HOUSE OF COMMONS LIBRARY

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Pension scheme charges

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Djuna Thurley Business and Transport Section

Summary

The charges applying to an individual's pension fund can have a significant impact on the value of their pension pot over time. While the percentage taken in charges might appear small, the cumulative impact can be significant (Cm 8737, October 2013, para 1.9).

A difficulty in addressing this is that there has been "no standard definition of the component services and activities included within the headline charge quoted for each DC scheme." (Ibid, para 2.6)

The introduction of auto-enrolment from 2012 has made it particularly important that workplace pension schemes deliver value for money. As DWP and the FCA explained in 2015, there was much to be done:

> 13. The introduction of automatic enrolment means that it is important to ensure that workplace pension schemes deliver the best possible value for money. However, the 2013 defined contribution workplace pension market study by the Office of Fair Trading (OFT) highlighted problems with the existing market, including poor outcomes for the buyer and the potential for conflicts of interest. The study covered both occupational and workplace personal pension schemes, since employers can choose either type of scheme for their employees.
>
> 14. In its report, the OFT found that the market for buyers was 'one of the weakest that the OFT has analysed in recent years'. Employers make most of the key decisions but may lack the capability and/or the incentive to ensure that members of their schemes receive value for money in the long term. Employees often take little interest in their pension savings and, with automatic enrolment, they make no active choice to join, are enrolled at a default contribution level, and do not need to choose the fund into which they save. The OFT concluded that neither employers nor employees can be expected to drive value effective value for money between firms. However, well-governed schemes are more likely to provide value for money by reviewing the quality of scheme administration, investment management services, costs and charges on an ongoing basis.(DP 15/2, March 2015).

Changes intended to provide "greater protection for people who have been defaulted into private pension saving" are being implemented in stages, starting with two reforms introduced in April 2015:

- A charge cap on the default arrangements of qualifying DC workplace pension schemes. The annual cap is set at 0.75 per cent of funds under management or an equivalent combination charge. It applies to all ongoing charges, and therefore excludes transaction costs (SI 2015/879)
- A ban on consultancy charges in all qualifying DC contract-based schemes. This followed 2013 legislation which banned new consultancy charge agreements from being set up.

Further changes were introduced in April 2016, to prevent providers from levying charges that would be particularly inappropriate to those who had been auto-enrolled:

- In the past, some providers gave active member discounts (AMDs) to members who people who were paying into a scheme, at the expense of those who had stopped doing so. AMDs were banned in qualifying DC workplace pension schemes from April 2016 (SI 2015/879);
- Commission and consultancy charges were banned in qualifying DC trust-based schemes (2016/304).

DWP's 2016 Pension Charges Survey found that:

- The charge cap had lowered charges in qualifying schemes to the level of the cap or below: as many as 98 per cent of members of qualifying contract-based schemes and 99 per cent of members of qualifying trust-based schemes now paid a maximum of 0.75 per cent.
- Among qualifying scheme members, the members of the smallest schemes, which previously charged higher than the cap, benefitted the most. For example, ongoing charges for qualifying contract-based schemes with 12 or fewer members fell by 0.2 percentage points on average.
- Non-qualifying schemes, whose charges are not subject to the cap and were already typically higher than it, had not generally brought down their charges in response. In non-qualifying contract-based schemes just 21 per cent of members paid charges within the cap; and in non-qualifying trust-based schemes 50 per cent of members paid charges within the cap – both showing little change since 2015.
- Charges for unbundled trust-based schemes, measured for the first time in the 2016 survey, were typically comparable to their equivalent bundled trust-based schemes, although a relatively small number of closed, non-qualifying schemes charged markedly higher than the average.
- 'Legacy' charges that were banned under the charges measures (i.e. Active Member Discounts (AMDs), consultancy charges and member-borne commission) had been eliminated from qualifying schemes, and remained extremely rare even among non-qualifying schemes.
- There was virtually no improvement in providers' abilities to report on transaction costs compared to 2015, with many providers, unbundled scheme trustees and their fund managers awaiting further guidance from the Government.

In November 2017, the Government introduced new rules to improve the transparency and disclosure of pension scheme charges. Providers of contract-based schemes are required to have an Independent Governance Committee (IGC), responsible for monitoring the value delivered by these schemes and producing an annual report detailing the costs and charges incurred in managing the pension scheme. Trustees of trust-based schemes have a similar requirement to consider and report on costs and charges, via an annual Chair's Statement.

In November 2017, the Government said that the charge cap was working "broadly as intended" and that it had decided not to change its level or scope at this stage (HCWS 249, 16 November 2017).

The *Pensions Act 2014* provided for a requirement to disclose transaction costs (i.e. the costs that a scheme incurs as a result of buying, selling, lending and borrowing investments). In September 2017, the FCA published rules on how such costs should be disclosed to governance bodies (PS 17/20). The Government is now consulting on how costs and charges should best be disclosed to members and others.

The *Pension Schemes Act 2017* (s41) provided for regulations to be able to override certain contractual terms in occupational pension schemes, to enable the implementation of a cap on early exit charges and a ban member-borne commission charges.

1. Background

There are two main types of pension scheme: a defined benefit (DB) scheme typically promises to pay a pension linked to salary and length of service and a defined contribution (DC) scheme which:

> [...] provides pension scheme benefits based on the contributions invested, the returns received on that investment (minus any charges incurred) and the rate at which the final pension fund is annuitised.[1]

DC schemes are sometimes referred to as money purchase schemes. They can be individual arrangements such as personal pensions. Employer DC provision can be either:

> - Workplace-personal pensions which are contract-based and include group personal pension plans (where employees of a particular employer participate in a personal pension scheme on a grouped basis) and group stakeholder pensions; or
>
> - Occupational schemes, which are sponsored by the employer and are trust-based (i.e. run by trustees nominated by the employer and/or members).[2]

Responsibility for regulation of DC pensions is split between the Pensions Regulator (TPR) and the Financial Conduct Authority (FCA), which took over from the Financial Services Authority (FSA) in April 2013. In broad terms:

- The FCA regulates contract-based schemes, in which scheme members sign a contract with a pensions provider appointed by their employer to run the scheme.
- TPR regulates trust-based schemes, which are sponsored by the employer but managed by a board of trustees.[3]

Their respective roles are in a Memorandum of Understanding published in April 2013.[4]

Auto-enrolment – which started to be introduced in 2012 - are expected to significantly increase the numbers saving in DC pension schemes.[5] Under these reforms, employers are required to automatically enrol workers aged between 22 and State Pension age who earn at least £10,000 a year (2016/17 rates) into a workplace pension scheme and, unless they opt out, make minimum contributions to that scheme.[6]

Employers will have to enrol them into a pension scheme that meets specified criteria. The National Employment Savings Trust (NEST) was

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1 DWP, Preparing for automatic enrolment – Response to the call for evidence, June 2011, Glossary
2 DWP research report no 630, Charging levels and structures in money-purchase pension schemes: report of quantitative survey, 2010, p5
3 For more detail, see MOU between the Financial Conduct Authority and the Pensions Regulator, April 2013
4 The Pensions Regulator, MoU between the FCA and the Pensions Regulator, April 2013
5 DWP, Framework for the analysis of future pension incomes, September 2013
6 For more detail, see Library Standard Note SN 6417 Pensions: automatic enrolment - 2010 onwards

established, available to any employer who chooses to use it.[7] The Government expected NEST's low-cost charging structure to act as a benchmark across the entire pensions industry.[8] However, the introduction of auto-enrolment has made it particularly important that workplace pension schemes deliver value for money. And as DWP and the FCA explained in 2015, there was much to be done:

> 13. The introduction of automatic enrolment means that it is important to ensure that workplace pension schemes deliver the best possible value for money. However, the 2013 defined contribution workplace pension market study by the Office of Fair Trading (OFT) highlighted problems with the existing market, including poor outcomes for the buyer and the potential for conflicts of interest. The study covered both occupational and workplace personal pension schemes, since employers can choose either type of scheme for their employees.
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> 14. In its report, the OFT found that the market for buyers was 'one of the weakest that the OFT has analysed in recent years'. Employers make most of the key decisions but may lack the capability and/or the incentive to ensure that members of their schemes receive value for money in the long term. Employees often take little interest in their pension savings and, with automatic enrolment, they make no active choice to join, are enrolled at a default contribution level, and do not need to choose the fund into which they save. The OFT concluded that neither employers nor employees can be expected to drive value effective value for money between firms. However, well-governed schemes are more likely to provide value for money by reviewing the quality of scheme administration, investment management services, costs and charges on an ongoing basis.[9]

To address these issues, DWP and the regulators have developed a package of measures for implementation from April 2015 that to "help ensure workplace pension schemes are well run and offer value for money":

> 16. These measures will require providers of workplace personal pension schemes to:
>
> - Set up and maintain IGCs [independent governance committees] who will act in the interests of scheme members, operate independently of the firm and will assess, and where necessary, raise concerns about the value for money of the workplace pension schemes;
> - Implement a charge cap on default funds offering money purchase benefits which are used for automatic enrolment

[7] DWP, Automatic enrolment and workplace pension saving reform – factsheet, May 2011

[8] HC Deb, 3 September 2012, c81-2W; The research referred to is Wood, Young, Wintersgill, Crowther (2011) 'Likely industry responses to the workplace pension reforms', DWP research report 753; For more on the background, see Library Briefing Paper SN-06415 National Employment Savings Trust (NEST) – 2012 onwards (October 2013)

[9] DWP and FCA, Transaction Costs Disclosure: Improving Transparency in Workplace Pensions – Call for Evidence, March 2015, p10; OFT, Defined contribution workplace pension market study, September 2013, para 1.4. The OFT was responsible for protecting consumer interests in the UK until 2014. Its responsibilities have now been passed to different bodies.

in workplace personal pensions to protect members from high charges; and

- Abolish consultancy charges in schemes used for automatic enrolment.

