Improving outcomes for DC pension savers

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Section Business and Transport Section

The outcome from a defined contribution (DC) pension scheme depends on a number of factors: contributions made to it, the charges applied, investment returns and decisions made when the individual comes to draw their pension (under current arrangements, these decisions will typically include whether to buy an annuity, the type of annuity to buy and at which rate).

This note aims to provide an overview of the recent debate on possible measures to ensure all workplace DC schemes are of good quality, offer value for money and are capable of delivering good outcomes. These include: whether a cap should be applied to any charges applied to the scheme; how to improve transparency in relation to charges; how to improve standards of governance and whether to encourage the development of larger schemes able to take advantage of economies of scale. There has also been a debate about whether contribution rates need to increase if individuals are to achieve the sort of income in retirement they are likely to consider adequate.

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1 Introduction

1.1 Pensions landscape

There are currently two main types of private pension scheme:

- Defined Benefit (DB) schemes, that typically promise to pay a pension linked to salary and length of service; and

- Defined Contribution (DC) schemes, that typically pay out a sum based on the value of a member's fund on retirement.

A key difference between these types of schemes is who bears the risk. In DB schemes, the risks inherent in pension saving – for example, those associated with longevity, investment and inflation - are borne by the sponsoring employer. In DC schemes, they are borne by the individual.[1]

DB schemes are in decline. Total active membership peeked in the 1960s at 8.1 million, and has fallen to 1.7 million by 2012.[2] This decline has, to some extent, been offset by an increase in DC provision. DWP explains:

> Between 1997 and 2012, the proportion of employees with a DB occupational pension scheme fell from 46 per cent to 28 per cent, while DC pension scheme membership, including group personal and group stakeholder pensions, rose slightly, from 10 per cent to 17 per cent - though not enough to replace the fall in DB membership.[3]

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1 DWP, Pension Schemes Bill Impact Assessment, June 2014, page 12, para 9
2 Ibid page 10-11
3 DWP, Framework for the analysis of future pension incomes, September 2013, para 4.3

To address the declined in pension saving that would otherwise occur, the Pensions Commission chaired by Lord Turner of Ecchinswell, recommended introducing a requirement on employers to automatically enrol workers into a workplace pension saving scheme.[4] This was legislated for by the Labour Government in the *Pensions Act 2008*.[5] The current Government, following a review, decided to continue with its implementation.[6]

Under the reforms, employers are required to automatically enrol workers into, and contribute to, a workplace pension saving scheme. Workers covered by the rule are those who:

- are not already in a workplace pension scheme;
- are at least 22 years old;
- have not yet reached State Pension age;
- earn more than a minimum earnings threshold (£10,000 in 2014/15).

Employers will have to enrol them into a qualifying pension scheme that meets specified criteria. A new pension scheme, NEST (National Employment Savings Trust) has been established, available to any employer who chooses to use it.[7]

Workers can choose to opt out. Where they remain in the scheme, minimum contributions must be made on a band of "qualifying earnings". Once the reforms are fully introduced, the minimum contributions will be 8% of qualifying earnings: 3% from the employer; 4% from the employee and 1% tax relief.

The reforms are being phased-in by employer size, starting in October 2012 with large employers. Medium employers will be allocated a staging date between April 2014 and April 2015. Small and micro employers will be brought into the reforms between June 2015 and February 2018. The minimum contribution is also to be phased-in. For employers, this will start at 1 per cent of qualifying earnings, rising to 2 per cent from October 2017 and to 3 per cent from October 2018.[8]

The policy is expected to increase the number newly participating or saving more in a workplace pension saving scheme by between six and nine million. It is also expected to reduce the numbers facing inadequate retirement incomes.[9] However, the vast majority of those automatically enrolled will be saving into DC pension plans, in which outcomes are uncertain and individuals bear the risks of pension saving.[10]

Because it workers being placed in a pension scheme without making an active choice, the introduction of auto-enrolment has focused the attention of policy-makers on DC scheme quality and value for money. A further factor is the planned introduction of measures to enable individuals to take their pension pot with them when they move jobs ('pot follows

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[4] Pensions Commission, *A New Pension Settlement for the Twenty-First Century; The Second Report of the Pensions Commission,* November 2005, p2-4

[5] Part 1

[6] 'Making automatic enrolment work. A review for the Department for Work and Pensions', October 2010; HC Deb 27 October 2010 c12WS; For more detail, see SN 6417 Pensions: automatic enrolment – 2010 onwards

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

[8] Impact Assessment – Employers' Duties (Implementation) (Amendment) Regulation 2012, p18

[9] DWP, Framework for the analysis of future pension incomes, September 2013

[10] DWP, Pension Schemes Bill Impact Assessment, DWP, 2014-0911, 26 June 2014

member'), making it "all the more important that all workplace DC pensions meet the minimum quality standards, to reduce the risk of detriment"[11]

1.2 Factors affecting outcomes

The outcome from a DC scheme depends on a number of factors: contributions made to it, the charges applied, investment returns and decisions made when the individual comes to draw their pension (for example, whether they buy an annuity and, if so, the type of annuity they buy and the annuity rate).

