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

## CHARGES IN QUALIFYING PENSION SCHEMES

## REGULATORY IMPACT ASSESSMENT

INVESTOR IN PEOPLE

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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[1] 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.[2]

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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[1] 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

[2] 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[3] the vast majority of schemes[4] 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.[5] 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[6] 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[7] (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. [8] In a recent briefing note on charges[9]

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[3] 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

[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

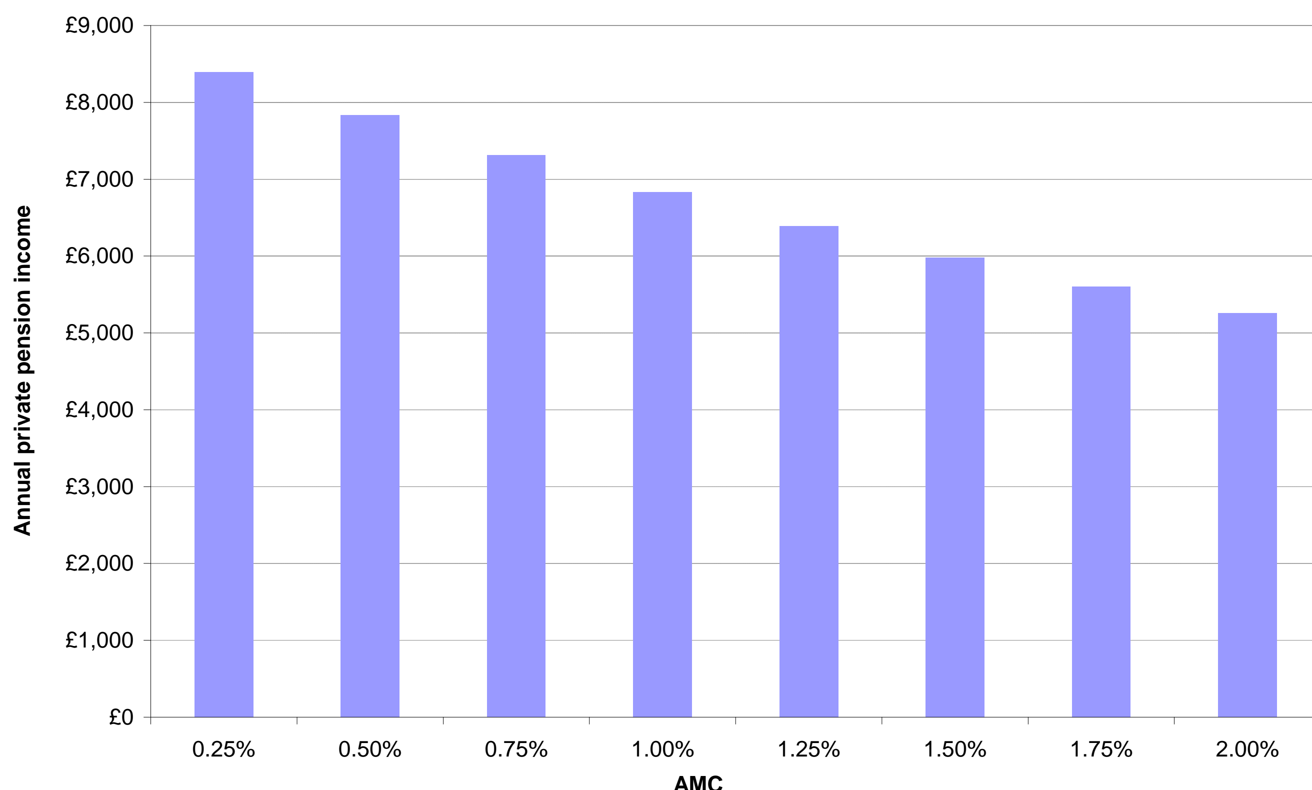
[8] Pensions Policy Institute, 2012, *Closing the gap: the choices and factors that can affect private pension income in retirement*

[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

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."*

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[10] 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

[10] In 2013 earnings terms

Survey 2013[11], average charges were 0.75% in trust-based schemes and 0.84% in contract-based schemes - below the level of the stakeholder charge cap.