17. The measures will also require IGCs to annually report on the value for money delivered by schemes, including standards of administration, information about member-borne deductions relating to the scheme, investment administrative costs, and transaction costs associated with buying and selling investments held within pension scheme wrappers.[10]

Corresponding measures were introduced for occupational schemes.[11]

For more on the background to the governance measures, see Library Briefing Paper CBP 7202 Pensions 2015 (March 2015), p69-70 and SN-06956 Improving outcomes for DC pension savers (September 2014).

[10] DWP and FCA, Transaction Costs Disclosure: Improving Transparency in Workplace Pensions – Call for Evidence, March 2015, p10; FCA, Final rules for independent governance committees, February 2015

[11] *Occupational Pension Scheme (Charges and Governance) Regulations 2015 SI 2015/879*.

2. How charges work

2.1 Definitions

There are different types of charge that may apply to DC schemes. The Pensions Regulator (TPR) explains:

> Charges may take many forms and vary greatly from scheme to scheme, both in amount and in the way they are applied. The rules of an occupational scheme and the conditions of the contract in a GPP include the charges that can be levied.
>
> Charges that are applied to DC funds may include flat rate fees (e.g. a monthly policy fee unrelated to the fund size), deductions from the fund (e.g. the annual management charge is usually expressed as a percentage of the fund value), initial charges (e.g. set-up costs such as the bid-offer spread: the difference between the prices at which investments are bought and sold), exit charges (e.g. transfer fee if member transfers to a different scheme).[12]

In 2013, DWP said there was "no standard definition of the component services and activities included within the headline charge quoted for each DC scheme".[13] The Office of Fair Trading (OFT) said it was:

> […] difficult to compare charges of different pension providers because there is a lack of consistency in the way charges are presented.[14]

It identified five broad types of costs that were being paid by scheme members, relating to: administration of the scheme by the provider, investment management services, additional investment management expenses, adviser payments and costs associated with investment transactions. [15] As discussed in section 3 below, work has been ongoing to improve transparency by ensuring that charges are presented in a more standardised way.

In the interim report of its Asset Management Study, the FCA set out the industry's current approach to disclosure. It explained that:

- Charges paid out of a fund for services provided directly by asset managers, are typically combined into a charge known as an **Annual Management Charge (AMC)**. The AMC is charged as a percentage of the net asset value of the fund. It is taken to pay for the cost of the management services, such as in-house research, analytics and portfolio management. It does not typically include third party services or charges paid to third parties on behalf of the fund. It is therefore only a proportion of the total charges of a fund.
- A more comprehensive figure is the **Ongoing Charge Figure (OCF).** This represents ongoing costs, including the AMC and

12 Pensions Regulator website – charges Q and A; See also PADA, 'Building personal accounts: choosing a charging structure. A discussion paper to support consultation', January 2008

13 DWP, Better workplace pensions: a consultation on charging, October 2013, Cm 8737, para 2.6

14 OFT, Defined contribution workplace pension market study, September 2013, para 1.16

15 Ibid, para 6.20

> services such as keeping a register of investors, calculating the price of fund units and keeping fund assets safe. However, this does not include all charges – for example, it does not include charges contingent on less predictable factors - including performance fees and transaction costs. And it does not include 'implicit costs', since these are only reflected in a lower level of assets under management than would otherwise have been the case. Examples of implicit costs include the cost arising from price changes over the course of a large securities transaction.[16]

2.2 Impact

The charges applying to an individual's pension fund can have a significant impact on the value of their pension pot over time. One difficulty in addressing this is that there has been "no standard definition of the component services and activities included within the headline charge quoted for each DC scheme."[17]

The impact of charges on an individual's pension fund will depend on factors including the duration of saving, the level and persistency of contributions, and investment returns. By way of illustration, DWP estimated the potential effect of a one per cent charge on funds under management:

> An individual who saves from age 45 until State Pension age could lose 12 per cent of their pot, whilst an individual who saves between the ages of 25 to 50 (and who remains deferred in their scheme until retirement) could lose 28 per cent of their pension pot.[18]

While the percentage taken in charges might appear small, the cumulative impact on the value of an individual's pension pot could be significant:

> An individual who saves throughout their working life into a scheme with a 0.5 per cent AMC could lose 13 per cent of their pension pot from charges. By contrast, at the 1 per cent level, the individual could lose almost a quarter of their pot (24 per cent), and at the 1.5 per cent level could lose around a third (34 per cent).[19]

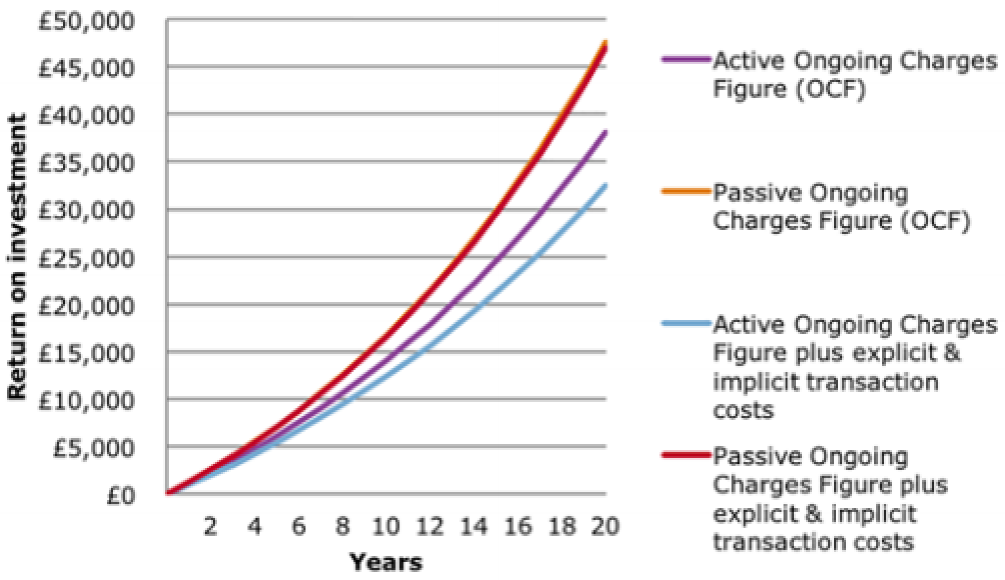
In November, the FCA published the interim report of its Asset Management Market Study. This included the chart showing the impact of different fund strategies on a £20,000 equity fund over 20 years – which were particularly significant once transaction costs were taken into account:[20]

> Figure 1.2 compares the net return on a £20,000 investment over 20 years to show the impact of charges. Assuming, for illustrative purposes, that both funds earn the same return before charges (the average FTSE all share growth), an investor in a typical low

[16] FCA, Asset Management Market Study. Interim Report: Annex 7 – Fund Charges Analysis, November 2016, p4-6
[17] DWP Better workplace pensions: a consultation on charging, October 2013, Cm 8737, para 2.6
[18] Ibid, para 1.7
[19] Ibid, para 1.9
[20] FCA, Asset Management Market Study MS15/22, MS 15 2.2November 2016, para 1.5

cost passive fund would earn £9,455 (24.8%) more on a £20,000 investment than an investor in a typical active fund, and this number could rise to £14,439 (44.4%) once transaction costs have been taken into account. We recognise that some investors in actively managed funds are likely to expect higher returns in exchange for the greater risk they are taking on.

Figure 1.2 – returns on a £20,000 equity fund over 20 years assuming average FTSE all share growth[5]



The FCA comments that "passive funds offer investors similar levels of risk and return as the market" but typically charge lower fees.[21] It found "no clear relationship between price and performance – the most expensive funds do not appear to perform better than other funds before or after costs".[22]

21 Ibid para 1.13
22 Ibid para 1.26

3. Disclosure

Recent years have seen industry initiatives to improve disclosure of charges, followed by government action.

