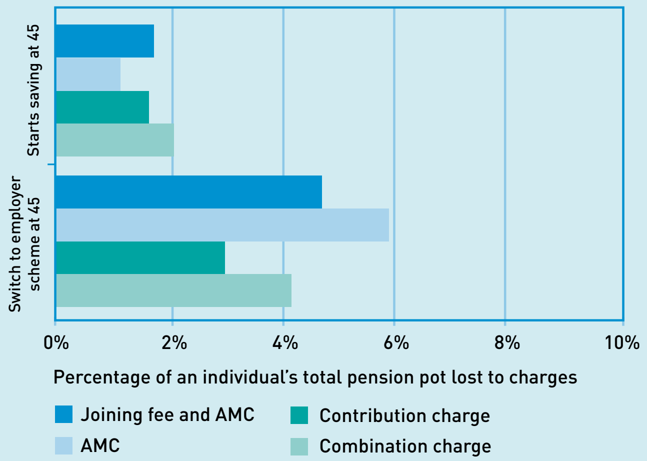
In this scenario, some interesting results are also found using *reduction in yield*.

In terms of *reduction in fund value*, the member who started saving at age 45 would have better outcomes, under all four of the charging structures, than the member who switched to an employer scheme at age 45, as shown in **Figure 4.5**.

This difference in outcomes is explained by the way each charge is levied. Under any structure with an AMC component, the member who switched to an employer scheme at age 45 would continue to pay charges, despite not making active contributions. In contrast, a member who started saving at age 45 would fare better, because they would pay charges on a smaller pot for a shorter period.

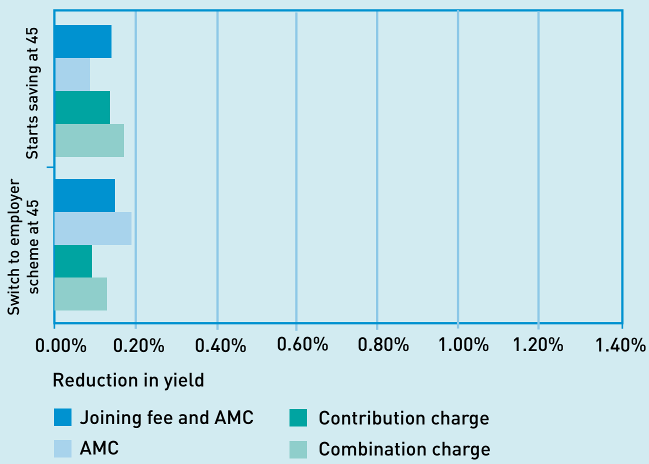
However, in terms of *reduction in yield*, final outcomes would not vary significantly between the two illustrative members, as shown in **Figure 4.6**. As in the previous example, this relates to fund growth. The individual who switched to an employer scheme at age 45 would benefit from compound investment growth, which would mitigate the impact of charges on this member's overall pension pot.

Figure 4.5: Reduction in fund value—outcomes for a member who begins saving into personal accounts at age 45, compared with one who stops saving into personal accounts at age 45



Source: modelling by personal accounts delivery authority

Figure 4.6: Reduction in yield—outcomes for a member who begins saving into personal accounts at age 45, compared with one who stops saving into personal accounts at age 45



Source: modelling by personal accounts delivery authority

Outcomes between generations of savers

In this example, the delivery authority considered the retirement outcomes for an individual aged 25 who started saving in the scheme when it was first introduced. This was then compared with two members who still joined at age 25, but who didn't turn 25 for another 10 and 20 years respectively.

In terms of *reduction in fund value*, the charging structure that would produce the least variation in outcome between the three members is the one that combines a joining fee with an AMC.

There are two reasons for this. First, the joining fee would remain constant as a proportion of each of these members' total contributions. Second, the joining fee would enable the scheme's set-up costs to be paid off earlier than under other charging structures. Therefore, under a joining fee with an AMC, the AMC could drop to its low, long-run level earlier than under other charging structures.

When assessed using *reduction in yield* the results produced would be broadly consistent with those produced using *reduction in fund value*. However, under those charging structures that include a contribution-based charge, there would be a difference in outcomes between the two measures for the two members who joined later. (who joined at age 25, but who didn't turn 25 for another 10 and 20 years respectively). This is despite the fact that they would both face the same level of charges.

In terms of *reduction in yield*, the member who joined last would have slightly worse outcomes under all charging structures that contained a contribution-based charge. When the charging structure analysed includes a contribution-based charge, the measure of reduction in yield will be sensitive to any changes in policy duration. This is because no charge is levied on the member's actual pension fund, only on their contributions. Therefore, due to fund growth, the impact of contribution charges on an individual's pot appears more diluted as time in the scheme progresses.

4.17 The analysis in the breakout box suggests that the use of any single measure could potentially be misleading, and therefore it may be preferable for both to be used.

