

**EXPLANATORY MEMORANDUM TO**  
**THE OCCUPATIONAL PENSION SCHEMES (CHARGES AND GOVERNANCE)**  
**REGULATIONS (NORTHERN IRELAND) 2015**

**S.R. 2015 No. 309**

**1. Introduction**

- 1.1 This Explanatory Memorandum has been prepared by the Department for Social Development to accompany the Statutory Rule (details above) which is laid before the Northern Ireland Assembly.
- 1.2 The Statutory Rule is made under sections 109(1) and 177(2) to (4) of the Pension Schemes (Northern Ireland) Act 1993, Articles 35(1), (3) and (4), 36(1), (1A)(a) and (9), 47(6)(a), 68(2)(e) and 166(1) to (3) of the Pensions (Northern Ireland) Order 1995, Article 3(5) of the Welfare Reform and Pensions (Northern Ireland) Order 1999, Articles 55(2)(h), 236(1) and 287 of the Pensions (Northern Ireland) Order 2005 and sections 42 and 51(6) of, and paragraphs 1(1), (2)(a), (3) and (5), 2(1) to (3) and (5), 3, 6 and 7 of Schedule 18 to, the Pensions Act (Northern Ireland) 2015 and is subject to the confirmatory procedure.

**2. Purpose**

- 2.1 These Regulations set out a range of measures aimed at protecting members of occupational pension schemes which offer money purchase benefits. In particular, they set out what actions trustees and managers of these schemes must take in respect of charges and governance matters concerning these schemes.

**3. Background**

- 3.1 The Regulations are in consequence of section 42 of, and Schedule 18 to, the Pensions Act (Northern Ireland) 2015 to restrict charges or impose requirements on certain occupational pension schemes (“relevant schemes”) and set requirements relating to governance.
- 3.2 The Regulations cover a range of measures aimed at controlling the level and range of charges in relevant schemes which are used by employers to meet their automatic enrolment duties (known as qualifying schemes). These include capping charges in the default arrangements within schemes (broadly, arrangements into which members are contributing without making an active choice or which have a minimum percentage of workers contributing) at 0.75 per cent annually of funds under management, or an equivalent combination charge (for example, a percentage of funds under management and scheme contributions).
- 3.3 The Regulations also impose a ban on active member discounts from April 2016. These are charge structures where the charge imposed on a member is increased when they stop contributing to the scheme, for example, because they leave their employment.
- 3.4 In addition, they apply new governance measures across broadly all occupational pension schemes which offer money purchase benefits. Some schemes are not covered by either the

governance or the charges measures, for example, small self-administered schemes and executive pension schemes where there is expected to be a higher level of member engagement.

3.5 The Regulations also include a number of largely technical provisions, for example, they –

- restrict the charges that can be imposed on members of relevant schemes in certain circumstances;
- impose limits on the charges which can be imposed on members of relevant schemes and prohibit certain charges;
- provide alternative ways of assessing the charges imposed on a member;
- amend existing sets of Regulations relating to the governance of relevant schemes. These provisions include the override of any provisions in the trust deed or scheme rules which limits the choice of service providers. They also impose duties on trustees and managers to –
  - appoint a chair of trustees or managers;
  - prepare an annual statement of governance;
  - process core financial transactions promptly and fairly;
  - calculate and assess the value for money of charges and transaction costs, and
  - prepare a statement of investment principles in relation to the default arrangement;
- provide additional governance requirements for multi-employer schemes (known as “master trusts”). This includes additional provisions for the annual statement, the appointment of trustees and the representation of members;
- provide for compliance in relation to the duties imposed by the Regulations;
- make minor technical and consequential amendments.

#### **4. Consultation**

4.1 There is no requirement to consult on these Regulations as they make in relation to Northern Ireland only provision corresponding to provision contained in regulations made by the Secretary of State for Work and Pensions in relation to Great Britain.

#### **5. Equality Impact**

5.1 Proposals for the Pensions Act (Northern Ireland) 2015 were subject to a full Equality Impact Assessment. In accordance with its duty under section 75 of the Northern Ireland Act 1998, the Department has conducted a screening exercise on the legislative proposals for these Regulations. They are technical and beneficial in nature and have little implication for any of the section 75 categories. The Department has concluded that they would not have significant

implications for equality of opportunity and considers that an Equality Impact Assessment is not necessary.

## **6. Regulatory Impact**

6.1 Regulatory Impact Assessments are attached as Annexes 1 and 2 to this Explanatory Memorandum.

## **7. Financial Implications**

7.1 None for the Department.

## **8. Section 24 of the Northern Ireland Act 1998**

8.1 The Department has considered section 24 of the Northern Ireland Act 1998 and is satisfied that these Regulations –

(a) are not incompatible with any of the Convention rights,

(b) are not incompatible with Community law,

(c) do not discriminate against a person or class of person on the ground of religious belief or political opinion, and

(d) do not modify an enactment in breach of section 7 of the Northern Ireland Act 1998.

## **9. EU Implications**

9.1 Not applicable.

## **10. Parity or Replicatory Measure**

10.1 The corresponding Great Britain Regulations are the Occupational Pension Schemes (Charges and Governance) Regulations 2015 (S.I. 2015/879), and the Occupational Pension Schemes (Charges and Governance) (Amendment) Regulations 2015 (S.I. 2015/889).

10.2 The Great Britain Regulations were made on 23rd and 25th March 2015, and came into force on 6th April 2015. Powers under which these Regulations are made came into operation on 16th July 2015 and the Regulations were made on the same day. Owing to parity considerations it is vital that the Regulations come into operation as soon as possible, in this instance on 17th July 2015.

## REGULATORY IMPACT ASSESSMENT

### THE OCCUPATIONAL PENSION SCHEMES (CHARGES AND GOVERNANCE) REGULATIONS (NORTHERN IRELAND) 2015

#### MINIMUM GOVERNANCE STANDARDS FOR DC TRUST-BASED SCHEMES

The costs and savings outlined in this Regulatory Impact Assessment are calculated on a United Kingdom-wide basis.

#### Background

1. Automatic enrolment began in 2012 for the largest employers and will be gradually rolled out to medium, small and micro employers by 2017. It will generate an extra £11 billion a year in private pension savings from around six to nine million people<sup>1</sup> newly saving or saving more into a pension. To date 5.2 million eligible individuals have been automatically enrolled into a pension scheme<sup>2</sup> and average opt-out rates have been much lower than predicted, at around 10%<sup>3</sup>.
2. Automatic enrolment drives a fundamental shift in the dynamics of the workplace pensions market. The old model - whereby most individuals had to actively decide whether to join a pension scheme and the pensions industry had to spend time and money persuading them to do so – has gone. Instead, employers have a legal duty to enrol their employees into a pension scheme and inertia keeps most of them there. This leads to a huge increase in the number of workplace saving arrangements and funds flowing through the pensions industry. It is believed that this shift brings a new responsibility to ensure minimum standards apply in workplace schemes, including ensuring that schemes are overseen by competent bodies acting in members' interests. The creation of these minimum standards will help maintain confidence in automatic enrolment and the pensions industry that supports it.
3. The Department for Work and Pensions (DWP) has undertaken three consultations on how best to create minimum standards that reflect these changed dynamics. In the summer of 2013 it issued a Call for Evidence on minimum governance standards in workplace defined contribution schemes that asked for views on governance, scale, investment and administration standards. In November 2013 this was followed by a Consultation on Charges, which made proposals about protecting savers from high and unfair charges. Proposed measures included a default fund charge cap and bans on certain charging practices inappropriate for the automatic enrolment environment. In March 2014 the DWP published the 'Better Workplace Pensions' paper (Cmd 8840), which responded to the charges consultation and built on the findings from the Call for Evidence to consult on minimum governance standards for workplace schemes. The

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1 DWP, July 2012, Workplace Pension Reform: digest of key analysis

2 The Pensions Regulator (TPR), April 2015, Automatic Enrolment Registration Report <http://www.thepensionsregulator.gov.uk/docs/automatic-enrolment-monthly-registration-report.pdf>

3 DWP, 2014, Automatic Enrolment evaluation report 2014, based on research with large employers

Department for Social Development sought the views of interested organisations in Northern Ireland on each of the DWP consultation papers.

4. In January 2013 the Office of Fair Trading (OFT) (now the Competition and Markets Authority) launched a market study to investigate whether the DC workplace pension market was working well for consumers. With the roll-out of automatic enrolment the OFT considered it timely to consider whether competition between pension providers is set up to work in the best interests of current and future savers. The OFT study was undertaken over a period of nine months and involved consultation with DWP, The Pensions Regulator and the Financial Services Authority. The OFT also engaged with key players including the National Association of Pension Funds, the Association of British Insurers, the Investment Management Association, pension providers, trade bodies and those that represent employers and employees. Their report provides the most up-to-date and thorough analysis of the DC workplace pension market available. Conclusions from the OFT's work are set out below and inform the policies considered in this Impact Assessment.
5. The proposals in this impact assessment are the result of considerable consultation, and are intended to strengthen the weak demand side in this market identified by the OFT.

#### Minimum Governance Standards for contract-based pension schemes and the role of the Financial Conduct Authority

6. The market for workplace DC pensions has evolved over many years. This has led to two main types of workplace DC pension scheme:
  - occupational pension schemes (required to be “trust-based” schemes)
  - work-based personal pension schemes (commonly known as “contract-based” schemes).
7. Trust-based schemes are established under trust and administered by individual trustees or a corporate trustee (the “trustees”). As trustees of these schemes, they have a general duty to act and exercise their powers in the best interests of the scheme membership. The Pensions Regulator (TPR) is the regulator of occupational pension schemes and focuses mainly on the conduct of the trustees.
8. Contract-based pensions involve a contract between each individual member and a product provider. There is no direct contractual relationship between the employer and the product provider regarding the pension itself. The Financial Conduct Authority (“FCA”) is responsible for regulating the conduct (and, in some cases, the financial stability) of providers of contract-based schemes. The FCA's remit extends across financial services – including individual personal pensions – and its focus is on firms, such as product providers and advisers, who are active in the market. The FCA requires firms to pay due regard to the interests of their customers and treat them fairly.
9. Both trust-based schemes and contract-based schemes are capable of delivering good outcomes for members of workplace DC pension schemes and TPR and the FCA have similar expectations for scheme quality and member outcomes. Despite existing regulatory measures to safeguard scheme members that apply to both trust-based schemes and contract-based schemes, the OFT found that more action was needed to

ensure that schemes deliver value for money to members. The Department will be amending the legislative framework for trust-based schemes. The FCA sets the standards for contract-based schemes.

10. The FCA's regulatory powers are set through the Financial Services and Markets Act 2000 ("FSMA"). Using these powers the FCA may amend the rules that apply to providers of contract-based schemes. The FCA consulted on the rule changes needed to deliver minimum governance standards for contract-based schemes through the implementation of Independent Governance Committees ("IGC"s). No legislative changes are required to deliver these rule changes – The FCA has published its rules that require providers to set up and maintain IGCs<sup>4</sup>.
11. This impact assessment analyses the impact of changes to pensions legislation that will affect trust-based schemes.

### **Rationale for intervention**

12. The introduction of automatic enrolment will generate an extra £11 billion a year in pension savings from around six to nine million people newly saving or saving more into a pension<sup>5</sup>. Automatic enrolment will change the pensions landscape with many more people saving and many more employers choosing a workplace pension scheme on behalf of their employees. Against this backdrop of structural change in the DC workplace pensions market it is considered important to ensure that savers have confidence in the system and they are getting value for money through low cost, high quality pension schemes.
13. In September 2013 the OFT published the findings of its market study into DC workplace pensions. Overall they found that competition alone cannot be relied upon to drive value for money for all savers in the DC workplace pension market. Their report, based on extensive and rigorous analysis and argument, concluded that:
  - the DC market had one of the weakest buyer sides they had witnessed and that competition alone could not be relied upon to drive good retirement outcomes for consumers;
  - the weak buyer side is primarily a result of a principal-agent problem – the employer chooses a workplace scheme for their employees but has different incentives. The complexity of the market and products further complicates the ability of employers to make decisions in the best interest of employees;
  - good quality, independent scheme governance can 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, but that the governance of many schemes across the market is not sufficiently strong to provide this scrutiny;
  - the reference test for a market investigation had been met, but such an investigation by the competition authorities was not required on the basis that government and industry

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<sup>4</sup> <http://www.fca.org.uk/news/ps15-03-final-rules-for-independent-governance-committees>

<sup>5</sup> DWP estimates that around 6 million people are already saving in private pension prior to the start of automatic enrolment; Source: Workplace Pension Reform Regulations Impact Assessment; 19 March 2010; DSD



would work together in addressing the weak demand side and safeguarding against consumer detriment.

### Weaknesses in the buyer side of the market

14. The OFT identified three significant weaknesses in the buyer side of the market. Firstly, unlike other, well functioning markets, the ultimate beneficiary of the pension (the individual) in a workplace scheme is not responsible for selecting the scheme and monitoring value for money. This gives rise to a clear principal-agent problem, as employers will often be driven by factors other than what is best for individuals. The potential for misaligned incentives is evident from research carried out by the National Association of Pension Funds (NAPF) and B&CE<sup>6</sup>, which found that whilst many employers are motivated by keeping staff happy, and smaller employers are often the most concerned about the welfare of their employees, the very smallest employers tend to be most concerned with survival, and minimising the costs of automatic enrolment to them as an employer.
15. The second weakness identified by the OFT was the complexity of the product. There is considerable survey evidence showing that individuals have little understanding or engagement with their pension<sup>7</sup>. In addition, given the benefits are realised in the distant future; beneficiaries are unable, or lack the incentive, to influence employers to act in their interests.
16. The final weakness they identified in the buyer side of the market was the ability of employers to drive competition on key elements of value for money. The OFT found that many employers do not have the necessary understanding of workplace pensions to make good judgements on the value for money of their pension schemes. In addition, many employers may not have the resource or willingness to provide ongoing governance or scrutiny of scheme value for money.

### Improving Governance to tackle weaknesses in the buyer side of the market

17. The OFT study emphasises improving scheme governance as a way of mitigating the buyer side weaknesses in the market. Good quality, independent scheme governance can ensure ongoing scrutiny of value for money on behalf of scheme members, helping to achieve good retirement outcomes. They said: *“well governed schemes are more likely to provide value for money by reviewing the quality of administration and investment management services and the costs and charges on an ongoing basis. If governance is not performed well, it can lead to member detriment due to the use of outdated investment strategies that do not deliver returns or expose members to excessive risks, or result in them paying higher charges than necessary to leave them with sub-standard administration.”*
18. The OFT found that the governance of many schemes across the market is not sufficiently strong to provide this scrutiny at the moment. Whilst governance appears to be working well for many large occupational schemes, or in some cases where employers have put together internal governance panels, governance gaps have developed that increase the risk that many other scheme members will not get value for money in the long term. In

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<sup>6</sup> NAPF and B&CE, September 2012, Telling Employers about DC Pension Charges: Research

<sup>7</sup> Office of Fair Trading (OFT), September 2013, Defined contribution workplace pension market study, p.16 and p.76

particular, the OFT raised concerns that trustees of many smaller schemes are not regularly scrutinising value for money of their investment choices or scheme administration and that in many cases those scheme's trustees do not have the necessary expertise either.

19. The fact that some smaller occupational schemes are not being governed effectively is reflected in TPR's 2014 Governance Survey, which found that large DC schemes are more likely than medium or small DC schemes to view their trustee board's governance as very effective – 78% of large DC schemes view their trustee board's governance as very effective compared to 58% of medium DC schemes and 30% of small DC schemes<sup>8</sup>.
20. The 2013 Governance Survey found that one in five (22%) of the DC schemes asked were not aware of TPR's 'six principles for good workplace DC'<sup>9</sup> published in 2011. Of those schemes that were aware, just under a third (31%) assess their scheme as meeting all the principles<sup>10</sup>.
21. On the basis of the evidence they collected the OFT concluded that they had "*concerns that lack of capability and incentive misalignment on the buyer side of the market, and the difficulty for many employers and employees in assessing and comparing quality, make it very difficult to generate competition on administration, the investment strategy and the quality of scheme governance*". In light of their findings, the OFT recommended that the Government introduce a minimum governance standard for all pension schemes, in order to ensure a consistent degree of ongoing scrutiny and assessment of value for money for members.

#### Conclusions from OFT and the government response

22. The response to the consultation on charges (contained in the Better Workplace Pensions paper) set out a number of measures to strengthen governance in DC trust-based schemes. In August 2014, the FCA published a consultation and a cost-benefit analysis on measures to strengthen governance in DC contract-based schemes, including the introduction of IGCs.
23. Based on the evidence presented by the OFT and through consultation, it is considered better to legislate for minimum governance standards in DC trust-based schemes to ensure that all individuals automatically enrolled into these schemes are defaulted into well governed, high quality arrangements. During the consultation there was broad and deep consensus on the need for minimum standards, including from industry bodies such as the Association of British Insurers (ABI) and the National Association of Pension Funds. Not only will this help to ensure good retirement outcomes for savers, it will also help to build confidence in the workplace pensions industry as it grows to deliver a significant increase in the levels of workplace pension saving.
24. The introduction of new minimum governance standards in both DC trust-based and DC contract-based schemes is a crucial element in a package of proposals being introduced

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8 <http://www.thepensionsregulator.gov.uk/docs/governance-survey-technical-report-2014>

9 <http://www.thepensionsregulator.gov.uk/about-us/principles-igg-dc.aspx>

10 <http://www.thepensionsregulator.gov.uk/docs/governance-survey-technical-report-2013.pdf>



to ensure that all those saving into a pension scheme can be confident that they will be in an efficient, high quality scheme.

## **Policy objectives**

25. The policy objective is to ensure that all individuals saving into a workplace pension get value for money and thus enjoy greater income in retirement from private pension sources.
26. Introducing minimum governance standards in DC trust -based schemes will help to ensure good retirement outcomes for savers and build confidence in the workplace pensions industry. These measures will make a direct contribution to ensuring the pensions system is fair and affordable and encouraging people to save for their old age.
27. The OFT recommended that good quality, independent scheme governance can 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. They found that governance of many schemes across the market is currently not sufficiently strong to provide this scrutiny. Introducing minimum governance standards in DC trust-based schemes will address this weakness in the market and improve retirement outcomes for scheme members.

## **Description of options**

28. Two options were considered during the consultation for DC trust-based schemes:

### Option 1: Maintaining the status quo (Do nothing), Continue to work with The Pensions Regulator to improve governance on a voluntary basis.

29. Under this scenario, the status quo would be maintained. Work would continue with TPR to improve governance standards in DC trust-based schemes on a voluntary basis. Additional governance requirements for DC trust-based schemes could be set out in strengthened TPR guidance, without requirements being set in legislation. Members of schemes that do not voluntarily comply with either of these initiatives would not be protected from possible detriment that could result from poorly governed schemes.
30. This approach would likely be of concern to the competition authorities. The OFT decided to stop short of referring the workplace pensions market for a full market investigation on the basis that industry and government would work together to address the market failures they identified and safeguard against consumer detriment. Failure to act on their recommendations would increase the risk of a full market investigation by the competition authorities. Such an investigation would be likely to create uncertainty, disruption and reputation damage for the pensions industry.
31. The OFT concluded that the buyer side of the DC workplace pensions market was one of the weakest they had analysed in recent years and recommended a minimum governance standard that would apply to all pension schemes to mitigate the effect of the weak buyer side.

32. This option serves as a baseline option for assessing the impact of the other options considered. For the purposes of this impact assessment, this option therefore has zero costs and benefits (relative to itself).

### Option 2: Introduce legislative requirements for new minimum governance standards in DC workplace pensions

33. To address the weaknesses flowing from the buyer side of the DC workplace pension market, the OFT recommended that a minimum governance standard should be embedded. The Better Workplace Pensions paper included consultation on the introduction of a set of minimum governance standards that would apply to all DC trust-based schemes.
34. The detail and application of these minimum standards for DC trust-based schemes is considered below, and will entail changes to how schemes are currently governed. These standards will improve oversight of DC trust-based 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.

### **Preferred option**

35. The preferred option is option 2 – to act on the OFT’s recommendation to embed a minimum governance standard by legislating for minimum governance standards in DC trust-based schemes.
36. Responses to the consultation demonstrated that there was a broad and deep consensus on the need for minimum standards, including support from industry bodies such as the ABI and NAPF.
37. A proportionate legislative approach is considered to be the best option to ensure all DC trust-based scheme members are protected and guaranteed a minimum standard of governance, and that TPR can intervene where members are not being sufficiently protected. This will help to mitigate the buyer side weaknesses in the market and ensure that schemes are being run in members’ interests, leading to better retirement outcomes for individuals.
38. In addition, without regulatory action there is a risk of a market investigation by the Competition and Markets Authority. The OFT were clear in their assessment of the DC workplace pensions market that the buyer side was one of the weakest they had analysed in recent years and that action was needed now to embed a minimum governance standard across all pension schemes.
39. Evidence from the TPR Governance Survey 2013 indicates that 22% of occupational DC schemes are not aware of TPR’s publication on ‘Six principles for good workplace DC’<sup>11</sup> adding to the case that intervention is required. Consideration was given to whether non-legislative options – including, for example, strengthening TPR guidance on governance – would be sufficient to address the risks identified by the OFT. However, it was concluded that legislative measures were necessary to ensure that members of all DC trust-based

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<sup>11</sup> <http://www.thepensionsregulator.gov.uk/docs/governance-survey-technical-report-2013.pdf>. Information for micro schemes is not available

schemes are protected, not just those who are saving into schemes which have chosen to meet best practice or voluntary requirements.

40. Despite the considerable material on good DC governance that already exists the OFT identified a number of schemes where members are at risk of receiving poor value for money. It therefore does not seem likely that adding to this non-compulsory material would sufficiently protect savers, and particularly not to the extent that it could remedy the weaknesses identified by the OFT. There has been nothing preventing schemes from improving governance in the past, but as this approach has failed to deliver sufficient improvements, strengthened legislation is now needed to ensure that all savers in defined contribution trust-based pension schemes can be confident that they are getting value for money and saving in an efficient, high quality scheme.
41. There will be ongoing work with TPR and the industry on non-regulatory measures. However, it is believed that enshrining additional governance requirements in legislation is the only way to ensure these standards are met by all DC trust-based schemes, providing protection for all members.

### **Standards for DC trust based schemes**

42. Trustees of all DC trust-based schemes<sup>12</sup> will be required through secondary legislation to ensure that the following minimum governance standards are met:
  - Default investment strategies must be designed in members' interests with a clear statement of aims, objective and structure and how these are appropriate for their membership;
  - The default investment strategy and net performance of the underlying funds must be regularly reviewed, 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.
43. Schemes will also be required to have a chair of trustees for the first time, who will have responsibility for making an annual statement reporting how the above standards have been met. There is evidence that some current requirements on DC trust-based schemes are not being met. The introduction of a chair of trustees is expected to increase compliance with requirements by introducing personal accountability for reporting on these requirements (notwithstanding each individual trustee's personal accountability for ensuring legislation is complied with).
44. Trust deeds and rules will be prevented from being able to constrain trustees in relation to their choice of third party service provider. This is in order to address the concern raised by the OFT that some trustees, particularly in mastertrusts, may be constrained in their ability to fully exercise their fiduciary duty through the ability to move scheme assets to alternative fund managers and administrators where it is in members' interests.

