Institute
and Faculty
of Actuaries

Better workplace pensions: a consultation on charging

Department for Work and Pensions

Consultation Response

29 November 2013

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Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

Elias Koufou
DWP Consultation Coordinator
2nd Floor, Caxton House
Tothill Street
London
SW1H 9NA

29 November 2013

Dear Elias

Better workplace pensions: a consultation on charging

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to this consultation. The IFoA is the UK's professional body for actuaries with members working in a range of roles across the pensions industry. This response has been prepared by a number of our members who have experience of working within the Defined Contribution (DC) sector. Some of these members work for providers who deliver pensions products to employers, trustees and scheme members whilst other members work for consultancies who advise trustees and employers.

The breadth of experience of our members involved in this response reflects the range of interests in the consultation. Our response also reflects the tension that exists in providing pensions at a reasonable cost, while at the same time, ensuring that product providers have sufficient capital to continue offering pension schemes to the marketplace. The consequence of reducing charges is that providers have less income, which could have implications for those companies in meeting their statutory responsibilities. While the consultation mainly focuses on the impact of lower charges for scheme members, our response addresses both sides of the argument.

It may also be helpful to consider that low charges do not guarantee "good outcomes" for scheme members. Good outcomes will primarily depend on the amount of contributions paid and the returns from the investments selected. Other factors, including the level charges, will also influence the outcome for members. In some cases, but not all, higher charges may give members access to the range of investment funds and information that would provide better outcomes. Alternatively, there is a cost in providing improved standards of governance, which can assist in improving outcomes for members.

Within the discussion of good outcomes, there should also be consideration of "value for money". We recognise that this is a difficult term to define. We also note the use of the term by the Pensions Regulator (tPR) in its DC Code of Practice, but without a specific definition. We also recognise that scheme members will interpret that term differently depending on their stage of life and circumstances. Any regulatory impacts should consider the variety of consumers' views of their own circumstances. It is also possible that members may value extra choice at different stages of their working lives, which could affect the charges they would be willing to pay. For example, younger members may accept greater risk, whereas, older members may wish to have protection of accumulated funds. It would be helpful if work was done to build a consensus on an appropriate definition of "value for money" in this context.

Charges should be considered as part of a broader analysis of what is provided for scheme members. As already noted, value for money is not straightforward to define; nonetheless, it is an important concept that should not be ignored in this debate. We note that the concurrent consultation on Defined Ambition may lead to a degree of sophistication in scheme design that may result in higher charges. This would be a clear example of how implementing a policy initiative may have consequences for the overall provision of benefits.

Scheme members in DC schemes will always have some freedom in making decisions that are not available to members of Defined Benefit schemes. Any time members take decisions, the possibility of making decisions that are not optimal is likely to result in member outcomes that are not as good as they could have been.

The IFoA is aware that the pensions landscape is moving very quickly. We would only welcome further changes that ensure individuals understand and take responsibility for ensuring they have sufficient income to fund their lives in retirement. However, the danger of such a rapidly shifting scene is that too much attention is paid to small parts of the landscape, rather than the complete picture of providing good outcomes for scheme members beyond retirement.

Part of that shifting landscape is the enrolment of a very large number of employees into pension provision over the next two years. This will require a large amount of advice to employers. As a consequence, there may be a resource shortage that would constrain the ability of the advice sector to support the requirements of employers who are considering moving existing schemes to new providers, or at least carrying out a full review. This capacity limitation will become more pronounced as smaller employers face auto-enrolment. Smaller employers will be less likely to have the internal resource, in both time and knowledge, to deal with new pension scheme provision, or to conduct a review of existing arrangements. They are more dependent on external support than some larger employers and the sources of this external support will be limited as smaller employers deal with auto-enrolment.

Whilst we welcome the encouragement of lower charges, where appropriate, we would emphasise the importance of having the right structures in place over the most appropriate period of time to ensure that any changes have the best impact on member outcomes.

1. We would welcome views and evidence on the effectiveness of these initiatives and the extent to which the industry discloses charges upfront, in a consistent manner, to members and employers.