4.18 As part of its wider advice to the Secretary of State on a funding strategy for personal accounts, the delivery authority will undertake a thorough appraisal of the potential charging structure options, including an assessment of the impact of each option on the final retirement outcomes of members. Final retirement outcomes will be assessed using both the *reduction in yield* and the *reduction in fund value* measures.

4.19 How to communicate information such as the effect of charges on retirement outcomes to members and potential members will be a key issue for the delivery authority to take forward. It is important that members and potential members receive clear and helpful information. The delivery authority is working to ensure that it finds the best way to achieve this.

Other issues raised

4.20 As well as the way in which member outcomes should best be measured, respondents were also interested in the differences in member outcomes themselves, and what these differences would mean for members. How the delivery authority should define the fairness of outcomes between different members was discussed by several respondents.

4.21 The discussion paper considered several different definitions of 'fairness' in relation to member outcomes, including charging people for the costs that they incurred, and charging well-off members more than less-well-off members.

4.22 The discussion paper proposed a definition of fairness in terms of making the proportion of fund values lost to charges constant across members. This definition was put forward for two reasons. First, it related to the overall objective—namely, to maximise retirement outcomes for individuals. Second, it would be simple and easy to understand.

What you said

4.23 While most respondents did not comment on this issue, several respondents supported the delivery authority's definition of fairness.

4.24 However, a number of respondents disagreed with the delivery authority's definition and proposed alternative definitions.

4.25 Some respondents proposed a definition of fairness in terms of a constant annual reduction in yield across all members.

4.26 Other respondents proposed definitions of fairness based around limiting the degree of cross-subsidy between members. Suggested definitions included an equal reduction of yearly investment return growth for each individual member, or a £-based amount for each individual account in line with the costs they incurred.

4.27 Respondents therefore suggested ways of reducing the degree of cross-subsidy between members, by implementing discounts for persistent savers or those with large funds or by capping the total amount that could be paid in charges.

4.28 **Active member discounts:** these would reduce the level of charge for members who were actively contributing to their account. Active member discounts would reward members who persisted in making contributions to their account. Alternatively, all members could receive a reduction in charge level after a set period of membership, regardless of whether they were still contributing.

4.29 **Fund-size discounts:** these would reduce the level of the charge once a member had built up a set amount in their account. Charges could also be operated on a sliding scale, so that the level would decline in stages as the account grew. Reductions in charge levels would act as incentive for members to persist in making contributions to the scheme.

4.30 **Charge caps:** these would limit the overall amount paid by an individual in charges each year. No matter how large the account, the charge could not exceed a set monetary value. This would act as an incentive for members to persist in making contributions, as the proportion of the fund lost to charges would begin to decrease when funds reached a certain size.

4.31 Many respondents also raised questions about the sensitivity of the analysis in the discussion paper to the actual charge levels chosen for that analysis. In particular, respondents felt that the conclusions drawn may have differed had alternative charge levels been applied.

Other issues raised: some comments from respondents

"The concept of fairness in the charging structure will be important to getting consumer buy in." (Prudential)

"Beyond that, charges should reflect the level and incidence of cost for members as closely as possible, having taken account of any cross-subsidies thought to be desirable." (Scottish Widows)

"The criteria should be: does the impact reflect the true cost of delivering the personal account? Is the overall reduction in the pot equal for each member – ie no cross-subsidy?" (The Pensions Advisory Service)

"There are a number of other potential options which the Government could consider for the AMC element of a combined charge: offering a sliding scale annual management charge (AMC), constituting a reward/loyalty bonus for long-term membership of the fund, ie a sliding scale of 1 per cent for the first 10 years, 0.8 per cent for the next 10 and 0.6 per cent for the remainder. This would incentivise participation, and minimise opting out. Offering an AMC reduction linked to fund size, with the benefit of incentivising fund growth." (Association of British Insurers)

"However, we have concerns over the way in which 'fairness' is defined. We do not accept that the most appropriate definition is 'making the proportion of fund values lost to charges constant across members'. We believe further consideration should be given to more closely matching charges to costs incurred by groups of individuals [...] One recent development aimed at addressing a particular point of 'fairness' is the increasing popularity of 'active member discounts' [....] We are not suggesting this approach would be appropriate for personal accounts because unlike in other forms of pension, the individual who stops contributing will not, at least initially, have the ability to transfer their pot to an alternative vehicle." (AEGON)

"While we recognise that certain assumptions may be commercially sensitive, we believe the personal accounts delivery authority should conduct a sensitivity analysis evaluating the impact of altering assumptions about the cost of capital, the number of non-contributing members, participation and levels of contributions." (Which?)

"A further question that is not answered in the paper is how sensitive the outcomes of different savings 'profiles' are to charging levels." (Age Concern)

"A wide range of charges has, therefore, to be modelled to determine how different savers are impacted by the different charging structures." (EDS Sungard)

How the delivery authority will take this forward

4.32 The delivery authority recognises that there are different definitions of fairness to that proposed in the discussion paper, and that these may also be valid.