3.1 Industry initiatives

Joint Industry Code of Conduct (2012)

In a discussion document published in November 2011, the Pension and Lifetime Savings Association said there was no clear universal requirement for charges to be disclosed, or specification as to how they were shown.[23] It announced that it would work with others to develop a "code of practice on the transparency of fees and charges."[24]

Following consultation on a draft, a Joint Industry Code of Conduct - endorsed by PLSA and the ABI, in association with the Investment Association and the Society of Pension Consultants (SPC) – was published in November 2012. It required all charges to be clearly and accurately stated in writing, in a standard template summarising the pension charges levied and the corresponding services. Transaction costs would be stated in line with Investment Association guidance.[25] The focus was on making sure that "charges are disclosed in a very plain, consistent format to employers."[26] The need for improved disclosure was emphasised by DWP research published in 2012, which found that employer awareness of charge levels was low.[27]

Comment

The then Pensions Minister, Steve Webb, welcomed the announcement of the Code as a useful starting point in improving transparency but said the Government was "prepared to consider taking action more broadly on charges if insufficient progress is made."[28]

The then Shadow Pensions Minister, Gregg McClymont said the Code represented "a significant step forward, albeit with room for further improvement." He added that there was "a long way to go on reform of occupational pensions and we want to see critical developments, including on scale and governance to ensure that people get pensions

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23 NAPF, Making Pension Charges Clearer, November 2011

24 NAPF press release, Greater clarity on pension charges needed ahead of auto-enrolment, 28 November 2011

25 NAPF, Telling Employers about DC Pension Charges: A consultation, May 2012 NAPF, Pension Charges Made Clear: Joint Industry Code of Conduct Telling employers about DC pension charges, November 2012; ABI News Release, Wednesday, 28 November 2012, Industry publishes joint code on pension charges; The IMA guidance on Enhanced disclosure of fund charges and costs (September 2012)

26 Uncorrected Transcript of Oral Evidence on Wednesday 28 November 2012. To be published as HC 768-ii (Q81)

27 Andrew Wood et al, Pension landscape and charging: Quantitative and qualitative research with employers and pension providers, DWP Research Report No 804, 2012, Summary

28 'Webb and McClymont cautiously back code', *Professional Pensions,* 28 November 2012

they can trust."[29] *Professional Pensions* commented that although the NAPF had originally pledged that providers would be required to express charges in "pounds and pence", this "central feature of the report did not make the final cut."[30] Although the Code was welcomed by some providers as a step in the right direction, others were concerned that the focus on charges would blind employers and members to other factors affecting member outcomes, such as investments and governance.[31]

ABI agreement on the disclosure - 2013

In August 2012, the Association of British Insurers (ABI) wrote to regulators with a proposed "action plan on clearer pension charges and costs". The aim was to develop a protocol, to sit alongside the PLSA's work on disclosure to employers.[32]

The ABI published its Agreement on the Disclosure of Pension Charges and Costs in January 2013. The aim was to deliver the consistent and straightforward disclosure of pension charges and costs to employees in workplace pension saving schemes. It required:

- disclosure to employees of total charges at outset, to a standard definition, across workplace pension schemes
- disclosure of the total charges taken in the previous year. The intention is that this will be expressed in pounds and pence where reasonably practical
- disclosure of the previous year's investment transaction costs (using the IMA's Enhanced Disclosure guidance)

A common definition of all charges to be disclosed would be developed in the first half of 2013. The agreement would be implemented by summer 2014 for schemes newly established for auto-enrolment, and by 31 December 2015 for all older workplace pension schemes.[33]

Comment

In its report published in September 2013 (see below), the OFT welcomed the ABI initiative as a welcome step but noted four areas for further improvement:

> • First, we would encourage the ABI to make this single 'total charges' figure disclosable at the point when employers are choosing a scheme, in addition to using the figure for annual reporting to scheme members. This will help employers and employees to make better decisions and help encourage competition on charges. We understand that this is the intention of the ABI.
>
> • Second, we note that the definition of the 'provider charges' component of the 'total charge' figure can vary, depending on whether the provider includes the standard investment

[29] 'Cautious welcome for 'first step' charges code of conduct', Money Marketing, 28 November 2012

[30] Rachel Dalton and Hannah Brenton, 'Downward pressure: Will the NAPF charges code work?', Professional Pensions, 6 December 2012

[31] ABI News Release, Wednesday, 28 November 2012, Industry publishes joint code on pension charges

[32] ABI Press release, ABI announces action plan on clearer pension charges and costs, 23 August 2012

[33] ABI Agreement on the disclosure of pension charges and costs, January 2013

> management charges. It is important for there to be a consistent definition of what is disclosed in each component part of the 'total charges' figure and that this is clearly defined.
>
> • Third we would question whether 'total charges' is an appropriate final name for the figure given that it would not include investment transaction costs.
>
> • Finally, the OFT notes that these initiatives are currently voluntary and that not all market participants are members of these industry associations.[34]

In response, the ABI said new Independent Governance Committees would help to ensure that schemes used for auto-enrolment were governed in a way to ensure good value for money.[35]

Investment Association guidance

In September 2012, the Investment Association published voluntary guidance on Enhanced disclosure of fund charges and costs. The aim was to "provide easier access to information on fund charges and costs" In May 2014, it issued a revised Statement of Recommended Practice ("SORP") for the Annual Report & Accounts of UK Authorised funds.[36] This requires managers of UK authorised collective investment schemes to provide a new comparative table in the annual report and accounts of each fund from January 2016. This summarises (amongst other items) operating chares and direct transaction costs.[37]

3.2 OFT report

In its Defined contribution workplace pension market study published in September 2013, the Office of Fair Trading (OFT)[38] said that competition alone could not be relied upon to drive value for money:

> 1. 6 Overall we have found that competition alone cannot be relied upon to drive value for money for all savers in the DC workplace pension market. This arises from the combination of two factors:
>
> • weaknesses on the buyer side of the market. Scheme members are reliant on their employers to make most of the key decisions about their pensions for them and many employers lack the capability and/or the incentive to ensure that members of their schemes receive value for money in the long term. Good quality, independent scheme governance can help to mitigate the impact of the weak buyer side of the market by ensuring ongoing scrutiny of value for money on behalf of scheme members. However we have found the governance of many schemes across the market is not sufficiently strong to provide this scrutiny, and
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> • the complexity of the product. DC workplace pensions are complicated products, both their costs and quality are difficult to

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[34] OFT, Defined contribution workplace pension market study, September 2013, para 6.27

[35] ABI, 'Charges at lowest ever level' - ABI responds to OFT report into workplace pensions', September 2013

[36] IA website Statement of Recommended Practice

[37] DWP and FCA, Transaction Costs Disclosure: Improving Transparency in Workplace Pensions – Call for Evidence, DP 15/2, March 2015

[38] The OFT was responsible for protecting consumer interests until 2014. Its responsibilities have now been passed to different bodies.

> observe and outcomes may not be apparent for some years. This makes decision- making on value for money very difficult.[39]

It said the buyer side of the DC workplace pensions market was "one of the weakest" that it had analysed in recent years:

> 1.10 Part of the reason for this is that most employees do not engage with or understand their pensions. Pensions are complicated products, the benefits of which occur, for many people, a long time in the future. Considerable survey evidence testifies to the low levels of understanding and engagement that many employees have in relation to their pensions.
>
> 1.11 Furthermore, while the person who takes the risks and rewards of a DC workplace pension is the scheme member, they are not responsible for choosing key elements of the product. Instead, the choice of a DC workplace pension rests largely with the employer.
>
> 1.12 However, the evidence we have gathered suggests that many employers may not have the capability or the incentive to drive competition on the key elements of value for money in the interests of scheme members:
>
> • Many employers do not have the necessary understanding of workplace pensions to make good judgments on the value for money of their pension schemes. Those employers without the resources to fund the use of capable trustees, internal governance panels or high quality advice to improve decision making and 16 OFT1505 monitoring may not get the best value for money for their employees.
>
> • It also appears that many employers do not always prioritise all the elements which we consider to be key to assessing value for money (see below) when they select a scheme. Whilst some employers appear likely to prioritise ensuring that the charges that their employees face are as low as they can be, there is little evidence that many employers prioritise the key elements of scheme quality, such as investment design and performance, or scheme governance. Instead, OFT research suggests that many employers that are automatically enrolling employees into pensions for the first time are likely to prioritise minimising the costs to themselves of setting up and administering the scheme. Employers may also seek to prioritise the interests of scheme members that are current employees, over those scheme members that are former employees.[40]

There was "insufficient transparency and comparability of charges to ensure that competition on costs and charges is working optimally." It had two particular concerns:

- providers are not including costs and charges within AMCs they quote in a consistent way – which means that the AMCs being quoted by different providers are not easily comparable, and
- AMC figures do not capture all the costs and charges that a scheme member pays, in particular:

39 OFT, Defined contribution workplace pension market study, September 2013
40 Ibid

- costs associated with investment management transactions are not included in AMCs quoted by any pension providers
- pensions sold before the introduction stakeholder pensions have a range of other types of charges in addition to AMCs, including fixed monthly fees, other monthly charges as a percentage of the value of the pension pot, and initial charges levied as a percentage of members' contributions on schemes.[41]

To improve transparency, it recommended that costs and charges should be disclosed in a framework that would enable employers to compare a commonly defined single charge. The exception was transaction costs, which it said should be disclosed to Independent Governance Committees:

> 1.36. In order to address our concerns about the transparency and consistency of charges (see paragraph 1.15), we suggest that, building on the ABI's current transparency initiative, all costs and charges associated with pension schemes, including those associated with investment management, should be disclosed in a framework that will allow employers to compare a commonly defined single charge.
>
> 1.37. The only type of costs that the OFT suggests is omitted from this single charge would be investment management transaction costs because in the OFT's view their inclusion could potentially create incentives for investment managers to avoid carrying out transactions in order to keep costs down, even where this is contrary to the member's interest. However, these costs should be transparently reported and made available to Independent Governance Committees (see paragraph 1.32) who will be best placed to make an informed decision about whether transaction costs represent value for money. To this end, regulators should agree a consistent methodology for reporting comparable information on investment management transaction costs and portfolio turnover rate. We recommend that the Financial Conduct Authority (FCA) undertake this work as part of its planned competition review of wholesale markets.
>
> 1.38. In order to address our concerns about the difficulties that employers face when assessing and comparing scheme quality (see paragraph 5.22), we suggest that the DWP considers mandating that information about the key elements of scheme quality - such as scheme administration standards, past investment performance and the quality of providers' governance standards – be provided to employers in a comparable format by all providers of AE schemes where no intermediary is involved, building on the joint industry Pension Charges Made Clear code of conduct.[42]