The consultation paper notes (2.19) that the industry has undertaken a number of voluntary initiatives to improve the disclosure of information to members. We would suggest that the success of these initiatives can only be assessed over a sufficient period of time after implementation. There are a number of relevant points that should be considered:

- The initiatives are voluntary and have been developed by participants in the industry. The IFoA welcomes those steps towards greater and consistent disclosure. Developments in how charges are communicated to members come at a significant cost to industry participants as disclosure is built deeply into IT systems. Any further changes to these would require a longer lead time and would impose additional costs for product providers.
- Voluntary initiatives have previously become industry best practice as a consequence of competitive pressures. Further evidence on the efficacy of such schemes would be of benefit in promoting such practices more widely across the industry and, in particular, improving commonality between trust and contract based schemes.
- The actual charges and costs included in AMC and TER are not consistent across the market and are not always clearly communicated. This makes it more difficult to accurately compare scheme charges and, consequently, assess value for money in the different propositions.

- Different providers will set up charges in different ways; therefore, any communication must reflect the charges actually paid. Explaining these concepts appropriately to members could provide help them interpret the implications of their provider's charging model.
- Comparison is complicated further by the return of non-AMC type charges, such as a percentage of premium charges and fee deductions. Incorporating these into a single charge measure creates the risk of more confusion.
- Providing too much information about all charges may confuse rather than clarify. We note the recognition in 2.22 that disclosure does not necessarily lead to a rational change in behaviour.
- Setting a lower rate for charges does not generate higher interest in pensions for employers or members. We note the impact that charges can have in eroding the value of DC funds at retirement, but members will require other incentives to take ownership of their scheme membership.

2. Is further action required by the Government to improve disclosure and if so which of the options should be introduced? Are there any other options?

The IFoA would emphasise the balance between disclosing charges and providing excess information that would act as a disincentive to scheme members. It is fair that members should be aware of how much their service costs. The DWP recognises that providers have gone beyond their statutory minimum duty (3.15) by providing a breakdown of charges at outset to employers. This is an indication of how better practice can be developed without legislative provision.

The consultation notes that there is no consistency in the disclosure of charges information in trust and contract based schemes. Best, or as a minimum better, practice should be expected of all schemes, no matter how they provide benefits. As more people are auto-enrolled, the disclosure of the same information should be encouraged for all schemes, whether trust or contract based. Providing too little information to employers and trustees will make it more difficult for them to make informed decisions on the value available from providers and fund managers. Conversely, as members do not make an active choice in the selection of their scheme, it is questionable as to whether such disclosure would result in a positive outcome for those members. There is a delicate balance between these issues to ensure positive outcomes for all parties.

If the DWP required a standardised form of disclosure (3.16), such an approach would have to consider the different structures that product providers have in place for charges. If the DWP believes that the current voluntary initiative for disclosing charges is deficient, it would be helpful if the DWP identified the specific aspects that failed to meet the standard required. Further engagement from the DWP and regulators could assist the industry in implementing these initiatives consistently and in the way that is most effective in improving disclosure to members.

The perception of charges can appear to be that they are deductions from members' funds, implying that pension services should cost nothing. It would be helpful to members if disclosure recognised that charges are necessary to provide pension services to trustees, employers and members, as well as ensuring the financial stability of providers.

3. How might the total cost of scheme membership including transaction costs be captured, what would be reasonable and practical to ask providers and investment managers to report on and to whom (members, employers and governance committees/ trustee boards)?

It is important that the information provided is relevant to the person who receives it. Therefore, the disclosure should be to any decision maker in the provision of pensions, as well as to members. The information should also be in a format that is easily understood. Additional disclosure requirements will add little to the success of pensions if they are full of industry jargon and too complex.

The terms AMC and, to a lesser degree, TER and transaction costs are frequently used by industry participants and in communication with employers, trustees and members. The key factor is what each term includes, so it would be helpful to define what each term means. For example, the AMC could include all charges that are known and fixed; whereas TER could be defined to include all costs and charges that are variable in nature that are deducted from the fund, such as performance fees. It would help member understanding if, transaction costs are disclosed separately given their different nature, but a clear definition is equally important.

TER and transaction costs will be variable; therefore, it is important that the costs included within them relate to the likely experience of the member. TER and transaction costs could be presented as the costs over a rolling 12 month period.

