

Pension landscape and charging: Quantitative and qualitative research with employers and pension providers

By Andrew Wood, Dominika Wintersgill and Niall Baker

Background

This research explores the charging levels and structures in trust and contract-based pension schemes, commissioned as part of the Department for Work and Pensions (DWP's) on-going workplace pension reform research programme. The research consisted of a quantitative survey of around 700 trust based schemes, and 500 contract based schemes, along with qualitative research with leading pension providers. Interviews took place between September and November 2011. The research was carried out on behalf of the DWPs by RS Consulting.

Key findings

- Employers' awareness of member charges was low, with only around a third aware that members paid any charges at all, with significantly lower awareness among smaller firms.
- An Annual Management Charge (AMC) was the most common approach to charging, where members paid a fixed percentage of their total pension fund to the provider per year.
- The average AMC for trust-based schemes was 0.71 per cent of the fund per year, the average AMC of contract-based pensions was 0.95 per cent.
- Apart from scheme type, the key determinants of the AMC are size the scheme, use of commission, contribution levels, employee turnover, how long the employer is likely to stay with the provider, and in some cases average workforce age and the relationship the provider has with the adviser.

- Sixteen per cent of contract-based schemes, and four per cent of trust-based schemes used Active Member Discounts (AMDs). Providers indicated AMDs were gaining in popularity among contract-based schemes.
- Provider costs for scheme set up varied and were as low as £50 to £100 per member in larger schemes, but the very smallest schemes could cost the provider much more per member.
- On-going costs were extremely difficult for providers to measure. Annual estimates varied from £30 to £166 per active member. Costs for deferred members were lower, estimated at between £25 and £55 per member.
- Transfer costs were perceived to have little impact on charges because they were generally seen as a low one-off cost. Typically, the cost to transfer a pension pot was reported at around £50 per member.

Charges paid by scheme members

In most DC pension schemes, members are required to pay an Annual Management Charge (AMC), which covers the costs that the pension provider incurs in setting up and running the pension scheme, and in some cases, commission paid to an intermediary.

Employers' awareness of the charges that their members paid was, however, low. Only around a third of trust-based and contract-based employers were aware that members paid any charges at all, with significantly lower awareness among smaller firms. Awareness was also lower among those employers that did not use an adviser: while they

were often aware that there were some fund-related charges, typically they were unsure what these were or how they were charged.

Where employers were aware of charging levels, the most common approach to charging was where members paid a fixed percentage of their total pension fund to the provider per year. Providers confirmed that this 'traditional' AMC charging structure was usual, as it was a simple and transparent way of charging customers, and since the introduction of GSHPs had become the 'norm' in the marketplace.

The average AMC for trust-based schemes was 0.71 per cent of the fund per annum; the average AMC of contract-based pensions was higher at 0.95 per cent. Apart from scheme type, the key determinants of the AMC were:

- Size of the scheme: members of the largest schemes were likely to pay significantly lower charges, a result demonstrated both by the employer and the provider surveys.
- Commission: where a commission-based adviser was used, this led to an average increase in the AMC paid by members of trust-based schemes by around 0.3 percentage points; and in contract-based schemes of around 0.2 percentage points.
- Contributions: higher contributions, which were driven both by salary and the percentage of salary contributed by employers, also led to lower charges being paid by members.

Providers also considered a range of other factors in setting the AMC, including likely employee turnover, how long the employer is likely to stay with the provider, and in some cases average workforce age and the relationship the provider has with the adviser.

Fees paid for advice and other services

Almost 60 per cent of trust-based schemes had used an adviser in relation to their scheme in the past 12 months, with schemes of over 100 members significantly more likely to do so. The largest schemes were also more likely to pay a fee for their

advice. While a similar proportion of contract-based and trust-based schemes used an adviser, employers with contract-based schemes were far less likely to pay a fee for advice.

Although commission is being banned for new schemes sold from 2013 under the Retail Distribution Review (RDR), 20 per cent of trust-based schemes and 28 per cent of contract-based schemes had used a commission-based adviser in the 12 months prior to this research. Paying for advice through commission was more common among smaller schemes, with around a quarter of schemes with six to 99 members having done so.

Where employers with trust-based schemes paid a fee, this was on average £210 per active member; those with contract-based schemes paid £160 per active member. Employers claimed that such fees were virtually never passed onto members.

Almost half of trust-based schemes used one or more additional services, with larger schemes more likely to use a wider range of services: auditors and accountants were the most commonly-used service, used by 42 per cent of schemes; no other service was used by more than 20 per cent of schemes. Where employers with trust-based schemes did pay for additional services, they spent an average of £300 per member on these, with larger schemes spending less per member than smaller schemes.

