Summary
- Cross-subsidies are where one group of customers pay higher prices in order to subsidise lower prices for another group. Within the pensions industry this occurs with the percentage-based annual management charges, resulting in those with larger pots paying larger amounts to subsidise the costs of maintaining those with smaller pots. It also appears within default funds versus self-selected funds and active members compared to deferreds.
- Increased fee transparency, facilitated by new technology, may threaten the sustainability of the cross-subsidy system.
- Potential new fee structures include larger AMCs as pot sizes grow, a cap on the pound size of fees and separating out the costs of certain services.
- There are concerns that removing the cross-subsidy approach to fees may raise costs for some members.

A house of cards

The fee system within the pensions industry relies strongly on an element of cross-subsidy. As there is now a greater focus on costs, and more transparency thanks to technological developments, Laura Blows asks if the current charging structure is still sustainable

As anyone who has attempted to build a house of cards can attest, surprisingly great heights can be reached but it just takes one knock to bring the whole fragile system down. And just like a house of cards, the pensions industry may not realise the precarious position it's in with its current charging structure.

Cross-subsidies

Pension fees have been in the spotlight for a while now, with the auto-enrolment charge cap, value for money and transparency all taking centre stage. However, waiting in the wings to steal the show and potentially throw the industry's entire fee structure into disarray is the issue of cross-subsidies.

The concept of cross-subsidies, where one group of customers pay higher prices in order to subsidise lower prices for another group, occurs in many sectors of society.

A significant way in which it occurs within the pensions industry is with the annual management charge (AMC) for DC scheme members. This is usually a set percentage fee (and of no more than 0.75 per cent for auto-enrolment schemes).

To use a lower AMC example of say, 0.3 per cent, that raises just 60p on a £200 pot – which wouldn't cover the postage costs for mailing out the annual benefit statement, AB head of multi-asset strategies David Hutchins says. In contrast, that same charge on a £20,000 pot would result in the member paying £60 a year. Presumably the scheme member with the larger pot isn't actually utilising £60-worth of costs; instead the money they pay is being used to fund the services for the scheme member with the smaller pot.

Another place where cross-subsidies appear is with default funds. Here, those in default funds are paying the same fees as those in self-selected funds, despite defaults being nowhere near as complex to administrate. "If you've got 95 per cent of the members in the default fund and 5 per cent in self-select, and yet the charges for everyone is the same, is that fair?" Hutchins asks.

An additional example is the costs applied to active members versus deferred members. There are 'active member discounts' but it really should be 'deferred member discounts', as active members' monies require far more work than deferreds due to the contributions coming in every month, Hutchins adds.

Sustainability problems

While the default fund example – along with the deferred members one – may conjure up issues surrounding 'fairness', it is the cross-subsidy from typically older members with larger pots to younger

members with smaller pots where sustainability problems may arise.

Cross-subsidisation within annual management charges was previously never a cause for concern because those younger savers with smaller pots eventually became the older members with larger savings funding the younger members in turn.

This current system is "all well and good, as long as the member doesn't switch to a different scheme when they are older, where they may pay £30 in fees instead of £60", Hutchins warns.

There's nothing stopping that occurring now and causing problems. But the reason why it is more likely to be a greater risk in the near future is down to technology.

The upcoming pensions dashboard is likely to be just the start of members being able to view their retirement savings more easily, and hopefully in turn increasing their engagement. Therefore Hutchins can see this being the spark to light change.

"We will see solutions come to the market that will really expose this *[cross-subsidies]* and show that a member is overpaying. For example there may be a 'GoCompare'-style site for pensions that looks at a member's current pension scheme and searches the market for a scheme with the same investment strategy but with lower costs," Hutchins explains.

Advancements with new investment models could also facilitate this. Hutchins gives an example of an ETF fund that can mimic the investment strategy of a member's current pension scheme, but at a fraction of the cost.

The members most likely to do this and implement a switch are those with the larger pots "as the fees become relevant", Hutchins states.

This is particularly the case when they notice the significant impact charges have on their pension pot.

The Transparency Task Force gives the example of a 65-year-old member that had been saving £400 a month since the age of 20, receiving 5 per cent growth per annum and paying 2 per cent costs per annum. The total fund size would be £452,255, with an additional £334,912 (or 42.6 per cent of the total fund) lost to charges.

Now if the charge was reduced to just 1.9 per cent annum – representing the beneficial effect of a cross-subsidy – the member would save £12,215, instead paying £322,697 (or 40.9 per cent) in charges.

In contrast, paying a AMC of 2.1 per cent – so being on the 'wrong' side of the cross-subsidy – would mean an additional £11,841 being paid in fees, costing £346,753 (or 44 per cent).

"Clearly, even a relatively small difference in the level of charges being applied has a considerable effect, and therefore the answer to the question 'should trustees be concerned about cross-subsidies' is 'yes'," The Transparency Task Force founding chair Andy Agathangelou says.

Members seeing these numbers and wanting to switch may sound harmless enough, but Hutchins warns that this could have a significant impact on the way the pensions system generally operates.