TPR has set out the six principles it thinks good quality DC pension schemes should meet:

> **Principle 1: Essential characteristics.** Schemes are designed to be durable, fair and deliver good outcomes for members;
>
> **Principle 2: Establishing governance.** A comprehensive scheme governance framework is established at set up, with clear accountabilities and responsibilities agreed and made transparent;
>
> **Principle 3: People.** Those accountable for scheme decisions and activity understand their duties and are fit and proper to carry them out;
>
> **Principle 4: Ongoing governance and monitoring.** Schemes benefit from effective governance and monitoring through their full life-cycle;
>
> **Principle 5: Administration**. Schemes are well administered with timely, accurate and comprehensive process and records;
>
> **Principle 6: Communications to members.** Communication is essential to make informed decisions about their retirement savings.[12]

These are underpinned by 31 quality features encapsulating the activities, behaviours and control processes that are more likely to deliver good member outcomes.

1.3 Areas of concern

In September 2013, the Office of Fair Trading (OFT) published the report of its defined contribution workplace pension market study. It found that competition alone could not be relied upon to drive value for money for all savers, due to a 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. [13]

Overall, the OFT identified two parts of the market where there was a particular risk of savers losing out:

> **Old and/or high charging schemes.** Around £30 billion of savings in old and/or high charging contract and bundled-trust schemes may not be value for money.

[11] *Pensions Act 2014,* s 33; DWP, Better workplace pensions: a consultation on charges, Cm 8737, October 2013, para 1.5. For more on the background see RP 13/37 Pensions Bill, June 2013, section 7.1

[12] TPR, Strategy for regulating defined contribution pension schemes, October 2013

[13] OFT website (archived – snapshot taken November 2013); OFT, Defined contribution workplace pension market study, September 2013, para 1.9

> **Small trust based schemes.** Around £10 billion of savings in smaller trust-based schemes are at risk of delivering poor value for money due to low levels of trustee engagement and capability.[14]

It announced an audit of so-called 'legacy schemes' sold before the introduction of stakeholder pensions in 2001, to be overseen by an Independent Project Board (IPB):

> […] the Association of British Insurers and its members agreed to undertake an audit of these schemes that will be overseen by, and report into, an Independent Project Board (IPB). The role of the IPB will be to agree the terms of reference for the audit, scrutinise the results and agree what industry-level actions are needed to address schemes not assessed as value for money.[15]

The IPB produced a progress report in July 2014 and will produce a final report in December 2014.[16]

1.4 Initiatives to improve outcomes

The OFT said it had secured agreement with the industry and the Pensions Regulator on a number of measures to address the issues it had identified. These included:

> **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 - 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.
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> **Preventing future risks of detriment.** The OFT recommends DWP consult on preventing schemes being used for auto-enrolment that contain in-built adviser

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[14] OFT – Defined contribution workplace pension market study 19 September 2013

[15] OFT, Defined contribution workplace pension market study – latest update 27 March 2014

[16] Defined contribution workplace pensions: The audit of charges and benefits in legacy schemes. A progress update from the independent project board, July 2014

NAPF press release, IPB publishes progress report on audit of charges and benefits in legacy DC schemes, 31 July 2014

commissions or that penalise members with higher charges when they stop contributing into their pensions.[17]

The OFT was confident that its recommendations would address the risks of consumer detriment in the short to medium term. In the longer-term, it would be helpful for future policy and regulatory initiatives to be informed by longer-term principles for how the DC workplace pension market should evolve:

> 9.34 We are confident that the recommendations above will address the risks of consumer detriment arising in the short to medium term in the context of AE. This is the urgent challenge to which this report is addressed.
>
> 9.35 A longer term challenge remains, however. The structure of the DC pensions market in the UK has resulted from the rapid decline of DB provision and the need to put alternative provision in its place. It has therefore been built largely on the back of structures and products designed for the provision of single firm DB workplace pensions topped up by individual private pensions. Key elements of the DC market – single firm trusts, integrated insurance providers and contract based schemes – are based in this DB tradition.
>
> 9.36 One would expect this market structure to evolve as the demand for DC workplace pensions grows. The emergence of master trusts is one example with the potential to offer scale coupled with independent governance. We also note that greater investment flexibility is being built into new contract pension products. However, one consequence of a weak demand side is that product innovations and market structures can take time to evolve.
>
> 9.37 We therefore consider it would be helpful for future policy and regulatory initiatives to be informed by longer term principles for how the DC workplace pension market should evolve. In our view, these principles would be:
>
> **Scale**: there are significant economies of scale in the purchase of administration and investment, and in the governance of pension schemes. We would expect the market to take greater advantage of these scale economies over time, but policies could help accelerate this process and remove barriers to scale while avoiding concentration.
>
> **Alignment of incentives**: better alignment of the incentives of employers, trustees, advisers, providers and investment managers with those of scheme members is the best way to ensure that actions are taken in the interest of scheme members. This should be coupled with clear responsibility and accountability for those making choices on behalf of savers. Regulation should promote this alignment and accountability and avoid steps that might result in misalignment of incentives.
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> **Robust independent governance**: DB schemes created strong incentives for employers to set up engaged expert investment governance given the risks that employers were exposed to. While some parts of the market may be able to re-create robust governance for DC schemes, there is a role for policy to promote this across the market.
>
> **Flexibility**: effective governance needs to be backed up by the flexibility to move assets and change administration. We would expect the DC market to develop products that allow greater flexibility in investment decisions, including products

