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ABI RESPONSE TO BETTER WORKPLACE PENSIONS: DWP CONSULTATION ON CHARGING

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EXECUTIVE SUMMARY

Automatic enrolment

1. The successful implementation and development of auto-enrolment is critical to the future prosperity and security of the UK. With an ageing population but one of the lowest savings rates in the Western world, the UK is highly vulnerable to a future where its pensioner population is forced to live in relative poverty compared to the living standards enjoyed during their working lives.

2. Auto-enrolment offers an opportunity to begin to tackle this challenge with up to 11 million employees due to be enrolled into workplace pension provision between 2012 and 2018. Although overall contribution levels are still low, with an eventual level of 8% compared to a typical 9.25% in Australia (rising to 12% in 2020) and 16.5% in typical occupational Defined Benefit schemes[1], it still offers a once in a generation chance to set the UK on the right track thanks to a pioneering partnership between the UK Government, a new State-enabled pension provider and the UK's world-leading long-term savings and pension industry ('the industry').

3. For its part, the industry has always highlighted the need for a cross-party political consensus to underpin auto-enrolment with a stable legislative and regulatory framework within which industry can work to advance Government policy and serve consumers.

4. The industry has committed the very significant investment required to develop systems capable of servicing the hundreds of thousands of new schemes required. While clearly a successful introduction of auto-enrolment offers a commercial opportunity for the UK industry, the basis on which the investment was made was that we now had a firm and settled foundation on which auto-enrolment could be built.

5. Implementation of auto-enrolment since October 2012 has proceeded well and exceeded the expectations of many. The industry has delivered high-quality and well-performing schemes that large employers have implemented while, for its part, the UK Government's advertising campaign has helped employers and providers convince employees to stay enrolled with retention rates so far of

[1] ONS Pension Trends, September 2011, Chapter 8, p.8.

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91%.[2] This has proved a good foundation from which to approach the more challenging next phases of staging with medium and small enterprises starting their enrolment from April 2014. It is important that this momentum is not jeopardised in the lead up to the crucial "twin peaks" period of 2014 which will see in excess of 22,000 employers stage between April and July.

<u>OFT Inquiry into Workplace Pension Provision</u>

6. Although the Office of Fair Trading (OFT) inquiry into workplace pension provision was announced in January 2013, after auto-enrolment had already begun, the UK industry recognised the residual concerns about whether the market was working well enough to provide for such a potentially huge increase in workplace pension provision and co-operated fully with its investigation.

7. The OFT considered whether competition between market providers is working sufficiently well to ensure that existing and future customers would benefit from high-quality, low-charging schemes. While it found that competition appears to be applying downward pressure to charges on newer schemes (charges in newly set-up automatic enrolment schemes are now at an all-time low of 0.52% AMC[3]), it also concluded that two areas of the contract-based market were a cause for potential concern and reached an agreement with the industry, via the ABI, on a programme of action to address this. This involved:

   - An industry-led audit of pre-2001 workplace pension products, and post-2001 workplace pension products with charges over an equivalent of 1% AMC, overseen by an Independent Project Board (IPB). The audit will assess the level of charges applied to a scheme and the benefits associated with being a member of that scheme;

   - The establishment of Independent Governance Committees (IGCs) within providers to ensure workplace DC schemes offer ongoing value for money. The scope of these IGCs will include default funds and funds with significant usage in all DC workplace pension products in respect of all members of the scheme, whether active, deferred, or future leavers.

8. The OFT also recommended that Active Member Discounts should be banned so that employees who stop contributing to a DC workplace pension scheme are not penalised in respect of the charges that they pay in comparison to those who continue to contribute actively. OFT also recommended that schemes

[2] DWP, Automatic enrolment opt-out rates: findings from research with large employers, August 2013.
[3] ABI, Time to Act 2012. The OFT found that the average AMC on new contract based schemes and bundled trust based schemes written each year has fallen from 0.79% in 2001 to 0.51% in 2012 (p. 19 of the report).

containing adviser commissions should not be used for employees who are automatically enrolled in the future. It is therefore appropriate that DWP are consulting on these issues. Importantly however, OFT stated, in light of the industry commitments set out above, that it did not believe a charge cap was either necessary or desirable.

