

To switch or not to switch, that's the question

An analysis of the potential gains from switching pension provider

Isaac Alfon

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FSA Occasional Paper

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Biographical Note

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1 Executive Summary and introduction

The question of whether or not to switch from an existing personal pension to another personal or stakeholder pension is a timely one following the introduction of stakeholder pensions. The maximum 1% charge makes stakeholder pensions cheaper than many personal pensions sold in the past – making it potentially attractive for some people to switch. For example, it is estimated that there are about two million people in the government's original target group for stakeholder pensions who already have a personal pension and who might, therefore, consider whether to switch to a stakeholder pension.¹

Whether someone would benefit from switching or not is not a simple issue. There are potential gains from switching if the charges on the new pension are lower than those on their existing pension. But there are also potential costs because of up-front charges and/or exit charges on the existing pension. Consumers need to weigh carefully the costs and benefits before making their decision and may need to consider taking financial advice.

This paper discusses the range of different issues that consumers need to consider in deciding whether or not to switch pension provider.²

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- 1 13% of employees (and 17% of people in employment, including the self-employed) are contributing to a personal pension, DSS (2000) and about 45% of consumers with a personal pension earn between £10,000 and £20,000, ONS (2000). About 4.5 million of consumers contribute to a personal pension (an estimate based on DSS data). This suggests that the original target population is about two million consumers. Although people outside the target range could also switch to a stakeholder pension if they wished. Indeed, more recent pronouncements have referred to the target group of stakeholder pensions by reference to a minimum level of income: "if you earn more than around £10,500 a year and you want to build a second pension, you should think about a stakeholder pension scheme along with the other pension options" ('Stakeholder pension' leaflet in www.pensionguide.gov.uk, January 2002).
 - 2 The paper presents a general framework to consider whether or not to switch from an existing pension and illustrates the relevant factors for this decision using examples of unit-linked personal pensions. So, the paper does not address the specific issues that arise in cases such as: (a) switching between occupational pensions and personal pensions; (b) switching from 'retirement annuity contracts' that existed before the introduction of personal pensions; (c) switching from a with-profits pension; (d) switching from a closed fund; (e) an increase in contributions to a personal pension, in other words whether the extra contributions be diverted to a new contract; and, in the future, (f) switching between stakeholder pensions. The framework should be relevant to these cases, but as it stands it does not represent a tool for specific cases.

First, they need to ask if there are features of their existing personal pension that they value, such as the range of funds available, that are not provided by the alternative pension.

If the product features are similar, consumers need to consider:

- how the charges on their existing personal pension compare with those on a stakeholder or other pension;
- how long they have been contributing to a personal pension and for how much longer they plan to contribute to a pension;
- what they are going to do with the money they have saved in their existing personal pension – take a transfer value and invest it in their new pension, or leave the funds in their existing pension until maturity.

Using information on pension charges for unit-linked personal pensions offered in recent years, this paper explores the factors that are likely to determine the gains from switching in practice. The analysis uses examples to show that:

- consumers who took out a pension with above-average charges that have not subsequently been reduced could potentially benefit from switching to a stakeholder pension;
- consumers need to tread carefully. Even among those with personal pensions with above-average charges, not everyone would benefit from moving to a stakeholder pension;
- the potential gains from switching are sensitive to the timing of the decision. Typically, the earlier the decision to switch and the longer the consumer has left to contribute, the larger are the gains from switching; and
- the potential gains from switching are also sensitive to the decision about what to do with the money that consumers have saved in their existing personal pension.

An important caveat to this analysis is the issue of whether providers are reducing charges on existing personal pensions. There is some indication that this is happening – partly in an attempt to discourage people from switching to a stakeholder pension.

This paper is structured as follows:

- Section 2 explains from a theoretical perspective, why switching is likely to be important – not just for individual consumers, but for the efficient functioning of markets. It also discusses why consumers might not switch;
- Section 3 contains a brief analysis of the factors that customers need to consider in deciding whether or not to switch;
- Section 4 uses examples of unit-linked products to illustrate the potential gains from switching; and
- finally, Section 5 summarises the results of the analysis.

2 Switching: theoretical considerations

2.1 Potential gains from switching

Differences in charges on similar personal pensions – or between personal and stakeholder pensions – create an opportunity for consumers to gain from switching their future contributions and their accumulated savings to another provider. With up-front costs³ and/or exit charges⁴ on their existing pension there are also potential costs to switching. But, there are potential net gains to individual consumers from switching to a similar pension with *sufficiently* low charges to increase final fund value.

Switching is not only about generating gains for the individual consumers who switch. Given that pensions are long-term contracts, typically lasting 25 years, a low level of switching creates a customer base that can effectively be regarded as captive for many years. This is likely to reduce the level of effective competition and affect the operation of the market in various ways:⁵

- a low level of switching might enable firms to increase charges over time, or to set excessively high charges for personal pensions, or both;
- a low level of switching is likely to mean that firms would devote resources to competing for new business, rather than serving existing customers. With an increased level of switching (or threatened switching) firms will tend to pay relatively more attention to the interests of existing customers – as recent developments in the mortgage market have shown;⁶

3 When a consumer switches to another personal pension, the first set of initial charges has already been incurred and the switching costs arise from the second set of initial charges.

4 The following quotations from Walford (1998), which sets out the terms of the policies available from different providers, illustrate the exit charges that existed at that time:

- “Transfers out: available at any time, but penalty applies if transferred out from a regular contribution plan before 15 years of contributions have been paid. Penalty as for early retirement or paid-up plan. [...]”
- “Transfers out: available at any time, but with penalty, which depends upon policyholder’s age.”

5 Most of these issues are covered in Klemperer’s survey of existing economic analysis of the effect of consumers’ switching costs, Klemperer (1995) and in a recent paper on the role of consumers in competition, Waterson (2001).

