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

A REPORT FROM THE INDEPENDENT PROJECT BOARD

December 2014

The audit of charges and benefits in legacy schemes

	Foreword	1
	Executive Summary	3
1	Context and background to the legacy audit	9
2	Scope of the audit	21
3	Approach to audit	27
4	Analysis and results	41
5	Guidance and Recommendations	63
Annex 1:	Methodology	69
Annex 2:	Summary of in-scope data	75
Annex 3:	Analysis of saver scenarios	77
Annex 4:	The Terms of Reference	85
Annex 5:	Scope of the audit	87
Annex 6:	The Independent Project Board	89
Annex 7:	Providers participating in the audit	91
Annex 8:	Assessment criteria as set out by the FCA in the rules establishing IGCs	93
Annex 9:	Legal framework applying to defined contribution workplace pensions	95
Annex 10:	Glossary	99

Foreword

As part of Government initiatives to develop a robust and sustainable approach to workplace pension saving there has been much focus on improving governance arrangements and ensuring quality and value for money in schemes qualifying for automatic enrolment (AE), including a default fund charge cap now set at 0.75% or an equivalent combination charge. All savers in defined contribution workplace pension schemes will benefit from the enhanced governance arrangements, and the charge cap will mean that no new savers are automatically enrolled into high charging schemes going forward. However, savers invested now, or in the future, in schemes that are not used for AE, and savers who have ceased contributing before April 2015 (or the date the scheme is used for AE, if later) will not benefit from the charge cap. These savers are the focus of our report.

We were asked to look at legacy schemes at risk of being exposed to charges over an equivalent of 1% annual management charge (AMC) and to recommend what actions needed to be taken by the new Independent Governance Committees and by trustees.

This report sets out our findings and recommendations. I am very grateful to the members of the Independent Project Board who have brought their considerable and diverse set of skills and experience as well as unstinting commitment and energy to this task.

The delivery of this data and analysis, in a form which allows the governance bodies to focus on those most at risk, is a critical step in allowing Government policy in this area to be effectively implemented.

The challenge now is for providers and governance bodies to work together under the watchful eyes of the regulators to review our analysis and recommendations in the context of the schemes and savers they are responsible for, and bring about the necessary changes so that all savers who are not in automatic enrolment schemes can benefit from modern standards and outcomes.

Carol Sergeant
Chair of the Independent Project Board

Foreword

Executive Summary

Background and context

Automatic enrolment (AE) in workplace pensions is the Government's flagship policy to address the challenges of an aging population and the need to support adequate pensions saving in future. Most new savers will be automatically enrolled into defined contribution (DC) schemes.

In light of this the Office of Fair Trading (OFT) undertook a market study into DC workplace pensions in 2013. It found that competition alone could not be relied upon to deliver value for money for all savers in this market. The OFT identified around £30bn of savers' money in schemes with charges at risk of being poor value for money. This included all workplace pensions sold pre-2001 and all post-2001 workplace pension products with charges over an equivalent of 1% annual management charge (AMC). However the OFT did not have sufficient information on the full range of charge types paid by savers to be able to make a comprehensive assessment of charges.

The OFT made clear that in addition to charges, other important but more qualitative and subjective elements should be considered in assessing value for money. These include investment performance and transaction costs, communication with savers, and governance.

In response to these findings, the Association of British Insurers (ABI) agreed to set up Independent Governance Committees (IGCs) to ensure that all aspects of value for money, including qualitative aspects, are independently reviewed so that savers in workplace pensions can be confident of receiving value for money. Requirements for IGCs are currently being formalised in Financial Conduct Authority (FCA) rules and at the same time detailed and comprehensive regulations in respect of charges and governance for trust-based schemes are being developed in secondary legislation. Both will come into force in April 2015. In this report we refer to IGCs and pension fund trustees collectively as "governance bodies".

The ABI also agreed to set up an Independent Project Board (IPB) to oversee an audit of the "at risk" schemes identified by the OFT which are operated by ABI members. The IPB has an independent chair and members include representatives of the Department of Work and Pensions (DWP), the regulators, consumer experts and bodies representing the industry. Its remit is to establish both the charges and any benefits associated with them, excluding the more qualitative elements identified by the OFT, and make recommendations.

Since then, the Government has announced the introduction of a charge cap of 0.75% in qualifying schemes (schemes used for AE) from April 2015. Other charge types incompatible with automatic enrolment, such as active member discounts (AMD), will be banned from April 2016.

The IPB has collected a comprehensive set of data which includes all charges, excluding investment transaction costs, paid by savers in the schemes in-scope, and has applied a consistent and rigorous analytical framework across all providers' data.

This report sets out our findings and recommendations.

Scope of the audit

We collected data on charges and benefits from ABI member providers for all contract-based and bundled trust-based DC schemes which:

- commenced on or before 5 April 2001;
- commenced on or after 6 April 2001 and have more than one type of charge; and
- commenced on or after 6 April 2001 where all the charges paid by members, excluding investment transaction costs, exceed 1% of any member's fund value in any given year.

The data was collected as of April 2014.

£67.5bn worth of assets under management (AUM) were in-scope of the audit. £56.9bn of this is in contract-based schemes, and £10.6bn is in trust-based schemes. This £67.5bn represents 64% of the £106bn AUM in DC workplace pension schemes (excluding unbundled trust-based schemes which were out of scope). Of the remaining 36%, we estimate that half is in schemes with a single AMC between 0.7% and 1%. Along with unbundled trust-based DC schemes, defined benefit schemes were also out of scope of the audit. Together these types of schemes represent over 90% of the £1,526bn UK workplace pension market.

So whilst the findings in this report are significant, particularly for savers in the bundled (or insurer run) DC part of the market, they do not give a representative overview of the whole workplace pension market.

Drivers of pensions charges and approach to the audit

What savers pay in charges arises from the interaction of three factors:

- The types of charges and the charging structures (we found 38 different types of charges and 291 different combinations of charges);
- The level of each of those charges at any time; and
- The choices that individual savers make, for example when they join and leave schemes, how much they contribute, whether and when they take career breaks.

This combination of factors means that there is no one charge structure that is best for all savers all of the time. One of the key factors is the behaviours of individual savers and neither the IPB nor the savers themselves can know now what future decisions they may want or need to make. For this reason we decided to use a number of hypothetical saver scenarios designed to capture typical savers, but also potential outlier, higher cost outcome scenarios that could occur. Providers were asked to model all scenarios for all schemes or groups of schemes with a similar structure (in this case using the higher charges in these groups). They were also asked to tell us how many savers currently fall within each of these scenarios, so that schemes with savers with high charge impacts can be prioritised for early review.

Charges can be measured in many ways, giving different results depending on scheme structures, charge types and saver behaviours. We decided to use the reduction in yield (RIY) measure because it is an industry-standard measure that can be used to compare different schemes. The RIY we have used includes all costs paid by savers (except investment transaction costs) expressed as a percentage point reduction in the annualised return over a year. The RIY can be compared with other benchmarks, such as the 0.75% of charges borne by savers used by the DWP for its charge cap, or an AMC that includes all the charges a saver pays.

Key Findings

Rather than measuring historic charges, our results show the potential impact of charges on individuals in the future, depending on their savings behaviour.

It is important to note that our results are likely to overstate the amount of AUM subject to high charge impacts. This is because we used a conservative methodology to ensure that we captured all possible (but not necessarily actual) scenarios and schemes with high charge impacts, and because schemes may have reduced charges since April 2014 in response to the charge measures announced by the Government.

In our interim report published in July we set out four questions that we wanted to answer.

1. **What is the scale of schemes where the impact of charges is high relative to benefits?**

- £42bn out of the £67.5bn in-scope AUM has a RIY of less than 1% due to charges in all scenarios, including “worst case” scenarios.

- Between £23.2bn and £25.8bn of AUM is potentially exposed to a RIY of more than 1% due to charges.

- Not all instances of high charge impacts are in old schemes - £12.4bn out of £25.8bn is in post-2001 schemes.

2. What range of charges could savers be paying in some scenarios?

- Around half the AUM with high charge impacts is potentially exposed to a RIY above 1.5% (£13.4bn out of £25.8bn).

- Within that, between £5.6bn and £8.0bn is potentially exposed to a RIY greater than 2%, and £0.8bn to £0.9bn to a RIY greater than 3%.

3. What are the characteristics of charging structures with the highest charge impacts?

- Schemes where savers are potentially exposed to the very highest impact of charges are more likely to have complex charge structures. Nearly all AUM potentially exposed to a RIY of over 3% is in schemes with monthly fees or deductions from contributions.

- The majority of AUM potentially exposed to a RIY of over 1% (£19.1bn out of £25.8bn) is in schemes where charges are a proportion of fund value and which do not have monthly fees or deduction from contributions.

- Of this £19.1bn, around £14.4bn is in schemes where different savers may have different AMCs, depending on their decisions and choices. For example, some schemes have tiered charge levels that are higher for lower fund values (£9.2bn) and active member discounts (£6.4bn). Around £4.7bn is in schemes that have a single AMC.

4. What are the characteristics of savers with high impacts from charges?

- Savers with low fund values are potentially exposed to the very highest impact of charges. The majority of the AUM potentially exposed to charges over 3% (£0.7bn out of £0.9bn) is held by savers with pots of less than £10,000. Of this, over 90% is held by paid-up savers and savers who have stopped contributing. For such savers the impact of monthly fees can result in very high impacts from charges.

- The majority of AUM potentially exposed to a RIY of over 1% (£21.8bn out of £25.8bn) is held in pots of more than £10,000.

We also looked at new joiners and exit charges

- We estimate that there are 407,000 savers that have joined schemes in the last 3 years who are potentially exposed to a RIY over 1%. Of these, 178,000 savers may be exposed to a RIY over 2% and 22,000 to a RIY over 3%.

- We found around £3.4bn of AUM with potential exit charges of 10% if savers leave today. Of this £0.8bn is held by savers over age 55 who will be eligible to withdraw their pension savings from April 2015. The remaining £2.6bn is held by savers that cannot withdraw their pension savings but may wish to transfer to a scheme that offers better value for them.

Recommendations

There is no simple, "one size fits all" charge structure that will ensure that all savers get value for money all of the time. As set out above, value for money will depend on savers' decisions and behaviours, and also the important qualitative factors set out by the OFT, including governance, investment performance and transaction costs, and communication with savers. That is why governance arrangements are being strengthened via IGCs and increased requirements for trustees, to ensure that savers' interests can be appropriately safeguarded by people best placed to make these qualitative judgements. Our recommendations take account of these factors, and also that in many cases the new governance arrangements are still in the process of being set up.

Providers

We have written to the provider of each scheme where savers are potentially exposed to high charge impacts, or where savers face exit charges, setting out the AUM and the number of savers.

For each scheme or group of schemes, providers should by 30 June 2015 at the latest:

- Review their data and conduct any further analysis to reflect any actions already taken to reduce charges or other qualitative factors that might justify high charges;

- Identify what actions could be taken to improve outcomes for savers and what actions can be taken to stop new savers joining poor value schemes; and

- Provide the data, any further analysis and the proposed actions to the relevant governance body.

Governance bodies

Governance bodies are responsible for evaluating which, if any, of the provider's proposed actions best meet the needs of their savers. They should make recommendations to providers on which course of action will be most effective to ensure value for money for savers and have an implementation plan agreed with the provider and in place by the end of December 2015 at the latest.

We have developed guidance for governance bodies to help them evaluate whether schemes provide value for money and to support a consistent approach and outcomes across the industry.

The guidance covers:

- Where to look for potential areas of poor value for money based on our data collection and analysis.
- Key questions governance bodies should ask when considering value for money.
- The types of analysis governance bodies should regularly review.
- Potential actions that might be taken to ensure that savers receive value for money in future.

Training for governance bodies

Providers and regulators should work together to ensure that there is effective training and support available for IGCs and trustees.

Individual Personal Pensions (IPPs)

ABI members have committed to a sampling exercise of IPPs to identify those cases where savers were previously in a workplace pension and so may now be at risk of high charges. This exercise is due to be completed under the auspices of IGCs by June 2015. We support this exercise and recommend that it is implemented to this timetable.

Regulators and government

The FCA and The Pensions Regulator (TPR) each monitor the effectiveness of governance arrangements with respect to pensions saving. Robust governance is an important element in securing value for money for savers.

We recommend that the DWP and the FCA jointly review industry-wide progress in addressing and remedying poor value schemes and publish a report by the end of 2016.

1 Context and background to the legacy audit

1.1 This audit follows on from the Office of Fair Trading's (OFT) market study into Defined Contribution (DC) workplace pensions.[1] Since the publication of the OFT's study, the Department for Work and Pensions (DWP) has published a Command Paper, which proposes a comprehensive range of measures to improve the quality of workplace DC schemes. We set out below the OFT's findings, the recommendations in the DWP's Command Paper, broader changes affecting the pension landscape, and the scope and terms of reference of this audit.

OFT findings

1.2 In October 2012, automatic enrolment (AE) commenced, beginning with the largest employers in the UK with smaller employers and new businesses following in phases, completing the roll-out in 2018. 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. As of October 2014, over 4.8 million people had been automatically enrolled into workplace pension schemes.[2] However, due to the staging profile of employers, with the smallest businesses not completing AE until 2017, the vast majority of employers are not yet required to set up an AE pension scheme.

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".[3]

1.4 The OFT's report on the DC 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

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

2 DWP, Automatic enrolment opt out rates: Findings from qualitative research with employers staging in 2014, November 2014

3 OFT (2013), paragraph 1.5.

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 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".[4]

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.[5] 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 £30bn 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 annual management charges (AMC) higher relative to what it may cost to service them".[6]

---

4 *Ibid.,* paragraph 1.6.

5 *Ibid.,* paragraph 1.53.

6 *Ibid.,* paragraph 6.42 to 6.44.

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".[7]

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".[8] 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".[9]

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 Association of British Insurers (ABI) and those of its members that provide contract-based DC 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".[10]

---

7 *Ibid.,* paragraph 6.42 to 6.44.

8 *Ibid.,* paragraph 1.20.

9 *Ibid.,* paragraph 6.48 and 6.50.

10 *Ibid.,* paragraph 1.39.

1.11 This report sets out the results of the audit and our recommendations for what action needs to be taken in response.

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 of such schemes will not be disadvantaged".[11] "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".[12] 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".[13]

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".[14]

- "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."[15]

- "The only type of [charges] that the OFT suggests is omitted from this single charge would be investment management transaction costs because in the

---

[11] *Ibid.,* paragraph 1.25.

[12] *Ibid.,* paragraph 1.32.

[13] *Ibid.,* paragraph 1.33.

[14] *Ibid.,* paragraph 1.35.

[15] *Ibid.,* paragraph 1.36.

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 portfolio turnover rate. We recommend that the FCA undertake this work as part of its planned competition review of wholesale markets."[16]

- "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."[17]

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".[18] It therefore recommended 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 scheme 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

---

16 *Ibid.,* paragraph 1.37.

17 *Ibid.,* paragraph 1.38.

18 *Ibid.,* paragraph 1.44.

instead of being classified as deferred members of a scheme should also not be penalised in respect of the charges they pay.” [19]

- “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”.[20]

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 DC 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.”[21]
- “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.” [22]

1.17 In October 2014, the DWP confirmed these intentions in a subsequent Command Paper, which also set out the draft regulations for implementing these measures

---

19 *Ibid.*, paragraph 1.44.

20 *Ibid.*, paragraph 1.44.

21 DWP, “Better workplace pensions: Further measures for savers”, Executive Summary, paragraph 5.

22 DWP, “Better workplace pensions: Further measures for savers”, Executive Summary, paragraph 5.

for trust-based schemes. For contract-based schemes, the Financial Conduct Authority (FCA) published a consultation paper on charges which proposes rule changes, also in October 2014.[23] In terms of quality standards, the FCA consulted on its rules for IGCs in August.[24] The consultation closed in October, with final rules expected in January 2015.

