Defined contribution workplace pensions: The audit of charges and benefits in legacy schemes

A PROGRESS UPDATE FROM THE INDEPENDENT PROJECT BOARD

July 2014

The audit of charges and benefits in legacy schemes

Executive Summary

Encouraging people to save for their retirement is a critical challenge for the UK. The UK has an ageing population so it is of growing importance that individuals are encouraged to save for their income in retirement. For many people a workplace pension is a very attractive form of saving. This is because it is tax efficient and because employers also make a contribution.

These considerations lay behind the UK Government's introduction of automatic enrolment (AE) in October 2012. The policy requires employers to enrol their staff into a workplace pension scheme if their employees meet certain requirements. AE means that it is even more important to ensure that defined contribution workplace pensions, the type of pension product that will be used in most cases for AE, deliver good value for savers.

In January 2013, the Office of Fair Trading (OFT) launched a market study into defined contribution workplace pensions with the aim of "examining whether, in the light of automatic enrolment, competition is capable of driving value for money and good outcomes for scheme members".[1] The study found that "competition alone could not be relied upon to deliver value for money for all savers in the defined contribution workplace pension market".[2] The OFT identified "around £30 billion of savers' money in…schemes with charges at risk of being poor value for money".[3] This included "all workplace pensions sold pre-2001 and all post-2001 workplace pension products with charges over an equivalent of one per cent annual management charge (AMC)".[4] The OFT had found that schemes "set up before 2001, when stakeholder pensions were introduced, have an average AMC which is 26 per cent (or 0.16 percentage points) higher on average than those set up on or after 2001".[5]

In response to these findings, "the Association of British Insurers (ABI), and those of their members that provide contract based DC pensions, have agreed to carry out an audit of these 'at risk' schemes… to establish both the charges and any benefits associated with them" and "set up an Independent Project Board (IPB) comprising representatives from the Department for Work and Pensions

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1 OFT (2013), "Defined contribution workplace pension market study", paragraph 1.5.

2 *Ibid.,* paragraph 1.5.

3 *Ibid.,* paragraph 1.39.

4 *Ibid.,* paragraph 1.39.

5 *Ibid.,* paragraph 6.43.

(DWP), the regulators and industry, with an independent Chair to oversee" the audit.[6]

This report is the IPB's progress update on the audit of charges and benefits in legacy defined contribution workplace pension schemes.

Scope of audit

Based on the findings of the OFT and the announcement by the DWP of a charge cap, we have agreed the scope of this audit.[7] We are collecting data on charges and benefits from providers in order to establish charges and benefits for:

- all schemes that commenced on or before 5 April 2001;
- all schemes that commenced on or after 6 April 2001 where the scheme has multiple charge types, such as an AMC and a contribution charge or fixed policy fee; and
- all schemes that commenced on or after 6 April 2001 where all member borne **charges**, excluding investment management transaction costs, exceed 1 per cent of any member's fund value in a given year.

We will also assess the data submitted by providers to the OFT on schemes with charges above the DWP charge cap but not included in the schemes described above. These are schemes that only have an AMC and where all member borne charges are between 0.75 per cent and 1 per cent.

Approach to the audit of charges and benefits

The process of collecting data from all providers of defined contribution workplace pensions is underway. We will use this data to answer the following questions in our final report about the charges paid currently or that may be paid in future in the in-scope schemes:

- What is the scale (measured by number of savers or value of assets under management) of schemes that have high charges relative to benefits once a full assessment of charges and benefits has taken place?
- What is the range of charges savers could be paying in the pension schemes which are in-scope?

6 *Ibid.,* paragraph 1.39.

7 See annex 2 for the full description of the scope.

- What are the characteristics of charging structures in those schemes that have high charges relative to any benefits?

- What are the characteristics of savers paying high charges currently or potentially in future relative to any benefits (such as age, contribution and fund levels)?

The audit will also establish what benefits are associated with in-scope schemes. The OFT identified three types of scheme benefits: guaranteed annuity rates, guaranteed rates of return, and bundled insurance. We have asked providers for data to establish the extent of these benefits where they are non-discretionary for scheme members. Where these benefits are discretionary we have asked providers to submit data on the pension schemes excluding any charges for the benefit.

Other elements of value for money

The OFT's finding was that the charges in schemes covered by the audit were such that they were "at risk of poor value for money". Charges and benefits are important elements in the overall value for money of schemes, but should not be the only considerations. The OFT made clear that other elements of the quality of schemes should also be considered, which may include financial elements, such as investment performance and investment management transaction costs or the benefits identified above, and non-financial elements, such as communication and governance.

This is why the OFT and DWP made recommendations and proposals to improve the overall quality of schemes. In particular, "after discussion with the OFT and the Department for Work and Pensions (DWP), the Association of British Insurers (ABI) and its members have agreed the introduction of Independent Governance Committees" which will "consider all the key elements of the value for money of schemes" and have certain powers to take action where they identify problems.[8] The DWP also proposed "new minimum quality standards for DC workplace pension schemes. Independent Governance Committees (IGCs) will protect members' interests in contract-based schemes. This, and stronger requirements on trust-based schemes, will improve accountability and ensure compliance with the quality standards".[9] We refer to IGCs and trustees as 'governance bodies' in this report to recognise the role they will play in considering all elements of value for money for individual schemes and taking action if required. In particular, governance bodies will consider

8 OFT (2013), "Defined contribution workplace pension market study", paragraph 1.32.

9 DWP, "Better workplace pensions: Further measures for savers", paragraph 5.

investment performance and charges relative to savers' risk appetite, and governance and communications issues.

Assessing charges using saver scenarios

We draw a distinction in our analysis between a charging structure, which refers to the combination of charge types (such as AMC, fixed policy fees or initial charges) and charge levels, which is the amount that these charges are set at. The amount a saver pays in a scheme will depend upon the charging structure as well as the charge levels. It will also depend on savers' personal circumstances and this means that any assessment of scheme charges must take into account these different circumstances.[10] The length of time a saver is in a scheme will also determine how much they pay as a percentage of savings in their fund. For example, if there are initial charges in a scheme, a saver will pay a higher proportion of their savings in their fund in charges if they leave early than if they remain in the scheme for longer.

In order to take account of the impact of different charging structures, personal circumstances and behaviour, we have chosen to use a number of hypothetical saver scenarios. Each scenario has different characteristics, such as value of fund or length of time in a scheme. These hypothetical scenarios include both typical savers as well as potential outliers that are more likely to pay high charges, such as savers with short contribution histories or low fund values. We have asked providers to model all of these scenarios for each scheme, or groups of similar schemes. This will allow us to establish the range of charges that may be paid across all in-scope schemes. We have also asked providers to tell us how many savers currently fall within each of these scenarios so that we can prioritise which schemes and scenarios are likely to have a greater incidence of higher charges and would benefit most from an early review by governance bodies.

We will also assess the incidence and level of exit charges in the in-scope schemes. Exit charges are how much a saver may lose from their fund value if they decide to leave a scheme. Such charges may be a concern if they deter savers switching to alternative schemes that offer better value for money. We will publish information on the extent and level of such charges in our final report.

With-profits funds are types of investment offered by some schemes. The charges or deductions paid in these schemes are not always explicit and may be at

10 For example, a scheme with an AMC of 0.5 per cent and a fixed monthly policy fee of £2 would have charges of £5 + £24 = £29 for saver with a fund of £1k, and £50 + £24 = £74 for a saver with £10k. Whereas a scheme with a 1 per cent AMC would cost £10 for a saver with a fund of £1k and £100 for a saver with a fund of £10k. The first scheme is more expensive for the saver with a £1k fund and less expensive for a saver with a £10k fund.

the discretion of providers. We have asked providers to submit data on the deductions made to with-profits funds where these are not explicit, as well as any explicit charges, and we will report on our findings. We will also report on the extent of these schemes.

The focus of the audit will be charges on a current and forward looking basis. This is because the focus of the original market study was the automatic enrolment of savers and we do not intend to make recommendations for action on charges already paid by savers.

All of the data submitted by providers will require sign-off by providers' Boards and is subject to the oversight of the IPB.

Progress and recommendations

The Independent Chair and Board of the IPB were appointed in February 2014. The audit is being conducted by Frontier Economics, which is working under the direction of the IPB. Frontier Economics is working with providers to collate the data we have requested from across the industry and will help us to interpret and analyse these results.

The final report will be published in December 2014. It will set out the data we have collected at an industry-level and the proposed generic industry-level actions that we decide may be needed to address in-scope schemes assessed as having high charges without commensurate benefits. It will also take into account the need to avoid unintended consequences, recognising any potential differences of approach that may be required for trust-based and contract-based schemes (including contract law). The report will be submitted to the CMA, Financial Conduct Authority (FCA), the Pensions Regulator, DWP, pension company Boards, trustee boards, and Independent Governance Committees (IGCs), as appropriate. It will consider industry-level actions and timescales that take into account the practicalities of implementation. The report will not contain any firm-specific references or recommendations.