6 See, for example, “Price war shake up could be good news for borrowers who do not chase special deals”, Financial Times, 21 February 2001.

- a low level of switching is likely to deter firms from entering the market because they would find it difficult to take customers from existing firms – and would have to rely only on new business (typically, those taking out a pension for the first time) rather than existing pension-holders. The same is true of new or existing providers who innovate. With a low level of switching, the competitive pressure from innovation is likely to be reduced; and
- arguably, a low level of switching, together with evidence of consumers' choices that are either ill-informed or ill-advised, may suggest a greater need for regulation – of either conduct of business or products – to deliver the appropriate degree of consumer protection.

Note that the gains from switching do not apply to 'churning', that is where consumers are advised to switch purely to generate commission for advisers. Of course, excessive switching or inappropriate switching is not beneficial to a consumer.⁷ Advisers recommending a switch should – and no doubt generally do – consider the relevant options available to the consumer, as illustrated in Section 4.

Switching is not ideal when there are switching costs.⁸ The ideal would be either for there to be no associated costs, or for all the benefits from 'switching' (lower charges and effective competition) to be realised without consumers having to switch. The extent to which personal pension providers are reducing their charge levels to discourage people from taking out a stakeholder pension is an example of this. But a genuine threat of switching is likely to be needed for providers to act.

2.2 Why consumers might not switch

There is little evidence from commercial and government databases or statutory returns to the FSA about the level of switching between personal pensions. What evidence there is – from informal discussions with line supervisors and from ABI

7 An example might be inappropriate switching between brands of PEPs. For example, an article in The Times (19 February 2000, 'Don't get ripped off') said that advisers "are encouraging clients to transfer [PEPs] needlessly to generate extra commission".

8 For example, given the volume of re-mortgaging in 1998, the direct costs of re-mortgaging could have been as much as £281 million, on the assumption that the typical cost of an individual re-mortgaging is £600 (FSA (1999)). This excludes the cost of people's time and effort involved in remortgaging and the associated marketing and set-up costs incurred by the lenders.

figures – suggests that the level is low.⁹ ABI figures show that, in the year 2000, fewer than 1% of consumers contributing to a personal pension transferred to another provider.¹⁰

So far, the introduction of stakeholder pensions does not seem to have changed this. ABI figures also show that about 3,100 stakeholder single premium policies originating from transfer values were sold in the first six months after the introduction of stakeholder pensions – out of a total of 22,100 stakeholder single premium policies sold.¹¹ It is unclear whether these transfers originated from personal pensions, occupational pensions or group schemes. However, even if all 3,100 single premium originated from personal pensions, the percentage of consumers with personal pensions who had switched would hardly increase above 1%.

This level of switching is close to that for current accounts – 2% of all consumers with current accounts switched providers in 2001.¹² This is in contrast with the market for mortgages. In recent years about one third of mortgages sold have been re-mortgages, CML (2001), and the turnover of existing mortgage stock has been estimated recently at about 10% a year, Samuels (2001).

The low level of switching in the case of pensions does not reflect uniform charges across different providers and hence the absence of a potential incentive to switch. As shown in Section 4.1, there are large differences in charges. Of course, even if there are potential benefits to switching from lower charges, the front loading of charges and/or exit charges may create costs to switching. This is examined further in Section 4.

9 It might appear as though there were a greater degree of switching if, for example, those consumers who stop contributions to personal pensions early (see PIA (2000)) subsequently start contributing to a new personal pension. But this is not the same as deliberately deciding to switch to a lower cost provider and may not be necessarily in the consumer's interest. Evidence suggests that most consumers stopping their contributions leave the funds that they have accumulated with the current product provider (see Money Marketing (1999)) and this affects the extent of gains from switching (see Section 4.2).

10 It is estimated that there are about 4.5 million consumers contributing to a personal pension (see footnote 1). ABI figures report the number of single premium policies that originate from transfer values. It is, however, unclear whether these transfer values originate from personal pensions, occupational pensions or group schemes. So the proportion of consumers with a personal pension that have switched to another personal pensions will be smaller than 1% suggested by the ABI figures.

11 The figures exclude employer sponsored stakeholder pensions.

12 Figures taken from NOP Financial Research Survey for the year ending December 2001. The base is 51,133 adults interviewed who had a current account.

Alternatively, consumers may not switch even when they would be better off in financial terms. This may be for a number of possible reasons:

- there may be a significant degree of consumer inertia;
- the transaction may be perceived as overly complex;
- there may be other costs associated with switching, including the time and effort in comparing providers ('search costs') and what Cruickshank in his report on banking called the 'hassle factor';¹³
- consumers may underestimate the potential gains from switching if, for example, they believe that all products are similar with little difference in charges between providers;¹⁴
- consumers may place value on other aspects of a particular provider (rather than their charges), such as the reputation of the supplier, maintaining a long-lasting relationship and personal recommendations; or
- consumers may also place a value on other aspects of the provider's product, such as fund choice.

Another factor here could be intermediaries' preferences against this type of transaction in the wake of pensions mis-selling.