[17] Ibid

that allow for collective pooling of risk between scheme members. There is however likely to be a role for policy in providing the regulatory context for these developments.

Simplicity and switching: in the interests of promoting switching ,policy should look to promote simpler products, with transparent charges. It should also look to ease the process for employees and trustees of switching between different pension products.[18]

The OFT considered whether to make a reference to the Competition Commission but decided against this on the basis that action was underway to address the issues.[19]

In March 2014, the Government announced measures to outcomes for DC pension savers.[20] In line with the OFT's recommendations, it proposed introducing independent governance committees for contract-based DC schemes and measures to improve disclosure around charges. However, it intends to proceed with a cap on charges in qualifying schemes used for auto-enrolment, a measure which the OFT thought could have unintended consequences.[21] These issues are discussed in more detail below.

2 Charges

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 is "no standard definition of the component services and activities included within the headline charge quoted for each DC scheme".[22]

The Annual Management Charge (AMC) is often referred to. It is a charge that members pay as a fixed proportion of their funds under management each year until they retire, including those years when no contributions are made. However, there is no consistency in the costs and charges different providers include within the AMC, so the figures quoted by different providers are not easily comparable. Furthermore, they do not capture all the costs and charges that a scheme member pays. Evidence gathered by the OFT suggested that administration costs, investment management service costs and additional investment management expenses were not being consistently included in AMCs.[23]

The "Total Expense Ratio" (TER) is a more comprehensive measure, applying to collective investment schemes. Fund managers are required to disclose both their initial and annual management charges and they are required to publish their TER.[24] However, there are also additional costs outside the TER which may not be disclosed, such as transaction costs, associated with buying and selling investments.[25]

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[18] OFT, *Defined contribution workplace pension market study,* 2013

[19] OFT, *Defined contribution workplace pension market study. Decision not to make a market investigation reference to the Competition Commission*, February 2014

[20] This followed a Call for Evidence on Quality standards in workplace defined contribution pension schemes in July 2013

[21] DWP, Better workplace pensions – further measures for savers, Cm 8840 , March 2014, Executive Summary

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

[23] Ibid, para 6.21

[24] Regulations regarding information which fund managers must disclose to investors can be found in the relevant part of the FCA Handbook – COLL. See, COLL4 Annex 1. ; See also NAPF, Making Pension Charges Clearer, November 2011

[25] DWP, Better workplace pensions: a consultation on charging, October 2013, Cm 8737, para 2.8; TPR website, Costs and charges

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. A DWP calculation showed the potential effect of a 1 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.[26]

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).[27]

Average charges have fallen over time.[28] Research for DWP published in 2012 found that average AMCs were 0.71 per cent for trust-based schemes and 0.95 percent for contract-based pensions. Key determinants of the AMC were size of scheme, commission and contribution level.[29]

Some schemes paid a fee for advice through commission, although this has been banned for new schemes sold from 2013 under the Retail Distribution Review.[30]

Some schemes operate Active Member Discounts - where early leavers with deferred pension rights pay a higher AMC than active scheme members.[31] The OFT said AMDs were used by a number of major pension providers and that a number of factors led it to believe they "may lead to consumer detriment."[32]

2.1 Charge cap

The Secretary of State already had the power, under section 16 (2) of the *Pensions Act 2008* to establish a charge cap for qualifying schemes to be used for auto-enrolment. The *Pensions Act 2011* extended this power to cover charges to deferred members of qualifying schemes as well as active members.[33]

In debate in Westminster Hall on 7 December 2011, Pensions Minister, Steve Webb said he did not think charges would be a problem in the early stages of auto-enrolment, when the reforms applied to large employers, already engaged with pensions and able to "drive a hard bargain." The challenge would come when it applied to medium and smaller firms.[34]

In its report published in September 2013, the OFT said it thought a charge cap could have unintended consequences:

