Department
for Work &
Pensions

Better workplace pensions:

Further measures for savers

Presented to Parliament by the Secretary of State
for Work and Pensions by Command of Her Majesty
March 2014

Cm 8840

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Foreword by the Minister of State for Pensions

As we move towards our goal of enrolling around ten million workers into workplace pensions, we need to make sure that those pension savings are invested in value for money schemes that are well-governed. Protecting savers is particularly important as automatic enrolment moves to smaller firms.

That is why this Government is introducing a charge cap of 0.75 per cent for the default funds of all qualifying schemes and taking action against charging practices ill-suited to automatic enrolment.

Our new governance standards, applying across all workplace schemes, will further protect members by ensuring schemes are run in their interests. A new wave of transparency measures will allow those running schemes, employers and scheme members to see exactly what they are paying for and compare across the market. Finally, in 2017, we will decide whether some or all transaction costs should be included in the default fund charge cap, and whether the level of the cap should be lowered.

Automatic enrolment is a stunning success and reversing the decades-long decline in workplace pension provision. By this April, there will be over three million more people in workplace pensions, and a third of these will be in National Employment Savings Trust (NEST). Pension participation figures published for April 2013 showed the biggest rise in workplace pension coverage since figures began in 1997, and we expect the figures for 2014 to show a much bigger increase.

This is a full package of measures to ensure value for money in workplace pensions. It complements the measures announced last week to provide savers with greater freedom and choice in how they access their savings. Taken together these changes are a major step in our programme of pensions reform, supporting those who do the right thing to reap the full benefits of saving.

Steve Webb, MP
Minister of State for Pensions

Executive summary

1. To meet the fiscal challenge of an ageing society, the UK needs its working age population to save significantly more in workplace pension schemes. Automatic enrolment is the first step towards meeting that challenge – two years into the programme over three million individuals have been enrolled into a workplace pension scheme and opt-out rates are below 10 per cent – lower than anyone predicted. By the time automatic enrolment applies to all firms – 2018 – it is estimated that between six and nine million people will be newly saving or saving more into their company scheme.

2. While the previous government set some basic requirements for workplace schemes – minimum contribution levels and a default fund – no minimum standards were created. Many pension schemes are well-governed and provide good value for money, and industry bodies have recently undertaken important work with regard to governance, charges and transparency. However, this government recognises that the process of defaulting millions of individuals into savings plans brings with it a new responsibility to set minimum quality standards and remove practices suited to outdated commercial models. These standards should apply to all workplace defined contribution (DC) schemes so all savers benefit.

3. Therefore the next stage of this transformation is for government, regulators, the pensions industry and employers to work together to ensure that all workplace pension schemes are of high quality, offer value for money and are capable of delivering good outcomes. This will be underpinned by a robust regulatory approach which offers consistent levels of protection for all members of workplace pension schemes. The Government, the Pensions Regulator and the Financial Conduct Authority are, therefore, actively working together to promote consistency and coherence in the regulatory regimes for both trust-based and contract-based provision.

4. The Government's vision for workplace DC schemes is based on the following principles:

   - Those running pension schemes are informed, competent and have members' interests as their priority.
   - Charges borne by members in default arrangements are fair and only relate to services that add value to their pension saving.
   - There is full transparency of all costs and charges throughout the value chain – in a way that enables scheme managers to compare across the market and get the best deal for their members.
   - The regulators and regulatory regimes are joined up and focused on member protection.

5. Consultations by the Department for Work and Pensions (DWP) and the Office of Fair Trading's (OFT's) report into the DC workplace pensions market have demonstrated that important steps need to be taken before this vision is realised[1]. This Command Paper proposes a comprehensive range of measures to improve the quality of workplace DC schemes, placing particular importance on protecting those who have been defaulted into private pension saving.

   These measures include:

   - New minimum quality standards for DC workplace pension schemes. Independent Governance Committees (IGCs) will protect members' interests in contract-based schemes. This, and stronger requirements on trust-based schemes, will improve accountability and ensure compliance with the quality standards.
   - A charge cap on default funds of DC qualifying schemes. The cap, to come into force from April 2015, will be set at 0.75 per cent of funds under management and will apply to all management charges, but exclude transaction costs. Consultancy charges will also be banned in qualifying schemes from this date. In 2017, the Government will examine the level of the cap and consider whether some or all transaction costs should be included within it.
   - Member-borne charges incompatible with automatic enrolment will be eliminated. Adviser commissions and Active Member Discounts will be banned in qualifying schemes from April 2016.
   - A step change in the way transparency operates in workplace schemes. From April 2015, trustees and IGCs will have new duties to consider and report on costs and charges. We will then introduce new requirements to make standardised disclosure of all pension costs and charges mandatory. This information will be disclosed to trustees and IGCs, in a format that enables comparison between schemes, and made available to employers, scheme members and regulators.

6. The strengthened governance and transparency measures will apply to all workplace DC pension schemes, protecting all members who save into a DC scheme through their employer. Members who may not have made active choices about their saving – those in the default funds of schemes used for automatic enrolment – will be further protected by the measures on charges. The coverage of each particular measure is set out in the chapters that follow.

[1] Department for Work and Pensions, 2013, Better workplace pensions: a consultation on charging, Cm 8737, TSO.
Department for Work and Pensions, 2013, Quality standards in workplace defined contribution pension schemes.
Office of Fair Trading, 2013, Defined contribution workplace pension market study, OFT 1505.

7. These measures will build trust and confidence in workplace pension saving and allow people to feel that they have been enrolled into schemes that will deliver value for money. They have been designed after an extensive period of analysis and consultation:

- The DWP issued a Call for Evidence on quality standards in DC workplace schemes in the summer of 2013.
- This was followed in October 2013 with a DWP consultation on charges in DC workplace schemes.
- In September 2013, the OFT made a vital contribution to our understanding of these issues in their market report into workplace DC schemes.

8. This Command Paper forms the Government's official response to the two DWP consultations and the OFT's market report. The Pensions Bill, currently going through Parliament, contains primary powers that will deliver this package of measures. Assuming the Bill receives Royal Assent, secondary legislation will be laid in the latter part of 2014. This paper contains further consultation on policy proposals to inform that secondary legislation.

9. The Financial Conduct Authority (FCA) and FCA rules will also form an important part of the implementation of some of the proposals set out in this paper. For example, recent amendments to the Pensions Bill have created new duties on both the Secretary of State and the FCA to introduce new regulations and rules about the disclosure of transaction costs. The FCA will consult on any changes to its rules in lines with its statutory responsibilities. We will continue to work closely with the FCA as well as with the Pensions Regulator on the implementation of these proposals.

10. To support the automatic enrolment programme and give employers, schemes and providers time to adjust to the new requirements, the Government will adopt a phased approach to implementation. The first wave of measures will come into force in April 2015 with the second wave from April 2016. In 2017, the Government will consider whether the level of the default fund charge cap remains appropriate and whether some or all transaction costs should be included within the cap. Chapter 7 has more detail on the implementation timetable.

The case for change

11. Automatic enrolment is continuing to bring more people into workplace pension saving in the UK. Over three million workers have now been enrolled and indications are that opt-out rates remain low. The biggest test for automatic enrolment is yet to come, as large numbers of small employers reach their staging dates later this year. It is vital for the Government to ensure that people are saving into high quality, value for money schemes and that all individuals, irrespective of their employer and their choice of scheme, can have confidence in their private pension saving.

12. In the Budget we announced measures to give savers new choice and freedom about how they access their pension savings, alongside other significant measures to support savers. This paper complements those reforms to introduce new protections for savers in DC workplace pension schemes.

13. The use of automatic enrolment brings new dynamics to the pensions market and new responsibilities on government and industry to protect savers. The old commercial model – whereby most individuals had to actively decide whether to join a pension scheme and the pensions industry spent time and money persuading them to do so – has gone. Instead, employers have a legal duty to default their employees into a pension scheme and inertia keeps most of them there. This is leading to a huge increase in the numbers of workplace saving arrangements and funds flowing through the pensions industry.

14. Automatic enrolment also presents a new challenge with regard to small, dormant pension funds, created when an employee moves employer but doesn't transfer their savings. On average, individuals have 11 jobs during their working lives. If no reform is undertaken DWP research indicates there will be around 50 million dormant pension pots by 2050.

15. The Government plans to introduce the automatic transfer of small pension pots when the member changes scheme or moves employment. This will help to consolidate pension savings into an individual's current employer's scheme. This will make it easier for people to keep track of their pension savings, plan better for their retirement and secure a better income in retirement. The current Pensions Bill gives broad powers to implement the 'pot follows member' model, and we intend to bring forward subsequent secondary legislation later this year that will set the framework for the implementation model.

16. If a system of automatic transfers is to be successful members need to have confidence that their pot is being transferred to a scheme with competitive charges, and an acceptable scheme governance and administration framework. Competitive charges and quality standards will ensure the risk of member detriment is minimised as transfers will occur from a good scheme to another good scheme. This need to maintain member confidence also enhances the need for transparency around costs and charges. Automatic transfers will significantly increase the volume of transfers, and people running pension schemes will need to be able to see, measures and control the costs involved.

17. The Government has undertaken two consultations on how best to create minimum standards that reflect these changed dynamics created by automatic enrolment. In the summer of 2013 it issued a Call for Evidence on minimum quality standards – that asked for views on governance, scale, investment and administration standards. In October 2013 a consultation on charging took place that sought views and evidence on whether the current charging models and levels remained appropriate in the new environment of default enrolment.

18. Between these two DWP consultations the OFT issued its market report into workplace pensions in September 2013. Their report, based on extensive and rigorous analysis and argument, concluded that:

- the workplace DC market had one of the weakest buyer sides they had witnessed and that competition alone could not be relied upon to drive good outcomes for consumers;
- this weak buyer side is a result of a principal-agent problem – the employer chooses a workplace scheme for their employees but has different incentives – and the complexity of the market and products;
- the reference test for a market investigation had been met, but a referral to the competition authorities was not required on the basis that government and industry would work together in addressing the weak demand side and safeguarding against consumer detriment.

19. The OFT also raised concerns about so-called 'legacy' schemes sold before the introduction of stakeholder pensions in 2001. In these schemes, charges are currently around 26 per cent higher than schemes sold after 2001. Many of those paying into such schemes are unaware of the level of charges they are paying. To address these concerns, the Association of British Insurers has agreed to carry out an audit of high cost and legacy schemes. On 11 February the OFT announced the appointment of the Independent Chair and Board members to oversee the audit, which is scheduled to be completed by the end of 2014.[2]

20. This Command Paper forms the Government's response to its consultations on minimum quality standards and its formal response to the OFT market report. It brings forward a package of proposals that will ensure that individuals are enrolled into schemes with low and fair charges, good governance and increased transparency.

- **Chapters 1 and 2 describe the Government's plan to improve governance in DC workplace schemes**. They include proposals for both contract and trust-based schemes, examine how administration standards might be improved and look closely at the relationship between scheme size and good member outcomes.
- **Chapters 3 to 5 contain the Government's plans to create fair and appropriate charging structures in DC workplace schemes** – through a charge cap on default funds used in qualifying schemes and an end to inappropriate member-borne charging structures such as Active Member Discounts, consultancy charges and adviser commissions within qualifying schemes.
- **Chapter 6 sets out how transparency will play a vital role in delivering these changes** – for the first time providers and schemes will be required to produce line item disclosure of all charges in a standard format. This will help all market players – and government and regulators – to compare scheme quality and value.
- **Chapter 7 describes the timetable for implementing these measures**.

[2] http://www.oft.gov.uk/OFTwork/markets-work/pensions/#.UvzmRazRp6E

Minimum quality standards in workplace pension schemes 1

- **New quality standards will apply across all defined contribution (DC) workplace pension schemes. These are designed to ensure that people running schemes understand and consider the key components of scheme quality and have members' interests as their priority.**
- **The implementation of the quality standards will take into account the different strengths and weaknesses of trust and contract-based structures.**
- **From April 2015, there will be requirements for providers of contract-based schemes to operate Independent Governance Committees (IGCs) to assess the value for money delivered by these schemes and report on how they meet the quality standards. They will have the power to escalate concerns to members, employers and the FCA.**
- **From April 2015, there will also be requirements for trustees to consider and report against the quality standards, and new measures to strengthen the independence of governance in mastertrust arrangements.**
- **We welcome views on the proposals relating to trust-based schemes by 15 May, 2014. The FCA will consult later in the year on changes to its rules for providers of contract-based schemes.**

1. The quality of governance in workplace schemes is fundamental to securing good outcomes for members. The Office of Fair Trading (OFT) recognised the particular importance of governance in substituting for a lack of employer and employee scrutiny of the value for money delivered by schemes.

2. Consultation, research and analysis by the DWP, OFT, the Financial Conduct Authority (FCA) and The Pensions Regulator (TPR) has revealed several areas where standards need to be raised, particularly in an environment where millions of individuals are defaulted into workplace arrangements. The challenges differ across the trust and contract-based sectors, but the OFT recommended that government should embed minimum governance standards that will apply across all DC workplace pension schemes. The Government agrees with this recommendation, and this chapter therefore describes those standards and then sets out sector-specific proposals to best ensure those standards are met.

3. We think these standards are so important that they should go beyond guidance and be required of all schemes used for workplace saving. Subject to Parliamentary approval, we therefore intend to set new requirements for trust-based schemes in regulations, and the FCA will consult later in the year on changes to its rules to introduce IGCs to oversee the quality standards in contract-based schemes. This chapter contains a consultation on the proposals to strengthen governance in trust-based schemes.

4. These standards will improve oversight of workplace schemes. The new structures and practices they introduce will also build the foundations for more sophisticated measures of value for money in the medium and longer terms.

Minimum quality standards across all schemes

5. Building on the standards suggested in the Government's call for evidence on DC quality standards and reflecting the work of the OFT, we propose the following set of overarching standards across all schemes:

- All schemes must be governed by a body with a duty to act in members' interests.
- The governing body must be able to freely exercise its duty to act in members' interests and must be able to explain how any conflicts of interest are handled.
- The majority of individuals – including the chair – of the governing body must be independent of the pension provider.
- The governing body must consider:
  - the design and net performance of default investment strategies;
  - standards of administration;
  - charges borne by scheme members; and
  - costs incurred through investment of pension assets.
- The governing body must have – or have access to – all of the resources, knowledge and competencies necessary to properly run the scheme.
- The chair of the governing body must produce an annual report explaining how the scheme has performed against the quality requirements.

6. The application of these quality standards is considered below, and will entail changes to how many trust and contract-based schemes are currently governed.

Applying the minimum quality standards to trust-based schemes

7. One of the four conditions for effective governance described by the OFT is an alignment of interests between people governing a scheme, and members of the scheme. An inherent strength of models of trust-based governance is the presence of trustees to run the scheme on behalf of members. However, the OFT and responses to the call for evidence raised concerns about the quality of the ongoing governance delivered in some trust-based schemes, particularly smaller single-employer schemes. In applying the quality standards to trust-based schemes, we will therefore focus on the need for trustees to provide a clear, independently audited annual statement that they have met the governance requirements below, and therefore taken those steps that are so important to governing in members' interests.

8. Responses to the call for evidence and the OFT's research also raised concerns about the independence and effectiveness of governance in some models of mastertrust, particularly those using a vertically integrated provider[3]. The structure of these arrangements means there is similar potential for conflicts of interest within them as within contract-based schemes. We therefore propose introducing some additional requirements to strengthen the independent governance of mastertrusts. These are set out from paragraph 22 and reflect the way in which the FCA is going to consult on proposals for independent governance of contract-based schemes, set out later in this chapter.

Governance requirements

9. To ensure that trustees are focused on the key aspects of the quality of their scheme, we propose specifying the following new duties in regulations, and supporting these with guidance. These are the steps we think trustees must take to ensure that the quality standards listed at paragraph 5 are met:

   - Default investment strategies must be designed in the interests of members, with a clear statement of aims, objective and structure and how these are appropriate for their membership.
   - The characteristics and net performance of default investment strategies must be regularly reviewed to ensure alignment with the interests of members, and action taken to make any necessary changes.
   - Core scheme financial transactions must be processed promptly and accurately.
   - Trustees must assess the levels of charges borne by scheme members.
   - Trustees must assess the costs incurred through investment of pension assets.
   - The trustee board must have, or have access to, all of the knowledge and competencies necessary to properly run the scheme.

10. These standards will ensure that trustees are considering the key aspects of the running of their scheme, and are discussed further in the sections below.

Investment

11. We expect that the majority of individuals who are automatically enrolled into a pension scheme will remain invested in the scheme's default fund. While it is important that people governing schemes consider all of the scheme's investments, it is particularly important that there is active oversight of the design and performance of the default investment strategy.

[3] A vertically integrated provider is responsible for both the asset management and administration of a scheme/schemes.

12. We therefore think that governance of the default investment strategy is sufficiently important that trustees' responsibilities for overseeing it should be set out in legislation. This was echoed in responses to the call for evidence on DC quality standards, where respondents generally agreed that default investment governance is so critical that a legislative approach would be appropriate. As well as signalling the importance of this aspect of a trustee's role, this will allow TPR to intervene in situations where members' savings may be at risk because of a lack of oversight of the default investment strategy.

13. DWP published guidance on governing a default investment option in 2011. While many stakeholders support the content of this guidance, there is evidence that it is not being followed by all schemes. For example, research published by TPR in January 2013 shows that only 53 per cent of schemes assessed themselves as complying in full with this guidance[4]. Clarifying trustees' legislative duties – and a new requirement to report on these – will ensure consistent oversight of these investments.

14. In October 2013, the Law Commission published a consultation on the Fiduciary Duties of Investment Intermediaries, commissioned by the Government as part of its response to the Kay Review of the UK Equity Market. The Law Commission consultation on fiduciary duties asks a number of questions pertinent to pension scheme investments, including whether the current law encourages excessive short-termism among investors; the extent to which trustees can consider factors relevant to long-term investment performance and ethical standards; and whether the Occupational Pension Scheme (Investment) Regulations 2005 should be extended to all trust-based schemes. We look forward to the Law Commission's report in summer 2014 and will consider their recommendations in developing our policy and regulations.

Administration

15. Despite the importance of accurate administration in ensuring that an individual receives the pension pot due to them, the OFT observed that there is little competition on the basis of standards of administration. Ensuring good quality administration should be a core part of a trustee's role, and is arguably even more important to good member outcomes in a DC scheme than in a defined benefit (DB) scheme. We therefore propose giving trustees a new legislative responsibility for ensuring and reporting on how core scheme financial transactions are processed promptly and accurately.

16. In the call for evidence on DC quality standards we suggested setting out specific administrative stages and timings in legislation. Responses highlighted the risks of this approach and, in particular, the potential for legislation not to keep pace with developments in administration practices. It is therefore appropriate for this sort of detail to be set out in guidance, for example by extending the TPR code, rather than in legislation.

17. As with investment governance, we recognise that administration is often undertaken by a third party administrator or pension provider, rather than being directly controlled by trustees. However, the ongoing responsibility for ensuring that standards of administration are meeting members' needs rests with the trustees rather than with any third party.

[4] The Pensions Regulator, 2013, Defined contribution trust-based pension scheme features.

18. We are also interested in exploring non-legislative ways of improving standards of administration and helping schemes get assurance about their administration standards, in particular through accreditation or quality marks. Some respondents to the call for evidence mentioned this as a way of improving standards either as a requirement on all administrators or something that trustees and governing bodies should consider and value when selecting their service provider.

19. In October 2013, the Pensions Administration Standards Association (PASA) launched an accreditation programme for pension administrators. We would encourage schemes to take advantage of this programme, and will consider ways in which we can raise awareness in this area. While we are interested at this stage in developing a culture of accreditation on a voluntary basis, we may also, as our thinking develops, consider the alternative options of requiring schemes to seek accreditation or compulsory reporting from scheme administrators.

Consultation question – ways of ensuring good administration

1. We would welcome views on the potential benefits of accreditation of administrators, and what role Government and regulators could play in supporting this.
2. We would also welcome suggestions of other approaches to helping trustees and IGCs ensure that their scheme is being administered to a good standard.

Costs and charges

20. A common theme of responses to the consultation on charges was the importance of good, informed governance in ensuring that members receive value for money for the charges and costs incurred through their pension investments. We agree that a central part of a trustee's role should be to assess the value for money delivered by the costs and charges borne by all members of their scheme. Given the importance of costs and charges for the size of a member's pot we think that this responsibility should be set out in legislation.

21. People governing a scheme can only fulfil this role if they are provided with information on costs and charges in a clear and transparent format. To enable this, we propose introducing new duties about the disclosure of charges and costs information to trustees and IGCs. These and other proposals to also strengthen disclosure to members and employers are explored further in Chapter 6.

Independence and conflicts of interest

22. Some models of trust-based schemes – particularly those mastertrusts associated with vertically integrated providers and run for profit – have the same potential for conflicts of interest recognised in contract-based schemes. To mitigate this, we think mastertrusts should be subject to requirements regarding independence of membership in the same way as the proposals for contract-based governance.

23. This will mean that mastertrust boards must have at least seven trustees, the majority of whom, including the chair, are independent of the providers of services to the mastertrust. Arrangements must also be in place for the scheme to hear directly from members, either through direct representation on the mastertrust or through a members' panel, annual general meeting, or similar.

24. We intend these requirements to apply equally to mastertrusts which have a corporate trustee board and to those which are unincorporated. We recognise that some mastertrusts have appointed independent trustee firms to act as their corporate trustee; we envisage the same principles will apply in this situation but would welcome responses to this consultation which highlight any special issues that would need to be addressed in these slightly different set-ups.

Consultation question – mastertrusts

3. Should mastertrusts have to meet the same independence standards as providers of contract-based schemes?
4. We would welcome views on the proposed definition of 'independent' at Annex B.
5. Should the independence requirements be applied in different ways to different models of mastertrust. In particular, how should the independence requirements be applied to mastertrusts that use an independent trustee firm to act as their corporate trustee?

25. It is also important that trustees are not constrained in their ability to change service providers, if they deem this to be in members' interests. We therefore propose that trust deeds and rules should not be allowed to constrain trustees in relation to choice of third party service providers such as investment or administration providers, or require them to make particular investments. While we suspect this practice may be more prevalent in mastertrusts, it may also be present within single-employer trust-based schemes.

26. As well as helping schemes implement these new legislative requirements, TPR will continue to work with the pensions industry on other ways of ensuring good standards and member protection in mastertrusts. The new assurance framework for mastertrusts, developed in partnership between TPR and the Institute of Chartered Accountants of England and Wales, will form an important aspect of this work. Consultation on the framework closed in December 2013, and TPR will publish guidance to support its implementation in summer 2014.

Regulation and accountability of trustees

27. As well as setting new standards about what trustees should consider when running a pension scheme, we propose that there should be a new requirement for all schemes to have a chair of trustees, with responsibility for reporting on how the scheme has complied with the quality standards. We think that this role will drive compliance with the new standards by ensuring that there is a named individual in each scheme who is accountable for demonstrating how the standards have been met.

28. To achieve this strengthened approach, we propose that the chair must make a statement in the scheme's audited annual report and accounts that explains how they have complied with the quality standards as set out in legislation. As well as the scheme auditor providing a degree of assurance over the fairness of the description made by the chair, the auditor's whistleblowing responsibilities will provide an additional route for reporting to TPR if a scheme is not adequately meeting the quality standards.

29. TPR's DC code and guidance will be updated to reflect the new governance standards when these are introduced. In the interim period, schemes should continue to assess themselves against the DC quality features set out in the current DC code and guidance.

Skills and competence of trustees

30. As well as being aligned with members' interests, it is important that trustees have the skills and experience to act in members' interests. Work undertaken by TPR and the OFT has revealed varying levels of skills and competence among trustees. Having considered responses to the call for evidence, we do not think that schemes should have to have a quota of members with particular qualifications. While some qualifications can prepare individuals well for being a trustee, we accept that having a qualification is not in itself evidence of who would make a good trustee and that it is more appropriate to look at access to skills and experience across the trustee board as a whole.

31. The chair's annual report will therefore be required to include a statement about how the trustee board as a whole either has, or has access to, all of the knowledge and competencies necessary to properly run the scheme. This should include assurance that each trustee has met their trustee knowledge and understanding requirements (already set out in regulations and TPR's Code of Practice 7), as well as a broader assessment of the knowledge and competencies across the board as a whole, including access to professional advice. We also expect that the new governance and reporting requirements will in themselves drive better performance from trustees.

Introducing the standards for trust-based schemes

Consultation questions – trust-based governance

The proposed quality standards for trust-based schemes are summarised at Annex B.

6. We would welcome views on the proposed quality standards for trust-based governance which are summarised at **Annex B**

7. Are the requirements listed at paragraph 8 the right quality standards to be set in regulations for trust-based schemes?

8. Should trust-based schemes be required to have a chair of trustees?

9. Will the new reporting requirements help drive compliance with the standards and regulation of these?

32. **A consultation-stage impact assessment is published alongside this Paper. We also welcome information on the costs and benefits of these proposals to inform a final-stage impact assessment.**

33. **We would welcome views on these proposals by 15 May 2014. Subject to Parliamentary approval, the new requirements for trustees will be introduced in regulations made under the Pensions Bill currently being considered by Parliament, and will be enforced by TPR. We plan to bring these into force in April 2015.**

Value for money

- We expect trustees and IGCs to assess the value for money delivered by their schemes for members. As well as the costs and charges incurred by the scheme, this should involve consideration of key benefits such as investment performance and standards of administration.
- Proposals in this document, particularly regarding governance and transparency, will put the structures in place to ensure that trustees and IGCs have clear, transparent information about the costs and benefits delivered by their scheme.
- Working with TPR and the FCA, we intend to build on this to develop a consistent approach to assessing value for money across schemes, and to enable schemes to compare their value for money to that obtained by other schemes.

Applying the minimum quality standards to contract-based schemes

34. The governance of contract-based schemes can have many strengths, particularly access to benefits of scale and professionalism of services. However, as expressed in responses to the call for evidence and the OFT's analysis, there is typically no direct agent acting to protect members' interests within these schemes. The OFT identified particular concerns about the impact of many contract-based providers having a vertically integrated fund management arm, noting that while this can lead to efficiencies, there is a potential for conflicts of interest.

35. In implementing the quality standards in contract-based schemes, we will therefore focus on introducing new governance arrangements to ensure that independent oversight of schemes, in members' interests, is built in to all contract-based arrangements. In particular, we propose to build on the agreement between the Association of British Insurers (ABI) and OFT to establish IGCs and introduce them on a mandatory footing.

Independent Governance Committees

36. Following the OFT's concerns about the potential weaknesses in contract-based governance, the ABI and its members agreed to embed IGCs within providers of contract-based schemes. The key elements of this agreement were:

    - IGCs should be made up of a majority of independent members and have an independent chair.
    - The IGC will need to have both the expertise and the resources to carry out its duties.
    - The IGC should consider all the key elements of the value for money of schemes.
    - If the IGC identifies a problem with the value for money that a scheme or number of schemes offer, it will report a proposed action to the pension provider's Board. The Board will have a 'comply or explain' duty to act on these recommendations. If the Board fails to act on the Committee's recommendation in a way that satisfies the Committee then it will have the power to make the matter public, to inform employees and the employer and to escalate the matter to the relevant regulator.

    The OFT stressed that IGC implementation will need careful consideration, particularly given the potential for conflicts of interest and information asymmetry.

37. We welcome the work done by the ABI and OFT to agree the introduction of IGCs. Acting on the OFT's recommendation that government embed a minimum standard of governance for all schemes – and particularly given the potential for conflicts of interest identified by the OFT – we intend to build on this by introducing IGCs on a compulsory footing by establishing them via FCA rules. As well as ensuring that IGCs reflect the key OFT recommendations, this will ensure consistency across providers.

Proposed terms of reference for Independent Governance Committees

38. The key objective of IGCs will be to act in members' interests through assessing and reporting on the value for money delivered by contract-based schemes on an ongoing basis. Ultimate responsibility for delivering these products will continue to rest with the pension provider with whom the member has a contract. The role of IGCs will be to address the problem arising from the weak buyer side identified by the OFT by scrutinising the value delivered by these products on an ongoing basis, on behalf of members.

39. As per the new requirements proposed for trustees, this will in particular include an ongoing review of the features needed to meet the quality standards:

    - Whether default investment strategies are designed in the interests of members, with a clear statement of aims, objective and structure and how these are appropriate for their membership.
    - Whether the characteristics and net performance of default investment strategies are regularly reviewed to ensure alignment with the interests of members, and action taken to make any necessary changes.
    - Whether core scheme financial transactions are processed promptly and accurately.
    - Assessment of the levels of charges borne by scheme members.
    - Assessment of the costs incurred through investment of pension assets.

    A fuller list of the duties on providers and IGCs is attached at **Annex B**.

Acting in members' interests

40. We think that IGCs should be given an explicit duty to act in members' interests. We recognise that Committees may need to take difficult decisions about how a decision will impact on a large and potentially diverse group of members. Managing this will be an important part of their role, and is not incompatible with a duty to act in members' interest. Parallels can be drawn between this and the ability of mastertrust trustees to fulfil their fiduciary duty to members across a large scheme.