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 DC 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".[25]

1.19 While highly relevant to our work, the charge cap proposal did not obviate the need for the audit. This is because a charge cap will only apply to schemes that are qualifying schemes (schemes used for the purposes of AE), and only for those members of qualifying schemes that actively contribute to their pension at least once after 6 April 2015 (or their employer's staging date if that is later). Members of schemes that are not used for AE as well as scheme members who have stopped contributing before the charge cap comes into force, will therefore not benefit from a cap on charges. These savers have therefore been the focus of this audit.

1.20 We considered the implications of the charge cap proposed by the DWP's Command Paper for the scope of the audit. We have considered data with charges above the DWP charge cap but not included in the scope of the data collection described above. These are schemes that only have a single AMC and all member borne charges are between 0.75% and 1%. These schemes were already included in the OFT's data, and there is no further information that we would need to collect to understand the total impact of charges. We have therefore reviewed the OFT's data to understand the assets under management (AUM) with an AMC between 0.75% and 1%, which is out of scope of the data we have asked providers to submit. We estimate that there is around £20bn of the £38.5bn of AUM out of scope that is in schemes with an AMC of between 0.7% and 1% (the OFT data did not split AUM at 0.75%).

---

23 FCA, CP14/24 Charges in workplace personal pension schemes, October 2014.

24 FCA, CP14/16 Proposed rules for independent governance committees, August 2014.

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

Broader changes affecting the pension landscape

1.21 Automatic enrolment, charge control measures and quality standards are not the only changes affecting the pension landscape. In the Budget 2014 on 19 March 2014, the Government announced fundamental changes to how people can access their pension savings. Under the previous system in place before the Budget, only those with a very large pension pot typically worth over £310,000 or those with total pension wealth below £18,000 could access their pension savings flexibly. From April 2015, everyone with DC pension savings will be entitled to flexibility, regardless of their total pension wealth.

1.22 From April 2015 individuals aged 55 and over will have the freedom to make the decisions that suit their own circumstances. Individuals will be able to access their DC pension savings as they wish, subject to their marginal rate of income tax (rather than the current 55% charge for full withdrawal).

1.23 Those who want the security of an annuity will still be able to purchase one. Equally, those who want to access all of their pension savings will be able to take them as a lump sum. Those who do not want to purchase an annuity or withdraw their money in one go, but would prefer to keep it invested and access it over time, will be able to purchase a drawdown product, or access their pension through a series of uncrystallised lump sum payments, each involving a tax-free portion of 25%.

1.24 To support people in this new environment, every individual with DC pension savings will have a new right to free and impartial guidance at retirement to help them make confident and informed decisions on how they use their pension savings in retirement. The intention is that this guidance will be tailored to individuals' personal circumstances, but will not recommend specific products or providers.

1.25 To ensure that this guidance is completely impartial, it will be provided by independent organisations that have no actual, or potential, conflicts of interest. The government is legislating in the Pension Schemes Bill to give the FCA responsibility for setting standards for guidance and monitoring compliance with those standards.

1.26 The March 2014 Budget changes add to a history of changes to workplace pensions in the UK. The most important changes between 1988 and 2017 are set out in the table below.

Table 1. Key workplace pension interventions

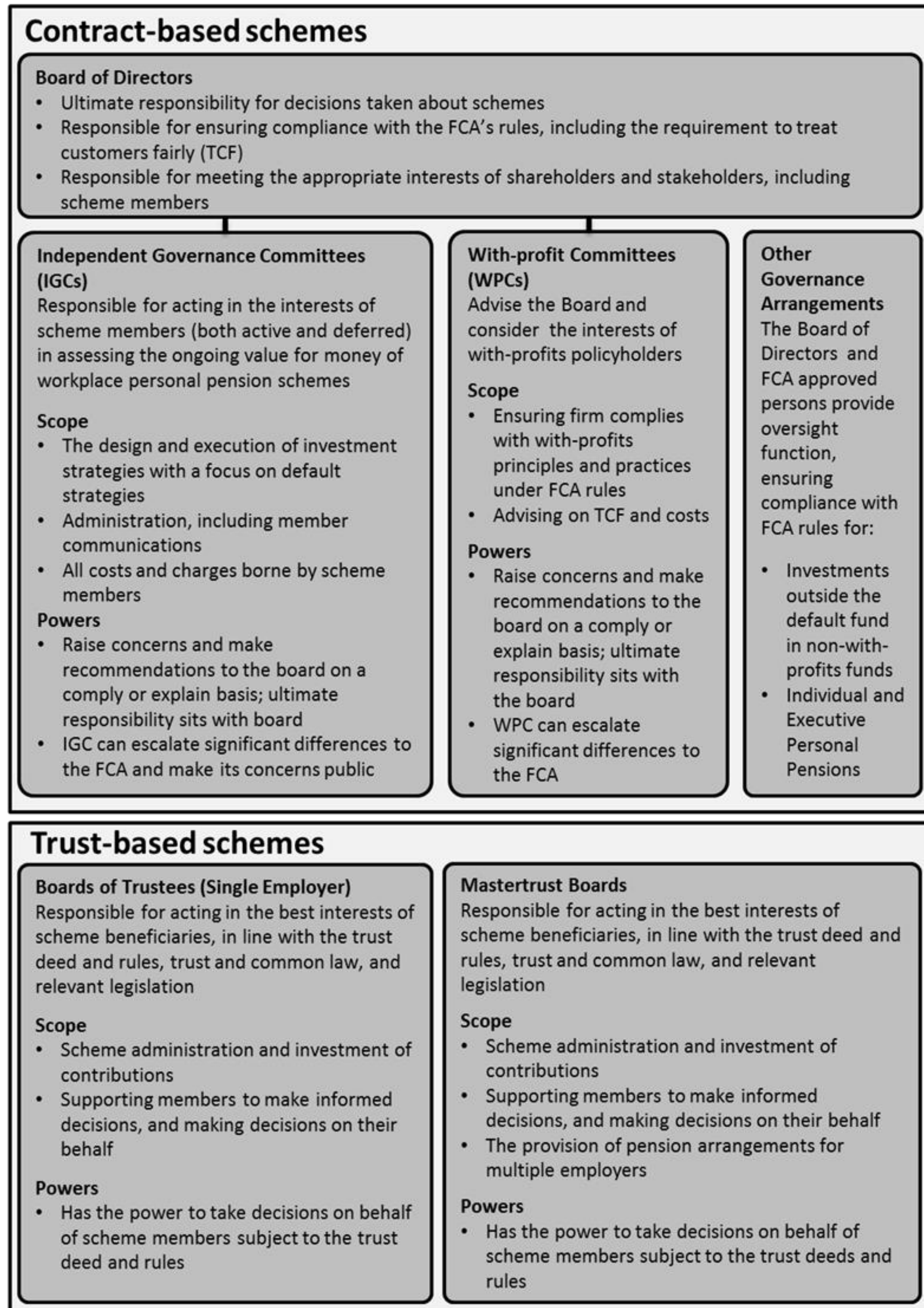
Date	Description
1988	Introduction of personal pension schemes, and allowing contracting out (of the State Second Pension) into these.
2001	Introduction of Stakeholder Pensions legislation. Stakeholder Pensions were intended to encourage more long-term saving for retirement, particularly among those on low to moderate earnings. They must meet a number of conditions, including a cap on charges and low minimum contributions. Employers with five or more employees are required to provide access to a Stakeholder Pension scheme for their employees unless they offer a suitable alternative pension scheme. FSA rules were also amended to require advisers to set out why the recommendation of a personal pension was at least as suitable as a Stakeholder Pension.
2006	Pensions A Day – New rules came into effect, simplifying the previous eight tax regimes into one single regime for all individual and occupational pensions.
2008	2008 Pensions Act enshrines automatic enrolment into law.
Oct 2012	Automatic enrolment commences with the UK's biggest employers as part of a staged programme. The smallest employers will complete automatic enrolment by April 2017, with new employers completing automatic enrolment by February 2018. Contribution levels will also increase over this period.
Dec 2012	The FSA's Retail Distribution Review came into force in on 31 December 2012, to introduce more transparency in the retail investment market. In particular, financial advisers are no longer permitted to earn commissions from fund companies in return for selling or recommending their investment products, but must agree the fees with their customers upfront. Financial advisers have to offer either "independent" or "restricted" advice, making clear whether their recommendations are limited to certain products or product providers.
2013	OFT market study of defined contribution workplace pension schemes.
Mar 2014	Freedom and Choice – wide-ranging changes to the tax rules for taking income from pensions to be implemented with effect from April 2015.
April 2015	DWP Occupational Pension Schemes (Charges and Governance) Regulations come into effect (subject to parliamentary approval), as well as FCA rule changes. They cap charges for default funds in workplace pension schemes at 0.75% (or equivalent) and ban consultancy charges. Commission payments and AMDs must be within the charge cap. They also require the establishment of Independent Governance Committees for contract-based schemes, and establish minimum governance standards for trustees of occupational schemes.
April 2016	Ban of Active Member Discounts and commission comes into effect for all pension schemes (through DWP Occupational Pension Schemes (Charges and Governance) Regulations and FCA rules).
2017	Government review of automatic enrolment and the default fund charge cap, including whether transaction costs should be included within the cap.

Summary of governance and consumer protection

1.27 Both contract and trust-based workplace pension schemes are subject to substantial governance requirements and consumer protection frameworks. These arrangements are not straightforward. We have summarised the governance structures and consumer protection frameworks that are currently in place in the DC workplace pensions market in Figure 1 and Figure 2 taking account of the changes and interventions described above.

Figure 1. Governance structures in the DC workplace pension market

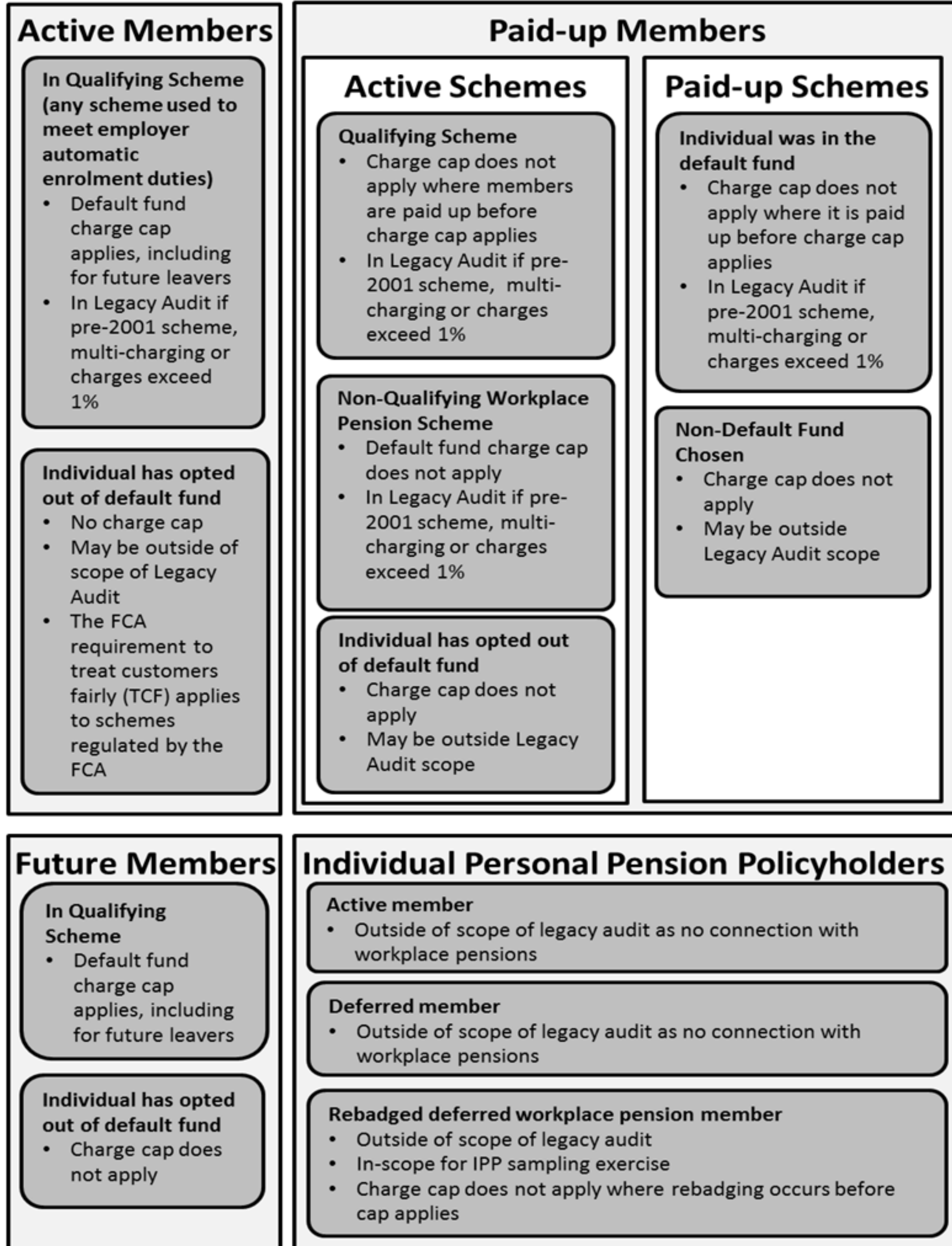
Note: The chart is illustrative, and box sizes are not proportionate to the scale of the type of scheme.



Source: ABI

Figure 2. Consumer protection framework for DC workplace pensions

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



Source: ABI. Notes: Rebadged deferred workplace pension members have been reclassified as individual personal pension policyholders after leaving a workplace pension. ABI members have committed to a sampling exercise of individual personal pensions to identify those savers previously in a workplace pension that may now be at risk of high charges.

Consultancy charging will be banned in all qualifying schemes from April 2015, and commission and AMDs will be banned in all qualifying schemes from April 2016.