3.3 DWP consultation

DWP said its October 2013 consultation on charging sought to examine:

> [...] whether the pensions industry can be relied on to address the issues identified by the OFT, or whether it would be necessary for

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41 OFT, Defined contribution workplace pension market study, September 2013, para 6.19

42 OFT, Defined contribution workplace pension market study, September 2013

> the Government to intervene in some way to protect people from being enrolled into schemes which have high charges.[43]

As well as consulting on proposals for a charge cap, it asked for views on potential options to improve disclosure:

> • **Mandating disclosure to members** by widening the disclosure requirements, to include information about charges, on all providers and scheme managers in respect of the basic scheme information and annual benefit statement. This would ensure a consistent approach across all scheme members.
>
> • **Standardising disclosure to employers** to introduce a standard framework for the disclosure of costs and charges, and the services provided at the point of sale through a code of conduct and on an ongoing basis by mandating information provided to employers.
>
> • **Disclosure of transaction costs** – require disclosure to members, employers, as well as trustees, and independent governance committees (as recommended by the OFT).[44]

3.4 Legislation

In debate on the *Pensions Bill 2013/14,* the then Shadow Pensions Minister, Gregg McClymont moved an amendment intended to ensure "full disclosure of all costs and charges with respect to a pension scheme.[45] The then Pensions Minister, Steve Webb, responded that the Government already had powers on disclosure.[46]

A similar amendment was moved by Opposition spokesperson, Lord Browne, at Committee Stage in the House of Lords.[47] In addition, former Chancellor of the Exchequer, Lord Lawson, moved an amendment create a power to require disclosures at least annually of certain management and transaction charges incurred by administration and management of investment portfolios.[48] Responding, Lord Bate said the Government was considering how to proceed following the consultation it had launched in October 2013.[49]

At Report Stage on 26 February 2014, the Government added a new clause to the Bill ('disclosure of information about transaction costs to members etc'). This would require regulations to be made requiring greater transparency around transaction costs by pension schemes.[50] Lord Lawson welcomed this but said more was needed.[51]

The Government made amendments to the new clause at Third Reading. Lord Freud explained that the Government would require information about costs and charges to be made publicly available. Provisions in the Bill, together with existing provisions, would enable it

43 DWP, Better workplace pensions: a consultation on charging, October 2013, Cm 8737, Executive Summary
44 Ibid
45 PBC Deb 11 July 2013 c376
46 PBC Deb 11 July 2013 c386
47 HL Deb 20 January 2014 c270GC
48 Ibid c274GC
49 Ibid, c278GC
50 HL Deb 26 February 2014 c955-8
51 Ibid c958-9

to provide for "full transparency of all pension scheme costs and charges." The amendment being made would place a duty on the Financial Conduct Authority, mirroring that on the Secretary of State, requiring disclosure and publication of information about costs for contract-based schemes.[52] Lord Lawson responded that the Minister has "met pretty well in full the points" that he had made at earlier stages of the Bill. However, one loose end remained: whether the same disclosure and transparency requirements would apply to DB schemes.[53]

A March 2014 consultation paper included proposals for "full transparency of all costs and charges in workplace pensions." Its proposals would cover "both the administration charges that come under the default fund charge cap and transaction costs":

> - From 2015, trustee boards and Independent Governance Committees will have new duties to consider and report on costs and charges, and pension schemes and providers should start making progress immediately in these areas.
> - Thereafter, the Government will introduce new requirements to standardise the disclosure of administration charges and transaction costs, making this the first international example of full transparency in pension schemes.
> - The Government will start work immediately with regulators, providers, trustees and asset managers on the design and implementation of the relevant standards and products to ensure maximum effectiveness of these transparency measures.[54]

From April 2015, schemes have been required to report annually on costs and charges:

- FCA rules required workplace personal pension schemes to set up and maintain Independent Governance Committees (IGCs) who will act in the interest of scheme members and assess, and where necessary raise concerns about value for money in workplace pension schemes;[55]
- Regulations require occupational pension schemes to appoint a chair of trustees responsible for signing off an annual statement on value for money delivered by the scheme, investment administrative costs, and transaction costs associated with buying and selling investments held within pension scheme wrappers.[56]

Consultation on disclosure

In October 2017, the Government launched a consultation on how to ensure that, when trustees were making this information available to members of occupational pension schemes, it was presented

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52 HL Deb 12 March 2014 c1770 [See also Dep 2014-0362]
53 Ibid
54 DWP, Better measures for workplace pensions – further measures for savers. Cm 8840,March 2014
55 FCA Final rules for independent governance committees, PS 15-03, February 2015; See also DP 15/2, March 2015
56 *Occupational Pension Schemes (Charges and Governance) Regulations 2015 (SI 2015/879)*

meaningfully and via channels that met members' needs. The proposed regulations would apply to those schemes already required to assess charges and transaction costs and prepare an annual governance statement already applied.[57]

3.5 Transaction costs

In a 2014 report on investment costs, the Financial Services Consumer Panel described problems with "cost opacity and cost control as widespread and longstanding." In evidence, it pointed to a series of independent reviews and reports by bodies such as the Office of Fair Trading and the Financial Conduct Authority. [58]

As explained above, section 44 of the *Pensions Act 2014:*

> […] places duties on the Secretary of State (in relation to occupational pension schemes) and the Financial Conduct Authority ('FCA') (in relation to personal pension schemes) to make regulations that require the disclosure of certain information about the transaction costs incurred by money purchase pension schemes. In addition, duties are imposed in a similar way to require information on transaction costs and administrative charges to be published.[59]

Transaction costs are the costs that a scheme incurs as a result of buying, selling, lending and borrowing investments.[60]

In a report published in 2014, the Financial Services Consumer Panel said that the full costs incurred by consumers making long-term investments were "not consistently and comprehensively defined, nor understood":

> […] the full costs borne by savers are simply not known, and costs are deducted from the fund directly by the provider. The main reasons are simply that many costs are not properly measured or declared. Even fund managers frequently do not appear to know: in its survey of fees, consultancy Lane Clark and Peacock, found that around two-thirds of investment managers could not provide information on transaction costs.[61]

It concluded that this was "not a market where competition works in the consumers' best interests". It proposed a number of possible options for reform, including a "single management investment charge" to include "all other intermediation costs, charges and expenses incurred by the investment manager, including transaction costs." It added that disclosure should be seen as a complement to structural reform, not a substitute:

> […] without a fundamental alignment of incentives, the industry is always likely to find ways around even the most prescriptive forms of regulation.[62]

57 DWP, Disclosure of costs, charges and investments in DC occupational pensions, October 2017
58 Financial Services Consumer Panel, Investment costs – more than meets the eye, 2014
59 Pensions Act 2014 – Explanatory Notes
60 SI 2015/879 – Explanatory Memorandum para 7.20
61 Financial Services Consumer Panel, Investment costs – more than meets the eye, 2014
62 Ibid

In a call for evidence published in March 2015, DWP and the Financial Conduct Authority sought views on how transaction costs should be reported:

> From April this year, Independent Governance Committees (IGCs) and pension scheme trustees will be required to report annually on the costs and charges involved in managing and investing the pension pots of scheme members.
>
> The FCA and DWP are seeking views to feed into the next phase of this work, which looks at how information about transaction costs should be reported in a standardised, comparable format.[63]

It explained that transaction costs include:

- **Explicit costs** – which are the direct costs of transacting (e.g. commissions charged on orders by brokers, fees charged by custodians for clearing and settlement, and taxes such as stamp duty; and
- **Implicit costs** – the indirect costs of transactions. Usually no receipt is given for these, but they are recognized by market participants as real costs. They include the 'bid-ask spread', market impact, missed opportunity costs and delay costs.[64]

It referred to work to increase transparency of transaction costs at European Union level and the importance of working towards achieving consistency across the information consumers would receive.[65]

In October 2016, the FCA launched a consultation on proposed rules and guidance to improve the disclosure of transaction costs:

> The rules we are consulting on here set out a standard way in which transaction costs should be disclosed, using the approach described as slippage cost. They require those managing investments to report transaction costs in response to a request from a pension scheme, whether a workplace pension or occupational pension, that is required to obtain them. We consider that this will lead to greater availability of transaction costs for governance bodies. Because Section 44 of the Pensions Act 2014 includes an equivalent duty to make rules.[66]

Its policy statement, published in September 2017, said that:

> 1.2 With effect from 3 January 2018, in response to a request from the governance body of a relevant pension scheme, firms must provide:
>
> - information about transaction costs calculated according to the 'slippage cost' methodology
> - information about administration charges
> - appropriate contextual information
>
> Where firms do not have the relevant information, they must seek it from other firms, and those other firms, where they are

63 FCA and DWP publish call for evidence on transaction costs, March 2015
64 FCA and DWP, Transaction Costs: Improving Transparency in Workplace Pensions – Call for Evidence, March 2015, see the foreign exchange example on page 26
65 Ibid, p12
66 FCA, Transaction cost disclosure in workplace pensions, CP 16/30, October 2016

Financial Conduct Authority (FCA) authorised, must provide the information.

1.3 The methodology for calculating transaction costs matches that required for products subject to the Packaged Retail and Insurance-based Investments (PRIIPs) Regulation. This aligns our final rules with work firms will already be required to do and ensures consistency with firms' European obligations.

1.4 By setting out a methodology for calculating transaction costs in a consistent way, and by placing obligations on firms to respond to requests for information about costs, we are building the foundations that will enable the governance bodies of these schemes to meet their obligations to review and consider the value for money of transaction costs and administration charges.