41. In its consultation on fiduciary duties, the Law Commission expressed a tentative view that members of IGCs should be subject to clear duties to act in the interests of members. The Law Commission further recommended that providers should provide a full indemnity to the members of their Committees for any liabilities they incur. As well as helping to ensure people are not put off from sitting on IGCs, this would give providers a clear interest in ensuring that the Committees carry out their tasks correctly. We agree with these proposals.

42. Some respondents to our call for evidence also called for the provider's Board to be given a duty to act in members' interests. The Law Commission has also sought views on whether the duties on contract-based pension providers to act in the interests of scheme members should be clarified and strengthened.

43. The Government is clear that providers should ensure that schemes are run in the interests of scheme members. We do not consider it necessary for the Boards of providers to be given an explicit duty to act in members' interests in order for IGCs to be effective in achieving this objective. As per the IGC model outlined by the OFT, we think that the provider Board's duty to comply or explain with regard to the IGC's recommendations – when coupled with IGC members' duty to act in members' interests – provides a practical and direct way of ensuring that members' interests are acted on. At this stage we do not therefore propose giving provider Boards an explicit duty to act in members' interests.

Powers

44. It is vital that IGCs are a powerful influence within pension providers, and also that they have a direct route to communicate with scheme members and their employers.

45. We therefore propose implementing the model outlined by the OFT, under which the IGC makes recommendations about value for money delivered by schemes directly to the provider's Board. To ensure that the IGC's recommendations carry weight, the IGC will also be able to make their recommendations public, as well as communicating with the FCA, if they are not content with a provider's actions following their recommendation. This independent ability to publish information will ensure that IGCs have the necessary teeth to hold providers to account, coupled with the regulatory escalation route of reporting to the FCA. More details about FCA supervision of the IGC requirements will be set out in the FCA's consultation on changes to its rules.

46. The chair of the IGC will also be responsible for publishing an annual report setting out the assessment of the value for money delivered by the schemes they oversee. This should in particular cover their assessment of how schemes meet the standards listed at paragraph 39, as well as how the Committee has acted in members' interests over the course of the year, and recommendations they have made to the provider's Board. As well as providing communication to scheme members and employers, this will enable greater transparency and comparability between contract-based schemes.

47. We have considered whether IGCs should be able to make decisions about how a scheme is run rather than making recommendations to the pension provider's Board. However, it would not be possible for IGCs to both be independent of the provider and have executive powers to make decisions about how that provider runs its pension schemes.

48. Given the importance of ensuring that IGCs are truly able to independently act in members' interests, we have therefore focused on alternative ways of ensuring that IGCs have influence within a provider, as well as being able to communicate with scheme members and with the FCA, rather than giving them decision-making powers that could damage their independence.

Interaction with FCA rules

49. The FCA will consult later in the year on draft changes to its rules to introduce IGCs on a mandatory footing. Under revised FCA rules, it would be expected that providers' management should fully consider all recommendations received from IGCs, and should act on these unless there are reasonable barriers to doing so. Where there are reasonable barriers, the provider will need to explain to the IGC why it is not feasible to implement the recommendations. If the IGC is not satisfied with the explanation received, options for escalation will be reports to the FCA and/or to scheme members and contributing employers.

50. IGCs will be expected to consider and make recommendations on all aspects of the value for money delivered by a scheme, regardless of how these relate to current FCA principles and rules. However, if a provider's scheme does not meet the quality standards listed at paragraph 39, it is likely that this could be in breach of the existing FCA Principles of Business[5]. These principles apply to providers on an ongoing basis, as well as at the point of sale, and the FCA expects providers to be able to demonstrate how they have complied with these principles. As an example, Table 1.1 shows how the quality standard relating to default investment strategies may be compared to the FCA's existing Principles of Business.

Table 1.1: How quality standards relating to default investment strategies may be compared to the FCA's existing Principles of Business

Default investment strategy – quality standard	Existing FCA expectation	Principle of Business
Whether the design and net performance of default investment strategies is in the interests of members	Providers should be able to demonstrate they have: • considered the needs of members when designing default strategies • managed conflicts of interest in the selection of funds in their default investment strategy • monitored the performance of their investment funds against appropriate objectives	Principle 6 Principle 8

51. The FCA will consult on changes to its rules to introduce IGCs later in the year. As well as considering interaction with existing FCA principles and rules, the consultation could also consider whether an explicit FCA rule is required to ensure that providers can provide evidence that they have given due consideration at an appropriate level of seniority to recommendations made by IGCs.

Changes to contract terms

52. A number of stakeholders have commented on the different abilities of trust and contract-based schemes to make changes to members' investments. While trustees can change investments on an ongoing basis to reflect trustees' assessment of what will be in members' interests, contract-based providers may be restricted in doing so by the terms of members' contracts.

[5] The most relevant principles in this context are Principle 2 'A firm must conduct its business with due skill, care and diligence'; Principle 6 'A firm must pay due regard to the interests of its customers and treat them fairly'; and Principle 8 'A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.'

53. The extent to which providers can change individuals' arrangements will differ depending on how contracts have been written. The audit of high cost and legacy schemes – announced by the OFT on 11 February – should provide further information about the extent to which contract terms may prevent providers from making changes that are in members' interests. In particular, the OFT has advised that the Independent Project Board overseeing the audit will have a duty to consider how to transfer any poorly functioning schemes identified and/or how to ensure that the terms of the schemes are amended to ensure value for money for scheme members.

54. When the results of this exercise are known, we will consider, with the FCA, whether there is a role for government in intervening to make such changes possible. Any changes to contract terms would need to be handled very carefully, with clear safeguards to ensure they would be in members' interests.

Membership

55. Further to the agreement that the majority of members of the IGC, including the chair should be independent of the pension provider, the terms of reference at Annex B set out a proposed definition of independent.

56. This includes a requirement that providers go through an open and transparent recruitment process for recruiting independent IGC members, and that members should be appointed for fixed terms with limited numbers of reappointments, to avoid the possibility that they have incentives not to challenge providers in order to remain in post.

57. We also think it important that providers have arrangements in place to ensure that members' views are directly represented. IGCs and mastertrusts will be required to report on what mechanism they have used to hear from members in their chair's annual statements. Some providers already have arrangements in place to fulfil this purpose, for example, NEST's members' panel and Legal & General's plans to hold an annual general meeting for members of its mastertrust. We welcome these innovations and think they perform important roles, both in informing members about their scheme and generating input from members. Some providers may also choose to directly recruit IGC members from the membership of the schemes the IGC oversees.

58. As set out above, we propose that the same requirements about independent membership and member representation should be applied to mastertrust trustee boards as to IGCs.

Resources

59. To be able to scrutinise the value for money delivered by schemes it will be necessary for IGCs to have access to sufficient data from providers to assess the balance of costs and benefits provided by a scheme, including information that might be commercially sensitive. Providers will, therefore, have a duty to furnish IGCs with the information they request in order to fulfil their duty of scrutinising the value for money delivered by that provider's schemes.

60. Providers will also have a duty to ensure that IGCs have access to professional advisers who are independent of the provider. We do not propose that IGCs should be required to take advice, but that where they wish to do so there must be resources available for them to engage advisers who are independent of the provider. As a minimum this should include an independent investment adviser and independent lawyer.

Introducing the standards for contract-based schemes

61. The proposed terms of reference for IGCs are attached at Annex B. The agreement between the ABI and OFT committed to establishing IGCs in 2014. These terms of reference should give providers the clarity they need to establish IGCs this year, in advance of any new FCA rules being introduced from April 2015.

62. **We welcome views on the proposed terms of reference for IGCs, ahead of the FCA's consultation on changes to its rules to introduce IGCs. The FCA plans to consult on these rules in 2014, and for new rules to come into effect from April 2015.**

63. **The FCA will also publish a cost benefit analysis of its proposals alongside its consultation, and would welcome information on the costs and benefits of these proposals to inform this analysis.**

Scale in workplace pension schemes

2

- **It has been argued that small workplace schemes present unacceptable risks to their members, as only larger schemes can enjoy the benefits of scale, such as good governance, investment expertise and low costs.**
- **We recognise this risk, but evidence shows that it is diminishing. Scheme consolidation is accelerating and we do not expect new single employer small schemes to be set up.**
- **Under automatic enrolment requirements, smaller employers are already moving towards larger arrangements such as Group Personal Pensions (GPPs), mastertrusts, and NEST.**
- **We want to ensure schemes are well-governed and deliver good quality and low charges to their members, regardless of their size. The proposals in this paper will protect members from poor governance and unfair charges whatever size scheme they are in.**
- **Issues relating to existing small schemes are also being addressed by a variety of non-legislative means – by The Pensions Regulator's (TPR's) DC code and guidance, and the Association of British Insurers (ABI) audit of legacy and high-charging schemes. Forcing consolidation would also come at a financial cost which would be borne by members.**
- **Consequently, at this time, the Government has concluded that there is not a case for further intervention to accelerate the clear trend towards consolidation.**

Introduction

1. The Government wants all workplace pension schemes to provide value for money for their members. There is a continuing discussion among stakeholders about scale and whether small schemes can ensure good outcomes for their members. There is a view that large schemes are much better placed to secure value for money due to the scale benefits they enjoy.

2. This chapter explores whether there is a direct correlation between scale and scheme quality by examining the current pension landscape. It also considers whether there is a rationale to force scale rather than see it encouraged through other regulatory activities and competitive processes within the market.

The importance of scale

3. The OFT in their market study raised the risk of potential governance failures in small trust-based schemes. Their analysis suggests that scheme trustees may not be regularly scrutinising value for money and that they may not have the necessary expertise to implement sophisticated investment strategies. The OFT recommended that good quality, independent scheme governance could help to mitigate the impact of the weak buyer side of the market by ensuring ongoing scrutiny of value for money on behalf of scheme members.

4. In addition, some responses to the Government's consultation on charges favoured scale and some thought that consolidation in the industry should be supported. Many responses to the call for evidence on scheme quality standards referred to the economies of scale that can be accessed by large schemes. They also recognised that scale cannot deliver good outcomes unless it is combined with good governance and other quality standards. A small number of respondents called for greater intervention from government to drive scale, including suggestions that government or TPR should compel small, underperforming schemes to merge.

5. We agree that in some cases, members of small-trust based schemes may be disadvantaged because of low levels of trustee engagement and competence meaning that they are unable to secure the lower charges which larger schemes are able to do. We recognise that good governance can help resolve this issue, and the requirements set out in Chapter 1 for trustees to consider and report against a set of quality standards will help to drive good member outcomes.

6. Evidence from DWP's charges survey and TPR's occupational pension scheme governance survey also suggests that smaller schemes tend to have higher charges than larger schemes. Our proposals to cap charges in default funds will help to mitigate this risk by ensuring that small, high charging schemes cannot be used as qualifying schemes. Our proposals to cap charges outlined in this paper will help to mitigate this risk by ensuring that small, high charging schemes are excluded from automatic enrolment.

7. We also recognise that the scale offered by larger schemes is not necessarily a determinant of good value and bigger schemes are not automatically better. That is why our proposals for governance, transparency and charges cover schemes of all sizes.

8. Although it may appear that there is a clear correlation between scale and scheme quality, all small schemes are not the same. We have, therefore, undertaken a detailed examination of this part of the pensions market. This, as expected, has revealed a complex picture. For instance, some seemingly small schemes are often linked to larger employers operating other schemes or sit under larger insurers. Many employers also take advantage of bundled arrangements (where all or the majority of services are provided by a single insurer) so may also have economies of scale passed onto them from the insurer. The services purchased from an insurer as a bundled trust-based arrangement will often be similar to those offered by the provider to members of its GPP.

9. These findings indicate that there are already effective benefits of scale operating within the marketplace and across employers. Our examination of scheme size data has also revealed a significant consolidation of schemes and members towards the larger end of the market.

10. The benefits of scale in provision should not be confused with the advantages of consolidating an individual's savings. Those individuals who have a number of different employers over their working-life will continue to build up a range of small pots in a number of schemes, irrespective of the size of those schemes. It is better and more efficient to consolidate those individual savings pots up to a certain value, irrespective of where they are saved.

The current pension scheme landscape

11. Before we can draw any conclusions around whether scale is an issue requiring direct intervention, it is important to understand the size and nature of existing schemes. This section, therefore, explores the characteristics of the current pension landscape in more detail by scheme size and membership, and schemes within employers and insurers. We have examined a broad range of evidence from TPR's DC trust, micro scheme and insurer data, the FCA's Financial Sales data and DWP's Employers' Pension Provision Survey.

DC trust-based schemes

12. Currently, there are around 39,000 trust-based schemes with a total current membership in excess of 2.7 million savers. Although the total number of large schemes (1,000+ members) represents less than 1 per cent of the total of trust-based arrangements, it is encouraging that they account for the vast majority – around 82 per cent – of total trust-based membership. This means that 2.2 million trust-based members already benefit from the scale which a large scheme provides.

13. Of the remaining approximately 488,000 total scheme members, some 324,000 (12 per cent of total trust-based membership) sit within 920 medium-size schemes (100-999 members), 62,000 (2 per cent of total trust-based membership) sit within 1,790 small size schemes (12-99 members) and 102,000 (4 per cent of total trust-based membership) sit within 35,640 micro schemes (2-11 members).

Table 2.1: Trust-based landscape by scheme size, market share and membership

Scheme size	Number of schemes	% share of total market	Number of members	% of total membership
Large (1000+)	380	1%	2.2m	82%
Medium (100-999)	920	2%	324,000	12%
Small (12-99)	1,790	5%	62,000	2%
Micro (2-11)	35,640	92%	102,000	4%
Total	39,000*	100%	2.7m*	100%

Source: DC Trust: A presentation of scheme return data, TPR, 2013-14

http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx

* Columns do not sum because of rounding

Small and medium trust-based schemes

14. Our evidence shows that the vast majority of medium and small-size schemes can also offer significant benefits from scale, because they purchase services from a large provider.

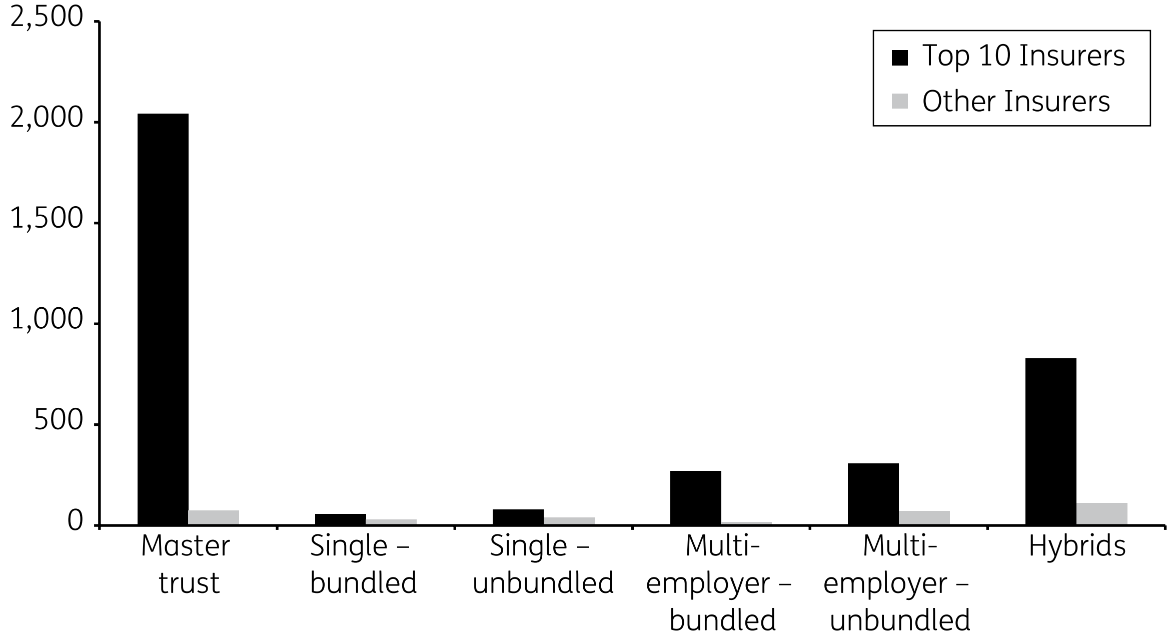
15. Looking specifically at employers and the insurers and schemes they use, we have found that there are 4,200 employers using medium-sized (100 to 999 members) DC trust-based schemes (including hybrid schemes with DC members). Of these:

- 2,100 (50 per cent) are in mastertrusts; and
- 400 (9 per cent) are in bundled schemes.

Of the remaining employers, 1,200 (70 per cent) are with one of the ten largest insurers.

16. This is illustrated in Figure 2.1.

Figure 2.1: Number of employers by medium scheme type and insurers used



Source: TPR Insurer Data.
Note: DC schemes with an unknown scheme type have been removed from the chart, but are included in all calculations.

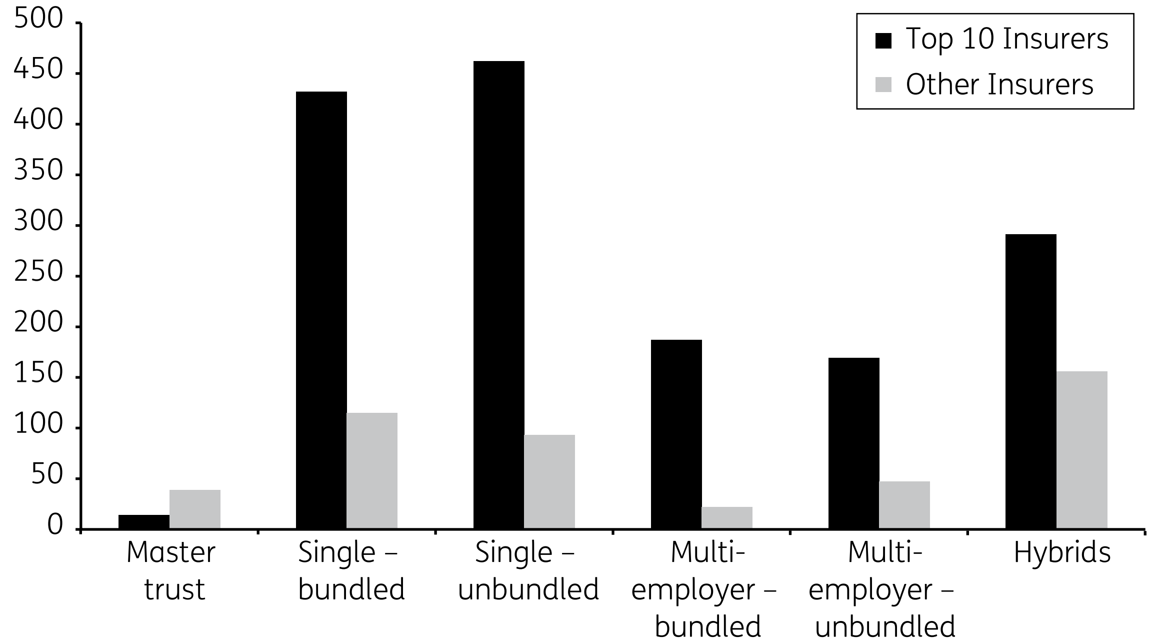
17. We have made a similar study of small schemes and found that the outlook is also reassuring in terms of being able to access the benefits of scale. Our findings show that there are 2,300 employers with small schemes. Of these:

- 800 (32 per cent) are in bundled arrangements; and
- 50 (2 per cent) use a mastertrust.

Of the remaining employers, 1,000 (64 per cent) are with one of the 10 largest insurers.

18. Figure 2.2 illustrates this.

Figure 2.2: Number of employers by small scheme type and insurers used



Source: TPR Insurer Data.
Note: DC schemes with an unknown scheme type have been removed from the chart, but are included in all calculations.

19. Our analysis of small and medium-size schemes shows that the vast majority of employers using these schemes will have access to scale through the largest insurers, mastertrusts or other schemes which can provide the benefits of scale. It also indicates that there are fewer small single employer schemes than has been previously perceived, given that many employers provide more than one scheme.

20. We have also made a detailed analysis of the membership landscape. Our key findings for members of medium-size schemes show that there are 324,000 members of medium schemes. Of these:

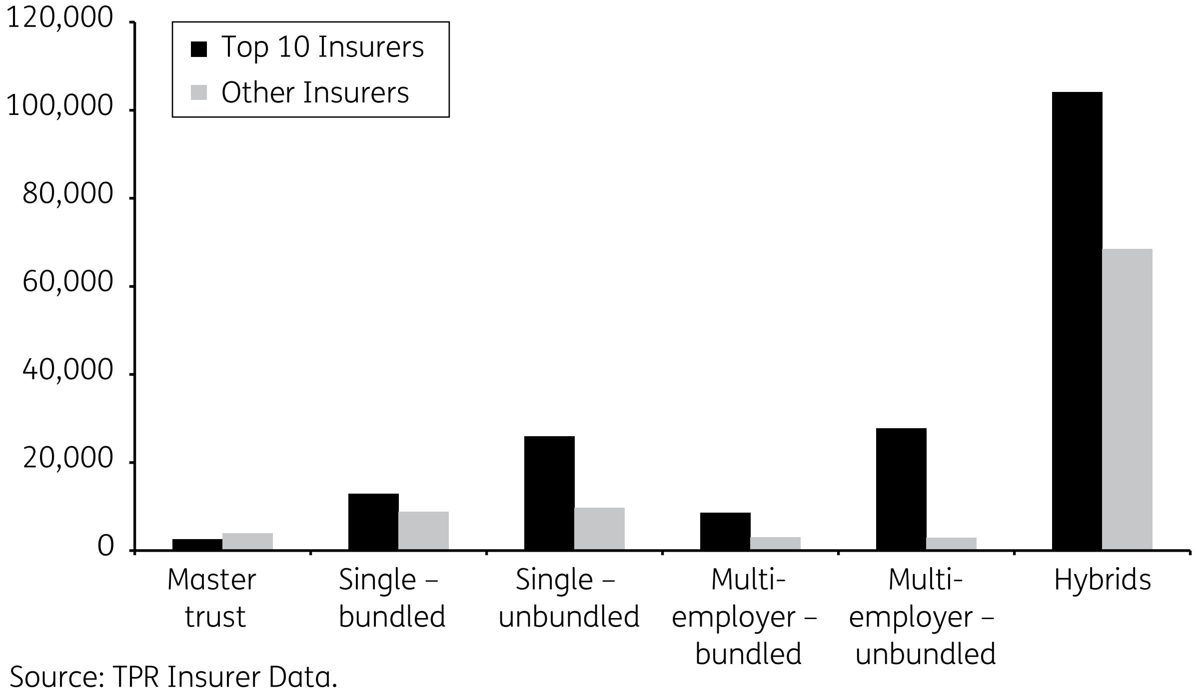
- over 33,000 (10 per cent) are in schemes with bundled arrangements; and
- 6,500 (2 per cent) are members of mastertrusts.

Of the remaining members, 56 per cent are with one of the ten largest insurers.

Some 25 per cent of members in medium schemes belong to unbundled arrangements which do not use one of the ten largest insurers.

21. This is illustrated in Figure 2.3.

Figure 2.3: Number of members by medium scheme type and insurers used



Source: TPR Insurer Data.
Note: DC schemes with an unknown scheme type have been removed from the chart, but are included in all calculations.

22. Our findings for members of small-size schemes show that there are 62,000 members of small schemes. Of these:

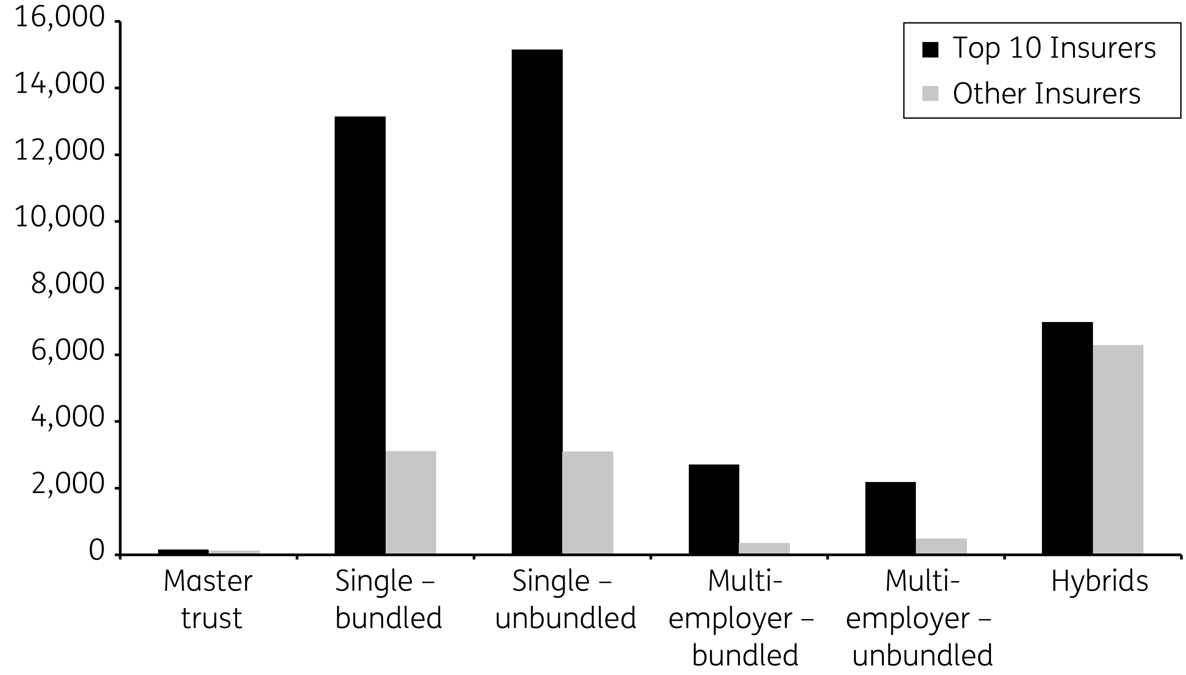
- over 19,000 (31 per cent) are in schemes with bundled arrangements; and
- 300 (less than 1 per cent) are in mastertrusts.

Of the remaining members, 58 per cent are with one of the ten largest insurers.

Only 16 per cent of members in small schemes belong to unbundled arrangements which do not use one of the ten largest insurers.

23. Figure 2.4 illustrates this.

Figure 2.4: Number of members by small scheme type and insurers used



Source: TPR Insurer Data.
Note: DC schemes with an unknown scheme type have been removed from the chart, but are included in all calculations.

24. Our analysis overall shows that a large proportion of members of medium and small-sized schemes will also have access to scale through their scheme insurer or the scheme to which they belong.

Micro trust-based schemes

25. The remainder of the trust-based market comprises of micro schemes (2-11 members). Micro schemes account for around 92 per cent of the total trust-based market[6], but only account for 4 per cent (around 102,000) of the total trust-based membership.

26. Of the 35,640 micro schemes, over half (61 per cent) are small self-administered schemes (SSAS) representing around 58,000 members[7]. The majority of these scheme members will be directors or scheme trustees so will all have a personal interest and responsibility in ensuring that their scheme is well governed and administered. There is, therefore, a low risk associated with these schemes and that it is right to exclude these schemes from our examination of value for money and scale in the trust-based market place.

27. The remaining 14,000 non-SSAS micro DC schemes are used by around 16,000 employers for some 44,000 members or around 1.5 per cent of total trust-based scheme membership. Looking at these 16,000 employers, at least 32 per cent are in bundled arrangements. Of the remaining employers, at least 39 per cent are with one of the top ten insurers.

[6] DC Trust: A presentation of scheme return data, TPR, 2013-14.
[7] TPR micro scheme data.

28. Looking at the 44,000 members of non-SSAS micro DC schemes at least 35 per cent are in bundled arrangements. Of the remaining members, at least 41 per cent are with one of the top ten insurers.

29. Our evidence also shows that a large proportion of SSASs (over 54 per cent) are provided by one of the ten largest insurers.

30. Overall, therefore, this vertical integration of services means that the vast majority of medium, small and micro scheme-size members are having their schemes run by insurers who should be able to deliver the benefits of scale.

31. As a result of this analysis, we have concluded that any consideration of further intervention should be limited to those schemes which were not able to access the benefits of scale via other means, such as connection with a large insurer.

DC contract-based schemes

32. The same issue of the benefits of scale being delivered via connection to a large insurer are also evident in the contract-based market. The majority of DC contract-based schemes are made up of GPPs and workplace Stakeholder Pensions (SHPs), which are used for workplace saving, but there are also individual personal pensions (IPPs) and self-invested personal pension (SIPPs) arrangements, which may also be used for personal saving outside the workplace. In 2013 there were 107,000 IPP sales and around 573,000 sales for SIPPs which were provided by a broad range of insurers[8].

33. Although workplace SHP schemes are the most common form of contract-based provision, provided by 19 per cent of all firms in 2011, 51 per cent of these do not have any active members (shell schemes)[9]. This is more prevalent in smaller employers with five to nine employees (62 per cent of firms in 2011).

34. This clearly signals that there is less of a risk around existing SHP schemes, given that a significant number do not have any active members. It is also the case that members of these schemes – whether active or deferred – will be protected by the standards that a scheme has to meet in order to qualify as a stakeholder scheme. The evidence we examined for GPPs, which are provided by 5 per cent of employers, shows that in 2011 65 per cent of firms with 500+ employees had 100+ participants. This indicates that economies of scale are likely to exist within the larger employers using a GPP.