Context and background to the legacy audit

2 Scope of the audit

2.1 The scope of data collection for the audit covers defined contribution (DC) 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 1% of any member's fund value in a given year; or
- on or after 6 April 2001 that have combination charges, that is, more than one charge type. These have been included because where there is more than one charge type, it is possible that the charges for some savers under some circumstances will exceed 1% over the course of their membership. This means that some schemes that would be below the charge cap for automatic enrolment purposes have been included within the scope of the audit.[26]

2.2 There are a number of exclusions from the audit that are listed in annex 5. This includes:

- schemes provided by non-ABI members. This includes the National Employment Savings Trust (NEST) which was set up under the Pensions Act 2008 to facilitate automatic enrolment. It has over 1 million savers and over £100m in assets under management (AUM);[27]
- unbundled trust-based schemes;
- executive personal pensions; and
- individual personal pensions, even if savers started out in workplace schemes. Association of British Insurers (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 governance bodies.[28] We expect that this exercise will go ahead and we

---

26 See table 3.1 and 3.2 in DWP, "Better workplace pensions: Further measures for savers".

27 NEST Annual Report and Accounts 2013/14.

28 This will only apply to contract-based schemes, as savers will not have been moved to IPPs from trust-based schemes.

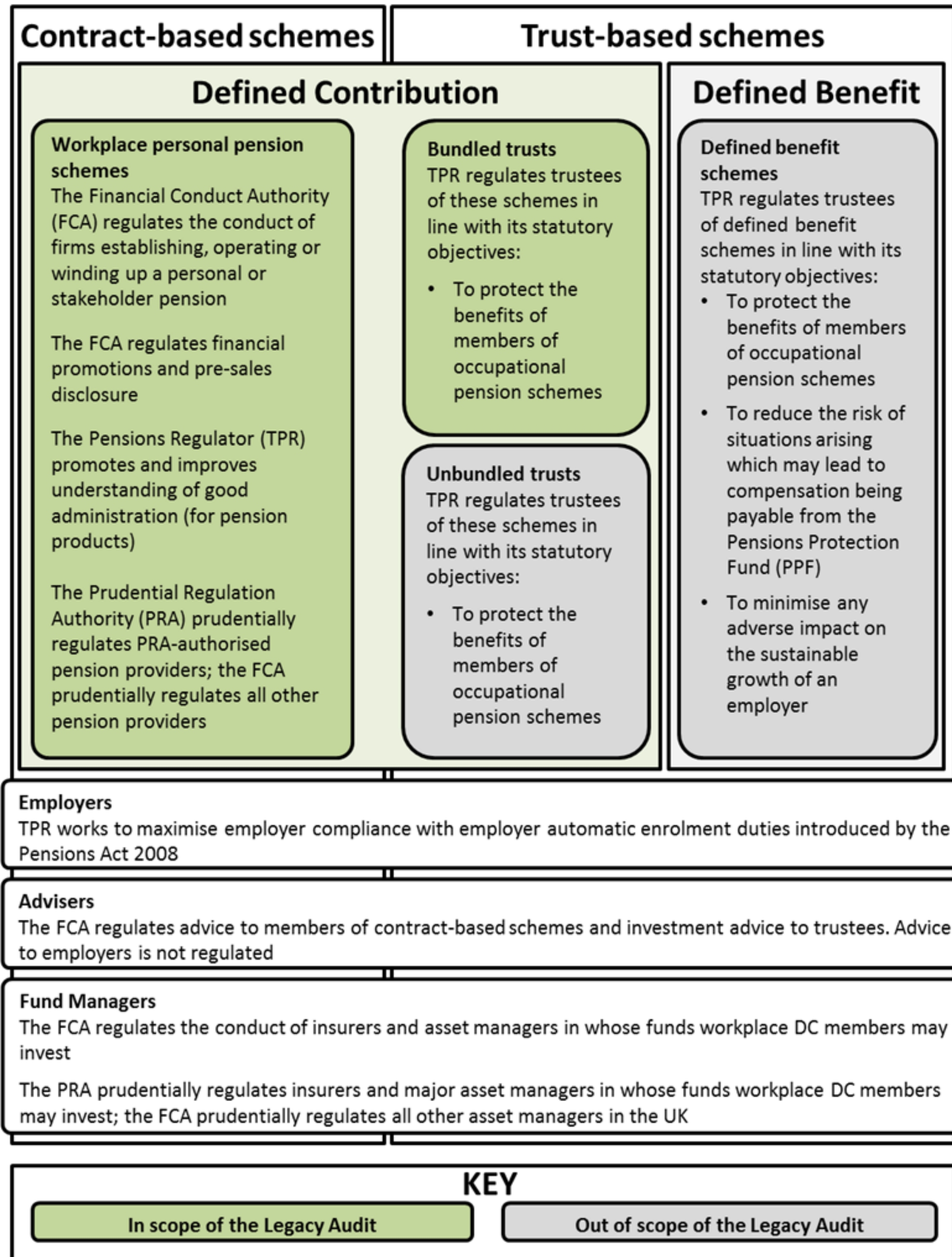
recommend that it should, in order to ensure that these savers are also protected.

2.3 Some other types of workplace scheme are explicitly excluded from the audit. A full list of these exclusions is provided in Annex 5.

2.4 The regulation of the workplace pensions market is illustrated in Figure 3 below. This highlights in green those schemes that fall within the scope of the audit: DC contract-based schemes and DC bundled trusts and master trusts. All defined benefit (DB) schemes, as well as DC unbundled trusts fall outside of the scope of the audit.

Figure 3. The regulation of workplace pensions

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



Source: ABI, based on the 'Guide to the regulation of workplace defined contribution pensions', TPR and the FCA, March 2014.

Note: The diagram illustrates both the regulatory oversight of contract and trust-based arrangements which are in and out of scope of this audit.

2.5 The table below shows the AUM and number of savings pots that are in and out of scope for the audit. Total AUM in the UK pensions market is around £1,770bn. Of this, DB schemes account for £1,250bn and individual personal pensions around £243bn. There is £276bn in DC workplace pension schemes. The audit focuses on £67.5bn of the DC pension market. The scope of the audit therefore covers 4% of total pension AUM and 25% of DC workplace pension AUM. Around £31bn of the in-scope AUM is from pre-2001 schemes and £36.5bn from post-2001 schemes. In total, there are 189,000 schemes in-scope of the audit.

Table 2. Summary of AUM and number of pots in and out of scope of audit

Description	Scope	AUM	Pots	How treated in audit
Total pension market		£1,770bn	18.9m	
Individual personal pensions	Out	£243bn	5.6m	
Defined benefit pensions	Out	£1,250bn	7.8m	
Total defined contribution workplace pension		£276bn	5.5m	
Unbundled trust-based schemes	Out	£170bn†	Not known	
Single AMC < 1% and other exclusions	Review data	£38.5bn	Not known	Review of data collected by OFT if AMC>0.75%
Total in-scope	In	£67.5bn	3.6m	
Contract-based*	In	£55.5bn	2.9m	Full data collection
Trust-based bundled*	In	£10.8bn	0.6m	Full data collection
Traditional with-profits	In	£1.2bn	0.1m	Bespoke data collection

Source: FCA (2014), Proposed rules for independent governance committees, annex 1 chart 1. *Excludes traditional with-profits. **Excludes unbundled trust-based schemes. †OFT Final Report para 4.4 and 4.5.

2.6 The scope of the audit covers 3.6m savings pots. These cannot be equated with the number of savers as some savers may hold multiple pots in different in-scope schemes. Savers may also have individual personal pensions and be members of DB schemes. This means the number of pots may be greater than the number of savers.

3 Approach to audit

3.1 The Office of Fair Trading (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.[29] The OFT's study collected data on one charge type, the annual management charge (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 total 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.

3.2 The audit was completed by Frontier Economics, working under the direction of the IPB and directly accountable to the independent chair of the IPB. The board of each contributing provider was required to attest in writing to the accuracy and completeness of the data submitted.

3.3 This section sets out how we approached the audit of charges and benefits given the complexity of charges and the range of outcomes for different savers, depending on the interaction between charge structures and the actions, decisions and circumstances of individual savers.

Questions for data collection and analysis

3.4 The terms of reference for the audit required us to establish the criteria for the data that providers must extract from their systems. We agreed criteria for the data that would 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, saving pots, AUM) of schemes where the impact of charges is high 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 wanted to refine this estimate to identify the scale of schemes where the impact of charges is high relative to the benefits. The main part of the audit was at the level of schemes. However,

29 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.

where we identified schemes that are at risk of high charge impacts we also collected data to understand how many savers are actually affected currently and potentially in future.

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 wanted to build a complete picture of how much savers may actually pay in these schemes depending on their decisions and circumstances.

3. **What are the characteristics of the charging structures with the highest charge impacts relative to any benefits?**

   The impact of different charging structures will be higher or lower for different savers. However, the extent that different charging structures are used across the industry was largely unknown. We wanted to identify the relationship between high charge impacts and charging structures.

4. **What are the characteristics of savers with high impacts from charges relative to any benefits?**

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

3.5 These questions have guided our approach to the data collection part of the audit.

Audit is forward looking

3.6 The impact 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.

3.7 The focus of the audit has been 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 to ensure that in future all savers can be confident of getting value for money in their workplace pension schemes.

Assessing charges

3.8 The total overall *impact* of charges that a saver pays for their pension scheme will depend on the charging *structure* in a scheme, charge *levels* and the circumstances and *behaviour* of individual savers.

3.9 We chose to use reduction in yield (RIY) to measure the impact of scheme charges for this audit. The RIY we have used includes all member borne charges expressed as a percentage point reduction in the annualised return over a year. We have used 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% of fund charges used by the Department for Work and Pensions (DWP) for its price cap, or an AMC (that includes all member borne charges).[30]

3.10 Low charge levels for any charge type reduce overall charges for all savers in that scheme. 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, as we illustrate in the box below.

Impact of charging structures on different savers

Different charging structures may be better for some savers and worse for other savers. For example:

- A scheme with an AMC of 0.5% and a fixed monthly policy fee of £2 would have charges of £5 + £24 = £29 for saver with a fund of £1,000, and £50 + £24 = £74 for a saver with £10,000.
- A scheme with a 1% AMC would cost £10 for the saver with a fund of £1,000 and £100 for a saver with a fund of £10,000.
- The first scheme is more expensive for the saver with a £1,000 fund and less expensive for a saver with a £10,000 fund.

30 Suppose a fund starts with a value of £10,000 with no further contributions 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.

3.12 Two potential implications of different charging structures are described below.

- Providers largely incur the same costs to serve each saver. If schemes are designed to ensure each saver covers their own individual cost to serve, then the impact of 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 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.

3.13 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.

3.14 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 should have a better understanding of the specific needs, preferences and circumstances of the members of each scheme. In this audit, we have collected data and reported 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

3.15 The amount that a saver pays in a scheme will depend upon the charging structure and their personal circumstances as we describe above. The overall impact of 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.

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

3.17 We considered an alternative approach that used the impact of charges for actual individual savers. However, this approach would still have required a number of assumptions to be made about existing savers' behaviour in the future and would also have required us to make assumptions about future savers joining the scheme.

Approach to audit

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

3.18 We selected 37 hypothetical saver scenarios (see annex 3 for a full list of scenarios). Each scenario represents a combination of saver characteristics that may drive the impact of charges paid in a scheme. For each saver scenario, providers calculated the impact of charges and we then compared across schemes.

3.19 There are five main drivers of the impact of charges paid by a saver shown in the box below. Each of these may affect the impact of charges. We selected saver scenarios that would 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 we specifically included scenarios that would be 'outliers' in order to ensure we could capture the highest potential impacts of charges. This means that they are likely to reflect higher impacts of charges than many savers would actually experience.

Key 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 impact of 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.

3.20 For the saver scenarios, we also assumed values for the growth in wages and investments. We assumed 4% per annum growth in nominal wages and a 5% per annum return on investments. This is in line with the FCA's guidance.[31]

3.21 For each scheme in the audit, we have collected data on the charge profile across scenarios. For example, the chart below shows how two hypothetical charging structures compare across the different saver scenarios (the description of each numbered saver scenario can be found in annex 3). Each of these schemes would fit under the 0.75% charge cap based on the equivalence tables produced by the DWP.[32]

- Scheme A has a charging structure made up of a £20 per year policy fee and a 0.5% 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 the impact of charges in Scheme A is likely to be high for savers with small fund values or who have short periods of contributing small amounts.

- Scheme B has a contribution charge of 2% and a 0.5% 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 the impact of charges in Scheme B will be higher 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.

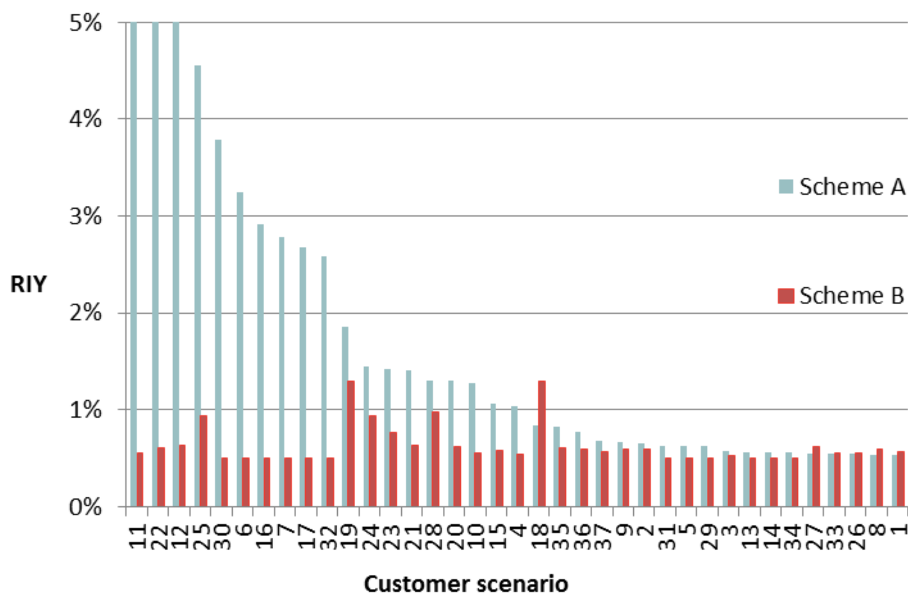
- The impact of charges in Scheme B is lower than for Scheme A for all scenarios except scenarios 1, 8, 18, 26, 27 and 33 where the saver is contributing £200 per month and has a long enough contribution period. This is because these savers pay more in charges under the contribution charge than they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

---

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

32 DWP, "Better workplace pensions: Further measures for savers", Tables 3.1 and 3.2.

Figure 4. Comparison of two schemes



See Annex 3 for description of each numbered saver scenario.

Assessing benefits

3.22 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.

3.23 We have considered each of these benefits and collected data on the prevalence of them being offered with schemes. We only considered benefits where they are non-discretionary for savers in a scheme. Where benefits are discretionary, we considered the charging structure excluding the charges for any benefits. We describe below each of these benefits and the extent to which they are found in schemes, and therefore how we have taken account of them in the audit.

Guaranteed annuity rates

3.24 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.

3.25 These are mainly associated with traditional with-profits schemes, and we consider them alongside our analysis of with-profits funds in section 1. There is a further £264m (0.4% of in-scope AUM) of unit-linked schemes that have guaranteed annuity rates.

3.26 Where guaranteed annuity rates are available, whether alongside with-profits or unit-linked products, the IPB generally considers that these are likely to be valuable for savers. If schemes with high charge impacts offer guaranteed annuity rates, then governance bodies should consider the value of these guarantees in their overall assessment of value for money.

Growth guarantees

3.27 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. We identified around £50m of AUM (0.1% of in-scope AUM) that may have growth guarantees that are not with-profits products.

3.28 We considered how to treat growth guarantees in our assessment. We recognised that there is a cost to providing 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 be 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 but higher risk 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 governance bodies will be best placed to assess.

Other forms of bundled insurance

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

3.30 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 not other optional products. Hence, we collected data on pension schemes

excluding any additional charges for other products.[33] This allowed us to assess the value of pension schemes alone. We also collected data on any bundled insurances that are not discretionary and so cannot be split out from the cost of the pension scheme. We identified £1.1bn of AUM (around 1.6% of in-scope AUM) that has non-discretionary insurances.[34] Around £64m of this is potentially exposed to a RIY of over 1%. As part of their assessment of overall scheme quality, governance bodies should consider the value of this benefit against the impact of charges in these schemes.

Exit charges

3.31 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. However, exit charges may deter savers from switching provider, even if an alternative is available that offers lower charges or better benefits. Exit charges may also deter savers from taking advantage of the new freedoms to withdraw savings from age 55. For these reasons, we have considered exit charges as part of the audit.

Alternative approaches to recovering set up costs

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

- **Set up costs paid up front by each saver.** This means that the impact of charges is high at the start, but is 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 leave early by charging a higher ongoing rate, which will ultimately be paid by those savers that remain in the scheme. This means long term savers bear a share of the set up costs of savers who exit early.

---

33 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.

34 One provider also offers a form of life insurance for plans set up since 1 January 2013 for the first five years of the policy. This is not included in this figure.

- **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 to cover the proportion of set up costs that have not been recovered through regular charges. This charge will diminish 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.

3.33 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.

3.34 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 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.

3.35 We have collected data on exit charges as part of this audit. We describe below our approach to exit charges using the on-going saver scenarios and for specific exit scenarios.

On-going scenarios

3.36 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 asked for the transfer-out value to be modelled in the 37 saver scenarios described above.[35]

Exit scenarios

3.37 We wanted to assess the extent and scale of exit charges in the audit and did 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.[36]

---

35 See annex 1 for further detail of this approach.

36 To compare the charges in different scenarios, we 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.

3.38 In reality, savers may contribute for more or less than 5 years. Savers that contribute for longer are likely to pay lower exit charges than our scenarios will show. Equally, these scenarios will understate the impact of exit charges for savers that contribute for shorter periods.