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[12]). 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%.[13]

**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%.[14] The DWP Charges Survey 2013[15] found that 7% of employers with contract-based schemes and 10% with trust-

[11] 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

[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

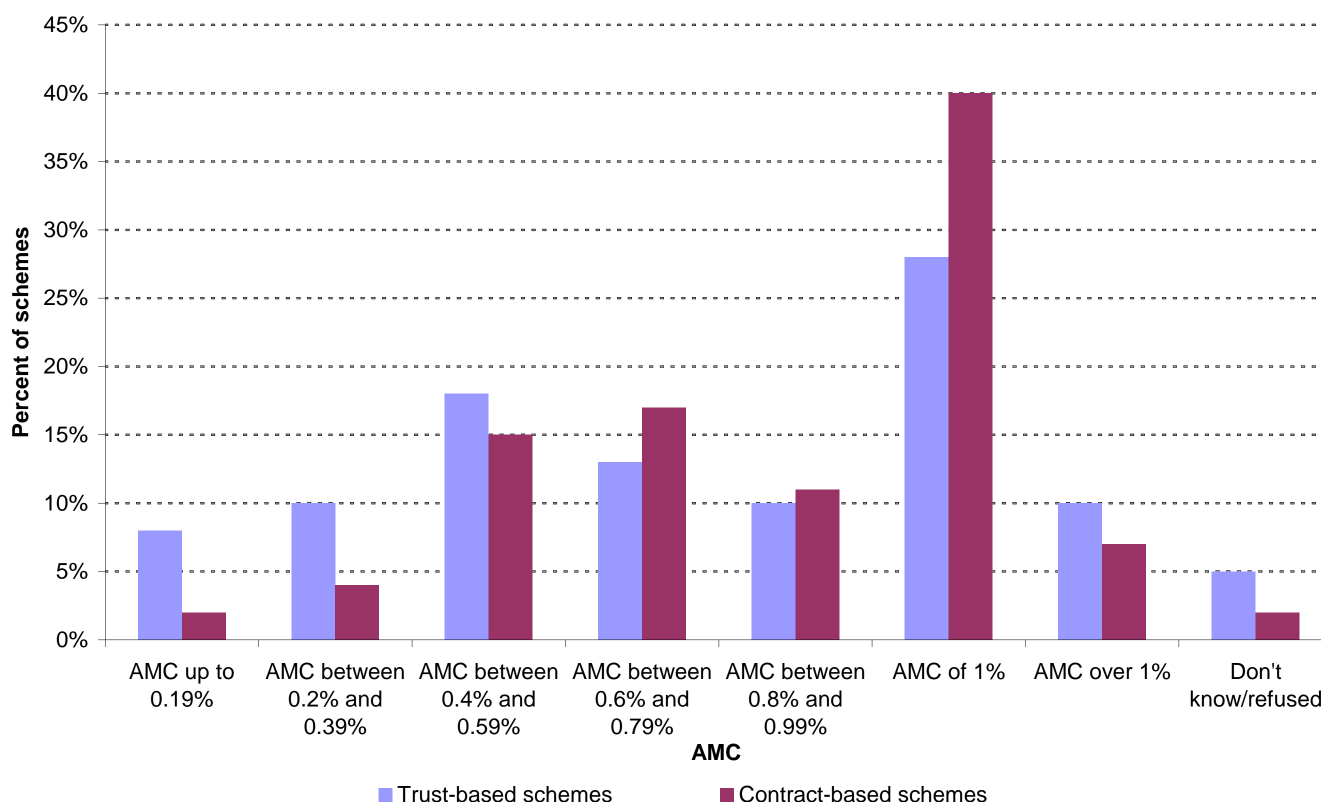
[13] Association of British Insurers, June 2012, *Time to Act: Tackling our Savings Problem and Building our Future*, page 12 https://www.abi.org.uk/~/media/Files/Documents/Publications/Public/Migrated/Pensions/Time%20to%20Act.ashx

[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 qualitative research with employers and pension providers, DWP Research Report

based schemes reported an AMC of more than 1%[16] (see Chart 3), and the ABI found a small handful of schemes charging above 2%.[17] 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.