Insurers generally work with 20-year-plus time horizons, Hutchins explains, meaning they expect to lose this money through their charging structure at the beginning, but then the business will eventually become profitable.

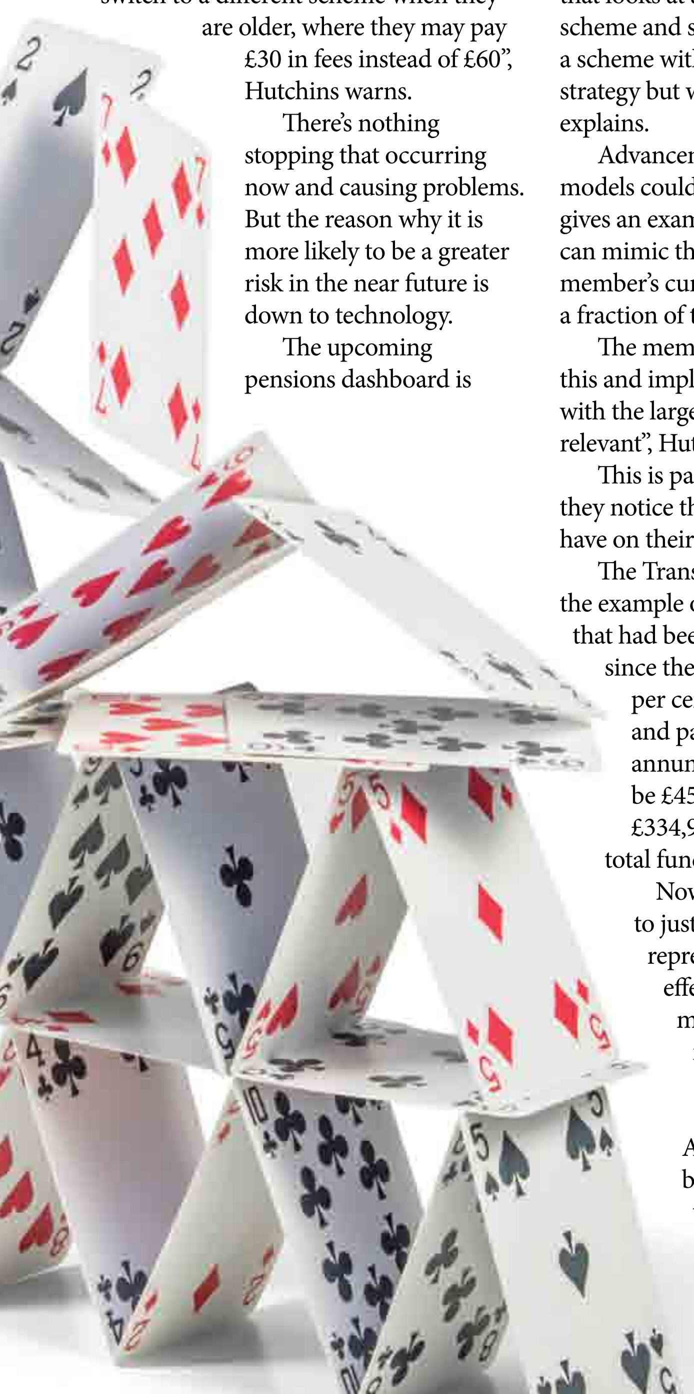
This way PASA board director Peter Dyer notes that it is actually the providers that subsidise the costs in order to attract business with competitive AMCs.

But the problem with this model is "it makes the assumption that people won't leave", Hutchins says.

"The dangerous part of it is you could take a big insurance book and if all the £20,000-plus pots are taken out, then something like 70-80 per cent of the assets under management would leave, but only 20-30 per cent of their cost base," he explains.

Or, to use a car insurance analogy, this is akin to charging £200 per annum to each driver, irrelevant of details. "I'm going to get all the reckless drivers, the new drivers, those with fast cars, all the wrong type of customer. All the people who are more attractive types of driver for a company to insure will go somewhere else where they may only be charged £100 per annum. So I will be going broke," Hutchins says.

This kind of separation is already occurring at a company level. For instance in 2013, when McDonalds first auto-enrolled its 37,000 UK employees – of which 2,000 were salaried staff and the others hourly-paid employees, the 2,000



salaried employees entered a stakeholder scheme with Friends Life and the rest went into the government-subsidised master trust, the National Employment Savings Trust (Nest).

If a problem does begin to occur where those with larger posts are no longer staying put to subsidise the smaller ones' costs, then the industry will need to adapt to survive.

Hutchins already notes the change has occurred within the annuities market, which has developed a more "refined" charging structure following companies 'cherry-picking' those with shorter life expectancies and granting them better deals. As a result everyone updated their pricing structures beyond just age and gender, so the sector is heading towards every annuity deal being individually underwritten, he says.

Another example of a charging structure reducing reliance on cross-subsidies is The People's Pension's EasyBuild stakeholder scheme, which uses "a tiered charging structure that removes a significant element of cross-subsidy," its director of policy and market engagement Darren Philp says.

Potential models

There are also a number of other ways that charging models could adapt to reduce cross-subsidies.