Table 3. 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	£10,000
		£1000	£100,000
45	54, 57, 60, 63, 66, 69, 72, 75	£100	£10,000
		£1000	£100,000

3.39 We collected 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

3.40 There are different types of with-profits investments. We decided to use the saver and exit scenario approach set out above for some types of with-profits investments. We also used a different approach where scenarios were not appropriate for other types of with-profits investment. We describe the types of with-profits investment below, and our approach to assessing the charges faced by savers.

3.41 There are three main types of with-profits investment:

- Unitised with-profits where there are explicit charges, such as an AMC.
- Unitised with-profits where there are no explicit charges.
- Traditional with-profits (also called conventional with-profits), where there are no explicit charges.

Unitised with profits with explicit charges

3.42 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.

3.43 Where a with-profits fund has explicit charges, we asked providers to model our saver scenarios in the same way as for unit-linked investments. In our analysis of unit-linked investments in the following section we do not distinguish whether the fund choice is with-profits.

3.44 Unitised with-profits funds may make deductions to asset shares to reflect the cost of growth and annuity guarantees which may be offered with the fund. We see growth guarantees as part of the attributes of investment strategy and performance which governance bodies will be best placed to assess.

3.45 These unitised with-profits funds may also make deductions for expenses or other costs, not related to investment performance. We asked providers for the level of any such deductions and were told that there were none above the explicit charges levied on these funds. Therefore, the relevant measure of charges is the explicit RIY on these schemes as reported using our scenarios.

Traditional with-profits and unitised with-profits without explicit charges

3.46 Traditional with-profits make up £1.2bn of in-scope assets. Unitised with-profits without explicit charges make up £2bn of in-scope assets.

3.47 In traditional with-profits funds, savers typically pay regular contributions or premiums in exchange for a minimum sum or annuity at retirement. These contributions are held in a fund with each saver notionally allocated a share of the assets determined by the provider.[37] Savers benefit from the growth in the fund by receiving bonuses that increase the minimum sum assured or a final bonus that increases the benefits they leave with. Unitised with-profits without explicit charges work in a similar way, with asset shares expressed in units.

3.48 Regular deductions from the shared fund are typically 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.

3.49 We collected 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. We used this information to estimate the average deductions faced by savers of in-scope schemes who have invested in with-profits funds which we report in section 1.

---

[37] Often these allocations are notional.

Value for money

3.50 The OFT found that "competition alone could not be relied upon to deliver value for money for all savers in the defined contribution (DC) workplace pension market" and many of its conclusions focus on value for money.[38] This audit was 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.

3.51 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.

3.52 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."[39]

3.53 The OFT and DWP have made a number of recommendations and proposals about scheme quality, as we describe in Section 1. These include new quality

---

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

39 *Ibid.*, paragraph 7.4.

standards for DC workplace pension schemes. IGCs are intended to protect savers' interests in contract-based schemes and a detailed and comprehensive legislative requirement will be placed on trustees of occupational schemes in respect of costs and governance. These changes are designed to improve accountability and promote compliance with the quality standards. IGCs and trustees are best placed to assess the value and relevance to their members of the qualitative aspects of workplace pension schemes.

Approach to audit

4 Analysis and results

4.1 Charging structures can be complex and the impact of charges will not only depend on the scheme itself, but also on savers' own characteristics and behaviour. That is why we used a saver scenario approach to understand these charges as set out in section 3. As we explained there, the approach we took tends to overstate the impact of charges, because we wanted to ensure that all instances of high charge impacts were captured by the audit to highlight these to providers and governance bodies. Any interpretation of these results should keep this overstatement in mind.

4.2 We set out four questions in section 3 that we wanted to answer in this audit. Below we provide a summary of what we have found for each of these questions.

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

- £42bn out of the £67.5bn in-scope AUM has a RIY of less than 1% due to charges in all scenarios, including "worst case" scenarios.
- Between £23.2bn and £25.8bn of AUM is potentially exposed to a RIY of more than 1% due to charges, depending on savers' decisions and choices.
- Not all instances of high charge impacts are in old schemes - £12.4bn out of £25.8bn is in post-2001 schemes.

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

- Around half the AUM with high charge impacts is potentially exposed to a RIY above 1.5% (£13.4bn out of £25.8bn), depending on savers' future behaviour.
- Some savers are potentially exposed to charges where the impact is significantly higher than a RIY of 1%. There is between £5.6bn and £8.0bn of AUM potentially exposed to a RIY greater than 2%, with £0.8 to £0.9bn potentially exposed to a RIY greater than 3%.

3. What are the characteristics of the charging structures with the highest charge impacts relative to any benefits?

- Schemes where savers are potentially exposed to the very highest impact of charges are more likely to have complex charge structures. Nearly all AUM

potentially exposed to a RIY of over 3% is in schemes with monthly fees or deductions from contributions.

- The majority of AUM potentially exposed to a RIY of over 1% (£19.1bn out of £25.8bn) is in schemes where charges are a proportion of fund value and which do not have monthly fees or deductions from contributions.

- Of this £19.1bn, around £14.4bn is in schemes where different savers may have different annual management charges (AMC), depending on their decisions and choices. For example, some schemes have tiered charge levels that are higher for lower fund values (£9.2bn) and active member discounts (£6.4bn). Around £4.7bn is in schemes that have a single AMC.

4. What are the characteristics of savers with high impacts from charges relative to any benefits?

- Savers with low fund values are potentially exposed to the very highest impact of charges. Savers with less than £10,000 hold the majority of the AUM potentially exposed to a RIY of more than 3%, £0.7bn out of £0.9bn. Around 94% of this is held by savers that are paid-up and have stopped contributing. For such savers, with low fund values who are unlikely to increase their fund value through further contributions, the impact of monthly fees can result in a very high RIY.

4.3 As well as the impact on existing savers in unit-linked schemes, we also looked at new joiners, exit charges and traditional with-profits. Our key findings are below.

- We estimate that there are 407,000 savers that have joined schemes in the last three years that may go on to have a RIY of more than 1% due to charges. This estimate is based on how long paid-up savers in these schemes contributed in the past. There are 178,000 savers who have joined schemes in the last 3 years that may potentially be exposed to a RIY of greater than 2% and 22,000 at more than 3%. We recognise that this backward look does not reflect what may happen in future given automatic enrolment and the charge cap, and will depend on the behaviour of these savers.

4.4 We considered the impact of exit charges on savers that had stopped contributing after 5 years. Our results overstate the impact of exit charges on savers that have contributed for more than 5 years, and understate the impact on savers that contribute for less than 5 years. The majority of savers in schemes with exit charges stop contributing in less than 5 years.

4.5 We found that there is around £4.8bn of AUM held by savers that have exit charges in our scenarios. Of this, £0.8bn is held by savers over age 55 who could withdraw their pension savings from April 2015 and are in schemes with potential

exit charges of over 10%. A further £2.6bn is held in schemes with potential exit charges of over 10% by savers under age 55 who are not able to withdraw savings, but may want to transfer to another scheme that offers better value for them.

4.6 We found that there is £1.9bn of AUM in traditional with-profits and unitised with-profits without explicit charges that had annual deductions of more than 1% in the last financial year.

Interpreting the results of the audit

4.7 We wanted to ensure that we captured the highest potential impacts from charges for savers in each scheme, and that we did not miss any instances of high charge impacts now or in future. When we have interpreted this data, we have therefore taken account of a number of issues that may result in our results overstating the impact of charges in aggregate for the in-scope schemes. These are set out below.

- Our audit has looked at the impact of charges that savers *may* face over the lifetime of their membership of a scheme from today until they exit, and how much they could reduce the yield on their investment under different scenarios of future behaviour. This is because the behaviour of many savers may change in future (such as by stopping contributions), and we wanted to capture the impact of such behaviour on the impact of charges. In our results below, for each group of savers, we identify the impact of charges in the 'best' (for example, contributing until retirement) and 'worst' of our scenarios (for example, stopping contributions) depending on their behaviour.

- Charges for workplace pensions are changing, partly as a result of the Government's charge cap, and the banning of active member discounts (AMDs), consultancy charges and commission payments. The data we used for this audit is based on a snapshot from April 2014. Already, some schemes have been re-priced and others are likely to be so in coming months. We welcome these changes, and recognise that this may mean that charges are lower today for some schemes and in some scenarios than in the analysis below.

- We allowed providers to group together some schemes which shared the same charging *structure* because this was more efficient for providers in collating and submitting the data (see annex 1 for a description of how we asked providers to group schemes). Where providers chose to do this, we asked them to provide data on the highest charging *levels* for each group. This means that there may be some schemes in each group that have lower charges than those reported to us in the audit.

- We have only sought to assess the impact of charges in funds promoted by providers (such as default, popular and lifestyle funds). Providers were therefore asked to submit data for the 'most popular' fund choice when there was not a default. In some cases, the most popular fund might be an option with high charges that members have actively chosen, rather than a fund that is promoted by the provider. As with all instances of high charges these factors would need to be assessed by governance bodies that will be best placed to understand the circumstances of individual schemes and their savers.

- The AUM and number of savings pots we report as potentially exposed to high charge impacts includes all AUM and savings pots in the scheme, even though some of this may not be in the default or most popular fund choice. Savers invested in funds other than the default or most popular may pay more or less than the charges reported for each scheme.

- Some scenarios are not relevant for some schemes, such as new joiner scenarios for schemes that are closed to new members, or scenarios with low fund values that are significantly below what any saver actually has. We specifically chose scenarios that were likely to have higher impacts from charges. This is why we also asked for data to understand the potential number of savers and AUM that may actually face each scenario. In our analysis below, we have scaled the likely exposure to high charge impacts in each scenario by data on actual scheme members.

- There are a number of exclusions to the scope of the audit, including the exclusion of post-2001 schemes that have a single AMC that is less than 1%. In addition, non-ABI members did not participate. In total, around £38.5bn of contract-based and bundled trust-based schemes are not included in the audit. This means that any data we report on an average or aggregate basis is a subset of the total population of defined contribution (DC) workplace pensions.

4.8 The main implication of this context is that the results below are likely to overstate the extent of high charge impacts. We believe that this conservative approach is appropriate given the value at stake for individual savers and the findings of the Office of Fair Trading (OFT). However, governance bodies and other interested parties should recognise this potential overstatement in reaching any conclusions based on the audit.

Ongoing charges for existing savers

4.9 In this section, we set out our analysis of ongoing charges using our scenario approach. The *impact* of charges paid will depend on charge *level* (e.g. 0.8% or 1.2% AMC), the charge *structure* (e.g. AMDs and fixed fees) and the characteristics and

behaviour of the saver (e.g. how much they contribute and when they stop contributing). In this section, we look at:

- the charge structures used by in-scope schemes; and
- the AUM and number of saving pots in schemes where savers are potentially exposed to high charge impacts.

Characteristics of structures that have high impacts from charges

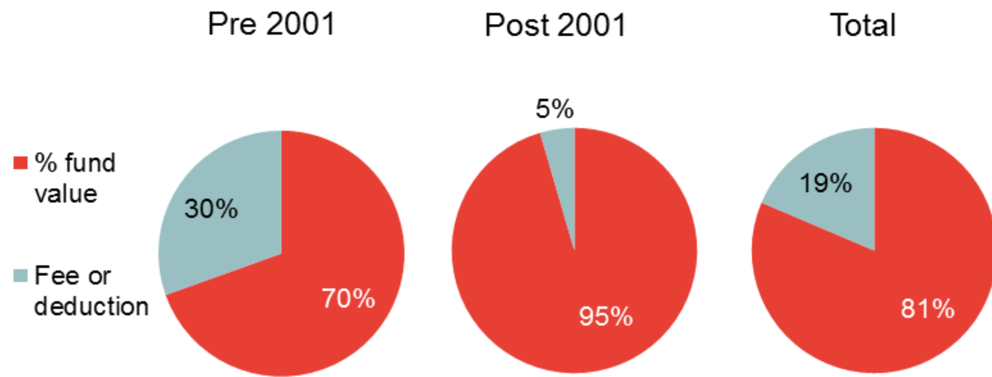
4.10 We asked providers to describe the charging structure for each scheme along 38 dimensions. For example, whether the AMC varied by fund value or whether a monthly fee was charged. There were 291 different combinations of these dimensions across all schemes, i.e. 291 different charging structures.

4.11 We found that:

- 19% of AUM is in schemes that have monthly fees or deductions from contributions.
- We found that 97% of savers potentially exposed to a RIY > 3% are in schemes with charging structures that have monthly fees or deductions.
- However, 74% of AUM potentially exposed to a RIY of more than 1% (£19.1bn out of £25.8bn) is in structures that do not have fees or deductions from contributions – charges are a % of the fund value in these schemes.
- Only around 18% of AUM potentially exposed to a RIY of more than 1% (£4.7bn out of £25.8bn) is in schemes with a single AMC.

4.12 We have identified two broad types of charging structure. In some schemes, charges are all expressed as a proportion of the fund value – we call these '% fund value' structures. Other structures, charges may either be fees which are fixed in monetary value (e.g. a monthly policy fee of £2) or taken as a deduction from contributions (e.g. 5% charge on all money paid into scheme) – we call these 'fee or deduction' structures. The figure below shows the proportion of AUM in schemes with 'fee or deduction' structures. 'Fee or deduction' structures were much more common before the introduction of stakeholder pensions in 2001. Stakeholder pensions have a '% fund value' structure and seem to have had a role in pushing 'fee or deduction' structures out of the market.

Figure 5. Distribution of charging structures for all in-scope schemes



Coverage: £66.3bn of in-scope unit-linked AUM (excludes traditional with-profits).

4.13 The table below shows the most common charging structures, which make up 66% of AUM in in-scope schemes. The top 5 most common structures are all '% fund value'. A simple flat AMC is the most common structure making up £13.5bn of in-scope schemes. A large proportion of the £38.5bn out of scope AUM will also have a simple flat AMC below 1% as such schemes were specifically excluded from the scope of the audit.

Table 4. Top 5 charging structures for all in-scope schemes

	1	2	3	4	5
Is there an ongoing charge, levied as a % of fund value (i.e. AMC)?	Y	Y	Y	Y	Y
Is there a different ongoing % charge for members who are contributing compared with those who are not (i.e. AMD)?	-	Y	-	-	Y
Does the ongoing % charge vary depending on fund value?	-	-	Y	Y	Y
Is there a different ongoing annual % charge for funds that have been transferred in from another provider?	-	-		Y	Y
Are charges deducted from funds that are transferred in from another provider?	-	-	-	-	Y
AUM (£bn)	13.5	12	11	4.2	3.6
% of total in-scope AUM	*20%*	*18%*	*16%*	*6.2%*	*5.3%*

Coverage: £66bn of in-scope AUM, excluding traditional with-profits. Only top 5 shown here.

4.14 We identified schemes where savers are potentially exposed to high impacts of charges with a RIY of more than 1%. The profile of charging structures for these schemes where the impact of charges may be high is different to the average. The table below shows the top 5 charging structures for these schemes.[40] These five structures account for 63% of the AUM in these schemes.

[40] Schemes where at least one saver is potentially exposed to a RIY of more than 1%.

Table 5. Top 5 structures for schemes where savers are potentially exposed to a RIY >1%

	1	2	3	4	5
Is there an ongoing charge, levied as a % of fund value (i.e. AMC)?	Y	Y	Y	Y	Y
Is there a different ongoing % charge for members who are contributing compared with those who are not (i.e. AMD)?	-	-	Y	Y	
Does the ongoing % charge vary depending on fund value?	-	Y	Y	-	
Is there a different ongoing annual % charge for funds that have been transferred in from another provider?	-	Y	Y	-	Y
Are charges deducted from funds that are transferred in from another provider?	-	-	Y	-	
Is there an ongoing regular fixed fee (e.g. a monthly policy fee)?	-	-	-	-	Y
Are there deductions from a member's 'standard' regular contributions (e.g. bid/offer spread, allocation rate less than 100%)?	-	-	-	-	Y
AUM (£bn)	4.7	3.8	3.6	2.8	1.4
	18%	15%	14%	12%	11%

Coverage: £25.8bn of AUM where savers are potentially exposed to RIY>1%.

