

think piece

Promoting debate and fresh thinking in the financial services industry

Charging Fairly for Pensions

Steven Cameron

Summary

- The Department for Work and Pensions (DWP) has announced a controversial new charging structure for the National Employment Savings Trust (NEST) scheme which will combine a fund management charge with a charge on contributions – currently expected to be around 2% of contributions and 0.3% of fund each year.
- The decision has prompted both praise and strong criticism from different corners. There has been some misleading analysis mixing contribution and fund charges. Some have claimed a single charge would be easier for customers to understand. Others suggest large occupational schemes could be operated at charge levels below those proposed for NEST.
- AEGON believe that the majority will be better off under the combination charging structure than under a single charge of equivalent amount: analysis by PADA shows that for most customer groups (6 of the 7 tested) the projected return at retirement is higher under the combination structure.
- And counter to some arguments, research suggests people will not be put off by the ‘complexity’ of a combination charge; research by BMRB for AEGON finds that respondents are no more likely to opt out of a scheme with a combination charge than one with a single flat fund charge.
- In addition the implementation of the Retail Distribution Review (RDR) will make the cost of advice more transparent and combination charging structures the norm.
- Ultimately, what matters most is not differences in pension charging structures (which have relatively little effect on final retirement outcome), but delivering adequate income in retirement through a system that encourages early and ongoing engagement with saving, better investment decisions and higher ongoing contributions.

Number 41 (July 2010)

As the leading professional body for the insurance and financial services sector with over 95,000 members in more than 150 countries, the CII Group is committed to protecting the public interest by guiding practitioners in the sector towards higher technical and ethical standards. We do this by offering them a broad portfolio of services and support to achieve this, including membership, qualifications, continuing professional development, thought-leadership, and the maintenance of a benchmark Code of Ethics.

The views expressed within the article are those of the authors and should not be interpreted as those of the Chartered Insurance Institute or their members. AEGON has asserted its right under the Copyright, Designs and Patents Act 1988 to be identified as the author and copyright owner of the text of this work, and has granted the CII worldwide perpetual licence to reproduce and distribute it royalty-free in whole and in part, with the stipulation that the role of AEGON in its production be duly acknowledged in each case. We welcome suggestions from potential contributors, and also seek reader feedback.



CII Introduction: new pensions initiatives often cause controversy. The 2012 pension reforms introduce NEST and also mean all employees are automatically enrolled into a workplace pension with an employer contribution, unless they actively opt out. Aimed at low to moderate earners who don't currently have access to a workplace pension, the reforms aim to go a long way towards solving the inadequacies in current pension saving. But critics are questioning some aspects, not least the previous Government's decision on a charging structure. In this thinkpiece AEGON examines both sides of the argument, and concludes that a combination charging structure is a positive move for all parties.

The Department for Work and Pensions (DWP) has announced a controversial new charging structure for the National Employment Savings Trust (NEST) scheme which will combine a fund management charge with a charge on contributions – currently expected to be around 2% of contributions and 0.3% of fund each year.¹

The last time there was such interest in pensions charges was when stakeholder pensions were introduced. NEST is being launched into a dramatically different world from that which saw the introduction of stakeholder pensions a mere nine years ago. In 2001 those offering stakeholder were required to levy a single form of charge – a fund-related charge, capped at 1% to cover all costs, including any advice. The NEST charges will be of a different shape and at a much lower level, currently expected to be around 2% of contributions and 0.3% of fund each year.

Some commentators looked at the 2% contribution charge and confused it with the 1% fund charge for a stakeholder pension. There's a big difference between a charge of 2% of fund and one of 2% of contributions, with the former being far higher in all but the very early years. As the DWP has indicated, the combination is broadly equivalent to a flat fund charge of 0.5% a year – in other words, it is roughly half the original stakeholder charge cap.

A key difference from stakeholder is that no one is suggesting there will be any payment to cover advice from NEST charges. Instead, it's argued that automatic enrolment will secure mass take-up. Arguably, however, employer support through advisers remains crucial and it's not clear how this will be paid for.

¹ [New low cost pension to help millions save for retirement](#), DWP, 16 March 2010. See also, Tim Jones (Chief Executive of NEST), [Personal Accounts: Encouraging People to Save for Retirement](#), CII *Thinkpiece* no.21 (August 2009). Available on www.cii.co.uk/thinkpiece

Will the combination charge structure lead to a better outcome for the various parties involved?