The decision-makers (whether employers, trustees or governance committees) may have the time and expertise to make use of having access to detailed breakdowns of the AMC, TER and transaction costs. This detailed disclosure would have value in decision making. Members will normally engage more effectively with less data. A single total charge (i.e. TER) with an illustration of the impact of the charge as part of the annual benefit statement would meet the requirements of providing relevant, but useful information.

We would again emphasise that disclosure of charges must be considered as part of the broader communication of pensions information to members. If the focus is too great on charges, there may be a distraction from the overall purpose of providing financially for life after work. However, as members should be able to see charges in the context of the wider discussion of value for money, further consideration needs to be given to this element of disclosure.

4. Do the proposed implementation dates for a cap provide sufficient time for employers to review and put in place compliant arrangements?

The arranging and setting up of corporate pension schemes can typically take three to twelve months. This was recognised within the auto-enrolment process. An implementation date of April 2014 could cause initial difficulties for employers currently setting up a new scheme (particularly where significant time and effort has already gone into design and implementation), or using an existing scheme, that has charges over the cap level. The danger is that such employers or trustees may make quick decisions that would not be in the members' long term interests leading to less than good outcomes. As the advisory market is likely to be working to maximum capacity in the next year due to the volume of employers going through auto-enrolment, there may be difficulty in obtaining good advice quickly. We would draw attention to the experience of schemes under auto-enrolment. Employers have been grateful for any additional time to set up new schemes. For smaller employers, the difficulties may be more acute as there is a lower likelihood of in-house expertise to encourage timely decision making.

While there is an obvious benefit for pension scheme members in having a cap in place quickly, it is important that introducing the cap is not detrimental to the products they receive. Therefore, we would propose the following alternative options:

- Apply the cap six to twelve months following the announcement of the cap; or
- Apply the cap for all qualifying schemes from a fixed date. April 2015 would be a suitable date, assuming any charge cap is announced by April 2014.

Either of these options should provide sufficient time before a scheme stages that would enable employers and trustees to ensure their scheme satisfies the new cap and provides value for money. Employers and trustees should still be aware that the advice market may struggle to provide the necessary resource to review their scheme and to move it, if a sufficient time period is not allowed.

5. Which of the three options for a cap is the most appropriate?

There may be existing schemes with charges that exceed a proposed cap, but which when considered holistically, still meet a "value for money" test. Some of these schemes may have terms that are very advantageous to scheme members, e.g. guaranteed annuity rates. If such schemes were required to alter their terms, members may not have as good a range of outcomes as would otherwise have been the case.

All options will have advantages and disadvantages for different stakeholders. We have set out below a range of impacts arising from each option.

Option 1: A charge cap of 1 per cent of funds under management

- There will be limited consequences on a large number of schemes.
- The schemes affected will have been, in the main, set up prior to 2001. Employers or trustees of such legacy schemes should be encouraged to review their schemes.
- Some other schemes affected require members to pay for administration, communications and governance. In such cases, a charge cap could result in a small residual budget for schemes to pay for investment governance or management services (where the employer is unwilling, or unable, to pay) beyond basic strategies, which could potentially reduce the quality of investment options. We have covered this further in Questions 6 and 8.
- A charge cap could encourage providers to restate or redistribute charges to recoup losses. For example, simpler, or cheaper, options could attract a higher charge to compensate for reductions in charges for more sophisticated or expensive, options.
- It is simple to apply as it is the same as the current well known stakeholder charge cap.
- It would ensure the same stakeholder cap standard applies across all auto-enrolment qualifying schemes.
- The current market is competitive for new schemes, with charges available for many new schemes significantly below 1% cap. If the cap encouraged employers or trustees with older schemes to change schemes, members would benefit from the lower charges.

