

A Summer Stocktake - part two

Pensions Reform 9

July 2009

Introduction

The pensions reform agenda has continued developing apace during 2009. As we reach the halfway point for the year, and approach the parliamentary summer recess, it's worth taking a step back and reviewing the progress so far.


This factsheet gives an overview of the development of the personal accounts scheme over recent months. Factsheet 8 gave a summary of the work done since the Pensions Act was passed at the end of 2008 to introduce the employer duties, including the duty to automatically enrol eligible members of their workforce.

The main points

- The Personal Accounts Delivery Authority (PADA) is pressing ahead with designing and implementing the personal accounts scheme, and has a shortlist of four potential administration contractors.
- We expect a decision on the charging shape and level for the personal accounts scheme to be made later this year or early 2010.
- PADA has issued its consultation on investment, especially looking at the design of its default fund. It has proposed a 'fund of funds' approach, using major asset classes and diversification, including a tracker fund.
- Personal accounts members will use a self-service online system to establish what type of retirement income they need, and they'll be encouraged to buy this from the open market.
- It's proposed the personal accounts scheme will have a contribution cap, and generally a ban on transfers in and out of the scheme.

Pensions reform – a brief reminder

The Pensions Act 2008 sets out the new pension responsibilities for employers from 2012. In future, employers will have to automatically enrol all jobholders who are aged between 22 and state pension age into a pension scheme. Jobholders are those who work in Great Britain and earn more than around £5,000 a year. The pension scheme could be a private pension scheme or the new personal accounts scheme. Employers don't have to automatically enrol jobholders who are already members of a qualifying scheme.



Jobholders can opt out of the pension scheme if they want to. If they do, neither they nor their employer has to pay any pension contributions. But if they remain a member, then minimum contributions of 8% of a band of total earnings has to be paid, of which their employer has to pay at least 3%. (Defined benefit schemes will have different requirements.)

Jobholders outside that age range can also choose to opt into a pension scheme. If they do, the same minimum pension contributions will apply.

The Pensions Act 2008 also laid down the foundations for creating the new personal accounts scheme.

Building the personal accounts scheme

PADA has been pressing ahead with the delivery of this occupational scheme. It will be a registered pension scheme set up under trust. The working title of the scheme is personal accounts – but a new name is expected to be announced by the end of 2009.

The government has initiated the development of the personal accounts scheme. However, it will be run by the private sector. PADA has whittled down to four its shortlist for the contractors of the administration services, including contribution collection.

These are:

- a consortium (including Logica UK, International Financial Data Services and DST Systems)
- Tata Consultancy Services
- a Danish firm Arbejdsmarkedet Tillaesgspensions (ATP)
- a team made up of Great West Retirement Services and Canada Life

Private companies will also be able to tender for other contracts, including trustee services, member of the provider annuity panel, investment administration, and investment of the assets.


The tendering process has to take place in line with European rules, and is expected to last at least 18 months.

Charges

The decision on both the shape and level of charges of the personal accounts scheme is a critical one. We expect the Department for Work and Pensions (DWP) to make this decision late in 2009 or early in 2010, once more information is known about how the administration of the personal accounts scheme will work.

In the feedback on its charging consultation last year, PADA highlighted that views were polarised between two different charging structures: a single fund management charge and a combination of a fund management charge and a contribution charge.

We believe a dual charging structure is fairer in the long run for different groups of customers, and is a significantly more sustainable method of charging for personal accounts, requiring far less upfront capital.



We're concerned that unless the personal accounts is built on solid financial grounds, then if reality proves different to the assumptions the scheme has made, it may be forced to return to taxpayers to ask for extra subsidy or even raise charges for members. This could be damage the reputation of savings in the UK.

Securing a retirement income

In early December, PADA published a consultation paper on how people should use their personal accounts pension pot to securing a retirement income.

It proposed that buying an annuity would be best for most people in their target market. It put forward for debate a process whereby a significant number will secure an annuity through the open market option, after deciding which type of retirement income would suit their needs best using an electronic 'self-service' customer experience. For those who don't make a choice using the open market options, the consultation paper suggested annuities could be secured through a panel of providers.