So will NEST and auto-enrolment work better than stakeholder? Before the introduction of stakeholder, the pensions industry argued for a combination charging structure. The NEST charging structure could be seen as validating this. Does it constitute Treating Customers Fairly for potential members of NEST? What are the implications for members of other forms of pension, advisers and importantly the taxpayers who might ultimately be called on to help out if NEST gets into financial difficulties?

What does the customer get in return for pensions charges?

There is more to pensions than investment management. Those who compare pensions charges to wholesale investment management charges are ignoring the raft of other functions pension scheme providers perform. There are also costs associated with:

- supporting scheme- and member-level administration
- collecting contributions from employers and employees
- making sure proper tax relief is collected
- communicating regularly with members
- making sure contributions and benefits paid out are in line with complex pensions legislation

These functions are, at a high level, similar for NEST and its private sector 'competitors', in other words large occupational defined contribution, group personal and stakeholder pension schemes.

But private sector pension schemes typically also face costs associated with advice and/or intermediation. This is a key difference from NEST.

Advantages and disadvantages of a combination charge

Funding the early costs

If the combination of 2% contribution plus 0.3% annual fund charge is broadly equivalent to a charge of 0.5% of fund each year, why not simply go with the latter? Certainly, a single charge has some appeal because of its simplicity. However it has significant drawbacks from financial and sustainability perspectives. All schemes, including NEST, incur significant upfront costs both in terms of scheme-wide infrastructure and through the initial costs of enrolling members, setting up records and communication links. But the timing of income to cover these costs seldom matches expenditure.

Indeed, under most charging structures, the timing of any charge income is very different. Typically,

charges at the start don't generate enough income to cover the initial costs when they arise. This means these costs need to be recouped over time from ongoing charges, and this mismatch is particularly acute where there's only a flat fund-based charge.

A flat fund charge of 0.5% would generate very little income in the early years. With a staged approach to the launch of NEST, where members pay lower levels of contribution in the early years, the problem is even worse, as the fixed costs don't change but the charge revenue received comes in even more slowly.

The 'ideal' answer from a purely financial perspective would be to cover all initial costs from upfront charges. But this would be unattractive to many of those considering joining. So a mismatch is inevitable, leading to a shortfall between income and costs in the early years. The key is to minimise that mismatch while not damaging the attractiveness to potential members.

NEST has two possible ways of financing its shortfall. One would be a direct subsidy from the taxpayer. In fact, NEST has already received considerable help from the government relating to set-up activities, including the initial consultancy services the Personal Accounts Delivery Authority (PADA) provided to the Government. Of course 'government funding' is really taxpayer funding, and it's unrealistic to expect any government to give huge financing to a new venture like NEST, particularly in the current climate.

The other option, which is how things will actually work, is for NEST to borrow the money required.

The Pensions Policy Institute (PPI) has calculated² that under a 0.5% amc-only structure, set up could require £1.3 billion of borrowing in 2012 alone, peaking at £2.4 billion in 2020 which could be repaid by 2030, or 18 years after the introduction of NEST. The combination charge structure the PPI considered required considerably less capital than this, and was repaid over a much shorter time period.

Any borrowing costs money. So there's a benefit in borrowing less rather than more and a combination charge helps this.

Of course, the 2% contribution charge won't cover anything like the costs incurred in the first year and a smaller, but still very substantial, amount of borrowing will be required. The previous government anticipated that the total loan period, during which the 2% charge will apply, would last for 20 years. Their original intention was to provide this loan at a rate below what would be commercially available,

² [Charging structures for personal accounts](#), Pensions Policy Institute, March 2007

and the European Commission has now approved this as consistent with their rules.³

Will the customer pay more under a combination charge?

There is potential for considerable confusion here, with some misleading analysis mixing contribution and fund charges.

The key point is that 2% of contributions is far less than 2% of fund value in all but the very early years.

Outcome for customers

Because of the many variables involved, such as when a customer joins a scheme, how old they are, and whether they take contribution breaks, working out whether they'll be better off under a flat or combination charging structure isn't straightforward.

PADA looked at the outcomes for seven groups of customer⁴:

- Median age individual (age 36)
- Full savings history (joins NEST at age 25)
- Caring breaks (as above but with two caring breaks of 11 and five years)
- Starts saving at age 45 in 2032
- Short period of saving at age 25 (four years)
- Short period of saving at age 60 (five years)
- Switches to another scheme at age 45 (having joined at age 25)

With the exception of the 'short period of saving at 60' category, the projected return at retirement is higher for all groups under the combination structure. Those close to retirement would in any case often benefit from opting out of the NEST scheme because of the adverse interaction with mean-tested benefits. Whatever structure is used, there will always be winners and losers, so the DWP has chosen what was best for the majority - the option where people in six out of the seven groups analysed should be better off. This looks like the right way to treat the overall customer base of NEST most fairly.