35. Our evidence shows us that in the contract-based market, provision of GPPs, SHPs, SIPPs and IPPs are provided by a broad range of insurers which we would expect to be competent and experienced. Whilst they have varying proportions of market share, we would also expect all to have increased buying power compared to a small provider. Evidence also shows us that for the period 2009 to 2013 almost 75 per cent of sales of the above products were with one of the ten largest insurers. However, looking at GPP and SIPPs sales for 2013, larger insurers made the vast majority of sales. Insurers who sold 1,000+ scheme products accounted for over 99 per cent of total GPP sales and 98 per cent of total SIPP sales.

[8] FCA Product Sales Data.

[9] Forth I, Stokes L, Fitzpatrick A, and Grant C, 2012, Employers' Pension Provision Survey Department for Work and Pensions Research Report 802, DWP.

36. All of these schemes that are used as qualifying schemes will need to meet the charges standards proposed in this paper, and all of these schemes used for workplace saving will have to meet the proposed quality and governance standards in Chapter 1. The ABI and its members are also undertaking an audit of schemes that were set up pre-2001 or have charges above 1 per cent, following the OFT's finding that schemes in these categories are at risk of not providing value for money.

Market trends

37. Having examined the current landscape and concluded that any questions regarding delivering the benefits of scale are primarily linked to a subset of trust-based schemes, we have considered how the market might change with the advent of automatic enrolment. Whilst many more small employers will be brought into pension savings by automatic enrolment, this is unlikely to increase the number of small schemes, and that the trend will be towards consolidation or use of existing established provision in order to benefit from scale.

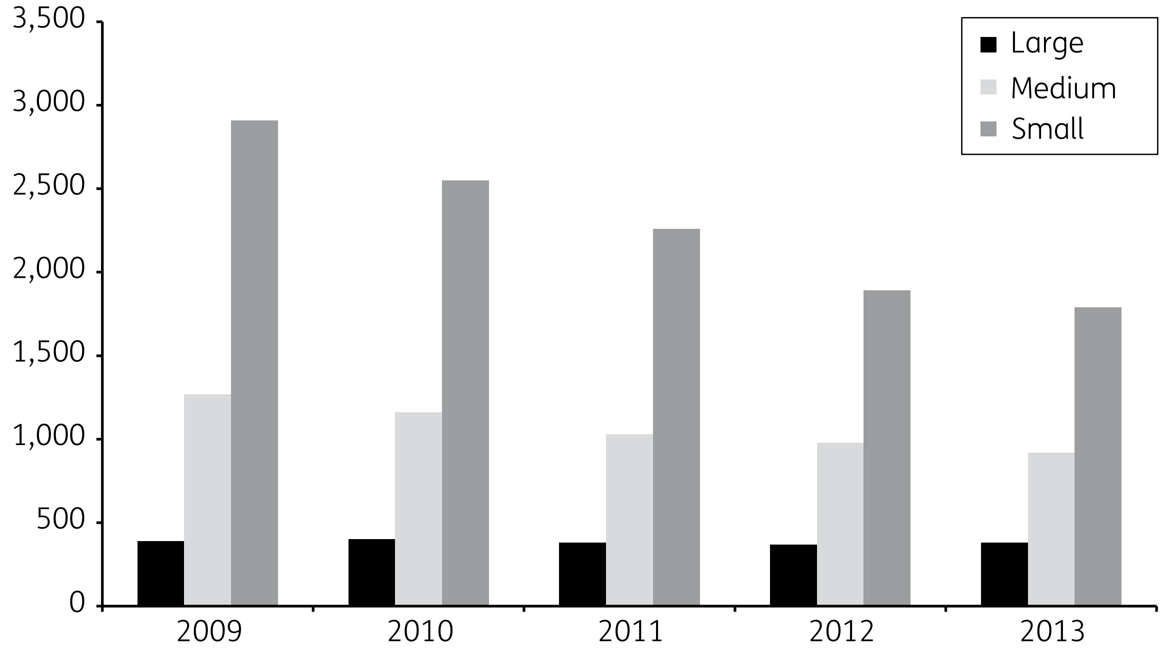
38. There are already ways in which smaller employers can access the benefits of scale, where these are passed on by the insurer or mastertrust provider. These include joining a large GPP or mastertrust, or by purchasing investment or administration services from a large organisation.

39. Whilst accessing and benefiting from scale will become more important as smaller employers are brought into automatic enrolment, as discussed above, our data suggests that consolidation in the DC trust-based space is already happening. Our evidence below clearly shows the diminishing number of micro, small and medium schemes, in that:

- Between 2009 and 2013 the number of small trust-based schemes (between 12 and 99 members), including hybrid schemes, fell by over a third, from 2,910 to 1,790 schemes.
- The number of medium trust-based schemes (between 100 and 999 members) has fallen by over a quarter, from 1,270 to 920.
- The number of micro trust-based schemes (less than 12 members) fell by over a fifth from 45,460 to 35,640 in the same timeframe.
- In the same period, the number of large schemes stayed fairly stable, decreasing slightly from 390 to 380 schemes.

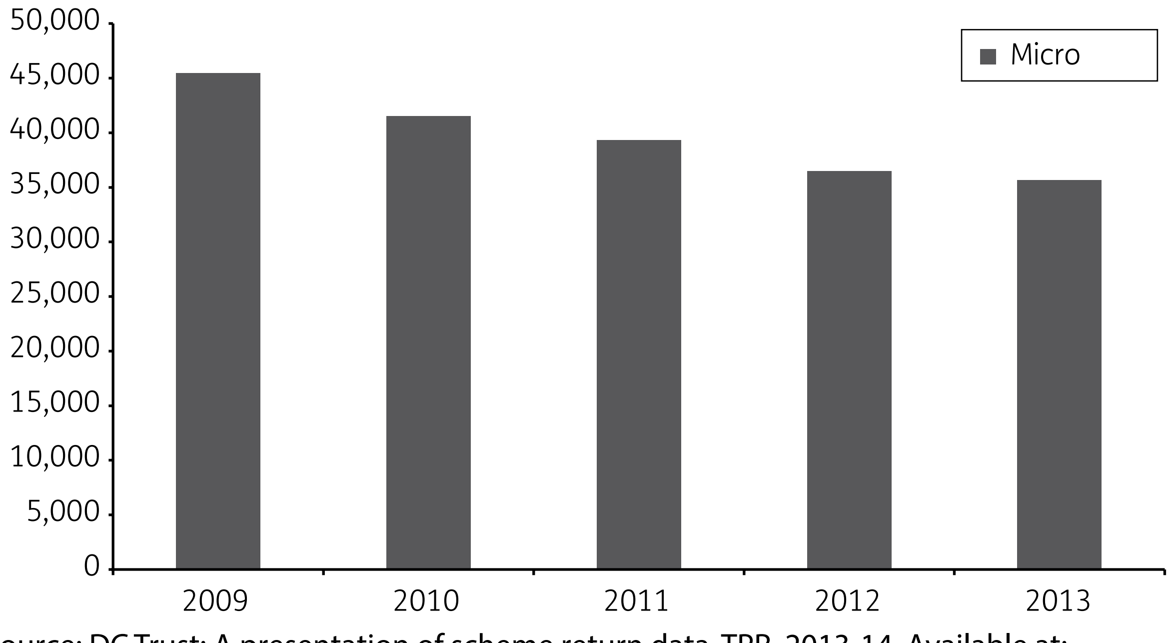
40. This is illustrated in Figure 2.5a and Figure 2.5b.

Figure 2.5a: Number of occupational DC trust-based schemes by size, 2009-2013



Source: DC Trust: A presentation of scheme return data, TPR, 2013-14. Available at: http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx

Figure 2.5b: Number of occupational DC trust-based schemes by size, 2009-2013



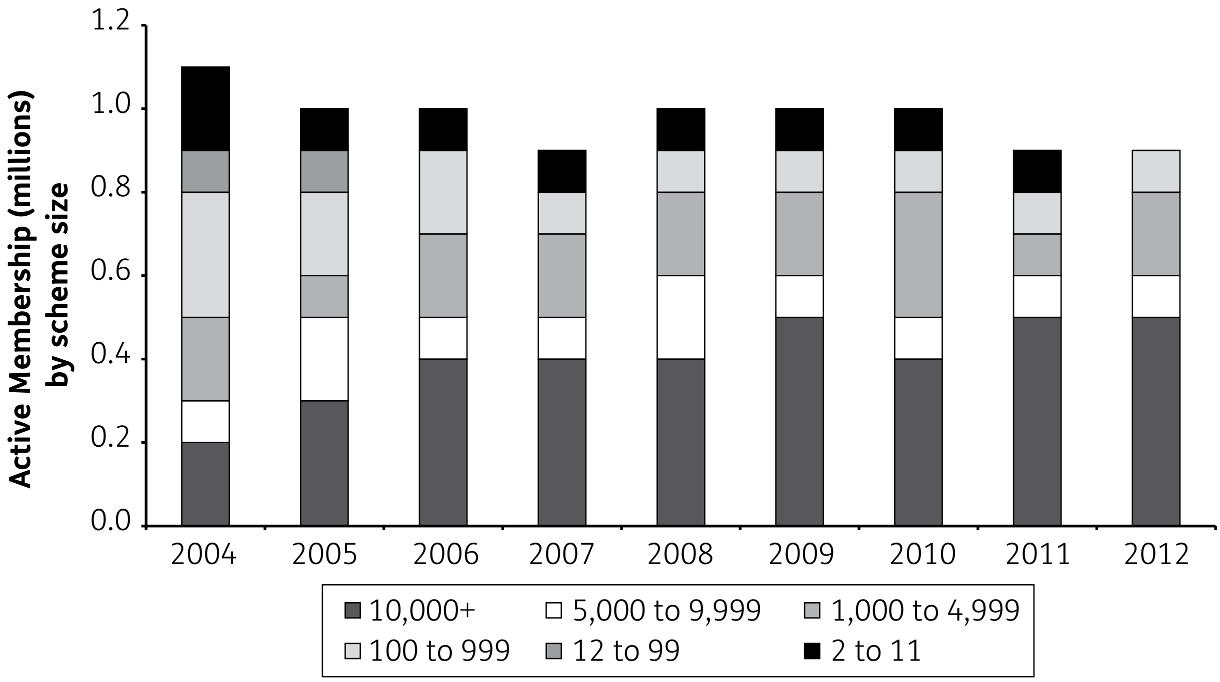
Source: DC Trust: A presentation of scheme return data, TPR, 2013-14. Available at: http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx

41. Similarly, the number of active members in micro, small and medium schemes is reducing significantly. The evidence shows that:

- In 2012, around half of the active members of private sector trust-based schemes (0.5 million members) were in schemes with more than 10,000+ members. This has increased from the 0.1 million active members in schemes of this size in 2000, out of the total of 0.8 million active members.
- The proportion of active members in small (12-99) and medium (100-999) schemes has reduced in this same timeframe. Their combined active membership has decreased to 0.1 million from 0.3 million.
- The proportion of active members in micro (2-11) schemes had remained stable at 0.1 million, until falling below this in 2012.

42. Figure 2.6 highlights the switch in membership from smaller schemes to a much higher proportion in larger schemes.

Figure 2.6: Number of active members of private sector occupational DC schemes: by size, 2004-2012 (UK, millions)



Sources:
Occupational Pension Scheme Survey, ONS, 2004-2012. Available at: http://www.ons.gov.uk/ons/rel/fi/occupational-pension-schemes-survey/2012/stb-opss-2012.html
ONS published ad-hoc data. Available at: http://www.ons.gov.uk/ons/about-ons/business-transparency/freedom-of-information/what-can-i-request/published-ad-hoc-data/econ/february-2014/active-members-of-small-defined-contribution-ops.xls

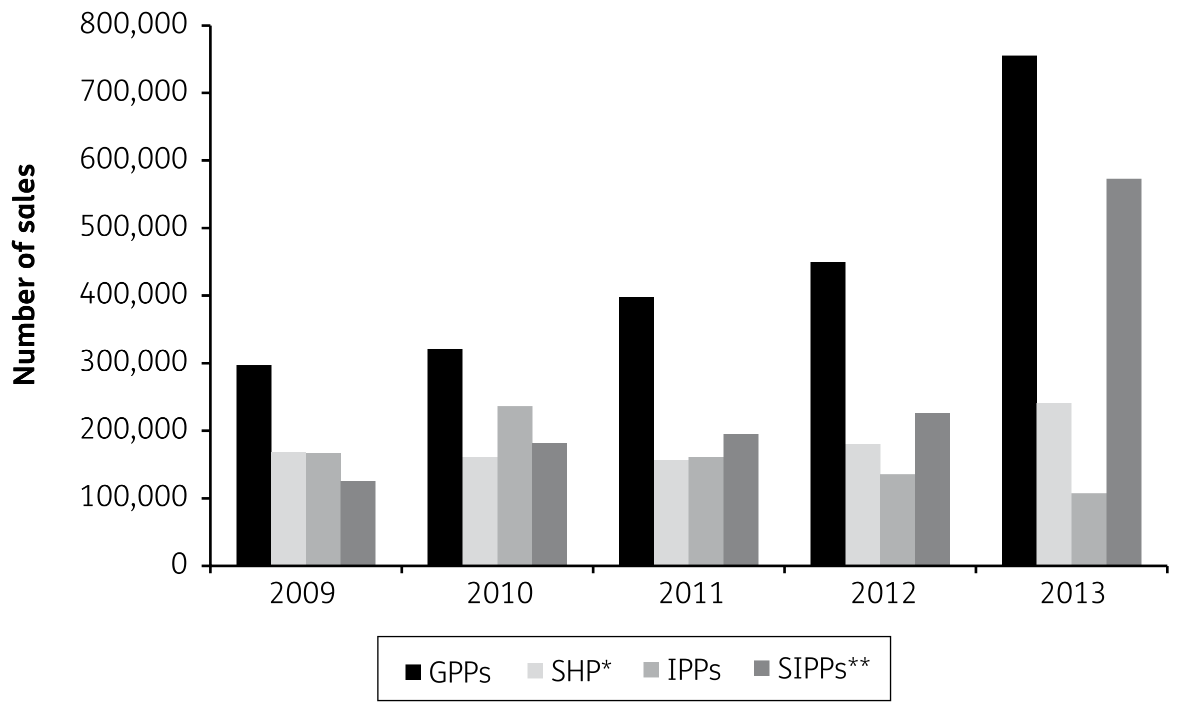
DC contract-based schemes

43. DC contract-based schemes have seen similar trends around consolidation:

- Since 2009, there has been a large increase in the number of GPPs sold, rising from 297,000 to around 755,000 in 2013.
- In the same period, the number of SHP schemes sold has remained fairly steady, until a 34 per cent increase in the latest year, to around 241,000.
- Sales of IPPs have fallen by 36 per cent to 107,000 over the same timeframe, but there has been more than a fourfold increase in the number of SIPPs sold, from 125,000 to around 573,000.

44. As discussed above within the section on current scheme landscape, the majority of these products, particularly GPPs and SIPPs, were sold by the larger insurers where economies of scale are more likely to be present.

Figure 2.7: Sales of GPPs, SHPs, IPPs and SIPPs, 2009 to 2013



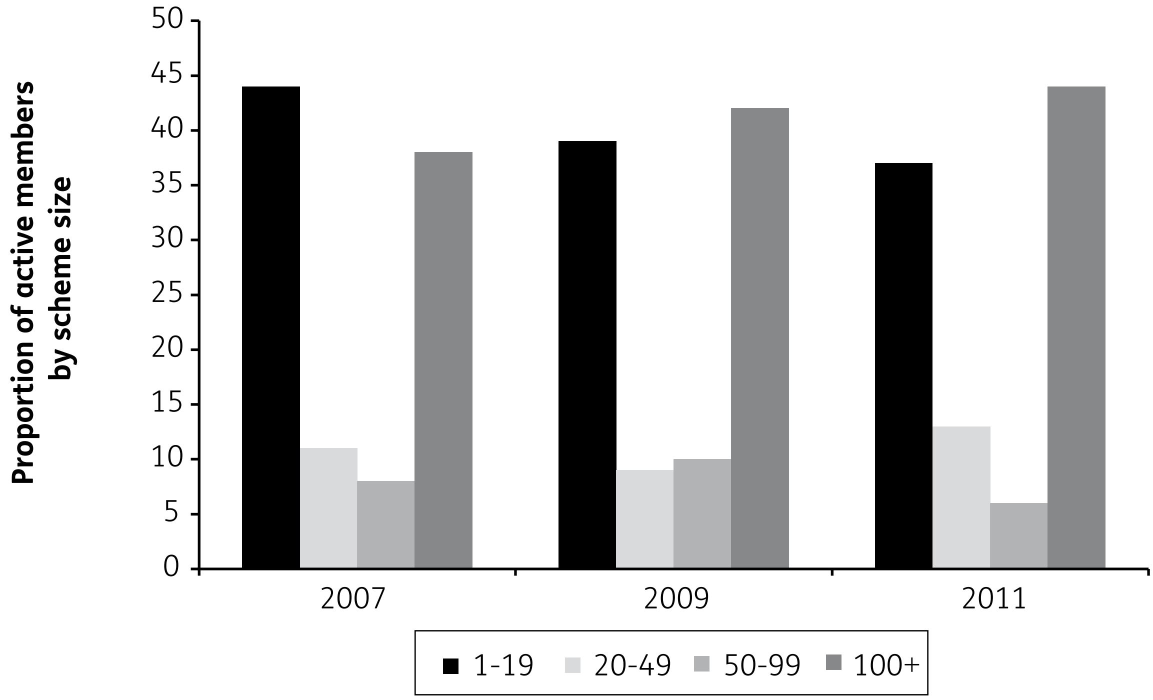
Source: FCA Product Sales Data.
* All SHP sales. Separate breakdown of group SHPs not captured separately.
** All SIPPs sales. Separate breakdown of group SIPPs not captured.

45. The fall in proportion of active members within small SHPs and GPPs is also evident, along with an increase in proportional membership in the larger type schemes. Our evidence shows that 49 per cent of SHPs provided by firms had some form of active membership in 2011, an increase from 37 per cent in 2007. Of this, the proportion of active members in SHPs with less than 20 members has fallen from 44 per cent in 2007 to 37 per cent in 2011.

46. This compares to the increase from 38 per cent to 44 per cent of the proportion of active members in schemes with 100 or more members in the same time frame.

47. This, along with the snapshot of data on the existing stakeholder scheme landscape shown in Figure 2.8, demonstrates the number of active members within the larger schemes is steadily increasing, allowing those members to benefit from scale. We expect this trend to continue.

Figure 2.8: Size of SHP schemes, active members, 2007 to 2011



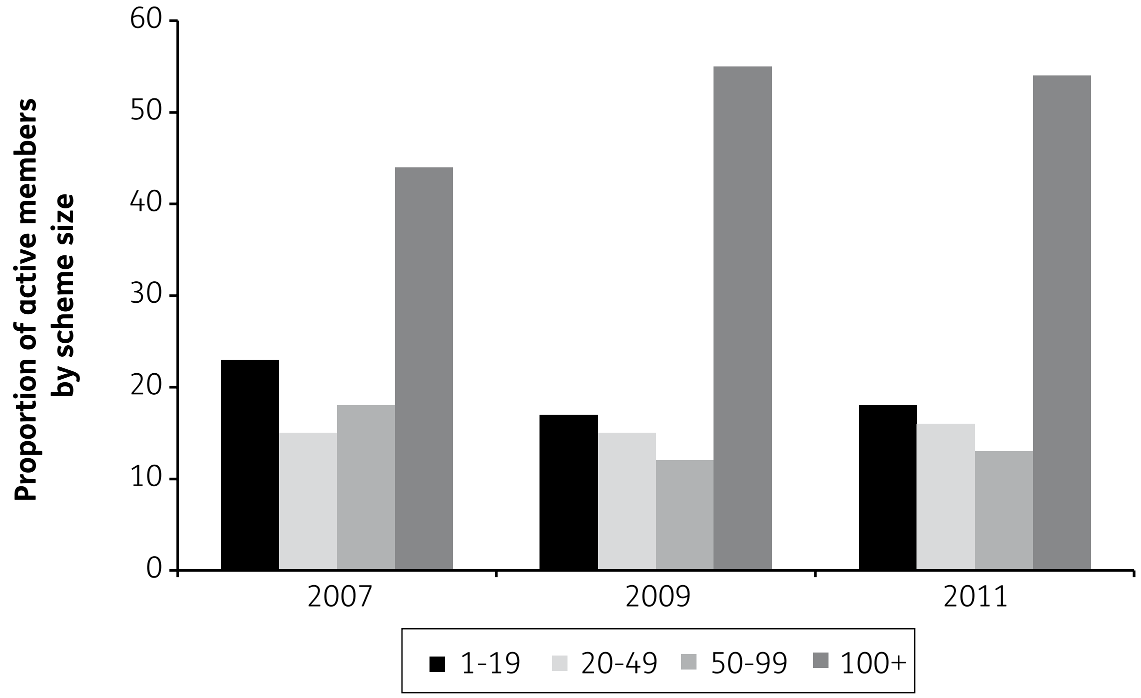
Source: Employers' Pension Provision Survey, DWP, 2009 (Table E.6) and 2011 (Table D.6). Available at:
https://www.gov.uk/government/publications/employers-pension-provision-survey-2011rr802

48. Membership of GPPs displays a similar trend towards greater scale, as shown in Figure 2.9. In the GPP market, 99 per cent of schemes had active membership in 2011, a slight increase on the 96 per cent in 2007. Of this, the proportion of active members in GPPs with less than 20 members has fallen from 23 per cent in 2007 to 18 per cent in 2011.

49. This compares to the increase from 44 per cent to 54 per cent in the same time frame of the proportion of active members in schemes with 100 or more members.

50. This signals a significant shift in employer attitude (possibly with advisers taking the lead) in that smaller employers are accessing scale. We expect this trend to continue.

Figure 2.9: Size of GPP schemes, active members, 2007 to 2011



Source: Employers' Pension Provision Survey, DWP, 2009 (Table E.7) and 2011 (Table D.7). Available at:
https://www.gov.uk/government/publications/employers-pension-provision-survey-2011rr802
Note: Please be aware of possible rounding errors in the 1-19 member categories, due to different breakdowns within this group being published. This group has been derived here for comparisons with the stakeholder scheme graph above.

51. Overall, our evidence and examination of market trends suggests that significant consolidation is already happening and that employers being brought into automatic enrolment are already accessing scale. In addition, the number of small schemes and members of those schemes are likely to decrease further as smaller employers choose existing larger schemes for automatic enrolment. Given the complexity around setting-up a new scheme, it is less likely that they will establish new, small, individual trust-based schemes.

52. Furthermore, once the requirements for minimum quality and charges standards are introduced, automatic enrolment will play a key role in driving consolidation as those smaller schemes which cannot offer charges within the cap would not qualify as being suitable for automatic enrolment. As we have explained above, smaller employers are also more likely to choose a GPP or mastertrust as their preferred scheme for automatic enrolment.

53. This is also confirmed, to a broad degree, by the Employers' Pension Provision Survey 2011[10]. Relevant key findings of this survey show that:

- 6 per cent of employers who already offered a form of workplace pension planned to enrol all current members into NEST and 19 per cent said that they would enrol all non-members and new employees into a scheme such as NEST.

[10] Employers' intentions, as expressed in the survey, were not always based on extensive prior reflection. 51 per cent of employers had not given the reforms any thought prior to the survey and only 3 per cent had a firm plan in place at the time of the survey interview. However, the survey provides the best available indication of how employers are likely to respond to automatic enrolment.

- 45 per cent of firms with no current workplace pension scheme indicated that they would enrol all employees into NEST or a similar scheme.
- In firms where the current largest scheme was a GPP, 76 per cent planned to retain all current members in this scheme.

54. From this, it is reasonable to conclude that only the subset of trust-based legacy schemes identified above might not be able to access the benefits of scale. The evidence on consolidation suggests that this subset will reduce further and that this trend will continue as automatic enrolment is rolled out. Our proposals to strengthen governance, improve transparency and control charges set out in this paper will protect members of all schemes including those within this subset.

Accessing the benefits of scale

55 As we have shown, accessing the benefits of scale – good governance and ability to drive down costs – may remain an issue for a subset of trust-based schemes. It should be noted that it is already the case that trustees should consider how to deliver good value for members, which should include considering whether the scheme is operating with the correct scale. Where this is not the case, trustees should consider options for merging or otherwise expanding the scheme, alongside the option to close the scheme and move members to a pre-existing one. The key consideration in all cases should be the impact on members, including the practicalities and costs involved in taking such steps.

56. Our proposals to strengthen governance in trust-based schemes will re-emphasise this point and lead to the chair of the governing body focusing on this issue. TPR is also planning to provide trustees with guidance on scheme closure and winding-up small and medium-size schemes.

57. There are also a range of relevant regulatory activities already taking place across the trust-based market:

TPR is addressing scale by:

- encouraging employers to use mastertrusts or GPPs for automatic enrolment through their education and enable regime, and directing employers towards a list of insurers,
- revising the code of practice on Trustee Knowledge and Understanding, aimed at improving trustees' competence,
- the code of practice for trustees of DC schemes which sets out expectations for trustees to consider value for money and options for consolidation if scheme size has the potential to have an adverse impact on the overall performance of the scheme,
- value for money guidance (to complement the code), and
- a comply or explain regime which will allow trustees to assess their scheme against the standards and features set out in the code, explain how the feature is met or how trustees comply with the underlying law (for features in the code) or implement good practice (for features in the regulatory guidance).

58. It has been suggested that government should require small schemes to close. It should be noted, however, that winding-up a scheme, irrespective of its size, is neither a rapid or cost-effective process, and that the costs may ultimately be met by the members. A draft report on timings and cost of winding-up small and medium-sized schemes commissioned by TPR suggests that the costs of winding up larger schemes could be as much as £50,000.

59. This is a significant sum of money which scheme members could be expected to meet. Trustees need to consider all these factors in the ongoing running of their schemes, including consideration of wind-up.

Conclusion

60. The Government's focus is on ensuring that schemes are well-governed and deliver good quality and low charges to their members, regardless of their size.

61. We are already addressing the lack of benefits of scale in this subset of schemes by way of our broader work to strengthen governance, improve transparency and control charges which will ensure that members of all schemes are protected. There is therefore not a case for further legislative intervention to particularly target scale.

62. Our analysis shows that the benefits of scale will be delivered in the future, both by market trends and ongoing regulatory activity. Nevertheless, as part of monitoring the impact of our proposals for scheme quality and charges, the Government will continue to consider additional non-legislative activity to deliver the underlying benefits of scale across the market.

Tackling unfair charges – a cap on charges 3

- **A charge cap on default funds of DC qualifying schemes will protect savers from high charges.**
- **The default fund charge cap will cover all member-borne charges and deductions excluding transaction costs. It will be introduced from April 2015 for all qualifying schemes and will be set at 0.75 per cent of funds under management.[11]**
- **The Government recognises the need to tackle complex and opaque transaction costs. We expect pension schemes and providers to make progress immediately in this area ahead of new reporting requirements coming into force from April 2015. This improved disclosure of transaction costs will inform consideration in 2017 of whether some or all of these transaction costs should be capped in workplace pension default funds.**

Introduction

1. The Government is committed to ensuring that savers get the best possible retirement income. Supported by the OFT's analysis of the workplace pensions market and its weak demand side, the Government launched a consultation on charges in October 2013. It asked for views and evidence to examine how, in a marketplace where members do not choose their workplace scheme and are defaulted into a fund, charging practices may need to change.

2. The OFT's analysis of the principal-agent problem – where the member doesn't choose their workplace scheme – was supported by evidence of high and unfair charges. This evidence shows that many employers are unaware of the level of their scheme's charges and the impact that these have on the retirement income of their employees.[12] This is particularly the case for smaller

[11] We set out later in this chapter how this will apply to schemes with combination charge structures.
[12] A DWP survey in 2012 found that only a minority of employers (28 per cent of trust- and 33 per cent of contract-based schemes) believed that their members of their workplace pension scheme paid any charges. Of those overseeing smaller schemes, this minority was even smaller: 11 per cent of trust-based schemes with six to eleven members, and 21 per cent of contract-based schemes of the same size thought that their members paid charges. Wood *et al.*, 2013, Pension Landscape and Charging: Quantitative and qualitative research with employers and pension providers, Crown, p54.

employers, who are less able to fund advice services, capable trustees, or governance panels. The complexity of pensions adds another layer of difficulty, as employers often struggle to make valid judgements on the costs and quality of the product, making it hard to put pressure on the seller to offer something competitive. The OFT's analysis showed that automatically enrolled savers may be at risk of paying excessive charges.

3. Analysis and modelling by the DWP and bodies such as the Pensions Institute demonstrates that even small variations in charges can result in a significant difference in saving outcomes.[13] The Pensions Institute's recent report on value for money in DC default funds stated that a default fund's charges are more significant than investment strategy in determining saving outcomes.[14]

4. Following the OFT's analysis and our consultation on charges, this chapter examines proposals to introduce a charge cap on the default funds of DC qualifying schemes.

A default fund charge cap

5. In Chapter 3 of the Government's consultation on charging, we examined various options for protecting savers from being automatically enrolled into default funds with high charges.

