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Department for Work and Pensions
3rd Floor, The Adelphi
1-11 John Adam Street
London
WC2N 6HT

Dear Sirs

**PERSONAL ACCOUNTS: A NEW WAY TO SAVE
RESPONSE TO CONSULTATION**

Thank you for giving the Association of Consulting Actuaries (ACA) the opportunity to set out our comments on the above.

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and are subject to the code of professional conduct of the Faculty and the Institute of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes.

The ACA is the representative body for consulting actuaries, whilst the Faculty and Institute of Actuaries are the professional bodies.

The answers to the specific questions raised in the white paper are set out in the Appendix but our main concerns are set out in more detail below.

Overview

The ACA welcomes the intent of Personal Accounts to extend private pension provision to those not presently covered by employer pension schemes. We broadly support the proposed design and arrangements for implementation. The important next step is that the Government takes really positive steps to strengthen and encourage existing and new work place pensions that are better than the minimum provided by Personal Accounts. Measures to do this need to be included in its legislative program for 2007/08 otherwise we believe there is a real danger that many employers will level their pension provision down to Personal Accounts with minimum contributions.

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We have some more specific comments covering:

- The impact of volatility in investment returns
- The impact on State Means Tested Allowances (SMTAs)
- The Maximum Annual Contribution Limits

Detailed comments on these are set out below:

Volatility of Investment returns and annuity rates

Depending on the period over which contributions are invested and on the investment strategy adopted, the funds available at retirement to purchase a pension can vary considerably within defined-contribution schemes. While investment strategies such as “life-styling” (the use of less volatile investments as the member approaches retirement) can reduce the variation, not all members will choose investment options that reduce investment volatility. Variations in fund values of 30% to 40% or more for the same level of contributions are not unusual.

Rates at which funds can be converted into pensions (annuity rates) also vary over time and between different providers. Typically the rates can vary by more than 10% between different annuity providers at any one time.

It is important that members of defined-contribution schemes are aware of these risks and take sensible steps to mitigate them where possible and appropriate. The proposal to offer a default fund is welcome as a way to mitigate some of these risks. However, it will be very difficult to communicate effectively the nature and extent of the investment risks without personal financial advice. The white paper contains little information on how this will be achieved. This part of the communication exercise needs to be carefully considered.

The white paper mentions documentation and the necessity of choosing a competitive annuity provider in sections 5.17 to 5.19. However, the details of this important element of scheme design are left for a future review of the operation of “Open Market Options”. There is little information regarding the expected expenses of annuity purchase, what if any advice should be provided and how the process will be administered.

The potential for unpleasant surprises for individuals and disappointment of expectations is a significant risk for all defined-contribution schemes. The larger the funds involved the greater the significance of these risks. We are concerned that, with the maximum contribution limits suggested, some members will be investing substantial proportions of their income, potentially in excess of 10%, into Personal Accounts with insufficient advice.

The Impact on SMTAs

Some lower paid employees, specifically lower paid women now aged 45 to 60 and men aged 50 to 65, would be very unlikely to build up sufficient benefits in Personal Accounts to exceed the value of the State Means Tested Assistance (SMTA) that they would lose as a

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result of saving in Personal Accounts. This is addressed in sections 1.18 to 1.21 of the white paper but we suspect the impact has been underestimated.

Paragraph 54 of the Executive Summary states "Those who want a simple approach to saving will only have to decide whether to remain in the scheme and how much to contribute". This is an oversimplification: men and women who may fall into the trap outlined above need advice over when or whether to opt-out of Personal Accounts. This is supported by paragraph 2.28 of the white paper "...many UK consumers find choice in pensions.....overwhelming ...many ...are reluctant to seek information ...research reveals a widespread lack of confidence ...in their ability to make decisions about pension provision. This lack of confidence is underpinned by low levels of financial capability.."

There is growing concern that there has been some pensions mis-selling of Stakeholder Pension Contracts because vulnerable groups of the lower paid were left with the complex decision tree device as 'best advice'. While there were suggestions that individuals should refer to IFAs, it is unlikely that this was effective due to the cost of providing such advice and the complexity of SMTAs. It is now practicable to provide a fairly straightforward comparison of an individual's personal account and the SMTA: we believe this should be done as it would provide a useful guide to the likely interaction of SMTAs with the Personal Accounts for this vulnerable group.

Paragraph 112 of the executive summary includes the statement that "It will be Government's role to ...[provide] appropriate degrees of consumer protection". How will this be achieved? It is only fair that Government should make sure that the interaction of Personal Accounts with SMTAs does not disadvantage individuals when Personal Accounts are introduced.

The Maximum Contribution Limit

We agree with the White Paper's conclusion that a contribution limit should be imposed. We believe this is essential to limit the risk of levelling down existing good employer pension provision.

We challenge the proposal that this limit should be set as high as £5,000. Paragraph 5.18 of the Regulatory Impact Assessment states that a £3,000 p.a. limit would be sufficient for median earners to earn a pension of 67% of pre retirement earnings about 75% of the time. The justification for increasing this figure to £5,000 p.a. in respect of median earners is not clear.