1 Context and background of the legacy audit

1.1 This audit follows on from the OFT's market study into DC workplace pensions. Since the publication of the OFT's study, the DWP has published a Command Paper, which proposes a comprehensive range of measures to improve the quality of workplace defined contribution schemes. We set out below the OFT's findings, the recommendations in the DWP's Command Paper, and the scope and terms of reference of the audit.

OFT findings

1.2 In October 2012, AE commenced for employees of the biggest businesses in the UK. AE is changing the pensions market. Employers now have a legal duty to default their employees into membership of a pension scheme. This is leading to an increase in the numbers of workplace saving arrangements and the funds flowing through the pensions industry. Over the next few years, smaller firms will start enrolling their staff.

1.3 In January 2013, the OFT launched a market study into the market for DC workplace pensions. This aimed to "examine whether, in light of automatic enrolment, competition is capable of delivering value for money and good outcomes for scheme members".[11]

1.4 The OFT's report on the defined contribution workplace pensions market was published in September 2013. It 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
- "the complexity of the product. DC workplace pensions are complicated products, both their [charges] and quality are difficult to observe and outcomes may not be apparent for some years. This makes

[11] OFT (2013), paragraph 1.5.

decision-making on value for money very difficult. Employers, who have the responsibility for deciding which pension scheme to choose for their employees, may often lack the capability or the incentive to assess value for money".[12]

1.5 The OFT provisionally concluded that the legal test for making a Market Investigation Reference (MIR) was met. A MIR would have resulted in an extended and in-depth investigation by the Competition Commission (now part of the Competition and Markets Authority) into workplace pensions over a period of up to two years. However, the OFT concluded that "an MIR would not be appropriate in this instance" and considered that "the concerns we identified can be tackled most effectively and efficiently by the actions" it set out.[13] We describe below the OFT's recommendation for the audit and for other actions which include improving governance, improving the quality of information available and ending the risks of consumer detriment, particularly in light of AE.

OFT recommendations for the legacy audit

1.6 The OFT found that "the difficulty of comparing costs and charges of older schemes with newer schemes, the way that schemes are individually priced and the level of switching in parts of the market have all contributed to around £30 billion of contract and bundled trust-based schemes (approximately one quarter of the total assets in schemes) being left with charges that are at risk of being out of step with the levels of charges on newer schemes. The weak buyer side and other barriers to switching, appear to be contributing to a lack of competitive pressure on charges for these older schemes. There is a risk that providers' market power over this segment of the market keeps AMCs higher relative to what it may cost to service them".[14]

1.7 The OFT also said "these schemes, which were set up before 2001, when stakeholder pensions were introduced, have an average AMC which is 26 per cent (or 0.16 percentage points) higher on average than those set up on or after 2001. A significant proportion of these pre 2001 schemes are open to AE, which means there is a risk that employees will be automatically enrolled into schemes that may have higher charges. From the OFT sample the OFT estimates around one quarter of schemes which are open to AE and accepting new members were set up before 2001".[15]

12 *Ibid.,* paragraph 1.6.

13 *Ibid.,* paragraph 1.53.

14 *Ibid.,* paragraph 6.42 to 6.44.

15 *Ibid.,* paragraph 6.42 to 6.44.

1.8 The OFT found that "schemes sold before 2001 are more likely to have other charges in addition to an AMC. Pension providers have not provided sufficient evidence for us to assess the additional impact of these charges in the course of the market study".[16] The OFT found that some "schemes may also have additional benefits that schemes sold post-2001 do not have" and "it was not possible for the OFT to estimate their overall value for scheme members".[17]

1.9 In addition, the OFT was concerned that similar problems – specifically that scheme members may only benefit from lower charges if employers or trustees regularly switch schemes or use the threat of switching to renegotiate terms – might occur in the future without measures to improve the governance and scrutiny of pension schemes and the quality of information available on behalf of savers.

1.10 Following the market study, the ABI and those of its members that provide contract-based defined contribution pensions therefore agreed to:

- "Carry out an audit of these 'at risk' schemes – covering all workplace pension products sold pre 2001 and all post 2001 workplace pension products with charges over an equivalent of one per cent AMC – to establish both the charges and any benefits associated with them by the end of December 2014;
- Set up an Independent Project Board comprising representatives from the DWP, the regulators and industry, with an independent Chair to oversee an audit of these schemes; and
- the Independent Project Board determining what action needs to be taken in response to the findings of the audit with the new Independent Governance Committees that each provider will establish during 2014, to ensure that these recommendations are carried out".[18]

1.11 This report sets out the progress, scope and methodology that have been agreed by the IPB in the conduct of this audit.

OFT recommendations for Independent Governance Committees and transparency

1.12 The OFT found that "the governance that providers put in place on the contract side of the market is often not sufficiently independent and may not take into account all the key elements of value for money to give confidence that members

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16 *Ibid.,* paragraph 1.20.

17 *Ibid.,* paragraph 6.48 and 6.50.

18 *Ibid.,* paragraph 1.39.

of such schemes will not be disadvantaged".[19] "After discussion with the OFT and the DWP, the ABI and its members have agreed the introduction of IGCs which would be embedded within all providers of contract based pensions".[20] The intention of the IGCs is to act as a proxy for an engaged, active and informed consumer in order to address historic legacy problems and prevent them recurring in the future. This is similar to the role of trustee boards.

1.13 The OFT recommended that "the key elements of this governance solution – including the importance of governance being independent, expert, considering all of the key elements of value for money and having the ability to ensure that concerns are appropriately addressed in the interests of members where necessary – should be embedded by the Government in a minimum governance standard that will apply to all pension schemes".[21]

1.14 The OFT also developed three recommendations "for the Government on how transparency of pension costs and charges, and quality can be improved for those schemes eligible for AE…in order to make decision making on value for money easier".[22]

- "In order to address our concerns about the transparency and consistency of charges, 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."[23]

- "The only type of [charges] 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 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

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19 *Ibid.,* paragraph 1.25.

20 *Ibid.,* paragraph 1.32.

21 *Ibid.,* paragraph 1.33.

22 *Ibid.,* paragraph 1.35.

23 *Ibid.,* paragraph 1.36.

portfolio turnover rate. We recommend that the FCA undertake this work as part of its planned competition review of wholesale markets."[24]

- "In order to address our concerns about the difficulties that employers face when assessing and comparing scheme quality, 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."[25]

OFT recommendations on preventing risks of consumer detriment in future

1.15 The OFT "want to ensure that those people due to be automatically enrolled into DC workplace pensions are in a position to get value for money in the long term, by preventing some of the practices that have emerged in the market in response to weaknesses in competition".[26] It therefore recommends that the Government consider introducing standards for schemes used for AE.

- "In order to address our concerns about the unfairness of active member discounts (AMDs), we recommend that AMDs be banned such that employees who stop contributing to a DC workplace pension schemes should not be penalised in respect of the charges they pay in comparison to those scheme members that continue to actively contribute into that scheme. In addition, employees who are converted into an individual personal pension instead of being classified as deferred members of a scheme should also not be penalised in respect of the charges they pay." [27]

- "In order to address our concern that employers may use existing schemes containing adviser commissions for AE we recommend that such schemes should not be used for employees who are automatically enrolled in the future".[28]

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24 *Ibid.,* paragraph 1.37.

25 *Ibid.,* paragraph 1.38.

26 *Ibid.,* paragraph 1.44.

27 *Ibid.*, paragraph 1.44.

28 *Ibid.*, paragraph 1.44.

DWP Command Paper

1.16 In March 2014, the DWP published a Command Paper that proposed a comprehensive range of measures to improve the quality of defined contribution workplace schemes. The Command Paper placed particular importance on protecting those who have been defaulted into private pension saving. The measures include:

- "New minimum quality standards for DC workplace pension schemes. IGCs will protect members' interests in contract-based schemes. This, and stronger requirements on trust-based schemes, will improve accountability and ensure compliance with the quality standards."[29]
- "A charge cap on default funds of DC qualifying schemes" (see below).
- "Member borne charges incompatible with automatic enrolment will be eliminated. Adviser commissions and Active Member Discounts will be banned in qualifying schemes from April 2016."
- "A step change in the way transparency operates in workplace schemes. From April 2015, trustees and IGCs will have new duties to consider and report on costs and charges. We will then introduce new requirements to make standardised disclosure of all pension costs and charges mandatory. This information will be disclosed to trustees and IGCs, in a format that enables comparison between schemes, and made available to employers, scheme members and regulators." [30]

1.17 The IPB has taken the DWP's Command Paper into account in setting its terms of reference and scope of schemes in the audit. In making its recommendations, the IPB will also consider the implications for the audit and its recommendations of the DWP's range of measures for workplace DC schemes which will be qualifying for automatic enrolment in the future.