6. In its market study, the OFT referred to the possibility of a charge cap as a means to address the consumer detriment that may arise from the use of legacy schemes, although they stopped short of recommending it, as they favoured an audit approach. The report stated that: 'While we would not rule out a charge cap, it should be considered in full knowledge of the different charges and benefits that apply in the market and the risks that a cap might entail.'[15]

7. The DWP consultation outlined the case for a default fund charge cap and, in light of the OFT's comments, aimed to gather evidence and insight into the various questions associated with this kind of market intervention, including:

   - Is a default fund charge cap necessary – are there any alternatives?
   - What would be the impact of a default fund charge cap – on members, employers and providers?
   - If introduced, how should a default fund charge cap be designed and at what level should it be set?
   - When should any default fund charge cap be introduced?

Is a default fund charge cap necessary – and are there any alternatives?

8. In the consultation paper we outlined the reasons why government action was necessary to protect savers from the market failures identified by the OFT. In Chapters 3 and 4 we outlined a number of options for resolving these market failures, including the principle of a default fund charge cap.

[13] Modelling from the Department for Work and Pensions demonstrates that an individual saving throughout working life into a scheme with a 0.5 per cent AMC could lose 13 per cent of their pension pot; if the scheme had a 1 per cent AMC, that same individual could lose 24 per cent of their pot. Department for Work and Pensions, 2013, Better workplace pensions: a consultation on charging, Cm 8737, Crown, p11.

[14] The report found that, 'as a rough rule of thumb, each percentage point increase in the TER leads to a fall in the expected replacement ratio at retirement of about 20%.' Harrison, Blake and Dowd, VfM: Assessing value for money in defined contribution default funds, January 2014, The Pensions Institute, pp44.

[15] Office of Fair Trading (OFT), 2013, Defined contribution workplace pension market study, OFT 1505, Crown, p26.

9. We sought views on whether a default fund charge cap was the right measure to introduce, or whether there were more appropriate alternatives. We described three options for the proposed default fund charge cap, but also stated that any final cap could lie between the levels suggested, depending on the evidence received:

- **A default fund charge cap of 1 per cent of funds under management**, reflecting the current stakeholder pension cap for certain scheme members
- **A default fund charge cap of 0.75 per cent of funds under management**, reflecting the charging levels already being achieved by many schemes
- **A two-tier 'comply or explain' default fund charge cap**. There would be a cap of 0.75 per cent for all qualifying schemes. A higher cap of 1 per cent would be available to employers who reported to The Pensions Regulator (TPR) why the scheme's charges are in excess of 0.75 per cent.

Responses to the consultation

10. Many respondents expressed support for the principle of a default fund charge cap. Indeed, some suggested that automatic enrolment should have been introduced with one in place to start with.

> 'I have always considered it an oversight of the automatic enrolment legislation that a charges cap was not introduced from day 1. Without a cap, it was always possible that a scheme with high charges by today's standards (anything north of the original stakeholder cap of 1 per cent AMC) could enrol workers, and that would clearly be detrimental to those employees.'
>
> **Jelf Employee Benefits**

11. Those respondents in favour of a default fund charge cap explained that although larger employers have negotiated low charges for their automatic enrolment schemes, charges may well drift upwards as smaller employers approach their staging dates, unless there is a backstop in place. Any drift upwards would be unfair, as it would mean that many savers would have to pay higher charges, simply because they worked for a smaller employer. Many responses also referred more generally to the principal-agent issue at the heart of workplace pension arrangements as another key reason for a default fund charge cap.

> '... The DWP is right to be concerned about smaller employers and the consultation suggests that the Government is already aware of the dangers that small firms may be offered far less attractive terms than larger companies that have auto-enrolled so far. SMEs are bound to have less buying power than larger employers [...]. Just forcing disclosure of charges would not require employers to act, but setting an upper limit will mitigate the risks of pension companies taking advantage of the lack of buying power of small firms.
>
> The principal agent problem is an important issue and workers need to be sure that their employer will select a pension scheme that offers them value for their money. Without controls on the charges for workplace pension schemes, workers would be at risk of poor value, because the employer chooses the scheme but does not have to pay the actual fees.'
>
> **Ros Altmann**
> **Economist, pensions and investment expert**

12. Some respondents thought that a default fund charge cap was a ‘blunt tool’, but also stated that it was the only option that could truly protect those savers who had made no choices about their pension scheme.

> ‘In our view, there is no tenable alternative that would guarantee protection for **all** consumers [...]. A charge cap is an essential part of the message that consumers can have trust and confidence in workplace pensions as an effective way for providing for their old age.’
>
> **JLT Employee Benefits**

13. A number of respondents did not support the principle of a default fund charge cap, suggesting it was not justified as there is no excessive profit-making in the industry. A number pointed to the fact that recently charges have fallen to record lows. These respondents disagreed with the OFT’s analysis, arguing that competition would indeed continue to drive down charges in the market place, and ensure good value for all savers.

> ‘Price caps are appropriate where excessive profits are being made by providers, but that is not the case in this market. Indeed, providers lose money in the short term because costs exceed charges, and even in the longer term workplace pensions are not highly profitable. In addition, competition has driven prices down significantly in recent years, and there is every indication that this will continue [...].’
>
> **Scottish Widows**

14. Other responses opposed the principle of a default fund charge cap because they were concerned about possible unintended consequences (see next section), and did not believe that it would have the effect of keeping charges low in the long term. Some respondents offered up alternative measures to protect savers, including: promoting competition in the marketplace; improving levels of financial capability amongst savers; enforcing better governance; legislating on quality standards and scheme reviews; and mandating clearer, more consistent disclosure to enable scheme comparisons and benchmarking.

> ‘It is imperative that effective scheme governance, quality investment management, improved scheme member engagement and educated decision making at retirement are the cornerstones of the protection of scheme members.’
>
> **Standard Life**

> ‘The best protection for scheme members is to ensure a successful competitive market for workplace pensions [...]. If the main structural barriers were removed [...] and disclosure was improved to allow ease of quality and charge comparison, workplace pensions would be able to function correctly and in the best interests of all parties in the market.’
>
> **Royal London**

15. Other respondents, however, argued that there were no alternatives to a default fund charge cap, primarily because of the principal-agent issue identified by the OFT. They did agree, however, that any suggested alternatives could be introduced alongside a cap to help improve the quality of schemes more generally.

> ‘The alternative to charge capping is to rely on the market to deliver good outcomes, but there is no evidence that this will work. The demand side is very weak with many disengaged employers and disempowered members so traditional theories of good market practice and the impact of effective competition are not at play. There is no evidence that the employer will take action on the basis of more transparent information about charges to switch schemes. That, however, should not be seen as an argument against the need for clear and standardised presentation of information about charges as a good thing in itself.’
>
> **TUC**

> ‘A charge cap or benchmark is absolutely the right way to ensure members receive value for money. Strong governance and the enforcement of the Regulator’s recently published DC code of practice (including the need to provide formal governance statements) is also essential but not an alternative.’
>
> **Legal and General**

Possible unintended consequences of a default fund charge cap

16. In its market report, the OFT stated that the introduction of a charge cap could result in unintended consequences: ‘Set too high, a cap can become a target for providers. Set too low, a cap can create incentives for providers to lower quality and/or impose charges elsewhere.’[16]

17. In the consultation we sought to gain a better insight into the potential unintended consequences and assess their likelihood. In particular we wanted to understand how employers and providers would respond to a default fund charge cap, whether a cap would create unmanageable solvency requirements for providers, and what behaviour a cap might drive in investment management.

Provider and employer behaviour

18. Responses to the consultation generally agreed that the risk of the ‘levelling-up’ of charges following the introduction of a default fund charge cap was very low – many pointed out that after the introduction of the stakeholder cap at 1 per cent, a number of providers continued to offer GPPs below this level. Other responses stated that providers would be wary of losing schemes to competitors if they did level-up.

> ‘We do not believe that charges will be ‘levelled-up’ in response to a cap as commercial pressures on providers, and pressure from the Government-backed NEST scheme will keep charges low.’
>
> **B&CE**

19. Many responses stated that the timing of any default fund charge cap was very important, in particular with regard to how the cap interacts with the wider automatic enrolment timetable. A cap will oblige those employers who have already staged to review the scheme they have put in place for automatic enrolment – if the default fund charge is in excess of the cap’s level, the employer will have to re-negotiate the scheme with their provider; if the provider refuses to lower the charges, the employer will have to find another provider and write a new scheme.

[16] Office of Fair Trading (OFT), 2013, *Defined contribution workplace pension market study*, OFT 1505, Crown, p162.

The number of employers looking either to rewrite their scheme or find a new scheme, when combined with the work underway to confirm terms for those employers still to go through automatic enrolment, could create resource difficulties. In this scenario, providers may have to turn employers away, not because they are commercially unviable, but because they simply don't have the capacity to deal with them all. This is an issue we deal with later in the section on timing.

20. Additionally, some responses argued that, following the introduction of a default fund charge cap, certain providers would withdraw from the small and medium-sized employer market, as it may no longer be commercially viable for them. Furthermore, a default fund charge cap may act as an entry barrier to new providers, which, combined with the possible withdrawal of some providers, may result in an oligopoly.

> 'The DC market has already seen several large participants withdraw from the workplace pensions market, due to the squeeze on margins from servicing lower salaried workers. We do see issues for the DC market if a cap is introduced at a level that could act as a barrier to entry. The DWP should ensure that the cap that is introduced does not promote imperfect competition by introducing barriers to entry.'
>
> **Now:Pensions**

21. Another theme that emerged in several responses was the risk of more frequent 'employer charges'. Often providers offer middleware services[17] to employers free of charge, and build the cost of these into the members' charges. Following the introduction of a default fund charge cap, providers may shift responsibility for these costs onto employers. This could in turn result in a situation where employers are reluctant to switch schemes, as this would involve additional cost. However, as other respondents suggested, it may not be fair for the members to have to cover such costs, since they relate to the employer's legal duties.

> 'An unintended consequence of the introduction of a charge cap would be that the market became very 'sticky'. This would arise because of the greater upfront charges and additional employer fees for less proficient smaller employers. Such employers having faced significant upfront charges would be very concerned to avoid incurring them again due to switching, even though members' interests might indicate otherwise.'
>
> **The Society of Pension Consultants**

22. As for employers' reactions to a default fund charge cap, many respondents (including a number of employers approaching their staging date), suggested that there would be a significant degree of frustration amongst those employers whose chosen schemes fell foul of charge controls – these employers would either have to re-negotiate terms with their provider, or set up a new scheme, both of which could have a financial impact. The result may be that employers who had previously engaged with pensions no longer take as active an interest in their workplace pension as before, instead doing the absolute minimum necessary.

> 'We believe organisations that have already done the right thing by their staff should be left alone to manage their own affairs, rather than told to replace a scheme we already feel is fit for purpose and being swept into new legislation because some schemes in the UK fall outside a charge cap.'
>
> **Sabio Limited**

[17] In its report on value for money, the Pensions Institute defines 'middleware' as 'the IT systems that integrate the employers' payroll system with the auto-enrolment duties to enrol employees and to pay the correct level of contributions.' It explains that middleware is often provided free of charge to employers, as the cost is built into the members' charges instead. The report questions the fairness of this, suggesting that perhaps it undermines value for money.

23. Some respondents did suggest that, as a positive consequence, a default fund charge cap may oblige more employers to review their scheme, which could result in changes to the scheme in terms of its quality and governance, in turn leading to better member outcomes.

> 'The introduction of a cap will prompt employers (and trustees) to review, and to better understand, current charges if it is not currently part of their ongoing governance.'
>
> **Lane Clark and Peacock**

Solvency Requirements

In the charges consultation we asked: What impact will a charge cap have on the capital reserves pension providers need to hold under: a 0.75 per cent or equivalent cap? A 1 per cent or equivalent cap?

24. Because of the specialist nature of this question, only a small number of responses were able to offer an answer. These responses explained what impact a cap might have, both under the current regime of Solvency I, Pillar 1 (with the added constraints of Pillar 2 of the Individual Capital Adequacy Standards) and under Solvency II, which will be introduced on 1 January 2016.

25. Generally respondents agreed that the impact under Solvency II would be less significant than under Solvency I, and would depend on the extent to which employers use existing schemes to comply with automatic enrolment.

Solvency I, Pillar 1

26. Usually unit-linked business has a capital requirement of 25 per cent of net relevant administration expenses. When an insurer cannot increase charges, there is an additional capital requirement, typically 1 per cent of assets under management. The amount required would be the same regardless of the level of the cap – estimates from the responses put the total capital requirement increase for the whole industry at approximately £1 billion, which could cost an estimated £60 to £90 million per year.

27. Under Pillar II of the Individual Capital Adequacy Standards,[18] however, insurers already face a capital expense risk, because the constraints of increasing charges are recognised. The impact of a cap under this regime would be less significant than under Pillar 1, as many insurers are already obliged to hold capital reserves. The new requirements would therefore vary depending on the level of the cap and the particular circumstances of each insurer.

[18] 'The PRA comes to a view, currently through the use of Individual Capital Adequacy Standards (ICAS), on whether any adjustments are necessary to the overall required level of capital the insurer should hold to reflect adequately the particular risks it takes. The PRA's view is informed by the insurer's own assessments, but it also reflects its views of the risks to its objectives. It has particular regard to the idiosyncratic risks facing the insurer, in the context of its business model, the wider circumstances or external context, and the effectiveness of the insurer's governance and of its management of the risks it faces. Following the implementation of Solvency II, the PRA will carry out this assessment in a manner consistent with the provisions of the Directive.' Bank of England, Prudential Regulation Authority (PRA), April 2013, The Prudential Regulating Authority's Approach to insurance supervision, p30.

Solvency II

28. Most respondents agree that under Solvency II the impact of a cap on capital reserves would be less significant than under Solvency I – one estimate suggests that the impact of a 1 per cent cap under Solvency II would be around 80 per cent less than that of Solvency I. The same estimate suggests that the impact of a 0.75 per cent cap would be around 40 per cent less under Solvency II than under Solvency I.

29. We have shared the evidence sent in regarding how a default fund charge cap would affect solvency requirements with the Prudential Regulation Authority (PRA), and their analysis suggests that the impact will vary depending on the timing of a cap, and the extent to which existing schemes are used to comply with automatic enrolment. According to their analysis, the estimated £1 billion increase in capital requirements across the industry would represent an increase of 1.8 per cent on current requirements.

30. It is important to note, however, that this estimate assumes a static market – namely, that following a cap, insurers do not alter their current behaviour. As we have noted in this chapter, most insurers will not remain insensitive to the rule changes, and some are likely to withdraw from what they see as the less profitable areas of the market. This means that any estimate about an increase in capital requirements will not be certain, as it cannot take into account these behavioural changes. Indeed, owing to likely behaviour changes, the increase in capital requirements may be lower than those assuming a static market.

The impact of a default fund charge cap on scheme quality, including investment strategies

In the charges consultation we asked: What evidence is there on the link between scheme charges and scheme quality or investment returns?

31. A number of responses suggested that a default fund charge cap may result in a 'levelling-down' of scheme quality, as employers will focus solely on the level of charges in a scheme, as opposed to its quality or suitability.[19] This could result in providers reducing the number of additional features they offer members, for instance bespoke communications, strong governance, financial education, and advice services. However, other responses argue that many of these features are superfluous when it comes to 'double defaulters' (several respondents used this term to refer to those who have exercised no active choices, having been defaulted, through automatic enrolment, into saving in the default fund) – many of these savers are unlikely to engage with their pension and as such should not be paying for such services. Others argue that quality can be provided at a low price, and the most important feature of this is governance – where excellent quality governance is in place, charges are often lower than average.

> 'If a scheme is a well governed, quality scheme, charges are likely to be competitive and lower than the suggested caps.'
>
> **William Hill Pension Trustee Limited**

[19] See chapter one for our proposals on scheme quality. This forms part of our holistic approach to address all aspects of a workplace pension.

32. Many responses, in particular those from asset managers, suggested that an unintended consequence of a default fund charge cap could be that default funds will no longer be able to build active management into their investment strategies. According to some responses, more innovative (and more expensive) actively managed funds can deliver higher returns net of fees than cheaper, passive alternatives. Several responses referenced the same fund as an example – the Invesco Perpetual High Income Fund, managed by Neil Woodford – which has consistently outperformed the market since 1988.

> 'There are a number of active managers who have consistently delivered higher levels of performance for their investors. One example is Neil Woodford, of Invesco Perpetual, who manages £30 billion of money on behalf of retail investors, including pension savers. He has turned £1,000 invested in 1988 into £21,400 today, compared to the £9,200 returned by the UK market he invests in. This fund costs 1.25 per cent per annum.'
>
> **Hargreaves Lansdowne**

33. Many responses also stated the importance of diversifying risk by accessing 'alternative' asset classes like property or infrastructure that are often more expensive than equities or bonds. Such responses pointed to the success of diversified growth funds, although many responses believed that these would still be available under a default fund charge cap for certain schemes. Furthermore, a number of responses argued that more expensive funds often include enhanced features, for instance guarantees, smoothing, life cover, and disability or incapacity benefits, which help improve the member journey. According to some respondents, a default fund cap may make these kinds of features untenable. We consider later in this chapter whether scheme members should be defaulted into paying for these additional services, some of which would in fact mean that schemes could be classified as defined benefit under the Pensions Act 2011, and would not therefore be in scope of a cap on charges in the default funds of money purchase qualifying schemes.

34. On the other hand, a significant number of responses stated that while certain, more expensive actively managed funds may outperform the market, the evidence points to the fact that overall, more expensive strategies do not result in higher returns net of fees than cheaper, more passive alternatives. Indeed, according to evidence provided, where out-performance is delivered through active management, the whole of this superior benefit may be extracted by fund managers via fees, leaving nothing for members.

> 'In Blake *et al.* (2013a) we have examined the performance of UK equity unit trusts over the period 1997-2008, both before and after allowing for management fees by comparing two alternative bootstrap methodologies. We find that the average equity mutual fund manager has an out-performance in terms of gross returns after allowing for market timing of 16 basis points which is marginally significant, but is unable to deliver out-performance once allowance is made for fund manager fees. Average out-performance using net returns is a negative 10 basis points, which is insignificantly different from zero. We find that 95 per cent of fund managers on the basis of the first bootstrap and almost all fund managers on the basis of the second bootstrap fail to outperform the zero-skill distribution net of fees; and both bootstraps show that there are a small group of 'star' fund managers who are able to generate superior performance (in excess of operating and trading costs), but they extract the whole of this superior performance for themselves via their fees, leaving nothing for investors.'
>
> **Professor Ian Tonks**
> **University of Bath, School of Management**

35. Many responses dismissed the assertion that a cheaper investment strategy will result in lower returns. These responses argued that if you cannot guarantee that a higher charge will result in a higher return, it is not right to automatically enrol savers into such high charging schemes. Some referred to 'actively passive' investment strategies that regularly review asset allocation, and are available at a much lower cost than active alternatives. It seems that paying more cannot guarantee a better return, but the cumulative impact of higher charges is guaranteed to result in a smaller pot if these returns do not materialize.

> 'We do not subscribe to the view that you get what you pay for in fund management [...] The evidence, such as it is, suggests that the more a member pays, the less the retirement pay-out. This underpins our support for a charge cap.'
>
> **Pension PlayPen**

36. Many respondents also felt that it was inappropriate for people to be defaulted into schemes where extra features, such as life cover or annuity broking, were included for an additional charge. They argued instead that these are non-standard add-ons that people should choose to pay for. Many responses therefore recommended the introduction of standards which would define what a value-for-money default fund should look like, with any extra features strictly optional.

> 'Members who are double defaulted into a particular fund due to automatic enrolment need a simple, inexpensive product that meets certain basic standards rather than a more expensive one with enhanced features; people who want such products can choose to pay more for them but they should not be double defaulted into them.'
>
> **Prospect**

37. This argument is supported by analysis in the recent Pensions Institute paper on value for money in default funds, which stated that the impact of charges is more significant than that of investment strategy when it comes to the income replacement ratio at retirement.[20] It is the view of many respondents, therefore, that members should have to opt into more expensive funds if they feel this is the right option for them, rather than being defaulted into such strategies.

> 'Investment returns are undoubtedly important and out-performance would be worth paying for. However, this cannot be guaranteed, unlike charges which are paid regardless of return and are also guaranteed to have a negative effect on total returns. Therefore it is vital that control of charges is prioritised within a scheme's default fund.'
>
> **Citizens Advice Bureau, Northern Ireland**

[20] Harrison, Blake and Dowd, VfM: Assessing value for money in defined contribution default funds, January 2014, The Pensions Institute, pp44-45.

38. Additionally, some responses raised concerns about how pension assets are used to derive revenues from activities like stocklending,[21] interest income[22] and foreign exchange transactions, the profit of which may not be equitably shared with members. Some respondents believed that, following a default fund charge cap, investment managers may look to make greater revenues from such activities – for these respondents, this potential issue justified arguments that transaction costs should also be included in a cap.

> ‘There is a risk that if all charges are not included in the index cap, fund managers will look to alternative sources to increase revenue for example stock lending and this will be very difficult for fiduciaries to keep track of.’
>
> **Now:Pensions**

The level of any default fund charge cap

In the charges consultation we asked: Which of the three options for a cap is the most appropriate? (1 per cent, 0.75 per cent, or a comply-or explain of 0.75 to 1 per cent)

In the charges consultation we asked: Under option 3, what conditions would you expect for schemes levying a higher charge?

A charge cap of 1 per cent of funds under management

39. Of those respondents in favour of a default fund charge cap, few favoured the proposed 1 per cent cap. The main reason for discounting this option was the fact that the stakeholder cap came in at this level over ten years ago, and since then charges have fallen[23]. A 1 per cent cap would not lead to any significant savings, and could even increase the risk of charges being ‘levelled-up’.

> ‘A 1 per cent cap is no lower in practical terms than the standard stakeholder price cap and will only have minimal benefits for consumers, less than 3 per cent of workplace pensions currently levy an AMC of more than 1 per cent a year.’
>
> **Which?**

40. The respondents who preferred a 1 per cent default fund charge cap suggested that a cap set any lower, for instance at 0.75 per cent, would lead to disruption in the industry, as many schemes would have to be rewritten. They also expressed a view that a 1 per cent cap would allow providers to continue writing quality schemes for small and even micro employers, which generally are less profitable and therefore harder for providers to take on.

[21] One respondent stated that in 2011, 26 per cent of pension funds actively participated in a stocklending programme, lending an average of 3 per cent of the portfolio. The mean return to the 41 pension funds that provided data on the returns received in 2011 was 104 basis points (bps), with a range of 3 bps to 404 bps.

[22] The same respondent quoted figures showing that around 30 per cent of revenue generated by Custody Banks is from interest income on cash held. This cash is largely pension fund cash held in custody, a service for which the Custody Bank receives a fee of around 0.9 bps. The custody fee is comparatively tiny, and usually viewed as a loss-leader. The respondent in question examined 1100 Local Authority Pension Fund annual reports and found very few references to the revenues raised from interest income being shared with pension schemes, even though net interest is around 1.3 to 1.4 per cent.

[23] For new members from 6 April 2005, the charge cap is 1.5 per cent per annum, reducing to 1 per cent after 10 years of continuous membership in the scheme.

> 'An example of the charges collected by a provider administering pensions at the legislative minima for contributions and a 1 per cent cap are as follows:
>
> Employee earning £20,000 paying AE minimums i.e. 2 per cent of banded earnings i.e. (£20,000 – £5668) * 2 per cent = £286.64 p.a. = £23.89 per month
>
> With a 1 per cent AMC, charges taken between Oct-13 to Oct-17 would be:
>
> Oct-13 – Oct-14 = £1.50
>
> Oct-14 – Oct-15 = £4.40
>
> Oct-15 – Oct-16 = £7.20
>
> Oct-16 – Oct-17 = £9.90
>
> £23.00 cumulatively over the first 4 years
>
> This level of charge would barely cover costs 4 years after membership started. A charge cap of less than 1 per cent would discourage providers from tendering for this type of business and restrict choice within the market.'
>
> **Aviva**

A charge of 0.75 per cent of funds under management

41. Many respondents expressed support for a default fund charge cap at this level, saying that this reflected the fact that charges have fallen since the stakeholder cap was introduced in 2001. While some pointed out that many default funds charge significantly less than 0.75 per cent, others recognised that it was important to leave some margin to enable a variety of investment offerings from providers, in particular to smaller employers.

> 'A cap of 0.75 per cent, while being above the current average, should allow for continued viability of smaller schemes to maintain wider choice in the market.'
>
> **Citizen's Advice Bureau, Northern Ireland**

A two-tier 'comply or explain' cap of 0.75 per cent and 1 per cent

42. Some respondents supported this option, although a significant number of those in support argued that employers who could explain why charges exceeded 0.75 per cent should be able to charge above 1 per cent if it was in the interests of the members. Many felt a comply-or-explain cap was the most appropriate, because it would protect members of schemes where there was a disinterested employer, but would allow more engaged employers to put in place a more expensive scheme if this was right. Such flexibility would allow innovation to thrive. Suggested conditions for the 'explain' part of the cap included:

- an employer contribution that is significantly higher than the statutory minimum of 3 per cent
- added features that markedly improve member outcomes, for instance one-to-one support sessions encouraging members to increase their contributions, annuity broking, and other additional customer services
- a more innovative investment strategy, that is more expensive but delivers higher returns, net of fees, than cheaper alternatives.

43. However, as other respondents pointed out, a charge cap would only be on the default funds of qualifying schemes. As such it would not preclude providers or employers from designing more innovative and expensive funds, which members could opt into if they wished.

> 'It may be reasonable for members to choose a scheme that costs up to 1 per cent due to the possibility of higher returns. However it is not appropriate for double defaulters to be placed in this kind of fund. A simple, cheap product is more appropriate for the situation under consideration here.'
>
> **Prospect**

44. Furthermore, many respondents (including a number of those in favour of the comply-or-explain cap) pointed to the practical difficulties of implementing this kind of cap – would the regulator have enough resource to deal with the amount of explanations that would be sent its way? Moreover, what would the consequences be when a higher charging scheme did not deliver its expected higher performance net of fees, and would the regulator have some liability for having signed off the scheme? Many responses concluded that comply-or-explain was a good idea in theory, but perhaps should be something introduced later, once there was a greater understanding of the automatic enrolment landscape and its interaction with a default fund charge cap.

The design and application of a default fund charge cap

45. The OFT explained that one of the reasons for the market's weak buyer-side was the complexity of pensions. For instance, they found that for schemes set up before 2001, there can be 18 different names for and configurations of charges members can pay. This complexity can make it difficult to compare schemes and to understand the level of charges members will be subject to. We address this issue in Chapter 6 of this paper, where we propose a new wave of transparency for workplace pension charges.

46. The complexity of pension charges becomes relevant again when we begin considering the design of a default fund charge cap. It is important to find a way of applying the cap that best captures all member-borne charges and does not leave room for innovative avoidance mechanisms. For this reason, it is necessary to introduce a cap alongside measures to improve governance, transparency and disclosure. Furthermore, in a market place that includes single as well as combination charging structures, it is vital that the cap is designed in such a manner that broadly equivalent outcomes are delivered by both structures.

47. Many responses suggested that designing and applying the cap may be difficult, because of the complexity and variety of charges in the DC workplace pensions market. Furthermore, other responses raised concerns that if not properly designed, it could result in a 'water-bed effect' – additional costs may pop up in areas not covered by the cap. As such, some responses suggested that legislation should specify what charges the cap excludes, as opposed to trying to list what it should include.

> 'Where some costs are currently covered within scheme charges, these costs will not necessarily be eliminated simply as a result of the introduction of a charge cap. Like pushing down on a water-bed, the result will be for those costs to reappear elsewhere.'
>
> **Hargreaves Lansdown**

48. As for how to approach the issue of capping schemes with a single AMC as well as those with combination charging, most responses stressed the importance of having both types of structure treated equivalently. A number of responses recommended that the Government produce a mechanism for comparing these different forms of charging structures, which would enable an appropriate cap to be set for them. One response suggested using a calculation akin to the 'reduction in yield' to measure whether a scheme's charges are appropriate:

> 'Our proposed method is based on creating an index that adopts a charge cap of 0.75 per cent as a benchmark and schemes are ranked relative to this AMC. We then take an average of the Pot lost due to charges, weighting each scenario equally. We then utilise the 0.75 per cent AMC as the maximum level of charging ranked at 100, and schemes are ranked accordingly. In order for schemes to be classified as suitable for auto-enrolment they must score below 100. This method has several advantages over publication of an unqualified charge cap over a single year and provides a simple method for schemes to show that they comply with the DWP's legislation.'
>
> **Now:Pensions**

In the charges consultation we asked: Should transaction costs be included in a cap?

49. Another recurrent theme included in the responses to the consultation was the question of transaction costs, and whether these should be included in the scope of a default fund charge cap. There was broad agreement that genuine transaction costs should be excluded from a cap, as these are not a charge, but rather an operating cost linked to making an investment.

> 'Transaction costs are necessary in order to obtain any form of investment return. They may vary considerably across asset classes, across markets within the same asset class, and across time depending on market conditions. Furthermore, some aspects of costs, such as brokerage and transaction taxes are explicit and much easier to quantify than others. Bid-offer spread is an implicit cost, forming an inseparable part of the investment return. The challenges in quantification are widely recognised.'
>
> **The Investment Management Association**

50. The view of many respondents was that including transaction costs in a cap could be damaging in certain circumstances. Sometimes trades are absolutely necessary for the good of the portfolio, for instance during the financial crash of 2008. If genuine transaction costs were capped, a manager may be unable to trade or only able to do so at the firm's expense. As a result the portfolio could take a huge hit, reducing investment returns to the members' pots.