1.5 Beyond this, following our Asset Management Market Study2, we have set in train a number of initiatives that will further enhance the ability of both governance bodies and consumers to obtain the information that they need, in a way that helps them to assess those managing money on their behalf.[67]

As explained above, a consultation is ongoing on how transaction cost information should be presented when disclosed to scheme members and others.

[67] FCA, Transaction cost disclosure in workplace pensions, PS 17/20, September 2017

4. The charge cap

The duty to auto-enrol applies in respect of jobholders who are not already an active member of a "qualifying scheme".[68] A qualifying scheme has to meet certain conditions. For example, in the case of a defined contribution scheme, a minimum level of contributions must be paid into it (3% from the employer and 8% in total).[69] Where the jobholder is not a member of a qualifying scheme, they must be enrolled into an 'automatic enrolment scheme', which must certain requirements.[70] For example, automatic enrolment schemes are required to have a default option, so that members need not express an investment choice.[71] In 2011, DWP guidance stated that charges in the default option should not be excessive and should be clearly disclosed.[72]

The legislation to introduce auto-enrolment provided the Secretary of State with power to establish a charge cap for qualifying schemes.[73] This was extended by the *Pensions Act 2011* (s10) extended this power to cover charges to deferred members (i.e. early leavers with entitlement to a preserved pension) as well as active members. This was in response to concerns about the impact of "active member discounts" (whereby higher charges are applied to deferred members).It also clarified the sorts of charges that would be covered by the cap.[74]

Implementation

In terms of when the cap would be implemented, the then Pensions Minister Steve Webb explained that he did not think charges would be a problem in the early stages of auto-enrolment. This was because the new duties would apply first to large employers, who were already engaged with pensions and could "drive a hard bargain."[75] The challenge would come when the new duties applied to medium and smaller firms.[76]

In evidence to the Work and Pensions Committee, he said the Government would act if necessary. Important issues to be decided included the definition of charges to be capped and to ensure people were still able to opt for schemes with higher charges if they wanted to.[77] In its report on auto-enrolment published in 2012, the Work and Pensions Committee recommended that the Government should consider using its powers to intervene from 2013 onwards:

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68 Pensions Act 2008 s3 For more detail, see Library Note SN 6417 Automatic enrolment – 2010 onwards
69 Pensions Act 2008, s16 and ss 20-28
70 Pensions Act 2008 s17; Explanatory Notes, para 58
71 Section 17 (2)
72 DWP, Guidance for offering a default option for defined contribution automatic enrolment pension schemes, May 2011
73 *Pensions Act 2008* s16 (3)
74 PBC Deb, 14 July 2011, c263-4; Explanatory Notes to Pensions Act 2011, para 85
75 Ibid
76 HC Deb, 7 December 2011, c126-9 WH
77 Steve Webb in evidence to the Work and Pensions Committee, 25 January 2012, c374

> From 2013 onwards, if it transpires that some auto-enrolment providers are applying hidden charges, or charges that represent poor value for money, the Government should use its powers to intervene.[78]

In response, the Government said it would continue to monitor the situation.[79]

The Committee made a further recommendation on charges in its report on improving governance and administration in workplace pension schemes, published in April 2013:

> *We further recommend that the Government carefully monitors the level of pension scheme charges more generally and reviews its position on capping charges in auto-enrolment schemes frequently, at least bi-annually, commencing in 2014. It should act without hesitation if it becomes apparent that some pension scheme members are at risk of detriment from high charges.*[80]

The Government said would consult on proposals in autumn for "a cap on charges in the default funds for DC schemes."[81]

The Office of Fair Trading, which published the report of its defined contribution workplace pension market study on 19 September, was concerned that a charge cap could have unintended consequences:

> 1.40 We have considered whether a charge cap might be a more effective approach to address the potential consumer detriment arising from legacy schemes. However we concluded that the audit process above is preferable for three main reasons. First, from the evidence we have seen, some legacy schemes may offer value for money benefits such as guaranteed annuities. We are concerned that a blanket approach, such as a charge cap, could result in such benefits falling away. Second, as noted above, we have found up to 18 different names and configurations of charges for legacy schemes. Defining a charge that captures all these configurations and setting the level of the cap on that charge would be difficult in this context. Finally and more generally, charge caps can create a risk of unintended consequences. Set too high, a cap can become a target for providers. Set too low, a cap can create incentives for providers to lower quality and/or impose less visible charges elsewhere. While we would not rule out a charge cap, it should be considered in full knowledge of the different charges and benefits that apply in the market and of the risks that a cap might entail. We consider the audit of scheme charges to be an important part of that process.[82]

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78 Work and Pensions Committee, Automatic enrolment in workplace pensions and the National Employment Savings Trust, Eight Report of Session 2010-12, HC 1494, March 2012

79 Work and Pensions Committee - Second Special Report, Automatic enrolment in workplace pensions and the National Employment Savings Trust: Government Response to the Committee's Eighth Report of Session 2010-12 (23 May 2012).

80 Work and Pensions Committee, Improving governance and best practice in workplace pensions, Sixth Report of Session 2012-13, HC 768-I, April 2013

81 Improving governance and best practice in workplace pensions: Government Response to the Committee's
Sixth Report of Session 2012–13, First special report of session 2013-14, 26 June 2013

82 OFT, Defined contribution workplace pension market study, September 2013, para 1.40

In evidence to the Work and Pensions Committee on 23 October 2013, the Steve Webb agreed that there were complex issues to be considered:

> We will very shortly produce our consultation on charges. The key point, as the OFT rightly said, is a charge cap is not a no-brainer. Some people say, "Just cap charges; it is obvious." The OFT said no; there were two or three things to think about. First of all, how do you define what it is you are capping? The OFT said there are 18 different sorts of charges they have identified, so you have to sort out which of those you are counting. You have to have the data. Alright, you set a cap. Where do you set it? Do we know enough about current charges? We are about to do a big review of legacy schemes, because none of us know much about the pre-2001 scheme, so we are data gathering. The third worry they had was levelling up. You set a charge cap. Does that just mean everyone drives up to the cap? I think those things can all be dealt with, but part of our consultation will be asking people how they can be dealt with.[83]

4.1 October 2013 consultation

In the Report Stage debate of the Pensions Bill on 29 October 2013, the Minister announced his intention to publish a consultation paper, which would include the option of a 0.75% charge cap and would discuss what should be included in that cap.[84] The consultation document, Better workplace pensions: a consultation on charging, was published on 30 October 2013. It asks for views on whether and how a cap should be set for "qualifying schemes" used for auto-enrolment from April 2014:

> 15. There is evidence to suggest that information alone may not act to correct the incentive problems that exist in this market and some employers will struggle to act on any information they receive. Therefore the Government is interested in hearing views on whether:
>
> • **A cap on pension scheme charges should be introduced** for all members, both active and deferred, of default funds in qualifying DC schemes for those employers staging from April 2014. This cap would then be extended to capture all employers who have staged from October 2012 up to and including March 2014 by April 2015. The Government is considering three options for capping charges:
>
> – **Option 1: A charge cap of 1 per cent of funds under management**, reflecting the current stakeholder pension cap.6
>
> – **Option 2: A lower charge cap of 0.75 per cent of funds under management**, reflecting the charging levels already being achieved by many schemes.
>
> – **Option 3: A two-tier 'comply or explain' cap**. There would be a standard cap of 0.75 per cent of funds under management for all default funds in DC qualifying schemes. A higher cap of 1 per cent would be available to employers who explained to the

[83] Work and Pensions Committee, Update on auto-enrolment and a range of current pensions issues, HC 728, Wednesday 23 October 2013
[84] HC Deb 29 October 2013 c775

> Pensions Regulator the reason for charges in excess of 0.75 per cent.[85]

The consultation document also asks whether active member discounts should be banned in qualifying schemes:

> **Differential charging between active and deferred members should be banned in DC qualifying schemes**: this would address active member discounts (AMDs) and prevent a similar practice whereby scheme members are moved to an individual personal pension with higher charges when they leave employment and stop making contributions. This ban could take effect for schemes put in place for employers staging from April 2014. We are interested in views on transitional arrangements for dealing with schemes in place prior to this date.[86]

Initial responses

Pension provider Aegon warned that an outright charge cap could harm the auto-enrolment policy, arguing that "value for money" did not necessarily mean the lowest price:

> Low charges have obvious surface appeal but they can also produce adverse consequences for customers – poorer quality of services, less choice and loss of investment in innovation and development.[87]

Director General of the ABI, Otto Thoreson said:

> It is important that any cap doesn't have the effect of levelling charges up. The detail around what is included in the charge definition will be crucial, as is the need to recognise that other factors contribute to customers receiving value for money.[88]

Adrian Boulding of Legal and General argued that the benchmark charge level should be 0.5%:

> There are two ways forward. The Pensions Minister could use his statutory powers to impose a cap equivalent to 0.5% pa. Or, [The Pensions Regulator] could let it be known that employers who choose to auto-enrol people into schemes with higher charges than the state provider National Employment Savings Trust (NEST) are exposing themselves to challenge that they have disadvantaged their staff.[89]

Which? urged Ministers to set the cap lower than 0.75%, saying that:

> Even a fraction of a per cent can have a significant impact on pension funds, and people need to be confident that their scheme is giving them the best value for money. We also need to see tight regulation so these charges can't simply be hidden elsewhere, and the government should look at what can be done to bring down charges on existing schemes set up before 2001.[90]

[85] DWP, Better workplace pensions: a consultation on charging, Cm 8737, October 2013; HM Treasury and DWP, Government to bring forward reforms to help savers and protect pension pots, 30 October 2013
[86] Ibid
[87] IFAonline, Aegon warns 0.75 pension charge cap may not fit, 30 October 2013
[88] BBC News, Pension fees cap plan unveiled by government, 30 October 2013
[89] Naomi Rainey, Charge cap won't guarantee AE value for money, Professional Pensions, 30 October 2013
[90] BBC News, Pension fees cap plan unveiled by government, 30 October 2013

The National Association of Pension Funds described the cap as a "blunt tool" and was concerned that it would "inhibit innovation."[91]

Andrew Warwick-Thompson, executive director for defined contribution, governance and administration at the Pensions Regulator made the point that value for money was not just about low cost, the quality of member service was also critical.