Hutchins thinks one option could be a charging structure that changes so that fees are reduced as savings build up.

"Members should care about the cost over time. So it would be fairer to have 1-2 per cent fees when a person first joins, falling to 0.25 per cent when nearing retirement," Hutchins suggests. "That would make the individual economically better off because they are leveraging those lower fees against a bigger pot of money."

However, Dyer is concerned that this type of structure could discourage people, particularly those on lower salaries, to save early enough for retirement.

Instead, a potential compromise would be to operate a charge basis that equates to the maximum cap charge as members start to save with a provider, "but with small step increases applied over the early years until a flat capped amount (not percentage but amount) is reached", Dyer suggests.

According to Aon Hewitt investment principal Joanna Sharples, a move to a more tailored charging system would be possible, "but would be more expensive to administer".

Instead, another option would be to charge members separately for the cost of fund management (sticking to a percentage of assets charge) and administration (which could be a pound-based fee), she suggests.

While stating that "currently members are charged equally, and we believe fairly, using fees calculated on a percentage basis", PLSA chief executive Joanne Segars acknowledges that charging for services that only affect the individual can be a "justifiable approach" in some circumstances as it prevents all members being penalised for the additional costs being generated by a small group.

Growing awareness

But these new charging structures are possibilities that *may* occur; that's not to say that they *will* arise. After all, cross-subsidies form the foundations of many pension scheme transactions, and they are not shaking yet.

But maybe people just aren't checking for cracks. For instance, The Transparency Task Force believes more discussions need to take place around the issue of cross-subsidies and the transparency of charges generally.

To that aim, it is currently requesting co-signatories to its open letter to the Work and Pensions Select Committee chair Frank Field, calling for him to open an inquiry on the whole issue of pensions' costs and charges.

While the campaign has the potential to make parliament sit up and take note, according to Agathangelou it will be the threat of litigation that will make trustees focus on charges and cross-subsidies.

"Trustees have a responsibility to scheme members, all of them, so if one group is in effect treated in a manner that results in detriment there may be the basis of legal action in the future," he warns.

Whether trustees are already sufficiently aware of the cross-subsidies occurring within the pension schemes' charging structure – without the threat of litigation opening their eyes – seems subject to debate.

On the one hand both Sharples and Dyer state that the pensions industry is perfectly aware of cross-subsidies. In contrast, Agathangelou believes that many trustees have not been particularly focused on the details around costs and charges until quite recently.

Both him and Hutchins highlight the need for trustees and IGCs to be at least aware of cross-subsidies within their schemes, in order to assess which are broadly 'fair' and which are unsustainable.

BESTrustees chairman Alan Pickering is certainly aware of cross-subsidies within the system, but seems unfazed by them.

"Cross-subsidies are an inherent feature of a modern society. So as far as my council tax is concerned, I do not benefit from schools or libraries but do take full advantage of public transport," he says.

While acknowledging that the "disruptive impact"of technology "may highlight cross-subsidies within the DC marketplace as never before", Pickering takes the view that simplicity and value for money is more important than absolute cost. "If we can achieve a combination of value and simplicity, I am prepared to live with a reasonable amount of cross-subsidy," he states.

No problem?

For many, Pickering makes a good point. To them, cross-subsidies may continue to exist in the industry, not due to a lack of

awareness, but simply because they're not really an issue to address.

According to Segars, trustees and IGCs already utilise their bargaining power to ensure the scheme – and therefore members- receive competitive charges.

Sharples agrees that "doing everything on an individual basis may help in some aspects but it potentially removes the benefits of bulk-buying power and could actually increase charges, rather than reduce them".

Also, technology and increased transparency may enable members to more clearly see what fees they are paying – and for what exactly. However, this leading to more movement into schemes with lower annual management charges (and therefore risking bringing down the nature of cross-subsidy funding for the original scheme) may not occur within occupational DC as the member would risk losing their employer contributions, which are more valuable than the savings generated by lower fees.

Philp believes that members will not want to shop around and regularly move schemes, but in the future will choose the scheme they they individually want to save with, similar to the Australian pensions saving model.

For Dyer, the majority of members will only be interested in pot size compared to contributions made, despite charges not being hidden.

But even many of those that are cynical about an upcoming problem with cross-subsidies are willing to discuss potential solutions in case issues do arise.

"We have no evidence that existing charges are not being applied correctly by providers," Dyer states, "but we do recognise the excessive degree of cross-subsidy and would welcome being involved in devising a more equitable scale that is still practical to apply."

While acknowledging that the cross-subsidy issue does not currently affect The People's Pension, as the vast majority of members have small pots from making minimum auto-enrolment contributions, Philp says the master trust "is not frightened of adopting alternative charging models". However, standardisation and comparability are the key issues to address for savers to be able to compare value for money between different schemes, he adds.

The cross-subsidy charging system may be more robust, or more fragile, than people think. But to find out either way, awareness and discussions about the subject need to grow – ideally in plenty of time to ward off potential problems. That is surely the first step in being prepared in case, just in case, the cards come tumbling down.

Written by Laura Blows