4.33 The delivery authority will outline the degree of cross-subsidy between members for each option, and therefore the trade-offs that would need to be made for that option, when it makes a recommendation as part of the wider advice on the funding strategy for the scheme.

4.34 In the longer term, the delivery authority recognises that the trustees should have the flexibility to define what is fair for members—including the degree of cross-subsidy—and to adapt the charges accordingly. The degree of cross-subsidy between members may therefore change as the scheme evolves over time.

4.35 In this context, it is therefore important to note that the degree of cross-subsidy between members would not only be affected by the charging structure itself, but potentially also by both the level at which charges are set and the manner in which charges might vary over time.

4.36 The delivery authority is aware of the sensitivity of its analysis, as presented in the discussion paper, to the charge levels adopted for that analysis. The breakout box highlights how variations in the level at which a particular charge is set (in this example an AMC) have an impact on the outcomes for different members.

4.37 When appraising different charging structures, the delivery authority will take account of these sensitivities.

Sensitivity of member outcomes to variations in charge levels

Each individual is likely to possess a unique set of characteristics that will influence their final retirement outcome. These characteristics could include:

- their individual savings history, including the age at which they start to save and the persistency with which they save; and
- their earnings profile over the lifetime of their membership.

Member outcomes will also be affected by factors relating to the scheme as a whole, such as the charging structure chosen and the investment performance of the funds.

It is important to note, however, that member outcomes will not only be influenced by the final charging structure chosen for the scheme but also the level at which the charge is eventually set.

The delivery authority will not know what the level of charges will be until the design of the scheme has been finalised and the services to set up and run the scheme have been procured. However, key factors that may influence the level of charges faced by members include:

- the final design and costs of the scheme; and
- participation in terms of the number of members that join personal accounts, the amount they save and the persistency with which they save.

When comparing the impact of different charging structures, it is important that the level of charge applied is broadly similar for each option. Otherwise, for example, one structure could appear to be the most beneficial for all individuals, simply because the level of the charge for that structure had been set artificially lower than for other structures.

The discussion paper outlined a set of illustrative charge levels to allow a meaningful comparison across the four charging structures.

This table compares the final retirement outcomes when applying a contribution charge of 5 per cent and 10 per cent, compared with an AMC set at 0.3 per cent and 0.5 per cent. Note the charge levels used in this analysis are for illustrative purposes to highlight potential sensitivity and are not necessarily equivalent. Also note that this analysis assumes no reduction in the charge level in the long term.

Figure 4.7: Reduction in fund value—sensitivity of member outcomes to variations in charge levels

Illustrative members	Contribution charge		AMC	
	5%	10%	0.3%	0.5%
Full saver	5%	10%	6.8%	11.0%
Caring breaks	5%	10%	5.7%	9.2%
Short period of saving at 25	5%	10%	11.6%	18.6%
Short period of saving at 60	5%	10%	1.2%	2.0%
Starts saving at 45	5%	10%	3.7%	6.1%
Switches to an employer scheme at 45	5%	10%	9.5%	15.4%

Source: modelling by personal accounts delivery authority

Figure 4.8: Reduction in yield—sensitivity of member outcomes to variations in charge levels

Illustrative members	Contribution charge		AMC	
	5%	10%	0.3%	0.5%
Full saver	0.23%	0.47%	0.31%	0.52%
Caring breaks	0.27%	0.57%	0.31%	0.52%
Short period of saving at 25	0.13%	0.27%	0.31%	0.52%
Short period of saving at 60	1.30%	2.66%	0.31%	0.52%
Starts saving at 45	0.42%	0.87%	0.31%	0.52%
Switches to an employer scheme at 45	0.16%	0.33%	0.31%	0.52%

Source: modelling by personal accounts delivery authority

CHAPTER FIVE

Participation

5.1 For personal accounts to succeed in increasing retirement savings, participation in the scheme—in terms of the number of people joining the scheme and the amount they choose to save—will be critical.

5.2 A number of factors could drive participation, including people's perceptions of personal accounts generally, and of charges in particular.

5.3 The discussion paper, *Building personal accounts: choosing a charging structure*[19], highlighted the high-level findings from qualitative research[20] conducted by the delivery authority. The delivery authority considers the key findings from this research are that:

- personal accounts were, overwhelmingly, viewed positively by people—partly because of the scheme's perceived simplicity;
- charges are not likely to be a significant barrier to people accepting the personal accounts scheme, so long as people are not given cause for concern;
- single charging structures, such as the annual management charge (AMC) and the contribution charge, were preferred over a structure combining different charges, because the former is easier for people to understand; and
- in general, people were willing to accept some marginal reductions in their final pension pot in order to achieve greater simplicity in the way they are charged.