> You can have high charges but with absolutely superlative service to members, and I would regard that as good value for money.[92]

4.2 Legislation

When it was introduced into the House of Commons in July 2013, the *Pensions Bill 2013/14* included provision to extend an existing power in the *Pensions Act 2008* to limit administration charges in 'qualifying schemes' used for auto-enrolment:

> 140. Clause 35 extends the existing power in the PA 2008 to limit administration charges in qualifying pension schemes used to fulfil an employer's duties under Part 1 of the PA 2008. It broadens the power, given greater flexibility for how charges can be limited and allows the Secretary of State to restrict the kinds of charges which may be made in qualifying schemes. The clause also enables detail of how any restrictions and limits work in practice to be set out in statutory guidance."[93]

However, at Report Stage on 29 October, the Government replaced this with a clause that would ensure the Government had the ability to apply standards to a broad range of schemes:

> [...] allow for regulations to limit or prohibit charges and to impose governance and administration requirements for pension schemes specified in regulations. This will ensure that Government has the ability to apply these standards to a broad set of schemes, and in particular those that are closed to new members or to new accruals. This follows the Office of Fair Trading's report on the market for Defined Contribution workplace schemes, which raised particular concerns about standards in legacy schemes. The Government will also consult shortly on charges in Qualifying Schemes, including on options for a charge cap.[94]

Steve Webb explained that:

> Government new schedule 1 and Government new clause 1 give us the power to put a set of powers to cap and regulate charges and quality all in one place. That includes automatic enrolment schemes, qualifying schemes and closed schemes. Lots of people have lots of money tied up in closed schemes. Without those measures, we would not necessarily have the powers we need to regulate the charges they pay. In some ways, the charges that people in closed schemes are paying—they are often old, high-

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[91] BBC website, Pension scheme charges cap proposed by minister, 30 October 2013

[92] Josephine Cumbo and David Oakley, Pensions regulator warns of 'race to bottom' over charges cap, *Financial Times,* 15 November 2013

[93] Bill 6-EN, para 140; More on the background to this is in Library Note SN 6209 Pension scheme charges

[94] DWP, Government Amendments to the Pensions Bill 2013 (Commons Report Stage) – briefing paper, October 2013

> charge schemes—are worrying, because people are often not engaged with their pension saving in a closed pension scheme.[95]

The Delegated Powers and Regulatory Reform Committee (DPRRC) raised concerns about the broad nature of the powers in Schedule 17.[96] However, the Government said it considered the broad scope of the powers to be necessary.[97]

At Report Stage in the House of Lords, Opposition spokesperson Lord Browne moved an amendment to require the Secretary of State to make regulations providing for a cap on charges by the end of April 2015. He said:

> This is the last opportunity for your Lordships' House to make it clear that Parliament has a different set of priorities which are in favour of the saver and not the industry. It can do so simply by creating a statutory deadline to compel the use of the power to cap, which the Government reluctantly put in this Bill by way of an amendment following the OFT report, on the date that the Government are creating the impression that it will be used by.[98]

Lord Turner said the issue of total charges was fundamental to what the Bill was trying to achieve and that a charge cap was needed, in addition to a requirement to disclose all costs:

> Although a price cap on explicit costs is important, it is not sufficient. That is why I strongly support the sentiment of the amendment of the noble Lord, Lord Lawson, which seeks to cover all the other costs which are not covered in explicit fund management charges.[99]

Conservative Peer Lord Eccles opposed the proposal for a charge cap, arguing that "picking a figure for the price control would be a very foolish thing for any Government to do."[100]

Lord Freud said the Pensions Minister had said he was "strongly minded" to cap charges. The Government's response to its consultation would be published shortly.[101]

4.3 Response to consultation

On 23 January 2014, Pensions Minister, Steve Webb announced that any cap would not be introduced before April 2015. The Government remained 'strongly minded to cap pension scheme charges in default funds used for auto-enrolment:

> This Government are committed to tackling high charges in workplace pension schemes, in particular, for those workers who do not exercise any choice, where they are automatically enrolled into a scheme then remain in the default fund.

95 HL Deb 29 October 2013 c776
96 Delegated Powers and Regulatory Reform Committee, Thirteenth Report 2013/14, 20 November 2013
97 DPRRC – Sixteenth Report, Government's Responses to Two Bills. 12 December 2013
98 HL Deb 26 February 2014 c963-4
99 Ibid c965
100 Ibid c967
101 Ibid c968; DWP, Better workplace pensions: a consultation on charging, November 2013

> Our consultation on pension scheme charging closed at the end of November. We continue to examine the responses, and will bring forward further proposals, in due course. However, one strong theme to emerge is about the timing for the implementation of any changes.
>
> We remain strongly minded to cap pension scheme charges in the default funds used for automatic enrolment. However, we have consistently encouraged firms to start getting ready for automatic enrolment 12 months ahead of the time the new employer duties apply to them. Therefore, to give those employers at least 12 months' notice of the rules that will apply to them, I can confirm that any cap on charges will not be introduced before April 2015.[102]

In March 2014, the Government announced that it would set a charge cap of 0.75% for default funds of DC qualifying schemes used for auto-enrolment from April 2015. It would cover all member-borne charges and deductions excluding transaction costs.[103]

The charge cap was legislated for in the *Occupational Pension Schemes (Charges and Governance) Regulations 2015 (SI 2015/879)* and came into force from April 2015.[104] The FCA made equivalent rules for workplace personal pension scheme.[105]

The Government has committed to a review of the charge cap in 2017, including its level and whether it should include some or all transaction costs.[106]

4.4 Review

Pensions Minister Guy Opperman announced on 16 November 2017 that the cap was working broadly as intended and that it did not feel now was the time to change the level of scope of the cap:

> The Government has now completed the examination of the cap that applies to member-borne charges in default investment funds within defined contribution (DC) pension schemes used for automatic enrolment (AE).
>
> After seeking a range of industry and consumer views and considering the findings of the recent Pension Charges Survey, which captures data from providers covering 14.4 million scheme members, we do not feel that now is the right time to change the level or scope of the cap.
>
> The cap is working broadly as intended, helping to drive down member-borne costs, whilst allowing flexibility to allow asset diversity or tailored services for members and employers. It appears some small schemes are less able to take advantage of the most competitive market rates, and we have launched proposals to simplify the scheme consolidation process. This will allow smaller schemes who cannot secure value for money in the

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102 HC Deb 23 January 2014 c14WS

103 DWP, *Better workplace pensions: further measures for savers,* Cm 8840, March 2014, chapter 3

104 SI 2015/879, Explanatory Memorandum

105 FCA PS 15/5 Final rules for charges in workplace personal pension schemes and feedback on CP 14/24

106 HL Deb 19 December 2016 c1528 [Lord Freud]; DWP, Transaction Costs Disclosure: Improving Transparency in Workplace Pensions, March 2015 Page 15, para 7

long term to exit the market and secure a better deal for their members elsewhere.

There continues to be a lack of transparency on transaction costs, which is hindering trustees and Independent Governance Committees' (IGC) attempts to monitor and evaluate whether these represent value. We believe that it is vital to get disclosure right before deciding on whether a cap on transaction costs is appropriate. Recently announced DWP legislative proposals will ensure trustees have sight of these costs and can give that information to members. The FCA is developing similar rules for providers.

The Government remains committed to ensuring AE members are protected from unreasonable and unfair charges, and recognises that there is on-going concern amongst consumers.

We will actively monitor the situation, by reviewing the information which trustees of DC schemes will be required to publish from April 2018, and which providers will publish in due course, to monitor whether the downward trend in charges is continuing.