9. The industry's engaged and positive co-operation with the OFT to tackle their concerns over high-charging schemes and governance of contract-based schemes was welcomed by the OFT and led it to the decision that a referral to the Competition Commission was not necessary to fix these particular issues. Since then, the industry has worked with the OFT and DWP in good faith to agree the detailed implementation of the programme of action and it awaits the OFT's appointment of the IPB chair to begin the audit work.

Charge Cap Consultation

10. It is against this backdrop that the industry's concern at DWP's proposal to implement a charge cap on auto-enrolment default schemes should be viewed. The reasons for industry's objection to a charge cap are:

- **Further burden and confusion for employers.** By seeking to change long-standing and previously approved charging structures in the middle of the automatic enrolment process, Government would be increasing the burden on employers who are legally responsible for delivering auto-enrolment. Some employers may now find that schemes already delivered and underway need to be revisited, re-broked and re-priced, while thousands more will find their advanced plans for a scheme have to be reconsidered to meet what are effectively retrospective regulations from Government. Many smaller employers will be confused by further complications in an already complex transaction and by being asked to reconsider questions of value for money and service proposition that they had already completed. TPR recommends that employers begin preparing for their staging dates 12 – 18 months in advance.[4] Significant changes at this late stage will penalise and inconvenience employers who have done the right thing by putting their arrangements into place within appropriate timeframes. Additionally, we believe that the DWP's Impact Assessment significantly underestimates the transitional costs to employers of setting up alternative pension provision.[5]

[4] http://www.thepensionsregulator.gov.uk/employers/planning-for-automatic-enrolment.aspx
[5] DWP estimates that the number of employers who currently intend on using existing provision, but will no longer be able to under a cap of 0.75% would be 90,000. The transitional cost to employers of setting up alternate pension provision is estimated at £54–55.5m. Using these estimates, the cost per employer to renegotiate their arrangements would be approximately £600 per employer which would seem highly optimistic considering resourcing alone.

- **Operational risk.** If it proceeds with a charge cap and series of other changes to pension structures after auto-enrolment has already begun, the DWP is creating hugely significant practical and operational risk to the delivery of the auto-enrolment programme just at its most operationally sensitive point. The introduction of a charge cap, as well as precluding the use of certain qualifying schemes for automatic enrolment, would effectively mean the Government is moving the goal posts only months before the staging dates of tens of thousands of employers. The legislation which set up the auto-enrolment programme was passed with cross-party support and finalised before the 2010 election while the current Government has been in office for over three and a half years. If the industry had waited until after auto-enrolment was underway to set up and price the systems used it would have been unable to deliver on its promises.

- **Impact on customers.** It would be difficult to set a price cap at the right level, not least because the basic cost of providing the pension for an employer will remain the same. As a result, if the cap is set too low, providers will have no choice but to either lower quality, or to consider which employers they are able to serve, potentially resulting in less competition and less organic pressure on price. If the cap is set too high, the State will be giving its sanction to its citizens paying a *higher* price for pension provision than they would pay in the competitive market place where prices had been at an all-time low before the State intervention.

- **Potential for inconsistency.** The consultation is vague on how a cap would apply to dual charging structures. We would urge DWP to engage with the industry over the next few weeks to undertake this work as there could otherwise be an unlevel playing field - with strict rules for AMC structures and only very vague guidelines for dual charging structures. This is critically important to get right.

- **Uncertainty.** The Consultation Paper does not address how its proposals would work with the proposed OFT programme and the array of existing regulatory and industry initiatives on pricing, charging and transparency. It is important for industry to be able to operate in an environment of certainty, and to be confident that there is a clear, long-term Government plan in place across all aspects of pension reform.