Evidence on participation

5.4 The delivery authority was interested in understanding people's perceptions of charges levied on other products and services, and whether these perceptions had affected participation. Evidence of people's perceptions of other products and services might provide a useful source of information about their likely response to the different charging structures.

What the discussion paper, *Choosing a charging structure*, asked

- What is your experience of the effects of different charging structures on the perceptions of consumers?
- What evidence is there about how consumers' perceptions affect participation in pension schemes or other financial products?

What you said

5.5 Many respondents indicated that charges, and in particular the charging structure itself, were unlikely to be key factors driving opt-out from the personal accounts scheme. Respondents felt that overall trust in the scheme would be of more relevance, as would the affordability to an individual of the total contribution they would need to make each month. If charges were to affect participation, it was felt to be more likely that this would be the result of the charge level, rather than the charging structure.

19 Personal accounts delivery authority, January 2008 *Building personal accounts: choosing a charging structure, a discussion paper to support consultation.*

20 BMRB and Henley Centre HeadlightVision for the personal accounts delivery authority, Rowe B, Hunt J and Phillips J, January 2008, *Personal accounts: Attitudes and reactions to possible charging structures, a qualitative research study.*

5.6 In as far as the charging structure could affect consumer perceptions, the simplicity of the structure was felt by respondents to be important. Respondents suggested that consumers would find a complex charging structure confusing and off-putting, and that a simple structure would be necessary to reassure consumers.

5.7 However, opinion was divided as to whether a simple charging structure would necessarily mean a single charging structure. Some respondents felt that a single charging structure was important, as it would be clearer and easier for members and potential members to understand; others argued that a combination charging structure could be presented and communicated just as simply.

5.8 Most respondents identified clarity and simplicity of communication as critical to member perceptions. Some respondents pointed to the potentially low levels of financial literacy and capability among the target population as a possible problem for the scheme. Respondents further felt that this could be compounded by the lack of personal advice that will accompany auto-enrolment. Clear, simple explanations of the rationale for the charging structure, and what it might mean for members, was therefore felt to be important—potentially much more so than the nature of the structure itself.

5.9 A number of respondents suggested that gaining support for the approach across a range of key opinion-formers would be important to obtaining the trust and confidence of consumers. If opinion-formers were critical of personal accounts, perceptions of and participation in the scheme could be affected. While opinion-formers would be unlikely to see the scheme negatively purely because of its charging structure, respondents felt that opinion could be influenced by the charging structure if it was seen to be unfair, confusing or too expensive.

Perceptions and participation: some comments from respondents

"It is vital that we understand the impact that charges on personal accounts could have on participation [...] What we need greater understanding of is the whole decision making process that a potential personal accounts member will have to go through when deciding whether to opt out [...] What place in their decision making priorities is the charging structure, or even the level of charges? If the key issue for participation is affordability of contributions at that point in time, them the charging structure will have little impact." (Equality and Human Rights Commission)

"From our experience members are more interested in the projections they receive and therefore how charges are reflected in terms of final figures are more likely to affect behaviour [....] In the context of charging structures individuals tend to not proceed when something is perceived as too complicated, poor value or too time consuming." (HBOS)

"Complexity, in our experience, does put consumers off engaging with and saving in pensions. If they cannot see what all the costs are and compare them, they are put off." (The Pensions Advisory Service)

"[T]he greatest influence is likely to come from the media and in particular the press. Most tabloid newspapers now have a 'money' column and it is fair to say that pensions have featured heavily over the last decade or so. This is likely to have a far greater impact on the target groups for personal accounts." (Gissings)

"The majority of personal accounts members will have been automatically enrolled and will thus not have given much, if any, thought to the charging structure [...] However this must be tempered against the need to bring public opinion formers, such as media, trade unions and employer bodies onside. Personal accounts will have a very diverse membership, and it is key that public opinion holds that personal accounts offers good value across the whole spectrum of its congregation." (Legal & General)

"Simplicity of charging structures is important to maintain consumer confidence. Any charging structure which introduces additional complexity or multiple charging options could damage consumer perceptions and possibly participation." (Which?)

"[W]e do not think that the charging structure is going to be as crucial in terms of maximising participation as achieving confidence in the system as one which is trustworthy and worthwhile." (Association of Chartered Certified Accountants)

"Evidence[21] suggests that none of the charging mechanisms under consideration for personal accounts will directly inhibit participation. Other factors, such as affordability, will have a far greater impact on participation. Nevertheless, it is important that the charges are transparent and seen to be both fairly applied and a fair reflection of the cost of administration, as any negative publicity about the charging is likely to have some impact on participation." (Xafinity Paymaster)

"Keeping the level of the scheme charges as low as possible will be more important to potential personal accounts customers than the structure by which they are applied. Potential members are more likely to opt-out due to high charges rather than because they do not understand the charging structure." (Confederation of British Industry)