13 See paragraph 2.33 in Cruickshank (2000).

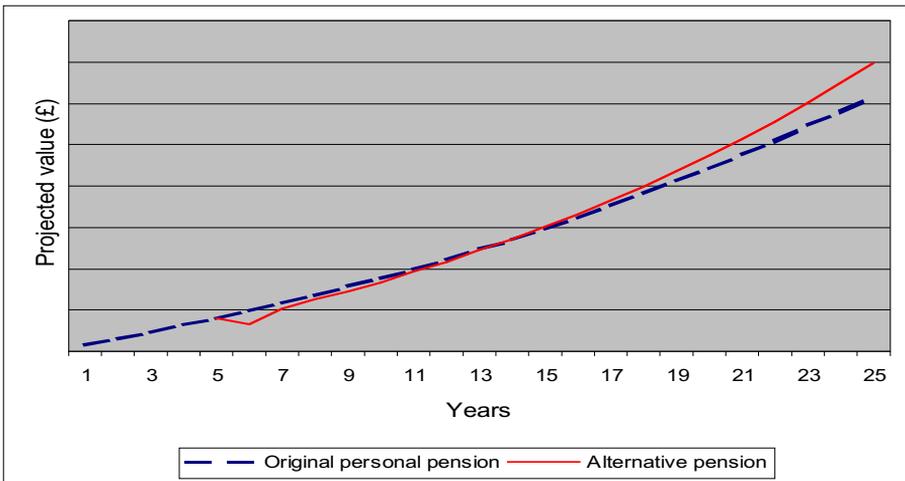
14 DTI (2000) shows that well above 50% of consumers with motor and property insurance, mortgages and current and savings account expect to make none or a minor saving through switching.

3 The decision to switch

Before deciding whether or not to transfer accumulated savings and future contributions to another personal pension or to a stakeholder pension the consumer must carefully weigh the potential costs and benefits. To illustrate, Figure 1 shows what would happen if, after five years of contributions to a personal pension, someone chose to transfer the accumulated funds to a cheaper pension and continued contributions for a further 20 years.

In this case, at the end of 25 years, the projected value of the fund is higher than it would have been if the consumer remained with the existing, higher cost provider. So, switching brings net benefits (but see also the discussion below of the other issues that consumers should consider before they switch). Initially, however, the value of the accumulated fund goes down because of the effect of exit charges on the existing pension.

Figure 1
An illustration of the possible projected gains from switching the accumulated savings and future contributions to an alternative personal pension



If the consumer had been contributing to their existing personal pension for longer, the 'dip' would have occurred later, making it less likely that the value of the fund at maturity with the new pension would have been higher. If they stopped contributing to the new pension shortly after having switched, they would also be worse off. The issue of the timing of the decision to switch is discussed again in Section 4.3.

In reality, consumers deciding whether to switch will also have to consider a number of other issues.

First, consumers will need to consider whether their employer is currently contributing to their existing personal pension and would contribute to an alternative. They also need to consider whether their employer is not currently contributing, but would contribute if they switched to a group-sponsored scheme. The empirical analysis in this paper does not take into account the possibility of employers' contributions.

Second, consumers will have to consider what to do with their accumulated funds.¹⁵ Consumers could transfer the accumulated funds to another pension provider (that is, take a transfer value). This is the option assumed in Figure 1. Alternatively, consumers could leave the accumulated funds with the existing pension provider until the contract matures (that is, make the policy paid-up) and switch only the remaining contributions. Deciding what to do with the accumulated funds matters because the charges on the existing pension may include a flat fee, independent of the size of the fund, and this fee may still be levied even when the policy is paid-up. This is discussed in more detail in the next section.

Third, consumers will have to consider whether there are other (non-charges) differences between the existing personal pension and the new pension they are considering.¹⁶

It might be argued that differences in charges reflect persistent differences in the investment performance of the underlying fund – so someone might be prepared to pay higher charges to benefit from higher investment performance. However, if this were the case, one would expect to see some persistency in investment performance

15 This analysis assumes that the contributions are not stopped before a minimum number of contributions specified in the contract are made. If the contributions are stopped before then, the consumer may not get anything in return.

16 DTI (2000) discusses the relevance to a decision to switch of product features such as the dissatisfaction with the provider's level of service.

that could be identified at the point of purchase. Rhodes (2000), reviewing the evidence on this finds that:

“[the] general pattern is one in which investment performance does not persist. Small group of funds may show some repeat performance over a short period of time, particularly poorly performing funds. However, the size of this effect and the fact that it is only very short lived means that there is no investment strategy for retail investors that could usefully be employed” (page 45).

There might be differences in the range of funds offered. For example, a range of different funds might be offered to enable consumers to develop a ‘lifestyle’ investment strategy that suits their needs.¹⁷

The existing pension might also have features such as the option of a guaranteed annuity rate at the date of retirement. Such an option becomes valuable to a consumer who has kept contributions if, at retirement, annuity rates are below the guaranteed annuity rate. Consumers contributing to a personal pension with such a feature should consider its potential value before they switch into another personal or stakeholder pension.

Also, quality differences may result from consumers’ valuation of brands. For example, if consumers value established brands, they will be willing to pay more for products with that brand. This is not directly observable. But, to the extent that consumers decide not to switch because of these quality differentials, the potential financial gains from switching will represent the amount that consumers are implicitly willing to pay.

Fourth, consumers may also need to take account of the time and effort (search costs) required to find out the prices and attributes of several different providers’ products. More generally, differences in charges for similar products are consistent with effective competition when consumers have search costs (see, for example, Stahl (1996)). In this case, the level and dispersion of prices will depend on the distribution of consumers’ search costs, which are not trivial in retail financial services. But developments in business processes (call centres), technology (the internet) and

¹⁷ This means changing the investment strategy as retirement is closer to limit the volatility of the fund. This normally requires reducing the exposure to equities and increasing the exposure to bonds and cash. Booth and Yakoubob (2000) express doubts about the effectiveness of such ‘lifestyle’ investment.

regulation (the introduction of the FSA's comparative information tables for retail financial products) should reduce search costs, albeit from a high level.

Finally, as already mentioned, pension providers are reducing their charges on existing pensions to discourage people from switching – and this is also something that consumers will need to consider.¹⁸

18 In March 1999 the Personal Investment Authority (PIA) expressed a similar but distinct concern about those personal pensions sold *after* the announcement of the proposed details of the stakeholder pension. Some of these consumers may wish to switch to one of them after their introduction in April 2001. Whether these consumers gain from switching to a stakeholder pension depends on the terms of the personal pension. So the PIA recommended to advisers that they “take full account of any penalties that would arise on early discontinuance” when they make recommendations, before April 2001, on the suitability of individual and group contracts and increases in contributions under existing contracts (PIA (1999b)).