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<sup>12</sup> With the exception of those small self administered schemes where all the members are trustees, and are therefore governing their own pension savings

45. Finally, there will be new requirements for independent governance of mastertrusts, in particular to address the OFT's concerns that some of these arrangements may have similar potential for conflicts of interest as contract-based schemes. Mastertrusts will have to have a minimum of three trustees, of which two – including the chair of trustees – must be independent of the scheme's providers. Trustees must be appointed for fixed terms of no longer than 5 years, or a cumulative maximum of 10 years (unless they are a professional trustee firm in which case the 10 year maximum does not apply). Trustees for mastertrusts must be recruited via an open and transparent recruitment process and mastertrusts must have arrangements in place to ensure that members' views are directly represented.
46. TPR will be responsible for monitoring compliance with the minimum governance standards in trust-based DC pension schemes. The costs of monitoring compliance will be met within TPR's existing budget. The new legislative requirements are specific, making them easier to monitor and enforce.
47. TPR will provide guidance and toolkits to pension schemes, to aid understanding and compliance with the new standards, building on their existing work relating to good governance. It is expected the guidance and toolkits, along with the advanced notice of these measures via three consultations on how best to create minimum standards, will enable all pension schemes to meet the minimum governance standards.

## **Costs and benefits**

48. The main published source of information on pension scheme governance is the TPR Governance Survey. This is a representative sample of trust-based occupational pension schemes. The survey monitors the governance and administration of trust-based schemes, explores levels of trustee knowledge and probes areas of scheme practice. It does not provide any quantitative information on the cost of undertaking governance or administration activity. The Governance Survey has been used, where possible, to make an assessment of governance activity that is already taking place.
49. Information on the costs associated with undertaking governance and administration activities is not readily available. Costs for these activities are likely to vary by scheme size, but also by the type of scheme (mastertrust, unbundled<sup>13</sup> or bundled<sup>14</sup>) and the preferences of the scheme. During the summer 2013 Call for Evidence and the March 2014 consultation, additional information was specifically requested on the costs and benefits associated with the proposals. The consultation provided only a very limited amount of information that could be used to inform the estimates of the impact of the proposals.
50. Work was subsequently undertaken with TPR to quantify the impacts of the new reporting requirements which all schemes will be required to meet. In addition data from the TPR and desk based research has been used to quantify the impact of the new requirements on mastertrusts to have a minimum of three trustees and for the majority of these to be independent of the scheme's service providers.

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13 In an unbundled DC trust based scheme the administration and investments are managed separately by selected third party providers

14 In a bundled DC trust based scheme a single third party provider provides both the administration and investment services

51. In order to make an assessment of the impact of the other requirements DWP contacted a range of industry stakeholders who provided some indicative information on potential costs. This information has been used to make an assessment of the potential scale of these requirements.
52. In order to gather comprehensive, representative information a large-scale representative survey of DC trust-based schemes would be needed. Previous experience with surveys of this type has demonstrated the difficulty in obtaining cost information from pension schemes as awareness of costs is generally low. A previous DWP working paper on pension scheme administration costs<sup>15</sup> found that the majority of respondents did not know the approximate rate charged per hour for any of the professional services they were asked about. In 2011 the Landscape and Charges Survey found that only 28% of trust-based schemes believed that members paid any charges at all, with significantly lower awareness amongst smaller firms. In the 2013 Landscape and Charges Survey it was explained to employers how they could find out about the level of Annual Management Charges paid by members. As a result of this approach, 74% of employers of trust-based schemes confirmed that their members did pay a charge in 2013. The OFT also found that there was insufficient visibility and comparability of charges in their study of the DC workplace pensions market.
53. Following an extensive 9 month study of the DC workplace pensions market the OFT identified governance gaps and made a clear recommendation for the introduction of a minimum governance standard for all pension schemes to ensure consistent ongoing scrutiny and value for money for scheme members. A large scale survey could only be done at significant cost, would take several months and may not yield data of sufficient quality for the reasons set out above. In the absence of minimum governance standards set out in legislation the risk of a market investigation by the Competition and Markets Authority would be likely to create uncertainty, disruption and reputational damage to the pensions industry. For these reasons undertaking a large-scale data collection exercise is considered disproportionate. The estimates presented in this Impact Assessment represent the best estimates given the data constraints.
54. The monetised and non-monetised costs and benefits on key groups are summarised in Table 1. Further details and description of the impacts of option 2, the final stage proposal follow this Table. It is important to note that this is not a static comparison of options but a dynamic comparison of how things might evolve under the different options.

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15 [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/214389/WP91.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/214389/WP91.pdf)

**Table 1: Summary description of monetised/non monetised costs and benefits**

	<b>Employers</b>	<b>Pension Industry</b>	<b>Individuals</b>
<p><b>Option 1: Do nothing</b> Government to continue to work with The Pensions Regulator (TPR) to improve governance on a voluntary basis</p>	<p>No additional regulatory cost</p> <p>Existing requirements on trustees are set out by TPR in its DC Code of Practice, and supplemented by non-legislative guidance. This Code is aimed at ensuring trustees are able to perform their functions correctly and competently.</p> <p>Strengthened governance requirements could be introduced via TPR guidance, but as these would not be required by legislation these are out of scope as no new legislative burden would be imposed.</p> <p>Any costs would be met by employers or scheme members, or a combination of the two.</p>	<p>No additional regulatory cost</p> <p>Risk of a market investigation by the Competition and Markets Authority, which would be likely to carry significant disruption and costs to the pension industry.</p>	<p>There may be benefits for individuals if the voluntary non-regulatory initiatives lead to improvements in governance.</p> <p>There remains a risk that there will be governance gaps in the market for some scheme members or that non-regulatory approaches do not go far enough to improve governance standards so some may see no benefits at all.</p>
<p><b>Option 2:</b> Introduce legislative requirements for new minimum governance standards in DC trust-based schemes</p>	<p>DC trust-based schemes will be required to ensure that they meet and report on minimum governance standards.</p> <p>Some schemes will be meeting some of these requirements already, particularly those currently present in TPR's Code of Practice. The additional cost of meeting the minimum governance standards will therefore depend on the extent to which they are already being met.</p> <p>The cost of meeting the requirement to report on how the governance standards are being met could be anywhere from £350-£3250 per year depending on scheme size. It is estimated that the total annual cost will be £8.6million per year for DC trust-based schemes in 2013/14 prices.</p> <p>The additional costs for mastertrusts will also vary, depending on whether they already meet the minimum requirements. The ongoing costs of retaining the required number of independent trustees are estimated to be £1.4million in 2013/14 prices. A cost of £410,000 in 2013/14 prices every 5 years to cover the costs of a recruitment exercise is expected.</p> <p>It is estimated that the cost of reviewing the default strategy</p>	<p>Newly strengthened governance of DC trust-based schemes may lead to renegotiation of costs and charges with service providers and/or better investment returns through more appropriate investment strategies for members. This will however vary and is not possible to quantify.</p> <p>The industry would not be at risk of a market investigation by the Competition and Markets Authority.</p> <p>The pensions industry may benefit from these measures through increased consumer confidence in the industry.</p>	<p>All DC trust-based scheme members will benefit from good quality governance. This would lead to a better alignment of incentives and therefore better value for money and improved retirement outcomes for individuals.</p>



	<p>will be £8.5m in 2013/14 prices every 3 years and some schemes may require a one-off demographic analysis of the membership profile estimated at £ 3.1m in 2013/14 prices.</p> <p>These costs may be met by employers or scheme members, or a combination of the two.</p> <p>Employers will be getting value for money and they can demonstrate to their employees that the schemes they are providing are good.</p>		
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## Impacts of option 2

### Benefits of minimum governance standards for DC trust-based schemes

55. The introduction of minimum governance standards in DC trust-based schemes will ensure that all individuals saving in these schemes will benefit from good quality governance, leading to a better alignment of incentives. There are currently 2.7 million people saving in DC trust-based schemes<sup>16</sup>. Better governance should lead to better value for money, higher private savings levels and higher retirement incomes for individuals. The new governance and reporting requirements will drive better performance from trustees, by ensuring that they consider the key aspects of running the scheme, and particularly those that will affect members of the default fund. In the 2013 Landscape and Charges Survey pension providers and employee benefit consultants saw scheme governance as key to ensuring good retirement outcomes:

*'The most important feature in any pension scheme is how well it is governed, because if somebody is looking at how well that scheme is doing on an ongoing basis, then you have got a good chance that if the investments are under-performing or the members are not paying enough, that somebody will do something about that; or if the administration is poor, someone will do something about that.'*

(Provider)

56. OFT identified existing good practice as well as identifying a number of governance gaps, so the introduction of minimum governance standards for all DC trust-based schemes will ensure all scheme members can have confidence that they are saving into schemes which are managed in their best interests. It has not been possible to quantify the long-term benefit for scheme members of improvements in scheme governance. Member outcomes are influenced by a range of factors including the performance of the economy and investment returns. It is therefore difficult to isolate the impact of good governance alone on member outcomes. All other things being equal it is expected that a well governed scheme aligned with members' interests would deliver better retirement outcomes for scheme members. Based on £26.5bn of assets held by DC trust-based schemes with over 12 members<sup>17</sup>, if improved governance led to even a small

<sup>16</sup> The Pensions Regulator (TPR), DC trust: a presentation of scheme return data 2013-14

<sup>17</sup> The Pensions Regulator (TPR), DC trust: a presentation of scheme return data 2013-14. Comparable data for micro schemes excluding small self administered schemes is not available

improvement in investment returns each year, scheme members would be substantially better off over the long-term.

57. Employers will also benefit from good scheme governance, as they will be getting value for money and they can demonstrate to their employees that the schemes they are providing are good which will have benefits for workforce management. The pensions industry may also benefit from these measures through increased consumer confidence in the industry. In addition, the OFT concluded in their study of the DC workplace pensions market that the reference test for a market investigation had been met, but a full market investigation was not required on the basis that government and industry would work together in addressing the weak demand side and safeguarding against consumer detriment. A Competition and Markets Authority market investigation would be costly and disruptive and create wider reputational damage for the pensions industry.
58. These measures will make a direct contribution to ensuring the pensions system is fair and affordable and encouraging people to save for their old age.

#### Costs of standards for DC trust-based schemes

59. The direct costs for meeting minimum governance standards in DC trust-based schemes will be met either by those employers who have chosen to run a DC trust-based scheme, by the scheme members, or by a combination of the two. In some schemes employers may choose to pay a greater share and in other schemes, members may pay a greater share.
60. There was no additional evidence provided via the consultation on who would bear the costs of the new measures. Following further engagement with TPR, it is understood that typically costs for meeting governance requirements would be more likely to be met by the employer in an unbundled<sup>18</sup> DC trust based scheme and by scheme members in a bundled<sup>19</sup> DC trust-based arrangements. The ratio of DC trust based schemes is 54% unbundled and 46% bundled<sup>20</sup>.
61. As costs associated with meeting the new requirements could be borne by the scheme and therefore scheme members, it is possible that members could face an increase in some member-borne charges. However, a default fund charge cap covering all member-borne charges and deductions excluding transaction costs will be set at 0.75% of funds under management. The introduction of the charge cap will mitigate the extent to which costs associated with meeting the new minimum governance standards can be passed on in full to scheme members.
62. The minimum governance standards build upon existing good practice. There is evidence that some of the activities it is intended to legislate for are already happening, but there is a need to ensure that they are met by all schemes, rather than just by those who have chosen to run their scheme to a high standard. DWP's Default Fund Guidance<sup>21</sup> and the TPR Code of Practice for DC trust-based schemes sets out good practice in scheme governance and administration. For example, performance of the funds within the default

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18 In an unbundled DC trust based scheme the administration and investments are managed separately by selected third party providers

19 In a bundled DC trust based scheme a single third party provider provides both the administration and investment services

20 The Pensions Regulator (TPR), DC trust: a presentation of scheme return data 2013-14

21 [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/185056/def-opt-guid.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/185056/def-opt-guid.pdf)

option should be checked informally at regular intervals throughout the year as well as undergoing a full review at least every three years. The additional costs of new legislative minimum governance requirements will therefore vary depending on the performance of the existing governance functions in DC trust-based schemes. Schemes already complying with existing legislation and operating on the basis of good practice standards will face relatively small increases in costs (relative to the assets they hold), and these will be largely associated with the new requirements to report on how these standards have been met.

63. Although this guidance exists the picture is inconsistent across schemes. In general, it is believed that large occupational schemes are most likely to already meet the standards. Results of TPR's Governance Survey and research on key features of running a DC scheme show that larger schemes are more likely to be well run. The TPR Governance Survey finds that governance is considered effective in 78% of large DC schemes, 58% of medium and 30% of small DC schemes<sup>22</sup>. This was also confirmed by the OFT, who found that governance appears to be working well for many large occupational schemes, or in some cases where employers have put together internal governance panels, but governance gaps have developed that increase the risk that many other scheme members will not get value for money in the long-run.
64. In addition, the baseline is not static. The TPR Governance Survey has shown year-on-year improvements to scheme governance and administration. It has therefore been difficult, for some of the requirements it is intended to legislate for, to estimate the additional regulatory burden as a direct result of these measures because of the variability across schemes, the year on year improvements captured in the Governance Survey and the continued winding up of legacy schemes that may not have met the standards.
65. Schemes falling short of existing guidance and good practice will face greater costs to meet the new legislative standards. It is believed that smaller schemes are less likely to be meeting good practice guidance, so are more likely to face increased costs in order to meet the new requirements. The level of costs will vary depending on how the scheme is administered and the costs of the advisers, administrators, fund managers and other service providers that the trustees contract with.
66. Given the size of the assets held by DC trust-based schemes, the proposal to introduce minimum governance standards is proportionate and targeted in line with the Government's Principles of Regulation. In addition, the incidence of the legislation relates to the effective operation of core business, it is focussed on the core activities that the board of trustees would be expected to undertake, and is therefore not excessive.
67. The assessment of the costs and benefits is set out below. In the case of wholly new requirements, for example to produce a statement in the scheme's audited report covering how the minimum governance standards will be met and the costs associated with appointing independent trustees to mastertrusts, it has been possible to quantify the costs in full. In other areas where there is limited data and activity may already be taking place DWP has made an assessment of the potential scale of the impact and provided its best estimate of costs based upon information provided by industry experts.

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22 <http://www.thepensionsregulator.gov.uk/docs/governance-survey-technical-report-2014>

The chair must produce a statement in the scheme’s audited report and accounts covering how the above governance standards are met (the ‘chair’s statement’)

68. All schemes will face costs in producing a statement attached to the annual audited report and accounts that explains how they have complied with the minimum governance standards. This is a new requirement. TPR has estimated that the additional cost of producing this statement and attaching it to the audited report and accounts, could be anywhere between £350 and £3,250 per scheme per annum, depending on the size of the scheme (see Table 2). In the context of scheme assets these costs are relatively small. An average small scheme (12-99 members) has assets of £1.2m, a medium scheme (100-999 members) £8.5m and the average large scheme (1000+ members) £116.1m.<sup>23</sup>

Table 2: Estimated additional costs of producing an audited report and accounts for DC trust-based schemes in 2013/14 prices

	Number of micro schemes (2-11 members)	Number small schemes (12-99 members)	Number medium schemes (100-999 members)	Number large schemes (1000+ members)	Total
	14,000	1,790	920	380	17,090
Statement costs	£350	£350	£1,700	£3,250	-
Total	£5,110,000	£650,000	£1,570,000	£1,240,000	£8,600,000

Source: The Pensions Regulator’s estimate of indicative audited report and accounts costs and DC Trust: a presentation of scheme return data 2013/14 and DWP estimates. Micro scheme figure provided by TPR excludes small self administered schemes. Figures may not sum due to rounding.

69. The overall cost to employers and schemes of fulfilling this requirement could be up to £8.6million per year in 2013/14 prices across over 17,000 schemes (see Table 2). This is calculated by multiplying the number of schemes in each size category by the estimated cost. Small self-administered schemes are excluded from the calculations as it is not intended that the requirements will apply to this group. In these cases the members are also the trustees so are acting in their own interests so incentives are aligned and legislation is not necessary. Based on £26.5bn of assets held by DC trust-based schemes with over 12 members, the cost per scheme relative to assets held is low, but the volume of schemes particularly micro schemes means that at the aggregate the cost is £8.6m per year. The cost of complying with this requirement is expected to be the same for small and micro schemes. This is because there is a fixed cost element in meeting the requirement that will not vary by scheme size.

All DC trust-based schemes must have a chair of trustees

70. The majority of consultation responses on the issue of appointing a chair of trustees suggested that many if not most DC trust-based schemes would already have a chair in place.

*“The vast majority of such schemes already have a person fulfilling this role, but we would have no issue with formalising this as a requirement”*  
(Industry representative)

<sup>23</sup> The Pensions Regulator (TPR), DC trust: a presentation of scheme return data 2013-14

71. It is therefore expected that in most cases this new legal requirement could be met without additional costs to employers and schemes. Most schemes can be expected to already have a chair. For those trustee boards that need to appoint a chair, it is expected that trustee boards would appoint a chair from amongst the existing trustees, and that this would not carry any additional cost. The chair will be responsible for signing the annual statement about how the minimum governance standards have been met. The introduction of a chair of trustees is expected to increase compliance with requirements by introducing personal accountability for the annual report on these requirements (notwithstanding each individual trustee's personal accountability for ensuring legislation is complied with).
72. Data on the number of schemes who have a chair of trustees is limited, as reporting this information to TPR is currently done on a voluntary basis. In future this information will be mandatory for schemes to disclose to TPR and therefore there will be better data available to monitor this new legislative requirement.

The trustee board must have, or have access to, all of the knowledge and competencies necessary to properly run the scheme

73. The consultation proposed to introduce a new requirement to the effect that trustees should have, or have access to, all of the knowledge and competencies necessary to properly run their scheme. Many respondents to the consultation questioned how much this would add to existing requirements. In particular, trustees are already required by legislation to have knowledge and understanding of the law relating to pensions and trusts and the principles relating to the funding of occupational schemes and the investment of scheme assets, and are also required to be conversant with their own scheme's policy documents<sup>24</sup>. TPR provides guidance to help trustees understand these requirements as well as an e-learning product; the 'trustee toolkit'; to help trustees meet the minimum level of knowledge and understanding of the Pensions Act 2004 and corresponding provision in the Pensions (Northern Ireland) Order 2005.
74. The intention is to introduce a new duty on trustees to annually report on how the trust board itself has, or has access to, all of the knowledge and competencies necessary to properly run the scheme. The existing legislative requirements means that schemes can already be expected to have sufficient knowledge and understanding to run their scheme. The only additional costs of this revised requirement are therefore associated with reporting on how the scheme meets the standard, and these are included in the costs of producing the chair's statement, set out above.

Trustees must assess the levels of charges and costs borne by scheme members and must assess the costs incurred through investment of pension assets

75. Trustees will be required to assess the level of charges borne by scheme members and the costs incurred through investment of pension assets. They will need to provide these details within the chair's annual statement including an explanation where details are unobtainable and how they plan to access information in the future. If trustees identify that members are not getting value for money from their pension scheme then the Board will be responsible for taking appropriate action to ensure the requirements on costs and

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<sup>24</sup> The Pensions (Northern Ireland) Order 2005, Articles 224-226 and TPR's Code of Practice 7



charges are met. Evidence from The Pensions Regulator Governance Survey 2014 suggests that 8% of trustee boards have poor knowledge of charges deducted from members and 20% have poor knowledge of the schemes Portfolio Turnover Rate indicating that not all trustees are currently likely to be meeting the standard, to assess levels of charges and costs.

76. Where trustees are not currently aware of the charges being borne by their members they will need to find these out. In the case of bundled schemes this should be quite simple as all services are being purchased from a single provider with a bundled charge. Where trustees are purchasing services from a number of different providers this may be more complicated as trustees will need to collate the various charges and work out how they translate into a member-borne charge. Either way, it is considered reasonable to expect trustees to have a clear understanding of the charges being passed on to members of their scheme, and to assess the value of these. It is recognised that it may be difficult for trustees to obtain full information about transaction costs from their investment manager/s. Where trustees are not able to access information about these costs they should explain this in their chair's statement, and the steps they will take to address this in future years. Work is ongoing with the pensions and investment industries to make this information more obtainable, for example through industry codes of practice.

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 the funds underlying the default strategy must be regularly reviewed to ensure alignment with the interests of members, and action taken to make any necessary changes

77. Trustees will also be required to ensure that that the scheme's default investment strategy is designed in members interests and that the strategy, and performance of underlying funds, are regularly reviewed. The annual chair's statement will have to describe the default's aims, objective and structure and how these are appropriate for the scheme's membership, as well as when it was last reviewed and what action was taken as a result.

*"We have long maintained that ensuring the default fund is fit for purpose is imperative as 98% - 100% of members will be auto enrolled into default funds. The structure of these funds will have a significant bearing on members' future retirement income."*  
(Provider)

#### *Default Strategy designed in members' interest*

78. There is evidence that schemes are designing their default arrangement in members' interests to some extent already, but that this is not consistent across all schemes. According to The Pensions Regulator Governance Survey 2013<sup>25</sup>, 73% of DC schemes say their default arrangement has been established principally based on the profile and risk appetite of scheme members. In 2011, default option guidance was published to assist DC schemes in offering a default arrangement. The latest Landscape and Charges Survey found that three-quarters of all trust-based schemes that had reviewed their

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25 The Pensions Regulator (TPR), 2013, A report on the 2013 (seventh) scheme governance survey, <http://www.thepensionsregulator.gov.uk/docs/governance-survey-technical-report-2013.pdf>



scheme said they were aware of default option guidance, and two-thirds of those said that they had used this guidance.<sup>26</sup>

- 79. This is backed up by discussions with industry experts who have suggested that it is likely that designing the default strategy in members’ interests and keeping it under review will be ‘business as usual’ activities for many schemes, and particularly for medium and larger schemes. Experts have advised that small schemes do not typically undertake formal demographic analysis but instead rely on the trustees knowledge of the membership profile. In these cases, the new burden of meeting the standard is likely to be limited to reporting on the default design in the chair’s statement, which is covered in the section on the chair’s statement.
- 80. Whilst there is evidence from the TPR and anecdotally from industry experts that the majority of schemes are designing their default strategy in the interests of members there are a minority of schemes who may need to undertake some demographic analysis of their membership profile. 73% of DC schemes say their default arrangement has been established principally based on the profile and risk appetite of scheme members, and it is therefore assumed that a maximum of 27% of DC schemes might need to undertake some demographic analysis (around 4,600 schemes, see Table 3). Following discussions with firms who typically work with medium and larger schemes it is understood that a demographic analysis of the scheme’s membership might cost around £1,750 - £2,250. Small schemes (12-99 members) and micro schemes (2-11 members) would be expected to pay substantially lower fees for these services as their membership is much smaller. It is estimated that if all these schemes undertook a demographic analysis of their scheme the costs could be around £3.1m in 2013/14 prices. This assumes the cost of a demographic analysis paper is £2,000 for large and medium schemes, £1000 for small schemes and £500 for a micro scheme. This would represent a one off-cost.