"In respect of charging, there is significant evidence across a wide range of products to suggest that consumers do not find charging a barrier to deciding whether to acquire a particular product. Mortgages, gym membership, mobile phone tariffs, boiler contracts and bank accounts are some products and services which all use relatively complex charging structures, yet attract very high numbers of users." (Association of British Insurers)

"[W]e have experienced that products with clear charges, reasonable fund choice and low commission have much better persistency than high front end charged products with associated high commission. This probably reflects a much better perception for the former product type." (Vertex)

"Charges and charging structures per se appear to be a relatively small consideration for the potential consumers targeted by personal accounts when considering whether or not to save; but people have historically been discouraged from saving by the complexity and variety of products and charges. These factors would point to the need for a simple charging structure—one that is based on a single charging basis, as opposed to a combination of charging structures." (EDS)

21 BMRB and Henley Centre HeadlightVision for the personal accounts delivery authority, Rowe B, Hunt J and Phillips J, January 2008, *Personal accounts: Attitudes and reactions to possible charging structures, a qualitative research study.*

How the delivery authority will take this forward

5.10 The sources of evidence identified during the consultation and summarised in the breakout box below will help to shape the delivery authority's thinking on the factors driving participation. More specifically, the sources of evidence may pinpoint the relative importance of charging structures in determining both people's attitudes to savings products and whether they choose to participate in these products.

5.11 The evidence provided by respondents clearly indicates the importance of people's attitudes to the scheme. Building confidence and trust is one of the biggest challenges the delivery authority faces in implementing personal accounts. Transparency, particularly around aspects of the scheme's design such as the charging structure, simplicity, and high standards in communications will be some of a number of ways that will help build this trust.

Areas for investigation and potential sources of evidence, as described by respondents

International comparisons

Some respondents suggested that the delivery authority should look at international comparisons, primarily with the New Zealand KiwiSaver pension scheme and the Swedish Premium Pension Scheme. Both of these schemes are fully funded defined contribution schemes established by national governments.

The KiwiSaver has no fixed charging structure. Licensed commercial providers run competing KiwiSaver products. Providers set their own charging structures and levels, which can involve multiple types of charges. For example, a fund might charge investment management, administration, membership and trustee fees. Some of these charges may be flat fees; others may be levied as an AMC.

Kiwisaver launched in July 2007. Early indications regarding participation are positive, although there is some evidence that potential members have found the range of different options and charging structures complex.

Members of Sweden's Premium Pension Scheme can choose between the Government-run default fund and funds managed by commercial providers. The scheme's charging structure is in two parts. A capped AMC to cover administration costs is charged by the Government. A money management fee is charged by the fund manager at a commercial rate as a percentage of assets. The Government-run default fund charges a considerably lower fee than any commercial fund manager.

The majority of members of the Swedish Premium Pension Scheme are enrolled in the Government-run default fund. In recent years, this fund has been considerably cheaper and has received a higher rate of return than alternative funds.

Participation in UK pension schemes

Several respondents mentioned the Pensions Commission report, *'A new pension settlement for the twenty-first century'* [22], which they felt indicated that consumers are not driven to invest in a particular scheme because the charges are lower—although the report also suggested that people have historically been discouraged from saving by the complexity and variety of the products and services on offer.

Which? has conducted focus group research[23] looking at consumer attitudes towards pensions, and personal accounts in particular. Which? found that the key findings from this research were:

- the pensions market was viewed as complex, with a confusing array of different products available;
- consumers were not particularly price-sensitive and found determining 'price' difficult;
- consumers viewed charges, fees and commissions as high and unjustified, therefore products could be seen as unlikely to be a good deal; and
- personal accounts were viewed positively as a result of their perceived simplicity: anything that increases complexity will reduce public interest and confidence.

Financial service industry respondents were able to provide evidence based on their own experiences of the market for pension schemes in the UK. Their research suggested that affordability has had a much greater affect on participation in a pension scheme than the scheme's charging structure.

Where consumers did take account of charges, research seemed to suggest that they were far more concerned by the actual amounts taken in charges, rather than the charging structure.

However, the experience of respondents did seem to suggest that upfront fees were less popular—especially if the rationale had not been explained beforehand—and that product complexity could prevent consumers from engaging with pensions.

There was evidence that consumers found the true impact of charges very difficult to assess. For example, respondents suggested that a lack of clarity in communication around charging and advice for Stakeholders Pensions has had a negative impact on the take-up of those plans.

Respondents also suggested that consumers' perceptions of products could be significantly affected by marketing and communication. More expensive and complex products, such as self-invested personal pensions (SIPPs), have had significant consumer interest, which respondents suggested could be due to marketing and press-led trends.

The presentation of charges was felt to be an important part of the packaging of financial products. Some respondents had experience suggesting that consumers were attracted to packages that suggest that:

- charges were small because numbers were small (a 0.5 per cent AMC sounds smaller than a 5 per cent contribution charge); and
- charges did not eat into actual money invested (a 0.5 per cent AMC would not appear to erode the amount invested, while a 5 per cent contribution charge would immediately seem to reduce investment of £100 to £95).