4 An analysis of the factors determining the potential gains from switching

This section uses examples of personal pensions to illustrate the potential financial gains from switching from an existing personal pension to another personal or stakeholder pension.¹⁹

Key factors for consumers are:

- the charges of the existing personal pension compared to the charges they could get on another personal pension or a stakeholder pension;
- what to do with the monies accumulated in the existing personal pension – whether to transfer them or to leave them; and
- the timing of switching.

These are considered in detail below.

4.1 Charges

The potential gains from switching arise from differences in charges going forward over the remaining years. These can be illustrated by calculating the reduction in yield (RIY) for different providers, see Box 1. Broadly speaking, given an assumption about the yield of the investment, the RIY shows the difference between an assumed return and the return after charges.²⁰

19 For simplicity, the charge is assumed to be 1%, although some providers are actually charging less than this.

20 This does not take into account the effect of undisclosed charges. These represent the costs of buying and selling the assets in the portfolio such as dealing costs, stamp duty and bid-offer spread which are charged directly to the fund. James (2000) identifies undisclosed charges as a substantial part of the total cost of investing. Switching between personal pensions is likely to be between broadly similar managed (or balanced) funds, which include fixed income and property in addition to equities. These tend to have high portfolio turnover and high undisclosed charges. So, assuming that the level of undisclosed charges is not affected by, for example, the 1% maximum annual management charge of stakeholder pensions, the assessment of switching is unlikely to be materially affected. Switching between a personal pension and stakeholder pension may well be, in effect, a switch between a managed fund and an index tracker. There are two main differences between them that affect a decision to switch. First, index trackers tend to have lower portfolio turnover – lower undisclosed charges – than managed funds; see, for example, Table 19 in James (2000). Second, index trackers tend to have a 100% exposure to UK equities. This is not necessarily the case for managed funds. They tend to have exposures to equities averaging 80% and some of this exposure, less than one third, may be to overseas equities, Clarkson (2001). The first difference makes the gains of switching to a stakeholder pension with a passive management strategy higher. The second one could make this type of stakeholder pension riskier so that a comparison is less straightforward. This is something that would have to be weighed by consumers considering a switch, even if switching takes place between two products from the same company and there are no switching costs.

Box 1: the price of a personal pension

One of the traditional features of personal pensions is the variety of charges that pension providers make. This approach seems to be related to a preference to make charges in such a way that they are related to categories of costs that the firm incurs. So, for example, charges may be made to reflect the costs of processing the contributions. Charges may also be made from the funds accumulated to reflect the cost of managing the underlying portfolio. As a result, the price of investing paid by consumers will depend on the level of contributions and the rate of return on the assets. Effective competition requires that consumers are able to respond to price signals. This makes it necessary to devise a summary measure of price.

One such price measure is the annual reduction in yield or RIY.* This is the equivalent of an annual charge on the fund. So this calculation spreads all fixed or initial charges over the life of the policy. Calculating RIY works as follows:

- suppose that the pension is held to maturity, typically 25 years;
- assume a level of contributions a month, say £200;
- assume a growth rate of investment – this is a standard rate for the industry, currently 7% a year for this type of business;**
- apply all charges and future expected charges and obtain a value of the fund at maturity, say, £124,000;
- calculate the net growth of the investment implied by the value at maturity, here 5.37%;
- the reduction in yield is the difference between 7% – in this case – and the net growth, that is 1.63%.

Various things are worth noting about this price measure. First, the RIY is the expected price because it assumes a standard growth rate of investment. The *actual* price will depend on the growth of the fund, which is unknown at the point of sale. Second, the RIY does not take account of charges made directly to the fund such as the cost of buying and selling the assets in the portfolio. On this see, footnote 20. Third, the use of initial and exit charges means that changing the assumption about the holding of the contract affects the price. The example above assumes that the pension is held to maturity, so this RIY represents a long-run price measure.

In the case of stakeholder pensions, much of this is simplified because there will be only a management charge, not exceeding 1% of the fund, payable each year. So the short-run and the long-run price are the same. The only difference between price and the yearly management charge arises because this may be applied daily and there is the effect of compounding. And so, assuming the standard 7% growth rate, a 1% annual management charge results in a maturity RIY of 1.06%.

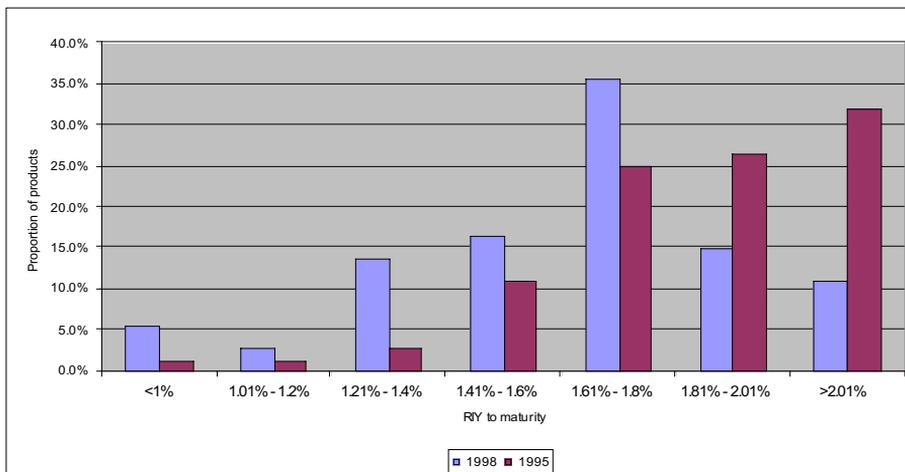
* See, James (2000) for an alternative price measure and Whitehouse (2000) for a comparison of various price measures.