Table 3: Estimated additional cost of undertaking demographic analysis of the scheme membership in 2013/14 prices

	Micro schemes (2-11 members)	Small schemes (12-99 members)	Medium schemes (100-999)	Large schemes (1000+ members)	Total
	3,780	483	248	103	4,614
Cost of demographic analysis	£500	£1,000	£2,000	£2,000	-
Total	£1,890,000	£483,300	£496,800	£205,200	£3,075,300

Source: DWP estimates

- 81. Robust quantitative information on the costs of designing the default strategy in the interests of members is not held. Industry sources have stressed that each trustee client takes an individual approach to running their schemes. Whilst there are standard approaches as a starting point for many items, trustees can choose to deviate from these. The costs of services will differ according to the nature, extent and impact of any bespoke, as well as on scheme characteristics.

26 Landscape and Charges Survey 2013: Charges and quality in defined contribution pension schemes

### *Reviewing the default strategy and the performance of the underlying funds*

82. Evidence about how often schemes review their default strategy or the performance of default funds is not held, but there is survey evidence on how often schemes review their Statement of Investment Principles as a proxy. According to TPR's 2014 Governance Survey<sup>27</sup>, 49% of DC trust-based schemes assessed their Statement of Investment Principle (SIP) at least once in the last three years. This could suggest that around half of DC trust-based schemes already review their default strategy in accordance with the new requirements.
83. Industry experts have advised that the cost of reviewing a default strategy can vary substantially. A review of the default strategy could cost around £1,000 or could be significantly higher – around £10,000 if the trustee wanted a more sophisticated approach such as stochastic analysis of different asset combinations and different types of defaults, but could be higher depending on the size and nature of the scheme. While trustees might choose to pay more for these services because they see it to be in the best interests of their scheme members, this level of analysis will not be required by legislation. If it is assumed that half of DC trust-based schemes would need to review their default strategy to meet the new requirements based on the TPR Governance Survey (around 8,500 schemes) and this would cost them £1,000 each, the cost of reviewing the default strategy for those schemes who are not already meeting the requirement would be around £8.5m in 2013/14 prices (8,500 schemes multiplied by £1,000 per scheme). It is expected that the default strategy would be reviewed once every three years.
84. Where the standards to design and review default strategies in members' interests are not being met, it is thought that trustees would most likely use their existing consultant or adviser to support them in designing and reviewing the default strategy. It is not the intention to be prescriptive in regulations about the factors that trustees should take into consideration when designing or reviewing their default strategy, but it would be expected that these would include the level of costs and the risk profile that are appropriate for the scheme's membership. These should be considered in light of the overall objective of the default arrangement strategy, which may vary depending on the needs and demographics of the scheme's membership. There is already practical guidance for trustees about designing and reviewing their default strategy and other investment options in TPR's Code of Practice.
85. Trustees will also be required to review the net performance of the funds underlying the strategy. Robust quantitative evidence on how many schemes already regularly review their fund performance is not held. Industry sources have reported that regular fund monitoring reports are already in place for most DC schemes, and that this is typically done quarterly, semi-annually or annually. This is more than required to meet the new requirement that fund performance should be reviewed at least every three years so this requirement should place no additional burden on the majority of schemes.

### Core scheme financial transactions must be processed promptly and accurately

86. It will be a requirement that all core scheme financial transactions must be processed promptly and accurately.

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<sup>27</sup> <http://www.thepensionsregulator.gov.uk/docs/governance-survey-technical-report-2014>

*“[We] recognise the importance of accurate administration in ensuring that an individual receives the pension pot due to them. We believe strengthening trustees’ legislative responsibilities for ensuring and reporting on how core scheme financial transactions are processed promptly and accurately should ensure accurate administration”*  
(Provider representative)

87. TPR’s Code of Practice 13 already says that trustees should have processes in place to ensure that financial transactions are recorded, so it is expected some schemes would be complying with this requirement – in part or full – already<sup>28</sup>. The UK Government has also considered evidence from TPR’s Governance Survey<sup>29</sup> relating to other administrative tasks, as these could indicate how far trustees are also monitoring the processing of core financial transactions. The percentage of DC schemes whose trustees receive regular reports from their administrator (at least annually) is 63% (16% at least quarterly), which is where trustees would generally find information about the standard of administration within their scheme. At a minimum trustees would need to receive such reports annually to be informed as to whether they are meeting their duty in respect of core financial transactions, and ideally have their administrators attend trustee meetings on a regular basis (63% have their administrators attend meetings at least annually, and 26% at every meeting).
88. Where schemes do not already meet this standard, they will need to work with their administrator to obtain information about how transactions are processed, and to take action where there are any problems. TPR’s Governance Survey indicates that the vast majority, around 81% of DC trust-based schemes use an external administrator<sup>30</sup> and that the majority of services required to carry out the core financial transactions are included in administrative contracts.
89. An administration survey from Kim Gubler Consulting Ltd<sup>31</sup> in 2013 asked administration firms to provide their fees based on tasks that would normally be considered to be ‘core’ to administering a scheme. The survey then asked whether they offer all of these core services to schemes of all sizes. The list of core tasks included provision of regular management information statistics to trustees of scheme activity; dealing with transfers and dealing with DWP requirements. For all scheme sizes the majority of firms offered 90% or more of the core tasks.
90. Where schemes are required to make changes to their administration contracts in order to meet the new requirements, the impact of this will vary depending on what is covered in their existing contract and the cost of the administrator the trustees have chosen to contract with.

**Minimum of three trustees, of which two must be independent of the scheme’s providers. Fixed appointment terms for mastertrusts**

91. Mastertrusts will need to meet some specific requirements in addition to those listed above. Mastertrusts will be required to have a minimum of three trustees, of which two

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28 <http://www.thepensionsregulator.gov.uk/docs/code-13.pdf>

29 <http://www.thepensionsregulator.gov.uk/docs/governance-survey-technical-report-2014>

30 External administrator refers to a scheme insurer or a third-party administrator

31 <http://www.kimgublerconsulting.co.uk/wp-content/uploads/KGC-Fourth-Administration-Fee-Survey-Published-Report-Final2.pdf>

must be independent of the scheme's providers. There must also be arrangements in place for representation of members' interests. These requirements may require some mastertrusts to recruit new members.

*"We have long been supportive of better regulation of master trusts to ensure their governance is fully independent and aligned with member interests."*  
(Industry representative)

92. This is a change to the standard consulted on, which would have required mastertrusts to have a minimum of seven trustees, and reflects feedback from industry that the higher minimum number would have introduced additional burden without necessarily being in members' interests.
93. Desk-based research<sup>32</sup> indicates that around 15% of existing mastertrusts already meet the requirements for the minimum of three trustees, of which two are independent. Therefore these schemes are not expected to incur additional costs. Of the remaining 85% of mastertrust schemes – DWP engagement with industry indicates the majority of mastertrusts will already have at least one trustee who is independent of providers to the scheme. Hence it is expected that the majority of schemes not meeting the requirements will need to appoint a second trustee who is independent. Of the c.60 mastertrusts<sup>33</sup> recorded by TPR it is therefore expected around 50 mastertrusts will be required to recruit one additional trustee who is independent.
94. Where schemes have to recruit additional trustees who are independent, there will be additional recruitment costs and additional ongoing salary costs. The estimated salary costs of each additional trustee who is independent, on the basis of 30 days, is £20,000 to £25,000 per annum<sup>34</sup>. Based on the assumption that 50 mastertrusts will have to recruit one additional trustee who is independent, it is therefore estimated that the additional annual running costs of meeting this minimum requirement would be around £1.0 million to £1.3 million. The best estimate is the mid-point £1.1m. These costs are lower than if the original proposal of requiring seven trustees had been taken forward.
95. The minimum standard will require mastertrusts to use an open and transparent recruitment process to recruit new trustees who are independent. DWP sought intelligence from the pensions industry about the costs of recruiting trustees who are independent. Where schemes have used a recruitment agency to recruit trustees, they report this costing around £25,000. Other respondents reported that they undertake recruitment themselves and see it as a business as usual activity with no additional costs associated.
96. Sufficient information on the methods which will be employed to recruit an independent trustee for all c.50 mastertrusts is not held. Legislation will not require schemes to use a recruitment agency and it is therefore expected that some schemes will seek to reduce costs by using other methods of recruitment. For example, a scheme might instead choose to place an advert in a national newspaper and online. Taking into account the

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32 Using The Pensions Regulators record of 59 open, closed and winding-up mastertrusts; information on who is meeting the minimum trustee requirements was collected from websites and engagement with industry

33 The Pensions Regulator has a record of 59 open, closed and winding-up mastertrusts

34 This assumption is drawn from the amount paid to trustee members at NEST  
[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/246533/0494.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/246533/0494.pdf)

costs of staff time, it is thought this approach would cost around £8,000<sup>35</sup>. While it would be possible to recruit for less than this amount, it is thought that this represents a reasonable assumption of the costs for a basic recruitment exercise, of the nature that would meet the legislation. It is estimated that the total cost for recruiting an additional independent trustee for all 50 mastertrusts would be around £410,000 in 2013/14 prices every 5 years.

97. Depending on the number of trustees in these schemes, some will also need to appoint a third trustee. Mastertrusts could choose for the third trustee to also be independent of the provider's of the scheme however this is not a legislative requirement and it is therefore expected that the scheme will opt to minimise their costs and appoint the third mandatory trustee from the scheme's providers. The associated costs are expected to be significantly lower in relation to hiring a trustee who is not independent as this individual can be an existing employee of a the scheme's provider – any costs would therefore relate to the time spent away from their existing role and on trustee activities. The cost will vary depending on the salary of the person who is appointed as trustee. The average salary of a chief executive or senior official is typical of the sort of person who might be appointed to this role. Taking an average salary of £84,453<sup>36</sup> and assuming that the trustee role will take 30 days a year, suggests a cost of £9,745.
98. It is not known how many of the c.50 mastertrust schemes that will have to recruit one additional trustee will also have to recruit a second. Taking the mid-point of 25 schemes, this would suggest an additional annual cost of around £240,000 in 2013/14 prices (based on a cost of £9,745 multiplied by the 25 mastertrusts).
99. Mastertrusts trustees must be appointed for fixed terms of no longer than 5 years, or a cumulative maximum of 10 years (unless they are a professional trustee firm in which case the 10 year maximum does not apply). Where schemes do not already appoint trustees on this frequency, this will lead to some additional recruitment costs for mastertrusts. However, there is insufficient information about how frequently trustees are currently appointed, to understand this impact. This is particularly the case because of the number of significant mastertrusts that have only been established within the last 10 years.

## Small and Micro Business Assessment

### *Impact on small and micro pension schemes*

100. The trust-based pensions sector contains a long-tail of small and micro pension schemes. Such schemes account for around 92% of schemes in the workplace pensions market (see Table 2), but a small minority of scheme members. Of the 2.7million individuals saving into an occupation DC scheme around 44,000 (or 2%) are in small or micro pension schemes – excluding small self-administered schemes<sup>37</sup>. The OFT's market study expressed concern about the risk of member detriment in small trust-based schemes, due to poor governance, and some responses to the consultation on charges

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35 c£8,000 breaks down into c.£5,000 - £6,000 advertising costs and 20 days of staff time at a total of £2,650, based on average Human Resources salary of £43,211 for HR managers and Directors (10 days) and £25,676 for HR officers (10 days) from the Annual Survey of Hours and Earnings 2013

36 ONS, Annual Survey of Hours and Earnings, 2013

37 Source: DC Trust: A presentation of scheme return data TPR, 2013-14; TPR micro scheme data and additional data from TPR on membership of micro schemes excluding small self-administered schemes



suggested intervention to promote the consolidation of small pension schemes. Currently non-compliance with the minimum standards is more likely amongst small and micro schemes e.g. 24% of small schemes compared to 10% of large schemes are unaware of TPR's publication on the 'Six principles for good workplace DC'<sup>38</sup> this adds to the case that intervention for small schemes is required.

101. There are benefits of scale in workplace pension provision and consolidation of schemes has been occurring in recent years. Between 2009 and 2013, the number of small DC trust-based schemes decreased by over a third from 2,910 to 1,790 and micros by around one fifth from 45,460 to 35,640.
102. In the Better Workplace Pensions paper of March 2014, the arguments around the value of scale were accepted, but not the case for forcing small pension schemes to merge. This conclusion was reached on the grounds that consolidation is occurring naturally, with very few new small schemes being set up, and that some small pension schemes are well governed in members' interests. At no point during the Call for Evidence and consultation, or the OFT report, has there been a suggestion from government or stakeholders that small pension schemes should be exempt from the minimum standards. There is a very clear consensus that all pension scheme members should be enrolled into well governed schemes, regardless of its size.
103. It is expected that schemes will already be complying with varying degrees with the required minimum governance standards in DC trust-based schemes as some quality requirements for DC trust-based schemes are already set out in legislation and supported by a TPR Code of Practice. Schemes who are not complying with existing legislation and good practice will be required to make changes to meet the new minimum governance standards. In addition all DC trust-based schemes will need to produce a statement in the scheme's audited report and accounts covering how the governance standards have been met. The costs associated with this are set out in paragraphs 59 to 61. Given trustees have a duty to act in members' interests, the lack of member choice about the scheme their employer chooses on their behalf, and the structural change in the DC workplace pensions market as a result of automatic enrolment, it is considered proportionate to legislate to ensure minimum governance standards for all DC -trust based schemes. Anyone who is automatically enrolled into a DC trust-based scheme should have confidence that they are in a well governed, low cost, value for money scheme.
104. Small, self administered schemes will be exempted from the new requirements, because in these cases the members of the schemes are trustees, so are administering the pension savings on their own behalves so incentives are aligned and they are acting in their own best interest.

#### *Impact on small and micros employers*

105. Around 40%<sup>39</sup> of employees work for small and micro employers. Employers of all sizes have a choice about whether to establish their own DC trust scheme, or use a contract-based scheme or mastertrust for their employees. The UK Government expects the majority of small and micro employers who do not currently have a scheme to use a mastertrust or contract-based scheme for automatic enrolment, rather than establishing

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<sup>38</sup> <http://www.thepensionsregulator.gov.uk/docs/governance-survey-technical-report-2013.pdf>. Information for micro schemes is not available

<sup>39</sup> Business Population Estimates 2013, Department of Business Innovation and Skills



their own DC trust-based scheme. DWP research states that around 65% of small and medium employers (with less than 250 workers) are expected to use National Employment Savings Trust (NEST)<sup>40</sup> to automatically enrol at least some of their workers<sup>41</sup>. TPR has published guidance saying that most employers would find that it is not cost effective to set up their own DC trust-based scheme unless it has at least 1,000 people saving in it.

106. Where a small or micro employer has chosen to operate a single employer DC trust-based scheme for their employees, then the scheme will be required to meet the new requirements. Employers sometimes contribute to the costs of operating their occupational scheme, and may therefore contribute to the costs of meeting the new requirements, but the extent of this varies across employers. For the purposes of this Impact Assessment it has been assumed that new costs associated with meeting these new legislative requirements will be split equally, with the employer meeting half of the new costs and the scheme meeting the other half. Employers could however choose for all new costs to be met solely by the scheme or vice versa. There was no additional evidence following further engagement with TPR on who bears the cost in unbundled and bundled DC trust arrangements (paragraph 52) the assumption is that costs fall on the scheme and employer equally.

#### *Impact on other small businesses*

107. At the pension provider level, the market is already very concentrated, with a relatively small number of organisations dominating the market – statistics released by the ABI in 2010 found that five companies accounted for two-thirds of all insurer-administered pension funds.<sup>42</sup> Furthermore, those who choose to stop offering schemes to smaller employers will still be able to provide schemes to larger, more profitable employers. The roll-out of automatic enrolment means that the DC workplace pensions market is growing rapidly with a huge increase in funds flowing through the industry.
108. There is no correlation between small pension schemes and small pension providers. Information from The Pensions Regulator shows that although there are some 1,790 small DC trust-based schemes (12-99 members), over two-thirds are operated by just 10 of the largest providers, accounting for over 65% of the total small scheme membership Pension providers are either insurance companies or mastertrusts and, in 2013, held assets for small schemes valued at almost £1.8billion.

#### **Risks and assumptions**

109. DWP has used the available information provided by industry, the TPR, survey data and through the consultation, to provide the best estimates of the costs of these measures. Some governance requirements for DC trust-based schemes are already set out in legislation and supported by a TPR Code of Practice. The additional costs, associated with meeting some of the new legislative requirements will vary depending on the extent to which existing legislation and good practice is being met. Information on the costs associated with undertaking governance and administration activities is not readily available. Costs for these activities are likely to vary by scheme size, but also by the type

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<sup>40</sup> NEST is a qualifying pension scheme open to all UK employer's; established by law to support the introduction of automatic enrolment

<sup>41</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/209864/ad-hoc-supporting-ae-further-analysis.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209864/ad-hoc-supporting-ae-further-analysis.pdf)

<sup>42</sup> <https://www.abi.org.uk/Insurance-and-savings/Industry-data/-/media/0131EC5ECD4F4ECCA9F2E154C9C55314.ashx>

of scheme (mastertrust, unbundled or bundled) and the preferences of the scheme. The estimates presented in this Impact Assessment represent the best estimates given the data constraints.

### Overall Net Present Value (NPV) of the introduction of minimum governance standards

110. The introduction of minimum governance standards in DC trust-based schemes has the potential to benefit large numbers of savers helping to deliver value for money and improving retirement outcomes. However, it is not possible to quantify the long-run benefits of these proposals to individuals for the reasons set out in paragraph 56. As a result, the total net present value is not quantified.

111. The net present value of the cost is estimated to be -£111.5 million (best estimate) in 2013/14 prices, over a ten year period beginning in 2015/16 (see Table 4). This is calculated by combining the estimates for:

- the chair’s statement;
- meeting the additional requirements for mastertrusts; and
- reviewing the default strategy every 3 years and undertaking a demographic analysis of membership if necessary.

Table 4: Present value of estimated costs £m

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	Total
Chair's statement	8.6	8.3	8.0	7.7	7.5	7.2	7.0	6.7	6.5	6.3	73.8
Demographic Analysis	3.1										3.1
Reviewing the default strategy	0.0	0.0	8.0	0.0	0.0	7.2	0.0	0.0	6.5	0.0	21.7
Mastertrust trustee salaries	1.4	1.3	1.3	1.2	1.2	1.2	1.1	1.1	1.0	1.0	11.8
Mastertrust recruitment costs	0.4	0.0	0.0	0.0	0.4	0.0	0.0	0.0	0.0	0.3	1.1
Total	13.4	9.6	17.3	9.0	9.0	15.6	8.1	7.8	14.0	7.6	111.5

Source: DWP estimates

Totals may not sum due to rounding

112. The chair’s statement is an annual cost so appears in every year. The demographic analysis is assumed to be a one off cost occurring in 2015/16 (the year the new minimum governance standards are introduced). The estimate is based on the proportion of schemes who might need to undertake some demographic analysis of their membership using evidence from the TPR Governance Survey (see paragraph 80). Based on evidence from the TPR Governance Survey on the proportion of schemes who regularly review their SIP, it is assumed that reviewing the default strategy will be a new activity for half of schemes (see paragraph 83). It is assumed that they will need to do it every 3 years, so the costs occur in 2017/18, 2020/21 and 2023/24. The additional trustee salaries for mastertrusts are an annual cost so appear in every year. The mastertrust recruitment costs occur every 5 years. It is assumed that mastertrusts will need to recruit and appoint additional trustees in 2015/16, then it is assumed that the trustees stay in place for 5 years and that future recruitment exercises start in the final year of the term of appointment so that the new trustees are ready to start at the beginning of the new term. Recruitment exercises are assumed to take place in 2015/16, 2019/20 and 2024/25.

113. Based on the evidence presented by the OFT in their DC market study, introducing minimum governance requirements in DC trust-based schemes seems the only reliable way of achieving the objective of ensuring that all individuals saving into a workplace pension get value for money (alongside the standards for DC contract-based schemes introduced by the FCA).

### **Direct cost to business of the preferred option**

114. As outlined in the Impact Assessment, the costs associated with the proposals for DC trust-based schemes will be met by employers who have chosen to run an occupational scheme, by the scheme members, or by a combination of the two. For the purposes of calculating the impact on business, it is assumed that the cost is split equally between scheme members and the employer.

115. Based on the estimates, the business net present value is -£55.7 million and the equivalent net cost to business of the preferred option, over the default period of 10 years recommended in the Better Regulation Framework Manual, is estimated at £5.05million.

### **Monitoring and Implementation Plan**

116. TPR will monitor compliance with the new requirements through a risk-based approach, including scheme governance and record keeping surveys; thematic reviews; and engagement with schemes through case work following whistle-blowing reports or pro-active engagement activity. Some mastertrusts will also engage with the mastertrust assurance framework which will also provide an indication of the strength of governance within these schemes.

### **Other Impacts**

#### Equality

117. Proposals for the Pensions Bill 2015 were subject to a full Equality Impact Assessment and the regulations are in consequence of the Bill. In accordance with its duty under section 75 of the Northern Ireland Act 1998, the Department has conducted a screening exercise on the proposals for the regulations and considers that the regulations do not have any additional implication for equality of opportunity.

#### Environmental

118. There are no implications.

#### Rural proofing

119. There are no implications.

#### Health

120. There are no implications.

## Human rights

121. The Department considers that the regulations are compliant with the Human Rights Act 1998.

## Competition

122. There are no implications.

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed for the Department for Social Development

A handwritten signature in black ink, reading "Anne McCleary". The signature is written in a cursive style and is positioned above the printed name and title.

Anne McCleary  
Director of Social Security Policy and Legislation

19 June 2015

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## REGULATORY IMPACT ASSESSMENT

### THE OCCUPATIONAL PENSION SCHEMES (CHARGES AND GOVERNANCE) REGULATIONS (NORTHERN IRELAND) 2015

#### CHARGES IN QUALIFYING PENSION SCHEMES

The costs and savings outlined in this Regulatory Impact Assessment are calculated on a United Kingdom-wide basis.

#### Background

1. Automatic enrolment began in 2012 for the largest employers and will be gradually rolled-out to medium, small and micro employers by 2017. It will generate an extra £11 billion a year in private pension savings<sup>1</sup> from around six to nine million people newly saving or saving more into a pension. To date 5.2 million eligible individuals have been automatically enrolled into a pension scheme.<sup>2</sup>
2. Automatic enrolment drives a fundamental shift in the dynamics of the workplace pensions market. The old model - whereby most individuals had to actively decide whether to join a pension scheme and the pensions industry had to spend 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. It is believed that this shift brings a new responsibility to ensure minimum standards apply in workplace schemes, including charging practices that are fair and appropriate for automatic enrolment. The creation of these minimum standards will help maintain confidence in automatic enrolment and the pensions industry that supports it.
3. The Department for Work and Pensions (DWP) has undertaken two consultations on how best to create minimum standards that reflect these changed dynamics. In the summer of 2013 it issued a Call for Evidence on minimum quality standards – which 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. The Department for Social Development (“the Department”) sought views from interested organisations in Northern Ireland on the consultation papers.
4. Between these two consultations, the Office of Fair Trading (OFT) issued its market report into workplace pensions (September 2013). Their report, based on extensive and rigorous analysis and argument, concluded:

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<sup>1</sup> Department for Work and Pensions (DWP), July 2012, Workplace Pension Reform: digest of key analysis, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/223031/wpr\\_digest\\_0712.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/223031/wpr_digest_0712.pdf)

<sup>2</sup> The Pensions Regulator (TPR), April 2015, Automatic Enrolment Registration Report

- that the defined-contribution 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;
  - the weak buyer side is primarily a result of a principal-agent problem – the employer chooses a workplace scheme for their employees but has different incentives. The complexity of the market and products further complicates the ability of employers to make decisions in the best interest of employees;
  - that 10% of the nearly £300billion assets managed by the pensions industry have potentially high charges which may not represent good value for money. To address these concerns, the Association of British Insurers (ABI) agreed to carry out an audit of high cost and legacy schemes (pre-2001 arrangements and those charging higher than 1% TER.). On 11th February 2014 the OFT announced the appointment of the Independent Chair and Board members to oversee the audit. In December 2014 the Independent Project Board published its report which makes recommendations of the actions to be taken by the proposed new Independent Governance Committees and trustees;
  - 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.
5. The consultation on charges (launched in October 2013), examined whether intervention was necessary to protect members of money purchase schemes used for automatic enrolment. The proposals included improved disclosure of information about scheme charges, a cap on charges in default funds and action to address certain charging structures such as Active Member Discounts (AMDs) and adviser commissions. Evidence gathered during the consultation is presented in this Impact Assessment.
  6. In March 2014, the Better Workplace Pensions Paper (Cmd 8840) responded to the recommendations made by OFT in their defined contribution market study and the consultation on charges. It set out proposals to cap charges in default funds in qualifying schemes used to meet the employer duty. The paper also included proposals to legislate for quality standard in workplace pension schemes designed to strengthen the weak demand side identified by OFT.