Relationship between the audit and a charge cap

1.18 A key proposal of the DWP Command Paper is a charge cap in default funds of defined contribution qualifying schemes. The cap, to come into force from April 2015, will be set at 0.75 per cent of funds under management and will apply to all management charges, but exclude transaction costs. Consultancy charges will also be banned in qualifying schemes from this date.

29 DWP, "Better workplace pensions: Further measures for savers", Executive Summary, paragraph 5.

30 DWP, "Better workplace pensions: Further measures for savers", Executive Summary, paragraph 5.

1.19 While highly relevant to our work, the charge cap proposal does not obviate the need for the audit. This is because a charge cap will only apply to schemes that are qualifying schemes for the purposes of automatic enrolment. Members of schemes that are not used for AE, or that do not qualify as AE schemes, will therefore not benefit from a cap on charges.

1.20 We have considered the implications of the charge cap proposed by the DWP's Command Paper for the scope of the audit. We have decided to include in the audit those schemes with charges above the DWP charge cap but not included in the scope of data collection described above. These are schemes that only have an AMC and all member borne charges are between 0.75 per cent and 1 per cent. To make this assessment, we will use the data provided to the OFT in the course of its market study.

Scope and terms of reference for the audit

1.21 The terms of reference, scope for the audit and the members of the Board are provided in full detail in Annexes 1 to 3.

1.22 The scope of data collection for the audit includes defined contribution workplace pension schemes if they were set up:

- on or before 5 April 2001; or
- on or after 6 April 2001 if all member borne charges, excluding investment management transaction costs, exceed one per cent of any member's fund value in a given year.

1.23 We have also specifically included in the audit all schemes opened on or after 6 April 2001 that have combination charges, that is, more than one charge type. This is because where there is more than one charge type, it is possible that the charges for some savers under certain circumstances will exceed one per cent.

1.24 Individual personal pensions are out of scope of the audit, even if savers were previously in workplace schemes. However, ABI members have committed to a sampling exercise of individual personal pensions to identify those cases where savers were previously in a workplace pension and so may now be at risk of high charges. This exercise will be undertaken between January and June 2015 under the auspices of governing bodies.[31] Some other types of workplace scheme are explicitly excluded from the audit. A full list of these exclusions is provided in Annex 2.

1.25 The regulation of the workplace pensions market is illustrated in **Figure 1** below. This highlights in green those schemes that fall within the scope of the Legacy

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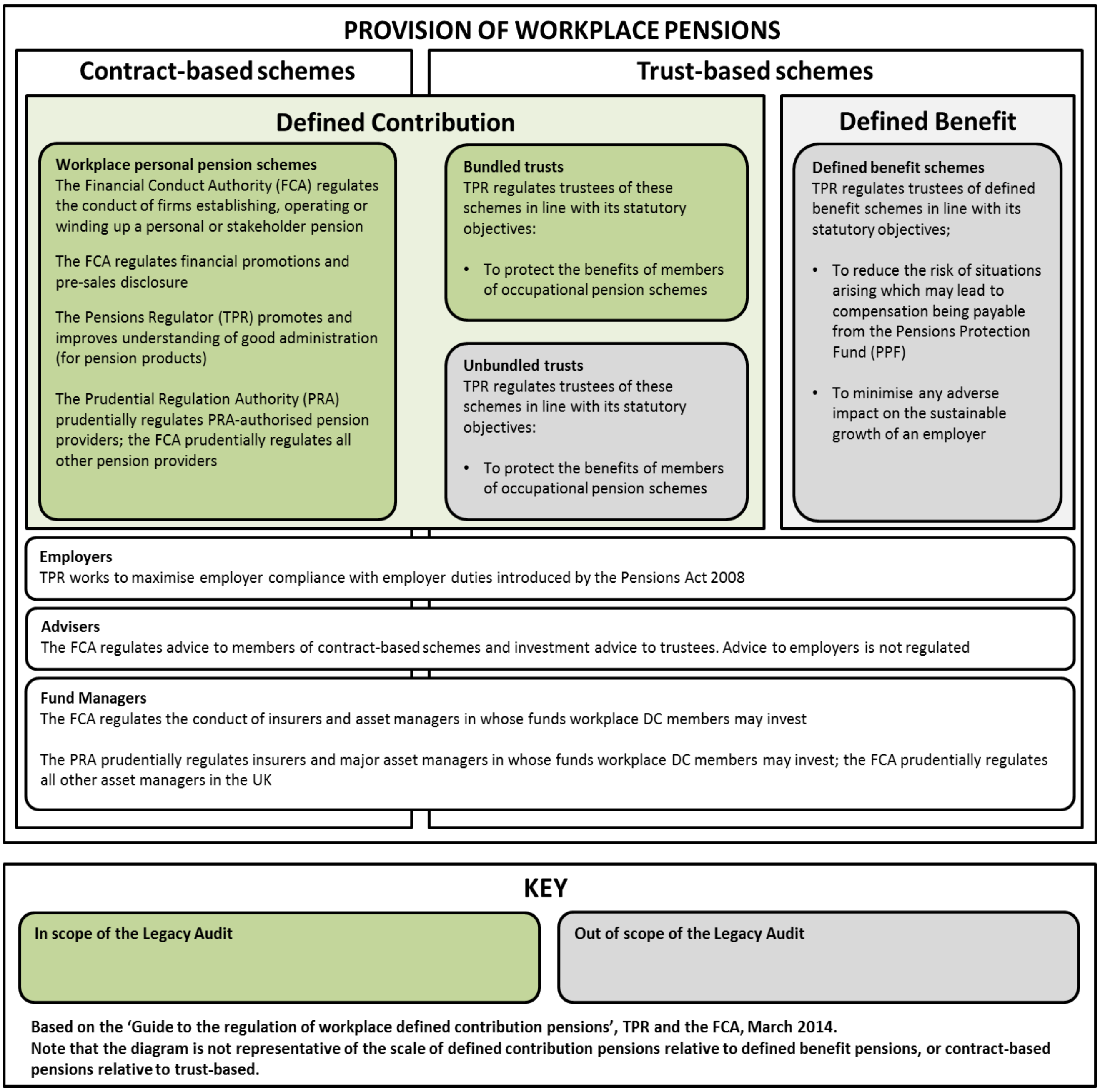
31 Members will not have been moved to IPPs from workplace pensions for trust based schemes.

Audit: defined contribution contract-based schemes and defined contribution bundled trusts and master trusts. All defined benefit schemes, as well as defined contribution unbundled trusts fall outside of the scope of the audit.

Figure 1. The Regulation of Workplace Pensions

Note: The chart is illustrative, and box sizes are not proportional to the scale of the type of scheme.



2 Approach to audit

2.1 The OFT found that, for schemes set up prior to 2001, there were up to 18 different names for charges that can be paid by savers which fit within five broad categories.[32] The OFT's study collected data on one charge type, the AMC, which is levied as a fixed proportion of fund value. It did not have enough information on the other types of charge to be able to assess overall charges. It therefore recommended this audit to establish the charges paid currently or that may be paid in future in in-scope schemes excluding investment management transaction costs. The OFT also identified that some schemes may have certain benefits for members and recommended that the audit also establish what these are for the in-scope schemes.

2.2 This section sets out how we will approach the audit of charges and benefits given the complexity of charges and the range of outcomes for different savers.

Questions for data collection and analysis

2.3 The terms of reference for the audit require us to establish the criteria for the data that providers must extract from their systems. We have agreed criteria for the data that will allow us to answer four questions about the schemes. These questions focus on charges and we describe our approach to quality in the following section.

1. What is the scale (measured by number of schemes, savers, AUM) of schemes that have high charges relative to benefits, currently and potentially in future, once a full assessment of charges and benefits has taken place?

The OFT identified £30bn of schemes that are "at risk of poor value for money". Through this audit we want to refine this estimate to identify the scale of schemes that we find may have high charges relative to the benefits. The main part of the audit will be at the level of schemes. However, where we identify schemes that are at risk of high charges we will also collect data to understand how many savers are actually affected currently and potentially in future.

32 The five broad categories of costs that are being paid by savers relate to administration of the scheme by the provider, investment management services, additional investment management expenses, adviser payments, and costs associated with investment transactions.

2. **What range of charges could savers be paying in the pension schemes which are in-scope?**

The OFT's analysis looked at a single charge type (the AMC) but recognised that there are a wide range of other types of charge that will determine how much savers pay. We want to build a complete picture of how much savers may actually pay in these schemes.

3. What are the characteristics of the charging structures in those schemes that have high charges relative to any benefits?

Different charging structures will deliver higher or lower charges for savers. However, the extent that different charging structures are used across the industry is largely unknown. We want to identify the relationship between high charges and charging structures.