** This is the intermediate rate allowed for projections of pensions business. Until January 1999, it was 9%. Then it was reduced to 7% to reflect the 'recent changes in expectations of long term investment conditions' (Personal Investment Authority (PIA) press release of 25 January 1999).

It could be that someone has an incentive to switch because they bought a pension that was relatively expensive at the time of purchase. Figure 2 shows charges on unit-linked personal pensions that were offered in 1995 and 1998. More precisely, it shows the (unweighted) distribution of RIYs, based on £60 monthly contributions over 25 years of contributions. The figure shows that, at the point of sale, there is wide cross-section variation in charges on personal pensions. For example, in 1998 the most expensive policy was over three times more expensive than the cheapest one. And it is not the case that all consumers tend to buy the cheapest pension on offer – in 1998 52% of total new business went to products with relatively high charges to maturity, in other words charges in excess of the median. Stakeholder pensions with a 1% charge have an RIY of 1.06%, see Box 1. If they had been available in 1998, they would have been cheaper than all but 7% of the products in the sample for £60 monthly contributions. (The equivalent proportion of products for 1995 would have been 1%.)

Alternatively, there may be an incentive to switch if the prices of new pensions have fallen since the existing pension was taken out. This might be because of competitive pressures, technological development or the introduction of new products (such as stakeholder pensions). These changes could mean that, even if someone bought the cheapest pension in the market at the time, they might still have an incentive to switch if there has been a substantial reduction in charges on new pensions since. Figure 2 illustrates the changes over time in charges on pensions at time of purchase. The figure shows a reduction in the proportion of relatively expensive products offered and an increase in the proportion of inexpensive products offered. Overall, there was a reduction in the median RIY from 1.9% in 1995 to 1.7% in 1998. However, there has been less change at the bottom – if someone had bought the cheapest pension available in 1995, there would have been little incentive to switch in 1998. Similarly, someone who had bought the cheapest pension in 1998 would have little incentive to switch to a stakeholder pension.

Figure 2
Changes in the distribution of projected annual RIYs to maturity for pensions offered in 1998 and in 1995



Note: 25-year unit linked pension with monthly contributions of £60.

Source: PIA (1996) and PIA (1999a).

In both cases however the existing pension provider might have reduced the ongoing charges after the pension was bought. Typically, this has been part of firms' response to the introduction of stakeholder pensions. Data gathered by the FSA during its ongoing monitoring of firms providing stakeholder pensions suggest that some, but not all, may have reduced charges on existing pensions. The extent of the reductions and the actions of firms not providing stakeholder pensions remain unclear. This suggests that consumers considering switching should start by contacting their existing pension provider (or adviser) to find out whether a reduction in ongoing charges has already taken place (or is about to occur).

4.2 Pension options – transfer value or paid-up?

Switching requires a decision about what to do with the accumulated savings – whether to transfer the accumulated funds into the new pension (take a transfer value) or to leave them in the existing fund (make the policy paid-up).

Which is the better option for the consumer depends on a number of factors, such as the maturity value of the existing personal pension, its transfer value and paid-up value, as well as the details of the alternative products. The sensitivity of the result is illustrated here with a series of worked examples.

The focus is on the decision to switch after 5 years out of 25 years of contributions. As Figure 1 has shown, the timing can make a difference to whether it is worth switching or not. The choice of 5 years reflects the greater data availability. The sensitivity of the results to the timing of exit is discussed in Section 4.3.

Consider the following example.²¹ Suppose that a consumer starts contributing £60 a month into a personal pension with a projected value at maturity – 25 years later – of £35,900 and an RIY of 1.9%. Assuming that this pension was sold in 1998, Figure 2 suggests that the charges were above the median. Five years on, the consumer decides to switch. Assuming that the standard gross return and the expected charges used in the original projections materialise, the existing pension has a transfer value of £3,500 and a paid-up value (in 20 years' time) of £9,500.²²

The consumer can switch either to another personal pension, or to a stakeholder pension. Suppose that:

21 The examples are based on data about unit-linked personal pensions. The existing pension is based on data about pensions offered in recent years but the various examples have been designed to illustrate the different outcomes, rather than what might happen by switching to specific pensions. They use the assumptions about the level of contributions and payment term that have been used in the PIA's disclosure survey, £60 per month and 25 years. This level of contribution is lower than the average contribution to personal pensions in recent years, £105 per month in 1998 (PIA(1999a)).

22 In reality, a consumer considering to switch should not rely on these assumptions and should obtain a new projection of the maturity value, the transfer value and the paid-up value to undertake this calculation. This should also reveal whether the product provider has reduced the ongoing charges on the pension.

- the alternative personal pension offers the following projected values: £26,500 for regular contributions of £60 a month during 20 years (RIY of 1.3%) and £32,400 for a 20-year single contribution of £10,000 (RIY of 0.9%);²³
- the stakeholder pension with the maximum annual charge of 1% offers £27,200 for £60 monthly contributions during 20 years and £31,700 for a 20-year single contribution of £10,000.²⁴

Table 1 summarises the four possible outcomes from switching.

In this example, the consumer will gain from switching if they can accumulate more than the projected £35,900 from the existing personal pension. So the analysis takes into account any loyalty bonuses, such as enhanced allocations, that a life office might offer in the late years of the policy. The projected value at maturity from switching is calculated as the sum of:

- the projected value at maturity of the remaining 20 years of contributions. In the case of the alternative personal pension in this example, this is £26,500; and
- the projected value at maturity of the money accumulated to date with the current personal pension. This obviously depends on whether the consumer makes the policy paid-up or takes a transfer value. Assuming that the consumer takes the transfer value to the alternative pension, the projected value at maturity is £11,300 (footnote 23 explains this calculation).