4.15 Savers potentially exposed to high charge impacts tend to be in schemes that have more complex charging structures. Structures with a single AMC make up only 18% of the AUM that is potentially exposed to high charge impacts. Structures with multiple ongoing charges depending on fund value and whether a member is active are the most common.

4.16 'Fee or deduction' structures are more likely to result in higher impacts from charges for some savers, than '% fund value' structures. The table below shows the prevalence of 'fee or deduction' schemes for AUM that are potentially exposed to high charge impacts.

Table 6. Prevalence of fee or deduction structures for savers potentially exposed to high charge impacts in the 'worst case' scenarios

	Proportion of AUM
All in-scope schemes	19%
Potentially exposed to RIY > 1%	26%
Potentially exposed to RIY > 3%	97%

4.17 Very high charge impact structures where savers are potentially exposed to a RIY > 3% are almost all 'fee or deduction' structures. The reason for this is that monthly fees can lead to a high RIY where a saver has a low fund value, as the fee may itself be a large proportion of the yield in each period. Deductions from contributions can also be significant if the saver leaves the scheme soon after making the contributions, as there is not sufficient time for the yield to reduce the impact of the charge.

4.18 However, a large proportion of high charge impact schemes are "% fund value' which is simply because the fixed percentage is high, which could either be the standard AMC, or because of other factors like an AMD or initial units that attract higher rates.

Savers potentially exposed to high impacts from charges

4.19 The OFT identified around £30bn of AUM that are "at risk of poor value for money" that was either in pre-2001 schemes, or post-2001 schemes with an AMC above 1%. The OFT was not able to conclude whether these savers received poor value for money because:

- it only had data on some, but not all, of the charges for each scheme. This meant a scheme could have a low AMC and appear to have low charges, but other charges might mean that savers got poor value for money overall depending on their characteristics and behaviour;
- any benefits, such as guaranteed annuity rates and bundled insurances, may mean that a scheme is value for money even with high charges; and
- the quality of the scheme may mean it is value for money even with high charges.

4.20 Based on our scenario analysis, we can update the OFT's £30bn figure to address the first two of these issues. We can show the scale of savers and AUM that are potentially exposed to high impacts from charges based on their actual behaviour

and the impact of all saver borne charges, not just AMCs. We are not able to judge whether the quality of a scheme may justify the higher impacts of charges, which governance bodies will be best placed to do.

4.21 How much savers actually pay in each scheme will depend upon their characteristics and behaviour, such as the size of contribution or how long they remain in the scheme. For many schemes, the scenarios will not all be relevant, for example if all savers are already paid-up or have high contribution levels.

4.22 We therefore also collected data on the profile of savers in each scheme today. We have used this data to estimate the impact of charges savers may potentially be exposed to by matching the profile of savers to each scenario. How much savers actually go on to pay in charges will depend on how they behave in future. For example, savers are likely to be subject to higher impacts from charges if they pay up soon and lower impacts if they remain in the scheme until retirement. We therefore estimate a 'best and worst' case for our sample based on the highest and lowest RIY in the relevant scenarios of future behaviour for each group of savers.

4.23 We first consider below the different types of savers that are potentially exposed to high impacts from charges. We then show the totals for all in-scope schemes and how this compares with the OFT's original figures.

Types of saver potentially exposed to high impacts from charges

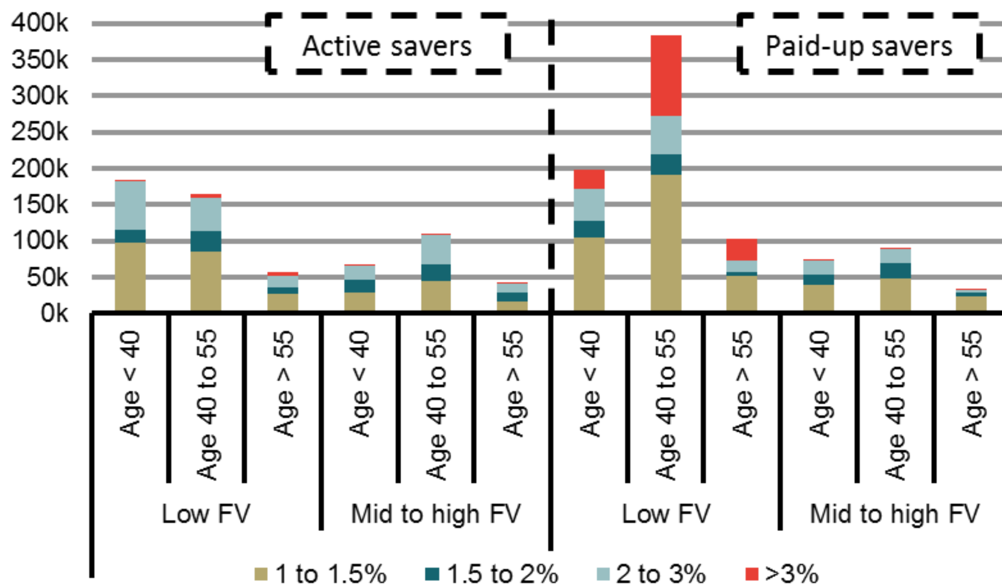
4.24 The figure below shows the number of savers that may be exposed to high impacts from charges split by fund value and age. The figure shows the 'worst case' for each scheme, which is likely to be if the saver stops contributing or exits early.

- Around 880,000 saving pots (savers may have multiple saving pots) are paid-up and 620,000 are still receiving contributions.

- The largest group at risk are paid-up saving pots with low fund values. There are around 380,000 of these saving pots potentially exposed to a RIY over 1% where the saver is aged 40 to 55. Around half of these are potentially exposed to a RIY between 1 and 1.5%.

- Savers potentially exposed to a RIY of over 3% are those with low fund values. This illustrates that when savers with low fund values stop contributing, the complexity of fee or deduction structures (accounting for 97% of AUM for these savers) can result in very high impacts from charges.

Figure 6. Number of saving pots potentially exposed to high charge impacts in 'worst case'

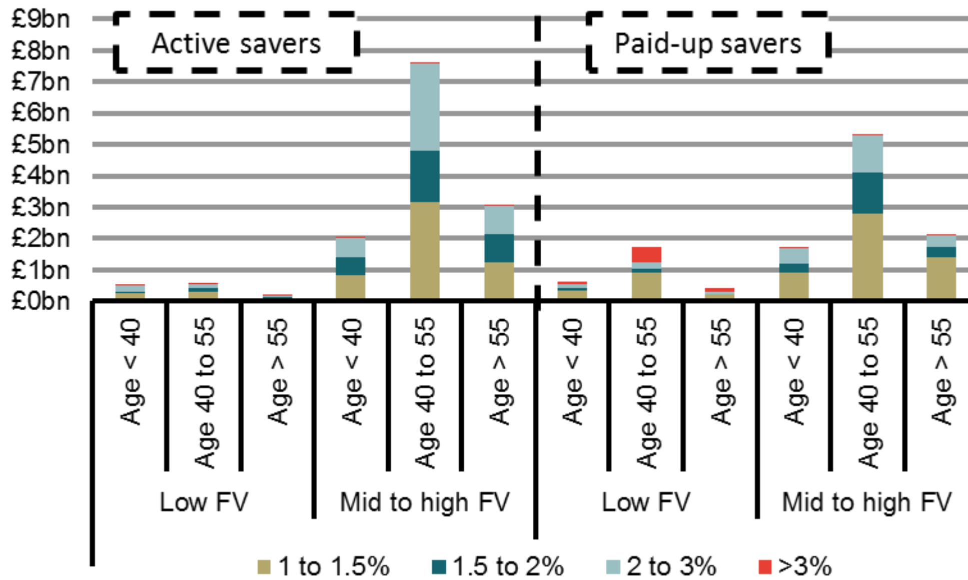


Coverage: £25.8bn of AUM potentially exposed to high charge impacts.

4.25 The figure below shows the same saving pots by AUM.

- Around £11.9bn is paid-up and £13.9bn is held by savers that are still actively contributing.
- The group with the largest exposure to high charge impacts by value is active savers with mid to high fund value (>£10,000) who together have £7.6bn potentially exposed to a RIY above 1%. Around £3.2bn of this is potentially exposed to a RIY between 1 and 1.5%.
- Although paid-up savers with low fund values are the largest group of savers potentially exposed to the highest charge impacts, the actual AUM for this group is only £2.7bn.

Figure 7. The 'worst case' RIY for savers depending on future behaviour by AUM



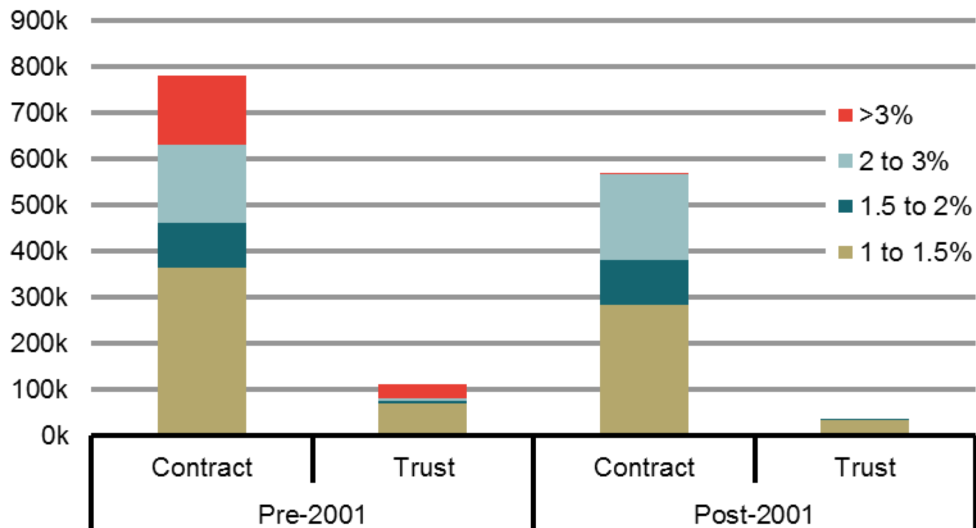
Coverage: £25.8bn of AUM potentially exposed to high charge impacts.

Total exposure to high charge impacts

4.26 The charts below show the total AUM and number of existing saving pots that we estimate are potentially exposed to high charge impacts at different RIY thresholds. We show the 'worst case' scenarios, generally where savers stop contributing or leave a scheme early.

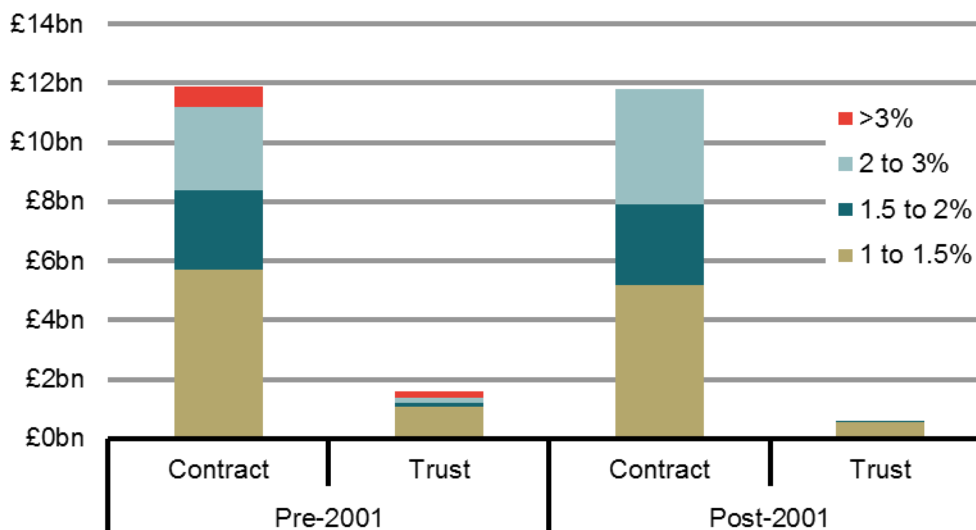
- There is £25.8bn of AUM and 1.5m saving pots that are potentially exposed to a RIY of 1% due to charges in the 'worst case' scenarios.
- Around £13.5bn and 890,000 saving pots out of this £25.8bn is in pre-2001 schemes and £12.3bn and 605,000 saving pots are in post-2001 schemes.
- Most of these schemes are contract-based – around £24bn and 1.35m savers.
- Around half, £12.5bn AUM and 0.75m saving pots, is potentially exposed to a RIY between 1% and 1.5%. £0.9bn and 184,000 saving pots are potentially exposed to a RIY above 3%.

Figure 8. Total number of saving pots potentially exposed to high charge impacts in 'worst case'



Coverage: 1.5 million saving pots potentially exposed to high charge impacts (£25.8bn of AUM).

Figure 9. Total AUM potentially exposed to high charge impacts in 'worst case'



Coverage: £25.8bn of AUM potentially exposed to high charge impacts (1.5 million saving pots).

Comparison between 'best and worst case' of our scenarios

4.27 How much a saver pays in charges will depend on their future behaviour. The figures above are based on the 'worst case' from our scenarios for each group of

savers, which is likely to be if a saver stops contributing or exits early. We have also estimated these figures based on the 'best case' of our scenarios for each group, which would generally be if the saver keeps contributing and remains in the scheme until retirement. The limitations we set out in paragraph 4.7 above apply to these 'best cases' too, which are also likely to overstate potential exposure.

4.28 The table below shows the range between 'best and worst case' by AUM and savers. The total potentially exposed to a RIY above 1% falls to £23.2bn and 1.35m saving pots. The biggest difference in the potential exposure to a RIY between 2% and 3% which is £4.8bn in the 'best case' and £7.1bn in the 'worst case'.

Table 7. Difference between 'best and worst' case potential exposure to high charge impacts

	1% < RIY < 2%		2% < RIY < 3%		RIY > 3%		Total RIY > 1%	
	Best	Worst	Best	Worst	Best	Worst	Best	Worst
AUM (£bn)	17.6	17.8	4.8	7.1	0.8	0.9	**23.2**	**25.8**
Saving pots (k)	885	960	295	360	175	185	**1,350**	**1,500**

4.29 The difference between the 'best and worst' cases is not large. This is because:

- Around half of AUM and saving pots are already paid-up and so are not able to increase their fund value. This means the impact of charges they pay cannot be changed, except by leaving the scheme early.
- Only around £1.8bn of the £25.8bn is held by active savers in schemes where the lowest possible impact of charges for active savers is less than 1%. This is because most of these schemes have a minimum AMC above 1%, as well as other charging elements.

Comparison with the OFT's findings

4.30 We considered our findings of £25.8bn AUM potentially exposed to a RIY of more than 1% alongside the OFT's identification of around £30bn of savers' money in contract and bundled-trust schemes with charges at risk of being poor value for money. There are a number of reasons for the differences including: the number of insurance companies that provided data for analysis; the number of charges that the companies provided data on (with the OFT only receiving data on

AMCs); differences in the periods over which the analysis was performed (during which time some schemes may have been re-priced and all will likely have experienced movements in funds values); the analysis was designed in different ways (the OFT's was based on the charges paid by the median saver in certain schemes, whereas the IPB's was based on the charges savers may incur if they stay in their scheme depending on their behaviour).