**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.[18]

Reasons for variation in pension scheme charges

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

    - the quality of services offered;

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[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

[18] Harrison D, Blake D, and Dowd K, October 2012, *Caveat Venditor*, Pensions Institute and Cass Business School

- 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 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[19] 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

[19] 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

around £200 per member.[20] 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 - 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 £11billion 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

[20] Capita Hartshead, May 2010, *17th Annual Pension Scheme Administration Survey 2010*

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[21] 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 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. [22] The National Association for Pension Funds (NAPF) and B&CE[23] 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.[24]

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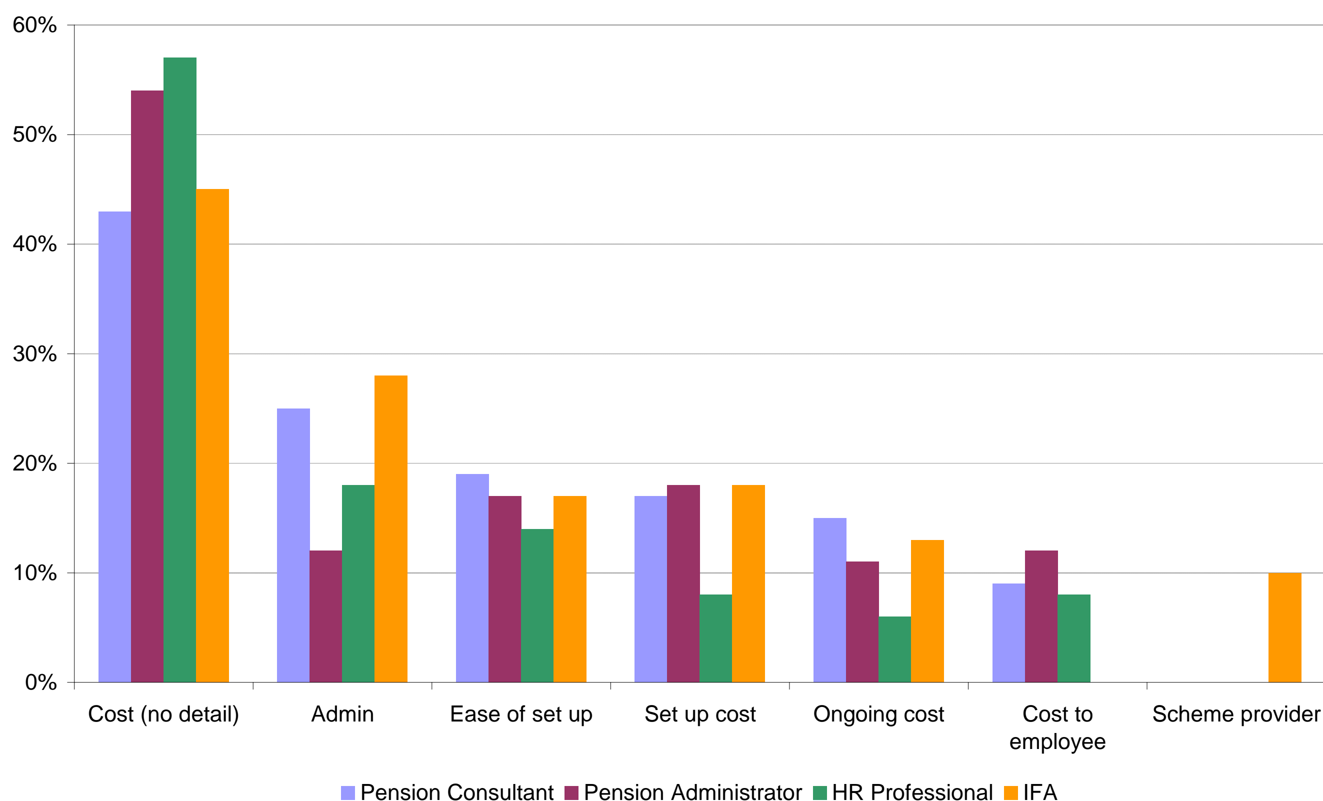
[21] Office of Fair Trading (OFT), 2013, *Defined contribution workplace pension market study*, OFT 1505

[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*

**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 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[25] 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.[26] 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.

[25] 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
[26] Office of Fair Trading (OFT), 2013, *Defined contribution workplace pension market study*, OFT 1505

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[27] in relation to the charges their employees pay.

32. The DWP Charges Survey 2013[28] found that while employers' awareness of member charges had increased since 2012 - around three-quarters[29] 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. [30]

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

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

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[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 qualitative 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*

[31] NAPF and B&CE, September 2012, *Telling Employers about DC Pension Charges: Research*

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.

   - 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[32] 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.[33] 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

[32] 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

[33] 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

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.
- 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.[34]

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.