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[26] DWP, Better workplace pensions: a consultation on charging, Cm 8737, October 2013, para 1.7
[27] Ibid, para 1.9
[28] DWP Research Report No 753 , Likely industry responses to the workplace pension reforms: Qualitative research with pension providers and intermediaries, 2011, section 3.1
[29] Andrew Wood et al, Pension landscape and charging: Quantitative and qualitative research with employers and pension providers, DWP Research Report No 804, 2012, Summary
[30] Ibid
[31] Ibid
[32] OFT, Defined contribution workplace pension market study, September 2013, para 1.22
[33] PBC Deb, 14 July 2011, c263-4; Explanatory Notes to Pensions Act 2011, para 85
[34] HC Deb, 7 December 2011, c126-9 WH

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.[35]

In evidence to the Work and Pensions Committee in October, Pensions Minister, Steve Webb said he agreed there were complex issues to consider: such as what charges should be included, where it should be set and how to avoid "levelling up."[36]

The Government published a consultation paper at the end of October 2013 which asked for views on whether and how a cap should be set for qualifying schemes used for auto-enrolment from April 2014. It was considering three options:

– **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 Pensions Regulator the reason for charges in excess of 0.75 per cent.[37]

Initial responses to the consultation were divided. Some pointed to the fact that outcomes are linked to other factors such as investment performance and that low charges could be linked to poorer quality of services and the loss consequences for customers – poorer quality of services, less choice and loss of investment in innovation and development.[38] Others argued that the cap should be set at a lower level than the 0.75% proposed by the Government, on the basis that even a fraction of a percent could have a significant impact on pension funds.[39]

In the *Pensions Act 2014,* the Government introduced broad powers, enabling it to apply standards to a broad range of schemes including those closed to new members or to new accruals.[40]

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[35] OFT, Defined contribution workplace pension market study, September 2013, para 1.40

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

[37] 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

[38] IFAonline, Aegon warns 0.75 pension charge cap may not fit, 30 October 2013; BBC News, Pension fees cap plan unveiled by government, 30 October 2013; BBC website, Pension scheme charges cap proposed by minister, 30 October 2013

[39] BBC News, Pension fees cap plan unveiled by government, 30 October 2013

[40] Section 43 and Schedule 17; DWP, Government Amendments to the Pensions Bill 2013 (Commons Report Stage) – briefing paper, October 2013; HL Deb 29 October 2013 c776 [Steve Webb]

In March 2014, the Government announced that it would set a charge cap of 0.75% the for default funds of DC qualifying schemes used for auto-enrolment from April 2015:

> The default fund charge cap will cover all member-borne charges and deductions excluding transaction costs. It will be introduced from April 2015 for all qualifying schemes and will be set at 0.75 per cent of funds under management.[41]

In addition, from April 2016, there would be a ban on Active Member Discounts (where a higher charge is applied to the deferred pension rights of early leavers) and member-borne commission charges in all qualifying schemes.[42]

2.2 Disclosure of charges

Another issue of concern about charges has related to a lack of transparency. In the report of its *Defined contribution workplace pension market study* published in September 2013, the Office of Fair Trading (OFT) said it was concerned that there was "insufficient transparency and comparability of charges" to ensure that competition on costs and charges was 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:
>
>   – 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. [...][43]

There have been a number of industry initiatives aimed at improving the position, including:

- A Joint Industry Code of Conduct on telling employers about DC pension charges: Pension Charges Made Clear, published in November 2012; and
- An agreement on the disclosure of pension charges and costs to employees produced by the Association of British Insurers in January 2013.

However, the OFT made three recommendations on how transparency of pension costs and charges, and quality could be improved for those schemes eligible for auto-enrolment (AE):

> 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.

[41] DWP, Better workplace pensions: further measures for savers, Cm 8840, March 2014, chapter 3
[42] Ibid
[43] OFT, Defined contribution workplace pension market study, September 2013, para 6.19

> 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.
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> 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.[44]

The Government published a consultation on charging in workplace pensions in October 2013, including options to improve disclosure about charges, such as:

- **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).[45]

In March 2014, it announced "a step change in the way transparency operates in workplace pension schemes":

> From April 2015, trustees and IGCs [independent governance committees] will have new duties to consider and report on costs and charges. We will then introduce new requirements to make standardised disclosure of all pension costs and charges mandatory. This information will be disclosed to trustees and IGCs, in a format that enables comparison between schemes, and made available to employers, scheme members and regulators.

Following inclusion of provision in the *Pensions Act 2014,* to impose a duty on the Secretary of State (in the case of trust-based schemes) and the Financial Conduct Authority (in the case of contract-based schemes) to make rules to require information about transaction costs to be given to trustees and IGCs, it is working to develop the necessary regulations.[46]

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[44] OFT, Defined contribution workplace pension market study, September 2013
[45] DWP, Better workplace pensions: a consultation on charging, Cm 8737,October 2013
[46] Section 44; DWP, Better workplace pensions: further measures to protect savers, Cm 8840, March 2014, p 94

For more detail, see Library Note SN 6209 *Pension scheme charges.*

3 'Pot follows member'

In a consultation paper published in December 2011, the Government said that an anticipated increase in the number of small pension pots due combined with barriers preventing people from transferring their pension pots would lead to poor outcomes unless action was taken:

> 3. We anticipate a significant increase in the number of small, dormant pension pots after automatic enrolment. This is because the workplace pension reforms will take place against the backdrop of an increasingly mobile labour market, where, on average, an individual will work for 11 employers during their working life. This combination of job churn and five to eight million new pension savers could lead to up to 4.7 million small pension pots added to the system by 2050. This, coupled with the barriers that prevent people from transferring their pension pots, will lead to poor outcomes for individuals and the pensions industry. The case for change is clear.[47]

In the Government's view, increased numbers of small pots would prove "costly and inefficient for pension schemes to administer" and would make it "difficult for individuals to keep track of and subsequently convert into pension income upon retirement. The existing system relies on individuals to initiate a transfer, and it is known that inertia acts as a significant barrier to individual engagement in pensions." The two main options for automatic transfers that the Government considered were:

- **Aggregator scheme**: when an individual leaves the employer, and their pot is under a certain size, that pot would transfer by default to a simple low-cost aggregator scheme. This aggregator scheme would, over time, consolidate the small pots accumulated by an individual into one place. This might be one single aggregator scheme for the whole market (such as NEST), or multiple aggregator schemes, with a range of industry players involved.

- **Pot-follows-member (PFM)**: an individual's pension pot would follow them from job to job by default as they move employment. The default transfer would be initiated by the individual's new scheme after they have taken up work with their new employer and been automatically enrolled.

The Government described the pot-follows-member option as the "most ambitious". However, it acknowledged the possibility that "the different charge levels in schemes may mean that some people could lose out in the long term". Some individuals may experience detriment as a result of their small legacy pot being transferred into a scheme with higher charges and/or a lower-performing investment fund. Conversely, some individuals may find their pot transferred into a more cost-effective scheme.[48]

On 17 July 2012, the Pensions Minister Steve Webb announced the Government's preference for PFM, summarising the reasons for this as follows:

> The overwhelming response to the consultation was that the small pots issue urgently needs to be resolved. The vast majority of our respondents agreed that an automated transfer system is the best way forward. Creating a system in which small pots follow

[47] DWP, Meeting future workplace pension challenges: improving transfers and dealing with small pension pots, December 2011, Cm 8184

[48] Ibid

> people through employment is the preferred approach among savers, according to a recent survey by the Association of British Insurers. The Government's analysis indicates that this option will achieve the most consolidation and generate the most administrative savings in the long run.[49]

In broad terms, the intention was that:

> […] when an individual is automatically enrolled into a new DC workplace pension scheme, their provider will check whether they have an existing pension pot, and (if the individual does not choose to opt-out) will automatically transfer the pot into their scheme. If the individual leaves a scheme but is not saving into a new one (for example, due to a period of unemployment or opting-out of their new employers' scheme), the pot will remain dormant in the scheme until they do. Further consideration will need to be given as to the appropriate timing of the transfer, to minimize burdens on business and individuals.[50]

According to the findings of the impact assessment, PFM compared favourably to the aggregator option for a number of reasons. It said, for example:

> In some cases the aggregator scheme could actually increase the number of dormant pots individuals have. Under current arrangements, if an individual leaves and then subsequently returns to a scheme their pot will be dormant for the intervening period only. By contrast, if the pot is automatically transferred to an aggregator scheme, it will remain dormant there even after they begin to save in their original workplace DC scheme again.[51]

In April 2013, the Government provided a summary of its key proposals:

> - We propose that:
>
>   – automatic transfers will take place between money purchase schemes;
>
>   – automatic transfer will apply to all members in workplace pension schemes who are workers;
>
>   – a pot will be eligible for automatic transfer either once all contributions have ceased and the individual has left employment or once all contributions have ceased for a prescribed period;
>
>   – a pot will be eligible for automatic transfer as long as the pot was created after a certain date;
>
>   – the pot size limit will be £10,000 with a requirement on the Secretary of State to review the limit and revise it if appropriate;
>
>   – there will be an option for members to opt out and leave their pension pots in their previous employer's scheme, retaining the right to initiate a transfer to an alternative pension arrangement.
>
> - We may prescribe standards for automatic transfer schemes.
>
> - We will work with interested parties to develop a transfer process based on either a pot-matching solution involving an IT system or a member-driven approach using a 'Pensions Transfer Information Document'.

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[49] HC Deb, 17 Jul 2012, cc140-2WS

[50] Small Pots and Automatic Transfers Impact Assessment, May 2012

[51] Ibid, pp. 1, 22-23

- Regulations will specify what information should be given to the member, and by whom, so that the member is properly informed about the nature of the transfer process and the effects it may have on their benefits.

- The Pensions Regulator (TPR) will be the main enforcement body for the automatic transfer process. The approach to regulation would be aligned with the overall regulatory approach for DC pensions schemes (currently under consultation). Details of the requirements and penalties for breaches would be set out in regulations.