Contribution charges

Some have suggested that a 2% contribution charge represents a big up-front charge. The actual situation is best illustrated by a worked example.

In the first year of phased auto-enrolment (when the employee will pay 1% of earnings, reduced to 0.8%

³ [Hansard](#), 16th March 2010

⁴ [Briefing note: Why does the proposed combination charge for NEST meet its low charge objective?](#), PADA, March 2010

with tax relief, and the employer a further 1%), a median earner would pay around £150 to the scheme. Tax relief and employer contributions increase this to around £380. For this employee, the combination of 2% of contribution and 0.3% of fund amounts to less than £1 a month in the first year, and an average of under £2 a month in the first five years.

Comparison with other forms of pension

A direct comparison of NEST charges with other retirement saving options can be misleading, as there are significant differences in underlying costs. On the one hand, NEST will have a different membership profile from other schemes – for example, it will have to accept anyone who wants to join, whatever their contribution level. On the other hand, NEST is deliberately simple and offers fewer options and less flexibility than private sector schemes.

Some have suggested that some large occupational schemes can be operated at charge levels below those proposed for NEST. It should be remembered that NEST is designed for low to moderate earners who don't have access to these sorts of schemes, in which the employer often subsidises running costs. It's highly unlikely that these people could find an individual pension with charges close to NEST levels. So for its target market, NEST looks like offering good, fair, value.

Will customers be put off by a combination charge?

There is an argument that, because a single charge is simpler to understand, a combination charge will be seen as unattractive and cause people to opt out of NEST. However, research by BMRB for AEGON⁵ shows otherwise. AEGON's research attempted to replicate the situation a customer will face when being enrolled into NEST, and to understand the motivation of those who decided to opt out of the scheme.

634 respondents were shown a single page explaining NEST (or personal accounts as they were known at the time). The design was deliberately aimed to mimic the type of literature AEGON believes could be used to communicate effectively with NEST customers. It drew on elements of the customer-facing literature used for PADA's research⁶ into charging structures, and was designed to be accessible and provide the key information in an easy-to-understand format, using graphics and text.

⁵ [Personal Accounts: charging structure research](#), BMRB research for AEGON, November 2008

⁶ [Personal accounts: Attitudes and reactions to possible charging structures](#), BMRB and Henley Centre HeadlightVision research for PADA, 2007

Half were shown a document with a yearly fund charge of 0.5%. The rest were shown a combination structure consisting of a charge of 5% of contributions and a yearly fund charge of 0.3% (this was based on an estimate of what a combination charge level might be, before the recent announcement).

The key finding was that respondents in the group shown the combination charge were no more likely to opt out of NEST than those shown a flat fund charge.

In fact, those shown a flat fund charge were slightly more likely to opt out, although this wasn't statistically significant. It's worth noting that this was true even though the research used a 5% contribution charge, more than double the 2% now anticipated.

Charging for advice

Charging structures across the pensions landscape will be affected by the Retail Distribution Review (RDR), which will be implemented at the end of 2012, within the same timeframe as pensions reform.

The RDR aims to make the cost of advice more transparent. There will be a separation of charges for 'manufacturing' and 'advice'. The provider will set the former and the adviser the latter. Providers may charge for their services through a flat fund charge, or may seek to better match their costs through a combination structure. Advisers are highly unlikely to ask for remuneration for regular premium pensions as a percentage of fund. They are much more likely to express their charges as a percentage of contributions over the early months or years, as this comes closer to matching adviser costs.

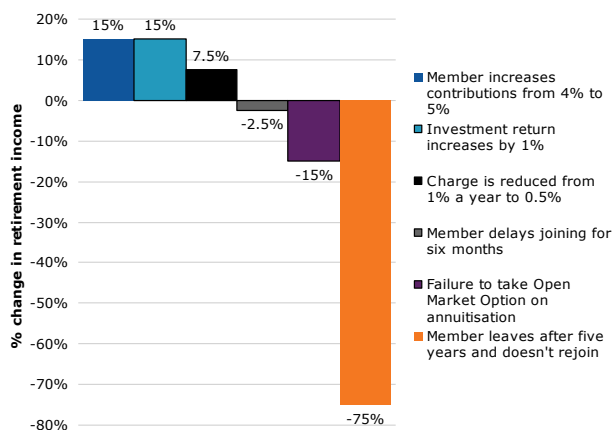
Under the RDR, unless all adviser costs are met by employers paying a separate fee, we're very likely to see combination charging structures become the norm.