Option 2: A lower charge cap of 0.75 per cent of funds under management

- Lower charge caps, assuming nothing else would change, will improve pension outcomes for more members, given the impact on a greater number of existing schemes.
- This proposed charge cap would have little impact on the placing of new schemes. However, it should be noted that as more small employers look to have schemes in place, providers may not be as willing to offer schemes with charges at existing levels.
- More employers or trustees will review their charges in comparison to the market, which will probably result in a re-pricing of schemes to the lower charge cap.
- There will be a cost to employers to get the necessary advice to determine the best option for their scheme and to support the transition to a new provider if necessary.
- There is a risk that the industry may not have the advisory capacity to properly review schemes affected by this lower cap. Employers or trustees may accept a re-pricing of their current scheme to just below the cap, rather than finding the best rate available in the market, or finding the scheme that provides the best value for money.
- There would be no impact on older legacy schemes that charged just under the cap for basic, or outdated, services that did not offer value for money.
- The arguments under Option 1 in relation to reduced investment sophistication and provider fees are clearly more pronounced with a lower fee cap.
- Pension providers will continue to act commercially. This lower cap level is likely to increase the number of schemes that pension providers decline due to low contribution levels, high turnover, or very small volumes. There is a risk that this increases the proportion of business

that NEST will need to take on under its public service obligation to accept any scheme. This will in turn have implications for capacity planning and the costs of NEST.

- The requirement to reduce charges for schemes staging will impact not only future members auto-enrolled, but members already invested. Whilst (all else remaining equal) this is a good outcome for the members, it may result in a significant impact on pension provider revenues if members' scheme assets are moved to the lower charge levels. Competition and innovation may be affected by such activity.

Option 3: A two-tier "comply or explain" cap

- Employers or trustees can select schemes that offer features aiming to provide better outcomes for members.
- This may create further complexity in an area that many employers and trustees already believe to be overly complicated. This option may cause confusion over the level of the cap.
- Employers or trustees may not be certain that additional scheme features will add sufficient value to justify a higher charge. Such features may provide members with better outcomes, but the impact of this will not be known for many years.
- Such a regime may not prevent a less competitive market or prevent less innovation by providers.
- Advice will be required to clarify when a rate higher than 0.75% would be acceptable. The "comply or explain" option would have to be sufficiently detailed to avoid being regarded as a tick-box exercise.
- "Comply or explain" may help the communication of other valuable benefits in legacy schemes, such as guaranteed annuity rates, to ensure the best outcomes for existing members. However, the cap at 1.00% might still be an issue for those types of arrangements. Something more specific for legacy arrangements with such benefits seems more appropriate.

The charge cap is easier to apply to schemes where there are only AMCs. The suggestion to have acceptable levels for other types of charges, pre-determined using a form of equivalence, seems appropriate to ensure clarity of what the cap means for those other types of charging structures. However, we would ask the DWP to consider carefully how it determines the relative equivalence. In particular, not all members would be better off compared to having an AMC at the charge cap level. To reduce the risk of a member being worse off under a different charge type, the calculation of equivalence should use a low average term and low contribution rather than just using the current industry average. The other matter to be considered is how to consider the trade-off between the different charges, given that an AMC tends to be mixed in with these other charge types.

6. Under option 3, what conditions would you expect for schemes levying a higher charge between 0.75 per cent and 1 per cent?

This question in itself demonstrates the extra complexity created by option 3. While encouraging best practice by "comply and explain" can helps progress towards the right result, it does reduce the transparency that appears to be the policy intent. In relation to the specific points raised by the consultation (3.50):

- **Governance**: Product providers should be able to spread governance costs over many schemes resulting in a lower cost than 0.25%. Furthermore, our members' experience suggests 0.25% may be high for governance costs. Although it can assist in providing good member outcomes, it is not always easy to demonstrate the extra value gained from improved governance. A basic level of governance will already be in place across all schemes. Governance costs for individual trust based schemes may be higher than for contract based schemes.