- Short service refunds proposed to be withdrawn for those in money purchase schemes from 2014.[52]

When the legislation was before Parliament, there was much debate on whether the Government had been right to opt for PFM rather than an aggregator model – see SN 6846 *Pensions Bill – House of Lords stages* (March 2014) (section 6.1) and SN 6634 *Pensions Bill – House of Commons stages* (November 2013) (section 4.4).

In the course of the debates, Pensions Minister, Steve Webb, said that infrastructure for PFM would need to be set up, so "we could easily be talking 2016 before we even start doing it."[53] A more recent report suggested implementation might not be until 2017.[54]

Provision for PFM is in section 33 of the *Pensions Act 2014*. There is provision in the legislation to prescribe a date from which rights accrue, meaning that there is flexibility to bring in stranded pots built up before the legislation is introduced.[55]

The Act also provided for members of money purchase schemes to be entitled to a 'short service benefit' after 30 days service. The effect is that the ability to make a refund to individuals with between 30 days and two years service will no longer be available.[56]

4 Governance

The OFT's report on workplace DC pensions stressed the importance of governance in achieving good member outcomes:

> 7.18 All pension providers, advisers, and industry experts that we consulted through the course of the study told us that good governance is crucial to achieving good member outcomes. Ongoing governance provided by the employer, trustees and provider is important for several reasons:
>
> > • A pension is a long term investment so the investment strategy has to be suitable for employees over the long term. The performance of financial markets, the cost of pension provision and investment philosophies can all evolve significantly over time, so it is important that costs and quality are kept under review.
> >
> > • There are significant potential conflicts of interests which are inherent in some providers' business models. These need to be identified and managed effectively in the interests of members.

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52 DWP, *Automatic transfers: consolidating pension savings,* Cm 8605, 23 April 2013; See also, HC Deb 23 Apr 2013, cc51-52WS

53 PBC Deb 9 July 2013 c319

54 Professional Pensions article, 28 January 2014

55 PBC Deb 9 July 2013 c323

56 *Pensions Act 2014,* s36 – Explanatory Notes, paras 154-6

- There is likely to be lack of oversight and scrutiny of schemes from most scheme members and many employers, so effective governance arrangements, particularly around the default option, at trustee and provider level are crucial for ensuring that the scheme continues to offer value for money.

7.19 Well governed schemes are more likely to provide value for money by reviewing the quality of administration and investment management services and the costs and charges on ongoing basis. If governance is not performed well, it can lead to member detriment due to the use of outdated investment strategies that do not deliver returns or expose members to excessive risks, or result in them paying higher charges than necessary or leave them with sub-standard administration.[57]

Trust-based pension schemes are governed by a board of trustees, each of whom will be under a fiduciary duty to act in the best interests of members (although the OFT identified issues of concern with "single employer trust-based schemes of different sizes and vertically integrated master trusts.".[58]

Contract-based schemes, on the other hand, did not have a recognised equivalent of the trustee board, ultimately accountable for representing the needs of scheme members. Without strong governance, there was a risk that conflicts of interest might not be managed in members' interests and providers might not "have the incentive and ability to address high charges, poor administration, poor performance and outdated or unsuitable investment strategies."[59] To address its concerns about lack of independent scrutiny of contract-based schemes, the ABI had agreed that its members would establish independent governance committees (IGC). These 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.[60]

Shadow Pensions Minister Gregg McClymont said that as proposed the IGCs would lack independence:

> The board of the contract-based schemes will appoint the 'independent' members of the governance committee. The board's duty to 'comply or explain' will be to a committee which it has appointed and whose future re-appointment will be dependent on their reputation as being compliant with the board's wishes. The board could legitimately explain that maximising profits made it regrettably infeasible to act in the savers' interest.[61]

In March 2014, the Government announced that from April 2015, there would be requirements for providers of contract-based schemes to operate Independent Governance Committees (IGCs) to assess the value for money delivered by these schemes and report on how they meet the quality standards. They would have the power to escalate concerns to

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[57] OFT, Defined contribution workplace pension market study, September 2013
[58] Ibid para 7.23
[59] Ibid, para 7.33-4
[60] OFT website, Defined contribution workplace pension market study
[61] Tom Selby, Labour warns OFT over workplace pension reforms, *Money Management,* February 2014

members, employers and the Financial Conduct Authority. Steps would also be taken to improve governance in master-trusts.[62]

The Law Commission made recommendations in relation to ICGs in a report on the fiduciary duties of investment intermediaries published on 1 July 2014:

> Our report […] welcomes the Government's announcement that from April 2015, all providers of contract-based pensions will be required to operate independent governance committees (IGCs) to assess the value for money delivered by these schemes and report on how they meet quality standards. We recommend that:
>
> > IGCs should owe a statutory duty to scheme members to act, with reasonable care and skill, in members' interests. This duty should not be excludable by contract; and
> >
> > - pension providers should be required to indemnify members of their independent governance committees for any liabilities they incur in the course of their duties.
> > - We also recommend that the Financial Conduct Authority consider whether IGCs need further guidance in interpreting the interests of members in default funds.[63]