What matters most

This thinkpiece set out to consider alternative pension charging structures and, in doing so, to explore what's 'fair'. But ultimately, what matters most is delivering adequate income in retirement. We need a system that encourages saving for retirement among those in a position to do. So as well as 'the numbers', we need to consider behavioural implications.

Internal AEGON modelling shows that product charges have a much lower effect on a person's retirement income than many other variables. In particular, increasing contributions, improved investment returns or leaving the scheme early have a far larger impact on the final retirement income.

What matters most - effect on final retirement income



(Figures are based on an employee paying in 4% salary, with tax relief of 1%, employer contribution of 3%, aged 35 and retiring at 65).

So the debate around charging structures has to be taken in context. If, for example, paying an extra charge for advice leads to earlier joining, better investment decisions and higher ongoing contributions, then it's clearly of value.

Conclusion

Securing an adequate income for retirement should be a key objective for us all. Government pension reforms, including NEST, are designed to help.

However, alongside NEST, we need a thriving private sector pensions landscape.

We have an opportunity right now to shape the pensions of the future. As part of this, we need to focus on:

- reducing barriers to saving
- creating trust in the financial security of pension schemes and savings institutions
- offering choices between NEST and private sector pensions
- achieving fair value through appropriate shapes and levels of charges
- making sure those who need it have access to advice

It's not easy to address all of these aspects in a fair and balanced way. But AEGON believes the DWP decision to have a combination charging structure for NEST is a very good place to start.

If you have any questions or comments about this thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact:

Laurence Baxter, CII Head of Policy & Research and Thinkpiece Editor, laurence.baxter@cii.co.uk or by telephone +44 (0)20 7417 4783.



Steven Cameron is Head of Business Regulation at AEGON UK. He leads the analysis of a wide range of regulatory and legislative departments, identifying potential impact on the industry in general and on AEGON in particular. An actuary by profession, he has 25 years' experience across a wide range of financial services functions. Currently, he is focusing on the FSA's Retail Distribution Review including Adviser Charging, implications for corporate pensions and interactions with the 2012 pension reforms. He has also championed the embedding of Treating Customers Fairly across AEGON. He's a member of a number of ABI committees and represents AEGON on the Scottish Financial Services Implementation Group and Scottish Financial Enterprise's Insurance Sector Policy Group.

The **Chartered Insurance Institute** is the leading professional body for the insurance and financial services sector and has over 95,000 members in more than 150 countries. This includes nearly 26,000 members of the **Personal Finance Society** which is the UK's largest grouping of financial advisers and related roles. We are committed to protecting the public interest by guiding practitioners in the sector towards higher technical and ethical standards. We do this by offering them a broad portfolio of services and support to achieve this, including membership, qualifications, continuing professional development, thought leadership, and the maintenance of a benchmark Code of Ethics. *For more information, see www.cii.co.uk/thinkpiece*

AEGON is one of the world's largest financial services organisations, with some 40 million customers in around 20 countries around the world. It's firmly focused on helping people build better financial futures through its innovative solutions for both individuals and companies. In the UK, it has pensions, investments, life insurance and advice businesses. It's financially solid with £55.7 billion assets under management, including all revenue-generating investments*, and has a financial strength rating of AA- (very strong) from independent analysts Standard & Poor's for its life and pensions businesses. Visit aegon.co.uk to find out more. *AEGON N.V. results 31 March 2010

Recent articles in the series:

- No.40: [The Future of International Financial Regulation](#), by Eric Pan, Associate Fellow in International Economics at Chatham House. **International Series no.9** (8 June 2010)
- This thinkpiece summarises the challenges confronting attempts to strengthen the global financial regulatory architecture. Prepared by a prominent regulatory law professor based in New York, the paper helps readers make sense of the various interlocking institutions such as the G20, IMF and European Union, and sets out the key issues and challenges facing them as they deal with the effects of the financial crisis.
- No.39: [Financial Education: It's Everybody's Business](#). By Wendy van den Hende, Chief Executive of the Personal Finance Education Group (pfeg) (24 May)
- Van den Hende summarises the importance of financial education for young people in enhancing public trust and confidence in money matters. She goes on to describe efforts by government and the industry (including the Personal Finance Society) to help develop and promote this, and sets out what more needs to be done.
- No.38: [Successes, trials and tribulations in regional economic recoveries](#), by Rodrigo Delgado Aguilera, **International Series no.8** (22 April)
- The developing world is seeing the same sort of multi-speed recovery as elsewhere. While the Asian economies have responded well following lessons learned from earlier crises, Latin America and the Middle East seem to have for the most part escaped the turmoil's major effects, but emerging Europe's recovery is still far from over.
- No.37: [UK Election 2010 Special: What the Parties Say](#), by Stephen Timms, Mark Hoban and Vince Cable (1 April)
- We have compiled an election special as part of our regular CII Thinkpiece series. The three main parties – represented by the Rt Hon Stephen Timms MP for Labour, Mark Hoban MP for the Conservatives and Dr Vince Cable MP for the Liberal Democrats – set out their respective visions for financial services.
- No.36: [The End of Dollar Dominance? Signs of Change in the International Financial System](#), by Vanessa Rossi **International Series no.7** (17 March)
- Changes in the international financial arena following the global recession could challenge the West's dominance the monetary system. In this latest addition in our special series of thinkpieces on global themes, Vanessa Rossi of Chatham House explores these changes.
- No.35: [Making Sense of it All: Convergence and Investor Protection in EU Financial Regulation](#), by David Doyle (9 March)
- While events in Brussels may seem far away to some, recent proposals for European financial regulation will have more impact than usual on financial practitioners in the member states. EU expert David Doyle looks at some of the proposals under consideration right now and discusses their implications.
- No.34: [Something Must Be Done! Sir Humphrey writes: Lessons for Financial Regulation](#), by Richard Hobbs (11 February)
- The author explores the government's response to the financial crisis. He warns that drastic, politically expedient intervention that is seen to be "doing something" risks stifling competition while failing to address the underlying causes of the crisis.
- No.33: [Too Big to Ignore: The Protection and Perception Gaps in Life and Health Insurance](#), by Ron Wheatcroft and Stephen Bale (29 January)
- A consumer-focused view of the long-term insurance market with a particular emphasis on long-term protection business. The authors explain why the time is ripe for that industry to engage with all stakeholders in a concerted effort to close the protection and perception gaps.
- No.33: [Comfortable Retirement Goes with a Crunch?](#) by Gemma Tetlow and Matthew Wakefield (12 January 2010)
- Gemma Tetlow and Matthew Wakefield of the UK economics think tank the Institute of Fiscal Studies consider the extent to which resources of those near retirement have been vulnerable to asset price changes as a result of the credit crunch and recession.
- No.32: [Financial Regulation: What Good Really Looks Like?](#) by Karl Snowden (10 November 2009)
- How much financial services regulation is appropriate to protect the public while promoting a free market has been a key debate. Karl Snowden examines various aspects of regulation, including what can and cannot be done to avert crises and produce the best outcomes.

No. 29: [Solvency II: Enabling Transformation Through Regulation](#), by Richard Jones, John Smith and Brid Meaney of IBM (8 October 2009)

Outlines the key decisions that need to be made now to design the appropriate Solvency II programme. Insurers need to understand the drivers that could influence both the scale of investment and the value to be derived from their Solvency II Programmes.

No. 28: [Risky Business: Rethinking Risk](#), by Clare Sheikh of RSA Insurance Group (1 October)

The economic downturn has affected people in many ways. One such example is the impact on perceptions towards risk, both in terms of businesses and individuals. This last in the Risky Business series on insurance and risk the ways in which attitudes have shifted and what this might mean for the future.

No. 26: [Emerging Markets: Upwardly Mobile Economies and New Consumerism](#), by Vanessa Rossi of Chatham House, [International Series No.6](#) (18 September)

In this sixth in the series looks at the prospects of the emerging markets after the recession. She argues that the fast rising ownership of consumer durables and property will enhance the demand for services such as bank accounts, credit and personal insurance.

No. 21: [Personal Accounts: Encouraging People to Save for Retirement](#), by Tim Jones, Chief Executive, Personal Accounts Delivery Authority (now National Employment Savings Trust: NEST) (21 August)

Tim Jones, Chief Executive of the Personal Account Delivery Authority, provides background to the personal accounts scheme which will be ready for the onset of employer duties in 2012, outlines the role of employer contributions and considers the investment strategy

All our Thinkpieces are freely available on our website: www.cii.co.uk/thinkpiece

If you would like to receive new Thinkpieces by email, please contact us on: thinkpiece@cii.co.uk

For more information on the views of the Chartered Insurance Institute and Personal Finance Society, including policy research, briefings, *Our View On* papers, *Papers in Professionalism*, and other publications, please visit www.cii.co.uk/policy



CII