22 Pensions Commission, 2005, *A new pension settlement for the twenty-first century: the second report of the Pensions Commission.*
23 Which? and Research Works Ltd, 2004, *Which? Pensions: Choice and Responsibility, report of qualitative research.*

However, other respondents felt that members were more interested in the projections of final retirement outcomes they received, and that this was more likely to affect behaviour.

Some respondents cautioned that it was very difficult to gauge patterns of perception and participation in the UK pensions market, as it is very complex and is based on products being sold to consumers rather than actively bought by them.

Other financial services and products

Several respondents referred to the Financial Services Authority's qualitative research into consumers' perceptions of services and costs when purchasing investment products from financial advisors[24]. This research suggested that consumers found fees and charges for financial products complex, and that consumers often had quite limited understanding of how the industry charges for investment products and advice.

The Thoresen Review of generic financial advice[25] was also suggested: this review was primarily concerned with improving financial capability through advice, but suggested that consumers found financial services and products complex.

Respondents also drew attention to financial advice columns in the media as a useful source of information about consumers' attitudes to charging for financial services.

Take-up rates for products and services that use relatively complex charging structures—such as mortgages, gym memberships and mobile phone contracts—were highlighted by respondents as suggesting that consumers do not necessarily find complex charging structures a barrier to participation. Marketing for these products was also raised as a source of evidence for the best way of presenting more complex charges simply and positively. A number of respondents pointed out that these kinds of products and services were more likely to be a part of the target market's experience than investment products. Simple, populist financial products such as premium bonds and direct-sales death benefit savings plans were also suggested as comparators, as respondents felt that these were popular with consumers.

24 Financial Services Authority, February 2008, *Consumer Research 65a, 65b, and 65c: services and costs disclosure.*

25 HM Treasury, Thoresen O, March 2008, *Thoresen Review of generic financial advice: final report.*

CHAPTER SIX
Sustainability

6.1 It is important that the delivery authority recommends a charging structure that helps to ensure the scheme will be viable in the short term, and sustainable over the long term. In the discussion paper, *Building personal accounts: choosing a charging structure*[26], the delivery authority evaluated four different charging structures in terms of their capacity to contribute to scheme sustainability.

6.2 In the delivery authority's view, there are three main objectives a charging structure should meet to help secure sustainability.

6.3 **Achieve a viable funding solution:** charging structures that minimise the scheme's funding requirements will be important. They will increase the probability of securing sufficient finance at a reasonable price.

6.4 **Minimise scheme costs:** charging structures that are more complex to administer, or that do not incentivise members to keep costs down, are likely to increase scheme costs

6.5 **Minimise business risks:** personal accounts will face a number of business risks that could affect long-run sustainability. Charging structures that minimise the effect of these business risks on the disparity between scheme costs and revenue increase the scheme's long-run sustainability. Business risks include a high number of non-contributing members, or fluctuations in the value of assets.

6.6 In the discussion paper, the delivery authority reached a series of conclusions about the effects of different structures on the scheme's sustainability.

6.7 An annual management charge (AMC) would perform least well in terms of reducing the scheme's funding requirements, but would be the most resilient to unexpected increases in the number of non-contributing members.

6.8 A contribution charge would bring in significant revenue during the early years of the scheme, thereby reducing the scheme's funding requirements compared with an AMC. It would also be the most resilient to fluctuations in the value of assets. However, it would leave the scheme exposed to the effects of an increase in the number of non-contributing members.

6.9 An AMC with a contribution charge would be best suited to deal with multiple risks. It would perform well in terms of reducing the scheme's funding requirements, but not as well as a contribution charge alone.

6.10 A joining fee combined with an AMC would be the best charging structure in terms of reducing the overall funding requirements of the scheme. The AMC component of the charge means it would also deal well with the effects of an increase in the number of non-contributing members.

26 Personal accounts delivery authority, January 2008, *Building personal accounts: choosing a charging structure, a discussion paper to support consultation.*

Minimising scheme costs

6.11 In advance of detailed work on the design of the scheme, it is not clear how complex each charging structure might be and how much this additional complexity might translate to additional scheme costs. It is also not clear how different charging structures are likely to impact on incentives for members to keep costs down. The delivery authority was interested in the way in which these factors have affected costs for existing organisations.

What the discussion paper, *Choosing a charging structure*, asked

- What evidence is there about the way in which administrative complexity or member behaviour have affected costs in existing financial products?

What you said

6.12 Most respondents who answered this question were clear that product complexity and member behaviour would both be key drivers of costs.

6.13 Respondents felt that more complex products tended to need more complex administration, resulting in higher costs. In particular, the experience of administration service providers suggested that more complex products often generated more manual interventions and higher levels of member confusion—for example, correcting errors or handling queries and complaints.