4. What are the characteristics of savers paying high charges relative to any benefits?

There are a number of characteristics of savers that interact with charging structures to determine the level of charges paid. We want to identify which characteristics apply to those savers who are at risk of incurring high charges in different charging structures.

2.4 These questions have guided our approach to the data collection part of the audit. The results and analyses of these questions will be reported and feed in to our recommendations.

Audit will be forward looking

2.5 The level of charges and benefits of a pension scheme could be established over the whole lifetime of a policy or only looking forwards. A whole lifetime approach would consider charges already borne by savers. A forward looking approach only looks at charges that will be incurred by savers in the future.

2.6 The focus of the audit will be charges on a current and forward looking basis. This is because the focus of the original market study was the automatic enrolment of savers and we do not intend to make recommendations for action on charges already paid by savers.

2.7 We recognise that the charges in a scheme could be considered low relative to benefits looking forward and high over the whole lifetime. We believe understanding this relationship is important and have therefore asked for data that will allow us to consider the charges of each scheme looking forwards and over the whole lifetime.

Assessing charges

2.8 The total overall charges that a saver pays for their pension scheme will depend on the charging structure in a scheme, charge levels and the circumstances of individual savers, including the size of their savings, when they join and when or whether they choose to exit a scheme. This section describes the types of charges and some of the different implications of charging structures, and then how we will assess charges using saver scenarios.

Types of charge and charging structures

2.9 The OFT identified five different charge types described in the box below.[33] We refer to different combinations of these charges as 'charging structures'. The amount in charges a saver pays will depend on the charging structure as well as the level at which each charge type is set.

Types of charge

- Fund-based charges – these are a proportion of fund value, such as the AMC. This proportion may vary, such as lower charges for active members or higher charges for contributions made during initial periods.

- Initial or contribution-based charges – these charges involve deducting a proportion from the contribution itself that is invested into a pension fund.

- Ongoing fixed charges – these charges can be levied on an ongoing basis. For example many pre 2001 schemes charge a fixed amount per month for each saver.

- Discontinuance or early surrender penalties – these charges involve a one-off penalty being levied on savers if they either stop regular contributions or prematurely withdraw funds. This may occur when employees change jobs, or if they want to transfer their savings to another provider. The level of exit charge is typically calculated as a proportion of the first few years of contributions into the scheme.

- Other one-off charges – these charges are levied when triggered by certain events. For instance, they can be levied when savers switch funds or change the level of their regular contributions.

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33 OFT (2013), "Defined contribution workplace pension market study", paragraph 6.46.

2.10 Charges can be measured in different ways, such as by absolute levels, proportions of fund value or reductions in the investment yield. Schemes may appear to have low charges by one measure and high charges by another measure depending on the combination and levels of charge types and the circumstances and behaviour of savers.

2.11 We have chosen to use reduction in yield (RIY) to measure the level of scheme charges for this audit. The RIY as we will use it includes all member borne costs expressed as a percentage point reduction in the annualised return over a year. We will use RIY because it is an industry standard measure that can be used to compare different schemes. Specifically, the RIY can be compared with other benchmarks such as the 0.75 per cent of fund charges used by the DWP for its price cap, or an AMC (that includes all member borne charges).[34]

2.12 Low charge levels for any charge type reduce overall charges for all savers. However, there is no single charging structure that will result in better outcomes for all savers at the same time. There will always be some savers that may do relatively better under some charging structures than others. Two potential implications of different charging structures are described below.

- Some charging structures may result in lower charges for savers in some circumstances, but may mean higher charges for savers in other circumstances.[35] Providers incur costs to serve each saver, with particularly large costs to set-up a policy. Depending on the charging structure, not all savers will pay enough in charges to cover the individual costs they incur for providers and some may pay considerably more in charges than the cost to serve them. If schemes are designed to ensure each saver covers their own individual cost to serve then charges could be very high for some savers, particularly those with small funds.

- Some structures may increase the overall costs of a scheme. All schemes have an initial cost of set up. If schemes do not recover these costs from savers at the outset with high initial fees, then the provider must incur a cost

34 Suppose a fund starts with a value of £10k and the underlying investment grows by 5% over a year. The fund has an AMC of 0.75% of the fund value (which includes all member borne charges), and is calculated on a daily basis as 0.75%/365. Total charges will be £76.44. The fund value therefore grows by 4.22% over the year, after charges. This means that the RIY is 0.78% (5%-4.22%). This value may be different if the rate of investment growth is different. At 0% investment growth, the AMC will equal the RIY. In some cases, AMCs used by providers do not include all member borne charges.

35 For example, a scheme with an AMC of 0.5 per cent and a fixed monthly policy fee of £2 would have charges of £5 + £24 = £29 for saver with a fund of £1k, and £50 + £24 = £74 for a saver with £10k. Whereas a scheme with a 1 per cent AMC would cost £10 for a saver with a fund of £1k and £100 for a saver with a fund of £10k. The first scheme is more expensive for the saver with a £1k fund and less expensive for a saver with a £10k fund.

of holding back capital or 'borrowing' to pay out these costs. This is an additional cost of the scheme that will need to be recovered through higher charges overall.

2.13 We have not taken a view as to whether one charging structure should be consistently preferred to another because of these different outcomes for different savers. However, we note that since the launch of Stakeholder pensions in 2001, there has been a trend towards AMC schemes where the only charge is a fixed percentage of fund value. The introduction of automatic enrolment will also change the profile of the population of pension savers, with implications for what may be the most appropriate charging structures in future.

2.14 We believe governance bodies will be best placed to determine whether a charging structure is suitable for savers in specific schemes. This is because they will have a better understanding of the specific needs, preferences and circumstances of the members of each scheme. In this audit, we will collect data and report back on the prevalence and impact of different charging structures across the industry, which will support governance bodies in this assessment.

Using saver scenarios to assess charges

2.15 The amount that a saver pays in a scheme will depend upon the charging structure and their personal circumstances. The overall charges paid in any scheme for all savers will depend on the mix of saver characteristics in that scheme. This means any assessment of scheme charges must take into account these different characteristics.

2.16 To do this, the audit uses a number of hypothetical saver scenarios for on-going charges and for exit charges as described below. Using hypothetical scenarios allows us to understand the impact of the drivers of charges given a particular set of saver characteristics, and provides a consistent approach to assessing multiple schemes.

2.17 We considered an alternative approach that used charges for actual individual savers. However, this approach would still require a number of assumptions to be made about existing savers' behaviour in the future and would also require us to make assumptions about future savers joining the scheme. We therefore decided that the approach using saver scenarios described below would be more useful to help us understand the impact of different charging structures.

On-going charge scenarios

2.18 We have selected 37 hypothetical saver scenarios as shown in Figure 2 below. Each scenario represents a combination of saver characteristics that may drive the total charges paid in a scheme. For each saver scenario, providers will calculate the impact of charges and we will then compare across schemes.

2.19 There are five main drivers of total charges paid by a saver shown in the box below. Each of these may affect the level of charge. We have selected saver scenarios that will show the impact of these drivers on total charges. We recognise that some of these combinations may not reflect actual saver behaviour or may not be relevant for some schemes, but have specifically included scenarios that will be ‘outliers’ and so likely to have higher charges than many savers would actually experience.

Drivers of total charges

- Years in scheme until today - Initial charges will increase charges at the start of a policy.
- Age today/future years contributing – The more years savers contribute the more likely they are to build up larger funds. This is likely to reduce charges as a proportion of fund value and the reduction in investment yield, but increase absolute charges.
- Exit age - Early exit may result in higher exit charges.
- Contribution level - Higher contributions generally lead to higher absolute levels of charges. Unless there are fixed fees or tiered charges, the contribution level will not impact the reduction in yield or charges as a proportion of fund value.
- Fund value at start - Higher fund values will result in higher levels of absolute charges. Unless there are fixed fees or tiered charges, the fund value will not impact the reduction in yield or charges as a proportion of fund value.

2.20 For the saver scenarios, we also assume values for the growth in wages and investments. We assume 4 per cent growth in nominal wages and a 5 per cent return on investments. This is in line with the FCA’s guidance.[36]

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36 FCA Conduct of Business Sourcebook, Section 13 Annex 2.