Paragraphs 5.19 to 5.21 of the Regulatory Impact Assessment provide information that is used to justify increasing the maximum contribution limit to £5,000 p.a. However, this appears to be based on the fact that average contributions to existing defined-contribution schemes for members earning over £30,000pa averages £3,970 for employed individuals and £4,460 for the self employed. This statistic will include contributions by individuals earning well in excess of £33,500. Such individuals are not part of the target group for whom Personal Accounts are aimed, and their inclusion must significantly distort the analysis. As a result, our view is that the required maximum contribution level is significantly lower than the government proposes. We do not believe this is sufficient evidence to justify a substantial increase in the maximum recommend by the Pensions Commission.

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In June 2006 the Government Actuary's Department (GAD) published "Occupational Pension schemes 2005, the thirteenth survey by the government actuary". Paragraph 8.8 of this report states that "[Average] Contributions to defined-contribution schemes were lower [than defined-benefit schemes] at 2.7% from members and 6.3% from employers." The ACA Pension Trends Survey 2005 found that average contributions to defined-contribution schemes were 5.9% from the employer and 4.1% from the member. This suggests that a £3,000 limit would cover average contributions to defined-contribution schemes for earnings in the £5,000 to £33,500 range. These figures certainly do not support the idea that the maximum contribution limit should be £5,000 or above.

We would also note that Personal Accounts are intended to complement existing pension schemes and that under current HMRC rules it is permissible for individuals to contribute both to a Personal Account and to another scheme such as a Stakeholder or a personal pension. There is nothing to stop individuals who find the annual contribution limit too low directing some or all of their excess contributions in to another savings vehicle. Since it is likely that additional investment advice will be needed for individuals that take this route it would also alleviate concerns about the lack of advice associated with Personal Accounts when significant amounts of members money are being invested.

Yours sincerely

Charles Young
Chairman
Pension Schemes Committee of the Association of Consulting Actuaries

APPENDIX

ACA RESPONSE TO PERSONAL ACCOUNTS CONSULTATION

Chapter 1

- **Whether there should be a cohort of employees approaching State pension age at the time personal accounts were launched they should not be automatically enrolled in to personal accounts.**

This depends on the information and advice available to such people. If there is enough information to establish whether personal accounts may simply offset State Means Tested Allowances (SMTAs) which might otherwise have been available there is less reason for this. Given the difficulty of making such an assessment we suspect that compulsory enrolment would result in some members receiving no overall benefit from personal account saving..

- **When in practical terms this might adversely affect the interests of this group because they have been less likely to exercise the positive choice to opt-in.**

Again, given the difficulty of making a sensible assessment of the affect on SMTAs it is likely that some people would fall in to this position.

- **Whether three years is the right period for repeat automatic enrolment of employees who have opted-out of personal accounts.**

A period shorter than three years would, we believe, unreasonably increase the burden on both the employers and on the administration of personal accounts. We therefore agree that three years is the right period.

- **How would this affect employers and employees?**

There is a risk that employees who are enrolled in to personal accounts will decide that they have dealt with pensions and hence do not need to consider whether higher levels of savings might be necessary.

Chapter 3

- **The Government is interested in views on how members' interests can best be represented in the governance of personal accounts.**

It is important that the Personal Accounts Board take responsibility for monitoring the expenses incurred by commercial providers, investment funds available and investment policy adopted. We would expect there to be an oversight body with representation from consumer representative bodies such as Which?, employee and employer representatives.

We also believe it is important that the operation of personal accounts, the investment returns achieved and the expenses incurred on members funds are transparent enough for members to provide additional oversight.

- **The Government would welcome views on what sort of information should support personal accounts and the responsibilities of different organisations in communicating this information.**

We believe that the information which should be available on joining include projections of estimated benefit levels and the variation that is likely to occur from investing in defined contribution accounts. Information concerning the effect on SMTAs should be provided possibly with access to more detailed advice from the DWP for those who might be worst affected by loss of SMTAs. The effect on members' take home pay should be clear. Given that there will be no transfers in or out of personal accounts allowed there needs to be warning that once contributed money can only be taken out in the form of benefits.

Information that should be provided periodically to members includes a summary of the operation of the scheme and a personal benefit statement indicating the levels of funds, current levels of contributions and projections similar to those provided at the outset.

Chapter 4

- **Which overall charge structure is most appropriate?**

An annual management charge would seem to be necessary to cover the bulk of the investment costs. However, given the comments in the White Paper regarding the effectiveness of competition in keeping charges down careful consideration would need to be given to how the Personal Accounts Board can ensure that such a charge does not become excessive.

A joining charge would seem counterproductive since it would act as a disincentive to members to join the scheme. Since the target audience has already demonstrated some reluctance to join pension schemes allowing any such disincentive would seem to be counterproductive. Likewise a contribution charge may well prove a disincentive.

A flat fee charged from the member's account would minimise any disincentive but depending on its level could have a serious impact on the eventual level of benefits, particularly for the less well-paid.

So overall, while not perfect in all respects, we believe that an annual management charge is most appropriate.