That will also inform our next review. In 2020 we intend to examine the level and scope of the charge cap, as well as permitted charging structures, to see whether a change is needed to protect members. This will also allow us to evaluate the effects of the next stage of AE and the new master trust and transaction costs.[107]

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[107] HCWS 16 November 2017

5. Active member discounts

Some schemes operate Active Member Discounts (AMDs) - where early leavers with deferred pension rights pay a higher AMC than active scheme members.[108] The OFT said a number of factors led it to believe AMDs "may lead to consumer detriment."[109] In March 2014, the Government said it agreed AMDs were unfair:

> - Firstly, the majority of automatically enrolled savers will have little or no experience of pensions and saving products, making it difficult for them to engage with their charges. In this scenario, bearing in mind that automatic enrolment has been designed to harness inertia, if an employee receives notice that their charges are about to rise because they have become deferred, they are unlikely to act on this information.
> - Secondly, when the average person moves jobs 11 times during their working life, the policy of automatically enrolling employees into a workplace pension could result in significantly more deferred members than active ones – at any one time each active member of one qualifying scheme may well be a deferred member of a number of other schemes too. The possibility for consumer detriment if AMDs continue to exist is therefore significant. Indeed, modelling from the consultation document showed that a deferred member of a scheme charging a 1 per cent AMC which increases to 1.5 per cent when the member stops contributing, would lose an additional 7 per cent of their pot if they became deferred.[110]

It would ban them in auto-enrolment qualifying schemes in two stages:

> 27. Nonetheless, having analysed the evidence and information sent in response to the consultation, we recognise that an immediate ban on AMDs in existing qualifying schemes could adversely impact the implementation of automatic enrolment. Furthermore, we recognise that it may be more complex to remove an AMD from a scheme than to reduce that scheme's charges below the level of the cap. Therefore we propose to give employers two years to remove AMD structures from qualifying schemes:
>
> • From April 2015 the default fund charges for both active and deferred members of qualifying schemes should fit under the default fund charge cap of 0.75 per cent of funds under management.
>
> • From April 2016 no qualifying schemes should contain an AMD or similar mechanism that results in higher charges for deferred members.[111]

Legislation for this was in the *Occupational Pension Scheme (Charges and Governance) Regulations 2015 (SI 2015/879).*

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108 Ibid
109 OFT, *Defined contribution workplace pension market study,* September 2013, para 1.22
110 DWP, Better measures for workplace pensions – further measures for savers. Cm 8840, March 2014
111 Ibid

6. Consultancy and commission charges

The Retail Distribution Review conducted by the FSA had as one of its main drivers concern about the way advisers were paid and the influence that commissions had both on the choice of product and on its performance. Its aim was to ensure that:

- consumers are offered a transparent and fair charging system for the advice they receive
- consumers are clear about the service they receive; and
- consumers receive advice from highly respected professionals.[112]

The effect of new rules which came into force in January 2013 is to ban pension providers from paying commission to advisers for recommending their products. Instead, have to "explicitly disclose and separately charge clients for their services."[113] DWP explained that the RDR had introduced a new concept of consultancy charging:

> Where an employer is not prepared to pay a fee to an adviser, but wants to use an adviser in connection with providing a workplace personal pension, they are able to agree a consultancy charge with the adviser. Consultancy charges enable employers to pass on the costs of advice to the individual members who join the pension scheme.[114]

DWP research found that few providers "expected employers that previously paid commission to be willing to pay a fee for advice, and most were unsure whether FSA-permitted alternatives to commission, such as consultancy charging, would be accepted in the market. Consequently, in mass market schemes, many providers expected to sell schemes directly to employers with no intermediary involvement at all. Some providers lamented the loss of advice to the part of the market that was currently serviced by commission-based intermediaries. Others felt that after 2012 the nature of the pensions market would not require it.[115]

In its report, published in April 2013, the Work and Pensions Committee recommended that the Government ban the use of member-borne consultancy charging in auto-enrolment schemes:

> Member-borne consultancy charging has the potential to cause serious consumer detriment and to damage confidence in pension saving and auto-enrolment. While we appreciate that the costs of complying with auto-enrolment can be a significant issue for some, especially small, employers, and therefore that it may be

[112] FSA website – Retail Distribution Review; See also Library Note SN5528 Retail Distribution Review (July 2011)
[113] FSA website – Retail Distribution Review
[114] Explanatory Memorandum to Occupational and Personal Pension Schemes (Automatic Enrolment) (Amendment) Regulations 2013 (SI 2013 No.XX)
[115] DWP Research Report No 753 , Likely industry responses to the workplace pension reforms: Qualitative research with pension providers and intermediaries, 2011, Executive summary

> reasonable in some circumstances for some or all of the routine costs of a scheme to be borne by the members, we do not think it appropriate, given the existence of low-cost schemes, for members to suffer the detriment of consultancy charges. We therefore recommend that the Government bans the use of member-borne consultancy charging in auto-enrolment qualifying schemes without delay. Until the ban has been put in place, the Government and the regulators should issue clear guidance to the pensions industry as a matter of urgency, to clarify the level of consultancy charges that they assess as being acceptable.[116]

On 10 May 2013, the Pensions Minister announced the Government's intention to "ban consultancy charges in automatic enrolment schemes."[117] He said that "by announcing these steps, we have sent a clear signal to the pensions industry about the risk that consultancy charges pose in terms of member detriment."[118]

The Association of British Insurers said there was a risk that it would "reduce the available to employers of advice and support to ensure they make the right pensions decision for their employees."[119]

Draft regulations to implement the ban on consultancy charges in auto-enrolment schemes were laid before Parliament on 1 July 2013.[120] In debate on the regulations, the Pensions Minister said they appear to be "universally popular in that it tackles a concern about charges in pension schemes." In response to concerns that had been raised, he argued that the reform would help improve the supply of advice:

> We are not saying that advice is a bad thing; we are not saying that some firms will not want to take advice; rather, we want the costs of advice to be transparent. Indeed, we believe that our changes have already generated much more of a market in advice because, instead of there being almost hidden consultancy charges, employers can now shop around more readily for people who will charge them for advice, so they can strike a good deal. We are finding that new advice products are coming into the market as a result, because those providers can now compete with the consultants who are already in the market..[121]

The *Occupational and Personal Pension Schemes (Automatic Enrolment) (Amendment) Regulations 2013 (SI 2013/2328)* provided that an automatic enrolment scheme:

> [...] must not include a provision which allows for any amount to be deducted from contributions or investment returns, or for the value of a jobholder's rights to be reduced by any amount, where

[116] Work and Pensions Committee, Improving governance and best practice in workplace pension schemes, Sixth Report, 17 April 2013
[117] HC Deb, 10 May 2013, c21 WS
[118] Improving governance and best practice in workplace pensions. Government response to the Work and Pensions Committee' sixth report of 2012-13, First special report of 2013/14. 17 June 2013
[119] MoneyMarketing, ABI: Consultancy charging ban puts auto-enrolment at risk, 10 May 2013
[120] Explanatory Memorandum – The Occupational and personal pension schemes (automatic enrolment) regulations 2010 (SI 2010/772), regulation 35
[121] HC Deb, 4 September 2013, c3-5

> the amount is to be paid to a third party under an agreement between the employer and the third party.[122]

Questions posed in the October 2013 consultation document include whether the ban on consultancy charges should be extended to all DC "qualifying schemes":

> **The ban on consultancy charges should be extended from AE schemes to all qualifying DC schemes**. Since September 2013, the use of consultancy charges in automatic enrolment schemes has been banned following a review which found they posed a significant risk of scheme member detriment. This ban does not encompass members of qualifying schemes, however, and so we may look to extend it. It is important to ensure all savers are protected, so we are considering how to extend the consultancy charges ban.[123]

DWP explained that, while all automatic enrolment schemes are qualifying schemes, only some qualifying schemes are automatic enrolment schemes.

> A qualifying scheme is a tax-registered, occupational or personal pension scheme that satisfies the minimum contribution requirements for automatic enrolment. Such schemes may have been in existence prior to the introduction of automatic enrolment. An automatic enrolment scheme is a qualifying scheme specifically set up for automatic enrolment that will accept anyone who is automatically enrolled or opts in. The scheme does not require anyone to express a choice or provide information to become, or remain, an active member.[124]

The consultation also asked whether adviser commissions set up prior to the introduction of the RDR should be banned in qualifying schemes.[125]

In March 2014, the Government said it agreed with the OFT that some charging structures were inappropriate for auto-enrolment schemes and would act to ban them:

> • The Government agrees with the OFT's analysis that some charging structures are inappropriate for the automatic enrolment environment.
>
> • From April 2015, no qualifying scheme will be able to contain a consultancy charge structure.
>
> • Between April 2015 and April 2016, any commission payments will be subject to the overall default fund charge cap, set at 0.75 per cent of funds under management, on member-borne deductions in the default funds of qualifying schemes.
>
> • From April 2016, no qualifying scheme can contain member-borne commission payments to an adviser.[126]

Occupational and Pensions Schemes (Charges and Governance) (Amendment) Regulations 2016 (SI 2016/304) amended SI 2015/879 to implement a ban on new member-borne commission arrangements in

122 Explanatory Memorandum – The Occupational and personal pension schemes (automatic enrolment) regulations 2010 (SI 2010/772)
123 DWP, Better workplace pensions: a consultation on charging, Cm 8737, October 2013
124 Ibid, footnote 7
125 Ibid
126 DWP, Better measures for workplace pensions – further measures for savers. Cm 8840, March 2014

occupational pension schemes used as qualifying schemes for automatic enrolment from 6 April 2016.[127]

Pension Schemes Act 2017

The *Pension Schemes Act 2017* (s41) provided for regulations to be made which override terms of certain contracts, which conflict with the regulations. The Explanatory Notes say:

> 12 The Act amends existing legislation to allow regulations to be made which override terms of certain contracts which conflict with the regulations. This seeks to support the government's intention to introduce a cap on early exit charges in certain occupational pension schemes.
>
> 13 This change will also support the commitment the government made in March 2014 to ban member-borne commission charges arising under existing arrangements in certain occupational pension schemes. Member-borne commission charges under new arrangements were banned from April 2016.