> 'Sometimes a manager needs to trade no matter what [....]. Market impact is linked to manager behaviour and while I would expect that most default funds are fairly standardised, we should not be telling managers how to manage their portfolios. You will end up dictating their investment strategy and implementation style and that is not a good idea'
>
> **Pension Playpen**

51. Furthermore, as many responses pointed out, there is still insufficient transparency in the area of transaction costs to give any indication of what they amount to. In their view, applying the cap to cost elements that are uncertain is highly problematic. However, many other responses raised concerns that, following the introduction of a default fund charge cap, excessive costs may be shifted onto members through an inflation of transaction costs, even where these costs do not qualify as such. Therefore, it is important that only genuine transaction costs are excluded from the cap.

52. One response suggested using an approach called ‘total charges earned’, which would cap all charges for which a manager or third party receives a direct payment when servicing the investment portfolio, or in other words the costs that are directly billable. This would mean that only those costs inherent to transactions, but not invoiced to the manager, would be excluded from a cap, reducing the likelihood of the ‘water-bed effect.’ This approach would rely on the introduction of strict disclosure requirements for transaction costs, and would complement efforts to benchmark schemes according to these costs.

In the charges consultation we asked: Are there any specific services that may need to be excluded from the cap to avoid constraining innovation, for example, in respect of annuity broking services?

53. There was general agreement from respondents that the default fund charge cap should only cover the essential services offered by a default fund. Any other services, which members could opt into if they so wished (but should not be charged for by default), should be excluded from a cap.

54. The most commonly mentioned example of opt-in services to be excluded was at-retirement services, such as annuity broking or income drawdown. A significant number of responses explained that turning a pension pot into a retirement income can be expensive and complex. As such, these respondents felt that it was important that members could access affordable help which could be paid for during the accumulation period. They argued that this should not be a default service, however, otherwise members could have to pay for a service they do not ultimately use, as they may have transferred to a different scheme prior to decumulation.

The timing of a default fund charge cap

55. In the consultation paper we suggested the following dates for the introduction of a default fund charge cap:

- **April 2014**, for all employers staging from April 2014 onwards
- **April 2015**, for all employers who staged between October 2012 and March 2014

56. The rationale behind the suggestion for timing was that from April 2014, small and medium sized employers are due to start staging. Evidence shows that these employers usually find it more difficult to negotiate low charges for their workplace pension schemes, as opposed to the larger employers who have already staged. As such, we wanted to consider the case for introducing protections ready for this group’s staging date. However, we also wanted to be sure that introducing the cap at this stage would support the policy of automatic enrolment, and not cause any disruption.

Responses to the consultation

In the charges consultation we asked: Do the proposed implementation dates for a cap provide sufficient time for employers to review and put in place compliant arrangements?

57. Many responses recognised the need to put protection in place for those people working for smaller employers due to be automatically enrolled this year. While employers who staged between 2012 and 2013 have negotiated charges that are significantly below the average level,[24] it is possible that when smaller employers start automatic enrolment, they will not have the same success. A number argued that the policy of automatic enrolment should perhaps have been introduced with a charge cap from the very start.

58. However, a significant number of responses expressed the view that the proposed implementation dates would not give employers enough time to get compliant arrangements in place. A number of responses referred to TPR's advice to employers to begin work on setting up a scheme for automatic enrolment 12 to 18 months in advance of staging. If a cap were to be introduced in April 2014 for all new stagers, this could cause a number of problems.

59. Many of the employers due to stage in 2014 will have already started putting arrangements in place for their scheme. These may not be compliant with the new rule changes, in which case the employer would have to either renegotiate terms with the provider, or attempt to find a new scheme at short notice.

> 'There is a conflict between doing what is right – setting and mandating a quality standard against which all pension charges and features can be compared – and putting this in place ready for April 2014.'
>
> **The Whitgift Foundation**

60. Furthermore, many employers may be planning to use an existing scheme to comply with automatic enrolment, some of which are likely to charge above the level of the cap. Resource in the industry is finite, and providers can only produce a certain number of schemes and scheme rewrites at any one time. It is possible that if a default fund charge cap is introduced with too short a transition period, demand will outstrip supply, and some employers may not be able to secure terms with a provider in time. A number of responses suggested that this kind of upheaval, coming in the middle of the automatic enrolment programme, could cause disruption or delay the policy of workplace pension reform.

> 'Whilst the market certainly has the products to cope with the proposed implementation dates, there may be capacity issues (particularly, if the measures were to apply to existing schemes being used for auto-enrolment). If providers choose not to offer particular products on the proposed charging basis (or worse, to withdraw support for existing products altogether), employers may find themselves with little choice but to go to master trusts. This would likely lead to bottlenecks, concentration of employers with too few providers, and a higher risk of failure or non-compliance with auto-enrolment duties.'
>
> **KPMG**

61. A number of responses argued that introducing measures too quickly could cause detriment to savers: in this scenario, employers looking to secure terms to replace their non-compliant scheme would not consider all the factors that make up a scheme, focussing on the charge level alone. It is important, however, that when putting a scheme in place, the employer considers all elements, and not just the charge.

[24] The most recent DWP charges survey found that the largest trust-based schemes had an AMC of 0.42 per cent, while the largest contract-based schemes had an AMC of 0.51 per cent. DWP, November 2013, Charges in defined contribution pension schemes, pp.4-5.

62. Many responses therefore expressed the view that the potential detriment that may result from introducing the default fund charge cap in an unsustainable manner would far outstrip the detriment faced by savers from slightly delaying the cap.

> 'The level of charge in the short term is almost irrelevant for members being automatically enrolled [...] The figures demonstrate that over the first three years, the cumulative difference in charges between a charge of 0.75 per cent and 1 per cent is £4.64.[25] In the first year, it is just 52p.'
>
> **Standard Life**

Government proposals on a default fund charge cap

Overview of measures

63. The Government's analysis of the evidence received in response to the charges consultation, alongside the OFT's analysis of market weaknesses, shows that it is appropriate to introduce a charge cap on default funds of qualifying schemes to prevent savers from incurring high charges. To support the implementation of automatic enrolment, we propose introducing the default fund charge cap alongside other measures, as follows:

- **April 2015:** a 0.75 per cent default fund charge cap on funds under management, excluding transaction costs, for all qualifying schemes. Any commission or AMD structures must not take member-borne charges above this level. Consultancy charging will be banned in all qualifying schemes. This is outlined in more detail below.
- **April 2016**: AMD structures and member-borne commission banned in all qualifying schemes (see Chapters 4 and 5).

64. Following further work with stakeholders on the detail of this approach, we will bring forward regulations to introduce these measures, which will then be subject to Parliamentary approval.

65. The default fund charge cap will ensure that, from April 2015, no one who has been automatically enrolled into pension saving without exercising any choice, and is therefore in the default fund, will experience charges above 0.75 per cent of funds under management. This cap will include all member-borne deductions relating to scheme or investment administration and therefore only exclude transaction costs. We set out later in this chapter how this will apply to schemes with combination charge structures.

66. In parallel, we will ban a number of charging practices which are inappropriate in the context of an increasingly flexible labour market and automatic enrolment, such as commission and AMDs. In order to give employers time to make adjustments to their schemes, the ban will apply from April 2016 and, in the meantime, any charges relating to these features must not take any member's charges above the level of the cap when it is introduced in April 2015.

[25] For a member earning the national average of £24,700, automatically enrolled on 1 April 2014, with an assumed salary escalation of 2 per cent, and fund growth of 5 per cent per annum.

67. These measures will be accompanied by the introduction of requirements for schemes to report on costs and charges, in line with the new quality standards, from April 2015, and thereafter to disclose all costs and charges (both administration and transaction costs) in a standardised, line item format to trustee boards and IGCs. This will ensure full comparability between schemes on a consistent basis (see Chapter 6 for further detail on our transparency proposals).

68. Following the introduction of both the charge controls and disclosure measures, the Government will consider in 2017 whether some or all transaction costs should be included in the default fund charge cap and whether the level of the cap should be lowered.

The case for a default fund charge cap

69. A charge cap on default funds used in qualifying schemes will provide important protection for those savers who may not have made active choices about their workplace pension scheme. While many employers who have already staged may be enjoying charges under the 0.75 per cent limit we propose, there is no guarantee that those working for smaller and medium-sized employers will enjoy the same outcomes, particularly given that the DWP Charges Survey 2013 found that scheme size was a key factor in the level of charges experienced by scheme members[26]. Savers who work for employers of all sizes should benefit from low and fair charges.

70. Evidence we have received suggests that providers and schemes should still be able to provide a good default fund offering under a 0.75 per cent cap. It is also important that scheme members should only be defaulted into paying for services from which they clearly benefit. As such, they should not be charged for costs and services applicable to previous distribution models that relied more heavily on communications and marketing to encourage enrolment. Nor should members be defaulted into paying for more expensive investment strategies, where there is little evidence that these consistently benefit members, or non-essential services which they may not make use of (for instance annuity broking).

71. Some stakeholders have expressed concern that a charge cap could prohibit certain providers from offering schemes to smaller employers. The Government's analysis indicates that a 0.75 per cent default fund cap would not significantly change current market dynamics – we understand that many providers do not intend to operate actively in this space anyway, leaving smaller employers to be picked up by providers who do intend to focus on this section of the market. Moreover member interest is paramount and the Government has a responsibility to protect all scheme members, regardless of employer size.

72. A small number of responses to the consultation suggested that a cap should be set at 0.5 per cent of funds under management. While we share their ambition for low charges, moving to a lower default fund cap at this point would present a higher risk of unacceptable market disruption. Furthermore, setting the cap too low could excessively limit the varieties of investment offering – in our view it is important that, below the level of the default fund cap, there should still be innovation and competition. However, this will be kept under consideration and the level of the cap will be examined in 2017.

[26] The DWP Charges Survey 2013 found that members of smaller schemes (12 to 99 members) paid a higher than average AMC in both trust-based and contract-based schemes, of 0.91 per cent. In contrast, members of larger schemes (1,000 members or more) paid an average of only 0.42 per cent in trust-based and 0.51 per cent in contract-based schemes. DWP, February 2014 Landscape and charges survey 2013: charges and quality in defined contribution pension schemes, p59.

73. The Government understands that the timing of the introduction of the default fund charge cap is important and changes must support the wider automatic enrolment programme. That is why, based on responses to our consultation, we decided to introduce the default fund charge cap from April 2015 and not April 2014, to give employers sufficient time to plan and prepare their provision under the new charge controls.

74. Furthermore, the original consultation proposals intended a two-stage implementation: those employers who had not yet begun automatic enrolment were to comply with the cap first, with those employers who had already gone through automatic enrolment complying a year later. Responses to the consultation, however, argued that simplicity was vital, and that this two-stage implementation risked confusing employers, who may as a result fall foul of the new rules. Additionally, many responses questioned the sense in giving those who had already staged additional time to make the necessary changes, since this group is comprised of the larger employers, who are more likely to have the resource and expertise to make any adjustments. Finally, as the OFT argued, large employers who have already gone through automatic enrolment are less likely to have high charging schemes, and as such do not need an additional year to make changes.

75. Given this evidence, the Government has decided to introduce the default fund charge cap for all employers at the same time. This will ensure that the implementation process is simple and easily understood, and that all savers, regardless of the size of their employer, are protected at the same time.

The design of the default fund charge cap

76. In its market study, the OFT found evidence of a myriad of different charges in workplace pensions, with approaches to and definitions of administration charges varying between schemes and providers. In order to introduce a default fund charge cap, the Government will therefore need to define a common and consistent approach to those member-borne charges to be included in the default fund cap.

77. The default fund charge cap will encompass **all member-borne deductions paid to the pension provider or another third party, excluding transaction costs**. This principle of member-borne deductions will include everything taken as a flat fee or percentage from members' funds under management, contributions, or investment returns, specifically related to the administration of assets (both general scheme administration and investment administration).

78. This measure of member-borne deductions (or MBD) will be used in place of the current Annual Management Charge (AMC) measure, as this differs according to the provider and scheme in question. The MBD will provide a new and consistent basis on which to gauge scheme charges. It will be slightly broader than some current AMC definitions. From April 2015 any such deductions taken in the manner and for the purpose described above must not exceed 0.75 per cent of members' funds under management.[27]

79. There is a clear difference between member-borne deductions – to be capped – and transaction costs – to be excluded from the cap. The MBD measure relates to the cost of administration (general scheme and investment administration) which can be identified in advance and relates to services such as administering the pension scheme, keeping records, complying with regulations, communicating with members and designing the investment strategy. Transaction costs, on the other hand, are the variable trading costs a scheme incurs when buying, holding and selling underlying investments. These costs cannot be predicted at the beginning of a reporting period as they are dependent on the level and nature of trading undertaken by a scheme, which in turn is influenced by market conditions.

[27] We set out later in the chapter how this will apply to schemes with combination charging structures.

80. To illustrate this distinction, we have devised the following table with a **non-exhaustive list of examples** of costs and charges which we would expect to be included and excluded.

In scope of the default fund charge cap on MBD: all member-borne deductions relating to scheme and investment administration paid to the pension provider or another third party
Set-up fees
Scheme-level entry fees; both on entry into, or on transferring a pre-existing pot into, scheme
Scheme-level exit charges
Fees for non member-initiated switching of funds
Fees paid to governance bodies, e.g. trustees, IGCs and others
Governance charges and expenses, e.g. trustee insurance
Fund or investment management fee, payments to investment consultants and administrators, including underlying and separate in-house fund managers, performance fees etc
Ongoing charges for underlying funds in investment portfolio, e.g. fee for holding units in a UCITS fund
Ongoing costs for running of scheme, e.g. IT, office and staffing costs, data management and record keeping
Registration and regulatory costs and fees
Payments to providers of professional services and other third parties or fees for related services, e.g. administrators, advisers, actuaries, lawyers, auditors, audit and legal fees for investment, accounting fees, valuation services
Depositary fees and fees to the custody bank
Banking fees
Costs of member communication services, e.g. statement costs, website, printing/ posting accounts
Costs of capital requirements
Unrecoverable VAT
Payments to shareholder service providers
Platform fees
Commission (pending ban from April 2016)

Excluded from the default fund charge cap on MBD: transaction costs: the variable costs associated with buying, holding and selling the underlying investment instrument
Brokerage commission and fees
Soft commission services included in brokerage fees, e.g. research costs
Transaction taxes, e.g. stamp duty and non-reclaimable withholding taxes on dividends
Spreads, e.g. bid-offer on bonds, FX (and associated costs such as commission)
Other charges embedded in the transaction price, e.g. payments incurred through financial derivative instruments
Entry fees, other initial charges and exit fees for investment in underlying funds
Deductions of expenses or fees from profits such that they are not shared equally with members, e.g. in relation to activities such as stocklending, interest income, foreign currency exchange

81. This distinction between costs related to scheme and investment administration, which will be capped in default funds, and transaction costs, which will be excluded from the cap, will provide a common basis on which to measure and control charges. Moreover, from evidence received in the consultation, we think that many schemes and providers already draw this distinction when allocating deductions made under an AMC definition.

82. Furthermore, in setting out a high level principle underlying the default fund charge cap (that it applies to all member-borne deductions paid to the pension provider or another third party, excluding transaction costs), rather than attempting to detail all of them in an exhaustive list, we are aiming to mitigate the risk of 'waterbed' effects, whereby charges could be hidden under new or false definitions.

83. DWP will work with both stakeholders and regulators on the application of this new definition of MBD to workplace pension schemes, ahead of the introduction of the default fund charge cap in April 2015.

Transaction costs

84. As outlined above, transaction costs will initially be excluded from the default fund charge cap. Although some respondents to the consultation suggested that they should be capped, there was broad consensus among most respondents that they should be excluded, at least for the time being. This was because restricting the ability of asset managers to trade could be disadvantageous to schemes and members.

85. Respondents also highlighted that there is no single consistent definition of, or measure for transaction costs, although developments at a European Union level, such as the new Markets in Financial Instruments Directive (MiFID II), designed to promote 'transparency of trading', may inform these definitions in the longer term.

86. More information is needed to understand the potential impact on investment decisions and fund performance if the default fund charge cap were to include some or all transaction costs. We will work closely both with stakeholders and regulators to ensure that charges are not incorrectly classified as transaction costs to avoid the cap.

87. This work will allow the Government, regulators and industry to together develop standardised terminology relating to charges. This will support the governance and transparency measures (described in Chapters 1 and 6 respectively of this paper) under which schemes will need to report on costs and charges in line with the new quality standards from April 2015 and, thereafter, to disclose all costs and charges (both administration and transaction costs) in a standardised, line item format to trustee boards and IGCs.

88. This will also enable trustees, IGCs, regulators and the Government to gain a clear picture of what transaction costs amount to and how they affect saving outcomes. This will help drive improved competition in the provision of investment services to pension funds and also inform a decision on whether to expand the scope of the default fund charge cap.[28] Amendments to the Pensions Bill, introduced in February and March 2014, pave the way for these measures. The amendments require regulations and FCA rules for the full public disclosure of management and transaction charges incurred by the administration and management of each investment portfolio managed by or on behalf of a workplace scheme.

89. Ensuring greater transparency will also shed light on activities such as stock-lending, interest income, and foreign currency exchange, where profits may not be equitably shared with members – if this profit were to be shared equitably, then members may receive a higher investment return. This practice should therefore be viewed as an additional cost to be made transparent, because it represents a missed opportunity for investment returns, when compared with those schemes where profit is shared equitably. These practices should be clearly disclosed, to drive fairer outcomes for members.

90. Increased transparency will enable the Government to monitor and control transaction costs as part of its wider programme to see fair charges for automatically enrolled savers, ahead of 2017, when it will explore whether the default fund charge cap should be expanded to include some or all of these transaction costs.

Services to be excluded from default fund charging

91. Some respondents to the consultation on charging noted that pension schemes often include what could be termed 'add-on services' – such as wider insurance features – as part of their default offering. These respondents felt that, while such services may be of value to some individuals, they are not suited to the automatic enrolment opt-out system which relies on inertia, and should instead be offered on an opt-in basis as bespoke features of a member's fund. This is because members may be defaulted into paying for a service they do not ultimately use.

92. We agree with this approach and therefore propose that the costs of providing such features should not be borne by scheme members without making any active choice. These individuals should only be defaulted into paying for those essential services without which the pension scheme cannot function – for instance, administering contributions, keeping records, sending out statements to members explaining costs and projections, and designing and implementing the investment strategy – and from which every member benefits. Services which could be viewed as optional should be marketed as add-on features. In accordance with this definition, the costs of providing the following services should not be passed on to members by default (and therefore

[28] Recent years have seen the introduction of various EU laws designed to reform financial markets across Europe. For instance, the Markets in Financial Instruments Directives (MiFID II), introduced in February 2014, will bring about major changes to the dealing and processing of financial instruments. Included in MiFID II is a requirement for UK investment companies to provide consumers with the total cost of investments, including: advisers, product, third party, transaction and platform costs, as well as any other hidden cost elements. EU member states will have to put in place all practices recommended in MiFID II by 2016. We welcome this development and believe it will strengthen and complement our proposals for disclosure and transparency of pension scheme costs and charges in the UK, to be implemented by 2015.

they will not be subject to the default fund charge cap). We will bring forward measures as part of the wider package of charge controls to support this proposal:

- Bespoke pre-retirement services, such as annuity broking
- Rider benefits
- Embedded protection benefits (i.e. disability/incapacity or life cover)
- Guarantees, either of investment performance and/or annuity rates (although in most cases such schemes would be classified as defined benefit schemes under the Pensions Act 2011 and would not therefore be in scope of the default fund charge cap, which applies only to money purchase schemes)
- Loyalty bonuses and other similar benefits

93. We will discuss the application of this principle in the context of wider pensions policy changes with stakeholders, to establish definitively where the boundary between essential default features and valuable add-on services lies.

94. This work will consider add-on services in default funds of money purchase qualifying schemes. The features of Defined Ambition (DA) schemes and DA default funds used for automatic enrolment purposes will be developed separately, as part of ongoing work between government and industry. We intend to publish further detail on this in the forthcoming government response to the consultation on DA.

Pensions flexibility and default fund charges

95. In the current workplace pension system guidance, information and advice is offered in a variety of different ways. Some members are provided with tailored support, some with access to more generic services, and some receive minimal information. Charging practices vary accordingly, with some member-borne charges linked to commission payments to advisers that facilitate advice services. Some of these charging arrangements will be incompatible with the principle of automatic enrolment and will need to be adjusted in the light of proposals outlined in this paper.

96. The new flexibilities announced in the Budget will allow individuals to access their pension savings in the way that suits them. The Government wants to ensure that people are empowered and equipped to make the most of their pension savings and therefore proposes that everyone is offered free, impartial and high quality guidance. To deliver this advice, the Government will introduce a new duty that, from April 2015, pension providers and trust-based schemes must offer to each of their defined contribution members this 'guidance guarantee' at the point of retirement. Consumers will not be charged for guidance delivered within the 'guidance guarantee' framework.

97. The Government is currently consulting on how the guidance guarantee will be implemented, and has asked the Financial Conduct Authority, working with the Money Advice Service, the Pensions Advisory Service, the Pensions Regulator and consumer organisations, to develop the standards governing it. The Government's aim is that the guidance guarantee meets consumers' needs and works in their interests, and is delivered efficiently and avoids unnecessary compliance cost.

Entry and exit fees

98. Some of the responses to the consultation raised concerns about the existence of entry and exit fees, which they felt had the potential to cause significant consumer detriment. These are fees applied when the member transfers their pension from one fund to another, or when they cease contributing.

99. The Government will take action against any charges that are deemed to be excessive or unfair. As such, these kinds of fees will be included in the MBD measure to be capped. We are also considering the case for taking further action, particularly in the light of proposals for automatic transfers. The increased transparency measures described in Chapter 6 will allow the Government to gauge the prevalence and impact of such fees and we will bring forward further findings in due course.

Default funds

100. We have been made aware that some schemes, set up before the introduction of automatic enrolment, may not have a fund which can be easily identified as the 'default fund', into which members who have made no choices (or 'double defaulters') can be enrolled. However, from the evidence we have collected, it seems that schemes generally do have one fund in which the majority of savers' assets are held, for instance named an 'employer nominated fund'.

101. Where there is no specifically nominated default fund or strategy, our intention is that the cap should be applied to the fund which has the greatest number of members from each saving cohort. It is likely that pension providers will have altered the make-up of their investment funds over the past decades, and as such there will be a concentration of customers in different funds, based on when they joined schemes. This distribution will need to be assessed, so that in each case, where a member is in the equivalent of a default fund, they will be protected by the charge cap.

The application of the default fund charge cap to combination charge structures

102. We recognise that not all schemes charge their members a flat percentage of funds under management – such as the AMC measure. Some schemes use a combination charge structure instead, usually incorporating a percentage of funds under management charge alongside either a flat fee, or a contribution charge. Such charging structures can help new providers enter the market as it allows them to raise capital from member contributions more quickly.

103. In many cases, combination structures can offer lower charges than single charging structures, particularly for savers who contribute over a long period of time or for those who become deferred members. However, for those who save for a short period of time, combination structures can result in higher charges than would have resulted under a single charge structure.

104. Responses to the charges consultation stressed the importance of applying a default fund charge cap to all schemes, regardless of charge structure. To do this would require a process by which employers and providers can understand how the levels of any combination charges compare to the level of the default fund charge cap, which is expressed as a single percentage figure. Those running these schemes will be able to use this information to ensure that their charging structure is compliant with the new charge controls.

105. To address this, we have devised tables of equivalence demonstrating how different combination charges would fit under a 0.75 per cent default fund charge cap. The results of this modelling are shown below in Tables 1 (contribution charge structures) and 2 (flat-fee structures). In both cases we have modelled a sample of 10 individuals who save for varying periods of time at different points during their working lives. This aims to reflect the diversity of the population and varying working lives, for instance some individuals modelled take career breaks. The tables present the average funds under management (FUM) equivalency for the 10 individuals compared to a range of combination charge permutations.

106. The modelling approach is based upon comparing the proportion of pension pot lost to charges in a combination charge structure with the equivalent proportion of pension pot lost in a FUM only structure for each individual. In the case of contribution charge structures, the length of time saving is the key variable which impacts on the equivalent FUM charge and salary has no impact on the proportion of an individual's pot lost through charges. For contribution charge structures, all individuals have therefore been modelled with a salary of £20,000. This is the median earnings for private sector workers in the eligible automatic enrolment population with no existing workplace pension[29].

107. In a flat-fee structure both length of time saving and salary will impact on the equivalency. To reflect this, the 10 individuals have been modelled at 3 salary levels £15,000, £20,000 and £28,000. This represents the 25th percentile, median and 75th percentile of the earnings distribution for private sector workers in the eligible autom atic enrolment population with no workplace pension.

108. For providers considering designing new schemes with combination charges, or for new entrants to the market wanting to use contribution charging, these equivalency tables will set the benchmarks for what charge levels are permitted in schemes used for automatic enrolment.

109. The permissible permutations of combination charges are shown in the white cells in Tables 3.1 and 3.2. Any permutations that are shaded or that are not included in the tables are not compliant with the new charges requirements.

Table 3.1: Equivalent proportion of pension pot lost through contribution and funds under management (FUM) charge structures compared to a FUM-only charge

Contribution charge (%)	Percentage charge of funds under management (%)						
	0.1	0.2	0.3	0.4	0.5	0.6	0.7
0.5	0.16	0.26	0.36	0.45	0.55	0.66	0.76
1.0	0.21	0.31	0.41	0.51	0.61	0.71	0.81
1.5	0.26	0.36	0.46	0.56	0.66	0.77	0.87
2.0	0.32	0.42	0.52	0.62	0.72	0.82	0.92
2.5	0.37	0.48	0.58	0.68	0.78	0.88	0.98

Note: Shaded areas indicate where the equivalent FUM-charge is greater than 0.75% and therefore not permissible under the default fund charge cap

Modelling assumptions: salary £20k; contribution rate 8%; investment growth 7%; earnings growth 4%; inflation 2%.

White shaded cells represent combination charges equivalent to an FUM charge of 0.75% or below; grey shaded cells indicate an equivalent FUM charge of above 0.75%

[29] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209864/ad-hoc-supporting-ae-further-analysis.pdf

Table 3.2: Equivalent proportion of pension pot lost through flat-fee and funds under management (FUM) charge structures compared to a FUM-only charge

Flat fee per year (£)	Percentage charge of funds under management (%)						
	0.1	0.2	0.3	0.4	0.5	0.6	0.7
5	0.15	0.25	0.35	0.45	0.55	0.65	0.75
10	0.21	0.31	0.41	0.51	0.61	0.71	0.81
15	0.26	0.36	0.46	0.56	0.66	0.76	0.86
20	0.31	0.41	0.51	0.62	0.72	0.82	0.92
25	0.37	0.47	0.57	0.67	0.77	0.87	0.97

Note: Shaded areas indicate where the equivalent FUM charge is greater than 0.75% and therefore not permissible under the default fund charge cap

Modelling assumptions: salary £15k, £20k, £28k; contribution rate 8%; investment growth 7%; earnings growth 4%; inflation 2%.

White shaded cells represent combination charges equivalent to an FUM charge of 0.75% or below; grey shaded cells indicate an equivalent FUM charge of above 0.75%

108. We have limited the allowable permutations such that members of default funds of qualifying schemes should not pay a contribution charge above 2.5 per cent, or a flat fee above £25 per annum. The permutations have been limited in this way in recognition of the fact that the equivalencies are an average across the group modelled and that charges above these levels would be excessive. This will prevent particular and unacceptable detriment for certain groups of savers, such as those who may only save for short periods of time.

109. Some responses to the consultation raised concerns that providers may consider flipping their charge structures between single and combination charges for financial benefit. The governance and transparency proposals outlined in Chapters 1 and 6 of this paper will prevent flipping from occurring, where it is motivated by perverse incentives and not the members' interests and the Government and regulators will continue to monitor the situation.

110. We will continue discussions with regulators and stakeholders on the detailed application of these equivalency table ahead of secondary legislation later in 2014.

Active Member Discounts 4

- **Active Member Discounts (AMDs) penalise deferred members and we agree with the OFT that they are unfair.**
- **From April 2015, the default fund charges for both active and deferred members of qualifying schemes should fit under the default fund charge cap of 0.75 per cent of funds under management.[30]**
- **From April 2016, no qualifying schemes should contain an active member discount or similar mechanism that results in higher charges for deferred members.**

Introduction

1. The Government's consultation on charges included a section examining practices which result in charge increases for members who stop contributing to their pension (deferred members). Some providers refer to this as an active member discount (AMD), while consumer groups refer to it as a 'deferred member penalty'.

2. This drew on the OFT's work on the use of AMDs, and the detrimental impact these have on members, as well as the practice of re-classifying deferred members of Group Personal Pensions (GPPs) as individual personal pension scheme members (IPP). This 're-classification' can facilitate an increase in charges for the member in question.

3. We agree with the OFT's recommendation that AMDs should be banned, and that deferred members who are re-classified as individual personal pension scheme members should not be subject to charge increases. This view has also been expressed by the Work and Pensions Select Committee, which has recommended a ban on AMDs.