Savers joining schemes with high charge impacts

4.31 The analysis above considers existing savers. We have also looked at the potential exposure to high charge impacts for savers joining schemes in the last 3 years. We found that:

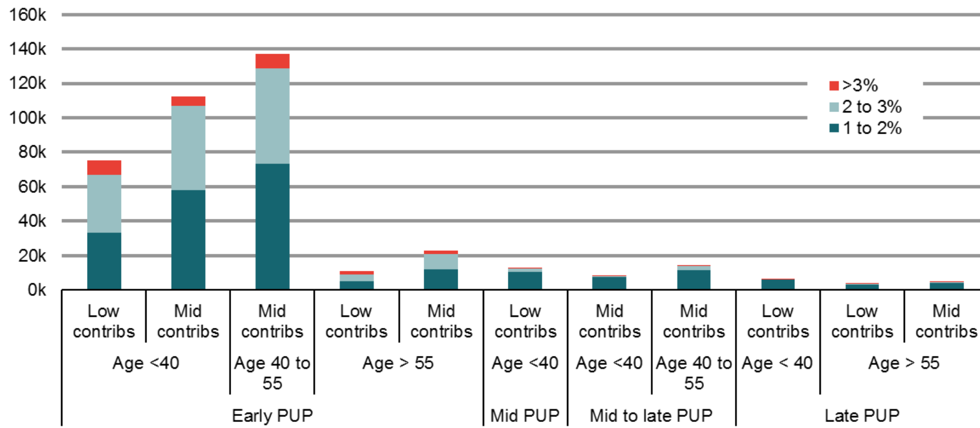
- Around 400,000 savers have joined schemes in the last 3 years where they are potentially exposed to high charge impacts.
- High charge impacts for new joiners are most likely if savers stop contributing early – we found that 50% of new joiners in these schemes that are paid-up stopped contributing within 2 years.

4.32 We recognise that this analysis of recent joiners may not represent the experience of savers in future given the legislative and regulatory changes currently taking place. In particular, automatic enrolment and the charge cap should largely remove any risk that savers will join schemes with high charge impacts without any active choice of their own. Governance bodies should satisfy themselves that this is the case for the schemes we identify below in particular.

4.33 The figure below shows the number of new joiners in the last 3 years potentially exposed to high charge impacts. To illustrate when savers might stop contributing, we have used data on the period that existing paid up savers in each scheme contributed for. We assume for this illustration that these new joiners will contribute for the same period.[41]

[41] This may over-estimate how many members pay up early as those who stay in the scheme longer will not be counted as paying up.

Figure 10. New members in last 3 years potentially exposed to high charge impacts



Note: PUP refers to paid-up. Early PUP means that savers contribute for < 2 years before contributions stop; Mid PUP is 2 to 5 years. Low contributions are <£100 per month; Mid contributions are £100 per month to £300 per month; High contributions are > £300 per month.

Coverage: £22.6bn of AUM in schemes that have new savers potentially exposed to high charge impacts.

4.34 Most of the savers that are potentially exposed to high charge impacts are those that stop contributing early because they will have lower fund values and be exposed to additional charges, such as AMDs, for longer.

4.35 Stopping contributions after a short period may be expected based on the historical behaviour of savers in these schemes. The table below shows the period for which savers contributed in those schemes where we have identified savers are potentially exposed to high charge impacts. Half of savers in these schemes that have stopped contributing did so within 2 years. Consequently they may have low fund values in the scheme. This may be a result of savers moving between jobs without moving their pension pot with them, and therefore accumulating several different pension pots. The DWP identifies that on average, individuals have 11 jobs during their working lives. If no reform is undertaken DWP research indicates there will be around 50 million dormant pension pots by 2050.[42] Only 4% of the savers contributed for more than 10 years.

42 DWP, "Better workplace pensions: Further measures for savers", Executive Summary, paragraph 14.

Table 8. The length of time before savers have stopped contributing in schemes where new joiners are potentially exposed to high charge impacts

	< 2 years	2 to 5 years	5 to 10 years	> 10 years
Proportion of savers who have paid up	50%	31%	14%	4%

4.36 We are concerned that over 400,000 savers may have recently joined schemes where they could end up facing a RIY of over 1% and nearly 200,000 savers a RIY of over 2%. The actual position will depend on the behaviour of the saver and whether they stop contributing or exit a scheme early. For such savers there are lower cost alternatives available.

4.37 Given changes to regulation, we expect that new joiners under automatic enrolment will not face these charge impacts. Governance bodies should satisfy themselves that this is the case and that new joiners are not exposed to high charge impacts in the future.

Exit charges

4.38 We separately considered exit charges in the audit. This is because exit charges may deter savers from switching provider, even if an alternative is available that offers lower charges or better benefits. Exit charges may also deter savers from taking advantage of the new freedoms to withdraw savings from age 55.

4.39 In the analysis above, we include several scenarios where savers exit early. We also asked providers to submit data specifically on the extent and size of exit charges.

4.40 The savers in our scenarios all stop contributing after 5 years. This means our results will overstate the impact of charges on savers that contribute for more than 5 years, and understate the impact of charges on savers that contribute for a shorter period. In those schemes with exit charges, 55% of savers that have paid-up did so within 5 years.[43] However, governance bodies and other interested parties should recognise this potential overstatement in reaching any conclusions about exit charges based on the audit.

[43] We include active savers with more than 5 years of contributions in those that stop contributing after 5 years. Active savers with less than 5 years of contributions are excluded from the calculation.

4.41 We found that:

- There is £5.8bn of AUM in schemes where savers would face charges for exiting a scheme early. Only around £0.1bn is in post-2001 schemes.

- Not all of these schemes levy exit charges for savers that make regular contributions for a period and then exit early. For example, in some schemes exit charges may only be applied to large single contributions and not regular contributions. The schemes where exit charges apply in our scenarios make up £4.8bn or 7% of AUM in in-scope unit-linked schemes.

- There is £0.8bn of AUM held by savers over age 55 in schemes with potential exit charges of more than 10% who would be eligible for the new freedoms to withdraw their pension savings.

- There is a further £2.6bn of AUM with potential exit charges of more than 10% held by savers under age 55 that cannot withdraw their savings, but may wish to transfer to another scheme that offers better value for them.

Average exit charges

4.42 The charges that savers pay by exiting early in these schemes depends on their fund value, when they started contributing and when they exit. The table below shows the average proportion of fund value that would be paid in exit charges for those schemes that have exit charges, for savers that have contributed for 5 years – the impacts may be lower for savers that contribute for longer. At age 55, a saver that started contributing at age 25 and has a fund of £100,000 would face an average exit charge of 8.7%. Charges could be as high as 17.3% on average for a saver that exits a scheme at age 45 with a low fund value.

Table 9. Proportion of fund value paid in exit charges

	Exit age 45		Exit age 55			
Starting age	25	25	25	25	45	45
Fund value at exit	£10k	£100k	£10k	£100k	£10k	£100k
Average charge	17.3%	15.4%	10.5%	8.7%	13.0%	12.5%

Note: Values for exit at age 55 are estimated based on scenarios for age 54 and age 57.

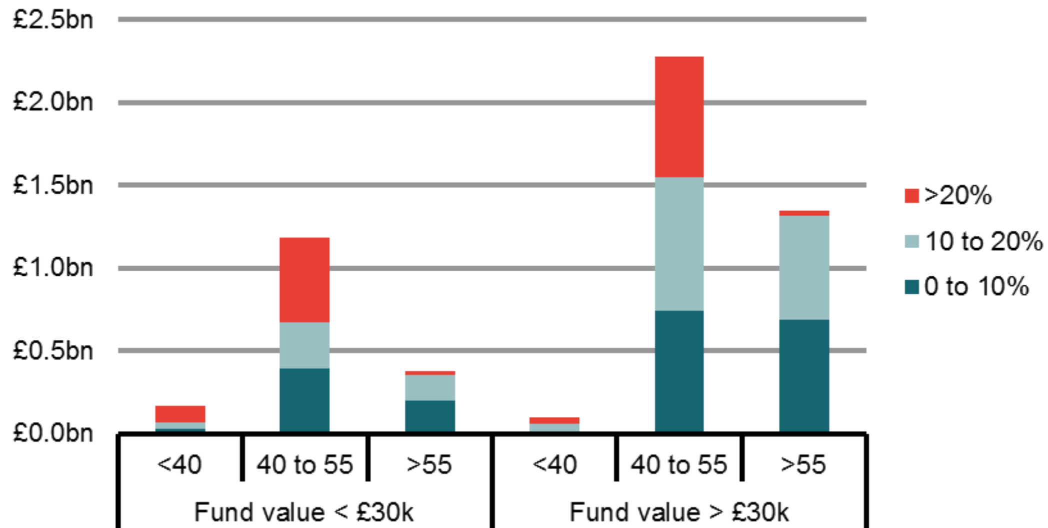
Coverage: £4.8bn of AUM with exit charges in our exit scenarios.

Characteristics of savers that could pay exit charges

4.43 The impact of exit charge that savers pay will depend on the charging structure and when they exit. It may be that many savers in these schemes are already over the age at which large exit charges apply. We asked providers for data on the age and fund value profile of savers. We have used this to estimate the charge that existing savers would face if they left today. This will overstate the risk as we take the 'worst case' charge in each group.

4.44 The figure below shows that there is around £3.4bn of AUM held by savers with potential exit of more than 10% (5.1% of AUM in in-scope unit-linked schemes). Of this, £0.8bn is held by savers over age 55 who would be eligible for the new freedoms to withdraw their pension savings. The remaining £2.6bn is held by savers that cannot withdraw their pension savings, but may wish to transfer to a scheme that offers better value for them. There is significantly less AUM held by savers below the age of 40 in schemes with exit charges, reflecting the declining use of charging structures that include such charges but also the fact that there are lower fund values in this age group.

Figure 11. Distribution of savers by exit charge



Coverage: £4.8bn of in-scope schemes where exit charges apply in exit scenarios.

4.45 Exit charges are one type of charge structure that has been used to recover the initial costs of setting up a pension scheme. As we describe in section 3, exit charges do not mean that a saver receives poor value for money over the lifetime of their scheme. This will depend on the total charges they will pay over the lifetime, and whether they paid relatively lower charges in the early years of the scheme, as well as the quality of the scheme.

With-profits

4.46 We looked at traditional with-profits and unitised with-profits without explicit charges separately, as we report below. Unitised with-profits that have explicit charges are included in our analysis of unit-linked investments above.

Traditional with-profits

4.47 There is £1.2bn invested in traditional with-profits, with 73% invested in just five products. The median deduction from these funds in the last financial year was 0.83% of asset share.

4.48 Many of these products have benefits that can be offset against these deductions. Distributions from inherited estate mean that, for £0.6bn of asset share, there was actually a net gain in the fund in the last financial year. Around 56% of asset shares have guaranteed annuity rates of at least 8% per annum.

4.49 However, there is around £0.4bn of asset share with deductions above 1% without any guaranteed annuity rate offered.

Unitised with-profits without explicit charges

4.50 There is £2.4bn invested in unitised with-profits without explicit charges by savers in in-scope schemes. This includes all AUM invested in these funds, even if it is not the default or most popular fund for the in-scope schemes.

4.51 The median deduction from these funds was 1.12% of asset share with £1.5bn having deductions greater than 1%.

Data shared with providers

4.52 We have shared with providers the details of all of the schemes where we have identified that the impact of charges is potentially high. In particular:

- schemes with existing savers that are potentially exposed to a RIY of more than 1%;
- schemes where savers have joined in the last 3 years and are potentially exposed to a RIY of more than 1%;
- schemes where savers face exit charges;
- traditional with-profits schemes with deductions above 1% where no guaranteed annuity rate is offered; and
- unitised with-profits without explicit charges where deductions are above 1%.

In section 5, we set out what providers should do with this information.

5 Guidance and Recommendations

5.1 Value for money is not solely determined by charges. Other elements of scheme quality outside the scope of this audit (such as administration and communication quality, investment performance and governance) are important determinants of value for money. Value for money is also highly dependent on the characteristics and behaviour of individual savers. None of these factors can be measured at an industry-wide level.

5.2 There is no simple 'one-size fits all' approach to ensure that all savers receive value for money. As we stated elsewhere, there is no single charging structure that will result in better outcomes for all savers irrespective of their future behaviour.

5.3 That is why, rather than industry-level actions, the IPB has focused on identifying schemes where savers are potentially exposed to high charge impacts, and providing information and guidance to providers and governance bodies on where to focus their attention, so that they can assess whether other qualitative factors justify the high charge impacts or not.

5.4 Governance bodies have a specific responsibility to act in the interests of scheme members. The IPB considers that governance bodies are best placed to judge if savers are receiving value for money as they should have the best understanding of the specific needs, preferences and circumstances of the members of each scheme.

5.5 Where savers may not be receiving value for money, the IPB expects providers and governance bodies to act together to ensure that savers receive value for money in future.

Guidance to providers and governance bodies

5.6 The following guidance has been developed to help providers and governance bodies evaluate whether schemes offer value for money and to support a consistent approach and outcomes across the industry. The guidance covers:

- where to look for potential areas of poor value for money;
- key questions governance bodies should ask when evaluating value for money;
- core analysis governance bodies should regularly review; and
- potential actions that might be taken to ensure savers receive value for money in future.

Where to look for potential areas of poor value for money

5.7 Our analysis shows that savers in around 107,000 different schemes, out of 189,000 in-scope, are potentially exposed to a RIY of more than 1% depending on their future behaviour. We have written to the provider of each of these schemes detailing the number of savers and associated assets under management (AUM) that are potentially exposed to charge impacts in excess of a RIY of 1%, 2% and 3% in the 'worst case' identified in section 1. This list of schemes and our analysis is the starting point for providers and governance bodies to identify schemes offering poor value for money for some savers depending on their behaviour and characteristics.

5.8 The IPB recommends that providers and governance bodies prioritise actions for schemes where savers may be exposed to a RIY impact above 3% under certain patterns of behaviour, subsequently considering schemes above the 2% threshold and finally the 1% threshold.

5.9 We have also identified in section 4 where savers in:

- 37,000 schemes have joined in the last 3 years and are potentially exposed to a RIY of more than 1% depending on their future behaviour;
- 39,000 schemes face exit charges;
- 2,000 traditional with-profits schemes had deductions of more than 1% in the last financial year and do not have a guaranteed annuity; and
- 4,000 schemes that have unitised with-profits without explicit charges have deductions of more than 1%.

5.10 The providers and governance bodies of these schemes should also prioritise actions for these schemes. Providers and governance bodies should pay particular attention to exit charges because of the impact these charges have on savers eligible to withdraw pension savings from April 2015 and also on savers wishing to transfer to schemes that offer better value for them.

5.11 The audit is based on data as at 1 April 2014, and charges in some schemes may have been reduced since then in response to the charge cap and other changes. Governance bodies will need to consider whether actions already taken by providers are sufficient to ensure schemes offer value for money.

5.12 Given that value for money may be dependent on the interaction of the characteristics of the savers and the complexity of the charging structure, the IPB also recommends that governance bodies conduct regular analysis of the charges and membership profiles of their schemes. This will ensure that governance bodies continue to understand the needs of savers in those schemes and identify those groups potentially exposed to receiving poor value for money.

Key questions governance bodies should ask when evaluating value for money

5.13 When evaluating if a scheme is value for money for members, the IPB recommends that governance bodies use the same assessment criteria as set out by the Financial Conduct Authority (FCA) in the rules establishing IGCs (see Annex 8) and the Pensions Regulator's (TPR) detailed guidance for trustees, while also benchmarking where possible against the charges in comparable schemes across the industry (as set out in this report).[44]

5.14 In addition, the IPB recommends governance bodies ask themselves the following 10 questions when evaluating value for money:

Actions taken to date

1. Has the provider taken action since April 2014 to reduce charges for existing savers in these schemes and are these actions sufficient to secure value for money for savers?

Scheme quality and benefits

2. Does the scheme include any additional benefits that fully or partially justify the charges?
3. Does the quality of the scheme fully or partially justify the charges (for example through superior administration, communications with members or investment performance)?
4. Do scheme charges include the impact of third party fees (for example external fund management costs)? If so, do the third party services provide value for money to scheme members?
5. Are the charges a result of fund choice? If so, has the fund been actively chosen by the scheme member?

Benchmarking

6. How do scheme charges compare to those for schemes with similar features and benefits set up by the provider and, where comparison is possible, other providers?

---

[44] See TPR (2014), "Regulatory guidance for defined contribution schemes".