- **Volatility risk management**: This can be expensive, but it is something many members will value. Typically this provides a solution for risk adverse members who do not want to have a decrease in fund value at any time. Such a feature can improve these members' confidence in pension saving. However, it will not necessarily result in better retirement outcomes, although members will value the greater level of certainty. Our response to question 8 covers this in more detail.
- **Member communications**: A basic level of communication is a pre-requisite for pension provision. Additional communication can encourage members to engage with their pension scheme, but a charge of up to 0.25% appears expensive. It is hard to quantify how communications actually improve member outcomes, but again, there is benefit in greater member participation and many employers or trustees value more sophisticated communication strategies.
- **Investment management**: Paying for an extra level of investment governance/management or active investment management can offer better outcomes for members. The difficulty is identifying whether this offsets any additional associated cost. If a cap of 0.75% only provides a basic investment strategy, the likelihood of a good member outcome may reduce. Furthermore if a cap at 0.75% only provides a default investment choice, members may not receive the choice required to provide them with better outcomes, or investment choices better suited to their risk attitudes or personal circumstances.
- **Legacy Features**: A number of legacy arrangements provide guaranteed annuity rates, guaranteed returns, bonuses, and life cover. If these were to be included within the cap, then they may still represent good value for customers with a higher charge.

7. How will employers and pension providers respond to a cap on charges and what evidence is there that charges will be 'levelled-up' in response to a cap?

Predicting behaviour is not exact; however, we would refer to the experience of the stakeholder cap. Under stakeholder pensions, with the cap at 1.00% AMC, many providers priced schemes significantly below the cap. Based on this experience, we would suggest there is a low risk of providers pricing schemes up to the cap.

The response of employers is likely to vary and, for some, it may depend on their appetite to move schemes at the same time as going through auto-enrolment. Many may not be able to afford the advice, or may not be able to deal with the extra work required to change provider. However, in the future, employers may review the marketplace once they have become more comfortable with broader pension provision. Conversely, without a clear regulatory view on what constitutes 'value for money', inertia may lead members to remain with their existing scheme.

The response of trustees of trust based schemes is also likely to vary. Where trust-based schemes are already under the cap, trustees are unlikely to take action. Where schemes are over the cap, trustees will likely attempt to negotiate with providers to reduce charges. However, some trustees value the sophistication that defines their scheme, so they are willing to pay the more expensive charges.

8. What evidence is there on the link between scheme charges and scheme quality or investment returns?

An emerging trend in investment management is to apply a level of volatility management, through blended multi-manager/multi-asset funds. The key benefits of this are that it enables the investment approach to react to changing market conditions and changing individual investment fund performance, while diversifying investment manager event risk. Clearly this additional sophistication results in extra costs. To work effectively, it requires some flexibility around the costs of the underlying funds and the investment platform provider. As we commented in our response to question six, it is difficult to identify if the extra cost from additional investment services is fully offset by benefits from those services.

This type of management is expected to result in better outcomes for members, compared to the traditional route of investing with a single fund manager. By managing the volatility of investments, member outcomes are linked less to the timing of market entry and exit, reducing the variance of outcomes. Disengagement from pension saving during periods of market stress is also likely to reduce. However, time will tell whether, or not, better outcomes will be achieved in the longer term. With these types of funds, it is possible to carry out back testing to see if they would have resulted in better outcomes for members had this management been used over the last ten years or so.

Investment returns are the area we would expect to see the greatest impact from a change in the level of charges. Scheme quality will also be affected by the level of charges (see examples discussed in our response to Q6) but we believe the link is harder to demonstrate and, in some cases, the amount of charge difference required is quite small to have a major impact.

9. If a cap is introduced, what if any changes should the Government consider in respect of the stakeholder charge cap?

Having two charge caps increases complexity in an industry which is already over complex. However, there are some negative consequences to aligning the stakeholder cap at a lower level than the current stakeholder cap:

- The stakeholder cap is specifically a percentage of funds charge cap, so it does not include other types of charges. Extending the cap to other types of charges would seem to be out of line with the intention of stakeholder legislation.
- The stakeholder charge cap applies to all funds in which members can invest. Reducing the level of the cap would result in the likely removal of a number of funds from stakeholder schemes, which reduces investment flexibility for members.
- Providers may have accepted schemes on the ability of charging up to the stakeholder cap. If they were unable to charge at this level, they may review their support of stakeholder business.

10. Are there any alternative options to capping charges that would provide protection for scheme members?

The consultation raises a number of matters that would encourage a more efficient market without imposing a cap. Alternative options to capping charges could include:

- Improved governance, with the clear objective of the governing body to give more prominence to value for money;
- Improved disclosure of charges to employers, members and governing bodies; and
- Standardised information about charge levels to enable governing bodies and employers to compare their charge levels.