[30] We outline the costs and charges to be included in the default fund charge cap, as well as the application of the cap to schemes with combination charge structures in Chapter 3.

4. This chapter examines the question of active member discounts (AMDs), and other practices which result in charge increases for members who stop contributing to their pension. It outlines the case for banning this kind of differential charging, and analyses the responses received on this matter.

Active Member Discounts

5. According to the OFT, the practice of charging deferred members more is a symptom of a lack of competition in the market[31]. In their view, AMDs prevent deferred members from benefiting from competition between providers on headline charges, as these only apply to active members. Seven out of thirteen of the major providers from the OFT's sample offer schemes with AMDs, and they have identified around 9,800 contract-based schemes written on this basis. They estimate that the schemes using AMDs contain around £13.4 billion of assets. The OFT's evidence suggests that 94 per cent of these schemes containing AMDs can be used by employers to comply with automatic enrolment. On average they state that when an AMD is in place this adds 0.47 percentage points onto the deferred member's AMC.

6. That so many schemes with AMDs in place should be available for use in automatic enrolment is a concern for two main reasons:

    - Firstly, the majority of automatically enrolled savers will have little or no experience of pensions and saving products, making it difficult for them to engage with their charges. In this scenario, bearing in mind that automatic enrolment has been designed to harness inertia, if an employee receives notice that their charges are about to rise because they have become deferred, they are unlikely to act on this information.
    - Secondly, when the average person moves jobs 11 times during their working life,[32] the policy of automatically enrolling employees into a workplace pension could result in significantly more deferred members than active ones – at any one time each active member of one qualifying scheme may well be a deferred member of a number of other schemes too.[33] The possibility for consumer detriment if AMDs continue to exist is therefore significant. Indeed, modelling from the consultation document showed that a deferred member of a scheme charging a 1 per cent AMC which increases to 1.5 per cent when the member stops contributing, would lose an additional 7 per cent of their pot if they became deferred.[34]

7. Evidence suggests that deferred members' pots cost less to administer, as they have no contributions to be managed. It therefore makes little sense to charge them more, suggesting that the motive behind AMDs may be the opportunity for profit or the chance to undercut rivals not facilitating this structure with the use of a lower headline charge for active members.

[31] Office of Fair Trading (OFT), 2013, Defined contribution workplace pension market study, OFT 1505, Crown, p106.
[32] Johnson P, Yeandle D and Boulding A, Making automatic enrolment Work, A review for the Department for Work and Pensions, October 2010, p102.
[33] In its evidence to the Work and Pensions Select Committee about active member discounts, the consumer group Which? estimated that increased charges for deferred members could potentially reduce pension income by around 25 per cent.
[34] Notes: Based on an individual who saves for 10 years, and is deferred for a further 20 years. This individual would have an initial total annual contribution of £1200; their fund would have nominal investment growth of 7 per cent and total annual contributions growth of 4 per cent. Department for Work and Pensions, 2013, Better workplace pensions: a consultation on charging, Cm 8737, Crown, p17.

Responses to the DWP charges consultation

8. There was general agreement amongst respondents that it was not fair to charge deferred members more than active ones, and it was almost universally accepted that no new schemes written on an AMD basis should be sold – indeed, several of the providers who responded said that they had removed AMDs from all new offerings for 2014.

9. Many respondents also wanted an immediate ban on AMDs in existing schemes.

> 'Active member discounts are a euphemism for leaver rip offs. There is no evidence that leavers cost providers more than active members and to penalise them is perverse [...] AMDs are likely to become more widespread in contract based schemes as more companies are compelled to provide a pension scheme.'
>
> **The Trades Union Congress**

10. Furthermore, a number of responses argued that, as some providers offer AMDs while others do not, this perversely skews competition in the market. It is possible for a provider to offer terms to an employer on a scheme, and for another provider to undercut these terms, because by using an AMD they can offer a lower headline charge. The employer in this case may believe that they are getting a better deal for their employees, but this is only at the expense of deferred members.

> 'A ban on active member discounts would improve the market by ensuring fairness to consumers. Employees who leave the scheme do not receive a better proposition or service so should not pay more. Active member discounts are also not well understood by the customer and therefore undermine industry efforts to restore confidence in pensions. AMDs were often used in conjunction with commission paying arrangements where the headline active rate was used to undercut those offering a clean single AMC while the increase to deferred members pays for additional commission to the adviser. Having two different prices for the same service offering is not appropriate.'
>
> **Scottish Life and Royal London Group**

11. A small number of responses did not agree with the analysis of AMDs and similar structures, suggesting that employers should not be obliged to extend benefits to former employees. Moreover, they pointed to the fact that, on becoming deferred, members receive information about the charge increases, and can therefore act – either by choosing to continue contributing, or by moving their pension to their new employer's scheme. In the view of these respondents, a ban on AMDs would result in an increase in charges for active members, which would seem to be at odds with the rest of the consultation's proposals.

> 'Former employees have a range of options available to them to not pay the additional charges. If AMDs are abolished, it is absolutely inevitable that charges will rise for our existing employees. So, you will expect employers to go to their workforces to say that their charges are going to increase because the Government cannot be certain that their former colleagues have the time or inclination to do something to avoid additional charges on their plans? This is not fair in any sense. You will be penalising the vast majority to make up for the inaction of the minority.'
>
> **Lifeplus Europe Ltd**

12. Moreover, a significant number of responses queried whether it was appropriate for the Government to take such a broad brush approach to AMDs. They pointed to schemes (mostly trust-based) where the employer pays all of the charges for current employees, although not for former ones (deferred members). This in effect results in a similar scenario for deferred members as in schemes with AMDs – they have to pay more when they cease contributing. But prior to this point in time, they have not had to pay any charges, so many responses felt that this distinguished it from the more formalised AMD. Furthermore, it resulted from a clear desire on the part of the employer to provide a benefit to current employees.

> ‘The NAPF is concerned that some well-run schemes that offer good value for money have a ‘real’ active member discount, where part or all of the charge for active members is paid by the employer as one of the workplace benefits on offer [...]. The NAPF believes that there should be some exemptions for employers that offer such support to their existing employees and are likely to have brought in a workplace pension scheme that offers good value for money to pension savers.’
>
> **The NAPF**

13. Nevertheless, as other respondents pointed out, employers who are committed to workplace pensions can always increase contributions if they want to do something positive for their current employees. This would provide a huge benefit to this group, without causing any detriment to the deferred members.

> ‘Employers should not be allowed to favour their own workers in terms of fund fees [...]. If employers wish to reward their own workforce with better value, then this can be reflected in the employer contribution, rather than in the charging structure. Deferred members will no longer be getting contributions from their previous employer, but should not be penalised with higher charges.’
>
> **Ros Altmann**
> **Economist, Pensions and Investment Expert**

14. Many responses referred to behavioural economics (which forms the basis for the policy behind automatic enrolment), and suggested that the majority of automatically enrolled, soon-to-be-deferred savers are unlikely to take action to avoid the higher charges, even when receiving an information pack about their options. When a policy has been built on harnessing inertia, it was argued that it was not reasonable to expect people to be proactive.

In the charges consultation we asked: What would the impact be of a ban on Active Member Discounts and other arrangements where deferred members pay an increased charge in qualifying schemes – would providers need to increase charges for active members and if so, by how many percentage points?

15. There was general support for a ban on AMDs and other similar structures, certainly as far as new schemes and new members were concerned. Some respondents questioned the impact that a ban for existing members of existing schemes might have, both on active members and more generally on the implementation of automatic enrolment.

Increases in active members' charges

16. Firstly, most respondents agreed that any ban on differential pricing that forced the removal of AMDs from existing schemes would result in charge increases for a large number of active members. This increase would depend on how much of a discount applied, and whether it was purely operating as a cross-subsidy between active and deferred members, or whether there was an element of additional profit being made from the deferred members' charges. In this case, there would not be a justifiable case to increase charges for active members. However, in the former case, providers may have to increase the active members' charges in order to prevent the scheme from becoming loss-making.

> 'If AMDs are removed we should expect that the AMC for active members will increase (and that for leavers will reduce). As a rule of thumb we would expect the increase in AMC to be around 40% of the differential between active members and leavers. For example: if the current scheme basis is set up at 0.35% for active members and 0.70% for leavers. The likely combined charge would be around 0.49% calculated as 0.35% + 0.4*(0.7%-0.35%).'
>
> **Friends Life**

17. Respondents varied on the estimates they gave for the likely increases. Some responses said that when a scheme is priced, the provider offers two options, one with an AMD, and one with a flat charge at the mid-point between the active and deferred price. In this instance, all members would revert to paying the flat charge that was originally offered. Other responses suggested that the amount by which the active price would increase would be greater than that of the deferred members' charge decrease, particularly where a genuine discount was in place.

> 'Following initial discussions with many of the providers operating these arrangements, we believe that the new charge level would be somewhere between the active and deferred charge, but is likely to be at the higher end of the middle pricing point. This reinforces in practice the principle that an AMD is not just an increased charge for leavers, but that the employer secured preferential pricing treatment for members of their scheme whilst active employees of the company.'
>
> **Mercer**

18. Many responses were apprehensive that if a ban on AMDs led to an increase in active members' charges, savers would lose confidence and trust in pension saving. This could in turn lead to reductions in contributions or, crucially, higher opt-out rates. Furthermore, this increase in charges for active members would be at odds with what the consultation originally set out to achieve.

Scheme rewrites and provider capacity

19. Another concern shared by responses from some of the providers was that a ban on AMDs could lead to a significant number of scheme rewrites. One provider included an annex outlining what a scheme rewrite entails in practice, and explaining that it is usual for the time elapsed between the first enquiry and the actual scheme change to be around 12 months or more. Coming at a time when the industry is already operating at full resource in order to implement automatic enrolment, this could cause significant capacity constraints. Indeed, responses suggested that a huge number of schemes would need to be rewritten following a ban, as the majority of business sold by some providers over the last couple of years had been on an AMD basis.

> 'The outright ban of AMDs will lead to renegotiation of terms and in some cases, re-broking of schemes between providers [...] We anticipate this adding considerably to the number of schemes needing to be reviewed during the period proposed; possibly over 10,000. In some cases, these will have been recently established schemes for automatic enrolment and would now be reviewed again within a matter of months.'
>
> **Standard Life**

20. Further concerns were raised about the likely reaction of employers to this change. Some of those employers who responded to the consultation had recently set up schemes in readiness for staging, which incorporated AMDs. These employers all felt that the scheme they had put in place was good quality, with high contributions and high take-up. They were concerned about the possibility of either having to rewrite the scheme or find a new one. This would cost them money, but would also potentially lead to their employees getting a worse deal: finding a new scheme at a time of capacity constraint may be difficult, and they may have to settle for what is available quickly, rather than taking time to find something that best suited the employees.

> 'We could of course set up a new pension (after just 2 years) but with pension providers stretched to cope with auto enrolment now is probably not a good time to negotiate the best deal.'
>
> **Mizuno Corporation UK**

In the charges consultation we asked: What if any transitional arrangements might be needed for those schemes already set up?

21. Because of the likelihood of charge increases for active members, the automatic enrolment timeline, and the dangers of member disengagement, a number of responses suggested that AMDs and similar structures should only be banned for new schemes and new members going forward. Those respondents sharing this view recommended that the default fund charge cap be applied to both active and deferred members, as this would curb the worst effects of an AMD, while not leading to the same scale of unintended consequences. It was their belief that over time, AMDs would disappear of their own accord.

22. Other respondents, however, argued that it was necessary to send a clear signal about AMDs, and that it wasn't enough simply to cap charges and wait for differential pricing to disappear. Nevertheless, many of these respondents recognised the difficult situation, and the likelihood that a blanket ban would create disruption. As such, many respondents recommended giving a transitional period of time, for instance three years from each employer's staging date. This would be particularly important if a ban on AMDs took place within the context of wider charge controls, such as a cap and a ban on commission, as these would also require scheme rewrites.

> 'Our preferred approach would be to apply new requirements for new joiners from staging date and to leave existing member terms unchanged until a fuller analysis of their charges and any valuable benefits has been completed through the OFT audit and until industry capacity can permit a smooth and orderly transition for them. If any changes are to be made, we would recommend staging the delivery, to be implemented within three years of employer staging, instead of a cliff-edge approach, to avoid capacity issues.'
>
> **Aegon**

In the charges consultation we asked: Can you provide more information about the scenario whereby employees who leave their job are converted into an individual personal pension? Does this require the member's consent and is this practice disclosed to employers when they choose the scheme?

23. Responses generally expressed concerns about this kind of arrangement, viewing it, in the words of one response, as a 'backdoor way of imposing a 'deferred member penalty' charge on consumers' which 'should be prohibited as part of the Government's ban of these charging structures'.

24. Many responses gave detailed answers about the scenario in which this 'conversion' occurs, explaining that it is a simple procedure because of the particular nature of GPPs: when a member joins this scheme, they are entering into a personal contract with the provider, effectively joining a personal pension scheme. However, because they are in a 'Group' by virtue of their relationship to an employer, they may have better terms than retail, personal pensions, as the employer will have negotiated these with the provider. This creates an artificial ring-fence around the scheme, turning it into a GPP. When a member leaves the employer, the 'G' from 'GPP' is removed, and they become an ordinary personal pension member of the provider's personal pension scheme.

> 'Group personal pension schemes are collections of individual pension policies, which are contracts between the member and the provider. We think that removing the employer link to the policy for a leaver has been good practice, as it ensures data protection and allows the provider to set up a separate payment method for continuing contributions. Removing the link is an administrative issue rather than a contractual one and does not normally require member consent. Naturally, the employer is no longer responsible for any on-going governance of a leaver's contract, which is then handled directly by the provider.'
>
> **Punter Southall Defined Contribution Consulting Limited**

25. At this point the member may no longer benefit from the improved terms negotiated by their employer, often receiving instead the same terms available to retail savers. It was generally agreed by most responses that providers did not have to seek members' permission for this kind of charge increase, because this feature of the scheme would have been included in their contract from the start. Most responses believed that this would have been disclosed to the employer at point of sale, and to the member when joining the scheme.

Government response on Active Member Discounts

26. Members should not be penalised for leaving an employer by having to pay higher charges for their pension, either through an AMD structure or by moving them into a higher charging individual personal pension (here our concern is not related to the reclassification of scheme members but specifically about where there is a mechanism to increase charges). This is particularly important since it is likely that the majority of savers will change jobs on more than one occasion and because evidence suggests that deferred members' pots cost less to administer.

27. Nonetheless, having analysed the evidence and information sent in response to the consultation, we recognise that an immediate ban on AMDs in existing qualifying schemes could adversely impact the implementation of automatic enrolment. Furthermore, we recognise that it may be more complex to remove an AMD from a scheme than to reduce that scheme's charges below the level of the cap. Therefore we propose to give employers two years to remove AMD structures from qualifying schemes:

- **From April 2015** the default fund charges for both active and deferred members of qualifying schemes should fit under the default fund charge cap of 0.75 per cent of funds under management.
- **From April 2016** no qualifying schemes should contain an AMD or similar mechanism that results in higher charges for deferred members.

Commission and consultancy charges

5

- **The Government agrees with the OFT's analysis that some charging structures are inappropriate for the automatic enrolment environment.**
- **From April 2015, no qualifying scheme will be able to contain a consultancy charge structure.**
- **Between April 2015 and April 2016, any commission payments will be subject to the overall default fund charge cap, set at 0.75 per cent of funds under management, on member-borne deductions in the default funds of qualifying schemes.**
- **From April 2016, no qualifying scheme can contain member-borne commission payments to an adviser.**

Introduction

1. In the past, almost all workplace pensions business was sold through an intermediary market – advisers found customers for providers, and were often remunerated through upfront or trail commission (or both). The introduction of automatic enrolment radically changed this structure, effectively bringing millions of new customers to the doors of providers, reducing their traditional reliance on intermediaries.

2. The OFT examined the issue of commission in its report on the DC workplace pensions market,[35]and found that these charges may be incompatible with the principles of automatic enrolment. They therefore recommended that schemes with built-in commission should not be used for automatic enrolment.

[35] Office of Fair Trading (OFT), 2013, Defined contribution workplace pension market study, OFT 1505, Crown, p94.

3. This chapter examines commission payments and consultancy charges in qualifying schemes. It outlines the evidence on this issue received during the charges consultation, and sets out the Government's response.

The impact of the Retail Distribution Review

4. A change in how intermediaries do business came with the Retail Distribution Review (RDR)[36]. This was introduced on 31 December 2012, and one of its outcomes was a ban on providers paying commission to advisers on new Group Personal Pensions (GPPs) and Group Stakeholder Pensions. Consultancy charges were introduced following the RDR to replace commission. Both are methods of payment for advice services: commission is agreed between an adviser and a scheme provider and can be paid as either an upfront or ongoing fee (often called trail commission); consultancy charges are an upfront fee agreed between an adviser and an employer. In both structures, the cost is recouped through member-borne charges.

5. However, on 14 September 2013 following a government review, regulations came into force that effectively banned consultancy charges in automatic enrolment schemes.[37] These specify that the scheme cannot include a provision allowing deductions to be made from members' pension pots, investment returns, or contributions, if the amount is to be paid to a third party under an agreement between an employer and the third party. As a result, advisers who are helping employers set up a new scheme must now charge an upfront fee for their services which cannot be passed on to members, where previously they may have asked for remuneration on a commission or consultancy charge basis.

6. However, the nature of the RDR and the ban on consultancy charges means that, while no new schemes can be set up with built-in consultancy charges or commission, it is still possible for employees to be automatically enrolled into existing qualifying schemes containing these charges.[38]

OFT recommendation on commission

7. In their market study, the OFT recommended a ban on commission in automatic enrolment schemes on the basis of two concerns. Firstly in a post-RDR world, built-in commission may represent a barrier to employers switching schemes, even where this would be in the members' interests. Where an employer has an existing scheme set up before January 2013 containing built-in commission, newly enrolled employees must still pay the trail commission (or the margin added to the management charge to enable the provider to recoup upfront commission).

[36] Further information is available at: http://www.fsa.gov.uk/about/what/rdr/rdr-library

[37] The Government announced its intention to regulate on consultancy charges in automatic enrolment schemes on 10 May 2013. Regulations came into force that effectively banned consultancy charges on 14 September 2013 in automatic enrolment schemes (though not qualifying schemes). These regulations (the Occupational and Personal Pension Schemes (Automatic Enrolment) (Amendment) Regulations 2013 (S.I. 2013/2328) do not affect the schemes where there was a legally enforceable agreement in place between an employer and a third party before the announcement on 10 May 2013 that the Government intended to ban consultancy changes in automatic enrolment schemes. Consequently, employees can still end up paying consultancy charges, either because they are enrolled into a scheme where such an agreement was entered into before this date, or because they are saving in a qualifying scheme.

[38] The main difference between commission and consultancy charging is the mechanism by which it is agreed – the terms of commission are agreed by the provider and adviser, while the terms of consultancy charges are agreed between the employer and the adviser. In both cases, however, the member is not part of the negotiations with the adviser, even though the payment is taken from their contributions or pension pot.

As such, there is an incentive for the employer's adviser to recommend that this existing scheme be used for automatic enrolment, even if more competitive alternatives are available, because setting up a new scheme would bring an end to their income stream. Furthermore, employers themselves may be reluctant to switch schemes in this scenario, as setting up a new scheme may involve additional cost to their business.

8. Secondly, automatically enrolled employees may pay commission without ever realising it – firstly because many will never actively engage with their pension and so will not consider the charges they are paying; and secondly because the cost of upfront commission is embedded in a higher management charge and therefore not directly visible. This means that where an ongoing service, such as access to financial advice, is provided in return for the commission, many employees may be unaware and never make use of it. The presence of these structures therefore highlights the principal-agent problem, leaving the automatically enrolled employee with just one alternative to paying such charges – to opt out of the scheme and lose their employer contribution.

9. The OFT's report suggested that there may have been an increase in the set up of schemes with built-in commission in the months before RDR.[39] Some have suggested that this increase was motivated by an effort to set up as many schemes of this type as possible for use with automatic enrolment before any ban came in – in some cases, these schemes may be 'shell-schemes', as yet containing no members. According to the OFT, employers are keen to minimise the costs of complying with automatic enrolment, and as such those with existing schemes are unlikely to set up a new scheme to comply. Where these contain commission, the automatically enrolled savers will end up paying the price for their employer's lack of desire to switch schemes.

10. This analysis of commission and automatic enrolment could also be applied to the issue of consultancy charges. As with commission, consultancy charges may be embedded within a member's annual charge to recoup the cost of setting up the scheme, and by extension the cost to the employer of complying with automatic enrolment legislation. Using consultancy charges in this way has therefore been likened to expecting workers to pay for steps taken by their employer to ensure compliance with health and safety law.

11. The 2013 DWP charges survey found that, according to employers, on average commission can add between 0.2 and 0.4 per cent on to a member's AMC.[40] The Pensions Institute report on Value for Money offered a higher estimate: 'Commission was embedded in the member's AMC as an annual percentage, which might be significant in the first year of membership (e.g. 20 per cent) and then continue as a 'trail' commission of 0.5-1 per cent.'[41] Under either of these two estimates, commission and consultancy charges (which are extracted either as a percentage of the funds under management or of contributions) can siphon off a substantial sum from the pension pot over time.

12. The Government's charges consultation sought to understand whether further action was necessary to deal with commission and consultancy charges, as well as what impact a ban on these charges would have on employers, advisers, providers, and savers.

13. The remainder of this chapter sets out how respondents to the consultation viewed the question of consultancy charges and commission, and outlines the Government's response.

[39] Office of Fair Trading (OFT), 2013, Defined contribution workplace pension market study, OFT 1505, Crown, p22.
[40] DWP, November 2013, Charges in defined contribution pension schemes, p5.
[41] Harrison, Blake and Dowd, VfM: Assessing value for money in defined contribution default funds, January 2014, The Pensions Institute, p35.

Commission – Responses to the charges consultation

14. Many responses were in agreement with the OFT's analysis of commission payments and supported a full ban. For these respondents, it was a question of fairness, as in their view automatically enrolled savers should not be paying for the steps taken by their employer to comply with legal requirements. This was particularly important, as in many cases it was felt that savers may not be receiving any additional ongoing service in return for commission. In this scenario, a member could end up paying for advice twice – once through the commission for their employer's advice, and then a second time if they paid for individual services from a fee-based adviser.

> 'Currently a position exists where a third party can receive commission without having any obligation to provide advice for scheme members. [...] Continuing commission payments will create an anomaly within the advice market in which commission has been banned by the Retail Distribution Review. It also allows for a scenario whereby an individual member could be paying commission within a scheme, not be in receipt of advice and then seek advice from another chosen adviser and pay an additional adviser fee on top of the commission.'
>
> **Citizens Advice, Northern Ireland**

15. Many felt that the current situation, whereby commission exists in old schemes but is banned in new schemes, was complicating the workplace pensions landscape – a ban would effectively level the playing field. Additionally, by removing an unnecessary cost, it would reduce the cumulative drag on members' pension pots and therefore increase saving outcomes.

> 'A ban on commission in qualifying schemes would almost certainly lead to better outcomes for members as a cost, for which they seem to receive little in return, will be removed. The ban would also level the playing field with new schemes.'
>
> **Charlton Frank**

16. By contrast, many responses argued that because commission denotes the involvement of an adviser in scheme selection and negotiation, it is only in place in very good quality schemes, where the employer is committed to workplace pensions. The adviser's involvement in setting up the scheme would mean that the employer had been able to secure more favourable terms than if he or she had approached the provider directly. According to these respondents, schemes with built-in commission are characterised by higher employer and employee contributions, and lower overall charges.

> 'Commission, in our experience, typically only applies to 'generous' employers paying significantly in excess of auto-enrolment minimums. In our experience those employers who pay well in excess of their obligations also negotiate hard for members, are committed to maximising member support and have a desire to drive good outcomes.'
>
> **Brunsdon Financial Services Ltd**

17. Additionally, other responses argued that commission may give members access to valuable services, which they would not consider using if they had to pay an upfront charge. These responses referred to one-to-one advice sessions, educational seminars, better communications, member support, and quality governance, which may be paid for with commission. It was the view of these respondents that these services help members better engage with their pension, which ultimately leads to lower opt-out levels, higher member contributions, use of auto-escalation agreements, and transfers of pension assets from older schemes. When combined,

this type of behaviour helps improve saving outcomes, thereby increasing the income members can expect in retirement.

18. Some of those who stated views of this kind were employers who have recently set up a scheme ready for automatic enrolment containing built-in commission. In their view, this advice structure benefited the members and the employers, and should not be subject to a ban.

> 'Unlike the vast majority of schemes, we have 100% take-up, in addition over 60% of our employees make additional contributions. A significant reason why they make additional contributions is because of the 1-2-1 advice and electronic marketing provided by our advisers. We are convinced that without the commission structure [...], we would not have such a good scheme. Our members would be saving less into their pensions, their outcomes would be significantly poorer.'
>
> **Easy Jet**

19. Other responses that favoured a ban on commission did recognise that, in some cases, it may provide the member with access to a number of valuable services. Nevertheless, these responses stressed the unfairness of defaulting members into paying commission, as it can never be guaranteed that all of them will use the services provided in return. Advice services should instead be provided on a strictly 'opt-in' basis, with the payment agreed between the adviser and member in question. As outlined in Chapter 3 of this Paper, default arrangements should only contain the essential features of a scheme, for instance administering and keeping records of contributions. Additionally, employees should on no account be paying for advice taken by their employer.

> 'Some employers have been all too ready to recoup the cost of financial advice they receive from the pension funds of the members of their schemes. [...] We support a ban on the application of ongoing commissions in respect of auto-enrolment schemes and qualifying schemes.'
>
> **Unite**

In the charges consultation we asked: Does commission present a barrier to switching?

20. A significant number of respondents agreed with the OFT's analysis that commission presents a barrier to switching. These responses suggested that an adviser was highly unlikely to recommend that an employer set up a new scheme, even where this was in the members' interests, because this would directly impact on their income stream.

> 'Common sense suggests that some advisers may be reluctant to recommend courses of action that lead to them no longer being paid.'
>
> **Towers Watson**

21. Other responses, however, did not support the OFT's arguments on this matter – it was the view of these respondents that it is not the presence of commission that represents the barrier per se, but rather that commission-based schemes contain valuable services not available in other schemes. As such, employers are reluctant to switch, because the replacement scheme may not have the same features.

> 'The most likely barrier is the member service which has been popular with and may not be affordable for the employer.'
>
> **Johnson Fleming, Employee Benefit Consultant**

22. Similarly, some responses suggested that commission is not the true barrier to switching, but rather it is the complexity of the automatic enrolment process which deters employers from making changes to their scheme. These responses argued that this reluctance is strengthened by the fact that employers can no longer rely on commission-based advisers to help them set up a new scheme, but are unwilling to pay upfront fees for the same advice.

> 'For fee based and commission paying schemes, auto enrolment provides the barrier to switching. The complexities of auto enrolment, particularly the fact that providers' systems are not being configured to start plans after their staging date, (they are unable to pass over data held i.e. opt outs, and start dates), makes moving schemes more difficult.'
>
> **Aon Hewitt**

In the charges consultation we asked: What evidence is there of an increase in sales of DC schemes with commission in 2012?

23. There was general agreement amongst respondents that there had indeed been an increase in DC schemes with built-in commission in 2012 and in particular in the run up to the introduction of RDR; some responses provided numerical data to evidence this increase in sales.

> 'Scottish Widows reported that in the first half of 2013, corporate pensions sales increased 29 per cent, from £2.86bn to £3.69bn. However, individual pensions sales dropped 19 per cent, from £911m to £738m. A spokesman for Scottish Widows was quoted in Money Marketing as saying that "the provider's half year results were heavily impacted by automatic enrolment. He says the strong corporate pensions sales figure reflects an increase in commission-based business in the build up to the RDR deadline."[42] He added that: "The growth in corporate pensions sales is built around the pipeline generated in the run-up to the implementation of the RDR. That is business written on a commission basis."
>
> **Which?**

24. While there was agreement about the increase in sales of commission-based schemes, there was no consensus about the possible reasons for this.

25. Some respondents argued that it was driven by employers whose staging dates were approaching in 2013 and 2014. These respondents suggested that employers favour schemes with commission, because it enables them to get a scheme in place, without having to pay the costs themselves. As such, they were eager to get a commission-based scheme in place, before the rules would prevent them from doing so.

> 'We are becoming aware of schemes where employers did strive to ensure they had a commission based scheme that could be used to meet Qualifying Rules so as to save fees.'
>
> **Keith Butten, IFA**

[42] MoneyMarketing, Scot Widows reports surge in pre-RDR corporate pension sales.

26. A significant number of other respondents argued that the main reason behind the increase in sales was an effort to get commission-based schemes in place that would provide advisers with income streams in the years to come. Some raised concerns about 'shell schemes', set up with no current members, but with the expectation of new joiners in the future who would generate commission payments. Mostly these responses offered anecdotal evidence for this kind of behaviour, and argued that this should be a reason for banning commission in all schemes used for automatic enrolment.

> 'We have not taken commissions on any schemes we established. Anecdotally we have heard some advisers talk of filling their boots'
>
> **Pension Playpen**

In the charges consultation we asked: What would be the impact of a ban on commission in qualifying schemes?