### **Problem under consideration**

7. Most individuals automatically enrolled will start saving into the default fund of defined-contribution workplace pension schemes. The eventual retirement income that an individual will receive from a defined contribution workplace scheme will depend on a number of factors: the charges deducted; the amount of money contributed; the investment return on their contributions and annuity rates. Before describing the impact that charges can have on retirement income it is first necessary to clarify an assumption about the way charges are expressed.



8. As the OFT described “...it is difficult to compare charges of different pension providers because there is a lack of consistency in the way charges are presented.” According to the DWP Charges Survey 2013<sup>3</sup> the vast majority of schemes<sup>4</sup> charge on an Annual Management Charge (AMC)-only basis, while only a minority of schemes set charges as a percentage of members’ contributions or as a flat fee per member. In some cases there will be additional costs which are charged separately from the AMC – including audit, legal and custodial fees. The Total Expense Ratio (TER) is another method of measuring the total costs associated with managing and operating a pension fund.<sup>5</sup> If all expenses are already included in the AMC levied by the provider, the TER will equal the AMC, but it is understood that this is not always the case. For example, not all providers include all investment management charges within their AMC. As relatively little information exists on the TER of pension schemes, the majority of the analysis presented in this Impact Assessment uses data on the AMC. More detail on charging structures is contained in Annex A.

### The impact of charges on an individual’s pension saving

9. Workplace pension schemes used for automatic enrolment are selected by employers and can levy a number of charges on the funds under management. Charges vary between schemes to cover the cost of services such as setting up and administering the pension scheme, fund management and scheme governance.
10. Most individuals saving into a pension scheme will pay an annual management charge (AMC) which is usually levied as a percentage of the funds under management. A minority of schemes charge a separate fee, sometimes in addition to the AMC, for example, a percentage charged on contributions or a flat-fee. As the value of an individual’s pension pot grows, the cumulative impact of these charges can over time significantly erode the value of an individual’s pension savings. Differences in AMCs between schemes can eventually result in large differences in the income received by different individuals in retirement.
11. A number of previous studies<sup>6</sup> have shown the extent to which higher charges can reduce the value of an individual’s pension pot. For example, the Pensions Policy Institute (PPI) found that even at the level of the stakeholder cap<sup>7</sup> (1.5% for the first ten years, and 1% thereafter), charges could have a large impact – reducing private pension income by 13% compared to the NEST charge.<sup>8</sup> In a recent briefing note on charges<sup>9</sup> the PPI said: “*While there are many factors affecting total pension savings in a DC scheme, the level of charges paid can have a significant impact.*”

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3 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

4 84% of trust-based schemes and 90% of contract-based schemes reported charges were made as a percentage of the member’s fund per annum, DWP charges survey 2013. Meanwhile, the NAPF 2013 Annual Survey found that 79% of schemes used an AMC

5 They do not include all costs however – for example, investment charges such as initial exit and entry fees, brokerage commissions, bid-offer spreads and stamp duty

6 For example, Johnson P, Yeandle D, and Boulding A, October 2010, Making Automatic Enrolment Work

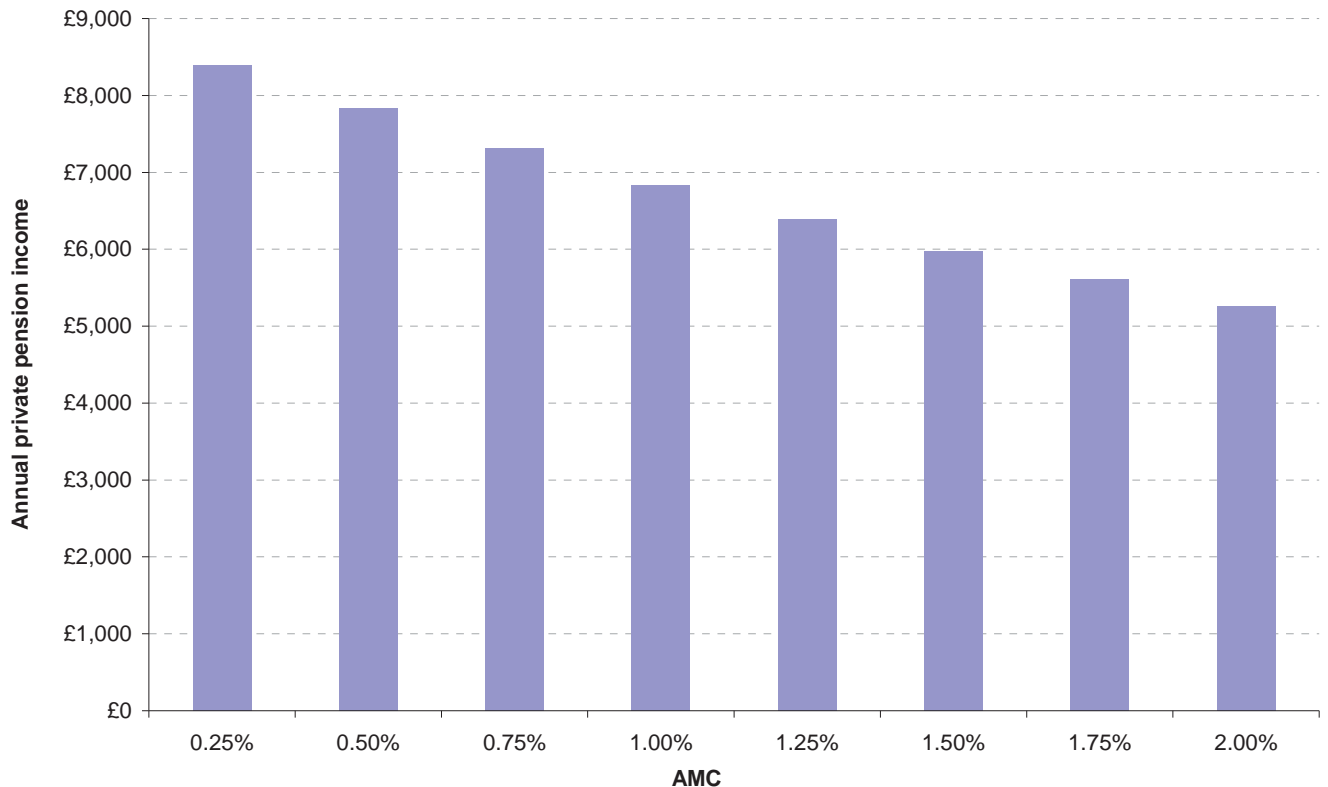
7 Stakeholder pension schemes were introduced in the UK on the 6 April in 2001 as a consequence of the Welfare Reform and Pensions Act 1999. They were intended to encourage more long-term saving for retirement, particularly among those on low to moderate earnings. They are required to meet a number of conditions set out in legislation, including a cap on charges, low minimum contributions, and flexibility in relation to stopping and starting contributions

8 Pensions Policy Institute, 2012, Closing the gap: the choices and factors that can affect private pension income in retirement

9 How do charges affect DC pension outcomes, 2013, the Pensions Policy Institute, [http://www.pensionspolicyinstitute.org.uk/download?ReturnUrl=uploaded%2fdocuments%2f20131129\\_BN64\\_How\\_Do\\_Charges\\_Affect\\_DC\\_Pension\\_Outcomes.pdf](http://www.pensionspolicyinstitute.org.uk/download?ReturnUrl=uploaded%2fdocuments%2f20131129_BN64_How_Do_Charges_Affect_DC_Pension_Outcomes.pdf)

12. Chart 1 presents the results of DWP modelling into the impact that different levels of charge taken as a percentage of funds under management could have on the private pension income received by individuals in the first year of retirement. Based on the example below, an individual who saves for their entire working life could – everything else being equal – see a private pension income that is over £1,800 a year (25%) higher<sup>10</sup> if they saved in a scheme with a 0.5% charge on funds under management compared to one with a 1.5% charge on funds under management.

**Chart 1:** Impact of charges deducted as a percentage of funds under management on private pension income in the first year of retirement (£ expressed in 2013 earnings terms)



**Source:** Based on DWP modelling

**Assumptions:**

- 1) Individual contributes to scheme every year from age 22 until retirement, aged 68
- 2) Contributes £1,500 a year, growing at 4% per annum.
- 3) Nominal fund growth of 7% per annum.
- 4) Annuity rate of 6%. No lump sum taken.
- 5) Earnings growth of 4% per annum.

Current charge levels and trends over time

13. Whilst stakeholder pension schemes (introduced in 2001) have their charges capped at 1.5% for the first ten years, and at 1% thereafter, the latest evidence suggests that most pension schemes now have charges below this level. According to the DWP Charges Survey 2013<sup>11</sup>, average charges were 0.75% in trust-based schemes and 0.84% in contract-based schemes - below the level of the stakeholder charge cap.

<sup>10</sup> In 2013 earnings terms

<sup>11</sup> Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

14. There is evidence that charges have been falling over time. The OFT cited three reasons for this downward trend: assets under management are growing over time (and this will continue under automatic enrolment); some providers have modernised their back office systems; and previous Government intervention has led to lower benchmarks for charges (the introduction of stakeholder pensions<sup>12</sup>). The OFT found that the average AMC for contract-based schemes and bundled trust-based schemes has seen a downward trend - from 0.79% in 2001 to 0.51% in 2012. The Association of British Insurers (ABI) has found that the average customers in schemes newly set up for automatic enrolment faced an AMC of 0.52%, whereas in pre-existing Group Personal Pension (GPP) schemes the average customer faced an AMC of 0.77%.<sup>13</sup>

**Chart 2:** Average AMC on schemes set up by contract-based and bundled trust-based pension providers in each year



Source: OFT; based on data submitted by providers

15. However, there remains a wide range of scheme charges across the market - the schemes covered in the National Association of Pension Funds (NAPF) Annual Survey 2013 had scheme charges ranging from 0.04% to 1.2%.<sup>14</sup> The DWP Charges Survey 2013<sup>15</sup> found that 7% of employers with contract-based schemes and 10% with trust-based schemes reported an AMC of more than 1%<sup>16</sup> (see Chart 3), and the ABI found a small handful of schemes charging above 2%.<sup>17</sup> The evidence suggests that whilst there has been a downward trend in the average AMC there is a tail of schemes that have relatively high charges compared to others on the market.

12 Wood A, Leston J, and Robertson, M, 2009, Current practices in the workplace personal pension market: Qualitative research with pension providers and intermediaries, DWP Research Report 591

13 Association of British Insurers, June 2012, Time to Act: Tackling our Savings Problem and Building our Future, page 12 <https://www.abi.org.uk/-/media/Files/Documents/Publications/Public/Migrated/Pensions/Time%20to%20Act.ashx>

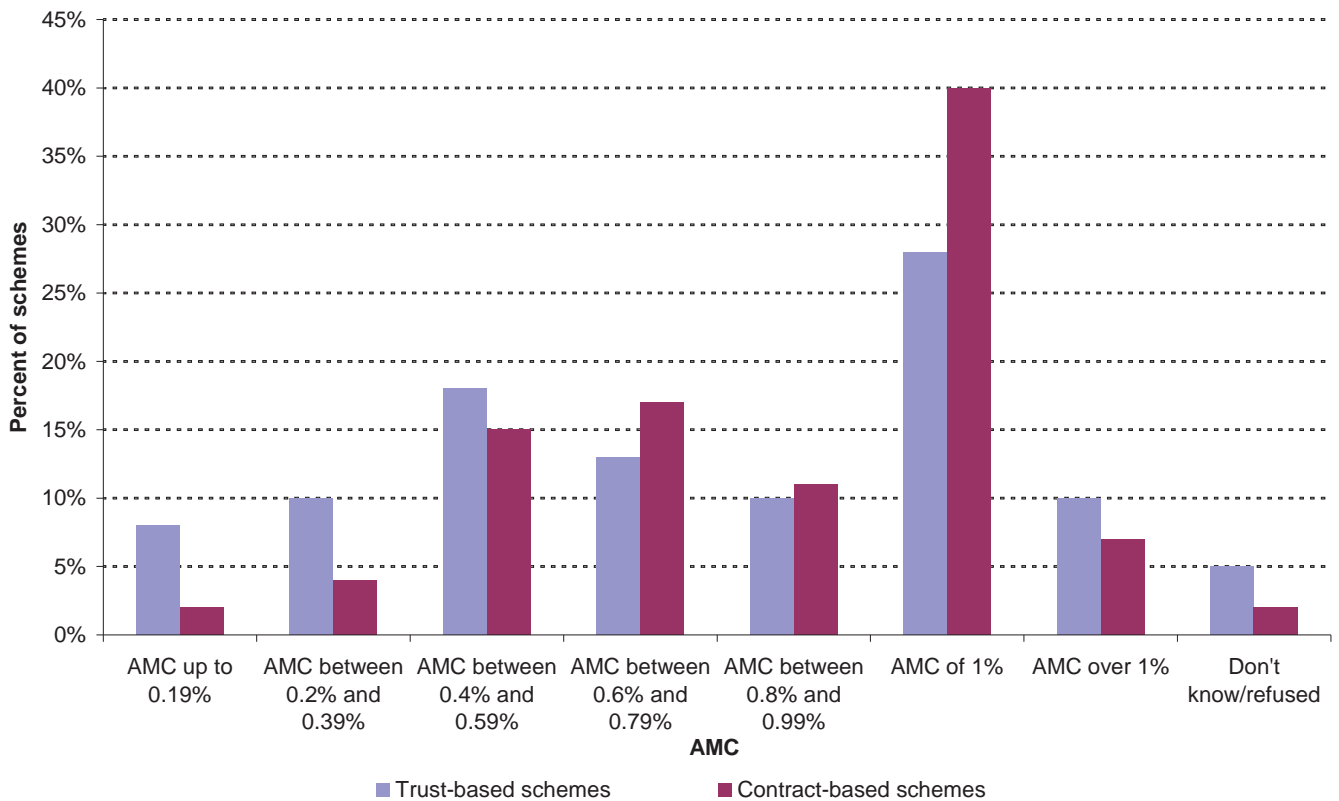
14 National Association of Pension Funds, 2013, Annual Survey 2013

15 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

16 A small proportion of employers reported that they did not know the charges their members paid, or refused to say - at least some of these are also likely to have charges above 1%

17 Association of British Insurers, June 2012, Time to Act: Tackling our Savings Problem and Building our Future, page 12 <https://www.abi.org.uk/-/media/Files/Documents/Publications/Public/Migrated/Pensions/Time%20to%20Act.ashx>

**Chart 3: Range of AMCs paid by members of trust- and contract-based schemes**



Source: DWP Pension Landscape and Charging survey 2013

16. Findings from the OFT’s study of the DC workplace pensions market support the view that some schemes - primarily but not exclusively those sold prior to 2001 have charges that may not represent value for money, or that may not reflect current standards of scheme design. The OFT concluded that: around £30 billion of savings in old and/or high charging contract- and bundled trust-based schemes may not be value for money. Other research supports the finding that many of the higher charges are found in older “legacy” schemes.<sup>18</sup>

Reasons for variation in pension scheme charges

17. Pension scheme charges vary for a number of reasons:

- the quality of services offered;
- the commercial proposition of each individual employer – driven by factors including workforce size, remuneration and savings persistency levels; and
- provider business models, efficiency and profit margins.

*The level of quality of services offered*

18. Other things remaining equal the greater the level of services delivered the higher the cost of providing a scheme. Additional scheme features that can drive cost in workplace pension schemes include one-to-one employee advice sessions; a high level of financial

<sup>18</sup> Harrison D, Blake D, and Dowd K, October 2012, Caveat Venditor, Pensions Institute and Cass Business School

education support; regular phone-lines; more bespoke administration, communication and marketing; and active investment management strategies (rather than passive management strategies). Commission arrangements – whereby third-party advisers receive payment for services in establishing a scheme and providing on-going services – can also be borne by scheme members.

*The commercial proposition of each individual employer – driven by size and workforce remuneration levels*

19. A key factor behind the variation in scheme charges is differences in scheme size – the DWP Charges Survey 2013<sup>19</sup> found that, apart from scheme type, this was the greatest determinant of the charge level. Employers with 12-99 members reported an average charge level of 0.94% for trust-based and 0.86% for contract-based schemes whereas trust-based schemes with 1,000 or more members reported members paid on average 0.42% and contract-based schemes paid 0.51% (see Table 1).

**Table 1:** AMC levels and scheme size, compared to average AMC (%)

	12-99 members	100-999 members	1,000+ members	Average for all schemes
Trust-based	0.94	0.60	0.42	0.75
Contract-based	0.86	0.65	0.51	0.84

**Source:** DWP Pension Landscape and Charging survey 2013

20. Given that only the largest employers have so far been subject to automatic enrolment the current low charge levels observed in schemes newly set-up for automatic enrolment could in large part reflect the size of those schemes. The charges observed by the ABI for individuals in schemes newly set-up for automatic enrolment (0.52%) is remarkably similar to the charges found amongst the largest schemes in the DWP Charges Survey.
21. The OFT reported that it may not be profitable for some providers to maintain low charges once small and medium employers reach their staging date. The reasons stated were that employees working for small and medium employers are likely to be less profitable from a provider's perspective if they have lower levels of funds under management and lower contributions. The higher charges found in smaller schemes also reflect the fact they are more costly to set up as fixed costs of starting a scheme are spread across fewer members, and the schemes are unable to benefit from the same economies of scale which larger schemes can. For example, research by Capita Hartshead found that schemes with more than 50,000 members report costs of around £10-30 per member, whilst schemes with fewer than 1,000 members report costs of around £200 per member.<sup>20</sup> A number of consultation responses noted that smaller employers/smaller schemes were often subject to higher scheme charges.

*Provider business models, efficiency and profit margins*

22. Each pension provider will have its own business model which in turn will drive its efficiency and profit expectations. Some providers operate from modern, digital platforms - which may have enabled them to lower member charges in recent years -

<sup>19</sup> Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

<sup>20</sup> Capita Hartshead, May 2010, 17th Annual Pension Scheme Administration Survey 2010

while others use less up-to-date approaches. Moreover, some providers operate from a variety of platforms based on their acquisition history which adds cost to their operations. It may also be assumed that providers, particularly on the contract-based side of the market, operate within different profit expectations, driven by the wider corporate context in which they operate. For example, one provider might offer low-cost workplace pensions, at little margin, in order to build opportunities for cross-selling wider financial products. Others may be more dependent on workplace pensions for their revenue and require a greater margin on their pensions book. These factors will influence the ability of an individual provider to operate at particular charge levels.

## Rationale for intervention

23. The introduction of the legal duty for all employers to automatically enrol their employees will generate an extra £11 billion a year in private pension savings, drawn from around six to nine million people newly saving or saving more into a pension. It is believed that these structural changes bring new responsibilities for the state, regulators and the constituent parts of the pensions industry to ensure that savers have confidence in the system and they are getting good value for their pension contributions.
24. In their study of the defined contribution workplace pensions market, the OFT concluded that the structure of this market was preventing effective competition on charges. The two main barriers are the weak buyer side of the market and the complexity of charges in the market. With regard to legacy schemes they found that around £30 billion of savings in old and/or high charging contract- and bundled trust-based schemes may not be value for money. With regard to the automatic enrolment market they expressed concerns that individuals may be defaulted into arrangements that represented poor value for money. Their concerns were based on two structural weaknesses:
  - a. **Principal-agent problem:** scheme members rely on employers to select a workplace scheme into which they are enrolled and their respective interests and incentives are often different, and
  - b. **Information asymmetry:** the complexity of the product creates difficulties for employers in making comparisons about costs and quality, and outcomes may not be judged for a number of years.

### Principal-agent problem

25. The principal-agent problem in workplace pensions describes the situation where the scheme member (principal) bears the risks and rewards of a defined-contribution workplace pension scheme, but the choice of the scheme is made by the employer (agent). Evidence suggests that there is often a misalignment of incentives between the two parties which leads to outcomes that are not optimal for the scheme member.
26. The OFT's defined-contribution market study<sup>21</sup> reported that some employers automatically enrolling employees into a pension scheme for the first-time are likely to be motivated by factors other than charges borne by members. Some employers might consider minimising the direct set-up and administration costs of the scheme to

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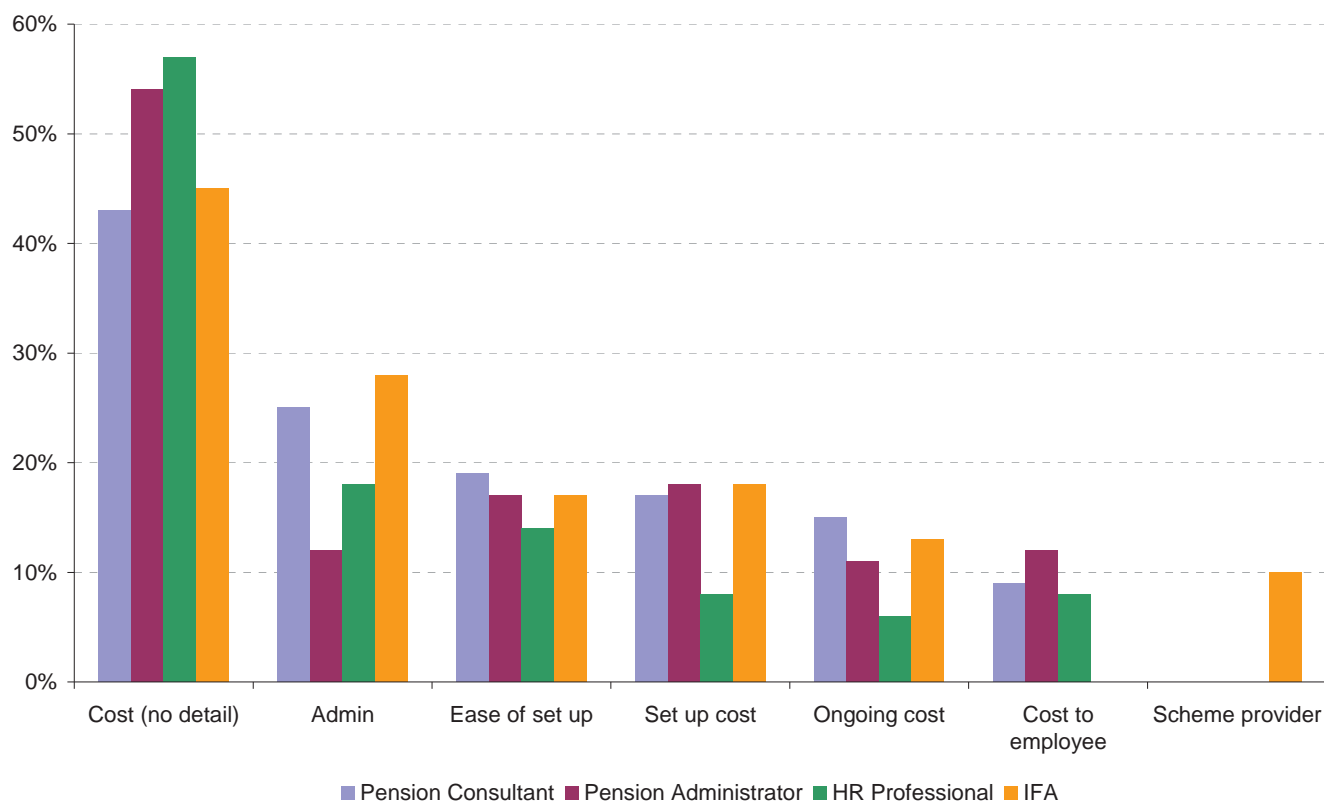
<sup>21</sup> Office of Fair Trading (OFT), 2013, Defined contribution workplace pension market study, OFT 1505



themselves, or prioritise the extent of employer support available, rather than focusing on the outcomes of their scheme choice for their employees. This is supported by DWP research showing that a key factor in scheme choice for many employers is likely to be a preference for a simple solution that is easy to implement, especially amongst employers who are new to providing workplace pensions.<sup>22</sup> The National Association for Pension Funds (NAPF) and B&CE<sup>23</sup> found that whilst many employers were motivated by keeping staff happy, and smaller employers were often the most concerned about the welfare of their employees, the very smallest employers tended to be most concerned with survival, and minimising the costs of workplace pension requirements.