6.14 The experiences of several respondents in the financial services industry suggested that pension schemes have considerably higher administrative costs than non-pension savings products, and that this higher cost is driven at least partly by member behaviour. Pension schemes often involve a greater degree of member driven change than other financial products. For example, any changes in a member's employment, salary, or contributions may result in additional administrative work, which could increase costs.

6.15 Using a web-based, automated interface system for employers and members to engage with the scheme emerged as a key means of keeping costs low. Most respondents who commented in this area emphasised that automated interface systems could reduce administration costs.

6.16 While acknowledging the need to minimise scheme costs, a number of respondents cautioned that service quality should also be an important consideration. Respondents suggested that a minimum standard of service quality should be determined before work was carried out on minimising the costs of the scheme.

6.17 Responses were often linked to the question of whether additional charges should be made for specific activities, as discussed in chapter two 'Options for charging structures'. Respondents saw levying an additional charge on individual members for specific activities as likely to help to keep the costs of core activities low—both by covering the administrative costs of particular activities, and potentially by affecting member behaviour.

6.18 Several respondents also drew attention to the possibility of some members having quite complex requirements in terms of their engagement with the scheme—such as the need for statements in braille—for which they felt it might not be fair to make an additional charge.

Minimising scheme costs: some comments from respondents

"The key to success will be the ability to automate processes through standardisation, and hence reduced cost. Exceptions to the standard process will generate cost." (Xafinity Paymaster)

"Based on our experience of people management, we believe that any charging structure must be kept as simple and clear as possible." (Chartered Institute of Personnel and Development)

"Administrative complexity can significantly drive up cost, particularly where manual intervention is required. If personal accounts are to be kept to an acceptable cost, they must be highly automated, and that implies very limited scope for non-standard services." (Scottish Widows)

"Maximising the automation of processes and standardising the product proposition will help personal accounts to keep costs down. However, personal accounts need to balance the desire for standardisation against the need to be the universal pensions provider, catering to a very broad audience. Some members of the audience will require non-standard services if they are to interface successfully with personal accounts." (Pensions Management Institute)

"As an organisation which has to deal with a wide variety of customers, products and systems it is clear that the simpler the administration the lower the costs and the less likely that rectification work is required. Increased complexity can lead to errors and potentially lead to an increase in complaints from members." (HBOS)

"In the market for large occupational schemes, we regularly see complex structures being put in place in an effort to achieve fairness, but the cost of such structures can more than cancel out any benefit that members might receive." (Legal & General)

"Administrative complexity will have a direct bearing on members (and employers) perceptions of a scheme and there willingness to interact (contribute) to it. It is essential therefore that administrative interfaces with members and employers are as simple and light touch as possible to encourage engagement. In particular where members are required to make active choices (such as in investment decision) this will lead to delays, confusion, complexity of administration and opting out." (Capita)

"A modern policy administration system would easily cope with any of the charging structure proposals that are under discussion with no noticeable difference in the charges which would have to be levied." (The Actuarial Profession)

"Member behaviour is also affected by the design of financial products. Complex products that are difficult to understand can lead to a greater volume of enquiries which significantly increase the overall administrative costs. But product complexity is only one factor in member behaviour impacting operational costs. Even with straightforward financial products, member behaviour can cause significant volatility in business processing volumes each month or each year. [....] The way that the scheme or product rules are defined can determine whether these additional costs can be minimised, either by automating the processing or reducing the number of transactions. Where this is not the case, the costs will have to be absorbed in the annual running costs which would lead to higher fees for the customer." (Siemens)

"Industry evidence suggests that the administrative costs of running pension schemes are around twice the costs of running an equivalent non-pension savings product [....] [M]ember behaviour also increases administrative costs. Pension schemes see rather more member driven change than other savings products, as in addition to the usual drivers of change for any savings product, pensions plans are changed by alterations in salary, by interruptions of employment, and fund change. Additionally member control over benefits and funds presents further costs." (Association of British Insurers)

How the delivery authority will take this forward

6.19 The delivery authority will consider the impact of the various charging structures on administrative complexity, member behaviour and scheme costs. One of the key considerations the delivery authority will take into account in designing personal accounts will be to keep the scheme simple, in part to ensure that costs are minimised. This simplicity should also help to reduce the extent to which member behaviour increases operating costs.

6.20 In designing personal accounts, the delivery authority will seek to ensure that the scheme meets the Government's policy intention to provide not only a low-cost savings vehicle, but also a high-quality scheme. This scheme will be an exemplar of good governance, to service the needs of those without access to a good-quality workplace pension scheme.

Other issues raised

6.21 Several respondents requested that sensitivity analysis and scenario testing of the various charging and funding options be conducted, and that more information about this analysis should be made public.