It is awaiting the Government's response to its recommendations.[64]

The NAPF welcomed the clarity that the Law Commission had brought to the debate:

> We welcome the clarity and certainty which the Law Commission's work brings to the area of fiduciary duty. While many pension fund trustees have always had a good grasp of their fiduciary duties to act in scheme members' broad interests, it is extremely helpful to have the reassurance that trustees should indeed use their judgement as to what is in the beneficiaries' interests over the appropriate time horizon. In many cases, trustees will decide that this will encompass risks that will go to value over the long-run, including issues such as governance and environmental matters.
>
> In addition, the Law Commission's report brings some welcome clarity to the debate concerning fiduciary duties as it applies to intermediaries. As the ultimate decision makers in appointing contract-based workplace pension schemes providers, employers have a responsibility to put in place pension arrangements that offer value for money and act in the scheme members' best interests. The report presses for clearer duties to be applied to the individual members of independent governance committees (IGCs) to ensure that members' interests are protected.[65]

5 Scale

In its November 2012 discussion document, the Government said it was keen to explore whether a smaller number of larger-scale, multi-employer schemes might deliver better for money by using economies of scale and greater buying power to offer diverse investment options, reduced administrative costs and higher charges.[66]

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[62] DWP, Better workplace pensions: further measures for savers, Cm 8840, March 2014
[63] Law Commission website – Fiduciary duties of Investment Intermediaries
[64] Ibid
[65] NAPF comments on Law Commission's report on fiduciary duty, 1 July 2014
[66] DWP, Reinvigorating workplace pensions, Cm 8478, November 2012, p24

In a consultation document published in July 2013, it asked for views on whether people running schemes should be asked to consider whether the scheme's size had an adverse impact on members of the scheme:

> 58. We recognise that some of the approaches suggested in this document may be more challenging for smaller schemes to meet than for larger schemes. We believe that legislative minimum standards should be met by all schemes, regardless of their size. There are international examples of the introduction of new requirements for schemes leading to increased scale. For example, the *Superannuation Industry (Supervision) Act in Australia* is seen as having played a role in prompting greater consolidation in the Australian pensions landscape. We are interested in whether the sorts of standards considered in this document might have a similar impact and how this would be managed by schemes and employers.
>
> 59. Evidence from DWP's charges survey and TPR's occupational pension scheme governance survey suggests that smaller schemes tend to have higher charges and less engaged governance than larger schemes. We would expect people managing a small occupational scheme to consider whether standards of governance and charges could be improved and, if so, whether the size of the scheme is a barrier in doing so.
>
> 60. If the lack of scale is identified as a barrier then options for merging or otherwise expanding the scheme should be considered, alongside the option to close the scheme and move members to a pre-existing larger one. The key consideration in all cases should be the impact on members, including the practicalities and costs involved in taking such steps.
>
> 61. In larger schemes, we would expect those running the schemes to particularly consider whether they are able to adequately focus the scheme on the needs of its members, and whether there are options for improving this.
>
> 62. There are ways in which small employers or small schemes may already access benefits of scale, including through joining a large Group Personal Pension or mastertrust, or by purchasing investment or administration services from a large provider. In some of these cases employees of small employers may pay a higher charge than employees of larger or more profitable employers, for comparable or identical services. We would therefore expect people running small schemes to consider whether members are disadvantaged by the charges they are paying and whether there are ways of improving this. If the lack of scale is identified as a barrier then options for merging or otherwise expanding the scheme should be considered, alongside the option to close the scheme and move members to a pre-existing larger one. The key consideration in all cases should be the impact on members, including the practicalities and costs involved in taking such steps.[67]

In March 2014, it said there was already a "clear trend towards consolidation" and it had decided not to take any further action at this time:

> […]Scheme consolidation is accelerating and we do not expect new single employer small schemes to be set up.
>
> - Under automatic enrolment requirements, smaller employers are already moving towards larger arrangements such as Group Personal Pensions (GPPs), mastertrusts, and NEST.

[67] DWP, Quality standards in workplace defined contribution pension schemes. Call for evidence, July 2013

- We want to ensure schemes are well-governed and deliver good quality and low charges to their members, regardless of their size. The proposals in this paper will protect members from poor governance and unfair charges whatever size scheme they are in.

- Issues relating to existing small schemes are also being addressed by a variety of non-legislative means – by The Pensions Regulator's (TPR's) DC code and guidance, and the Association of British Insurers (ABI) audit of legacy and high-charging schemes. Forcing consolidation would also come at a financial cost which would be borne by members.

- Consequently, at this time, the Government has concluded that there is not a case for further intervention to accelerate the clear trend towards consolidation.[68]

6 Contribution rates

Minimum contribution rates under auto-enrolment are being phased-in to help employers and individuals adjust. Full contributions will have to be paid from 1 October 2018.[69]

	Employer minimum contribution	Total minimum
Until October 2017	1%	2%
October 2017-18	2%	5%
From October 2018	3%	8%

When minimum contributions meet the full rate provided for under the legislation (8% of 'qualifying earnings' - between £5,772 and £41,865 in 2014/15), this will be made up of 3% from the employer, 4% from the employee and 1% tax relief.