27. This is further supported by research findings from the Pensions Regulator in which intermediaries - i.e. consultants, independent financial advisers, administrators and HR professionals – identified cost as the top aspect taken into consideration by the employer when selecting a scheme (see Chart 4). This factor was mentioned most often by all intermediary types – ranging from 43% of pension consultants to 57% of HR professionals, whilst only 8-12% cited cost to the employee as the main factor.<sup>24</sup>

**Chart 4: Main considerations of employers when selecting a pension scheme**



**Source:** The Pensions Regulator, *Intermediaries' awareness, understanding and activity relating to workplace pension reforms, Spring 2012*

28. The OFT also highlighted the potential for a misalignment of interests where employers seek to prioritise the interest of current employees (active members) when negotiating charges rather than former employees or others who no longer contribute to their

22 Woods A, Spinks S, Leong J, and Reeve K, 2010, Likely treatment of different types of worker under the workplace pension reforms: Qualitative research with employers, DWP Research Report 662

23 NAPF and B&CE, September 2012, Telling Employers about DC Pension Charges: Research

24 The Pensions Regulator, August 2012, Intermediaries' awareness, understanding and activity relating to workplace pension reforms, Spring 2012

pension (deferred members). This means that those not actively contributing may not have anyone looking at whether their charges still represent value for money. The existence of a significant number of schemes with an Active Member Discount (AMD) in place is an example of this. The DWP Charges Survey 2013<sup>25</sup> found that 3% of trust-based and 10% of contract-based schemes used AMDs.

29. In addition, the OFT also found that variation in headline charge levels is unlikely to be driven purely by factors such as the size and growth of assets under management but by the ability of the employer to negotiate a reasonable charge.<sup>26</sup> This means that scheme members could find themselves in high charging schemes simply as a result of their employer's negotiating ability.
30. On the basis of this evidence the UK Government believes that there is a clear risk that employees are bearing high or inappropriate pension charges due to a decision made by their employer - acting under different incentives.

### Information asymmetry

31. There is considerable evidence that there is information asymmetry in the workplace pensions market whereby employers lack the access and capability to assess value for money<sup>27</sup> in relation to the charges their employees pay.
32. The DWP Charges Survey 2013<sup>28</sup> found that while employers' awareness of member charges had increased since 2012 - around three-quarters<sup>29</sup> of employers are now aware that their members pay charges - this is unlikely to be consistent across the range of employer sizes. Research from the NAPF and B&CE found that awareness of charges was lowest amongst smaller employers. They were also generally unaware that it was possible to negotiate charges with providers, and struggled to understand the impacts of percentage based charges on employees' pension pots – preferring flat-rate charges on the basis of their simplicity even if such charges can often have a detrimental impact on individuals with smaller pots.<sup>30</sup>
33. Contributing to this lack of understanding is a lack of transparency in the information supplied by pension providers. At present there are limited requirements on providers to disclose the charges incurred by members. Currently disclosure requirements are inconsistently applied - for example - providers of stakeholder pensions are required to disclose deductions for charges made from an individual's pot, and contract-based schemes are required by the Financial Conduct Authority to provide illustrations that show the effect of charges. However, there is normally no requirement on trust-based schemes to disclose charges, and whilst regulations require all defined-contribution schemes to provide annual statements to members, there is no requirement to show information about charges. Research by the NAPF found that many employers feel that the structure of pension charges is not well explained nor transparent in how it is

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25 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

26 Office of Fair Trading (OFT), 2013, Defined contribution workplace pension market study, OFT 1505

27 Office of Fair Trading (OFT), 2013, Defined contribution workplace pension market study, OFT 1505

28 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

29 74% trust-based schemes and 85% contract-based schemes employers are aware their members pay any charges; DWP charges survey 2013

30 NAPF and B&CE, September 2012, Telling Employers about DC Pension Charges: Research

presented, whilst smaller employers felt charges were deliberately unclear with a perception that providers were obscuring certain add-on charges behind technical jargon.<sup>31</sup>

34. In January 2013, to help address this issue, the ABI announced that 14 of its 300 members had agreed voluntary standards for disclosing charges to scheme members. This initiative was implemented for new schemes by summer 2014 and will be implemented for older schemes by the end of 2015. Signatories are committed to disclosing all charges and costs in a consistent way, from the outset and annually. It is yet to be taken up by trust-based schemes.
35. The general lack of information on pension costs and charges also hampers those governing pension schemes from exerting competitive pressures. On the trust-based side trustees can lack the capability as well as the information to effectively act in members' best interests. On the contract-based side there is no current equivalent to trustees and scheme members' interests are not directly represented at all. These failings led the OFT to recommend that minimum quality standards be placed on all workplace pension schemes and that Independence Governance Committees be set up to improve governance in contract-based schemes. Those recommendations are accepted in principle. Whatever the final shape of the quality standards there is a need to make sure that those governing workplace schemes have the information and capability to do so in members' interests, including in the crucial area of costs and charges.

## Conclusion

36. The evidence available to Government, competition authorities and regulators suggests that the structure of the workplace pensions market inhibits effective competition on scheme charges. As charges can have a significant impact on an individual's pension saving over time this is of significant concern. The requirement on all employers to enrol their employees into a scheme, will bring 6-9 million people newly into saving or saving more by 2018, which presents a greater risk of member detriment if intervention is not made.
37. There have been a number of voluntary initiatives to ensure fairer charges in workplace pensions:
  - In 2012 the pensions industry was challenged to review charges in legacy schemes and to commit to ensuring schemes charging more than 1% of funds under management were not used for automatic enrolment. However, only a small number of providers responded to this challenge by committing to using lower charging schemes.
  - The ABI agreed voluntary standards for disclosing charges to scheme members with some of its members. Following the OFT market study the ABI agreed the audit into high-charging legacy pension schemes in 2014, after the OFT expressed serious concern about the potential for poor value for money in some arrangements.

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<sup>31</sup> NAPF and B&CE, September 2012, Telling Employers about DC Pension Charges: Research

- The NAPF has led an industry-wide group to develop a Code of Practice on the transparency of charges for employers, which it published in November 2012.
38. It is recognised that the largest employers have been able to secure fair charges for their members as they go through their automatic enrolment staging. However, there remains a significant risk, despite these factors, that those working for medium and smaller sized employers will incur higher pension charges as automatic enrolment is rolled out. Many employers<sup>32</sup> plan to use existing provision for automatic enrolment. Once employers have chosen a scheme, many remain with it – the average trust-based scheme was set up in 1993 and the average contract-based scheme was set up in 2001.<sup>33</sup> If employers use these existing schemes for automatic enrolment this would mean employees could end up in high charging default funds in qualifying schemes, or be subject to charging structures inappropriate to circumstances where individuals are defaulted into membership.
39. Even if employers do set up a new scheme there remains the risk that employees would incur high charges. It is possible that charges for default funds in qualifying schemes will increase as smaller employers reach their staging dates for automatic enrolment. Even if alternative low charging multi-employer schemes exist, there is no guarantee that employers will use these if they are unaware of the charges their members pay or if their primary concern is their own costs.
40. The OFT concluded in their market study that the defined contribution workplace pensions market met the conditions required for a Market Investigation Reference (MIR). They decided not to pursue an MIR on the understanding that appropriate remedies to address the market weaknesses they had identified would be pursued. It is recognised that those weaknesses provide a clear rationale for intervention on pension charges to protect those who have been defaulted into schemes. The market is growing rapidly and there is a responsibility to ensure that all savers who are automatically enrolled are defaulted into schemes with basic protections. It is believed that not only will this help to ensure good outcomes for savers, but it will also help to build trust and confidence in the workplace pensions industry as it grows to serve millions of additional customers and deliver a significant increase in the levels of pension saving.

## Policy objectives

41. When designing policy on workplace pensions and charges, the following objectives apply:
- Protecting members from high or unfair charges where they have been enrolled automatically into a pension scheme.
  - Ensuring those running workplace pension schemes – trustee boards and the proposed new Independence Governance Committees (IGCs) – have the tools to act in members' interests with respect to costs and charges.

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<sup>32</sup> Employer responses to the latest Employer Pensions Provision Survey 2011– 60% of those who already offer a form of workplace pension provision planned to keep all current members in their scheme, and 49% planned to use the existing scheme for non-members and new employees

<sup>33</sup> Wood A, Wintersgill D, and Baker N, 2013, Pension Landscape and Charging: Quantitative and qualitative research with employers and pension providers, DWP Research Report 804

- Maintaining a diverse and competitive market for workplace pensions and associated services and building public trust and confidence in this market.
- Supporting the implementation of the automatic enrolment programme.

## **Description of options considered**

### Option 1: Do nothing

42. Under this scenario, government and the Pensions Regulator would continue to encourage and support employers to use low charging schemes to fulfil their automatic enrolment duties, but there would be no additional requirement on providers to disclose charges to employers, scheme members or other parties, and no requirement on employers to ensure members did not incur excessive charges in default funds.
43. This option serves as a baseline option for assessing the impact of the other options considered. For the purposes of the impact assessment, this option therefore has zero costs and benefits (relative to itself).

### Option 2: Introducing a statutory requirement on all workplace schemes to disclose pension scheme charges

44. Existing legislation requires private pension schemes to disclose prescribed information to scheme members and others. To improve transparency of member-borne charges it is proposed that once an employer has selected a scheme there will be a statutory requirement on schemes to disclose standardised charges information on an annual basis to employers, scheme members, trustees and IGCs. Disclosure requirements would also be extended to those transaction costs incurred by pension schemes when investing member contributions. These measures would be instead of the current provisions where schemes provide information in line with guidance and the Pensions Regulator or by encouraging pension schemes to voluntarily sign up to the codes of practice developed by industry bodies. As noted, the current requirements are neither comprehensive across the market nor are easily comparable between schemes.

### Option 3: Charge controls on default funds in qualifying schemes

45. Alongside the duty to automatically enrol employees into a workplace pension scheme, the Pensions (No. 2) Act (Northern Ireland) 2008 also included a reserve power to limit charges in default funds in qualifying schemes. An amendment was made by the Pensions Act (Northern Ireland) 2012 to extend this power to those not actively contributing to a pension scheme. The Pensions Bill 2015 further extends the Department's powers to limit charges in default funds in qualifying schemes used by employers to fulfil their duties for automatic enrolment. This enables the Department to prohibit and limit particular types of charges across any workplace pension arrangement.
46. Under these powers the Department can therefore specify direct criteria which a pension scheme will have to meet in order for it to be used as a qualifying pension scheme for the purposes of the employer duties set out in the Pensions (No. 2) Act (Northern



Ireland) 2008. As such it would be the employer's responsibility to ensure that the scheme they choose to meet these duties complies with the criteria.

47. Informed by the OFT's analysis, the charges consultation in the autumn of 2013 set out proposals to control charges in the default funds in qualifying schemes used for automatic enrolment. These included:

- Three options to create a default fund charge cap – of either 1% of funds under management, 0.75% of funds under management, or a 'comply and explain' option whereby schemes would be able to charge up to 1% if they could justify a charge above 0.75%. Which charges should be covered by a default fund charge cap and how to treat combination charge structures under any cap.
- Whether particular charging approaches - Active Member Discounts, consultancy charges and advisor commissions - remained appropriate in the new commercial environment whereby all employers have to establish workplace schemes and scheme members are defaulted into those arrangements.

Option 4: Introduce a statutory requirement on all workplace schemes to disclose pension scheme charges and introduce charge controls on default funds in qualifying schemes – a combination of options (2) and (3)

48. Following from the consultation and DWP engagement with stakeholders on these issues, a fourth option is proposed which is a combination of options 2 and 3; to introduce a statutory requirement on all workplace schemes to disclose pension scheme charges information and introduce charge controls on the default funds in qualifying schemes.

#### Options not considered

49. This impact assessment is restricted to the issue of improved transparency of pension scheme charges and charge control options which directly address their level, the types of charges permitted, and the way they are disclosed to employers, scheme members and other parties. It does not consider options to strengthen or improve the governance of pension schemes, as recommended by the OFT in its study into the defined-contribution pensions market (which may have an indirect affect on some of the issues considered here).

50. While strong governance could be expected to exert a downward pressure on charges, this issue is considered in a separate Impact Assessment.

#### **Preferred option**

51. On the basis of the structural weakness in the market identified by the OFT, and the evidence gathered during consultation, it is believed there is a strong case for intervention to protect those individuals who have been automatically enrolled into a workplace pension from high and unfair charges. Doing nothing would continue to leave individuals at risk of being automatically enrolled by their employer into a high-charging workplace pension scheme, with no guarantee this will be rewarded with higher



investment returns or other scheme quality features. On this basis, supported by DWP and OFT analysis, option 1 is discarded.

52. Consultation responses showed strong support across the spectrum for Option 2 - a statutory requirement on all workplace schemes to disclose pension scheme charges in a comparable format, building on and strengthening existing industry initiatives in this area. It is believed that if those responsible for representing members' interests – trustees and the proposed Independence Governance Committees – have detailed information on costs and charges then these could exert a healthy downward pressure. Further, it is believed that this information should be standardised to enable trustees and Independent Governance Committees – and employers - to compare charge levels more effectively. This disclosure will relate to both administrative charges (such as those captured by AMC/TER measures and charged directly to members) and transaction costs (which are charged by asset managers to schemes but ultimately borne by members).
53. Consultation responses and evidence also supported the view that requiring the disclosure of pension scheme charges will by itself not be sufficient to guard against member detriment in default arrangements. Responses to the DWP consultation suggested that while greater transparency and disclosure were important for improving trust and understanding of pensions, members could not do anything with this additional information beyond opting out. This is because it is the employers who choose the pension scheme, not the members. Similarly greater information to employers was supported, because it would increase employers' ability to judge and compare schemes. However, many responses pointed to the OFT's analysis that the main factor behind an employer's scheme choice was a desire to limit costs to themselves, rather than secure the best deal for their employees. Therefore it is believed that charge controls on default funds should be introduced in addition to disclosure requirements, to ensure that members are protected from inappropriate charges. These controls will support the objectives described above and ensure charging practices and levels that are fair and appropriate when such a large number of individuals are making no active choice about their workplace saving. The preferred option is therefore option 4, a combination of options 2 and 3.
54. The intended measures and are as follows.
- A default fund charge cap set at 0.75% of funds under management for all qualifying schemes
  - An extension of the ban on consultancy charges to include all qualifying schemes
  - New disclosure requirements for all workplace schemes: full information on costs and charges throughout the value chain to be disclosed to scheme trustees and IGCs.

#### **From April 2016**

- All structures where deferred members must pay more than active members, such as Active Member Discounts, to be banned in qualifying schemes

- Member-borne adviser commission to be banned in all qualifying schemes

55. Alongside these measures on charges, the Better Workplace Pensions Paper (Cmd 8929) published in October 2014 confirmed the intention to improve scheme governance. These measures will complement the charges measures and the overall package will seek to address the market weaknesses identified by the OFT.<sup>34</sup>
56. In 2017, consideration will be given to whether the level of the default fund charge cap remains appropriate and whether some or all transaction costs should be within the cap.

### Monetised and non-monetised costs and benefits

57. The monetised and non-monetised costs and benefits for key groups, for all options, are described in Table 2. Further details and description follows this Table.
58. The DWP Charges Survey 2013<sup>35</sup> is the primary source of information for measuring charges levied on both trust- and contract-based pension schemes. For more details on the data sources used in the estimates presented in this Impact Assessment see Annex B. The estimates presented in this section are based upon an AMC measure of administrative charges. However, there is no single agreed measure of an AMC across the industry, or even of the Total Expensive Ratio (TER) measure which is slightly more comprehensive in terms of charges covered. It is proposed to include all member-borne charges in the default fund cap, excluding transaction costs, which it is believed is more akin to a TER measure.

**Table 2: Summary description of monetised/non-monetised costs and benefits**

	<b>Employers</b>	<b>Individuals</b>	<b>Pension industry</b>	<b>Advisers</b>
<b>Option 1:</b> Do nothing	No additional costs.	No change – some individuals would continue to be defaulted into paying high charges in workplace pension schemes and trustees, IGCs and the regulators would have incomplete information about costs and charges in such schemes.	No additional costs.	No additional costs.
<b>Option 2:</b> Introducing a statutory requirement on schemes to disclose pension scheme charges	No additional cost to employers.  Employers who request information on scheme charges may be more informed of charges and could find the standardised information easier to compare charges across schemes.	Those individuals who understand the information will be better informed. Research evidence suggests that for those individuals who can process the information, few of them will act upon it.  If employees were dissatisfied about the level of charges their	Cost and charges information is already disclosed but these proposals would require all schemes to do it in a standardised way.  The costs of disclosing pension scheme charges are expected to be minimal to pension providers as communication is	No additional cost to advisers.  They may be required to help explain costs and charges to clients who are either a member of a qualifying scheme, or are an employer who has set up a qualifying scheme.

<sup>34</sup> Office of Fair Trading (OFT), 2013, Defined contribution workplace pension market study, OFT 1505

<sup>35</sup> Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and qualitative research with employers and pension providers, DWP Research Report

	<p>The available evidence indicates employers may have more trust in their pension providers, but that many could find it difficult to understand. The information provided is unlikely to have an impact on the employers' choice of scheme.</p>	<p>only choice would be opt out of their workplace scheme, at which point they would lose access to the employer contribution element of their pension savings.</p> <p>Individuals would be more likely to benefit if the trustees/ IGCs pertaining to their scheme exerted a downward pressure on charges as a result of more and clearer information on charges.</p>	<p>expected to be done primarily electronically to employers. Disclosure of information to scheme members is expected to be done electronically or included in the annual benefit statement both at negligible costs. Disclosure to trust-based schemes and IGCs is expected to be paper-based.</p> <p>Achieving full and standardised transparency with regard to transaction costs represents more of a change with existing practice and therefore may incur more of a cost to pension schemes and providers. The Department does not have sufficient information to reliably quantify this cost.</p> <p>Ongoing costs of disclosure are estimated at £0.04million a year in 2013/14 prices.</p> <p>The pensions industry could benefit from improved disclosure of information through building trust and confidence in the market.</p>	
<p><b>Option 3:</b> Charge controls on default funds in qualifying schemes, including: a charge cap (0.75%), a ban on Active Member Discounts (AMDs), an extension of the consultancy charge ban, and a ban on commissions</p>	<p>If an employer's existing scheme contains a default fund with a charge higher than the cap level, or contains features such as commission / AMDs, and the pension provider is not willing to adjust the terms of the scheme to become compliant, there would be transitional costs from having to set up alternative pension provision.</p> <p>Total transitional costs of up to £55.5m in 2013/14</p>	<p>It is estimated that around 2 million active members would benefit from the introduction of the charge controls. These are individuals who would be enrolled in default funds in qualifying schemes which do not comply with the charge controls but would gain due to the charge controls – as long as member-borne charges elsewhere are not increased.</p> <p>It is expected the gain to individuals</p>	<p>The amount of money flowing into the industry as a result of automatic enrolment will remain the same but the proportion taken in charges will be smaller and the distribution of the funds across schemes will be impacted by the introduction of the charge controls.</p> <p>There will possibly be some consolidation in number of schemes – resulting in a smaller number of more efficient schemes, taking advantage of economies of scale.</p>	<p>The impact on advisers of the charge control measures will depend on the extent to which they have adjusted their fee models to the new commercial environment of automatic enrolment.</p> <p>The DWP Charges Survey 2013 showed that 25% of trust-based schemes and 41% of contract-based schemes have built in adviser commission (these figures do not distinguish between those used as qualifying schemes and those that are not). Following the</p>

	<p>prices could be expected for employers impacted by the charge controls.</p> <p>The estimated transitional costs could be lower depending on the number of employers who renegotiate the terms of their pension scheme when in breach of the charge controls.</p>	<p>would be a direct transfer from the pensions industry, all else being equal. The gain to impacted individuals is estimated to be £195m in 2013/14 prices over a ten year period as a result of the introduction of a charge controls.</p> <p>Other individuals not directly affected by the cap may see higher charges than they otherwise would, if providers level up charges to the cap level. However evidence from the consultation suggests this is unlikely to happen.</p> <p>Deferred members will no longer have to incur higher charges if AMDs are banned, while those currently paying commission or consultancy charges, but not receiving a service in return for this money, will also benefit.</p>	<p>It is estimated that there could be a net loss of revenue to the pensions industry of £195m in 2013/14 prices over a ten year period as a result of the introduction of charge controls.</p> <p>Introducing a charge cap will increase the level of capital insurers are required to hold in order to protect customers against the risk of insolvency.</p> <p>A ban on AMDs, commission and consultancy charges means that some schemes may have to be rewritten by the provider if it wants to keep business generated by automatic enrolment. This is not expected to lead to a withdrawal of business by providers as the net impact on their revenues is not likely to be significant.</p>	<p>RDR, no new schemes with commission can be set up, but employees can still be automatically enrolled into schemes that pre-date January 2013 where this structure is in place.</p> <p>Following the RDR, many advisers have moved to a fee-based model and banning adviser commissions in qualifying schemes is likely to accelerate this trend.</p> <p>Some advisers will have built the expected income stream from trail commission in some qualifying schemes into their balance sheet for the next two years and will thus need to negotiate with the employer and pensions provider new remuneration agreements for services previously supplied.</p> <p>As with commission, some advisers will have built income stream from consultancy charges into their balance sheets for the next few years. However, the impact of the extension of the consultancy charge ban will be small compared to that of commission, because so few schemes were set up on this basis. Evidence sent in to the DWP consultation estimated that there were only a couple of hundred schemes established with a consultancy charge.</p>
<b>Option 4: A combination of options (2) and (3) above</b>	See above options (2) and (3)	See above options (2) and (3)	See above options (2) and (3)	See above options (2) and (3)

## Impacts of option 2: Introducing a statutory requirement on schemes to disclose pension scheme charges

### Impact on the pensions industry

59. Disclosure of charges across the pensions industry is at present piecemeal. Industry and consumer groups alike have called for charges disclosure to be comprehensive and information standardised to ensure transparency across all schemes. The Government proposes that once an employer has selected a scheme there will be a requirement on schemes to disclose standardised charges information on an annual basis to employers, scheme members, trustees and IGCs<sup>36</sup>. This will place an additional ongoing cost on pension providers and schemes as, while many already gather and share this information, all workplace schemes will now need to make sure it is in a standard format and disclosed to the relevant governance bodies.
60. Table 3 below sets out the estimated annual cost to pension providers of sending standardised information to trust-based schemes and IGCs. It has been assumed that pension providers face no additional ongoing costs of disclosure of information to scheme members. This information can be communicated electronically or as a paper-based communication sent as part of the annual benefit statement which is already a requirement. The ongoing cost of disclosure of information to employers is also assumed to be negligible as this information can be sent to employers electronically assuming that all employers have access to electronic communications. The information provided to trustees and IGCs will be more detailed therefore it has been assumed this will be paper-based.
61. With regard to management charges, any additional cost is likely to be in collating detailed charges information then disseminating that to employers, trustees, IGCs and members in appropriate formats. Schemes already prepare some charges information within Statutory Money Purchase Illustration (SMPI) requirements. For members, it is therefore anticipated that this could be amalgamated within usual communications at the point of joining (within basic scheme information) and then annually (within annual benefit statements/SMPs). For employers, trustees and IGCs there may be some marginal additional cost in presenting, formatting and disseminating this information, however the approach would be flexible to allow schemes to use existing communication channels.
62. Achieving full and standardised transparency with regard to transaction costs represents more of a change with existing practice and therefore may incur more of a cost to pension schemes and providers. There are some existing regulatory requirements for disclosure - for instance European legislation requires that, when investors use funds to invest in financial markets, associated charges are disclosed in a standard format in the Key Investor Information Document. Additionally, the Investment Managers Association has made recommendations about how to enhance disclosure beyond what is currently required by regulation.<sup>37</sup> As a result of these recommendations, some schemes are receiving clearer, more detailed information about charges related to the investment of their funds. However, these recommendations are voluntary and not all pension schemes are covered.