PADA recently published its feedback statement. It rejected calls to adopt a default annuity shape.

We agree buying an annuity will be the best option for many personal account members. There are two stages at the heart of this process: first deciding what type of annuity to buy, and second choosing where to buy it from. The second stage is – in some way – much easier than the first, especially to those comfortable with comparing prices online. Deciding what type of income will be more difficult for a number of people, especially with no face-to-face support.

It will be interesting to see how the self-service customer experience develops, and how aligned it will be with the guided sales process being progressed through the retail distribution review (RDR).


Investment

Like every automatic enrolment scheme, the personal accounts scheme must have a default investment fund for members who don't want to make investment decisions. The design, objectives and performance of the fund will be crucial – given the vast majority of personal accounts members are expected to invest their pension savings in it.

In May 2009, PADA issued a consultation paper, focusing primarily on the design and objectives of the default fund. The target market is expected to be risk adverse, with low financial understanding, and low to median earnings, so the default fund strategy will need to balance risk and return with maintaining (and even growing) confidence in pension saving.

Following the consultation, PADA will make recommendations to the trustee corporation, which will ultimately be responsible for setting the investment strategy. The default investment strategy is likely to have the following characteristics:

- A 'fund of funds' approach, using major asset classes and diversification, including a tracker fund
- Passively managed, adopting some form of lifestyling, reducing investment risk as the member approaches retirement, possibly by using target date funds
- Transparent corporate governance and accountability
- Adoption of responsible investment approach over time, as the funds under management grows
- Setting and communicating objectives of the default fund will be paramount



In addition, PADA is consulting on the number of other funds, such as a sharia fund and an ethical fund. The choice of funds is expected to be in the region of 10 to 15.

The final decision on the investment strategy for the personal accounts default fund is one of the most keenly discussed points of the pensions reform agenda and the building of the personal accounts scheme.

The stance PADA recommends to the trustee corporation will be viewed with great interest by the remainder of the pensions industry. PADA has a difficult task ahead. It wants to make sure members have the right risk and reward exposure, but at the same time doesn't want to run the risk of people being turned off saving if investment returns aren't as great as expected.

The scheme rules

In April 2009, PADA and the DWP issued a joint consultation on a draft scheme order and draft rules for the scheme.

The personal accounts scheme will have particular rules in the following areas:

- **Setting a maximum contribution limit**
This is proposed to be £3,600 as at 2005/06, and increased in line with average earnings to 2012, probably giving a figure of closer to £5,000 by that time.
- **Generally banning transfers into the personal accounts scheme**
There's an exception for transfers in of cash transfer sums for existing members who are early leavers under their employer's occupational pension scheme and have short service of under two years.
- **Generally banning transfers out of the personal accounts scheme**
There's an exception for transfers out of all benefits after reaching normal minimum pension age (55 from 2010), and pension credit benefit transfers out after reaching that age.
- **Setting retirement age**
If the member doesn't nominate a retirement age, setting their retirement age as their state pension age.
- **Taking all benefits together**
Members won't be allowed to take only part of their retirement benefits, instead they'll have to take all their benefits at the same time.
- **Fund payment on death**
On death before any benefits have been taken, the fund will be paid out to whoever the member has nominated, or the estate, if no-one has been nominated. The funds may **be liable for inheritance tax** (IHT).

There will be some clear differences between the personal accounts scheme and private pension schemes. Some of these differences – such as the contribution cap and general ban on transfers – have developed as a way of making sure the personal account is clearly aimed at its target market of low- and medium-earning employees.



What it means for you?

The personal accounts scheme will be a new competitor for the private pension market, and some employers, especially those not currently providing pensions for their workforce, may feel it offers them the right solution.

Inevitably, there will be comparison between the personal accounts scheme and the private pension market.

However, private pensions may have several advantages over personal accounts, for example by offering customers the benefits of:

- administration experience
- fast and efficient contribution collection
- bespoke marketing and communications
- investment sophistication
- advice for employers and their workforce

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