The Pensions Policy Institute (PPI) published research in October 2013, looking at the likelihood of an individual achieving an adequate income in retirement, assuming contributions at the minimum auto-enrolment rate from 22 to State Pension age.

As there is no standard definition of what is meant by an adequate income in retirement, PPI looked at 'replacement rates' (retirement income as a ratio of earnings in working life) to assess whether pensioners would be able to replicate their living standards. Like the Pensions Commission, it suggested a replacement of around 80% for low earners, 67% for median earners and 50% for higher earners. The Pension Commission had concluded that it was a "reasonable aim of public policy to seek to ensure that the median earner achieves an income replacement rate of at least 45%" and had set the minimum contribution rate at 8% with this in mind. Beyond this, it thought the state should 'enable' additional low cost saving of 15-18%.[70]

PPI found that:

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[68] DWP, Better workplace pensions: further measures for savers, Cm 8840, March 2014

[69] HC Deb, 31 January 2012, c31-2WS; DWP Press Release, New timetable clarifies automatic enrolment starting dates, 25 January 2012

[70] Pensions: Challenges and Choices: The First Report of the Pensions Commission, October 2004, p142

Under the baseline scenario of starting to save at age 22, retiring at SPA and following a traditional lifestyle investment approach, a lower earner has a 63% probability of achieving their target replacement income, compared to 49% for a median earner and 40% for a higher earner. Lower earners have a higher probability of achieving their target replacement rate because the single-tier state pension introduced from 2016 will represent a higher proportion of lower earners' pre-retirement earnings than for median or higher earners.[71]

The contribution rate needed to achieve an adequate income in retirement depended on a number of factors, including whether they take career breaks, started to save later in life or decided to retire some years after SPA. The indexation arrangements for the single-tier (such as whether the triple lock is used) were also important:

If the single-tier state pension is uprated by the triple lock, a median earner that takes a career break needs a total contribution rate of 14% to have a two thirds chance of reaching the target replacement income, compared to 11% under the baseline of starting to save at age 22 and retiring at SPA. The contribution rate needed increases to 23% if the median earner starts to save at age 40. If the single-tier state pension is uprated by changes in average earnings a median earner needs a total contribution rate of 18% if taking career breaks and 27% if starting to save at age 40.

By contrast, a contribution rate of 9% of band earnings will be necessary to have a three-quarters chance of reaching the target replacement income if retiring two years after SPA and the single-tier state pension is uprated by the triple lock. This increases to 13% if the single-tier state pension is uprated by changes in average earnings.[72]

PPI said that, while the Government could try encouraging people to save more than the auto-enrolment minimum, as such efforts had not succeeded in the past. It therefore recommended the consideration of 'inertia mechanisms', such as auto-escalation:

The Government could consider a number of inertia mechanisms to increase contribution levels such as auto-escalation where a member contribution rate increases in line with earnings increases. However, some form of compulsion by making saving into a pension mandatory might need to be considered if individuals opted-out in large numbers as a result of higher minimum contributions. The Government could also promote initiatives that encourage people to use other types of wealth to increase their retirement savings and promote initiatives to make individuals work longer.[73]

DWP published its Framework for the analysis of future pension incomes in September 2013. It said there was a limit on exactly how much the Government can prescribe additional saving as this will depend on each individual's circumstances:

7.1 The Government has responded to the challenges of an ageing population on future retirement incomes, principally through announcing a single-tier pension and introducing Automatic Enrolment.

7.2 For many – 15.7 million (an estimated 56 per cent of the current working-age population) - this will be enough. This includes many people on lower incomes who, as long as they are eligible for the full single-tier pension, should broadly be able to maintain their standards of living; and those (from all across the income distribution) already saving into a workplace pension at an adequate level.

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[71] PPI, What level of pension contribution is needed to obtain an adequate retirement income?, 20 October 2013
[72] Ibid, p6
[73] Ibid

7.3 Others, however, will want to do more. Particularly higher and moderate earners who are saving at default levels, that is, the 8 per cent minimum combined contribution level. Of those who are currently under-saving, we estimate around half are within 20 per cent of their target income so can get to that level by making modest changes. The remainder will need to make more significant changes.

7.4 There is a limit on exactly how much the Government can prescribe additional saving as this will depend on each individual's circumstances. Individuals need to think about what the right amount of money to save during their working life is alongside other commitments, such as bringing up children. The Government's role is to put in place the right framework to enable people to make better choices and have a decent income as a default. We are working with industry to develop Rules of Thumb to enable individuals to save at an appropriate rate with confidence. [74]

[74] DWP, Framework for the analysis of future pension incomes, September 2013