Figure 2. List of saver scenarios with cash-in values at exit assuming zero charges

Customer	1	2	3	4	5	6	7	8	9	10	11	12
Years in scheme until now	5	5	5	5	5	5	5	0	0	0	0	0
Age today	25	25	25	25	25	25	25	25	25	25	25	25
Future years contributing	40	40	5	5	0	0	0	40	40	5	1	1
Exit date	65	65	65	65	40	55	40	65	65	65	65	40
Fixed monthly contribution since scheme entry	£200	£50	£200	£50	£200	£50	£50	£0	£0	£0	£0	£0
Initial monthly contribution	£200	£50	£200	£50	£0	£0	£0	£200	£50	£50	£50	£50
Cash-in value at start	£15,000	£1,000	£15,000	£1,000	£15,000	£1,000	£1,000	£0	£0	£0	£0	£0
Cash-in value at exit	£657,397	£144,989	£186,661	£27,305	£31,184	£4,322	£2,079	£551,797	£137,949	£20,265	£4,131	£1,220
Customer	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20**	**21**	**22**	**23**	**24**
Years in scheme until now	10	10	10	10	10	0	0	0	0	0	0	0
Age today	60	45	45	45	45	60	60	45	25	45	45	60
Future years contributing	0	0	5	0	0	5	5	5	1	1	5	1
Exit date	65	65	65	65	55	65	65	65	40	65	55	65
Fixed monthly contribution since scheme entry	£200	£200	£50	£50	£50	£0	£0	£0	£0	£0	£0	£0
Initial monthly contribution	£0	£0	£50	£0	£0	£200	£50	£50	£200	£50	£50	£200
Cash-in value at start	£35,000	£35,000	£1,000	£1,000	£1,000	£0	£0	£0	£0	£0	£0	£0
Cash-in value at exit	£44,670	£92,865	£10,291	£2,653	£1,629	£14,696	£3,674	£7,638	£4,880	£1,557	£4,689	£2,996

Customer	25	26	27	28	29	30	31	32	33	34	35	36	37
Years in scheme until now	0	10	10	10	5	5	10	10	10	10	0	5	5
Age today	60	45	60	60	25	25	45	60	45	45	25	25	25
Future years contributing	1	5	5	5	0	0	0	0	5	0	24 with caring breaks	24 with caring breaks	24
Exit date	65	55	65	65	65	65	55	65	55	65	65	65	65
Fixed monthly contribution since scheme entry	£0	£200	£200	£50	£200	£50	£200	£50	£50	£50	£0	£50	£50
Initial monthly contribution	£50	£200	£200	£50	£0	£0	£0	£0	£200	£0	£50	£50	£50
Cash-in value at start	£0	£35,000	£35,000	£1,000	£15,000	£1,000	£35,000	£1,000	£10k (+£25k transferred)	£10k (+£25k transferred)	£0	£1,000	£1,000
Cash-in value at exit	£749	£75,767	£59,365	£4,950	£105,600	£7,040	£57,011	£1,276	£75,767	£92,865	£81,031	£88,071	£96,047

Approach to audit

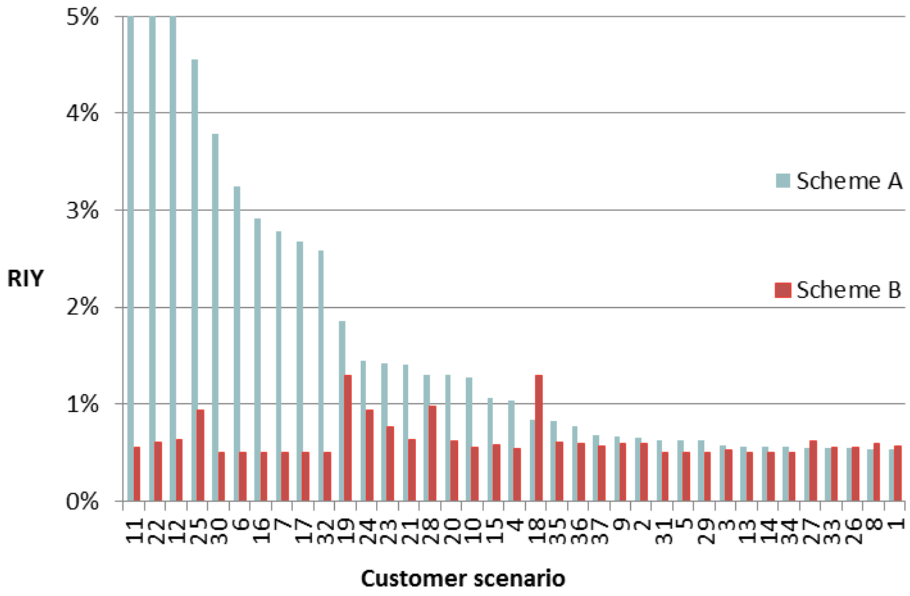
2.21 For each scheme in the audit, we are collecting data on the charge profile across scenarios. For example, the chart below shows how two charging structures compare across the different saver scenarios.

- Scheme A has a charging structure made up of a £20 per year policy fee and a 0.5 per cent AMC. In this scheme, scenario 1 has the lowest RIY (a 25 year old saver that remains in the scheme for life) and scenario 11 has the highest RIY (a 25 year old saver that contributes £50 per month for only 1 year). This indicates that Scheme A is likely to have high charges for savers with small fund values or who have short periods of contributing small amounts.

- Scheme B has a contribution charge of 2 per cent and a 0.5 per cent AMC. In this scheme, the scenarios with the lowest RIYs are those where savers are paid-up (and so do not contribute further) and scenarios 18 and 19 have the highest RIY (new joiners at age 60 that contribute until retirement). This indicates that Scheme B will have higher charges for savers that are likely to contribute for only a small number of years close to retirement as there is little time for the fund to grow.

- Scheme B has lower charges than Scheme A for all scenarios except scenarios 1, 8, 18, 26, 27 and 33 where the saver is contributing £200 per month and has a long enough contribution period. This is because these savers pay higher charges under the contribution charge than they would do under the policy fee.

Figure 3. Comparison of two schemes



2.22 To ensure we get a complete picture of charges we have asked for data on a range of scenarios including new savers and savers who exit early. This means we will capture in the scenarios the effect on existing savers described above as well as the effect of exit charges in reducing transfer values for new savers.

Assessing benefits

2.23 The OFT was not able to assess the scheme benefits in its market study and so specifically recommended that this audit consider any benefits associated with schemes. The OFT identified three types of scheme benefit. These may be given a monetary value and compared with scheme charges in an objective way.

2.24 We have considered each of these benefits and are collecting data on the prevalence of them being offered with schemes. We will only consider benefits where they are non-discretionary for members of a scheme. Where benefits are discretionary, we will only consider the pension scheme excluding the charges for any benefits. We describe below each of these benefits and how we intend to take account of them in the audit.

Guaranteed annuity rates

2.25 These are offered in schemes that have a guaranteed minimum rate at which the scheme saver can use their accumulated pension saving to purchase an annuity with a provider. These are mainly associated with traditional with-profits schemes.

2.26 Other than traditional with-profits schemes, it is not clear whether other schemes offer such guarantees and we are seeking further information through data collection. Where they are available, the IPB generally considers that guaranteed annuity rates are likely to be valuable for savers. We are collecting information on the extent of guaranteed annuity rates for traditional with-profits schemes and will compare these benefits with the charges of those schemes.

Growth guarantees

2.27 Some schemes offer investments that provide certainty over the minimum growth of members' accumulated savings. For example, providers may guarantee that the value of savers' assets will increase at a minimum rate per year. Alternatively, they may guarantee that the value of a saver's assets will be at least a certain amount at retirement. The OFT reported that these guarantees are relatively prevalent in pre 2001 schemes.[37] We are collecting data in the audit to understand what proportion of assets in these schemes are actually invested in funds that offer these guarantees and understand the relationship between guarantees and charges.

2.28 The IPB has considered how to treat growth guarantees in its assessment. The IPB recognises that there is a cost to growth guarantees – either through higher charges or deductions from the fund to cover the costs of guarantees or through investing assets in lower risk and lower yield investments. These costs mean that growth guarantees may not always of value to savers. Growth guarantees may be more suitable for risk-averse savers, but not for savers with a greater risk appetite who would prefer to invest in potentially higher yielding assets. Therefore, although market values can be placed on growth guarantees, the value of the guarantee to savers in any particular scheme will depend upon their risk appetite and whether the guarantee meets their objectives. For this reason, the IPB sees growth guarantees as part of the attributes of investment strategy and performance which governing bodies will be best placed to assess. We will draw this to the attention of governance bodies in our final report.

Other forms of bundled insurance

2.29 Schemes may offer various additional optional types of insurance together with a pension. The two most prominent examples are: incapacity insurance, under which the provider promises to pay the saver's regular pension contributions in certain circumstances; and life insurance, under which the provider promises to

[37] OFT (2013), "Defined contribution workplace pension market study", paragraph 6.49.

pay an additional lump sum to the saver's dependents in the event of death before retirement, in exchange for higher charges.