[34] Office of Fair Trading (OFT), 2013, *Defined contribution workplace pension market study*, OFT 1505

58. The DWP Charges Survey 2013[35] 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

| | **Employers** | **Individuals** | **Pension industry** | **Advisers** |
|---|---|---|---|---|
| **Option 1:** 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. |
| **Option 2:** Introducing a statutory requirement on schemes to disclose pension scheme charges | No additional cost to employers.<br><br>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.<br><br>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. | 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.<br><br>If employees were dissatisfied about the level of charges their 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.<br><br>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. | Cost and charges information is already disclosed but these proposals would require all schemes to do it in a standardised way.<br><br>The costs of disclosing pension scheme charges are expected to be minimal to pension providers as communication is 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.<br><br>Achieving full and standardised transparency with regard to transaction costs represents more | No additional cost to advisers.<br><br>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. |

[35] 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

| | | | | |
|---|---|---|---|---|
| | | | 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.<br><br>Ongoing costs of disclosure are estimated at £0.04million a year in 2013/14 prices.<br><br>The pensions industry could benefit from improved disclosure of information through building trust and confidence in the market. | |
| **Option 3:** 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 | 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.<br><br>Total transitional costs of up to £55.5m in 2013/14 prices could be expected for employers impacted by the charge controls.<br><br>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. | 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.<br><br>It is expected the gain to individuals 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.<br><br>Other individuals not directly affected by the cap may see higher charges than they otherwise would, if providers level up charges to | 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.<br><br>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.<br><br>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.<br><br>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.<br><br>A ban on AMDs, commission and | 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.<br><br>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 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.<br><br>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.<br><br>Some advisers will have built the expected |

| | | the cap level. However evidence from the consultation suggests this is unlikely to happen.<br><br>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. | 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. | 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.<br><br>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. |
|---|---|---|---|---|
| **Option 4: A combination of options (2) and (3) above** | 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[36]. 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.

[36] An Independent Governance Committee ensures the interest of members are protected in workplace pension schemes

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/SMPIs). 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.[37] 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.

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.

[37] IMA, September 2012, *Enhanced Disclosure of fund charges and costs*

64. The cost of disclosing information on scheme charges via paper-based communications is estimated to be a £1 unit cost[38] to each defined-contribution trust-based scheme (38,690[39]) 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 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.

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[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*

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[40] 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[41] 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 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

[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*

selection. Previous research carried out for the DWP[42] 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.

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.

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[42] 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

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[43] 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[44] 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[45] 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 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

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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 qualitative research with employers and pension providers*, DWP Research Report

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[46] 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[47] was used to calculate the proportion of employers who are currently using or are intending to use their existing provision to satisfy their duty to automatically enrol their employees into a workplace pension scheme.[48] 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%.

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[46] The Charges Survey 2013 indicates that 41% of contract-based and 25% of trust-based schemes contain an adviser-commission

[47] Employer Pension Provision Survey 2011 data collected before the introduction automatic enrolment

[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

**Table 4:** Number of employers by staging date and those who are currently using or intend on using existing scheme provision[49]

| 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[50] | 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

- 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

[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

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[51] 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[52] 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[53] | 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 qualitative 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[54] 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[55], has been calculated as 0.38%.[56] 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[57], and follows the standard cost model methodology recommended by the Better Regulation Framework Manual. [58]

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[54] 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

[55] 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

[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/wpr-ia.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

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.[59]

**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[60] | 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

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

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.

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). [61]

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

[61] The Pensions Regulator, February 2013, *Employers' awareness, understanding and activity relating to workplace pension reforms, Autumn 2012*

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.

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.[62] It is assumed that the individual saves into a pension scheme for ten years.[63] 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

| | Average number of scheme members | |
|---|---|---|
| Employer size | 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.[64]

[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
[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

**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[65] | 0.1 |

**Source:** DWP modelling
**Notes:** Rounded to the nearest 0.1million

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.[66] 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.[67] 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.[68] 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 –

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

[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 qualitative research with employers and pension providers,* DWP Research Report

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.

**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[69]

| 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

[69] Loss of provider revenue presented are before taxes

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 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.[70] 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.[71] 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.

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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

**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'.

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[72] 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[73] - 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. 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.[74]

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.[75] A survey by Towers Watson[76] indicates that 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[77] 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.

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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)

[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

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.[78] 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 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.

[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

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 defaults 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,[79] is estimated to be £18.8million.