Impact on employees

27. Many responses argued in favour of a ban on commission in all qualifying schemes, as this would help reduce the level of charges members pay, which over the long term will improve saving outcomes. Additionally, it would simplify the presentation of charges. Many stated that where services are being provided in return for commission, not all employees are taking advantage of them. As such these respondents felt people should not be defaulted into these kinds of arrangements. Some even suggested that the ban should go beyond schemes used purely for automatic enrolment, to include workplace pension schemes more generally.

> 'We believe that commission arrangements should be banned for all DC schemes, not simply new auto enrolment schemes. This would also help to bring greater clarity in relation to the fees being paid by members.'
>
> **Hymans Robertson, LLP**

28. Other responses argued that a ban on commission in all qualifying schemes would have a detrimental impact on those employees currently saving in commission-based schemes. It is likely that the employer in question would have to find a new scheme, and if they were unwilling to pay for a fee-based adviser, they may end up securing a lower quality scheme, perhaps with higher charges than before, but without access to the features available in the earlier scheme. Some responses suggested that in this way, a ban on commission would actually work against the consultation's stated purpose.

> 'If an existing Group Personal Pension scheme pays trail commission within a charge of 0.75 AMC or less, it would seem counterproductive to the primary objective of the proposals of capping charges, to impose a blanket ban on such a scheme purely because it pays trail. Additionally, if that scheme offers access to product features that would be lost if the scheme were closed … then this could potentially be to the detriment of the scheme member.'
>
> **Sesame Bankhall Group**

29. By contrast, other responses asserted that these structures are fundamentally unfit for use in an automatic enrolment context, as they enable the cost of advice to an employer to be passed on to the employee. These responses suggested that it should be for the adviser to sell any valuable services directly to the member, rather than assuming payment by default, regardless of whether the services were used or not. These responses also stressed the importance of combining a ban on commission with improved governance and disclosure, to ensure that the reduction in cost was passed on to the members in terms of a lower annual charge and not retained by the provider.

> 'The impact of a ban on commissions in qualifying schemes would be beneficial for consumers and Which? supports its implementation. However, this ban must be accompanied by strong regulation requiring insurers to pass on any savings in commission to scheme members. If this was the case then a ban on commission would lead to better value for money for consumers and remove a barrier to effective competition.'
>
> **Which?**

Impact on employers

30. Many responses stressed the importance of timing for the proposed ban – they argued that removing commission will be complex, and may require the employer to rewrite their scheme, or even secure a new scheme altogether. Additionally, many advisers who in the past received remuneration through commission explained that it would take time for them to switch over to a completely fee-based model. As such, many suggested delaying the implementation of a ban on commission, giving advisers, providers and employers time to make the necessary changes, while also concentrating on supporting automatic enrolment.

> 'The delay will give all parties in the pensions industry the time to develop and innovate their products and services and in many instances they will move towards the new regime much sooner than the deadline would dictate. This in turn will drive competition as providers and advisers strive to position themselves to capture market share in a lower charged, commission free world. The emphasis will then be on demonstrating value with good member outcome being the ultimate objective.'
>
> **Punter Southall Defined Contribution Consulting Limited**

31. Other responses emphasised employers' unwillingness to pay for advice. They questioned the impact that a ban on commission would have on those employers currently using a commission-based scheme and asked whether they would be able to pay upfront fees for an adviser to help them set up a new scheme. Additionally, some were concerned that employers who are currently engaged with pensions and are going beyond the minimum requirements may become disengaged following a ban on commission. Having to set up a new scheme, and pay the associated costs, may lead these employers to reduce their contributions to a minimum. Once again, these responses stressed the importance of getting the timing of a ban right, in order to limit any unintended consequences.

> 'If the option to ban commission paying schemes for AE is introduced, the consequence is unlikely to be positive. We do not have infinite resources to commit to our pension arrangements. If it is mandated that commission based schemes are unacceptable, one option might be to reduce our overall contributions to the scheme by the amount we will need to pay for advice, to the detriment of our employees.'
>
> **Lifeplus Europe, Ltd.**

32. Nevertheless, other responses argued that it was not entirely necessary for employers to take advice when setting up a scheme, as they could join many providers offering 'off-the-shelf' products.

Impact on advisers

33. There was general agreement that a ban on commission in qualifying schemes would have a significant impact on advisers, as many will have built trail commission into their balance sheet for the years to come. It is estimated that prior to the introduction of the RDR the value of commission in DC pension schemes was £200 million.[43] While not all schemes with built-in commission will be used for automatic enrolment purposes, the financial impact on those advisers still using this fee structure could be significant.

34. Despite this, many responses had limited sympathy for the commission-charging advisers' dilemma, arguing that the direction of travel had been clear for many years prior to the introduction of the RDR, and that they all should have shifted to fee-based models quickly, rather than just some.

35. Other responses, however, stressed the important role the adviser community has played in implementing automatic enrolment, and suggested that without them this policy would not have been so successful. These responses, while recognising the need to ban commission, argued against any immediate action, because of the impact this would have on advisers and therefore on automatic enrolment. Rather, they proposed that a ban on commission should be phased in slowly, to give employers, advisers and providers time to renegotiate terms.

> 'If there was to be a period of grace whereby commission could continue to be paid, then more advisers would be able to assist with the success of auto enrolment. It would allow time for advisers to renegotiate in an orderly way future remuneration agreements with their clients.'
>
> **Mercer**

Consultancy charges – Responses to the consultation

36. The consultation sought to understand how the regulations were working, and whether or not it is necessary to extend the ban to all schemes, including qualifying schemes and those schemes set up (or an agreement between an employer and third party in place) prior to May 2013.

In the charges consultation we asked: How are the existing regulations working in practice and how are the services now being delivered and paid for?

37. There was broad consensus amongst respondents that consultancy charges were not a good way of charging for advice, as they did not align the interests of the adviser with those of the consumer.

> 'Our view has always been that this is an inappropriate mechanism to use as employees are suffering a charge for a service which they might not necessarily be choosing to use.'
>
> **Richmond House Financial Services Ltd**

[43] This figure comes from Deloitte, and was quoted in the Pensions Institute's paper on value for money. Harrison, Blake and Dowd, VfM: Assessing value for money in defined contribution default funds, January 2014, The Pensions Institute, p35.

38. Generally the responses agreed that the regulations were working very well in practice, and that owing to the Government's swiftness in acting to ban consultancy charges, very few schemes were set up on this basis.

> 'Our discussions with providers indicate that, at most, a few hundred schemes were written or planned before the ban was announced.'
>
> **Towers Watson**

39. Some responses raised concerns about vertically integrated firms, where members may still be paying for services that do not directly benefit them, but where this is less visible because all of the services are provided by the same firm. Because a third party is not involved, such arrangements would not be covered by the existing regulations banning consultancy charges. Some responses indicated that greater transparency and improved governance in this area may help mitigate this problem.

> 'Firms that are vertically integrated, where a provider provides advice directly to an employer may pass that on to a member, even where the actual work is outsourced. While this is a difficult area because day-to-day management needs to be paid for, it is not clear whether the FCA using its treating customers fairly, or the general fiduciary duties, will act as an efficient safeguard. This is an area where the Government may wish to signal that it will create and use reserve powers if they do not already exist, to take action where abuse and member detriment is evident.'
>
> **TUC**

40. However, other respondents expressed concerns that, as a result of the RDR and the ban on consultancy charges, an advice gap has opened up in the market – advisers are starting to move to fee-based models, but not all employers are willing to pay them. This may be resulting in lower quality, less appropriate schemes. Alternatively, employers may reduce the levels of their contributions in order to fund fee-based advice services, which may have a detrimental impact on members' saving outcomes.

> 'It should be recognised that many employers are not expecting to pay for advice and have not budgeted for it. Any additional costs may cause employers to make savings elsewhere ....'
>
> **Punter Southall Defined Contribution Consulting Limited**

41. However, employers are not required to seek advice about automatic enrolment; the process has been designed to be as simple as possible and the Government established the National Employment Savings Trust (NEST) as a low cost pension scheme with a public service obligation to accept all employers who wish to use it to comply with their automatic enrolment duties. The Pensions Regulator have also provided guidance and tools in order to help employers comply with their new duties.

42. Despite some concerns about a possible advice gap, the majority of responses shared a desire for clarity on the question of consultancy charges – the current situation, where some schemes are allowed them, while others not, is believed to be causing both providers and advisers issues in selling schemes.

> ‘Now the DWP have announced their intention to extend the prohibition on consultancy charges to all qualifying schemes, the intention being to stop consultancy charges in existing schemes where there was a legal agreement in place before 10 May, providers and advisers are left without clarity on how to proceed with schemes written on a CC basis. To help advisers and providers we urge clarity on this point as soon as possible.’
>
> **Royal London/Scottish Life**

In the charges consultation we asked: What impact would extending these regulations to qualifying schemes have on providers, employers, advisers, and any other third parties, and what if any transitional arrangements would be appropriate?

43. Most respondents agreed that there would be an impact on those employers who have set up a scheme on a commission or consultancy charge basis, as they will have to either renegotiate terms, or set up a new scheme. This will involve a degree of cost, which could lead to the employer in question disengaging from pension saving and possibly decreasing their contribution level.

> ‘We believe that if pensions become too onerous for employers to manage we are likely to witness a move to schemes offering only the minimum of what is necessary under legislation. This is likely to be low cost funds delivering low returns with no (or minimal) additional features.’
>
> **Prudential**

44. Most other responses, however, suggested that the impact on employers, providers, and advisers would be minimal, because so few schemes were set up on this basis – some estimates put the figure at a couple of hundred schemes.

45. Generally, therefore, responses supported the ban – firstly because they viewed consultancy charges as inherently unfair; and secondly, because the current regulations had created inconsistencies and were complicating the charges landscape. As they can exist in qualifying schemes, but not automatic enrolment schemes, this means that while one member of a scheme may have to pay them (if it was an existing scheme, and they joined before their employer’s staging date), another member may not.

> ‘As consultancy charging is banned in automatic enrolment schemes, it should also be banned in qualifying schemes. There [...] is no obvious reason why the date on which an individual joined the scheme should determine whether consultancy charges can be taken from their contributions/funds.’
>
> **Towers Watson**

Government response on commission payments and consultancy charges

Commission

46. We fully recognise that advisers have played a vital role in the success of automatic enrolment. In many cases they have helped employers set up good quality schemes, which over time will help address the problem of mass under-saving.

47. Nevertheless, we have concluded that commission is an inappropriate charge in the automatic enrolment environment, as members may be defaulted into paying for a service they may not use and are not aware of. Moreover, we agree with the OFT's analysis that commission may represent a barrier to switching, and as such has the potential to harm saving outcomes. We propose, therefore, that commission be banned in all qualifying schemes.

48. In future, employers or providers should cover the costs of setting up a scheme, not members. Additionally, any bespoke advice services for members, such as one-to-one sessions or educational seminars, should be offered on a purely opt-in basis and should not be included in default funds. If an employee wishes to pay for advice, they can choose to do so.

49. We recognise that introducing this ban will require appropriate transitional arrangements. Commission payments are built into a significant number of schemes: the DWP charges survey 2013 found that around 25 per cent of trust-based workplace pension schemes used a commission-based adviser, while for contract-based schemes the figure was higher at 41 per cent.[44] While this makes it important that we act to protect automatically enrolled savers from having to pay these charges, it also means that implementation will be complex, because so many schemes will be affected.

50. We propose, therefore, that the ban on member-borne commissions be introduced after the proposed default fund charge cap. This will allow providers, employers, and advisers more time to renegotiate remuneration for work done. It will also give advisers more time to consider moving to fee-only payment structures.

- **April 2015:** Where commission is in place, this should not take any member's charges above 0.75 per cent, the level of the default fund charge cap.
- **April 2016:** Commission must be removed from all qualifying schemes.

Consultancy charges

51. Consultancy charges are not an appropriate mechanism for schemes used to comply with automatic enrolment and the ban will therefore be extended to cover all qualifying schemes. The member may never realise they are paying this charge, and indeed may receive no service in return for it. We also agree with the analysis from many of the consultation responses, demonstrating that the current regulations banning consultancy charges have created inconsistencies in the market. We want to provide clarity about what is and isn't allowed.

[44] Wood et al., 2014, Landscape and Charges Survey 2013: Charges and quality in defined contribution pension schemes, DWP, pp.65-67.

52. It is clear from the evidence received that very few schemes have been set up using consultancy charges. As such, it is our view that the impact of a ban on providers, advisers, and employers will be minimal and that one year will be sufficient for the removal of such structures.

53. We recognise that there may be risks associated with vertically integrated firms, as these are not subject to the regulations currently banning consultancy charges. In our view, our holistic approach outlined in this paper, that includes proposals for improved governance and transparency, will shine a light on how members' charges are spent and will help address the potential for consumer detriment brought about by such structures.

54. We therefore propose to make regulations to extend the existing ban to include all qualifying schemes, including those where a legally enforceable agreement was in place before 10 May 2013. We intend to introduce these changes in April 2015, at the same time as the proposed 0.75 per cent charge cap on default funds of qualifying schemes.

Transparency in workplace schemes 6

- **The proposals for full transparency of all costs and charges in workplace pensions, announced as part of the current Pensions Bill, extends the work of this Government to improve value for money for pension savers.**
- **These proposals will cover both the administration charges that come under the default fund charge cap and transaction costs.**
- **From 2015, trustee boards and Independent Governance Committees will have new duties to consider and report on costs and charges, and pension schemes and providers should start making progress immediately in these areas.**
- **Thereafter, the Government will introduce new requirements to standardise the disclosure of administration charges and transaction costs, making this the first international example of full transparency in pension schemes.**
- **The Government will start work immediately with regulators, providers, trustees and asset managers on the design and implementation of the relevant standards and products to ensure maximum effectiveness of these transparency measures.**
- **We are also seeking views on whether the transparency requirements we are introducing for DC schemes should, in the future, be extended to DB schemes to enable employers to further scrutinise the costs they are paying.**

Introduction

1. The Government agrees with the OFT's conclusion that there is a need for more information to be made available about DC workplace pension schemes. In particular, the OFT highlighted that there is insufficient transparency and comparability of charges to enable competition to work optimally.

2. One of the questions in the Government's charges consultation was whether government should introduce legislation to require further transparency – of both costs and charges – to encourage the DC workplace pensions market to operate in a more open and accountable way.

3. We welcome the industry initiatives that have sought to build a fuller picture of costs and charges. However, we agree with the OFT, and with respondents to our consultation, that the Government and regulators have a valuable role to play in mandating the disclosure of clear, comparable information from the key players in the pensions investment and governance chain.

4. The first step of this approach, from April 2015, will be for the strengthened trustee boards and Independent Governance Committees (IGCs) described in Chapter 1 to scrutinise and report on the costs and charges in their schemes. This will create a new demand for transparent information, and the trustees and IGC's reports will make this information public for the first time.

5. We will then build on this to introduce fully standardised, line by line disclosure of costs and charges. The nature of the information to be disclosed will be tailored to fit the different audiences that have an interest in it:
   - IGCs and trustees, who are responsible for governing schemes in members interests and will therefore need full detail of all of the costs and charges within each scheme
   - Employers, who need to be able to compare the costs and charges that their employees would face when selecting a scheme
   - Members, who need information about the headline costs and charges that impact their pension saving
   - The public, for the first time information about costs and charges will be made publicly available, to enable comparability between schemes

6. We intend to introduce the full range of transparency requirements in regulations, and will also work closely with the FCA to consider any changes to their rules needed to make full disclosure a reality. These will build on our work with regulators and stakeholders in 2014, and the lessons we can learn from the information disclosed by IGCs and trustees from April 2015. Amendments to the Pensions Bill in February and March 2014 pave the way for these measures and set out our direction of travel on transparency. These will build on our work with regulators and stakeholders in 2014, and the lessons we can learn from the information disclosed by IGCs and trustees from April 2015.

Existing initiatives

7. The OFT emphasised the need to build on work already undertaken by the ABI and others to improve the transparency of charges information, and we acknowledge the range of existing initiatives which aim to improve transparency and disclosure in our consultation on charges.

These include:

- a Joint Industry Code of Conduct on Charges, launched in 2012 and supported by The Pensions Advice Service (TPAS) hosted web tool to help employers understand the charges members will incur.
- the ABI Agreement on the Disclosure of Pension Charges, which a number of ABI members have already signed up to.
- the Investment Management Association (IMA) publication, in September 2012, of enhanced fund charges and costs, providing guidance to investors.
- TPR's Regulatory Guidance on DC Schemes published in November 2013 which covers value for money, transparency of costs and charges for members and employers.
- the FCA thematic review 'Supervising retail investment advice: how firms are implementing the RDR' which included examining how consumers are able to understand what firms charge.

8. We recognise and value the progress that has been made towards increased transparency and sought views on the effectiveness of these voluntary initiatives in the consultation document. Whilst there was general support for these initiatives – as described further below – there was also recognition that more needed to be done both to ensure transparency of charges across the workplace pensions market through a consistent and standardised approach mandated by government, but also to tackle the hitherto undisclosed range of transaction costs.

9. The Government consultation on charges noted the OFT findings that competition alone is not enough to ensure value for money in the DC workplace pension market and made a number of proposals to address these market failures. We consider the responses to the specific questions asked in the consultation document in relation to the disclosure of charges and costs below, and describe our proposals to improve transparency in more detail.

Responses to the DWP charges consultation

10. More than half of the responses to the charges consultation commented on some aspect of transparency or disclosure. The majority of the responses that addressed this subject were from pensions advisers, providers and employers, with others, such as consumer groups, lawyers and individuals making up the remaining responses.

In the charges consultation we asked: We would welcome views and evidence on the effectiveness of these [existing] initiatives and the extent to which the industry discloses charges upfront, in a consistent manner, to members and employers.

11. Of those who responded to this question the majority welcomed the voluntary industry initiatives. A number of respondents considered that it would be appropriate to give these initiatives time to 'bed in' before their effectiveness could be assessed. However, a large proportion of respondents indicated that, whilst these initiatives were welcome, there was a need for government to introduce regulations in this area to mandate for the disclosure of charges information, building on the voluntary initiatives.

> 'Current initiatives such as the ABI charges tool only apply to members of the body producing it. So for a level playing field we need government regulation to mandate disclosure'
>
> **Aviva**

> '...we support the OFT's recommendation that, building on the ABI Charges Agreement, all charges associated with pension schemes should be disclosed in a framework that will allow employers to compare commonly defined charges. This framework should be mandated by the DWP'
>
> **Association of British Insurers**

12. The general consensus amongst respondents is that greater transparency is a good thing, although a small minority of respondents felt that there was sufficient transparency already, particularly with regard to non-expert audiences who may have difficulty with further details.

> 'Without the assistance of a fully qualified Adviser, the DWP is correct that the Employer and its Employees would struggle with the complexity of any further disclosure. Indeed it is difficult enough to persuade individuals to save for retirement without making the process even more convoluted'
>
> **Churchill's consulting**

13. The consultation proposed a number of potential options for improving disclosure and transparency. These included:

    - mandating disclosure to scheme members;
    - standardising disclosure of charges information to employers;
    - proposals to standardise and require disclosure of transaction costs by investment managers; and
    - whether there was a role for a mechanism by which charges could be made available in a way that enabled public comparison.

    In the charges consultation we asked: Is further action required by the Government to improve disclosure and if so which of the options should be introduced? Are there any other options?

    In the charges consultation we asked: How might the total cost of scheme membership including transaction costs be captured, what would be reasonable and practical to ask providers and investment managers to report on and to whom (members, employers and governance committees/trustee boards)?

Mandating and standardising disclosure to trustees, IGCs and employers

14. The majority of those who responded to these questions considered that disclosure of charges information by schemes to those making the decisions about choosing or running a scheme was the most important issue. Many pointed out that those who are responsible for the ongoing oversight and evaluation of the scheme – trustees and IGCs – should have sufficient information on charges and scheme quality to make decisions based on value for money.

> 'We believe that although disclosure to members is important, it is ultimately the employer/Governance committees/Trustee Boards who make decisions regarding workplace pensions and as such, this is where any further regulated disclosure requirements should be focused.'
>
> **Portus**

15. Several respondents also pointed out that such comparisons would only be possible where information given to those responsible for the selection and oversight of schemes is in a standardised, comparable format.

> ‘There needs to be a standard basis (or a common currency) to compare charges between schemes, as it is currently impossible to directly compare (on a like for like basis) the various charging structures’
>
> **B&CE**

> ‘Clear transparent charge disclosure should be mandatory, building on work by the ABI and NAPF’
>
> **L&G**

Disclosure of transaction costs

16. As set out in Chapter 3, transaction costs are costs associated with investment transactions and will vary according to a number of factors, such as market conditions and the number of transactions made. While recognising that historic information about such costs and returns may not be an effective indicator of future performance, the OFT suggested that it is nevertheless important to improve the visibility of transaction costs as a way of driving competition. The OFT made it clear that whilst giving such information to individual members or employers may not lead to increased competition, trustees and IGCs would be in a position to challenge the value delivered by these costs.

17. As set out in the charges consultation, the Government wants to see improved transparency of transaction costs. There was general support for improving transparency in this area, although a number of respondents highlighted the difficulties in requiring the disclosure of these costs, including concerns about creating inappropriate incentives for under-trading which may not be in the member’s interest.

18. Respondents were generally supportive of requiring trustees and IGCs to be provided with detailed information about both charges and transaction costs, as it was acknowledged that they would be best placed to effectively scrutinise value for money and exert downward pressure on schemes to deliver this.

19. Respondents also stressed that transaction costs should be disclosed in a comparable format and presented within the wider context of investment performance and market conditions. This would enable trustees and IGCs to assess the transaction costs in terms of value for money. It may be that a more expensive, actively managed investment strategy can provide higher returns net of fees and costs than a cheaper passive alternative, but crucially this cannot be guaranteed.

> ‘Employees need to receive a meaningful single figure and a cash value (excluding transaction costs) as per the ABI proposals on disclosure to employees. Governance committees, providers, employers and trustees need to see a breakdown of all charges (including transaction costs) levied on the member’s account or the funds they invest in to enable them to hold the relevant parties to account.’
>
> **Friends Life**

20. There was some support for disclosing transaction costs to members retrospectively through annual statements so long as this was meaningful and relevant; although some concerns were raised about whether members would fully understand these costs and be able to assess their value relative to investment returns.

> ‘Individual scheme members should also receive this information through inclusion in the annual statements which are provided. ...we recognize the need for transparency and... consider that transaction costs should still be disclosed in order to provide all relevant information to trustees, governance committees and members.’
>
> **Blackrock**

> ‘...we are concerned that disclosure of these figures could push members into making poor choices. Where members have the option between choosing several funds, cash funds will often have the lowest/no transaction charges due to their strategy. If members see the cash fund with no transaction costs compared to a standard default fund with higher transaction costs, many could pick the cash fund without fully appreciating the implications...’
>
> **Now Pensions**

21. There was also support for transaction costs being made publicly available to members and employers.

> ‘We are in favour of disclosing charges upfront, in a consistent manner, to members and employers. We are also in favour of making transaction costs publically available to members and employers.’
>
> **JPMorgan Asset Management (UK) Limited**

> ‘While it is unlikely that the majority of individual scheme members would be interested in or gain much by receiving information around transaction charges, it is important that this data is publicly available both in the interests of transparency and for those scheme members that would want to see this information. It would also be useful to enable analysts to monitor if costs are shifted from the headline charge on to transactions.’
>
> **Age UK**

Public comparison of charges

22. A number of respondents also commented on whether there was a role for a mechanism by which charges could be made available in a way that would enable public comparison.

23. Of those in favour of such a mechanism, there was support for a national database of automatic enrolment schemes, or publication of pan-industry charges tables to create competition, although there are a variety of ways by which public comparison could be achieved.

> ‘...a scheme comparator tool should be developed by the industry, overseen by the Pensions Regulator, and be made publicly available. Users of the tool would be presented with a simple, standardised breakdown of charges that a scheme member can expect to pay.’
>
> **Federation of Small Businesses**

24. Some respondents were opposed to a public comparison mechanism, pointing out that such a mechanism would be difficult to achieve given the differing factors that can affect the pricing of a scheme. It was also felt that it could inadvertently mislead employers or cause consumer detriment unless those accessing it had a good understanding of pensions.

'...listing all charges on a public website will not be useful and has the potential to cause consumer detriment unless those accessing the information have a good understanding of pensions and the value for money provided through their workplace pension arrangement. Scale, governance, investment strategy and services all have an impact on the charges levied on a scheme and its membership.'

NAPF

Mandating disclosure to members

25. Whilst most respondents agreed that more transparency was a good thing, there was some concern expressed about the value of disclosing detailed charges information to members. Some felt that this could be counter productive and that giving full detailed charges information to individual members may lead to opt-outs from schemes into which members had been automatically enrolled. It was recognised that under automatic enrolment, individual members will have little choice in scheme selection and ultimately their only choice is to opt out.

26. Similarly, some argued that, in relation to transaction costs in particular, providing information to members would be counter productive and that disclosure of such costs should be confined to IGCs and trustees:

'...we are extremely wary of communicating these charges to members; it would be more suitable for transaction charges to be disclosed to trustees/governance committees who have the knowledge to understand these costs when picking fund ranges for their members.'

NowPensions

27. Nevertheless, a number of respondents felt that disclosure of charges information to members was desirable as long as the information was presented in a meaningful, proportionate way and did not discourage saving:

'for disclosure to members, a balance needs to be struck between better transparency which will hopefully drive down costs against reality that members have a limited choice – only opt out available.'

Assocation of Pensions Lawyers

28. One respondent cited the Danish model whereby consumers are able to log onto a government backed website and access information about their pensions. Scheme members are able to access straightforward information about their pensions, such as the funds they are invested in, contributions made into the fund and the returns that have been made.

'We need a change to the way annual statements and pre-purchase information are given to customers. The annual statement should be presented like a bank statement. This is simple to do. It already happens in Denmark. Pre-purchase information should show what effect charges will have on pension outcomes'.

RSA

Government response

29. We recognise and welcome the various industry-led initiatives which aim to increase transparency of charges. However, we share the view of many respondents to the charges consultation that disclosure of information should be mandatory and standardised. This will strengthen the ability of those who select and govern pension schemes to make meaningful comparisons about what scheme members are paying for. Such disclosure is essential if employers are to select schemes based on value for money and to the operation of the proposed strengthened trustees boards and IGCs, who will have the duty to assess and report on the value for money offered by schemes.

Transaction costs

30. The Government is committed to improving disclosure of transaction costs. As recognised in Chapter 3, transaction costs – as well as other charges – can have a direct impact on the size of a member's pot and eventual retirement income. It is therefore vital that trustees and IGCs have access to the full range of charges and costs which impact on their member's pension savings when making value for money assessments.

31. To signal the Government's strong commitment to tackle the hitherto undisclosed area of transaction costs and improve transparency in this area, we have introduced amendments to the Pensions Bill in February and March 2014 which impose a duty on the Secretary of State (in the case of trust-based schemes) and the FCA (in the case of contract-based schemes) to legislate and make rules to require information about transaction costs to be given to specified persons.

32. We propose to work with the FCA to develop regulations and rules under this duty to ensure full, standardised disclosure of transaction costs through a new requirement for providers to give information on transaction costs to trustees and IGCs. We recognise that our proposals will need to work for different models of scheme – including, for example, unbundled trust-based schemes that purchase service from a number of different providers – and will work with stakeholders on the development of our approach to regulations and rules.

Information to trustees and IGCs

33. We agree with respondents to the charges consultation that the crucial audience for information about charges and costs is those people who have responsibility for overseeing schemes and scrutinising their performance. Chapter 1 describes our proposals for new governance requirements requiring trustees and IGCs to assess and report on the value for money delivered by schemes. This will create a new demand for clear information about the charges and costs that impact on members' pension savings.

34. We will then build on this to introduce requirements for the disclosure of complete, comparable and consistent information on all costs and charges.

35. Given the different parties that will need to make and receive reports, it is particularly important to take a joined-up regulatory approach to implementing these requirements. We are therefore working closely with both TPR and the FCA on how to implement the new requirements via regulations and FCA rules as soon as possible, to require consistent and itemised transparency to trustees and IGCs of both administration charges and transaction costs from pension providers.

36. These new transparency requirements will enable trustees and IGCs to hold pension providers, asset managers and administrators to account for value for money derived from the costs and charges ultimately borne by the member and would therefore enhance and support good governance.

37. We recognise that this will need to operate in different ways for different models of scheme, particularly unbundled trust-based arrangements (including mastertrusts), where trustees might purchase services from a number of different service providers and where it is the trustees who are in control of the charge rather than this being set by a provider. We anticipate that the new governance requirement to report on charges and costs would incentivise trustees to not use service providers that levied excessive charges. **However, we would welcome views on how these transparency requirements could be made to work effectively in unbundled trust-based arrangements (including mastertrusts).**

Information to employers

38. Those responsible for initially choosing a scheme need meaningful, comparable information about the costs and charges which will ultimately be borne by the scheme members, to ensure that they can assess likely value for money offered by schemes and make appropriate choices. In this context, schemes and providers – including mastertrusts – must make available consistent and comparable information in a standardised format on charges and costs to employers.

39. We intend to set out the detail of what will be required of providers in regulations and work with the FCA on the development of rules after engaging with both regulators and the industry. We propose that this information will be at a headline level with more in-depth charges and costs information available to trustees and IGCs who will be better placed to hold schemes to account for providing value for money to their members.