2.30 These products may have a value to savers. However, these products are often not intrinsic to the pension scheme and are additional optional benefits that savers may choose to purchase or opt out of. The focus of the audit is pension schemes and we do not intend to assess the value for money of other optional products. Hence, we are collecting data on pension schemes excluding any additional charges for other products.[38] This will allow us to assess the value of pension schemes alone. We are also collecting data on any bundled insurances that are not discretionary and so cannot be split out from the cost of the pension scheme. However, we have already established from providers that there are only a negligible number of schemes that offer non-discretionary insurance. We will report on the incidence of non-discretionary insurance in our final report. As part of their assessment of overall scheme quality, governing bodies may want to consider the availability and cost of such products where they exist.

Exit charges

2.31 All schemes have an initial, administrative cost of set up. Joining fees and exit charges are used so that a provider can recover some or all of its set-up costs from those savers that give rise to the costs. However, exit charges may deter savers from switching provider, even if an alternative is available that offers lower charges or better benefits. For these reasons, the IPB will consider exit charges as part of the audit.

Alternative approaches to recovering set-up costs

2.32 There are three main ways that set up costs can be recovered.

- **Set up costs paid up front by each saver.** This means that total charges are high at the start, but are lower going forward. Under this charging structure, there are no exit charges. Each saver pays their own set-up costs but a saver who leaves early will have lost a high proportion of their contributions and fund value to charges arising from these initial charges.

- **Set up costs paid by everyone who remains in a scheme.** All savers pay the same ongoing charge as a proportion of their funds, (for example, an AMC) but no joining or exit charge. Because there is no joining or exit charge, the provider is likely to recover the set-up costs of those savers that

38 Although we note that there could be an element of cross-subsidy between the two, we assume this is immaterial to the conclusions we will draw.

leave early through charging a higher ongoing rate to those savers that remain in the scheme. This means long term savers bear the costs of savers who exit early.

- **Set up costs paid over the lifetime or at exit.** Savers do not pay an initial charge. However, should a saver leave early, they will pay an exit charge, which diminishes over time. Because all savers that exit pay their own set-up costs, these costs do not need to be recovered from savers that remain in the scheme for longer.

2.33 None of these approaches results in a better outcome for all savers, but each will have different consequences for different savers. However, some options may potentially act as a barrier to savers switching from one pension provider to another scheme where they would get better value for money. Barriers can be both financial and psychological.

2.34 Savers may incur a financial charge if they leave early. This charge reduces the face value of the fund they have accumulated and so may act as a disincentive to switch to another scheme. Schemes with initial costs, but without exit charges, may also create a barrier to savers switching. If savers have 'sunk' costs into a scheme, they may be deterred from leaving the scheme and 'writing off' these initial charges. This may act as a psychological barrier, even though savers may be better off moving to another scheme.

2.35 We will consider exit charges further in our final report and collect data on these from providers. When we assess the level of overall charges for different schemes we will also consider the impact of the reduction in exit charges over time. We describe our approach for the on-going saver scenarios below and for specific exit scenarios.

On-going scenarios

2.36 For some schemes, there may be a difference between the face value of a fund and the transfer-out value, due to exit charges. We have asked for the transfer-out value to be modelled in the 37 saver scenarios described above. The relevant comparison for a saver or governance body is whether staying in an existing scheme or moving to an alternative scheme with the transfer amount will result in lower charges. This is because this is the real monetary value that savers could choose to take out of a scheme and invest in an alternative scheme.

2.37 If the exit charges fall over time, this has an implication for the level of charges when we look on a current and future basis. For example, if a scheme has an exit charge of 5 per cent today then a saver with a face value of £10k would have £9.5k if they chose to leave the scheme. If there is an AMC of 1 per cent per year of the face value (and ignoring any fund growth or additional contributions), then the saver would have a face value of approximately £9k after 10 years for retirement (and no exit charges). The effect of charges has been to reduce their available funds from £9.5k today to £9k, which is an effective charge of around 0.5 per cent per year over the 10 years. This is less than the headline rate of 1 per cent AMC and is due to the fall in exit charges over time.

Exit scenarios

2.38 We want to assess the extent and scale of exit charges in the audit and will do this using exit scenarios. The charges of exiting a scheme will depend on how long a person has been a saver and their age relative to the scheme retirement date. We have selected 40 scenarios that are described in the table below. For each scenario the saver contributes for 5 years before becoming paid-up, and exiting at a later date as shown in the table below.[39]

Table 1. Description of 40 exit scenarios used in audit

Starting age	Exit age	Monthly contribution level	Face value at exit
25	35, 40, 45, 50, 54, 57, 60, 63, 66, 69, 72, 75	£100	£10k
		£1000	£100k
45	54, 57, 60, 63, 66, 69, 72, 75	£100	£10k
		£1000	£100k

2.39 We will collect data on the transfer-out value to compare with the face value in each scenario. For schemes without exit charges the face value will be the same as the transfer value. For some schemes, there may be an increase in the transfer value above the face value for ages above the scheme retirement date.

With-profits investments

2.40 There are a number of different types of with-profits investments. We have decided to use the saver and exit scenario approach set out above for some types of with-profits investments, but recognise that a different approach is required for others. We describe the types of with-profits investment below, and our approach to assessing the charges faced by savers.

39 To make comparisons between the charges in different scenarios, we have asked providers to model scenarios that have the same face value at each exit date. This means providers will calculate a certain level of investment yield throughout the lifetime of each scenario that results in the specified face value.

Approach to audit

2.41 There are two main types of with-profits investment:

- Traditional with-profits (also called conventional with-profits)
- Unitised with-profits (also called accumulating with-profits).

2.42 With traditional with-profits, savers typically pay regular contributions or premiums in exchange for a minimum sum at retirement or annuity. These contributions are held in a fund with each saver allocated a share of the assets determined by the provider.[40] Savers benefit from the growth in the fund by receiving bonuses that increase the minimum sum or a final bonus that increases the benefits they leave with. Regular deductions from the shared fund are made to reflect administrative expenses and the cost of financial guarantees and options. The size of these deductions may vary from year to year, depending on actual expenses incurred and the changes to the expected cost of meeting future liabilities. Deductions cannot always be directly allocated to individuals and may also vary from saver to saver, but are typically set in a way which seeks to achieve fair treatment for all policyholders.

2.43 Savers in a pension scheme can typically select unitised with-profits funds as an investment option alongside unit-linked investments. Some unitised with-profits funds have explicit charges set out in policy documents, while others do not. Where explicit charges are specified, providers may also make additional (positive or negative) adjustments where actual expenses incurred are higher or lower than charges deducted.

2.44 For with-profits investments where charges are explicit, we will assess saver and exit scenarios as we do for unit-linked non-profits investments. Where charges are not explicit, or where additional adjustments are made to funds with explicit charges, we will collect aggregate information on total deductions applied to in-scope policies in the last financial year, splitting out deductions relating to administrative costs and those relating to meeting the cost of guarantees. This information will be used to estimate the average charges faced by savers of in-scope schemes who have invested in with-profits funds when this is the default fund or most popular fund. There appear to be only a relatively small number of traditional with-profits schemes in scope of the audit and we will provide detail on this in the final report.

Value for money

2.45 The OFT found that "competition alone could not be relied upon to deliver value for money for all savers in the defined contribution workplace pension

40 Often these allocations are notional.

market" and many of its conclusions focus on value for money.[41] This audit has been set up to establish charges and benefits in in-scope schemes. However, although charges and benefits are important elements of value for money, there are also other elements of scheme quality that should be included in any assessment of value for money that the governance bodies undertake.

2.46 The quality and value to savers of a scheme may depend on savers' preferences. This may include a scheme's relevance and appropriateness to a saver's needs and risk appetite. The OFT and DWP have both made recommendations and proposals that aim to improve the quality of schemes.

2.47 The OFT identified three key elements of scheme quality.

- "Scheme administration and member communications. This includes managing and allocating member contributions in a timely and accurate way, keeping scheme records and providing member communications, such as annual statements, web-based tools and possibly also workplace seminars. Administration is important because errors can impose significant charges and losses on members, and administration costs in bundled schemes usually make up a significant proportion of the overall charge paid by members.

- "Investment strategies and their execution and performance. This includes setting member objectives and designing, executing and monitoring a default investment strategy against those objectives, offering an appropriate range of value for money funds for those who self-invest, and ensuring those funds remain suitable and continue to deliver value for money.

- "Scheme and product governance. Good governance should ensure that the quality of administration and investment management and the level of scheme charges represent value for money. [Governance] should also have an appropriate level of independence to ensure it acts in the interests of scheme members. Effective governance is important because it can substitute, to a degree, for the lack of employer and employee scrutiny of value for money." [42]

2.48 The OFT and DWP have made a number of recommendations and proposals about scheme quality, as we describe in Section 1. This includes new minimum quality standards for defined contribution workplace pension schemes. IGCs will protect savers' interests in contract-based schemes and there will be stronger requirements on trust-based schemes. These changes are designed to improve accountability and promote compliance with the quality standards.