Impact of charging structures on members

7. Are the charging structures in place appropriate given the membership profile of the scheme? If some members are particularly disadvantaged, what can be done for those members?
8. Are the charging structures in place unnecessarily complicated?
9. Does the scheme have exit charges? If so, what are the potential costs and impacts on individual member behaviour?
10. Are there any other facts you believe you need to know about the scheme?

5.15 For all of its schemes, grouped as appropriate, the governance body should explain in its annual report why action has or has not been taken to ensure members receive value for money, and where action has been taken, what those actions are. They should also set out the criteria they have deployed in reaching their conclusions.

Core analysis governance bodies should regularly review

5.16 The needs and behaviours of savers may well change over time. The IPB recommends that governance bodies analyse the composition and membership profile of all of their schemes on a regular basis to ensure that they understand the needs of members over time, paying particular attention to paid up savers and savers who have stopped contributing.

5.17 Governance bodies should regularly monitor charge impacts and qualitative aspects of their schemes, to ensure their members are receiving value for money.

What actions might be taken to ensure savers receive value for money in future?

5.18 Providers and governance bodies should also consider what actions could be taken to ensure savers receive value for money in future. This might involve:

- changing charging structures;
- reducing charges or waiving elements of charging structures;
- closing schemes and transferring members to new schemes; and/or
- closing schemes to new members.

5.19 Governance bodies should ensure they understand the potential challenges of taking action to remedy schemes, particularly legal issues. A summary of legal considerations when changing pension schemes is set out in Annex 9.

Recommendations

Providers

5.20 We have written to the provider of each scheme where savers are potentially exposed to high charge impacts, or where savers face exit charges, setting out the AUM and the number of savers.

5.21 For each scheme or group of schemes, providers should by 30 June 2015 at the latest:

- Review their data and conduct any further analysis to reflect any actions already taken to reduce charges or other qualitative factors that might justify high charges;
- Identify what actions could be taken to improve outcomes for savers and what actions can be taken to stop new savers joining poor value schemes;
- Provide the data, any further analysis and the proposed actions to the relevant governance body.

Governance bodies

5.22 Governance bodies are responsible for evaluating which, if any, of the provider's proposed actions best meet the needs of their savers. They should make recommendations to providers on which course of action will be most effective to ensure value for money for savers and have an implementation plan agreed with the provider and in place by the end of December 2015 at the latest. Wherever possible, governance bodies should take actions earlier.

Training for governance bodies

5.23 Providers and regulators should work together to ensure that there is effective training and support available for IGCs and trustees.

Individual Personal Pensions (IPPs)

5.24 ABI members have committed to a sampling exercise of IPPs to identify those cases where savers were previously in a workplace pension and so may now be at risk of high charges. This exercise is due to take place under the auspices of IGCs by June 2015. We support this exercise and recommend that it is implemented to this timetable.

Regulators and government

5.25 Savers in low value schemes will be reliant on governance bodies and providers effectively implementing our recommendations so that they receive value for

money in future. It is the role of the relevant regulator (TPR for trust-based schemes and FCA for providers of contract-based schemes, to whom IGCs can directly report concerns), as part of their oversight remit and in line with their published standards, to review how governance bodies and providers are handling these challenges.

5.26 The IPB recommends that the Department for Work and Pensions (DWP) and the FCA jointly review industry-wide progress in addressing and remedying poor value schemes and publish a report by the end of 2016.

Annex 1: Methodology

This annex sets out the methodology that we have used to conduct the audit. As explained in the main report, we have done this by using hypothetical saver scenarios and asking providers to model how each of the charging structures determines the level of charges paid for each hypothetical saver. This section sets out our methodology for how we collected the data from providers and describes the analysis we then conducted.

Methodology for collecting data for unit-linked schemes

There were five steps to the data collection process for the audit:

1. Providers first identified the relevant scheme or group of schemes for which to submit data.

2. Providers then identified the 'scheme investment' (defined below) that they would use.

3. Providers submitted data on the charging structure for each scheme.

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

5. For those schemes or groups of schemes where charge impacts for some saver scenarios are above a threshold of 1% over the course of their membership, we asked 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

This audit was conducted at the scheme level, rather than at saver level. This means that we measured how providers' schemes impact a set of hypothetical savers, rather than each saver in the scheme.

The first stage was for providers to identify all schemes in-scope, before submitting data on charge structures and levels for each of the schemes. However, we recognised that many schemes have similar or identical charging structures and that it was more efficient for providers to submit data for groups of these schemes with the same charging structures. Providers could therefore choose to group schemes together if all schemes in the group were of the same type, and if they had

identical charging structures. For example, schemes with a contribution charge and an AMC could all be grouped together.

Where groups of schemes had identical charging structures, individual schemes may still have had different charge levels. Where this was the case, providers chose the highest charge levels for each charge type to represent all schemes in the group. This ensured that all savers that may face high charge impacts within the group were identified. Table 10 below gives an example of how two schemes can be grouped together and charges reported.

Table 10. 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%

This approach means that the impact of charges for some schemes is overstated, as they may have been grouped with other schemes that have higher charges. Providers were aware of this as they made decisions on how and whether to group schemes. However, in step 5 below, we asked providers to submit further information on the schemes within some groups that were at risk of higher charges. This limited the extent that groups of schemes were overstating charges.

2. Identifying the 'scheme investment'

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

If providers had identified an individual scheme, then they used the scheme charges for the default fund, if one was available.[45] If there was no default fund, then providers submitted data using their most popular investment option.

If providers grouped schemes together, then there may have been different default or most popular funds for each scheme in the group. We 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

45 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.

schemes in the group. Providers reported 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% of the assets under management for that group of schemes. We selected 80% to ensure that any significant funds with higher charges were captured in the audit.
- Second, the provider identified the default or most popular fund (ranked by AUM) for each scheme. This may have been the same as the first fund.
- The provider then selected from each of the schemes the fund with the highest charges.

We understand that this method may overstate charges if the majority of savers in the group are actively choosing a fund which does not have the highest charges.

3. Submitting data on charging structures

For each scheme or group of schemes, providers were 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

We used hypothetical saver scenarios to assess charges as we describe in Section 0 in the main report. For each saver scenario, providers were 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.

Once all charging structures and charge levels were identified, providers then applied these charges to each saver scenario. Using the assumptions, providers then calculated a fund value at the given exit age which took into account all charges borne by each of the hypothetical savers, including any exit charges.

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

We calculated the fund value for each saver scenario with no charges. We then compared the cash-in values for each saver scenario with and without charges and calculated the reduction in yield (RIY) for each scenario.

5. Submitting additional data on saver characteristics

A scheme may have some saver scenarios where the impact of charges may be higher or lower as measured by RIY. We wanted to understand how many savers within these schemes are likely to be paying higher charges. The final step was therefore 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 1% per annum.[46]

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

For groups of schemes, we first asked providers to break up the group and only submit data on those schemes that were above the threshold and not those that may have been below the threshold.

These data allow us to map between the high charge impact scenarios and the likely size of the corresponding group of savers. We have done this in the following way:

- For each scheme we have data on the RIY for each scenario from providers' calculations.
- We have grouped existing saver scenarios together where the situation of each saver in terms of age, fund value and whether they are actively contributing today is the same. We also group scenarios for new joiners by age of joining and size of contribution.
- We asked providers for distributional data by age, fund value and whether they are contributing, and for data on the number of new joiners in the last 3 years by age and contributions.
- We match this distributional data to each group of scenarios to estimate the number of savers and AUM that may have high charge impacts in the 'best and worst' cases, depending on savers' behaviour.

With this information we can calculate the number of savers who are potentially exposed to high charge impacts and the size of funds under management.

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

Methodology for collecting data for with-profits

For traditional with-profits, providers submitted 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.

For schemes offering unitised with-profits as an investment option, providers treated unitised with-profits funds with explicit charges and no additional deductions as if they were unit-linked investments.[47] For all other types of unitised with-profits fund, aggregate information on deductions (either at the fund level or the bonus-series level) was required for all funds which either are the scheme investment of an individual scheme, or make up more than 5% of AUM of any group of in-scope schemes.

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

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

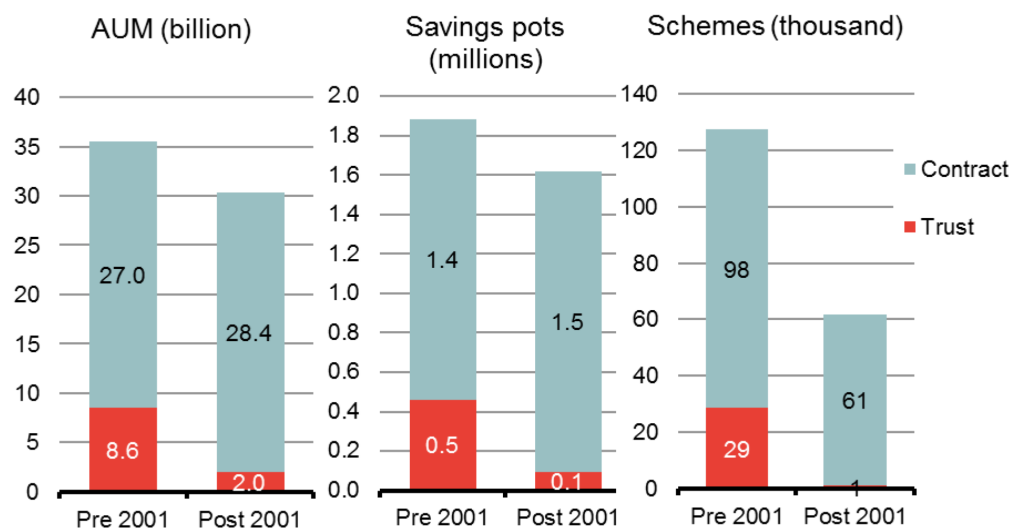
Annex 2: Summary of in-scope data

In this section, we provide further detail on the analysis in Section 1 of the main report.

Summary of in-scope schemes and savers

In total, 23 providers submitted data on £67.5 billion of in-scope assets. 80% of this came from the top five providers. These assets belonged to 3.6 million saving pots across 191,000 schemes. The £67.5 billion of in-scope AUM are broadly split evenly between pre and post 2001 schemes, but there are more pre 2001 schemes. Figure 12 below shows the split of the in-scope schemes.

Figure 12. Breakdown of schemes by AUM, saving pots and scheme numbers



Coverage: £66.3bn of in-scope AUM excluding traditional with-profits. Around £0.3bn of data cannot be identified as trust or contract and is omitted.

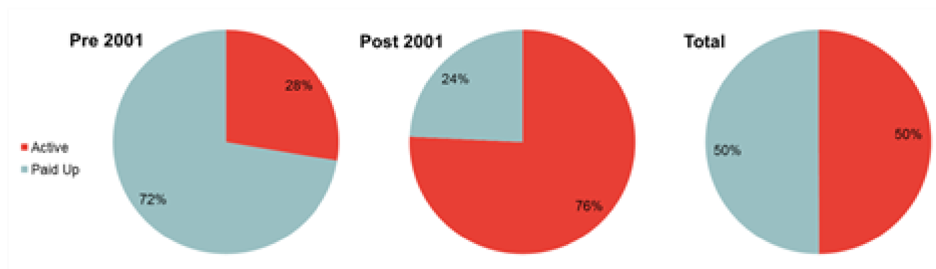
As shown in Figure 13 below, the vast majority of schemes are small, with most schemes having fewer than 25 members. Around 91% of pre-2001 and 84% of post-2001 schemes have fewer than 25 members. We are not able to use our data to identify the proportion of AUM held in small schemes across all in-scope schemes. However, for a subset of £22bn of AUM, around a quarter of AUM and savers are in small schemes with fewer than 25 members.

Figure 13. Schemes by Membership (Total number of schemes), all pension types

Coverage: £66bn of in-scope AUM, excluding traditional with-profits.

Around half of AUM is held by savers that have paid up and are no longer contributing to that particular scheme. There is a much higher proportion of paid up AUM in pre-2001 than post-2001 schemes, as shown below in Figure 14. This is likely to reflect the relative age of schemes, rather than a distinct change in activity in 2001.

Figure 14. Breakdown of AUM by active and Paid Up status



Coverage: £66bn of in-scope AUM, excluding traditional with-profits.

Annex 2: Summary of in-scope data

Annex 3: Analysis of saver scenarios

As outlined in section 3, we have chosen to use hypothetical saver scenarios to understand how charges impact savers. To understand the charge impacts of the various schemes, providers were asked to provide the RIY for 37 saver scenarios for each of their in-scope scheme or groups of schemes. We then measured how providers' schemes impact a set of hypothetical scenarios.

In this annex we describe each of the scenarios, present the average RIY for each scenario across all pre-2001 schemes and show the distribution of RIY across all schemes.

Our selected scenarios

Our scenarios are listed in Figure 15. This shows the key variables for each scenario. For example:

- Scenarios 1 to 7, 29, 30, 36 and 37 are all existing savers aged 25 who have been contributing for 5 years.
- Scenarios 1, 3, 5 and 30 have higher contributions and have built up a fund value of £15,000. The other scenarios have low contributions and a fund value of £5,000.
- Scenarios 5, 6, 7, 29 and 30 are paid-up and have stopped contributing.
- Scenario 1 and 2 continue to contribute until retirement. Scenario 3 and 4 stop contributing after 3 further years.
- Other scenarios look at older savers at age 45 and 60.

Figure 15. List of saver scenarios with cash-in values at start and 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

Annex 3: Analysis of saver scenarios

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

If a scheme has exit charges that fall as a saver approaches retirement, this has an implication for the impact of charges when we look on a current and future basis. Where there are exit charges, a scheme may be seen to have a lower RIY when we use cash-in values than if we used the face value in the scenarios.

For example, if a scheme has an exit charge of 5% today then a saver with a face value of £10,000 would have £9,500 if they chose to leave the scheme. If there is an AMC of 1% per year of the face value (and ignoring any fund growth or additional contributions), then the saver would have a face value of approximately £9,000 after 10 years for retirement (and no exit charges). The impact of charges has been to reduce their available funds from £9,500 today to £9,000, which is an effective charge of around 0.5% per year over the 10 years. This is less than the headline rate of 1% AMC.

Average RIY for each scenario

We used saver scenarios to identify which saver characteristics and behaviours are likely to be more expensive. As we show below based on these scenarios, savers who have low fund values, which may be because they make low contributions, stop contributing early or take career breaks, are more likely to face a higher RIY.

The table below shows the average RIY for some of the existing saver scenarios.[48] For example, for the scenario where a saver has a cash-in value of £1,000 and is 25 today, and contributes for 40 years, the average RIY is 1.05% over the lifetime of the saver's membership.

[48] The averages are for pre-2001 schemes, as we do not have a complete set of data on post-2001 schemes due to the exclusion of schemes with a single AMC less than 1%. The averages are weighted by the AUM in each scheme or group of schemes, although this may not reflect the value that is actually exposed to the scenario.

Table 11. Average RIY for existing saver scenarios in pre-2001 in-scope schemes

			Cash-in value at start					
			£1,000			£15,000/£35,000		
Exit age	Years contri-buting	Extra scenario	Age 25	Age 45	Age 60	Age 25	Age 45	Age 60
65	40		1.05%			0.96%		
65	24		1.09%			-		
65	24	Caring breaks*	1.15%			-		
65	5		1.33%	1.35%	1.67%	1.01%	-	1.00%
65	Paid up		2.06%	2.02%	1.86%	1.03%	0.98%	0.99%
65	Paid up	Transfer*	-	-	-	-	0.98%	-
55	5		-	-		-	1.03%	
55	5	Transfer*	-	-		-	1.09%	
55	Paid up		2.05%	1.96%		-	1.03%	
40	Paid up		2.01%			1.09%		

Note: Not all scenarios are possible due to age of saver (highlighted grey) and our 38 scenarios do not cover all possible combinations of characteristics so we do not have values for all cases.

*Our scenarios include the case of a saver that takes *caring breaks* during their career (scenario 36), or *transfers* in £25,000 of their cash-in value at the start.

Coverage: £35.6bn of pre-2001 in-scope AUM.