- **How much flexibility should the delivery authority or the Personal Accounts Board have in deciding the charging structure?**

It seems essential that one of these bodies should have the ability to change the charging structure in case the initial charges turn out to be too low to enable personal accounts to be effectively administered or too high and thus unfair to members. However, since the level of charges will be a consideration in members deciding whether or not to opt-out there should be restrictions on the degree to which charges on past contributions can be varied.

- **Are there particular circumstances or activities for which it is appropriate to make an additional charge?**

The White Paper contains little information on how funds will be converted into income at retirement. It may be necessary for advice to be taken at this stage and a charge for provision of advice from the fund may be the only practical way of ensuring that this can be paid for.

We would expect certain information to be provided to members periodically as the normal operation of the scheme however it would be appropriate to make additional charges for members who requested additional information at other times.

Chapter 6

- **How can the Government treat such arrangements [non occupational workplace pension arrangements] as schemes for the purposes of exemption from personal account requirements?**

Provided such schemes meet minimum contribution, benefit and charging requirements it seems sensible if such schemes could qualify for exemption from personal accounts.

- **How can the Government ensure that in the absence of automatic enrolment these vehicles can offer similar levels of coverage and saving to those estimated for automatic enrolment?**

This does not seem possible.

- **The Government is interested in views on whether employers of exempt schemes and contributions above the personal accounts minimum could operate a short waiting period of perhaps three or six months to encourage them to continue to offer high quality schemes.**

- **What should be the minimum level of contributions above which a waiting period is acceptable?**

A waiting period of six months, or possibly even as long as 12 months, would seem sensible.

- **The Government would welcome views on how to ensure that employers of exempt schemes have the flexibility to manage the implementation of the reforms in the same way as employers who will operate personal accounts, and in particular whether the approach should be by:**

- **Phasing in the minimum employer contribution or levels or accruals for exempt schemes over three years or an appropriate period**

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- **Phasing in by groups of employees or**
- **Some other approach**

Employers with exempt schemes will already have established their pension policy based on their own employment and remuneration policies. This issue is likely to arise in respect of employers where a significant number of their employees have opted-out of the current arrangements and must now be automatically enrolled. It is desirable that such employers should be allowed as much flexibility as possible if they do decide to provide automatic enrolment. Ideally the test would be based on a comparison of the contributions paid or benefits earned by members in this transitional period with the value of funds that would have been contributed to personal account giving employers the maximum flexibility as to how to achieve this.

- **The Government will continue to discuss with stakeholders how this outline approach might work in practice. Views on the approach to compliance would be welcome, in particular:**
 - **How can employees who chose to save in personal accounts best be protected from suffering detrimental treatment by their employers compared with those that opt-out?**
 - **What type of information and support would encourage compliance?**
 - **How can processes be designed to encourage compliance?**
 - **How could the proposed penalty regime be structured?**
 - **How valuable would a whistleblowing helpline for employees be?**

We feel it is essential that the intentions to deliver a light touch regulatory regime be achieved. Maximum compliance will be encouraged by simplicity, clarification of what is required by employers and assistance from the personal accounts delivery authority or the Personal Accounts Board as appropriate. As far as possible the emphasis should be education and persuasion and not on penalties for non compliance. Penalties should be reserved for persistent mal-administration or deliberate avoidance of the regulations rather than for misunderstanding and mistakes. In the main part the focus of dealing with errors and misunderstandings should be to protect members rather than to punish employers.

- **Exemption for defined benefit schemes**

We support the use of a simple test on the scheme accrual rate to check whether a defined contribution scheme qualifies for exemption. We also agree that, while a reference scheme test exists for contracted out schemes, this test coupled with automatic enrolment should be sufficient for schemes to be exempted.

We do not, however, agree that a 120ths accrual rate is necessary for a contracted in scheme. Bearing in mind the funding regime that occupational pension schemes must follow, our view is that employers will find that a 120th scheme will cost significantly more than 8% of pay for employers to fund. The 120th scheme pension is likely to lead to higher pensions unless investment returns in the personal accounts significantly exceed current best estimates.

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We recommend that, instead, an accrual rate of 150th should be the minimum permissible. This is nearer to a cost-neutral design for an employer.

Chapter 7

- **Given the twin aims of focusing the scheme on a target market by allowing sufficient flexibility for individuals within the scheme should the annual contribution limit be set higher than £5,000, if so at what level?**

We feel strongly that the proposal of the £5,000 is too high. At that level, it is extending the scheme beyond the lower and medium paid employees at whom personal accounts are aimed. There is a serious risk that a good employer's pension provision would eventually level down to the personal account level. We note that the majority of employers say that this would not happen but our experience of advising companies with pension schemes is that reductions to levels of benefits are always undertaken reluctantly and are forced on employers by commercial reality such as escalating costs and risks, or low cost competition, possibly from employers who do not offer such good pensions.

We believe that the annual limit should be set no higher than the Pension Commissions recommendation of £3,000 per annum. We also believe that there should be no higher level in the first year for the reasons given above but also because this would be likely to create a dead zone in the run up to the introduction of personal accounts as much of the target membership might be tempted to put off pension saving until the introduction of personal accounts.

Response from:

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