The projected value at maturity from switching the accumulated funds and remaining contributions to the alternative personal pension is £37,800. Given the projected value of the existing personal pension, £35,900, the gains from switching are £1,900.

23 Many personal pensions accept a transfer value (a single contribution) as part of a regular premium policy. If so, the consumer will incur only one set of additional initial charges instead of one for the single premium (transfer value) and another for the regular premium policy. However, not all companies offer this possibility and adjusted maturity values that reflect an initial lump sum are not readily available. For this reason, transfers into a stand-alone single premium policy, which requires an additional set of initial charges, and paying the same regular premium into a separate new policy are used here. Thus the projected value at maturity from investing the amount received as a transfer value, £3,500, is £11,340. The transfer value is invested in a single premium policy. The maturity value is calculated assuming that the projected value at maturity is proportional to the value for £10,000 in the text. If so, the projected value at maturity is £11,340 [= 32,400 × (3,500 ÷ 10,000)].

24 The projected value at maturity from investing the amount received as a transfer value, £3,500, is £11,095. This is calculated as 31,700 × (3,500 ÷ 10,000), using the same approach as in footnote 23.

Table 1
Potential net gain (loss) from switching pension provider

The table shows the projected gains at maturity. The consumer is assumed to switch after 5 out of 25 years of contributions. A positive (negative) value means an increase (a reduction) in the final value of the fund compared to leaving the accumulated savings and future contributions with the existing personal pension.

New product (future contributions for the next 20 years)	Options for accumulated savings in the existing personal pension	
	Take a transfer value	Make the policy paid-up
Personal pension with an RIY of 1.3%	Net gain = £1,900 (£1,200 in today's money) Increase in final fund value = 5.4%	Net gain = £100 (£100 in today's money) Increase in final fund value = 0.3%
Stakeholder pension – with the maximum annual charge of 1%	Net gain = £2,400 (£1,500 in today's money) Increase in final fund value = 6.7%	Net gain = £800 (£500 in today's money) Increase in final fund value = 2.2%

Notes: £60 monthly contributions to a unit-linked pension and a gross return of 7%. Figures rounded to the nearest £100. See text for further details.

Source: own calculations.

As Table 1 illustrates, taking a transfer value (and buying a single premium pension) is preferable to making the policy paid-up in this example. Also, in this case switching to a stakeholder pension provides greater net benefit than switching to the other personal pension. Switching the accumulated funds and the remaining contributions into a stakeholder pension gives projected gains of £2,400 in 20 years' time (£1,500 in today's money) or a 6.7% increase in the projected value of the existing personal pension at maturity.²⁵ It represents the case in Figure 1 where the consumer contributes for a long enough period to benefit from the lower charges of the alternative pension.

²⁵ Assuming that long-term inflation is 2.5% per annum.

Table 2
Potential net gain (loss) from switching pension provider

The table shows the projected gains at maturity. See Table 1 for further details.

New product (future contributions for the next 20 years)	Options for accumulated savings in the existing personal pension	
	Take a transfer value	Make the policy paid-up
Personal pension with an RIY of 0.9%	Net gain = £3,300 (£2,000 in today's money) Increase in final fund value = 9.2%	Net gain = £1,200 (£700 in today's money) Increase in final fund value = 3.3%
Stakeholder pension – with the maximum annual charge of 1%	Net gain = £2,400 (£1,500 in today's money) Increase in final fund value = 6.7%	Net gain = £800 (£500 in today's money) Increase in final fund value = 2.2%

Notes: £60 monthly contributions to a unit-linked pension and a gross return of 7%. Figures rounded to the nearest £100. See text for further details.

Source: own calculations.

The comparison between the potential gains from switching to a stakeholder or a personal pension would have been different if the consumer had found a personal pension with charges that are lower than the maximum annual charge of 1% of stakeholder pensions. For example, suppose the consumer is saving in the personal pension described above and that the alternative personal pension offered £27,600 for regular contributions of £60 a month during 20 years (RIY of 0.9%) and £33,100 for a 20-year single premium policy of £10,000 (RIY of 0.8%).²⁶ (The stakeholder pension available remains the same.) Table 2 shows the potential gains in this example. In this case the net gains from switching to another personal pension are greater than those from switching to a stakeholder pension with the maximum annual charge.

²⁶ The projected value at maturity from investing the amount received as a transfer value, £3,500, is £11,585. This is calculated as $33,100 \times (3,500 \div 10,000)$, using the same approach as in footnote 23.

One common element of the examples in Table 1 and 2 is that the the gains from taking a transfer value are greater than the gains from making the existing policy paid up. However, it does not follow that consumers should always take transfer values. There are cases of personal pensions where the charges levied on a paid-up pension are lower than the charges implicit in a transfer value so that making the policy paid-up is preferable as the following example illustrates. Suppose that a consumer starts contributing £60 a month into a personal pension with a projected value at maturity – 25 years later – of £35,400 and an RIY of 2%. Five years on, the consumer decides to switch between pensions. Assuming that the standard gross return and the expected charges used in the projections materialise, the existing pension has a transfer value of £2,600 and a paid-up value (in 20 years' time) of £9,300. The alternative personal pension and stakeholder pensions are as in Table 1. Table 3 summarises the gains from the four possible outcomes. In this case, the consumer gains more from switching to a stakeholder pension if he makes the existing policy paid up.

Finally, it is worth stressing that there will be cases where the consumer will be worse off switching. This may be because of various factors:

- the transfer value offered – resulting from the dip in Figure 1 – is so low that it cannot be offset by the lower charges of the alternative pension;
- there is little time left to offset the effect of any switching costs(see Section 4.3 below);
- the alternative pension has up-front charges, though these could be avoided by switching to a stakeholder pension.