Possible other alternatives include:

- Creating a new benchmark, rather than a cap, for charging and also value for money. This would require governance committees and trustees to consider their schemes against the benchmark. This would be a more principles based approach. We are aware, however, that under the current regulatory framework, many contract based DC schemes do not currently have governance committees in place. This approach may be difficult to apply. This would require a definite level of governance for all schemes.

- Enforcing a cap but allowing employers or trustees to "opt-out", where they believe that higher charges from additional sophistication is in the best interest of providing value for money and better outcomes for members. This would be similar to the proposed option 3, but with no explicit 1.00% hard ceiling.
- Making it easier for schemes to change provider. Some of the key challenges are differences in processes and formats for sending information to pension provider systems and in carrying out transfers of assets. Industry standards could make it easier to switch provider.
- Enabling easier access to advice/information for employers who may currently be deterred by fees. This would enable providers to support employers without providing advice (e.g. providing guidance).
- Removing some of the current restrictions on NEST by giving it more freedom could increase competitive pressure in this market.

11. What impact will a charge cap have on the capital reserves pension providers need to hold under:

- **A 0.75 per cent or equivalent cap?**
- **A 1 per cent or equivalent cap?**

The introduction of a charge cap will require some product providers to increase the capital allocated to support this business. The mechanism through which this works is dependent on whether a provider's capital is being constrained by Pillar 1 or Pillar 2 of the calculations. If when a provider's capital requirement is calculated Pillar 1 is bighting, then the introduction of a charge cap will have a direct impact on its capital provisions, but the size of the impact will be the same irrespective of whether the cap is set at 1.00% or 0.75%. However, the requirements will be different if the capital requirement is set by reference to Pillar 2, Individual Capital Assessment (ICA), where at one extreme there may be no impact of a cap if the ICA already assumed management actions would not increase charges. If there is an impact on ICA capital, the impact will be greater for the lower cap level. The introduction of Solvency II (which in principle is similar to the ICA regime) further complicates matters, but it is too early to fully identify how this effect will feed through the calculations for all life insurers.

The lower the rate at which the charge cap is set, the greater the capital requirement will become for product providers. The impact will also depend on how much stakeholder business providers have, in comparison to trust based and non-stakeholder contract business.

This is a complex area where the assumptions made can have a direct impact on capital held. However, at this stage, it is difficult to predict how comfortable insurance company boards will be allowing for an increase in the cap within their calculations if this is dependent on a political intervention by the DWP.

It should also be noted that some providers are mutual companies. Any increase in capital for those companies would not impact shareholder returns, but would have to come from funds that ultimately belongs to policyholders.

12. Should transaction costs be included within a charge cap?

As discussed in the consultation, we agree that transaction costs that arise from the default product and investment choice for employees should not be included within a charge cap. Including transaction costs within the charge cap has the potential to restrict investment managers in carrying out trades in order to ensure transaction costs stay within certain levels, leading to potentially lower investment returns and poorer outcomes. Transaction costs are indeed costs incurred, rather than charges. The suggestion that trustees and governance bodies review transaction costs would seem to be the more appropriate way to consider these costs.

In addition, transaction costs are not currently well defined in the market and are not widely available for all funds. Including them within the charge cap could cause delay in the introduction of the cap.

Other transaction costs, such as those that arise from employer duties, should not be included within a charge cap. The proposed charge cap and the successful delivery of auto-enrolment will be more difficult if employers are not able to pay pension providers to help them fulfil their employer duties.

We would encourage consistency with the stakeholder regime in terms of what is included within the disclosed costs to members. However, trustees, or governance committees must be aware of the total costs of running schemes; therefore, all transaction costs should be disclosed to those parties.

13. Would requiring the disclosure of transaction costs to trustees and the independent governance committees to be set up for contract-based schemes help to manage any potential avoidance risks associated with a charge cap?

As discussed above, we support the disclosure of transaction costs to trustees and governance committees. These bodies would be best placed to understand the relative level of transaction costs and to challenge them when they are deemed inappropriate. They would also be able to consider how the market dynamics might cause movement in the transaction costs.