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41 *Ibid.,* paragraph 1.5.

42 OFT (2013), "Defined contribution workplace pension market study", paragraph 7.4.

Approach to audit

3 Methodology and analysis

3.1 Our approach set out above is to look at all schemes in-scope and assess the level of charges in these schemes. As explained earlier, we will do this by using saver scenarios and asking providers to model how each of the charging structures determines the level of charges paid for each hypothetical saver. We will then analyse the output of these saver scenarios to answer the questions we set out in Section 1. This section sets out our methodology for collecting the data from providers and describes the analysis we will conduct.

Methodology for collecting data for unit-linked schemes

3.2 There are five steps to the data collection process for the audit:

1. Providers need to identify the scheme or group of schemes for which to submit data.

2. Providers then need to identify the 'scheme investment' (defined below) that they will use.

3. Providers will submit data on the charging structure for each scheme.

4. For each scheme or group of schemes, providers will model the impact of the charging structure for each saver scenario.

5. For those schemes or groups of schemes where the charges for some saver scenarios are above a threshold of one per cent, we will ask providers to submit additional data on saver characteristics for each scheme or group.

All providers have confirmed extensive due-diligence and oversight processes which include data submissions being signed off by their Boards.

We describe each of these steps below.

1. Identifying the scheme or group of schemes

3.3 The audit is being conducted at the scheme level. The first stage is for providers to identify all schemes in scope, before submitting data on charges for each of these schemes. However, we recognise that many schemes have similar or identical charging structures and that it is more efficient for providers to submit data for groups of these with alike charging structures. Providers can therefore choose to group schemes together if all schemes in the group are of the same type, and if they have identical charging structures. For example, schemes with a contribution charge and an AMC.

3.4 Where groups of schemes have identical charging structures, individual schemes may still have different charge levels. Where this is the case, providers should choose the highest charge levels for each charge type to represent all schemes in the group. This ensures that all savers that may have high charges within the group are identified. The table below gives an example of grouping two schemes together.

Table 2. Example of how charges are reported for a group of schemes

Charge type	Scheme 1	Scheme 2	Charges reported for group of 1 + 2
AMC	0.5%	0.75%	0.75%
Contribution charge	4%	3%	4%

3.5 This approach could mean that charges for many schemes are overstated, as they will be grouped with other schemes that have higher charges. Providers will be aware of this as they take decisions on how and whether to group schemes. However, in step 5 below, we will ask providers to submit further information on the schemes within some groups that are at risk of higher charges.

2. Identifying the 'scheme investment'

3.6 The charges a saver pays may depend on the fund they invest in. Therefore, providers will need to assume a specific investment for each scheme to submit data on charges for each scheme or group of schemes.

3.7 If providers have identified an individual scheme, then they will use the scheme charges for the default fund, if one is available.[43] If there is no default fund, then providers should submit data using their most popular investment option.

3.8 If providers have grouped schemes together, then there may be different default or most popular funds for each scheme in the group. We have therefore agreed an approach whereby providers submit data on the basis of the investment choices with the highest charges amongst the default and most popular funds for all the schemes in the group. Providers should report data for two different scheme investments.

- First, the fund with the highest charges out of all the funds that when ranked by size make up 80 per cent of the assets under management for that group

43 If a scheme has changed the default fund during the lifetime of the scheme, then providers should report on the basis of the most popular investment.

of schemes. We have selected 80 per cent to ensure that any significant funds with higher charges are captured in the audit.

- Second, the provider should identify the default or most popular fund for each scheme. Of these, the provider should select the fund with the highest charges. This may be the same as the first fund.

3. Submitting data on charging structures

3.9 For each scheme or group of schemes, providers have been asked to submit data on the charging structure, which refers to the type of charges that apply for a given scheme, and the protocols governing how each charge applies; any non-discretionary benefits paid for by employees which are included in scheme charges; and the charge level, which is the level of a particular charge within a charging structure.

4. Modelling impact of the charging structure for each saver scenario

3.10 We are using hypothetical saver scenarios to assess charges as we describe in section 2 above. For each saver scenario, providers have been given information on their start age, starting fund value after exit charges apply, contribution profile, exit age, and other events such as whether they take a career break, or transfer in additional funds.

3.11 Once all charging structures and charge levels have been identified, providers will then apply these charges to each saver scenario. Using the assumptions, providers will be able to calculate a fund value at the given exit age which takes into account all charges borne by each of the hypothetical savers, including any exit charges.

3.12 The scenarios will calculate the impact of charges on a forward looking basis. This means that any charges incurred in the past will not be captured by each saver scenario, although we do also include scenarios for new savers.

3.13 We will calculate the fund value for each saver scenario with no charges. We can then compare the cash-in values for each saver scenario with and without charges and calculate the reduction in yield (RIY) for each scenario.

5. Submitting additional data on saver characteristics

3.14 A scheme may have some saver scenarios that have higher or lower charges measured by RIY. We want to understand how many savers within these schemes are likely to be paying higher charges. The final step will therefore be to provide additional data on saver characteristics of those schemes and scenarios that have charges above a threshold. This threshold is that total member borne charges, excluding investment management transaction charges, are greater than one per cent per annum.[44]

3.15 If a scheme has some scenarios where charges are above this threshold, providers will submit data on the distribution of savers in that scheme by fund value, contribution level, age, and length of time in scheme. We will not request additional data from schemes if the scenario is not directly relevant, such as a scheme closed to new savers where the high charge scenarios only affect new joiners.

3.16 For groups of schemes, we will first ask providers to break up the group and only submit data on those schemes that are above the threshold and not those that may be below the threshold.

3.17 This data will allow us to map between the high charge scenarios and the likely size of the corresponding group of savers. With this information we can understand the number of savers who are at-risk of incurring high charges and the size of funds under management.

Methodology for collecting data for with-profits

3.18 For traditional with-profits, providers will submit aggregated information for every bonus series which contains at least one in-scope policy. Policies belonging to the same bonus series receive bonuses on the same scales, and expenses across savers are applied consistently across policies belonging to the same bonus series.

3.19 For schemes offering unitised with-profits as an investment option, providers will treat unitised with-profits funds with explicit charges and no additional deductions as if they were unit-linked investments.[45] For all other types of unitised with-profits fund, aggregate information on deductions (either at the fund level or the bonus-series level) is required for all funds which either are the scheme investment of an individual scheme, or make up more than 5 per cent of AUM of any group of in-scope schemes.

3.20 Aggregated information on deductions from with-profits funds and bonus series will be used to estimate the average charges faced by savers of in-scope schemes who have invested in with-profits funds.

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44 This is the same threshold as used to determine whether post-2001 schemes are in-scope of the audit.

45 Deductions other than for smoothing, whereby a proportion of the profits earned during good years is held back to ensure that a reasonable return is paid during years of poor performance.

Progress and next steps

3.21 Senior representatives from the Government, regulators, consumer groups and financial services were appointed to the Board of the IPB in February 2014. The full list of IPB members can be found in Annex 3.

3.22 Since March, we have been issuing data requests to providers based on the approach and methodology we have set out above. The full list of providers can be found in Annex 4. Providers have been submitting their completed data requests to Frontier Economics and are now providing additional information as outlined above.

3.23 Over the summer and autumn, we will review the data collected and report our findings in our final report which will be published in December 2014. We expect to provide analysis such as:

- a description of the schemes in-scope such as the proportion of savers and assets in open and closed schemes, size of scheme and so on;
- the incidence of different charging structures and charge levels used by providers in schemes covered by the audit, and their impact;
- an analysis of the saver scenarios for all schemes including with-profits schemes; and
- an overview of saver behaviours that are more likely to incur higher charges.

3.24 The secretariat can be contacted at Ben.Gaukrodger@abi.org.uk and would welcome any views on what issues it should consider as it determines the actions that need to be taken following the audit.

Annex 1: The Terms of Reference

Following the OFT's report, the ABI, and those of its members that provide DC workplace pension schemes, agreed to an audit of those schemes, to be overseen by an IPB. The terms of reference for the IPB that have been agreed for this audit are that the IPB will have the following objectives:

- Establish the criteria for the audit of pre-2001 workplace pension products and post-2001 workplace pension products that are multi-charging, or where all member borne charges, excluding investment management transaction charges, exceed 1 per cent of any member's fund value in a given year (the Audit), including the data (charges and benefits) providers (ABI members) should extract from their systems. These will be designed to capture information to allow an assessment of charges and benefits in legacy schemes.
- Provide additional high-level oversight (in addition to oversight by Boards and IGCs) to the Audit process carried out by providers.
- Ensure that the firm-specific Audits are carried out on a consistent basis.
- Analyse the results of the Audit.
- Agree what generic industry-level actions may be needed to address in-scope schemes assessed as having high charges without commensurate benefits, taking account of the need to avoid unintended consequences, and recognising any potential differences of approach that may be required for trust-based and contract-based schemes (including contract law).
- Submit a report to the CMA, FCA, TPR, DWP, pension company Boards, trustee boards, and IGCs, as appropriate, which sets out industry-level actions, and timescales that take into account the practicalities of implementation. The Report will not contain any provider- or scheme-specific references or recommendations.