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<sup>36</sup> An Independent Governance Committee ensures the interest of members are protected in workplace pension schemes

<sup>37</sup> IMA, September 2012, Enhanced Disclosure of fund charges and costs

63. The DWP Charges Consultation confirmed the opacity of costs and charges in this part of the value chain, so there is likely to be a cost to pension schemes in obtaining and collating this information from investment managers and disclosing it to trustees and IGCs. These costs are likely to be higher than the costs of collating management charge information given that this requirement is more of a change from existing practice. For members and employers, it is proposed that transaction costs are publicly reported by trustees and IGCs and it is anticipated that these bodies will use existing reporting mechanisms to do this (e.g. in an annual report, on a website) and should not need to establish a separate reporting mechanism for transaction costs. Sufficient information to reliably quantify this cost is not held.
64. The cost of disclosing information on scheme charges via paper-based communications is estimated to be a £1 unit cost<sup>38</sup> to each defined-contribution trust-based scheme (38,690<sup>39</sup>) and to each of the IGCs (20) on an annual basis. Communication to scheme members and employers is assumed to be through electronic communication (negligible cost) or in the case of scheme members, as part of their annual benefit statement (no additional cost). Table 3 presents the best estimate of the ongoing cost to pension providers from sending information on charges. The ongoing costs of disclosure to the pensions industry are estimated to be £0.04 million per year from 2015/16 to 2024/25.

**Table 3:** Annual costs to pension providers of sending standardised information to trust-based schemes and Independent Governance Committees, £m, 2013/14 prices

Year	2015/ 16	2016/ 17	2017/ 18	2018/ 19	2019/ 20	2020/ 21	2021/ 22	2022/ 23	2023/ 24	2024/ 25
£s millions	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04	0.04

**Source:** DWP modelling

**Notes:** Rounded to the nearest £5,000

Costs have been up-rated in line with inflation

65. Many of the large pension providers have already signed up to the Association of British Industry's (ABI) agreement on charges disclosure and, based on discussions with the ABI, it is expected that going forward the vast majority of members of contract-based schemes will receive summary information on charges as a result of this agreement. Therefore the additional regulatory costs presented in Table 3 could be lower in the future depending on whether the information required to be disclosed by the ABI is in-line with proposals. However, at present the best estimate captures the additional regulatory costs pension providers are expected to have to meet in order to comply with proposals on disclosure.
66. It is expected most of the information on management charges would be already available to pension providers and, for the reasons set out above (paragraph 60), it is expected this cost would be relatively small. Achieving full and standardised transparency with regard to transaction costs represents more of a change with existing practice, and pension schemes and providers may incur more of a cost. These costs are

38 Based on previous consultation with the pensions industry around changes to disclosure of information regulations. Department for Work and Pensions (DWP), July 2013, The Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013: Government response, <https://www.gov.uk/government/consultations/occupational-and-personal-pension-schemes-disclosure-of-information-regulations-2013>

39 The Pensions Regulator (TPR), DC trust: a presentation of scheme return data 2012-2013. <http://www.thepensionsregulator.gov.uk/doc-library/dc-trust-a-presentation-of-scheme-return-data-2013.aspx>



likely to be higher than the costs of collating management charge information. Robust information on which to base estimates of these costs to the pensions industry is not held.

67. The pensions industry may benefit from improved disclosure of pension scheme charges as this will improve transparency in the industry and may improve the industry's reputation, helping to build trust and confidence in pensions. The strength of support for such approaches from the pensions industry was evident during the charges consultation and this support applied both to management charges and transaction costs.

### Impact on employers

68. Under this proposal employers would have access to much clearer information about scheme charges from pension providers but would not be obligated to act upon this. Nonetheless, the information should help address concerns raised over the lack of clarity and transparency of pension scheme charges, and it is expected many employers would at least consider what is provided.
69. Research from the NAPF<sup>40</sup> as part of their consultation on their Code of Conduct on charges found that employers showed a strong interest in the concept of a standardised guide to pension scheme charges – particularly amongst the smallest employers who saw it as a useful starting point in selecting a pension provider. One possible benefit of standardised information on pension scheme charges is that it could make comparison of charges between schemes easier, which would in turn reduce the costs employers incur in selecting a workplace pension scheme.
70. Even if employers do engage with the information that pension providers send regarding pension scheme charges, there is little evidence to suggest that this will affect the way they behave. In particular, if employers are primarily motivated by the cost and ease of implementing a workplace pension scheme, information which makes it easier to understand and compare the charges across schemes is unlikely to have an impact on their decision.
71. Furthermore, research carried out by the NAPF<sup>41</sup> found that most micro employers - which make up the majority of employers and those most at risk of high pension scheme charges - struggled to comprehend the information set out in the prototype guide they were provided. For employers who have difficulty understanding pension scheme charges, an information-based approach is likely to have limited impact on the choices they make. So while there are clearly benefits to employers of improved transparency of pension scheme charges, this in itself is unlikely to be sufficient to drive behavioural change in order to address the weaknesses in the buyer side of the market identified by the OFT.

### Impact on individuals

72. In principle, ensuring individuals are fully informed about the charges they incur should improve their trust and confidence in pension savings and better enable them to engage

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40 NAPF and B&CE, September 2012, Telling Employers about DC Pension Charges: Research

41 NAPF and B&CE, September 2012, Telling Employers about DC Pension Charges: Research

with their pension and make better decisions over whether and how much to save. However, returning to the principal-agent problem identified by the OFT, the employee does not choose the scheme, the employer does. This means that individuals will be constrained in their ability to act upon any information they receive.

73. Evidence suggests that individuals would welcome greater disclosure of pension scheme charges. Those individuals who responded to the consultation indicated a desire for greater clarity and consistency in charges disclosure, in particular stressing that the headline charge reported for a scheme should include all charges and not just a selection. Previous research carried out for the DWP<sup>42</sup> found that whilst information on scheme charges might not be essential for individuals when making decisions about whether or not to remain in a workplace pension scheme, it was part of the supplementary information which they would like to have, as it would make them feel they were making a better informed decision, and feel more confident that the decision they made was the correct one. Even if they did not read this information, individuals felt its provision demonstrated a transparent and trustworthy process. However, beyond increasing trust and confidence, there is little evidence to suggest that most individuals will engage with the information provided.
74. Responses to the consultation warned against providing individuals with too much information about their pension scheme. A number of responses suggested that presenting charges information in a single number alongside projected outcomes would be an appropriate method of disclosure for individuals.
75. Because the employer chooses the workplace pension scheme on behalf of the employee, individuals receiving this information will not have the option to choose a different pension provider. Saving into a personal pension scheme (or ISA or other investment) instead does not appear to be a reasonable substitute – given that the individual would forgo their employer’s contribution if they opted out of the workplace pension scheme they are automatically enrolled into.
76. Therefore, if employers do not act upon the information provided, some individuals are likely to remain in schemes with inappropriate charges. Alternatively, with more information about the charges they incur, and with little other choice than to remain in or opt out of the scheme, there is also a risk that some individuals will choose to stop saving into their employer’s workplace pension scheme, which in turn will increase the number of individuals facing an inadequate income in retirement.
77. Increased transparency may help to exert downward pressure on charges within the pensions industry which would benefit individuals. Although there are clearly benefits to individuals of improved transparency, it is not believed that in itself this is sufficient to address the weaknesses in the buyer side of the market identified by the OFT.

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<sup>42</sup> DWP Research Report No 540, The information people may require to support their decision to remain in, or opt out of, a workplace pension, 2008

## Impacts of option 3: Charge controls on default funds in qualifying schemes

### Impact of charge controls on employers

78. It will be the employer's duty to ensure that charges for default funds in qualifying schemes meet the respective charge controls.
79. There would be minimal impacts on employers who plan to use existing provision if their scheme complies with the charge controls. They will incur some small administrative costs in confirming that this is the case, but in most instances the Government expects this to be straightforward, and beyond this no further action would be required by the employer.
80. Similarly, the Government does not anticipate a significant additional cost for employers who do not yet have a scheme or who do not intend to use their existing scheme as a qualifying scheme. Increased transparency requirements on scheme charges should help employers compare what providers are offering and may reduce employers' search costs. In addition, there are a number of pension providers offering schemes already compliant with the charge controls, including large multi-employer schemes set-up for automatic enrolment. Furthermore, close to half of firms<sup>43</sup> with no current workplace pension scheme who said they knew what scheme they intend to use for automatic enrolment indicated that they would enrol all employees into NEST.
81. The cost to these employers of familiarising themselves with the charge controls should also be small. Most employers will be able to do this when they familiarise themselves with the other details of automatic enrolment. Research by the Pensions Regulator<sup>44</sup> has found that whilst the vast majority of employers are now aware of their requirement to automatically enrol their workforce into a pension scheme and contribute to it, most small and micro employers do not yet generally understand the details of automatic enrolment, and most employers had not yet started to plan for it. Consequently, ensuring default funds in qualifying schemes meet certain criteria should have less impact on small and micro firms if standards are set immediately. Evidence from the Pensions Regulator also showed that many employers plan to "leave it as late as possible" to implement plans for automatic enrolment and the vast majority do not expect it to take more than six months from understanding the legislation through to registration. It will be important to ensure any new charge controls for default funds are communicated clearly and simply to all employers – minimising the familiarisation costs for these firms.
82. Where there is likely to be some cost to employers is where they are have an existing workplace scheme that would be non-compliant with the charge controls. Evidence from the DWP Charges Survey 2013<sup>45</sup> shows that 60% of contract-based and 50% trust-based schemes currently have charges greater than 0.75% - however, the majority of schemes sampled had not yet implemented automatic enrolment and experienced the higher participation it brings. Employers already using these schemes for automatic

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43 Forth J, Stokes L, Fitzpatrick A, and Grant C, 2012, Employers' Pension Provision Survey 2011. Around 40% of respondents said they didn't know their likely enrolment destination

44 The Pensions Regulator, February 2013, Employers' awareness, understanding and activity relating to workplace pension reforms, Autumn 2012

45 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

enrolment, and those who intend on using an existing scheme whose charges sit above the level of the default fund charge cap or have schemes with a banned charge, would be required to renegotiate charges with their pensions provider, or be subject to an additional cost to find and set up a new scheme with a provider offering a scheme that was compliant with the charge controls.

83. Consultation evidence suggested that some providers would be willing to make changes to meet the new requirements to comply with the charge controls to retain existing business, particularly given the significantly higher volumes automatic enrolment will produce – the lower charges seen already in ‘early stagers’ in automatic enrolment may in part be a reflection of providers recognising higher expected volumes. It is therefore likely that some employers who have schemes that they are using or intending to use but fall outside of the charge controls may be able to renegotiate their charges rather than setting up a new scheme. Some providers outlined transitional measures that would enable them to retain business, for instance setting up new ‘categories’ for new members within an old scheme that were compliant with charge controls, and shifting existing members into these categories over time. However, reliable information is not held on the likelihood of providers who would be willing to renegotiate their scheme charges, due to commercial confidentiality, so the best-estimate is to calculate the total costs to all employers who have non-compliant schemes and assume they will all have to set up a new scheme. This is a necessary, but strong, simplifying assumption. In reality it is expected that costs would be lower as some employers would be able to renegotiate charges with their pension provider, but there is insufficient information to make reliable adjustments to the estimates.
84. Employers who intend on meeting their duties with workplace pension arrangements that contain adviser commissions<sup>46</sup> will need to renegotiate with pension providers by April 2016. The potential for this requirement to trigger scheme re-tendering is expected to be relatively low, as it would not in itself affect the commercial viability of the scheme for the provider. Schemes could even be made more viable for providers if they could offer lower management charges to members through the removal of adviser commission. During the charges consultation several providers stated that they would find it easier to meet the default fund charge cap if adviser commissions were removed from all qualifying schemes.

### **Estimated cost to firms no longer able to use existing provision and methodology**

85. To assess the impact on employers of the charge controls it is necessary to understand how employers intend to meet the employer duty up to 2018.
86. DWP modelling has estimated the number of employers staging into automatic enrolment each month. The estimates take into account employer deaths but do not account for employer births as new employers are not currently in existence and are therefore not faced with additional costs of provision as they have never had a pension scheme in the first place.
87. The Employers’ Pension Provision Survey (EPP) 2011<sup>47</sup> was used to calculate the proportion of employers who are currently using or are intending to use their existing

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<sup>46</sup> The Charges Survey 2013 indicates that 41% of contract-based and 25% of trust-based schemes contain an adviser-commission

<sup>47</sup> Employer Pension Provision Survey 2011 data collected before the introduction automatic enrolment

provision to satisfy their duty to automatically enrol their employees into a workplace pension scheme.<sup>48</sup> From the estimates of the number of employers staging and the proportion of employers currently or intending to use existing provision, from the EPP 2011, the estimates have been calculated in Table 4 which shows the number of employers by staging date who are currently using or are intending to use existing scheme provision. It is estimated that there will be 145,000 existing employers who will stage into automatic enrolment by April 2017 and will need to ensure the scheme they use does not have a default fund charge of more than 0.75%.

**Table 4:** Number of employers by staging date and those who are currently using or intend on using existing scheme provision<sup>49</sup>

Employer staging date	Number of employers currently using or intending to use an existing scheme
October 2012 to March 2015	20,000
April 2015 to March 2016	25,000
April 2016 to March 2017	85,000
April 2017 <sup>50</sup>	15,000

**Source:** DWP modelling

**Notes:** Rounded to the nearest 5,000

88. Assessing how many of the employers in Table 4 might have to incur extra cost because of the charge controls is challenging because:

- the information on charge levels and practices in existing schemes is primarily based on the pre-automatic enrolment environment, where employee participation – and thus provider revenue - is much lower. Automatic enrolment transforms the economics of workplace pensions for providers - much higher participation boosts revenue and makes more employers commercially viable;
- without access to providers' and schemes' commercial assumptions it is not possible to estimate the extent to which they may be willing to lower charges in existing schemes as a result of the participation boost automatic enrolment brings;
- removing adviser commission may make it easier for providers to make schemes compliant - as they can pass on some or all of the adviser payment cost reduction to members through a lower charge. In the charges consultation many providers supported a removal of commission on this basis.

89. The additional cost to employers therefore comes from those employers who:

- have an existing scheme that has non-compliant features;
- planned to use that existing scheme as a qualifying scheme for automatic enrolment at their staging date; and

48 The EPP 2011 asks employers about the types of pension scheme they intended to use for their employees once the workplace pension scheme reforms are implemented. The proportions calculated are categorised by trust and contract-based schemes by employer size

49 In estimating the figures in Table 4 the Government has assumed that employers implement schemes for automatic enrolment six months prior to their staging date i.e. employers due to stage by April 2015 are assumed to have implemented their schemes by September 2014; this would capture mainly the large and medium employers who are due to stage by April 2015

50 By April 2017 all existing employers are expected to have staged into automatic enrolment



- the provider is unwilling to make the scheme compliant despite much higher expected participation (and in some cases the removal of adviser commission costs.)

90. During the charges consultation most providers responded that they would try to maintain existing relationships with employers and make adjustments to charging arrangements where commercially possible. However, in the absence of quantifiable information on the likelihood that pension providers will renegotiate with employers with existing schemes that have non-compliant features, it has been assumed that all affected employers set up a new compliant scheme. For the reasons set out above, this is considered a necessary but strong, simplifying assumption. Of the employers presented in Table 4, the number who would have default fund charges of above 0.75% has been estimated. The DWP Charges Survey 2013<sup>51</sup> indicated the proportion of schemes that are charging above 0.75% - for trust-based and contract-based schemes. Using this distribution it has been possible to estimate the number of employers who would be impacted by a 0.75% default fund charge cap by staging date. This is done by multiplying the number of employers staging into automatic enrolment by the proportion of schemes that have charges above the level of the 0.75% default fund charge cap.

91. Table 5<sup>52</sup> sets out the estimated number of employers who are currently using or intend on using an existing workplace pension but will no longer be able to do so because of the default fund charge cap. It is estimated that in total around 105,000 employers will be impacted by a default fund charge cap of 0.75% as the scheme they are currently using or intend using falls above this level. This represents around 12% of the total number of existing employers staging through the automatic enrolment process.

**Table 5:** Number of employers by staging date that would be impacted by the default fund charge cap

Staging date	Number of employers affected by the proposed charge controls
October 2012 to March 2015	15,000
April 2015 to March 2016	20,000
April 2016 to March 2017	60,000
April 2017 <sup>53</sup>	10,000

Source: DWP modelling

Notes: Rounded to the nearest 5,000

51 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

52 For estimates in Table 5 the Government has taken into account employers who either did not know the charge level their members paid or refused to say. Two alternative assumptions have been made; first, that charges in these schemes follow the same distribution as the charges which were reported by employers in Chart 3; and second, that all of these schemes have charges in excess of 1%

53 By April 2017 all existing employers are expected to have staged into automatic enrolment



92. As the charges reported in the DWP Charges Survey 2013<sup>54</sup> are for active members, an adjustment has been made to the estimates in Table 5 to account for schemes that charge an Active Member Discount (AMD)/Deferred Member Penalty (DMP). The DWP Charges Survey indicated that 3% of trust-based schemes and 10% of contract-based schemes have an AMD and it is assumed that this is the same proportion that levies a DMP. It is assumed that the distribution of schemes using a DMP is the same as the distribution of schemes at each charge level for active members. To make the adjustment the proportion of schemes that would be above a 0.75% default fund charge cap if the individuals were paying the average contract-based scheme Deferred Member Penalty, as reported in the DWP Charges Survey 2013<sup>55</sup>, has been calculated as 0.38%.<sup>56</sup> In making this adjustment it is possible to account for deferred members paying, in some schemes, an average charge which is higher than active members therefore increasing the number of schemes which fall above the level of the cap.
93. The total costs to employers of setting up a workplace pension scheme to comply with the proposed charge controls have been estimated. Table 6 sets out the average costs to employers of setting up a pension scheme in two cases:
- where the employer has already implemented a scheme for automatic enrolment; and
  - where the employer is yet to implement a scheme.
94. For employers who would not yet be expected to have started making plans for automatic enrolment, the costs reflect the *additional* activities it is expected employers will need to perform in setting up a new scheme for automatic enrolment *instead* of using an existing scheme - based on the estimates previously derived from the DWP modelling of administrative costs to employers from automatic enrolment. The approach is set out in Annex G of the Workplace Pension Reform Regulations Impact Assessment<sup>57</sup>, and follows the standard cost model methodology recommended by the Better Regulation Framework Manual.<sup>58</sup>
95. For employers who are expected to have already made plans or who have already reached their staging date, the costs reflect the *full* range of activities they are expected to perform in setting up a new scheme for automatic enrolment – on the basis they will have to repeat the steps they have already taken in setting up their current workplace pension schemes for automatic enrolment.<sup>59</sup>

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54 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

55 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

56 It is assumed that employers will be just as likely to use their scheme for automatic enrolment if it has a deferred member penalty. The Government has then considered how impacts will differ under two scenarios – (i) these schemes have the same distribution of charges as other schemes, but charge deferred members 0.38 percentage points more than active members (the average discount applied to contract-based schemes according to the DWP charges survey 2013); and (ii) all of these schemes charge deferred members more than 1%

57 Department for Work and Pensions (DWP), Workplace Pension Reform Regulations Impact Assessment, <http://www.dwp.gov.uk/docs/wpra.pdf>

58 Department for Business Innovation & Skills, July 2013, Better Regulation Framework Manual: Practical Guidance for UK Government Officials, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/211981/bis-13-1038-better-regulation-framework-manual-guidance-for-officials.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211981/bis-13-1038-better-regulation-framework-manual-guidance-for-officials.pdf)

59 It is assumed for the purposes of estimating costs that employers will implement their plans 6 months before their staging date. According to recent research carried out for the Pension Regulator, 70% of medium employers expected it to take no longer than this - around half thought it would take just three months. See The Pensions Regulator, February 2013, Employers' awareness, understanding and activity relating to workplace pension reforms, Autumn 2012. The Government has evidence that employers start preparing for automatic enrolment at differing times, some up to 18months in advance of their staging-in date and some with just a couple of weeks to go

**Table 6:** Average costs to employers of setting up a new scheme (£s 2013/14 prices)

Cost of using new scheme if already implemented a scheme for a/e	Cost of using new scheme if not already implemented
1,400	1,250

Source: DWP administrative cost model  
Rounded to the nearest £50

96. Using the costs set out in Table 6 and the number of employers expected to be impacted by the implementation of the charge controls (see Table 5) the total one-off transitional costs to all employers of the introduction of a 0.75% default fund charge cap can be estimated. As presented in Table 7, the total transitional costs to employers is estimated to be around £55.5million in 2013/14 prices (totals may not sum due to rounding).