Information to members

40. It is important that scheme members who wish to engage more fully with their pension have the opportunity to obtain details of the charges and costs being made against their pension pots. However, as highlighted in a number of responses to the consultation, this needs to be balanced against the dangers of inundating members with too much complex information about charges and costs in a way that is out of context and difficult to understand. The overriding principle is that information to members needs to be relevant, meaningful and proportionate.

41. We therefore propose to require trustees and providers to provide headline information about management charges in the basic scheme information to new and prospective members and to require the disclosure of headline charges and costs to members as part of the annual benefit statement.

42. We will work with regulators and industry to consider the most meaningful and effective way of presenting this information to members. We are initially of the view that stating transaction costs to members in full and separately may not be meaningful as it would be difficult for members to effectively gauge the value of these costs, and because of the risks of displaying these costs out of context. An option could therefore be for members to receive a total figure of all incurred charges, inclusive of transaction costs. Whatever approach we take, it is important that members should know at a headline level what they are paying for their pension membership.

43. As well as the individualised information in their annual benefit statements, members would be able to access information on the value for money delivered by their scheme – including charges and costs – from the annual report published by the scheme's trustees or IGC. We think that this approach to member disclosure could strike the necessary balance between greater transparency and meaningful, relevant information for members that the majority of responses to the consultation emphasised was essential.

Publication of charges information

44. We think there is merit in a mechanism by which standardised comparable information on all charges is published. The recent amendments to the Pensions Bill described above also introduce a duty on the Secretary of State and the FCA to make regulations and rules requiring the publication of transaction and administration costs.

45. We recognise the challenges in implementing a public comparison model that respondents to the charges consultation raised, and will work with industry and regulators to address these. This will include considering what reporting mechanisms might be required and how comparative data on costs and charges might be introduced to the market to facilitate comparison and competition.

Defined Benefit schemes

46. Whilst the focus of the Government's work on quality standards and charges, and the OFT's market report were improving transparency and competition in the DC pension scheme market; we are aware that our proposals on transparency could potentially have a wider application. **We would welcome views on whether the transparency requirements we propose for DC schemes should, in the future, be extended to DB schemes, to enable sponsoring employers to further scrutinise the costs of such schemes.**

Conclusion: summary of proposals

47. The first wave of enhanced transparency will come with the introduction of IGCs and strengthened trustee boards in April 2015. The new duties on these bodies to consider and report on costs and charges will create a new demand for this information, and a new route for making it public. We expect to see rapid progress in this area ahead of those new duties coming into force in April 2015.

48. We will then build on this strengthened base to introduce requirements – via regulations and FCA rules – for the full disclosure of all administration charges and transaction costs:

- Providers of workplace DC schemes would be required to disclose full information on all charges and costs in a standardised and comparable format to trustees and Independent Governance Committees. We would welcome views on how this could operate for unbundled trust-based schemes, including mastertrusts.
- Providers and trustees would be required to provide information about charges and costs to employers before the employer makes a choice of scheme and on an annual basis thereafter. This information will be made available in a standardised comparable format to ensure that employers can assess likely value for money offered by schemes and make appropriate choices.

- Providers and trustees would be required to provide information about charges to new and prospective scheme members, and headline charges and costs annually as part of the annual benefit statement.
- The Pensions Bill 2014 places duties on the Secretary of State and the FCA requiring the publication of information about transaction costs and administration charges. We will work with industry and regulators to develop a method by which charges and costs can be made publicly available in a format which is meaningful to members, employers and those charged with assessing the ongoing value for money of pension schemes.
- As per our proposals in Chapter 3, we will also use transparency information on transaction costs to consider, in 2017, whether to include some or all of these costs within a reviewed default fund charge cap.

49. We recognise that achieving transparency, in the ways described here, will require co-operation between the industry, regulators, employers and consumer groups ahead of implementation, which begins from April 2015. In this endeavour we will build on the positive steps made so far towards this objective; we are keen to keep up the pace of change and have introduced amendments to the Pensions Bill in February and March 2014 to pave the way for some of the transparency proposals set out above.

50. The improvements made so far as a result of industry initiatives have been valuable but, as described above and highlighted by OFT and the Work and Pensions Select Committee, these are voluntary initiatives which lack enforceability and have no definite timeline for implementation. Mandating full transparency and giving additional responsibilities in this area to those with a duty to members, together with the charge controls and governance proposals, is the most effective way to ensure that workplace pension schemes provide value for money to their members.

Timetable for implementing the Better Workplace Pensions reforms

7

1. The package of measures outlined in this Command Paper will introduce new standards in workplace pensions that will benefit scheme members immediately and over the long term. The Government recognises the significance of the reforms and understands the need to introduce them in a measured way. We want to be able to give employers, pension schemes and providers sufficient time to comply with the measures. So none of the proposed changes will be introduced before April 2015, and some will be implemented later.

2. The Pensions Bill currently going through Parliament contains primary legislation that will deliver most of this package of measures. Assuming the Bill receives Royal Assent, we aim to lay secondary legislation in the latter part of 2014.

3. The key implementation dates are set out below.

2014

- Primary legislation on quality and charges measures through the Pensions Act 2014 (assuming Royal Assent received March/April 2014).
- DWP consultation on quality standards in all workplace defined contribution pension schemes (spring 2014) – see consultation questions below.
- FCA to consult on rules for Independence Governance Committees (summer 2014).
- Begin work with industry, regulators, employer and consumer groups on achieving full transparency of information on costs and charges (From March 2014).
- Secondary legislation relating to quality and charges measures laid in Parliament (autumn 2014).

2015

- New governance standards for all DC workplace pension schemes to be introduced (April 2015).
- New FCA rules on Independent Governance Committees to be introduced (April 2015).
- IGCs and trustees have new requirement to report on costs and charges (April 2015).
- The default fund charge cap of 0.75 per cent of funds under management applied to all qualifying schemes. Consultancy charges banned in qualifying schemes. (April 2015).

2016

- All Active Member Discount structures and member-borne commission payments banned in qualifying schemes (April 2016).

2017

- The Government will examine whether some or all transaction costs should be included in the default fund charge cap, and whether the level of the cap should be lowered.

Annex A
Areas for further consultation and how to respond

1. Areas for further consultation

This consultation asks for responses to the following questions on standards in workplace Defined Contribution (DC) pension schemes by 15 May 2014.

Administration

1. We would welcome views on the potential benefits of accreditation of administrators, and what role government and regulators could play in supporting this.
2. We would also welcome suggestions of other approaches to helping trustees and Independent Governance Committees (IGCs) ensure that their scheme is being administered to a good standard.

Mastertrusts

3. Should mastertrusts have to meet the same independence standards as providers of contract-based schemes?
4. We would welcome views on the proposed definition of ‘independent’ at **Annex B**.
5. Should the independence requirements be applied in different ways to different models of mastertrust. In particular, how should the independence requirements be applied to mastertrusts that use an independent trustee firm to act as their corporate trustee?

Trust-based governance

6. We would welcome views on the proposed quality standards for trust-based governance which are summarised at **Annex B**.
7. Are the requirements listed at paragraph 8 the right quality standards to be set in regulations for trust-based schemes?

8. Should trust-based schemes be required to have a chair of trustees?

9. Will the new reporting requirements help drive compliance with the standards and regulation of these?

Transparency

10. We would welcome views on how these transparency requirements could be made to work effectively in unbundled trust-based arrangements (including mastertrusts).

11. We would welcome views on whether the transparency requirements we propose for DC schemes should, in the future, be extended to DB schemes, to enable sponsoring employers to further scrutinise the costs of such schemes.

About this consultation

Who this consultation is aimed at

We welcome comments from those involved in designing and running pension schemes, pension industry professionals and advisers, pension scheme members, consumer groups and member representative organisations, and anyone with an interest in pensions.

Scope of consultation

This consultation applies to England, Wales and Scotland.

Duration of the consultation

The consultation period begins on 27 March 2014 and runs until 15 May 2014. Please ensure your response reaches us by that date as any replies received after this may not be taken into account.

How to respond to this consultation or raise queries about its content

Please send your consultation responses and any queries to:

Private Pensions Policy and Analysis
Department for Work and Pensions
1st Floor, Caxton House
6-12 Tothill Street
London
SW1H 9NA

Email: reinvigorating.pensions@dwp.gsi.gov.uk

Please ensure your response reaches us by **15 May 2014**.

When responding, please state whether you are doing so as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents, and where applicable, how the views of members were assembled. We will acknowledge your response.

How we consult

Freedom of information

The information you send us may need to be passed to colleagues within the Department for Work and Pensions, published in a summary of responses received and referred to in the published consultation report.

All information contained in your response, including personal information, may be subject to publication or disclosure if requested under the Freedom of Information Act 2000. By providing personal information for the purposes of the public consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information provided, or remove it completely. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this.

To find out more about the general principles of Freedom of Information and how it is applied within DWP, please contact:

Central Freedom of Information Team
Caxton House
6-12 Tothill Street
London
SW1H 9NA

Email: Freedom-of-information-request@dwp.gsi.gov.uk

The Central Freedom of Information team cannot advise on specific consultation exercises, only on Freedom of Information issues. More information about the Freedom of Information Act can be found at https://www.gov.uk/make-a-freedom-of-information-request

Consultation principles

This consultation is being conducted in line with the Government's Consultation Principles, which were introduced on 17 July 2012, and have been recently updated. The revised Principles are at:

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/255180/Consultation-Principles-Oct-2013.pdf

The key principles are:

- departments will follow a range of timescales rather than defaulting to a 12-week period, particularly where extensive engagement has occurred before;
- departments will need to give more thought to how they engage with and consult with those who are affected;
- consultation should be 'digital by default', but other forms should be used where these are needed to reach the groups affected by a policy; and
- the principles of the Compact between government and the voluntary and community sector will continue to be respected.

Feedback on the consultation process

We value your feedback on how well we consult. If you have any comments on the process of this consultation (as opposed to the issues raised) please contact our Consultation Coordinator:

Elias Koufou
DWP Consultation Coordinator
2nd Floor
Caxton House
Tothill Street
London
SW1H 9NA

Phone: 020 7449 7439
Email: elias.koufou@dwp.gsi.gov.uk

In particular, please tell us if you feel that the consultation does not satisfy the consultation criteria. Please also make any suggestions as to how the process of consultation could be improved further.

If you have any requirements that we need to meet to enable you to comment, please let us know.

Annex B
Minimum quality standards

Term of reference for Independent Governance Committees

Duties – IGCs

- Assessing the ongoing value for money delivered by schemes, particularly, though not exclusively, through assessing:
  - Whether default investment strategies are designed in the interests of members, with a clear statement of aims, objective and structure and how these are appropriate for their membership.
  - Whether the characteristics and net performance of default investment strategies are regularly reviewed to ensure alignment with the interests of members, and action taken to make any necessary changes.
  - Whether core scheme financial transactions are processed promptly and accurately.
  - The levels of charges borne by scheme members.
  - The costs incurred through investment of pension assets.
- Acting in members' interests (both active and deferred)
- Recommending actions to the provider's Board where it identifies a problem with the value for money that a scheme/s offer/s
- If the Committee is not satisfied with the actions of the Board in response to a recommended action, reporting this to the Financial Conduct Authority (FCA), and to members and contributing employers, if considered to be in members' interests.

Reporting

- The Chair must produce an annual report covering:
  - the value for money delivered by schemes, particularly with regard to the standards listed above.

  - how the IGC has acted in members' interests
  - recommendations made to the provider's Board, and the response received to these recommendations.
- The report must also include:
  - how the membership of the committee as a whole has sufficient independence, expertise and experience to act in members' interests
  - identification of each independent member of the IGC
  - arrangements in place to ensure representation of members' interests

Duties – providers

- Ongoing responsibility for maintaining an IGC according to the following requirements:

Resources

- The provider must furnish the IGC with requested information, including commercially sensitive information.
- The provider must furnish the IGC with resources for independent professional advisers, including, but not limited to, an independent investment adviser and independent lawyer.
- The provider must have a 'comply or explain' duty regarding recommendations received from the IGC.

Membership

- The IGC must have a minimum of seven members, the majority of whom, including the chair, must be independent of the provider.
- The provider must have arrangements in place to ensure that members' views are directly represented.

Coverage

- One IGC per provider of contract-based schemes.
- We will explore alternative arrangements for smaller providers, for whom it may not be proportionate to require a full IGC.

Minimum governance standards for occupational Defined Contribution (DC) schemes

Coverage

- All DC occupational schemes and DC sections of sectionalised schemes, excluding small self-administered schemes (SSAS) and family trusts.
- Some additional standards for mastertrusts (see page 106).

New quality standards

- All schemes must have a chair of trustees.
- Default strategies must be designed in the interests of members, with a clear statement of aims, objective and structure and how these are appropriate for their membership.
- The characteristics and net performance of default options must be regularly reviewed to ensure alignment with the interests of members, and action taken to make any necessary changes.
- Core scheme financial transactions must be processed promptly and accurately.
- Trustees must assess the levels of charges borne by scheme members
- Trustees must assess the costs incurred through investment of pension assets.
- The trustee board must have, or have access to, all of the knowledge and competencies necessary to properly run the scheme.
- Trust deeds and rules must not require trustees to use particular investment or administration providers, or to make particular investments.

Reporting

- The Chair must produce an annual report in the scheme's audited report and accounts covering how the above quality standards are met.

Mastertrusts

In addition to the above requirements:

- Mastertrust boards must have a minimum of seven trustees, the majority of whom, including the chair, are independent of the providers of services to the mastertrust.
- The scheme must have arrangements in place to ensure that members' views are directly represented.

Definition of 'independent' for minimum governance standards

- An independent trustee/IGC member must not:
  - be an employee of the provider or scheme or paid by them for any role other than that which they fulfil on the trustee board/IGC, including participating in the company's share option or a performance-related pay scheme;
  - have been an employee of the company or group within the last five years;
  - have, or have had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such as relationship with the company.
- The trustee board/IGC should also determine whether each independent member is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the independent member's judgement.
- The trustee board/IGC should state its reasons if it determines that an independent member is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the independent member:

  - is a member of the provider's pension scheme;
  - has close family ties with any of the provider's advisers, directors or senior employees;
  - holds cross-directorships or has significant links with other trustees/IGC members through involvement in other companies or bodies;
  - represents a significant shareholder; or
  - has served on the trustee board/IGC for more than six years from the date of their first election.

Appointments

- The provider must use either an external search consultancy or open advertising to appoint independent members, including the trustee board/IGC chair.
- Where an external search consultancy has been used it must be identified by the provider and a statement made as to whether is has any other connection with the provider.
- The provider must involve the independent trustee board/IGC chair in the appointment of other members.

Duration of appointment

- Trustee/IGC members should be appointed for fixed terms of 3 years.
- Trustees/members should be eligible for re-appointment a maximum of twice. There should be particularly rigorous appraisal if appointing an independent member for a third term.
- Providers should manage appointments and end dates in such a way to ensure continuity.

Annex C
Combination charges equivalency tables

1. Equivalency tables 1 and 2 have been estimated to demonstrate how different combination charges compare to a 0.75 per cent charge cap on default funds. The results of this modelling are shown below in tables C.1 (contribution charge structures) and C.2 (flat-fee structures). The tables present the average funds under management (FUM) equivalent charge for 10 individuals compared to a range of combination charge permutations.

Table C.1: Average FUM-charges for the 10 individuals modelled for contribution charges

Contribution charge (%)	Percentage charge of funds under management (%)						
	0.1	0.2	0.3	0.4	0.5	0.6	0.7
0.5	0.16	0.26	0.36	0.45	0.55	0.66	0.76
1.0	0.21	0.31	0.41	0.51	0.61	0.71	0.81
1.5	0.26	0.36	0.46	0.56	0.66	0.77	0.87
2.0	0.32	0.42	0.52	0.62	0.72	0.82	0.92
2.5	0.37	0.48	0.58	0.68	0.78	0.88	0.98

Note: Shaded areas indicate where the equivalent FUM-charge is greater than 0.75% and therefore not permissible under the default fund charge cap.

Modelling assumptions: salary £20k; contribution rate 8%; investment growth 7%; earnings growth 4%; inflation 2%.

Table C.2: Average FUM-charges for the 10 individuals modelled for flat-fee charges

Flat fee per year (£)	Percentage charge of funds under management (%) 0.1	0.2	0.3	0.4	0.5	0.6	0.7
5	0.15	0.25	0.35	0.45	0.55	0.65	0.75
10	0.21	0.31	0.41	0.51	0.61	0.71	0.81
15	0.26	0.36	0.46	0.56	0.66	0.76	0.86
20	0.31	0.41	0.51	0.62	0.72	0.82	0.92
25	0.37	0.47	0.57	0.67	0.77	0.87	0.97

Note: Shaded areas indicate where the equivalent FUM charge is greater than 0.75% and therefore not permissible under the default fund charge cap.

Modelling assumptions: salary £15k, £20k, £28k; contribution rate 8%; investment growth 7%; earnings growth 4%; inflation 2%.

2. We have modelled 10 individuals in tables 1 and 2:

Group 1: Individual aged 60 who saves for 6 years and then retires.
Individual aged 52 who saves for 14 years and then retires.
Individual aged 44 who saves for 23 years and then retires.

Group 2: Individual aged 30 who saves for 6 years and then defers until retirement at 68.
Individual aged 30 who saves for 14 years and then defers until retirement at 68.
Individual aged 30 who saves for 23 years and then defers until retirement at 68.

Group 3: Individual aged 25, saves for 10 years, then defers for 5 years then saves for a further 25 years before retiring at 65.
Individual aged 25, saves for 5 years, defers for 10 years and then saves for a further 20 years before retiring at 60.

Group 4: Individual aged 22 saves for 2 years and then defers until retirement at 68.
Individual aged 62 years saves for 4 years and then retires at 66.

3. The four groups can be broken down into: those who start saving later in their working life; those who begin saving at 30; those who take career breaks and; those who save for short periods of time. These groups have been chosen to reflect a wide range of different savers with different working patterns. The choice of years saving for those who save later in their working life and those who begin saving at age 30 has been guided by modelling in PENSIM2 of the future savings distribution.

Contribution charges

4. The modelling is based upon comparing the proportion of pension pot lost to charges in a combination charge structures with the equivalent proportion of pension pot lost in a FUM-only structure for each of the 10 individuals. In the case of contribution charge structures, the length of time saving is the key variable which impacts on the equivalent FUM charge and salary has no impact on the proportion of an individual's pot lost through charges. Therefore all individuals have been modelled with a salary of £20,000. This is the median earnings for private sector workers in the eligible automatic enrolment population who have no existing workplace pension[45].

Flat-fee charges

5. In the case of flat fees, we have modelled the same 10 individuals, but we have done so for three salary levels. Flat fees are regressive, so salary is an important variable in these calculations. We have used £15k, £20k and £28k. This represents the 25th percentile, median and 75th percentile of the earnings distribution for private sector workers in the automatic enrolment eligible population who have no workplace pension[46]. This means that in the case of flat fees equivalency table (table 2) we have 24 scenarios.

[45] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209864/ad-hoc-supporting-ae-further-analysis.pdf
[46] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209864/ad-hoc-supporting-ae-further-analysis.pdf

Annex D
List of respondents to 'Better Workplace Pensions: A consultation on charging' and 'Quality standards in workplace defined contribution pension schemes: call for evidence'

List of respondents to 'Better Workplace Pensions: a contribution on charging'

Aegon
AgeUK
AJ Bell
AKQA
Alliance Bernstein
Aon Hewitt
Aquila Heywood
Asda
Association of British Insurers
Association of Consulting Actuaries
Association of Pension Lawyers
Association of Professional Advisers
Aviva
B&CE
Barclays
Benefex
Blackrock
Brunsdon
Buck Consultants
Calthorpe Estates
Capita
Change Agents
Charity Finance Group
Charlton Frank
Chartered Institute of Personnel and Development
Cheviot Trust
Churchills Consulting
Citizens Advice Bureau Northern Ireland
Close Brothers
Cognizant
Confederation of British Industry
Dean Whetton Advisory
Easy Jet
EEF
Electrocomponents Group Pension Scheme
Elton Consulting
Federation of Small Businesses
Fidelity
Financial Services Consumer Panel
Finnemeccania
Formula Chartered Financial Advisers

Foster Denovo
Friends Life
Fujitsu
GLE Group
GMB
Grant Thornton
Hargreaves Lansdown
Haskonig DHV UK ltd
Hymans Robertson
ICB Financial Services Limited
ILAG
IMI Retirement Savings Plan
Institute and Faculty of Actuaries
Institute of Directors
Investment Managers Association
Jaguar Land Rover
Jelf
JLT Employee Benefits
Johnson Fleming
JP Morgan
Kingfisher Pension Trustee Limited
KPMG
Lane Clark & Peacock
Law Society of Scotland
LEBC
Legal and General
Lifeplus Europe
Mercer
Mizuno Corp
National Association of Pension Funds
National Union of Teachers
Network Rail
Now:Pensions
Origen
Pension PlayPen
Pension Quality Mark
Pensions Management Institute
Pensions Policy Institute
Pensions Trust
Phoenix Group
PIMCO
Portus
Printing Industry Pension Scheme (PIPS)
Prospect
Prudential
P-Solve
PTL
Public and Commercial Services Union
Punter Southall
Railway Pensions Trustee Company Limited
Richmond House Group
Royal Society of Arts
Sabio
Sackers
Schroders
SCM Private
Scottish Life
Scottish Widows
Sesame Bankhall Group
Seven
Shanly Group
Skagen Funds
Skandia
Society of Pension Consultants
Somborne
Spence Johnson
St James's Place
Standard Life
Stonefish
Super Trust UK
Swiss Post Solutions
Syngenta
Tax Incentivised Savings Association
Thomsons
Towers Watson
Trade Unions Congress
Unison
Unite
University of Bath, School of Management
Which?
Whitbread Group Plc
Whitgift Foundation
William Hill Pension Scheme Trustees
Zurich

Forty individual respondents

List of respondents 'Quality standards in workplace defined contribution pension schemes: call for evidence'

Association of British Insurers
Aegon
Age UK
Alliance Bernstein
Aon Hewitt
Association of Pension Lawyers
Aviva
B & CE
Bank of America
Buck Consultants
Capita
Association of Member Nominated Trustees
Confederation of British Industry
Charlton Frank
Clifford Chance
Deloitte EEF
Elston Consulting
Fidelity
First Actuarial
Financial Reporting Council
Friends Life
Hargreaves Lansdown
Hundred Group Pensions Committee
Hymans Robertson
ICAEW
International Financial Data Services
Institute and Faculty of Actuaries
Investment Managers Association
JLT Employee Benefits
JP Morgan
KPMG
Legal & General
Lighthouse
Mercer
National Association of Pension Funds
NEST
NOW Pensions
Pensions Management Institute
Prudential
PwC
Sackers
Share Action
Schroeder
Scottish Life
Scottish Widows
Society of Pension Consultants
Squire Sanders
Standard Life
Tax Incentivised Savings Association
Towers Watson
Trades Union Congress
Welplan
Which?
Zurich

Two individual respondents

Glossary of terms

Accumulation	The period during which savings are accrued for retirement.
Active fund management	The management of assets in which a fund manager actively selects particular stocks at particular times, with the aim of achieving higher than average growth for the assets in question.
Active member	A member of a pension scheme who is at present accruing benefits under that scheme.
Active member discount (AMD)	A charge structure where active members of a scheme pay lower charges than deferred members who have stopped making contributions.
Administration	The day to day running of a pension scheme. This may include collecting contributions and payment of benefits.
Adviser	A professional who renders financial services to clients.
Annual management charge (AMC)	This is levied as an annual charge on the value of the scheme fund. It may cover a combination of the sales, administration and fund management costs of the fund.
Annuity	The fixed sum of money paid to individuals each year upon retirement. This is typically for the rest of their life based on their total accumulated pension savings.

Assets Under Management (AUM)	The total of all funds being managed on behalf of scheme members.
Automatic enrolment	Employers are be required to make arrangements by which eligible jobholders become active members of an automatic enrolment scheme with effect from the automatic enrolment date. Automatic enrolment is not applicable if the jobholder is an active member of a qualifying scheme on that date.
Automatic transfer	Making pension transfers the default action unless the individual indicates they would like to keep their pension pot in the scheme or transfer it to another pension scheme.
Bundled schemes	Pension schemes where the pension provider also administers the scheme.
Commission	A payment, which may be either an upfront or on-going fee (often called trail commission) or both, for advice services agreed between a scheme provider and an adviser. The cost is recouped through member-borne charges.
Consultancy charging	An upfront fee for advice services agreed between an employer and an adviser. The cost is recouped through member-borne charges.
Contract-based schemes	Schemes where an employer appoints a pension provider, often an insurance company, to run the scheme. The scheme members will sign a contract with the provider who will make the majority of decisions about the way the scheme is run.
Contributions	The money paid by members and employers to the pension scheme.
Decumulation	The process of converting pension savings into a retirement income.
Default fund	If employees do not actively choose an investment fund, they will have their contributions paid into a default fund, designed for this purpose.
Deferred members	In defined contribution schemes, this is someone who no longer contributes to the scheme but is not yet a beneficiary of that scheme. In some contract-based arrangements the member may be reclassified as a member of an Individual Personal Pension rather than a Group Personal Pension.

Defined Benefit (DB)	A scheme in which the benefits are defined in the scheme rules and accrue independently of the contributions payable and investment returns.
Defined Contribution (DC)	A defined contribution schemes' benefits are based on how much the member and employer pay into the scheme, and also on the performance of the investments made with that money.
Employment Benefit Consultants (EBC)	A firm of advisers that gives advice to employers on the benefits packages, including pensions, which they might offer to their employees
Financial Conduct Authority (FCA)	The FCA is responsible for regulating the standards of conduct in retail and wholesale, financial markets and for supervising the infrastructure that supports those markets.
Fund Management or Investment Management	The business of dealing with the investment of sums of money on behalf of clients.
Group personal pensions (GPP)	A pension scheme which is organised through the employer, but still takes the form of individual contracts between the employee and the pension provider.
Hybrid schemes	A hybrid scheme is a mixture of defined benefit (DB) and defined contribution (DC).
Independent Financial Adviser (IFA)	Someone who is authorised to provide advice and sell a wide range of financial products.
Individual Personal Pension (IPP)	A pension scheme taken out by an individual for their own benefit and to which only they make contributions.
Intermediaries	Advisers
Investment Manager	An individual (or company) to whom the management of all or part of a scheme's assets is delegated.
Investment Strategy	The rules and procedures for the selection of the range of investment products for a pension scheme.
Legacy schemes	Any scheme set up pre-2001 when stakeholder pensions were introduced.
Mastertrust	A multi-employer pension scheme where each employer has its own division within the master arrangement. There is one legal trust and, therefore, one trustee board.
Member	An individual who has contributed and/or continues to contribute to a pension scheme.

Memberships	The number of members in a scheme (an individual can be a member of multiple pension schemes).
National Employment Savings Trust (NEST)	A defined contribution occupational pension scheme backed by the government. It has a public service obligation to let any employer that wishes to use it to do so, regardless of their size.
Occupational pension	A pension which is provided via the employer, but the pension scheme takes the form of a trust arrangement and is legally separate from the employer.
Passive (fund management)	Passive management is a financial strategy in which an investor (or a fund manager) invests in accordance with a pre-determined strategy that doesn't entail any forecasting. The most popular method is to mimic the performance of an externally specified index, such as the FTSE100.
Retail Distribution Review (RDR)	On 1 January 2013, the RDR introduced new rules from the then FSA on how financial advisory companies could operate. These rules included a stipulation that advisers are not able to take commission as a form of remuneration but instead will have to quote a fee for any advice given.
The Pensions Regulator (TPR)	TPR regulates trust based pension schemes in the UK.
Pension scheme	The arrangement by which an employer and, usually, an employee pay into a fund that is invested to provide the employee with a pension on retirement.
Self-Invested Pension Plan (SIPP)	A personal pension where the individual chooses where to invest his funds instead of giving his funds to a financial services company to manage.
Small self-administered scheme (SSAS)	A workplace pension scheme where the members are usually company directors or key staff. A SSAS usually has less than 12 members and, in some cases, all the members are trustees. Employers and members have more flexibility around, and more control over, the investments of a SSAS than in other workplace pension schemes.
Stakeholder pension	These were introduced in 2001 and were intended to encourage more long-term saving for retirement, particularly among those on low to moderate earnings. They are required to meet a number of conditions set out in legislation, including a cap on charges, low minimum contributions, and flexibility in relation to stopping and starting contributions.

Transaction costs	Variable trading costs that a scheme incurs when buying, holding and selling underlying investments. These costs cannot be predicted at the beginning of a reporting period as they are dependent on the level and nature of trading undertaken by a scheme, which in turn is influenced by market conditions.
Trustees	A member of the board of trustees responsible for the management, administration and investment of the pension assets.
Trust based schemes	A trust-based pension scheme is a scheme that is managed by a board of trustees. The trustees have full responsibility for the management, administration and investment of the plan. The trustees' fiduciary duty is to act in the interests of members and while they can delegate tasks to various specialists, such as investment managers, the responsibility remains with the trustee.
Unbundled schemes	A pension scheme where there is separation in the provider of either the investment management or administration of a scheme.
Workplace pensions	A pension provided by an employer.

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