Annex 2: Scope of the audit

The audit will produce an assessment of current and future charges and benefits for scheme members in funds promoted by providers (such as default, popular and lifestyle funds), and all their subsidiaries that hold workplace pensions.

The scope includes defined contribution workplace pensions, including contract-based DC schemes and trust-based bundled DC schemes, including both occupational money purchase schemes and master-trusts.

DC workplace pension schemes are in scope if they commenced:

- on or before 5 April 2001;
- on or after 6 April 2001 if all member borne charges, excluding investment management transaction costs, exceed 1 per cent of any member's fund value in a given year; or
- on or after 6 April 2001 if the scheme has multiple charge types.

The audit will also review the OFT's findings and data on single-charge schemes between 0.75 per cent and 1 per cent, and consider the charges of these schemes in its recommendation.

The scope excludes:

- defined benefit schemes, individual personal pensions (including where policy holders were previously in a workplace scheme);
- additional voluntary contribution schemes;
- unbundled trust-based schemes;
- section 32 buy-out policies;
- executive pension plans and small self-administered schemes; individual personal pensions with employer contributions (e.g. where a member is a senior executive);
- Group Rebate Only Personal Pension Plans (GROPPs);
- Policies paid up and Assigned to Member, where the employee might have left service or the company is no longer trading; and
- schemes undergoing Wind Up, where the employer has ceased to trade and all contributions have ceased, are out of scope of the audit.

Annex 3: The Independent Project Board

The members of the IPB are as follows:

- Carol Sergeant, independent Chair
- Michelle Cracknell, The Pensions Advisory Service
- David Hare, Institute and Faculty of Actuaries
- Bridget Micklem, Department for Work and Pensions (until 22 July 2014)
- Charlotte Clark, Department for Work and Pensions (from 23 July 2014)
- Nick Poyntz-Wright, Financial Conduct Authority
- Joanne Segars, the National Association of Pension Funds Limited
- Ed Smith, Competition and Markets Authority
- Doug Taylor, independent consumer advocate
- Otto Thoresen, Association of British Insurers
- Andrew Warwick-Thompson, The Pensions Regulator

Annex 4: Providers participating in the audit

The following is a list of all ABI members with schemes in-scope of the audit and the brands under which they provide (or originally provided) DC workplace pensions.

- Abbey Life
    - Abbey Life Assurance
    - Hill Samuel Life Assurance
    - Target Life Assurance
- Admin Re
    - ReAssure
- Aegon
    - Scottish Equitable PLC
- Aviva
    - CGU
    - Commercial Union
    - General Accident
    - Norwich Union
    - Provident Mutual
    - Royal Scottish Assurance
- BlackRock Life Limited
    - BlackRock
- Canada Life
- Equitable Life Assurance Society
- Fidelity Worldwide Investment
- Friends Life
    - Friends Provident
    - London & Manchester
    - National Mutual
    - Equity & Law
    - Sun Life
    - AXA

  - Winterthur Life
  - Colonial Life
- Guardian Financial Services
- HSBC Life (UK) Limited
- Legal & General
- Mobius Life
- NFU Mutual
- The Phoenix Group
  - Phoenix Life Limited
  - Phoenix Life Assurance Limited
  - National Provident Life Limited
- Prudential
  - Prudential Assurance Company Limited
- Reliance Mutual
  - Criterion Life Assurance
  - University Life Assurance Society
- Royal London Group
  - Scottish Life
  - Royal London Plus
  - Royal London (CIS) Limited
- Scottish Widows
  - Halifax Financial Services
  - Clerical Medical Investment Group
- Standard Life
- Sun Life Financial of Canada
  - Sun Life Assurance Company of Canada (UK) Limited
- Wesleyan Assurance Society
- Zurich Insurance
  - Zurich
  - Allied Dunbar

Annex 4: Providers participating in the audit

- Eagle Star

Glossary

- **Association of British Insurers (ABI).** The ABI represents the collective interests of the UK's insurance industry, including all the major pension providers.
- **Accumulation.** The period during which savings are accrued for retirement.
- **Active member.** A member of a pension scheme who is at present accruing benefits under that scheme.
- **Active member discount (AMD).** A charging structure where active members of a scheme pay lower charges than deferred members who have stopped making contributions.
- **Administration.** The day to day running of a pension scheme. This may include collecting contributions and payment of benefits.
- **Adviser.** A professional who renders financial services to clients.
- **Annual management charge (AMC).** The AMC is levied as an annual charge on the value of the scheme fund. This charge may cover a combination of the sales, administration and fund management costs of the fund.
- **Annuity.** The fixed sum of money paid to individuals each year upon retirement. This is typically for the rest of their life based on their total accumulated pension savings.
- **Assets under management (AUM).** The total of all funds being managed on behalf of scheme members.
- **Automatic enrolment.** A legislative requirement for employers to enrol their employees into a pension scheme if they are aged between 22 and State Pension age, earn more than £9,440 a year and work in the UK.
- **Bundled schemes.** Pension schemes where the pension provider also administers the scheme.
- **Contract based schemes.** In a contract based scheme an employer appoints a pension provider, often an insurance company, to run the scheme. The scheme members will sign a contract with the provider who will make the majority of decisions about the way the scheme is run.

- **Contributions.** The money paid by members and employers to the pension scheme.

- **Default fund.** If employees do not actively choose an investment fund, they will have their contributions paid into a default fund, designed for this purpose.

- **Deferred members.** In defined contribution schemes, this is someone who no longer contributes to the scheme but is not yet a beneficiary of that scheme.

- **Defined benefit (DB).** A defined benefit scheme is a scheme in which the benefits are defined in the scheme rules and accrue independently of the contributions payable and investment returns.

- **Defined contribution (DC).** A defined contribution schemes' benefits are based on how much the member and employer pay into the scheme, and also on the performance of the investments made with that money.

- **Department of Work and Pensions (DWP).** The Department for Work and Pensions is responsible for welfare and pension policy.

- **Financial Conduct Authority (FCA).** The FCA is responsible for regulating the standards of conduct in retail and wholesale, financial markets and for supervising the infrastructure that supports those markets.

- **Group personal pensions (GPP).** A pension scheme which is organised through the employer, but still takes the form of individual contracts between the employee and the pension provider.

- **Investment manager.** An individual (or company) to whom the management of all or part of a scheme's assets is delegated.

- **Investment strategy.** The rules and procedures for the selection of the range of investment products for a pension scheme.

- **Legacy schemes.** Any scheme set up pre-2001 when stakeholder pensions were introduced.

- **Lifestyle funds.** An asset allocation strategy whereby a member's investments are adjusted depending on age and length of time to retirement. Typically assets are switched gradually from equities to bonds and cash as retirement approaches.

- **Master trust**. A master trust is a multi-employer pension scheme where each employer has its own division within the master arrangement. There is one legal trust and, therefore, one trustee board.
- **Member.** An individual who has contributed and/or continues to contribute to a pension scheme.
- **National Association of Pension Funds (NAPF).** The NAPF provide representation and other services for those involved in designing, operating, advising and investing in all aspects of pensions and other retirement provision.
- **The Pensions Regulator (TRP).** The TPR regulates trust based pension schemes in the UK.
- **Pension scheme.** The arrangement by which an employer and, usually, an employee pay into a fund that is invested to provide the employee with a pension on retirement.
- **Reduction in yield.** A measure of certain costs of a fund to the member and expressed as a percentage reduction in the annualised return over a defined period. This percentage shows the impact of the charges applied to a member's pot on its potential rate of growth.
- **Stakeholder pension.** Stakeholder pension schemes were introduced in the UK on 6 April in 2001 as a consequence of the Welfare Reform and Pensions Act 1999. They were intended to encourage more long-term saving for retirement, particularly among those on low to moderate earnings. They are required to meet a number of conditions set out in legislation, including a cap on charges, low minimum contributions, and flexibility in relation to stopping and starting contributions.
- **Trustees.** The board of trustees is responsible for the management, administration and investment of the pension assets.
- **Trust based schemes.** A trust based pension scheme is a scheme that is managed by a board of trustees. The trustees have full responsibility for the management, administration and investment of the plan. The trustee's fiduciary duty is to act in the interests of members and while they can delegate tasks to various specialists, such as investment managers, the responsibility remains with the trustee.

- **Unbundled schemes.** A pension scheme where there is separation in the provider of either the investment management or administration of a scheme.
- **Workplace pensions.** A pension provided by an employer.