**Table 7:** Employers one-off transitional cost of setting up alternative pension provision (£s millions 2013/14 prices)

Staging date	Employer costs
October 2012 to March 2015	30
April 2015 to March 2016	10
April 2016 to March 2017	15
April 2017 <sup>60</sup>	5

Source: DWP modelling

Notes: Rounded to the nearest £5 million

97. Employers who are impacted by the default fund charge cap may be able to mitigate some of these one-off transitional costs if they are able to renegotiate scheme charges with their pension provider and continue using their existing scheme. However, in order to avoid under-estimating the transitional costs to employers, it is assumed that all employers who have schemes above the level of the relevant cap would incur some costs in having to set up a new scheme.
98. With regard to a ban on commission in qualifying schemes individuals will benefit, assuming it triggers a reduction in their charge level. The likely impact on advisers will depend on a number of factors. Since the Retail Distribution Review (RDR), pension advisers have had to shift their business models away from commission to fee-based structures, as it is no longer possible to set up new schemes with built-in commission. Several of the large adviser firms - such as Aon Hewitt, Mercer and Towers Watson already have a completely fee-based model, while others such as Punter Southall are in the process of switching to this kind of structure. If commission was banned in existing schemes as well, there could be additional costs to those employers who wish to continue to use the services of advisers. There are three possible outcomes: the employer may bear the cost if they decide to pay the adviser up-front fees instead; the adviser may bear the cost if their services are no longer used; or the cost may be shared by the adviser and employer, if upfront fees are paid for a more limited service than before. Information is not held to reliably estimate how many employers that still use commission models would choose to pay upfront fees to advisers instead, so it is not possible to quantify this cost.

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60 By April 2017 all existing employers are expected to have staged into automatic enrolment

## Impact on smaller employers

99. Given that fewer small employers intend on using their existing scheme for automatic enrolment – and are less likely to have existing pension provision in the first place – it may be reasonable to conclude that they will be proportionately less affected by a default fund charge cap than larger employers.
100. On the other hand, smaller employers with existing provision, may be more likely to be affected because they tend to have smaller schemes and, as previously indicated, smaller schemes tend to have higher charges. The EPP 2011 survey found that four-fifths of occupational schemes with fewer than 20 active members were located in smaller organisations which themselves had fewer than 20 employees.
101. Due to small sample sizes it is not possible to break the distribution of charges from the DWP's Charges Survey 2013 (Chart 3) down by scheme size. As a result, it is also not possible to break the estimated costs in Table 7 down by employer size.
102. Nonetheless, because the vast majority of employers are small, and because automatic enrolment will apply, in time, to all employers, it is likely that the majority of employers who could in theory be affected by a default fund charge cap would be small and micro businesses.
103. It is necessary to extend the charge cap to smaller employers as otherwise many schemes with high charges would fall out of scope, and the rationale for the policy would be undermined – an employee should not have to pay higher charges for their pension because of the size of their employer. By setting up a low-cost pension scheme in the form of NEST, the Government has minimized the cost which these employers will incur in having to find alternative pension provision for their employees. Other easements for smaller employers should also manage these additional costs, including the fact they will not have to enrol their workers until June 2015 at the earliest (for those with fewer than 50 employees).<sup>61</sup>

## Impact on individuals

104. The benefits to individuals from the introduction of charge controls are quantified for those who are already automatically enrolled in a scheme or who would have been automatically enrolled into a scheme that does not comply with the charge controls i.e. is not within the level of the default fund charge cap or has a banned charge. However, there will be benefits to new employees entering into default funds in qualifying schemes which are now compliant with the charge controls but may have otherwise been automatically enrolled into a scheme that breaches these charge controls. It has not been possible to quantify the impacts of the charge controls on new employees joining default funds in qualifying schemes due to a lack of reliable information, such as the level and type of charges these individuals may have faced had the charge controls not been introduced. The estimates presented in this Impact Assessment are based upon an assessment of individuals whose current employers are expected to stage into automatic enrolment by 2018.

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<sup>61</sup> The Pensions Regulator, February 2013, Employers' awareness, understanding and activity relating to workplace pension reforms, Autumn 2012

105. The gain to individuals' pension pots is estimated where the scheme their current employer is using or intending to use for automatic enrolment is above the 0.75% default fund charge cap. The approach taken is to estimate the increase in an individual's pension pot if charge controls were imposed on default funds in qualifying schemes. The gain to an individual's pension pot is based on a median earner in the automatically enrolled population who did not previously have a workplace pension, and who is estimated to earn around £20,000.<sup>62</sup> It is assumed that the individual saves into a pension scheme for ten years.<sup>63</sup> It is assumed the median earner has no previous savings, as it is expected that the vast majority of the six to nine million individuals who will be automatically enrolled in to a workplace pension scheme will be newly saving into a pension scheme.

106. Table 8 presents the average number of active members in trust- and contract-based schemes by employer size from the Employer Pension Provision 2011. Using these estimates of active members in schemes (Table 8) and the number of employers estimated to be impacted by the default fund charge cap (Table 5), the number of individuals who may benefit from the charge controls is estimated.

**Table 8:** Average number of active savers in trust- and contract-based schemes by employer size

Employer size	Average number of scheme members	
	Trust-based	Contract-based
Micro (1-4)	2	1
Small (5-49)	6	8
Medium (49-250)	46	40
Large (250+)	465	318

**Source:** Employer Pension Provision Survey 2011

107. Table 9 indicates that around 2 million individuals would benefit from a 0.75% cap as their current employer is using or is intending to use an existing scheme where charges in the default fund are greater than 0.75%. These estimates have been adjusted to take account of opt-out from automatic enrolment. An opt-out rate of 28% has been used which is consistent with the DWP's automatic enrolment programme assumptions.<sup>64</sup>

**Table 9:** Number of active members who could benefit from a cap by employer staging date

Staging date	Number of active members (millions)
October 2012 to March 2015	1.3
April 2015 to March 2016	0.2
April 2016 to March 2017	0.4
April 2017 <sup>65</sup>	0.1

**Source:** DWP modelling

**Notes:** Rounded to the nearest 0.1million

62 Department for Work and Pensions (DWP), July 2013, Supporting automatic enrolment: further analysis of earnings, participation and provision, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/209864/ad-hoc-supporting-ae-further-analysis.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209864/ad-hoc-supporting-ae-further-analysis.pdf)

63 Lower level of qualifying earnings used in calculations is £5668 for the pay reference period 2013/14

64 [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/220500/wpr-rev-implementation-ia-final.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220500/wpr-rev-implementation-ia-final.pdf)

65 By April 2017 all existing employers are expected to have staged into automatic enrolment

108. The estimates in Table 9 potentially under-estimate the number of individuals who will benefit from the charge controls in a number of ways. The average number of scheme members as presented in Table 8 relates to active members and does not take into account deferred members - as reliable information on deferred members is not held. Hence the estimates in Table 9 do not take into account the number of deferred members in schemes who will benefit from the cap. The estimates also do not take into account the fact that the number of active members in pension schemes should grow over time as employees not currently saving into a workplace scheme are automatically enrolled.<sup>66</sup> As described in paragraph 104, the benefits to new employees entering into default funds in qualifying schemes which are now compliant with the charge controls but may have otherwise been automatically enrolled into a scheme that breaches these controls, has not been quantified due to a lack of information on these individuals.

#### Estimated benefits to individuals of charge controls

109. The increase in pension savings for a median earner under certain contribution levels, inflation and earnings assumptions is estimated.<sup>67</sup> Where the individual has a charge which is greater than 0.75%, the gain to this individual's pension pot as a result of introducing a default fund charge cap is estimated. This gain is estimated by calculating the difference in the amount deducted in charges between the current scheme and 0.75%, the level of the cap.

110. In order to estimate the gain to the median earner's pension savings, the charge levels for trust-based schemes from the DWP Charges Survey 2013 are used.<sup>68</sup> For each charge above 0.75%, the annual gain to the median earner's individual pension savings from a reduction in charges from the current charge to the default fund charge cap of 0.75% is estimated.

111. Account is made for the gain to the individual's pension savings by the staging date of their employer. For example, where an individual's employer must stage by April 2016 – it is assumed that where this individual would have incurred charges above the cap, they will continue to do so until their employer stages in April 2016.

112. It is assumed that individuals impacted by the 0.75% default fund charge cap (see Table 9) will be distributed at each charge level as per the distribution of schemes at the charge levels of trust-based schemes. Using the estimated gain to the median earner's pension savings and the estimated number of individuals in schemes at each charge level above 0.75%, the overall gain to all individuals from the introduction of the cap (Table 10) can be calculated.

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66 This depends on the proportion of the workforce not currently contributing to the employers' scheme, their opt-out rate, and the employers' choice of scheme for current non-members – according to the latest Employers Pension Provision Survey the proportion of employers which said they would use existing provision for non-members and new employees was lower than the proportion who said they would use it for existing members

67 Modelling is based on a median earner, earning £19,900 a year, with contributions at 2% for the first two years, 3% for the third year, and 8% thereafter - in line with automatic enrolment requirements. The lower earnings threshold is £5,668 and inflation is 2%, earnings growth is 4% and investment growth is 7%

68 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report



**Table 10:** Annual gain to all individuals impacted by the introduction of a charge control, £millions, 2013/14 prices

Year	2015/ 16	2016/ 17	2017/ 18	2018/ 19	2019/ 20	2020/ 21	2021/ 22	2022/ 23	2023/ 24	2024/ 25
£s millions	1	2	4.5	9	14	20	26	32.5	39.5	46.5

Source: DWP modelling

Notes: Rounded to the nearest 0.5million

Costs have been up-rated in line with inflation

113. The estimates in Table 10 assume that providers do not increase member-borne charges by, for example, increasing charges to the level of the cap for scheme members where the charge would have otherwise been lower i.e. “levelling up” of charges; this assumption is supported by the evidence presented during the consultation. The potential response by providers to the introduction of charge controls is discussed from paragraph 128. Given the assumption that there is no “levelling-up” of costs by the provider – based on responses to the charges consultation – it can be said that the gain to the individual is equal to the net loss of revenue to the pensions industry.
114. There are some limitations associated with the estimates in Table 10. The benefits to all individuals are based on the median earner subject to a number of specific assumptions which may not apply to every individual who is automatically enrolled into a workplace pension. In reality each individual will have different savings characteristics and will be impacted by a cap in differing ways. The estimates presented in Table 10 are indicative only of the potential gain to all individuals of the introduction of a charge cap. Although there are limitations with the estimates presented in Table 10, they represent the best estimates of the impact on individuals based upon the limited information available.
115. There is a risk that through the introduction of charge controls some individuals will be unable to gain access through their employer to services or products which they may otherwise like to use. For example, some employees may be receiving services for commission charges, i.e. one-to-one advice, which helps them engage with their pension savings. Under the charge controls individuals would no longer be defaulted into paying for these services. If they wished to access them they could do so on an opt-in basis with appropriate remuneration arrangements for financial advisers.
116. The information collected on AMC charges in the DWP Charges Survey 2013 includes adviser commissions where these are levied. However, it is not possible to identify how much of the reported AMC can be attributed to adviser commissions. Consequently Table 10 could be under-estimating the gain to the individuals pension savings - where their current scheme charge is in breach of the 0.75% default fund charge cap *because* of an adviser commission or where scheme charges are within the default fund charge cap but include a commission which will be banned. If the breach of the default fund charge cap would have occurred regardless of a ban on commission this would not impact the estimates presented in Table 10.
117. Consultation responses from providers suggested the risk of widespread “levelling-up” of charges for existing scheme members to the level of the cap is low. However, the risk remains that with the introduction of charge controls, some individuals in workplace pension schemes will see their charges increase. In particular, where an employer’s current scheme operates an AMD, it is possible that the active members of these



schemes will see their charges increase. The extent of any increase in charges is likely to depend on the size of the discount and the extent to which the higher charge for deferred members is subsidising a lower active member charge rather than simply boosting profit levels (i.e. the extent to which the difference reflects a “penalty” rather than a “discount”).

118. Banning AMDs by April 2016 will mean that deferred members will no longer be at risk of having to pay a higher charge for their pension because they are no longer contributing. Given that at any one time an individual can be an active member of just one scheme, but potentially a deferred member of two or more schemes, this will have a beneficial impact on member outcomes.
119. A minority of schemes operate consultancy charges. Due to a lack of evidence on the scale and levels of these charges it is not possible to quantify the impact a ban would have on individuals.

### Impact on the pensions industry

120. Through the introduction of automatic enrolment, it is projected that the pensions industry will receive an additional £11 billion a year in pension savings from around six to nine million people newly saving into a scheme or saving more. The analysis in this section, does not take into account this additional benefit to the pensions industry as it is outside the scope of this impact assessment. Although it is important to note that all costs identified here are set against a substantial increase in business for the pensions industry as a result of automatic enrolment. This expansion creates significant opportunities for greater volume and efficiency for pension providers.
121. To robustly quantify the impact of charge controls on the profits of the pension industry it would require access to commercially sensitive information, which is unavailable for the purposes of this analysis. Without this level of information, the estimate of the potential impact on pension provider revenue of the charge controls is based on the assumptions outlined in this section. However, the responses of providers will determine the actual extent of revenue lost. The estimates presented here represent the best estimates of the impact on pension provider revenue as a result of the introduction of charges controls but does not take into account any actions some pension providers might take to mitigate the impact of the proposed controls. Potential provider responses to the introduction of charges controls are discussed in more detail following the estimates on pension provider revenue.

### Estimated impact of charge controls on pension provider revenue

122. The net loss of revenue on the pension provider industry is estimated rather than the impact on profits due to the reasons stated in paragraph 121. This is a necessary, simplifying assumption. Given the evidence gathered during consultation about provider inefficiencies and the scope for greater efficiency provided by the expansion of the workplace pension market (through economies of scale) some providers may be able to drive down their cost base and mitigate, to some degree, the impact of the charge controls on their profitability. The concept of profitability within pension schemes varies between the trust- and contract-based sectors as trust-based schemes have no

requirement to build in a scheme based margin whereas those insurance companies who offer contract-based workplace schemes do have a direct profit imperative.

123. The loss of revenue to the provider is estimated in the same way as the benefit to individuals. It is assumed that if costs to scheme members do not increase (there is no “levelling-up”) then the loss of revenue to the provider is a direct transfer to individuals. Table 11 presents the estimated loss of revenue to providers where their schemes have charges in excess of the default fund charge cap – which is the same as the figures presented in Table 10.

**Table 11:** Annual loss of provider revenue due to the introduction of a charge control, £millions, 2013/14 prices<sup>69</sup>

Year	2015/ 16	2016/ 17	2017/ 18	2018/ 19	2019/ 20	2020/ 21	2021/ 22	2022/ 23	2023/ 24	2024/ 25
£s millions	1	2	4.5	9	14	20	26	32.5	39.5	46.5

Source: DWP modelling

Notes: Rounded to the nearest 0.5million

Costs have been up-rated in line with inflation

124. The estimates in Table 11 capture the net impact of charge controls on the pension industry’s revenue. Following the introduction of the default fund charge cap, the Government assumes that the amount of savings flowing into the pensions industry as a result of automatic enrolment will remain the same but the proportion taken in charges will be smaller and the distribution of funds across schemes is likely to be impacted by the introduction of the cap. There is likely to be a shift in demand from schemes charging above the level of the default fund charge cap to schemes charging below, hence some pension providers may benefit at the expense of others.

125. The estimates in Table 11 capture the difference in revenue for schemes which are currently charging above the level of the default fund charge cap and the loss of revenue to pension providers if they then offer these schemes at the cap level. From consultation responses evidence suggests that where it is not profitable to offer a scheme at charges within the default fund charge cap then the provider is likely to stop offering the scheme i.e. would withdraw from the market. In this case although there would be a loss of provider revenue from the current charge to nil, if they lose this business there will be a movement of these individuals into schemes of another provider, thus generating business in the market elsewhere. Given that all schemes that individuals would be automatically enrolled into would at most be at the level of the cap, the difference between the current charges over the level of the cap and the 0.75% cap to capture the net impact on the pensions industry is estimated (see Table 11).

126. As new employers entering the market will have information about the default fund charge cap it is assumed that they will select schemes for automatic enrolment that meet the level of the cap. Therefore the potential loss of revenue for pension providers of new employers entering the market (i.e. prospective future profits) is not estimated. There are potential revenue losses for pension providers where, before the introduction of a cap, they would have earned greater revenues from members on new business but are no longer able to. Given the lack of information on who these employers are and what

<sup>69</sup> Loss of provider revenue presented are before taxes

schemes they may have selected for the purposes of automatic enrolment it is not possible to quantify this impact.

## Active Member Discounts

127. The AMDs ban would mean that, where providers from April 2016 would have charged less for active than deferred members, they will no longer be able to do so and would have to adjust the charging structures within those schemes. The impact on provider revenues will depend on whether they were charging deferred members a higher charge and the extent to which they have been using this revenue to subsidise the lower charges of active members. The providers may be able to off-set any loss in revenue by increasing the charges on active members. The ban on AMDs would level the playing field for providers - during the consultation many providers suggested that they were being undercut by competitors who were able to offer a lower headline price because they offered AMDs and recouped the loss through higher charges on deferred members.

## Pension provider responses to the introduction of a charge controls

128. The impact of the charge controls on default funds in qualifying schemes is likely to affect the behaviour of pension providers as only schemes that comply with the charge controls – those that are within the level of the default fund charge cap and do not have any banned charges - can be selected by employers to be qualifying schemes. Hence, for providers to keep existing business or provide suitable schemes for new businesses generated from automatic enrolment, they must provide schemes that comply with the charge controls. There are a number of possible responses that providers may take as a result of the introduction of charge controls. In some cases these responses can help pension providers mitigate the impact on their revenue.

129. Pension providers and schemes that do not comply with the charge controls are expected to respond in the following ways:

- a) **Market adjustment:** some employers will become commercially less viable through the introduction of charge controls hence some providers could cease offering provision to certain sections of the market, leaving these sections to those schemes that can offer compliant schemes and funds;
- b) **Alternative revenue streams:** providers could adjust charges to protect their wider revenues – such as the “levelling up” of charges in schemes already operating or which will be operating under the cap, or by increasing charges elsewhere, for example, to employers;
- c) **Cost reduction:** through greater efficiencies or service reduction to maintain existing profit margins.

## Market adjustment

130. The introduction of charge controls is likely to change the distribution of funds among providers. The expected economic response of providers to the introduction of charge controls is to reduce supply of the product in the market. Several providers confirmed this behavioural response indicating that they would stop offering schemes to certain

employers where it was no longer profitable to do so. The reduced provision is likely to impact small employers in particular as they are more costly to provide for and are therefore likely to become unprofitable to administer at lower charges.

131. Any supply gap should, however, be filled by other schemes – in particular multi-employer schemes, which are able to offer lower charges by taking advantage of (administrative and investment) economies of scale available in pension provision.<sup>70</sup> As a minimum, NEST has a public service obligation to accept all employers that want to use it as a pension scheme to fulfil their duties under the Pensions (No. 2) Act (Northern Ireland) 2008, but there are also a number of other schemes which have been set up to offer smaller employers an alternative low-charge scheme to NEST. The consequence of a default fund charge cap is likely to be a transfer of business away from some providers with schemes above the level of the cap and towards others, namely larger multi-employer schemes which are offering low-cost provision to all. This was the reason that the Government accepted the Pensions Commission’s proposals and established NEST – to enable all employees to have access to pension saving with low charges regardless of the size of their employer.
132. This may result in a more consolidated industry, with fewer schemes operating at scale. There is reason, however, to suspect that this consolidation will happen primarily at the scheme, rather than provider, level i.e. fewer schemes provided by a similar number of pension providers. At the provider level, the market is already very concentrated, with a relatively small number of organisations dominating the market – statistics released by the ABI in 2010 found that five companies accounted for two-thirds of all insurer-administered pension funds.<sup>71</sup> Furthermore, those who choose to stop offering schemes to smaller employers will still be able to provide schemes to larger, more profitable employers.
133. In some cases, pension providers may choose to renegotiate scheme terms to comply with the charge controls in order to retain business provided it is profitable to do so. This might be the case if, for example, the increase in scheme membership generated by automatic enrolment increases the amount of money being contributed to the scheme, and therefore increases its profitability.

## Alternative revenue streams

134. Some providers may respond to charge controls by increasing charges elsewhere - for example, by increasing charges not covered by the default fund charge cap (although this will be constrained if the cap is sufficiently comprehensive in the charges it captures), or by increasing, or “levelling up”, the charges which it offers to new business - where these would already have been below the level of the cap before the intervention. This could either be as they seek to recoup the revenue they lose by having to reduce charges, or because the level of the cap becomes the ‘norm’.

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70 For example, work carried out by Charles River Associates for the Department for Work and Pensions in 2009 found economies of scale in setting up a scheme, given the fixed costs involved. Whilst the cost for scheme set up was found to increase with size of employer, if calculated on a cost per employees basis, the costs fell as size of firm increased. There was also a slight decline in the set-up costs per individual as the firm size increased  
<http://webarchive.nationalarchives.gov.uk/20130314010347/http://research.dwp.gov.uk/asd/asd5/WP74.pdf>

71 <https://www.abi.org.uk/Insurance-and-savings/Industry-data/~media/0131EC5ECD4F4ECCA9F2E154C9C55314.ashx>

135. The risk of widespread “levelling-up” of charges to the level of the cap for existing scheme members is considered unlikely, according to providers who responded to the DWP consultation. This is driven by commercial logic – that by increasing charges providers would risk employers re-tendering the scheme and moving their business elsewhere. Most of the responses to the DWP consultation agreed that the risk of “levelling-up” was, at least in the early years following the introduction of charge controls, low. However, given the general lack of awareness and understanding of pension scheme charges on the part of employers, were “levelling-up” to occur it is possible that employers would not re-tender their scheme. This issue was referred to by some responses, which suggested that “levelling-up” may occur later on, once automatic enrolment is complete and greater consolidation had been achieved.
136. However, the scope for this may be limited. There has been fierce competition amongst pension providers to provide schemes for the larger employers who were staged into automatic enrolment first. Perhaps most importantly, if providers could easily increase their charges on more competitively priced schemes, it would be reasonable to suspect that they would have already done so. There is some evidence which suggests that in reality it is very difficult to increase charges on existing schemes. Moreover, the responses with regard to improved transparency and minimum governance standards should help guard against this risk.
137. Responses from the consultation suggested that there is a risk that providers will increase charges elsewhere - possibly to employers to recoup the lost revenue when the charge controls are introduced. For example, DWP have identified that a large pension provider has started charging an ‘employer fee’ in order for employers to access a 0.5% AMC scheme.
138. However, as it is the employer who selects the scheme, any charges levied on them is less of a concern provided they have enough alternative provision to choose from and are making active choices about that provision. The appearance of additional fees is likely to encourage employers to shop around more for schemes with low employer fees and charges that comply with the controls. It is believed that there is sufficient low-cost supply in the market to provide employers with free alternatives should some providers move towards a model based on employer fees.

## **Cost reduction**

139. Alternatively, providers could look to lower charges by also lowering the cost of provision. One approach would be to set up a master-trust scheme<sup>72</sup> like other providers have done, to generate economies of scale and to allow the higher revenues from more profitable employers to offset the costs of less profitable ones.
140. However, previous analysis has found that the costs of setting up and running master-trusts can be considerable - £2-20 million to adapt existing systems, and £100 million to set up a new system entirely<sup>73</sup> - and as these costs would need to be recouped via member charges, it is not clear that many providers would find it a cost effective option.

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72 A master trust is 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

73 Johnson P, Yeandle D, and Boulding A, October 2010, Making Automatic Enrolment Work, page 86. (Cost estimates from Deloitte research cited in report)



Because these schemes operate on scale there is likely to be a limit to the number of master-trust schemes which could be in operation.