Consider the following example. Suppose that a consumer starts contributing £60 a month into a personal pension with a projected value at maturity – 25 years later – of £36,300 and an RIY of 1.8%. Five years on, the consumer decides to switch between pensions. Assuming that the standard gross return and the expected charges used in the projections materialise, the existing pension has a transfer value of £2,600 and a paid-up value (in 20 years' time) of £6,500. The alternative personal pension and stakeholder pension are the same as in Table 1. Table 4 summarises the gains from the four possible outcomes. In this case, the four outcomes have projected values lower than £36,300 so the consumer would be better off not switching.

Table 3
Potential net gain (loss) from switching pension provider

The table shows the projected gains at maturity. See Table 1 for further details.

New product (future contributions for the next 20 years)	Options for accumulated savings in the existing personal pension	
	Take a transfer value	Make the policy paid-up
Personal pension with an RIY of 1.3%	Net loss = - £500 (- £300 in today's money) Decrease in final fund value = - 1.3%	Net gain = £400 (£200 in today's money) Increase in final fund value = 1.1%
Stakeholder pension – with the maximum annual charge of 1%	Net gain = £0 (£0 in today's money) Increase in final fund value = 0%	Net gain = £1,100 (£700 in today's money) increase in final fund value = 3.1%

Notes: £60 monthly contributions to a unit-linked pension and a gross return of 7%. Figures rounded to the nearest £100. See text for further details.

Source: own calculations.

Table 4
Potential net gain (loss) from switching pension provider

The table shows the projected gains at maturity. See Table 1 for further details.

New product (future contributions for the next 20 years)	Options for accumulated savings in the existing personal pension	
	Take a transfer value	Make the policy paid-up
Personal pension with an RIY of 1.3%	Net loss = - £1,400 (- £800 in today's money) Decrease in final fund value = - 3.8%	Net loss = - £3,300 (- £2,000 in today's money) Decrease in final fund value = - 9.1%
Stakeholder pension – with the maximum annual charge of 1%	Net loss = - £900 (- £500 in today's money) Decrease in final fund value = - 2.4%	Net loss = - £2,600 (- £1,600 in today's money) Decrease in final fund value = - 7.2%

Notes: £60 monthly contributions to a unit-linked pension and a gross return of 7%. Figures rounded to the nearest £100. See text for further details.

Source: own calculations.

Summing up, this section has shown that someone with a personal pension with relatively high charges to maturity can gain by switching both the accumulated savings and future contributions to a low charges personal pension or to a stakeholder pension after 5 years out of 25 years of contributions. Some consumers would be better off making the policy paid-up instead of taking a transfer value. There are also cases where a consumer will not gain from switching.

4.3 Timing of the decision to switch

The analysis, so far, has assessed the gains from switching at a fixed point in time, after five years of contributions. However, as Figure 1 makes clear, the gains from switching are sensitive to the timing of the decision to switch. This section repeats the analysis of the previous section, assuming that consumers consider switching after 2, 3, 10 and 15 years of contributions into a 25-year pension.²⁷ Unfortunately, data are only available to undertake this analysis assuming £200 monthly contributions and that the consumer takes a transfer value. (This is, in effect, replicating the calculations in the left-hand column of Tables 1 to 4 using a different level of contributions.)

Consider the following example to illustrate the importance of the timing of switching. Suppose that a consumer starts contributing £200 a month into a personal pension with a projected value at maturity – 25 years later – of £122,300 and an RIY of 1.7%. Assuming that the standard gross return and the expected charges used in the projections materialise, the existing pension has a transfer value of £2,300 after two years of contributions.

Similarly, suppose that the consumer can switch either to another personal pension, or to a stakeholder pension. The alternative personal pension offers the following projected values: £124,800 for regular contributions of £200 a month during 23 years (RIY of 0.5%) and £44,100 for a 23-year single contribution of £10,000 (RIY of 0.3%).²⁸ The stakeholder pension with maximum charges offers £115,600 for similar contributions during 23 years and £37,800 for a 23-year single contribution of £10,000.²⁹ Similar alternative pensions are obtained using a fixed criterion on the assumption that the consumer considers switching after 2, 3, 5, 10 and 15 years of contributions. (See Table A1 and Table A2 in the Annex for the details.)

Figure 3 shows the gains from switching expressed as a percentage of the maturity value of the existing personal pension.³⁰ It shows clearly how the size of the potential gains of switching will be higher the longer the period to benefit from lower charges.

27 The choice of these points in time for switching is purely illustrative. For example, switching could also happen before two years of contributions have been made. In this case, the transfer value might be very small as a result of the initial charges and there may be personal pensions that require a minimum number of contributions before a transfer value is offered. In any event, whether it is worth switching will also depend on the alternative pension.

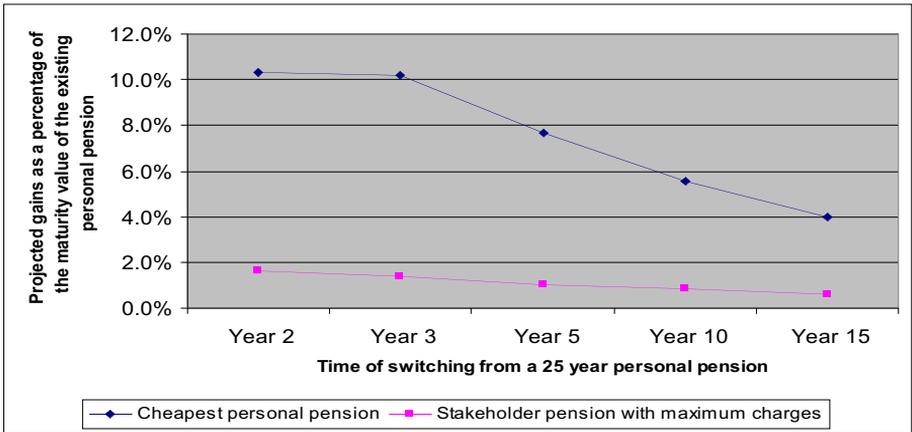
28 The projected value at maturity of the transfer value of £2,300 is £10,140. This is calculated as $44,100 \times (2,300 \div 10,000)$ using the same approach as in footnote 23.