In contrast the disclosure of investment transaction costs to members is only likely to have a limited impact on potential avoidance risks. The investment transaction costs for typical schemes are likely to be only a relatively modest part of a typical scheme charge in a very competitive market. So whilst the disclosure of transaction costs could improve transparency, they can only be generated at an additional cost with a limited benefit.

Disclosing transaction costs to trustees and governance committees does seem to be the most appropriate approach to ensure we maintain simplicity in the disclosure of charges to members. At the same time, it would hold providers accountable in delivering value for money.

14. Are there any specific services that may need to be excluded from the cap to avoid constraining innovation, for example, in respect of annuity broking services?

Some specific services should be excluded from the charge cap such as annuity broking, income drawdown services or individual employee financial advice charges. These services tend to be charged by explicit additional one off fees, where the member elects to use the service. This is important to maintain transparency and ensure that employees only pay for the services they are currently receiving and avoid paying for services that they may not use. Such fees should not be within the charge cap.

15. What would the impact be of a ban on Active Member discounts and other arrangements where deferred members pay an increased charge in qualifying schemes, would providers need to increase charges for active members and if so, by how many percentage points?

If AMDs are banned, some customers could benefit from significantly lower charges on their plans. The OFT has already reported that a typical AMD is around 0.5%. If a customer's pension charge is reduced by 0.5% by removing AMDs, this could typically reduce the customer's charge by around 50% in the context of a price cap of 0.75%-1%. It should be noted that any change will only be of benefit to future deferred members.

Whilst prohibiting AMDs will benefit some customers, it will also consequently have a negative impact on the profitability of existing schemes for pension providers which have promoted this type of product charge. These providers will need to review the pricing for these schemes and may consider increasing the price of the scheme for the current active employees up to around the current market price (assuming no AMD). This type of price increase would depend on the size of the AMD but could be around 0.25% for a 0.5% AMD. However, some of these providers will also consider maintaining the current low charge for all customers in order to avoid losing the scheme to another provider.

Ultimately, the amount by which pension providers could increase the charge will be constrained by the very competitive nature of the current pensions market where low pension charges for new schemes are the norm.

It is worth mentioning that very few providers, if any, appear to be currently marketing AMDs. Based on that, market practice and competitive pressures mean that it would be unlikely that they would be re-introduced. However, it should be noted that the introduction of auto-enrolment has just been for larger employers. It is possible that as smaller employers are looking to obtain schemes for their workforces, a charge cap, especially a lower charge cap of 0.75%, may mean providers may not offer terms for smaller schemes.

16. What, if any, transitional arrangements might be needed for those schemes already set up?

We would recommend that any legislation allows for a period of transitional arrangements in order to allow pension providers to make the relevant changes and avoid adversely impacting the successful delivery of auto-enrolment across the market. Transitional arrangements could be to:

- Allow a minimum period of six to twelve months after legislation and rules have been confirmed.
- Require pension providers to make changes in time for the triennial review of their schemes as part of the employer duties.
- Enable employers to make the changes required as part of their auto-enrolment process. Again this could be valuable to smaller employers.

17. Can you provide more information about the scenario whereby employees who leave their job are converted into an individual personal pension? Does this require the member's consent and is this practice disclosed to employers when they choose the scheme?

The practice of what happens to an employee's pension upon leaving an employer varies between pension providers. It can even vary amongst different products from a single pension provider. Pension providers will disclose what happens to advisers, employers and employees when a scheme is set up at outset.

18. How are the existing regulations working in practice and how are services now being delivered and paid for?

Our members' experience is that, even prior to the Retail Distribution Review (RDR) coming into effect, larger employers at least arranged for consultancy advice in relation to GPPs to be on a fee arrangement rather than commission. Such fees would not have been passed on to members. Smaller employers may have more commonly used a commission or consultancy charge arrangement, and thus will have seen a change in approach.

Some employers may not consider there to be a conceptual difference between consultancy charges and provider charges, so they may not appreciate why, in auto-enrolment schemes, some charges can be passed on to members and others not. This is as the current arrangements (as described in 4.12) allow vertically integrated providers to pass on consultancy charges to members, where charges from independent advisers could not be passed on and which illustrates some of the challenges faced by employers in trying to understand the current system.