Implementation timetables

11. Should the DWP proceed with the options outlined in its Consultation Paper, it therefore faces a difficult and complex set of choices about the consequences and the timing of the implementation of its decisions. These decisions will need to be made in the context of both a peak of automatic enrolment activity in the coming year, as well as the work the industry has committed to undertake in response to the OFT's concerns around legacy schemes and governance. Each of the proposed changes – a charge cap, a ban of Active Member Discounts (AMDs) and of in-built commission – in their own right, would require huge levels of provider resource to deliver within the required timescales. While an extension of the ban on Consultancy Charging is likely to present less of an impact on the resources of providers, it will add to the cumulative effect. This resource is finite, as there is only a limited supply of people in the industry with the requisite skills to undertake what usually is very detailed technical work. However, the cumulative impact of these changes, along with automatic enrolment itself, in particular the "twin peaks" of employers staging in 2014, and the resources required to carry out the legacy audit, could put the delivery of the entire automatic enrolment project at very severe risk, unless this work is scheduled appropriately.

12. For example, price capping an existing scheme requires significant amounts of provider and employer resource as it involves re-writing the scheme, making the necessary changes to literature, re-tendering the scheme and / or renegotiating with employers where necessary, contacting members and arranging for either the scheme to be changed or the employer to select a new scheme. Such changes will also likely require contacting members to inform them that the fund in which they are invested is changing. The DWP's own impact assessment states that a 1% charge cap would affect between 25,000 and 35,000 employers, and a 0.75% charge cap would affect 90,000 employers (out of an estimated total of 170,000 current schemes).[6]

13. However, provider capacity is already strained, with recent research showing that by the end of 2013, providers will be running at about seven times normal capacity.[7] Moreover, 23,500 employers will stage during 2014, with around 22,000 staging between January and July. Six ABI members alone will automatically enrol close to 7,000 employers in 2014 which do not have an existing pension scheme. Adding a price cap to this already very strained picture without taking into account provider or employer capacity could mean that providers are not able to on-board many employers in 2014, causing huge reputational risk for the auto-enrolment project as a whole. We would also point out that the average minimum period of time for ABI

[6] Defined Contribution Market Intelligence, Spence Johnson, 2013, p16
[7] DC in Practice, Towers Watson, January 2013, http://www.towerswatson.com/en-GB/Insights/IC-Types/Ad-hoc-Point-of-View/2013/~/media/ Pdf/Insights/IC-Types/Ad-hoc-Point-of-View/2013/Pension-auto-enrolment-provider-capacity.ashx

members to on-board an employer before their staging date is between 3 and 6 months, so employers staging in April 2014 are already well into the implementation process at this point.

14. Similarly, tens of thousands of schemes have been set up with commission, and thousands with AMD. The likely result of a ban on AMDs (even of limiting AMDs to a charge cap) would be a move by providers toward a mono-AMC charging structure. This in itself would require a complete scheme re-write, as well as requiring the scheme to be re-brokered and for existing IT systems to be reconfigured. This is a large and complex task. Equally, a ban on commission would mean that advisers would revisit all existing schemes, with two broad outcomes: if the employer is willing to pay a fee for advice, the scheme would be re-written under these terms; if the employer is unwilling to pay a fee, the adviser's services would be withdrawn. Providers would be required to either re-price or develop direct relationships with employers if a fee structure was not agreed, again with consequences for their capacity to on-board new schemes. Given the significant number of schemes written with commission, an overnight ban would therefore lead to major disruption at a critical time for the auto-enrolment project, making the advice gap much worse, with many employers not being supported at the critical point of auto-enrolment implementation. As a result, there would be a risk of employers failing to meet their duties, resulting in poor outcomes for employees.

15. Whilst the numbers of schemes with consultancy charging are smaller, unwinding existing schemes with this feature will still involve considerable resources for the providers affected.

16. Appropriate transition arrangements are therefore essential if the delivery and the reputation of the auto-enrolment project are to be preserved. Any changes will need to be co-ordinated and take into account future developments that are already in train so that the maximum protection for scheme members is put in place, with the minimum amount of disruption to the auto-enrolment project. We believe the following transitional arrangements would allow DWP and the industry to achieve this:

    a. Employees automatically enrolled in schemes newly set up from April 2014: DWP legislation for a charge cap and associated changes could come into force in April 2014 and would be implemented by April 2015 at the latest. This would mean no-one would be automatically enrolled into a default fund above the charge cap, or on terms with any features the DWP decides to ban – AMD, in-built commission or consultancy charging – from April 2015.