141. Pension providers have suggested that the introduction of charge controls may lead them to alter the services delivered. This could be less frequent communication to members, or switching investment strategies. However, there is also evidence that providers are building more efficient business models that bring costs down while retaining good quality services and investment propositions. Evidence from some providers, to varying degrees and in different ways, is demonstrating that this is possible.
142. There is little evidence to suggest that, in general, actively managed funds outperform other cheaper passively managed funds. Some responses offered examples of particular actively managed funds that consistently outperformed cheaper alternatives but these funds remained the minority. Evidence from one study of default funds found that net performance of passive equity funds was on average 0.8% better than that for active funds over the last five years.<sup>74</sup>
143. Providers could look to make greater use of passive investment management, to keep costs and governance low, and away from active fund management which can drive charges up – adding an estimated 0.3% premium to overall cost levels.<sup>75</sup> A survey by Towers Watson<sup>76</sup> indicates that the majority of both trust-based (62%) and contract-based (88%) schemes use passive management in their default funds – this then suggests that charge controls would have little impact in terms of movement away from active to more passive management of default funds. Evidence from the NAPF survey<sup>77</sup> found that 38% of pension provider respondents who offered a default fund as part of the scheme used passive management (30% used multi-asset funds and 20% used diversified growth funds). Responses to the consultation indicate that there will be only a few schemes that will have to move from a more sophisticated and expensive default fund management option to a lower cost version under charge controls.
144. There is some evidence to suggest that smaller schemes - whose charges are generally higher and are therefore more likely to be affected by charge controls, such as a default fund charge cap – appear to make less use of passive management.<sup>78</sup> However, from the available evidence it is hard to conclude that, in general, more expensive active management investment strategies provide superior returns to passive strategies.

### Impact on advisers

145. Banning commission and consultancy charging in qualifying schemes from April 2016 will have an impact on the business of advisers who may have previously earned commission from the providers of workplace pension scheme arrangements. The Government decided to phase this particular charge control as it accepts that providers and advisers need time to further adjust remuneration methods with regard to workplace

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74 Ashcroft J, 2009, Defined-Contribution (DC) Arrangements in Anglo-Saxon Countries, OECD Working Papers on Insurance and Private Pensions, No. 35, OECD <http://www.oecd.org/insurance/private-pensions/42601249.pdf>

75 Ashcroft J, 2009, Defined-Contribution (DC) Arrangements in Anglo-Saxon Countries, OECD Working Papers on Insurance and Private Pensions, No. 35, OECD <http://www.oecd.org/insurance/private-pensions/42601249.pdf>

76 2013 Towers Watson FTSE 100 defined-contribution pension scheme survey

77 NAPF 2013 Annual Survey

78 Estimates by Spence Johnson suggest that passive funds make up 69% of assets in DC schemes with more than 5,000 members, whereas smaller schemes have only around a third of assets in passive funds



schemes. The Government has no information to reliably estimate the extent to which the ban on commissions may cause financial losses to advisers.

146. The introduction of the Retail Distribution Review (RDR) on 1 January 2013 has already banned providers from paying commission to advisers on new Group Personal Pensions (GPPs). Consultancy charges were introduced after RDR to replace commission as a means for advisers to be remunerated from the pension scheme without charging an upfront fee to the employer they advise, but following a government review these were effectively banned in automatic enrolment schemes in September 2013. As a result of both RDR and the ban on consultancy charges, advisers who are helping employers set up a new scheme must now charge an upfront fee for their services.
147. However, the timings 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 schemes containing these structures. It is therefore possible for advisers to have built trail commission into their balance sheets for the years to come, and responses to the consultation generally agreed that a ban on commission in qualifying schemes would have a significant impact on those advisers. However, in general responses to the charges consultation had limited sympathy for this dilemma, arguing that the direction of travel had been clear for many years prior to the introduction of the RDR, and those advisers should have shifted more quickly to fee-based models.
148. The precise impact of this ban will depend on individual negotiations between employers, providers and advisers with regard to remuneration for services previously supplied. These negotiations will take place from the moment the commissions ban is announced in spring 2014 to April 2016, when the ban takes effect. There is no way of estimating the outcomes of these negotiations and the extent to which they may cause financial loss to advisers, however there is expected to be a transfer from advisers and/or employers to individuals from a ban on commissions. Individuals will benefit from the ban on commissions, all else being equal. It could either be the employer who bears the cost if they pay for the adviser upfront; the adviser who bears the cost if the employer no longer uses the adviser; or the costs could be borne by a combination of the employer and adviser.
149. The ban on member-borne commission in qualifying schemes relates to a specific set of arrangements - those schemes previously set up containing adviser commission and/or consultancy charges that are now being used as qualifying schemes. It will not impede advisers in any way from continuing to play an important role in the workplace pensions market as staging continues through to 2018, and beyond. The demand for their services will grow along with the workplace pensions market and remuneration structures will continue to adapt to that reality.

#### Impact of a charge controls on the solvency of insurance providers

150. The European 'Solvency I' regime introduced in 2002 sets out minimum solvency requirements for insurers. 'Solvency II' will be a wide-ranging reform of these requirements and is due to be implemented in 2016. The overall aim of these solvency requirements is to ensure adequate solvency of insurers, including those that provide pension products.

151. Discussions with the pensions industry and the Prudential Regulation Authority (PRA) have highlighted that introducing charge controls on default funds in qualifying schemes would have implications for the level of capital that insurers providing such schemes would be required to hold in order to protect their customers against the risk of insolvency.
152. The risks associated with running a scheme to an insurer's solvency posed by charge controls are two-fold. Firstly, there is a risk that if expenses rise far enough, then the inability to pass this on to consumers by raising the product's price may adversely affect the insurer's solvency. Secondly, where the charge is levied as a percentage of assets under management, its absolute level will vary depending on the performance of the underlying assets and there is a risk that when asset values are low the charges will not cover expenses. Where a default fund charge cap is present, an insurer would only have limited ability to increase the percentage charged when asset values are particularly low. Again this could lead to expenses exceeding charges. In order to protect against these risks, insurers would have to hold additional capital against the funds covered by the charge controls. This additional capital would have an associated cost depending on the type of capital that was used to meet the increased capital requirement.
153. Increasing capital requirements as a result of charge controls could impact on market dynamics. For example, the requirement to hold more capital may result in a lower rate of return on capital which may lead to a reduction in the willingness of insurers to take on smaller employers or providers withdrawing from the market altogether, thereby reducing competition.
154. From the limited consultation responses received, and based on the original proposals, it was estimated that the introduction of a 0.75% default fund charge cap would have the potential to generate a material extra capital requirement for some firms, whereas a cap of 1% would not be likely to give rise to a material increase in capital requirements. These estimates are based on the UK's current Individual Capital Adequacy Standards and the future Solvency II regime, rather than on the Solvency I rules which will soon be replaced.
155. The proposals mean that all employers will have to comply with a 0.75% default fund charge cap. The extent to which the capital requirements will impact upon each provider is dependent upon the extent to which employers propose to use existing schemes to comply with automatic enrolment, as it will take time for funds under management to build up in new schemes. Hence the majority of the impact is expected to come from older schemes that are being made compliant with the 0.75% cap and continue to be used for automatic enrolment.
156. It is important to note, however, that this assessment assumes a static market – namely that, following a cap, insurers do not alter their current behaviour. 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.

## Impacts of Option 4: Introduction of statutory requirement on schemes to disclose pension scheme charges and charge controls on default funds in qualifying schemes.

157. Introducing a statutory requirement for schemes to disclose pension scheme charges to employers, scheme members and other parties alone will not be sufficient to address the buyer side failure in the DC pensions market identified by the OFT and meet the objective of ensuring that individuals do not incur inappropriate charges. The preferred option is therefore Option 4, a combination of Options 2 and 3: combining improved and standardised disclosure of information with controls on member-borne charges on default funds in qualifying schemes and banning certain charge structures such as Active Member Discounts. The impacts of this option are discussed in the sections relating to option 2 and option 3.

### **Overall Net Present Value (NPV) of statutory disclosure by scheme of pension scheme charges and charge controls on default funds in qualifying schemes**

158. The proposals have the potential to benefit large numbers of individuals by increasing the value of their pension savings and their income in retirement through a reduction in the amount of money deducted from their pension savings in charges. The overall net present value will vary according to how the industry responds to the new disclosure requirements and charge controls - in particular the extent to which the benefit to individuals affected by the default fund charge cap is offset by any loss incurred by pension providers, or by other individuals who see higher charges than they otherwise would have faced.

159. As set out in this Impact Assessment, it is assumed that the estimated loss of revenue to pension providers following the introduction of the charge controls can be seen as a direct transfer from pension providers to individuals, as long as member-borne costs are not increased in any way. Evidence from the consultation supports the assumption that there is unlikely to be "levelling-up" of member-borne charges. There will be some costs for employers who are using or intending to use existing schemes which do not comply with the charge controls as they will need to set up a new scheme or renegotiate scheme terms with their existing provider. There will also be ongoing costs for pension providers associated with the statutory requirement on schemes to disclose pension scheme charges information.

160. The best estimate of the overall net present value of the preferred option, to introduce a statutory requirement on schemes to disclose pension scheme charges and introduce charge controls on default funds in qualifying schemes used for automatic enrolment, is -£54.1million.

161. Based on the evidence presented, improving transparency of pension scheme charges through the statutory disclosure of charges information and charge controls on default funds in qualifying schemes, is the only reliable way of contributing to the objective of ensuring that individuals receive an adequate income in retirement.

## Direct cost to business of preferred option

162. The statutory requirement on schemes to disclose pension scheme charges would create a cost to pension providers. There will be an ongoing administrative cost to providers of disclosing the required information to employers, scheme members, trustees and IGCs. Through the use of electronic communications the cost is expected to be minimal.
163. The introduction of charge controls on default funds in workplace pension schemes used for automatic enrolment would mean that employers with schemes they are using or were intending to use which do not comply with the charge controls may face a transitional cost of setting up a new scheme if they are unable to renegotiate the terms of their scheme with their existing provider. Once the employer has set up new pension provision to comply with the charge controls there will be no additional requirements placed upon them.
164. The charge controls on default funds in qualifying schemes used for automatic enrolment will also impact on pension scheme providers. The amount of money flowing into the industry as a result of automatic enrolment will remain the same but the proportion deducted in charges will be smaller and the distribution of the funds across schemes will be impacted by the introduction of the charge controls. Depending on provider responses, there is likely to be a net loss of provider revenue as a result of the introduction of the proposed charge controls.
165. As a result, the Equivalent Annual Net Cost to Business (EANCB) of the preferred option, over the default period of 10 years as recommended in the Better Regulation Framework Manual,<sup>79</sup> is estimated to be £18.8million.

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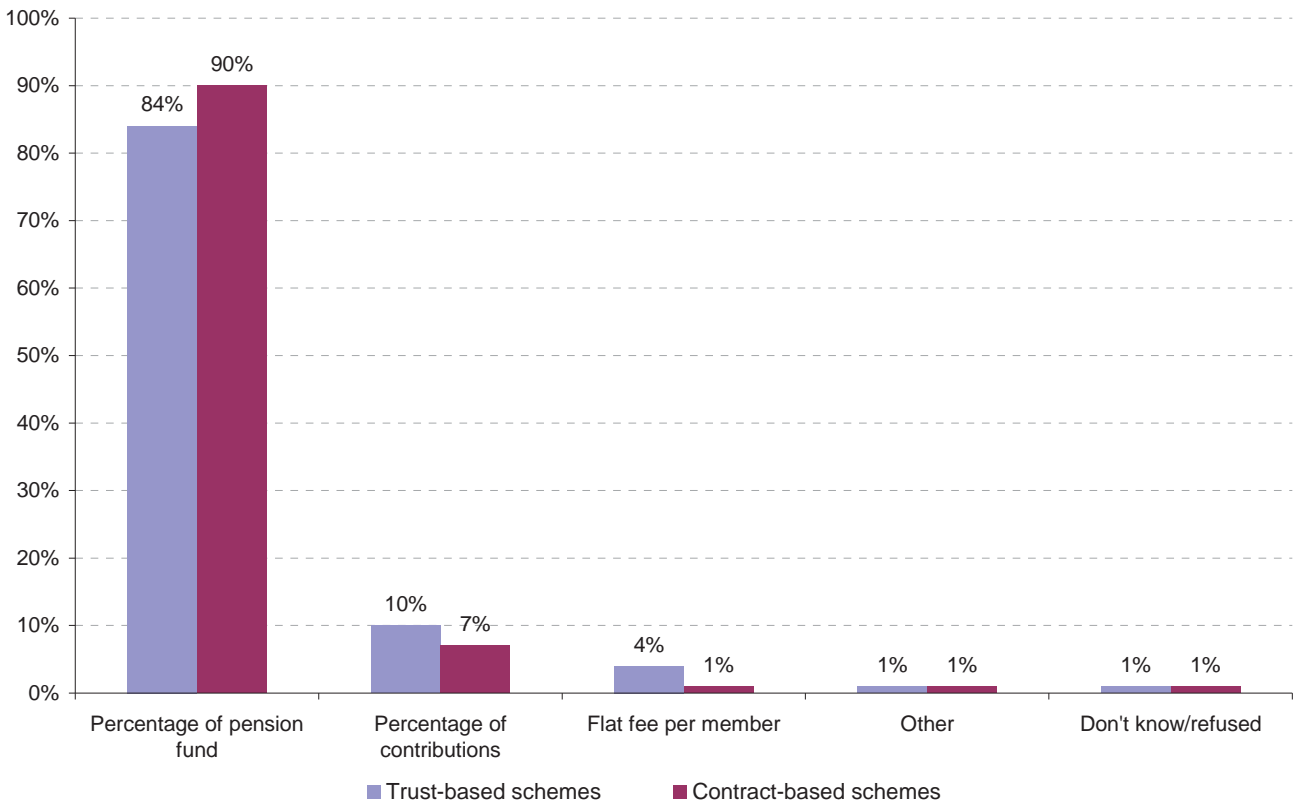
79 [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/211981/bis-13-1038-better-regulation-framework-manual-guidance-for-officials.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211981/bis-13-1038-better-regulation-framework-manual-guidance-for-officials.pdf)

## Annex A

### Differential charging structures

166. According to the DWP Charges Survey 2013<sup>80</sup> the vast majority of schemes<sup>81</sup> charge on an AMC-only basis and only a minority of schemes set charges as a percentage of members' contributions or as a flat-fee per member. As seen in Chart 1 below, 10% of trust-based schemes and 7% of contract-based schemes charge a contribution charge; and 4% of trust-based and 1% of contract-based schemes charge on a flat-fee basis.

**Chart 1: Type of charge structure applied**



**Source:** DWP Pension Landscape and Charging survey 2013

167. Contribution charges and flat-fees will affect different individuals in different ways. For example, a deferred member will by necessity incur no contribution charges but could see their pot quickly eroded by flat-fees, particularly if the value of their pension savings is relatively small. In contrast, a contribution charge is likely to have a bigger impact on individuals who regularly make large contributions. It is likely that over time, as the value of the individual's pension pot increases, a percentage of funds under management charge will have a bigger impact on an individual's pot than contribution charges or flat-fees.

<sup>80</sup> Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and qualitative research with employers and pension providers, DWP Research Report

<sup>81</sup> 84% of trust-based schemes and 90% of contract-based schemes reported charges were made as a percentage of the member's fund per annum, DWP charges survey 2013. Meanwhile, the NAPF 2013 Annual Survey found that 79% of schemes used an AMC

## Other pension scheme charges

168. In most cases, the different surveys described in Annex B only provide information on schemes' Annual Management Charges (AMC). In some cases there will be additional costs which are charged separately from the AMC – including audit, legal and custodial fees. The Total Expense Ratio (TER) is a method of measuring the total costs associated with managing and operating a pension fund.<sup>82</sup>
169. If all expenses are already included in the AMC levied by the provider, the TER will equal the AMC, but the Government understands that this is not always the case. Unfortunately, relatively little information exists on the TER of pension schemes. The concept is defined by the FCA for collective investment schemes, but does not apply directly to pensions although they may be given where a pension invests in unit trusts.
170. One source which attempted to measure the TER of schemes - the DWP Charges Survey 2013<sup>83</sup> - found that only around one third of employers with contract-based or trust-based schemes were informed of the TER by their pension provider, and only 65% of trust-based schemes and less than half of contract-based schemes could estimate it. In most cases they stated that the AMC and TER were the same, but around a third of employers with trust-based schemes and 20% of employers with contract-based schemes reported the TER to be higher.
171. Respondents to the DWP Charges Survey 2013 reported a number of additional member-specific charges outside the AMC, which could be levied in certain circumstances, for example charges for certain fund choices, which were reported in 41% of trust-based schemes and 32% of contract-based schemes. The survey also found that the likelihood of charging for certain fund choices increased significantly with scheme size.
172. Schemes can also have differential charges across members – most notably in the form of Active Member Discounts/Deferred Member Penalties. Where this is the case, members who contribute to their scheme will typically incur a lower AMC than those who no longer contribute.
173. The evidence available suggests that a minority of schemes currently adopt such differential charges<sup>84</sup>, but they have become more popular amongst employers in recent years.<sup>85</sup> Where Active Member Discounts were said to be offered in contract-based schemes, on average, deferred members were charged 0.38 percentage points more than active members, according to employers in the DWP Charges Survey 2013.<sup>86</sup>

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82 They do not include all costs however – for example, investment charges such as initial exit and entry fees, brokerage commissions, bid-offer spreads and stamp duty

83 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

84 The OFT estimated that approximately 15% of post 2001 contract-based schemes have Active Member Discounts, The DWP charges survey found that only 3% of employers with a trust-based scheme, and 10% of those with a contract-based scheme reported using active member discounts, whilst the Towers Watson 2013 FTSE 100 DC Pension Scheme Survey found that 19% of employers surveyed operate a different charging structure for active members

85 The DWP charges survey 2012 found that some of the very large providers had sold the majority of their GPPs with AMDs in the 12 months prior to the research - Wood A, Wintersgill D, and Baker N, 2012, Pension Landscape and Charging: Quantitative and qualitative research with employers and pension providers, DWP Research Report 804

86 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report



174. The cost of commission-based advisers can be passed on to members through deductions in an individual's pension pot via an increased AMC. The DWP Charges Survey 2013 shows that where a commission-based adviser was used this led to an average increase in the AMC paid by members of trust-based schemes of 0.4 percentage points<sup>87</sup> and in contract-based schemes of just under 0.2 percentage points.<sup>88</sup> However, how much of the reported AMC at each level of charges can be attributed to commissions is not known.

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<sup>87</sup> In trust-based schemes using fee-based advisers the AMC was 0.57%; whereas the average AMC for commission-based schemes was 0.97%

<sup>88</sup> In contract-based schemes using fee-based advisers the AMC was 0.73%; whereas the average AMC for commission-based schemes was 0.89%

## Annex B

### Data sources

175. The DWP Charges Survey 2013<sup>89</sup> is the primary source of information for measuring the charges levied on both trust- and contract-based pension schemes. There were significant changes in the methodology for the Charges Survey 2013 compared to previous years. The changes were in the methods used for determining the level of charges particularly in raising the awareness of charges amongst employers compared to the same study in 2011.<sup>90</sup>
176. In 2011, only 28% of trust-based and 33% of contract-based schemes believed that members paid any charges at all, with significantly lower awareness among smaller firms. While this was a useful finding in itself, in 2013 the research contractors worked with all 1,310 employers to explain, by letter and by telephone, how they could find out the level of Annual Management Charge (AMC)<sup>91</sup> from their pension providers. As a result, 74% of contract-based schemes and 85% of trust-based schemes have been able to confirm member charges allowing the research to draw upon a much larger data set for analysis. This means that over 800 employers have been able to report the level of AMC paid by members, compared to around 300 in 2011.
177. The DWP Charges Survey 2013<sup>92</sup> defines the AMC as a charge levied annually by a pension provider on a member's pension fund to cover the costs associated with providing a pension scheme. The AMC charge is usually levied as a percentage of funds under management.
178. Information on AMCs has also been collected by a number of other organisations, including the OFT in their market study of workplace defined-contribution pensions, the NAPF in their 2013 Annual Survey, the ABI, and Towers Watson in their 2013 survey of FTSE 100 companies' DC pension schemes. These alternative sources have broadly supported the findings in the DWP Charges Survey.

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89 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

90 Pension landscape and charging: Quantitative and qualitative research with employers and pension providers, 2011, DWP research report 804. [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/193451/rrep804.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/193451/rrep804.pdf)

91 Pension fund managers apply an Annual Management Charge (AMC) which is deducted directly from the fund to cover ongoing management of the pension scheme. The charge is taken to pay for investment management services, such as research analysts and portfolio managers

92 Wood A, Amantani L, McDougall D and Baker N, 2013, Pension Landscape and Charging: Qualitative and quantitative research with employers and pension providers, DWP Research Report

## Annex C

### How will a default fund charge cap impact on small schemes?

179. Small schemes are a very small part of the workplace pensions market.
180. There are clear benefits of scale in workplace pension provision and consolidation of schemes has been occurring in recent years. Between 2009 and 2013, the number of small trust-based schemes decreased by over a third from 2,910 to 1,790. There has also been a large increase in the number of Group Personal Pension (GPP) sales, rising from 297,000 in 2009 to 755,000 in 2013. Although these may appear to be small schemes, in fact, evidence from Financial Conduct Authority (FCA) shows that in 2013 providers making over 1000+ sales accounted over 99% of the total market.
181. In assessing the impact of any policy proposal it is important to understand the nature of the small scheme market. Information from the Pensions Regulator shows that although there are some 1,790 small trust-based schemes (12-99 members), over two-thirds are operated by just 10 of the largest providers, accounting for over 65% of the total small scheme membership. Providers are either insurance companies or master-trusts and, in 2014, held assets for small schemes valued at almost £1.8bn.
182. These providers will therefore react to the default fund charge cap across their whole range of business rather than on a single scheme basis. The impact on the revenue of pension providers and their responses to the introduction of charge controls was covered in the Impact Assessment. Where small schemes exist outside of the large providers they are either associated with a single small employer where there is no commercial element or are one scheme that a larger employer provides, again operating on a non-commercial basis.
183. Although there are a number of smaller providers in the Self Invested Personal Pension (SIPP) market, FCA evidence shows that, as in the GPP market, larger providers make the vast majority of sales. In 2013, providers who sold 1,000+ SIPPs in that year accounted for over 98% of total sales made. In addition, as the charge cap will only apply to default funds, and SIPPs are designed to require member investment selection, it is anticipated that any market impact will be reduced. Where SIPPs are offered as a vehicle for automatic enrolment, with a default fund it is expected that these will be offered across a range of employers by larger providers.

## Other Impacts

### Equality

184. Proposals for the Pensions Bill 2015 were subject to a full Equality Impact Assessment and the regulations are in consequence of the Bill. In accordance with its duty under section 75 of the Northern Ireland Act 1998, the Department has conducted a screening exercise on the proposals for the regulations and considers that the regulations do not have any additional implication for equality of opportunity.

### Environmental

185. There are no implications.

### Rural proofing

186. There are no implications.

### Health

187. There are no implications.

### Human rights


188. The Department considers that the regulations are compliant with the Human Rights Act 1998.

### Competition

189. There are no implications.

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed for the Department for Social Development



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