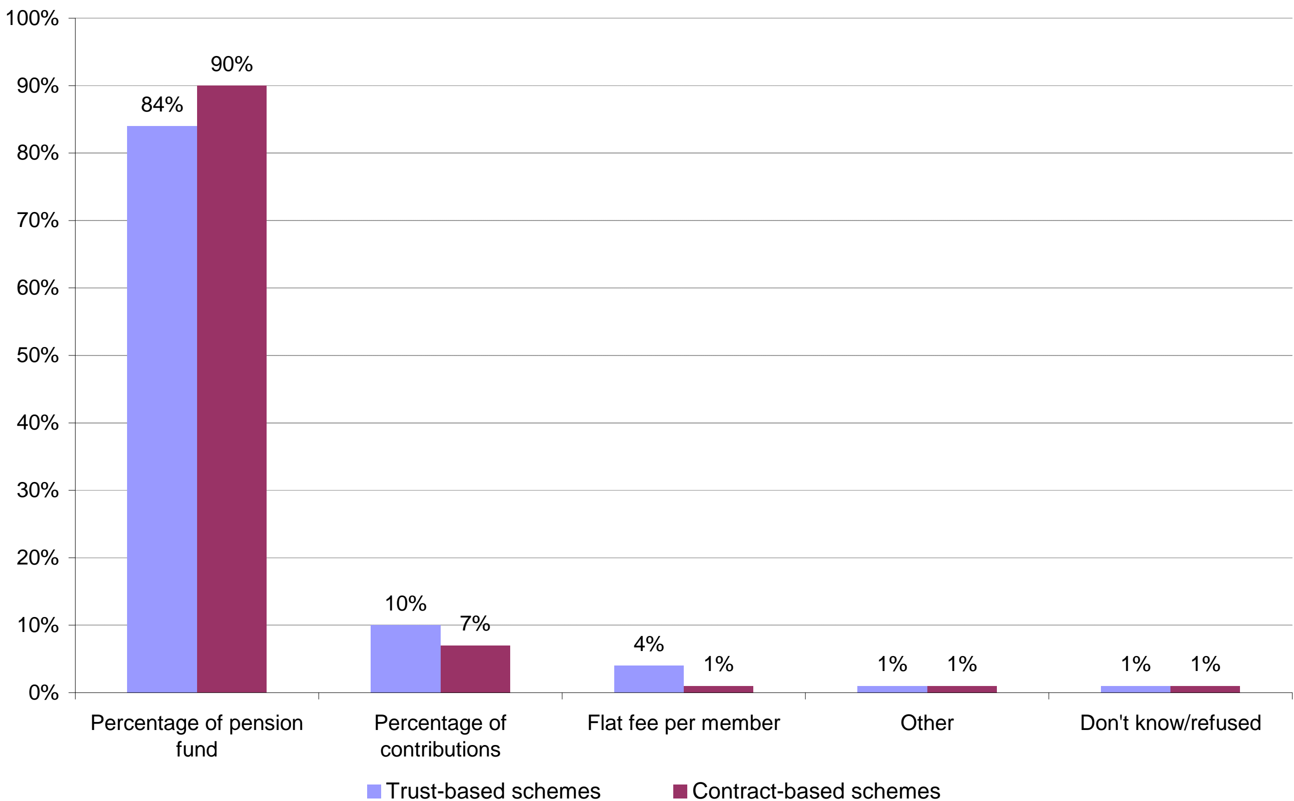
[79] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/211981/bis-13-1038-better-regulation-framework-manual-guidance-for-officials.pdf

## Annex A

### Differential charging structures

166. According to the DWP Charges Survey 2013[80] the vast majority of schemes[81] 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.

Other pension scheme charges

[80] 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

[81] 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

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.[82]

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[83] - 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[84], but they have become more popular amongst employers in recent years.[85] 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.[86]

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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 qualitative 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 qualitative 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[87] and in contract-based schemes of just under 0.2 percentage points.[88] However, how much of the reported AMC at each level of charges can be attributed to commissions is not known.

[87] In trust-based schemes using fee-based advisers the AMC was 0.57%; whereas the average AMC for commission-based schemes was 0.97%

[88] 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[89] 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.[90]

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)[91] 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[92] 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.

[89] 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

[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

[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 qualitative 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

Anne McCleary
Director of Social Security Policy and Legislation

19 June 2015

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