We can see the effect of different charging structures in these averages. For many schemes with a single AMC (around 20% of the in-scope sample), there are no significant differences in the RIY for each scenario. However, for other structures, charge impacts differ between scenarios. For example:

- A saver aged 25 with a low fund value today of £1,000 and low contribution level of £50 per month would face a different RIY depending on how they behave in future:
  - If they continue to contribute for 40 years until retirement at aged 65, then the average RIY is 1.05%.
  - If they stop contributing today, but remain in the scheme until retirement at aged 65, then the average RIY is 2.06%. This is because the saver would have a low fund value, and some schemes have fixed fees or other charge structures that may have a greater impact in such a scenario.

   - Leaving at age 40 would reduce the average RIY slightly to 2.01%. This is actually a lower charge impact than if they stayed in the scheme, which is because the saver would avoid some monthly fees or other charges which would erode their fund value if they stay.
   - If they contributed for 24 years, paid up at 48, and retired at age 65, they would pay 1.09% on average. If they contributed for the same total number of years but broken up by breaks for caring, the RIY would be 1.15%, which reflects the slower accumulation of funds and lower fund value at retirement.

- A saver aged 25 with a fund value and contribution level of £15,000 and £200 per month respectively would face lower charge impacts.
   - If they continue to contribute for 40 years until retirement at age 65, then the average RIY is 0.96%. This reflects the smaller impact of monthly fees and other charges that depend on fund value, such as tiered AMCs.
   - If they stop contributing today, but remain in the scheme until retirement at age 65, then the average RIY is 1.03%. This is higher because the saver would have a lower fund value, and face charges such as AMDs which would increase the RIY when they stop contributing.
   - Leaving at age 40 would increase the average RIY to 1.09%. With a higher fund value, leaving early increases the average charge impact because of exit charges and higher initial fees in some schemes.

- A saver aged 45 with fund value and contribution level of £35,000 and £200 per month respectively would face a similar impact from charges.
   - If they contribute for a further 5 years and then exit at age 55 they will face a RIY of 1.03%. If they had transferred in £25,000 then the RIY would be 1.09%, reflecting higher charge impacts on transferred funds and single payments.
   - If they pay up today and stay in the scheme until retirement they would face a RIY of 0.98%.

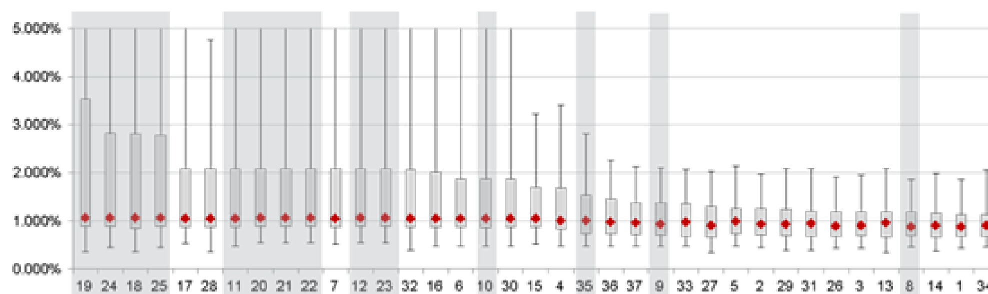
Distribution of RIY for each scenario

The charts below show the medians and ranges for all scenarios. These charge impacts are not indicative of what savers are actually paying. Whether savers do pay these charges will depend on their behaviour.

We have collected the range of RIYs from each provider for each saver scenario. The saver scenarios for all pre-2001 schemes are shown below in Figure 16 below as box and whisker plots. For each scenario, we calculate the proportion of AUM subject to various charge impacts across all of the in-scope schemes of all

providers. The scenarios in Figure 16 are ranked by the top quartile. The list of scenarios is provided at the start of this annex

Figure 16. Distribution of RIY for each saver scenario, pre-2001 schemes



Notes: Grey highlight shows new joiner scenarios. This figure shows the 5th percentile, 95th percentile, median, upper quartile and lower quartile AMC across providers' schemes or groups of schemes for the hypothetical saver scenarios.[49]

Coverage: £35.6bn of pre-2001 in-scope AUM.

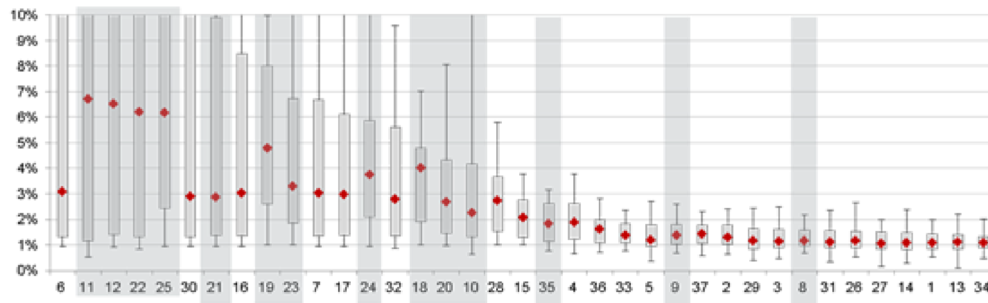
As shown by Figure 16 above, the median RIY is around 1% across all saver scenarios. For some saver scenarios, there is a long tail of schemes which could have high RIYs. As shown, scenarios 18, 19 and 24 are those where the impact of charges is highest. These scenarios all have savers who are new and join a scheme at age 60. The impact of charges is lowest in scenarios 1, 14 and 34. These scenarios all have high fund values at the start, and savers who are not new.

Figure 17 below shows a subset of all pre-2001 schemes which have 'fee or deduction' charging structures. The schemes below are ranked in order of the median RIY.

---

[49] The 5th percentile of a finite list of numbers can be found by arranging all the observations from lowest value to highest value and picking the one that represents the numerical value at the bottom 5th per cent. The median is the numeric value separating the higher half of a sample, a population, or a probability distribution from the lower half. The upper quartile is the numeric value separating the top quarter of a sample, a population, or a probability distribution, from the bottom three-quarters. In the OFT's view, using the median price provides a good measure of the central tendency of the underlying data, without being unduly distorted by very high or low observations (or outliers). Similarly, using the upper and lower quartiles provides a measure of the spread of the underlying data, without being unduly distorted by outliers.

Figure 17. RIY for each saver scenario, pre-2001 'multi-charge' schemes



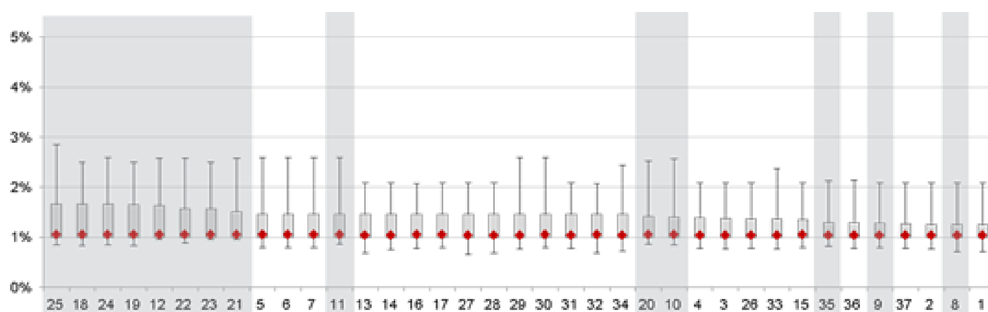
Coverage: £8bn of pre-2001 in-scope schemes with 'fee or deduction' charging structures.

As shown above, the median RIY is significantly higher for a number of scenarios. The scenarios with the highest RIYs are 6, 11 and 12. These scenarios are all of young savers with low fund values who stop contributing very soon after joining. The scenarios with the lowest RIYs are 1, 13 and 34. These are scenarios where savers have high annual contribution levels and high fund values at the start.

Figure **18** below shows the RIY for all saver scenarios for all in-scope post 2001 schemes. This represents £19bn worth of AUM. The scenarios in

Figure **18** are ranked by the top quartile. These schemes were only in-scope if the AMC was above 1% and therefore the figure does not show the average or range of all post-2001 schemes. Over 96% of AUM is in schemes with a '% fund value' charge. This means that there is little variation between the scenarios for post-2001 schemes.

Figure 18. RIY for each saver scenario, post-2001 schemes, ranked by top quartile[50]



[50] Figure 18 shows £19bn of AUM.

Annex 3: Analysis of saver scenarios

Annex 4: 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% 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 5: 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 (DC) 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% 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% and 1%, and consider the charges of these schemes in its recommendation.

The scope excludes:

- schemes provided by non-ABI members;
- 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 6: The Independent Project Board

The members of the IPB are as follows:

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

Annex 7: 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
  - CGUCommercial 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 7: Providers participating in the audit

Annex 8: Assessment criteria as set out by the FCA in the rules establishing IGCs

The following is taken from the Financial Conduct Authority (FCA) Consultation Paper (CP14/16) on proposed rules for independent governance bodies, appendix 1, paragraph 19.5.5.2:

The IGC will assess the ongoing value for money for relevant policyholders delivered by relevant schemes particularly, though not exclusively, through assessing:

a) whether the firm's default investment strategies are designed in the interests of relevant policyholders with a clear statement of aims, objective and structure appropriate for those relevant policyholders;

b) whether the characteristics and net performance of investment strategies are regularly reviewed by the firm to ensure alignment with the interests of relevant policyholders and action taken to make any necessary changes;

c) whether core scheme financial transactions are processed promptly and accurately;

d) the levels of charges borne by relevant policyholders; and

e) the direct and indirect costs incurred in relation to transactions and other activities in managing and investing the pension savings of relevant policyholders.

Annex 9: Legal framework applying to defined contribution workplace pensions

This annex sets out the general legal framework as it applies to defined contribution (DC) workplace pensions. It is intended as a summary only; it is not legal advice and should not be relied on as such. Governance bodies and providers will need to take specific advice where appropriate.

Contract-based schemes

In addition to the constraints placed on a provider by the terms and conditions of the contract, the activities of providers are governed by the Financial Conduct Authority under the Financial Services and Markets Act 2000 (FSMA). As such the conduct of business rules made under FSMA will also be relevant to the actions taken by providers. These will, for example, impose notification requirements on providers. In particular, under COBS16 providers will be required to notify policyholders in advance of changes to the policy terms.

Where intermediaries are involved in the distribution of relevant products, their responsibilities under the regulatory framework should also be considered

Amendments to terms of contract-based schemes

The general principle under contract law is that an alteration to a contract has to be agreed between the parties to the contract unless provision has been made to allow one party to make unilateral changes.

Workplace pension contracts will typically allow providers to make appropriate adjustments to take account of regulatory/legislative requirements. Similarly, contracts will allow charges to increase, subject to some form of limitation, to take account of rising costs for the provider. Indeed, providers do tend to reserve quite wide powers to make changes unilaterally, including to accommodate changes in the way they run their business and to respond to changes in general practice in the industry, subject to acting in a proportionate and reasonable manner. However, the extent to which changes can be made to contract-based schemes will depend on the specific drafting of each contract.

If a change is universally beneficial to members (for example, a reduction in the annual management charge or the removal of a certain type charge), providers are likely to be able to proceed unilaterally on the basis that there is little risk of disputes with members, particularly where contractual requirements as to the reasons for making the change and any notice period have been complied with. However, in some schemes there may be restrictions on the extent to which changes can be made without the consent of the member, even where those changes are in members' interests. These need to be checked.

Transferring members of contract-based schemes to different funds

Compared to reducing or waiving charges, it is generally difficult to transfer members to different funds without their consents (other than where a fund is closing or being wound up).

While providers can set a new default fund for new members, most contracts will give members the sole power to make any changes to their investment fund once they are a member. In these cases neither the employer nor the provider will have been granted power to alter the fund selection made by the member (other than where a fund is closing or being wound up).

Providers will normally have powers to close or wind up a fund and replace it with a similar fund. Such a power would be used in a variety of circumstances including, in the case of external fund managers, poor performance or governance by the fund manager. However, the circumstances in which they are able to do this are likely to be relatively well-defined and restricted. Contracts need to be checked.

Providers typically do not have the power to switch existing customers to a different investment fund without their consent if the original fund remains open. Funds used by providers will be used by other investors outside of the scope of the audit and the IPB recommendations, and so the closure of the fund purely as a consequence of our recommendations may not be feasible.

Therefore, in the case of a typical contract where a fund is not being closed or wound up, if a provider wanted to change the investment fund of an existing member, the provider would need to write to the member informing them of the recommended change and advising that if they wanted to change funds, they would need to instigate the change themselves.

For some changes to contract-based schemes, the employer will be required to consult with employees; for example if the employer is to cease employer contributions to the scheme (if it is closing), and in relation to any proposal to increase member contributions. So the consultation requirements for employers also need to be considered in relation to any proposed changes

Trust-based schemes

A trust-based scheme's trust deed and rules govern the trustees' and employers' actions, subject to general trust law principles and overriding pensions and tax legislation (for example, in the case of tax legislation, setting out the types of benefit that can be provided from a registered pension scheme).

Transferring members between funds in trust-based schemes

As a general principle, the trustees of a trust-based scheme have the power to invest the scheme's assets as if they were their own, subject to their duty of care to the

beneficiaries under the scheme, the requirement to take proper advice from qualified advisors, and broadly to ensure the suitability of the investments. There tends not to be any restrictions in the deed or rules themselves, other than to reflect overriding legislation (specifically sections 33 to 36 of the Pensions Act 1995 and the 2005 Investment Regulations).

Therefore, unlike with contract-based schemes, trustees do, in theory, have the ability to transfer scheme members to a different fund if the current fund is not providing value for money. However, the practice has grown up in recent years to let members choose their own investment funds and so trustees are in the same position as providers if they start moving members between funds (i.e. overriding the member's choice) - they could be subject to claims if the investment decision made by the trustees is found to be sub-optimal. Also, they may not have the power under the rules of the scheme to do this. So trustees also need to check what is and isn't possible under their trust deed and rules.

Providers also tend not to have the power to force trustees to transfer members between funds or to close schemes (although they do usually reserve the right to close or wind up a fund).

Trustees and employers will have the power to wind up a trust-based scheme and move members to a different scheme altogether (typically a contract-based scheme in this scenario). However, trustees and employers are unlikely to be able to force active members' to move their funds out of the trust when it is on-going. Most trust provisions require transfers out of a scheme to be with the member's consent, other than on the winding-up of the scheme and in other limited circumstances.

Amendments to trust-based schemes

If the trust deed and/or rules are to be amended, trustees must act in accordance with the scheme's power of amendment, as well as with general pensions law.

The power of amendment will usually be set out in a provision in the trust deed, and will typically require the agreement of both the employer and the trustees. The exact power will vary between trusts.

In trust-based schemes, the majority of charges result from the use of third party services (providers, fund managers, actuaries and legal advisors), rather than from the trustees themselves. As trustees usually have complete powers to appoint third party service providers, where a service is not deemed value for money because charges are too high the trustees are ultimately able to switch service provider. The ability to do this will not typically be restricted by the powers in the deed and rules. Contractual obligations between the trustees and the third party service provider will determine any costs incurred by the trustees when changing provider. These need to be checked.

For some scheme changes, the employer will be required to consult certain employees. If the trustees alone have the power to make amendments, they should

notify the employer of the proposed amendment and ensure that no changes are made until the employer has carried out the necessary consultation. For example in relation to trust-based scheme a decision to prevent new members, or new members of a particular description, from being admitted to the scheme, or to make any increase in member contributions by or on behalf of members are changes requiring consultation.

Annex 10: 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.

- **Fee or deduction charging structure.** 'Fee or deduction' structures are where charges are either fees which are fixed in monetary value (e.g. a monthly policy fee of £2) or taken as a deduction from contributions (e.g. 5% charge on all money paid into scheme).

- **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.

- **% fund value charging structure.** These charging structures are where all charges are expressed as a proportion of the fund value in a scheme.

- **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 (TPR).** The TPR regulates trust-based occupational 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.