An impact assessment was produced when the legislation was before Parliament.[128]

The detail was provided for in the *Occupational Pension Schemes (Charges and Governance) (Amendment) Regulations 2017 (SI 2017/774).*

[127] This was preceded by consultation in November 2015
[128] DWP, Banning member-borne commission in occupational pension schemes, Impact Assessment, December 2015

7. Early exit charges

The Government legislated in the *Bank of England and Financial Services Act 2016* (s35) to give the FCA a duty to:

> […] make rules requiring relevant firms to limit the early exit charges imposed in relation to contract-based schemes, at a rate (or rates) set by the FCA, following further cost-benefit analysis in relation to the appropriate level of any cap.[129]

In debate on the Bill, Financial Secretary to the Treasury Harriet Baldwin said the FCA was "best placed to determine how best to apply any cap, to ensure that early exit charges are not a deterrent to individuals using the freedoms."[130]

The FCA published a consultation paper on capping early exit pension charges in May 2016. It proposed that:

> for existing contract-based personal pensions, including workplace personal pensions, exit charges will be capped at 1% of the value of a member's pot. Firms will not be able to apply any exit charge for personal pension contracts entered into after the proposed new rules come into force.[131]

On 15 November 2015, it said it considered its original analysis was appropriate and it remained of the view that:

> 1. A cap of 1% of the member's benefits in relation to existing contracts delivers the appropriate protection required by the duty. It strikes a proportionate balance between benefits, in terms of reducing the deterrent effect of early exit charges, and costs to firms of applying the cap.
>
> 2. A cap of 0% for new contracts prevents the emergence of early exit charges in future, with little financial impact for most firms. The consultation responses support our findings that a) exit charges are no longer a feature of the majority of recent personal and stakeholder pension schemes; and b) the implementation of the Retail Distribution Review ('RDR') in effect removed any real justification for their inclusion in new contracts.[132]

In parallel, DWP launched a consultation on *Capping early exit charges for members of occupational pension schemes*. This set out the approach the FCA had adopted to determining the level of the cap in relation to personal pensions. It also considered the definition of early exit charges that should be applied in occupational pension schemes, statutory exclusions from that definition and how the cap should be implemented in occupational pension schemes. Responses were requested by 16 August.

In its response, the Pensions and Lifetime Savings Association said that while individual savers should not face prohibitive charges for accessing

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[129] Ibid para 2.16
[130] PBC Deb 23 February 2016 c119-20
[131] FCA proposes cap on early exit charges, 26 May 2016; CP 16/15 Capping early exit pension charges, May 2016
[132] FCA, Capping early exit pension charges: feedback on CP16/15 and final rules, November 2016, para 1.18

their benefits early, this needed to be "balanced in certain circumstances against considerations of proportionality and fairness for the membership as a whole." It was pleased that the proposals to cap early exit fees had been:

> […] designed to capture those fees which explicitly penalise those looking to access their benefits before the scheme's normal retirement age and do not prohibit schemes from recouping administrative costs in a way that is fair for the membership as a whole. Provided the Government achieves the aims it has set for itself in legislation we believe this approach will be successful in enabling savers to take advantage of the freedoms while ensuring cost recovery remains fair and sustainable for all scheme members.[133]

As stated above, the *Pension Schemes Act 2017* enabled regulations to be made to override certain contractual terms, in order to support the government's intention to introduce a cap on early exit charges in certain occupational pension schemes.[134]

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133 PLSA, Response to capping early exit charges for members of occupational pension schemes, August 2016

134 Pension Schemes Bill [HL] 2016/17 -Explanatory Notes

8. Legacy schemes

On 17 January 2013, the Office of Fair Trading (OFT) launched a study to examine whether the defined contribution workplace pension market was working well for consumers.[135] In the report of its investigation published on 19 September 2013, OFT said it had found that competition alone could not be relied upon to drive value for money for all savers in DC workplace pensions:

> Overall, the OFT found that competition alone cannot be relied upon to drive value for money for all savers in the DC workplace pension market. This arises from the combination of two factors:
>
> The complexity of the product. The complexity makes it difficult to make the right choices about pensions, for individual savers and employers.
>
> Employers, who have the responsibility of deciding which pension scheme to choose for their employees, may often lack the capability or the incentive to assess value for money. [136]

The OFT found that there was a particular risk of savers losing out in two parts of the market – 'legacy schemes' (old and/or high charging schemes) and small trust-based schemes. It was concerned that similar problems might occur in future without measures to improve the governance and scrutiny of pension schemes on behalf of savers and the quality of information available. To address these issues, it had secured agreement with the industry and the Pensions Regulator on a number of measures:

> **Dealing with old and/or high charging schemes.** To address the OFT's concerns about old and high charging contract and bundled-trust schemes, the Association of British Industries and its members have agreed to an immediate audit of these schemes, aimed at ensuring savers are getting value for money. This will be overseen by an independent project board.
>
> **Dealing with issues with small trust based schemes.** To address the OFT's concerns about small contract based schemes, the Pensions Regulator (TPR) has agreed to take rapid action to assess which smaller trust based schemes are not delivering value for money. The Department for Work and Pensions (DWP) has agreed to consider whether the TPR needs new enforcement powers to tackle the problem.
>
> **Improving governance.** To address the OFT's concerns about lack of independent scrutiny of contract based schemes, the ABI has agreed that their members will establish independent governance committees. Committees should recommend changes to providers and escalate issues to regulators where they see risks of poor outcomes for savers. We recommend that the key elements of this governance solution should be embedded by the Government in a minimum governance standard that will apply to all pension schemes.
>
> **Improving the quality of information available on costs and charges**. The OFT recommends DWP consult on improving the transparency and comparability of information about the charges

[135] OFT, Defined contribution workplace pension market study, September 2013
[136] Ibid

> - including whether providers could disclose a single Annual Management Charge and investment transaction costs - and quality of schemes in order to make employers' initial choice of scheme easier.
>
> **Preventing future risks of detriment.** The OFT recommends DWP consult on preventing schemes being used for auto-enrolment that contain in-built adviser commissions or that penalise members with higher charges when they stop contributing into their pensions.[137]

The OFT made a provisional decision not to make a reference to Competition Commission but asked for views on this by the end of October 2013:

> The OFT has provisionally concluded that the legal test for making a Market Investigation Reference (MIR) to the Competition Commission is met.
>
> However, in light of the fact that there are steps in place to address the competition concerns that we have identified, we have provisionally concluded that an MIR would not be appropriate in this instance.[138]

The OFT identified 'legacy schemes' (i.e. any scheme set up pre-2001 when stakeholder pensions were introduced) as a particular source of concern:

> 1.19 Based on the evidence we received, the lack of switching in the market may have resulted in around £30 billion of contract and bundled trust based assets (approximately one quarter of the total assets in those schemes) being left in schemes with charges at risk of being poor value for money. We estimate AMCs on schemes sold before 2001 (so-called 'legacy schemes') are currently 26 per cent higher on average than those sold after April 2001.[139]

The ABI and those of their members that provided contract-based DC pensions had agreed to carry out an audit of 'at risk' schemes by the end of December 2014. An Independent Project Board would determine what action needed to be taken and new Independent Governance Committees would ensure the recommendations were carried out. It concluded that this process was preferable to a charge cap for three main reasons:

> First, from the evidence we have seen, some legacy schemes may offer value for money benefits such as guaranteed annuities. We are concerned that a blanket approach, such as a charge cap, could result in such benefits falling away. Second, as noted above, we have found up to 18 different names and configurations of charges for legacy schemes. Defining a charge that captures all these configurations and setting the level of the cap on that charge would be difficult in this context. Finally and more generally, charge caps can create a risk of unintended consequences. Set too high, a cap can become a target for providers. Set too low, a cap can create incentives for providers to lower quality and/or impose less visible charges elsewhere. While we would not rule out a charge cap, it should be considered in

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137 Ibid
138 OFT website, Defined contribution workplace pension market study, November 2013
139 OFT, Defined contribution workplace pension market study, September 2013

> full knowledge of the different charges and benefits that apply in the market and of the risks that a cap might entail. We consider the audit of scheme charges to be an important part of that process.[140]

In its consultation on charging, DWP said there were powers in the Pensions Bill to introduce a cap if necessary:

> 18. We will continue to work closely with both the OFT and the Pensions Regulator as this audit is taken forward. The *Pensions Bill 2013–14* includes powers to set minimum quality standards on workplace pension schemes, including to limit charges in these schemes. Once this work is complete we will consider whether any further action is required to deal with the issues identified by the OFT.[141]

DWP and the FCA published an update on progress in December 2016. They said progress had been made, although there were still problems in 15-16% of schemes:

> The IPB recommended that scheme providers put in place plans, by the end of 2015, to reduce fees and charges to provide better value for money. As a result of this work, over a million customers within contract-based and trust-based schemes are now subject to lower charges than before.
>
> A small number of providers have put in place actions that rely on a response from another party, such as individual customers or the trustees of the scheme. Once received, this will improve the overall position across the industry further. Both the FCA and the DWP will continue to work with providers to ensure that customers are not being disadvantaged over the long-term, especially if responses have been slow or low in number.
>
> For 16% of the assets under management in contract-based schemes, and 15% in trust-based schemes, the progress is unsatisfactory or unclear, with customers still at risk of high costs and charges. The FCA and DWP will shortly be contacting these providers and will expect them to explain the reasons behind this and to ensure that savers are being treated fairly.[142]

Further detail is in Remedying Poor Value Legacy Workplace Pension Schemes: Findings from the Joint Review of Industry Progress against the Independent Project Board Recommendations (December 2016).

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140 Ibid, para 1.39

141 DWP, Better workplace pensions: a consultation on charging, Cm 8737, October 2013, Executive Summary; DWP, Government Amendments to the Pensions Bill 2013 (Commons Report Stage) – briefing paper, October 2013

142 Pension providers making good progress on reducing fees and charges, 13 December 2016

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