Additional charges for specific funds

While providers typically set a basic AMC, normally paid by the majority of a scheme's members, there were circumstances under which some members of a particular scheme might pay higher charges than others.

Most commonly this happened where a member chose to invest in certain funds other than the default fund. The vast majority of contract-based pensions and two-thirds of trust-based schemes offered members a choice of funds, although most scheme members tended to invest only in the default fund, which did not carry additional charges: providers themselves pointed out that between 80 and 95 per cent of members were invested in such funds.

Just under a third of employers reported that their schemes had certain funds that carried an additional charge; indicative information from providers suggested that somewhere between ten and 20 per cent of members and funds might be subject to additional fund management charges, most commonly where they choose to invest in the following:

- Externally-managed funds, which tended to carry additional charges for the external fund to be added to the provider's platform.
- Certain specialist actively-managed funds, which were more complex or required more intense management. Examples included property or emerging market funds.

Charges for fund switching were extremely rare.

Other member-specific charges

Some providers offered lower AMC's to members currently making contributions into the scheme (active members) than to members no longer making contributions (deferred members). There was evidence that such AMDs were gaining in popularity among contract-based schemes.

Sixteen per cent of contract-based schemes used AMDs, compared to just four per cent of trust-based schemes. In addition, some large providers claimed to have sold the majority of their contract-based schemes on this basis in the past 12 months, as they have reportedly become increasingly popular with employers who liked the idea of encouraging employee persistency. AMDs were also favoured by some of the providers, who could charge a higher AMC on deferred pots that were no longer growing and which might otherwise become unprofitable.

Other member-specific charges, including member joining fees, charges for transfers in or out of the scheme, higher charges in the early years of an individual's scheme membership and discounts for large funds or high contributions were all reported as being extremely rare by both employers and providers.

Providers' costs of pension provision

One objective of this study was to understand the costs incurred by pension providers in setting up and running a pension scheme for an employer. However, while providers were able to discuss broad elements that impacted their costs, most found it difficult to break down their own costs in detail as part of this study.

Provider costs for scheme set up, largely consisting of sales efforts, technical set up of the scheme and initial communications, varied and depended mostly on scheme size. Set up costs appeared to be as low as £50 to £100 per member in larger schemes, but the very smallest schemes could cost the provider much more per member because of fixed set up costs for each employer. Higher set up costs often put providers in a loss-making situation in the early years of a scheme, because the costs could only be recovered over the long-term via the AMC.

On-going costs were extremely difficult for providers to measure. Annual estimates varied from £30 to £166 per active member, mostly comprised of internal time, plus fund management costs. Costs for deferred members were lower, estimated at between £25 and £55 per member.

Fund management costs to the provider for a typical passive default fund ranged between 0.06 per cent and 0.12 per cent of the fund per annum, and costs for this were covered by the basic AMC. Additional fund management costs for specific fund choices were typically passed on to members via an increase in the AMC.

Where a commission-based intermediary was in place, the commission they charged also represented an additional cost to the provider. Adviser charging was expected to replace commission from 2013, which would not then represent an additional cost to providers as it would instead be taken directly from members' funds.

Transfer costs were perceived to have little impact on charges because they were generally seen as a low one-off cost. Typically the cost to transfer a pension pot was reported at around £50 per member.

Impact of the pension reforms on provider costs and charges

There was some uncertainty and disagreement between providers as to the likely effects of the pension reforms on provider costs. While all agreed that there would be initial set up costs which could be considerable, there were mixed views as to whether in the long term increased automation would lead to lower running costs or the increased administration required would lead to higher running costs.

Some providers did feel that the reforms would reduce scheme set up costs per member, because of a reduction in sales effort and in the communications required. With a larger number of members across the board, costs per member could decrease, particularly if processes can become more automated.

Conversely, many providers felt that automatic enrolment would lead to the creation of many very small pension pots, which, combined with high employee turnover, could lead to an increase in administration costs, with large numbers of members needing to be enrolled and de-enrolled on regular basis, while contributing little to their pension schemes. Their funds might therefore never reach the level required to generate enough revenue through the AMC to offset the provider's initial set up costs.

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You can download the full report free from: <http://research.dwp.gov.uk/asd/asd5/rrs-index.asp>

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Carol Beattie, Central Analysis Division, Department for Work and Pensions, Upper Ground Floor, Steel City House, West Street, Sheffield, S1 2GQ. Email: Carol.Beattie1@dwp.gsi.gov.uk.