Other issues raised: some comments from respondents

"We urge the personal accounts delivery authority to carry out extensive stress, scenario and sensitivity testing against a full range of business risks and to make this analysis public." (AEGON)

"The personal accounts delivery authority will need to be committed to maximum transparency even if the detailed figures are commercially sensitive." (Age Concern)

How the delivery authority will take this forward

6.22 In developing a funding strategy for the personal accounts scheme, the delivery authority will be conducting in-depth sensitivity analysis of the available options. However, it cannot disclose either the analysis, or its assumptions around costs and revenue flows: this information is commercially sensitive and its disclosure could compromise the delivery authority's ability to secure best value for money in the procurement process.

ANNEX A
Six members in profile

1. In the discussion paper, *Building personal accounts, choosing a charging structure,*[27] the delivery authority identified six illustrative members for the purposes of comparison.

2. **Full saver:** an individual who joins personal accounts at age 25, when the scheme first opens its doors to members, and saves consistently in the scheme until retirement.

3. **Caring breaks:** an individual who joins personal accounts at age 25, when the scheme first opens its doors to members, and saves consistently in the scheme until retirement—except for two breaks from saving, at age 29 for eleven years, and age 55 for five years.

4. **Starts saving at 45:** an individual who is aged 25, when personal accounts first opens its doors to members, but delays saving in personal accounts for 20 years, when reaching age 45.

5. **Switches to employer scheme at 45:** an individual who joins personal accounts at age 25, when the scheme first opens its doors to members, and saves consistently in the scheme until age 45, when they stop saving in personal accounts and begin saving in an alternative workplace pension scheme.

6. **Short period of saving at 25:** an individual who joins personal accounts at age 25, when the scheme first opens its doors to members, and saves in the scheme for four subsequent years only.

7. **Short period of saving at 60:** an individual who joins personal accounts at age 60, when the scheme first opens its doors to members, and saves in the scheme for four subsequent years only until they retire.

8. The illustrative members were not differentiated by income. This is because, in the four charging structures considered, income would not affect the proportion of fund value lost to charges.

9. All of the illustrative members were assumed to receive the same median income—around £24,000, growing in line with earnings—throughout the course of their respective savings histories. Note that in all cases it was assumed that the funds in the personal accounts scheme would remain there until the individual retired.

27 Personal accounts delivery authority, January 2008, *Building personal accounts: choosing a charging structure, a discussion paper to support consultation.*

ANNEX B
Seminar attendees

1. The delivery authority held a half-day seminar on Friday 28 March. The purpose was to bring experts and interested parties together to discuss the charging structure options, to debate the options and to provide evidence that could be used to inform the recommendation.
2. The seminar was attended by the delivery authority's Chairman, Paul Myners, Chief Executive, Tim Jones, and Non-Executive Director, Jeannie Drake, as well as a number of stakeholders from the pensions industry, consumer representative organisations and employer groups.
3. Over 30 individuals representing 23 organisations attended the event. The organisations at the event were:

   ABI

   AEGON

   Age Concern

   Axa

   British Chamber of Commerce

   Confederation of British Industry

   Department for Work and Pensions

   Engineering Employers Federation

   Equality and Human Rights Commission

   HBOS

   Her Majesty's Treasury

   Institute of Chartered Accountants England and Wales

   Investment Management Association

   Institute of Payroll Professionals

   Legal & General

   National Association of Pension Funds

   Pensions Policy Institute

   Prudential

   Society of Pension Consultants

   The Pensions Advisory Service

   Trades Union Congress

   Which?

   Xafinity Paymaster

ANNEX C
Respondents

1. The delivery authority received a total of 47 responses to its consultation. The categories shown here correspond with the types of organisations that responded, and are in alphabetical order.

Academic

Professor David Blake, CASS Business School, City University

Pensions Policy Institute

Consumer representative organisations

Age Concern

Equality and Human Rights Commission

Fair Pensions

Financial Services Authority Consumer Panel

The Pensions Advisory Service

Trade Unions Congress (TUC)

Which?

Employer representative organisations

Arc Benefits Limited

Association of Consulting Actuaries

British Chamber of Commerce

Chartered Institute of Personnel and Development

Confederation of British Industry (CBI)

Depositary and Trustee Association

Engineering Employers Federation

Institute of Directors

Tesco

Investment managers

Capital International

Fidelity International

Life offices

AEGON

Friends Provident

HBOS

Legal & General

Prudential

Scottish Widows

Zurich Assurance

Pensions and investment industry representative organisations

Association of British Insurers (ABI)

Association of Chartered Certified Accountants

Gissings

Institute of Chartered Accountants England and Wales

Investment Management Association

National Association of Pension Funds

Pensions Management Institute

Society of Pensions Consultants

Tax Incentivised Savings Association

The Actuarial Profession

UK Social Investment Forum

Pensions systems providers

Capita

Electronic Data Systems (EDS) and Sungard

International Financial Data Services

Invesco Perpetual

JP Morgan

Mercer

Siemens

Vertex

Xafinity Paymaster

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