Providers would work on a best endeavours basis to implement these changes more quickly.

b. Employees automatically enrolled into a default fund between October 2012 and April 2014: DWP legislation for a charge cap and banned features comes into force in April 2014, with a three-year implementation period from the staging date of the employer. For example, where an employer staged in October 2012, all those automatically enrolled from that date would have their arrangements reviewed and any adjustments made from October 2015. This would align with their employer's re-enrolment duties. Providers would work on a best endeavours basis to implement these changes more quickly, including for new employees automatically enrolled into these funds during this transition period.

c. Employees in workplace pension schemes set up pre-auto-enrolment:

- As agreed with the OFT, all providers will undertake an audit to produce a "snapshot" of the charges and benefits of pre-2001 workplace pension products and post-2001 workplace pension products with charges over an equivalent of 1% AMC. Once the audit is concluded by the end of 2014, the IPB will submit a report to TPR, relevant pension company boards and the IGCs which sets out recommended industry-level actions. The IGCs will consider these and make appropriate recommendations to the Boards of these companies. This process should be completed by April 2015.

- As agreed with the OFT, all providers will establish IGCs to maintain an on-going oversight of the value for money of all of the provider's DC workplace pension products, including legacy workplace pension products. The scope of this assessment will include default funds and funds with significant usage.

17. There would be minimal consumer detriment as a result of employees paying charges higher than the charge cap during the implementation periods. This is because the charges will be paid by the new auto-enrolment population which in many cases will only be paying in the minimum employee contribution of 1% of banded earnings (2% in total). The difference between the charges they are paying and the capped charge will therefore be minimal in monetary terms (as the AMC charging structure has a much larger impact in the later years of a savings career due to the bigger pot). For example, ABI modelling shows that the difference in

deductions from a scheme member's pot between a 1% AMC and a 0.75% AMC over three years, in monetary terms, would be £5.43.[8]

18. Any charge cap would also need to be clearly defined. We strongly reject including transaction costs in the cap. As has been set out by the OFT, there is as yet no common methodology for measuring transaction costs. In the absence of this, it seems unworkable to include transaction costs in a charge cap.

19. Additionally, there is a significant practical challenge to including transaction costs within a cap. DC schemes will be strongly cashflow-positive over the coming decade. As a result all funds - both active and passively managed - will incur significant transaction costs in order to invest the flow of contributions. In order to facilitate this investment process, Government would be required to arrive at a methodology that excludes the effect of contribution flows from a charge cap. Capping discretionary investment transactions would also run counter to established practice in European and international markets and could end up restricting the investment options available to DC decision-makers and scheme members.

20. We do however agree that a common methodology should be developed to ensure that there is consistent disclosure of transaction costs and look forward to working with the FCA on this. Removed from the context of investment performance, transaction costs have little meaning. IGCs will be well placed to make an assessment on the reasonableness of the level of these costs when assessing the quality and performance of the scheme as a whole.

21. On disclosure, we would support extending current member-level point-of-sale FCA disclosure requirements to trust-based schemes, as well as requirements for charges to be disclosed in a single pound figure on an annual basis in line with the enhanced disclosure developed through the ABI's Charges Agreement. Further, we support the OFT's recommendation that, using the ABI's Charges Agreement as a starting point, all charges associated with pension schemes should be disclosed in a framework that will allow employers to compare commonly defined charges. This framework should be mandated by the DWP and we would look forward to providing input into this framework based on the work on charges disclosure we have recently undertaken.

22. Finally, we would highlight that the Consultation Paper is incorrect in its assumption that the initial amount of capital required to be held will be small. If insurers have to

[8] Based on a newly auto-enrolled employee with average earnings, statutory minimum contributions of band earnings and realistic economic growth assumptions.

apply hard guaranteed charge caps, the current Solvency 1 rules require them to hold regulatory capital of approximately 1% of mathematical reserves (Pillar 1 of Solvency 1). This highlights again the lack of a level playing field between contract-based and trust-based schemes. We are exploring the capital consequences of a charge cap under Solvency 2.