29 The projected value at maturity of the transfer value of £2,300 is £8,690. This is calculated as $37,800 \times (2,300 \div 10,000)$, using the same approach as in footnote 23.

30 The gains from switching are affected by the level of contributions so the results in this section (based on £200 monthly contributions) are not directly comparable with those from the previous section (based on £60 monthly contributions).

Figure 3
Postponing the decision to switch reduces the projected gains from switching

The figure shows the projected gains at maturity as a proportion of the maturity value of the existing personal pension. The consumer takes a transfer value after, say, 2 years out of 25 years of contributions and switches the remaining contributions to the alternative pension.



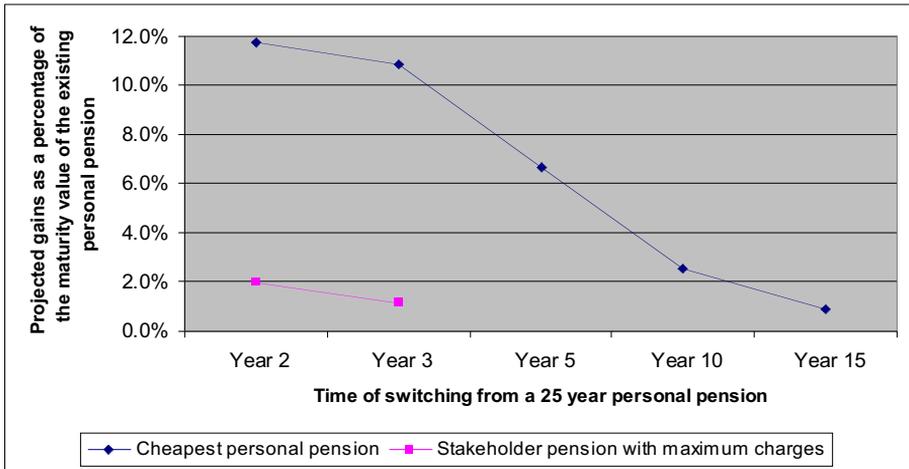
Notes: £200 monthly contributions to a unit-linked pension and a gross return of 7%. See text for further details.

Source: own calculations.

Postponing the decision to switch may make switching not worthwhile. Consider the following example. Suppose that a consumer starts contributing £200 a month into a personal pension with a projected value at maturity – 25 years later – of £129,900 and an RIY of 1.3%. Assuming that the standard gross return and the expected charges used in the projections materialise, the existing pension has a transfer value of £4,400 after two years of contributions. (Table A1 in the Annex provides details about the transfer values at other points in time.) The alternatives for switching after 2, 3, 5, 10 and 15 years of contributions are the same as in the previous example. Figure 4 shows that the gains from switching to a low cost personal pension could be small after five years. Indeed, in this example switching to a stakeholder pension would generate potential gains only within the first three years of contributions.

Figure 4
Postponing the decision to switch may make switching not worthwhile

The figure shows the projected gains at maturity as a proportion of the maturity value of the existing personal pension. See Figure 3 for further details.



Notes: £200 monthly contributions to a unit-linked pension and a gross return of 7%. See text for further details.

Source: own calculations.

5 Conclusions

Using information on pension charges for unit-linked personal pensions offered in recent years, this paper has explored the factors that are likely to determine the potential gains from switching in practice.

The analysis uses examples to show that:

- consumers who took out a pension with above-average charges that have not subsequently been reduced could potentially benefit from switching to a cheaper personal pension – or to a stakeholder pension;
- consumers do need to tread carefully. Even among those with personal pensions with above-average charges, not everyone would benefit from moving to a stakeholder pension;
- the potential gains from switching are sensitive to the timing of the decision to switch. Typically, the earlier the decision to switch, the larger are the typical gains from switching; and
- the potential gains from switching are also sensitive to the decision about what to do with the money that consumers have saved in their existing personal pension.

An important caveat to this analysis is the issue of whether providers are reducing charges on existing personal pensions. There is some indication that this is happening – partly in an attempt to discourage people from switching to a stakeholder. If charges on existing pensions are coming down, then consumers may be receiving the benefits that would have arisen from switching (lower charges) without any of the costs of switching.

Annex: Examples used to assess the timing of switching

Table A1
Existing personal pension

	2 years	3 years	5 years	10 years	15 years
Figure 3 – maturity value £122,300					
Transfer value after	£2,300	£4,900	£10,400	£27,800	£50,800
Figure 4 – maturity value £129,900					
Transfer value after	£4,400	£6,900	£12,200	£29,300	£52,900

Notes: Assumes £200 monthly contributions and intended contributions of 25 years of contributions. Figures rounded to the nearest £100.

Table A2
Alternative personal pension – used in both figures 3 and 4

Switching after	2 years	3 years	5 years	10 years	15 years
Maturity value after	23 years	22 years	20 years	15 years	10 years
Single premium of £10,000	£44,100	£41,100	£35,300	£25,200	£18,500
Regular premium of £200 a month	£124,800	£114,900	£95,000	£59,100	£33,100

Notes: The alternative pension here has been selected as the pension with the lowest charges to maturity from a sample of unit-linked personal pensions. Assumes £200 monthly contributions and intended contributions of 25 years of contributions. Figures rounded to the nearest £100.

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