19. How are charges for blended funds structured, their level set and what disclosure is in place for members and employers?

Blended funds would typically be priced at a margin above the charges for the underlying funds, with the size of the margin dependent on the extent of the adviser involvement in ongoing review of, and potential change to, the choice of the underlying funds, along with specifics to the investment platform provider. Employers and trustees can negotiate these charges.

Members would typically be aware of the overall charge only, rather than the underlying fund charges or the explicit statement of the blending fee, unless those underlying funds were also available as investment options for those members.

For some blending structures, the adviser may be able to negotiate discounts to the pricing of the underlying funds on the grounds of economy of scale. Such charges may not otherwise be available to the individual employer / member. It may not be possible to identify an explicit fee for the selection and monitoring of the funds, if comparison is with a price quoted by the provider for the separate underlying funds.

20. What impact would extending these regulations to qualifying schemes have on providers, employers, advisers and any other third parties, and what if any transitional arrangements would be appropriate?

This would give consistency between the approaches for auto-enrolment schemes and the broader category of qualifying schemes.

For employers, the change would provide a direct incentive to balance price, quality and value for money of advice taken, rather than the costs being passed to the members. However, this may have the consequence that employers would be less willing to take advice, with potential negative implications for members. It also appears to create an inconsistency in the treatment of pre-January 2013 GPPs where advice could be arranged on a commission basis, with the cost passed on to members, and post January 2013 GPPs on a consultancy fee basis, which could not be passed to members. (Q21 and Q22 of the consultation address this issue.)

For providers, if the current exemption in 4.12 remains, this would appear to place vertically integrated providers at an advantage relative to independent advisers, as integrated providers would have more flexibility in how charges are met.

The financial impact on providers and employers of the removal of the ability to pass charges to members in respect of agreements made before 10 May 2013 may depend on the nature of those agreements. Either the employer will need to cover those charges, or the provider will suffer a loss of expected income.

An alternative approach which appears to avoid some of these inconsistencies would be to include any consultancy charges passed to members within the maximum charge which can be applied to members.

Given the difficulties of changing previously agreed arrangements and the need that employers continuously offer an arrangement that is qualifying for auto-enrolment purposes, a lengthy transition period may be needed.

21. What would be the impact of a ban on commissions in qualifying schemes and does commission present a barrier to switching?

A commission ban would affect payments to advisers who are helping employers meet their duties for auto-enrolment. This could lead to a range of possible outcomes:

- Advisers and employers agree fees in lieu of commission and may continue to use the existing scheme with lower charges to reflect the removal of commission;
- Employers and/or advisers set up a new lower cost scheme on a fee basis; or
- Employers and pension providers liaise directly without employee advice.

Whilst, if commission is allowed to continue on existing qualifying schemes it will incentivise the advisers receiving these commissions to keep employees in existing schemes. This may be in the employees' best interest if the alternative is opting-out and not saving in a pension. However, the system does not create incentives to support employers or individual members in finding the most suitable provider for their needs. The barrier to switching will be greater as the number of employees joining the commission scheme increases because this will normally generate more commission.

22. What evidence is there of an increase in sales of DC schemes with commission in 2012?

There is evidence that group pension sales increased over 2012 and in Q4 in particular. However, it is not clear that these higher sales were necessarily generated by a spike in commission scheme sales because commission sales are not reported separately. Moreover, the sales increase will have been significantly influenced by larger employers reaching their staging date towards the end of 2012, the majority of whom are likely to be advised on a non-commission basis.

23. How much (on average) has commission on these schemes increased the AMC in percentage points?

Typically commission can increase AMC on a scheme by around 0.25%-0.50% depending on a range of factors such as the scheme premiums, commission levels and the advice required. The level of commission paid (advisors tended to request a certain level of commission, from which the AMC was determined) is the most significant driver, resulting in the AMC covering a very wide range.

If you wish to discuss any of the specific points raised in the consultation response, you should contact our Policy Manager, Philip Doggart, in the first instance. You may contact him at Philip.Doggart@actuaries.org.uk, or on 0131 240 1319.

Yours sincerely

David Hare
President
Institute and Faculty of Actuaries